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Adding Social Responsibility and Accountability to the Mandate of *Shari'a* Advisory Boards

Aly Khorshid

Introduction

The period from 2008 to 2010 presented a number of opportunities for the development of the Islamic finance industry. The conventional sector was reverberating after a series of high profile collapse and bail-outs, while the Islamic sector suffered only mild aftershocks. But the challenge of proper *shari'a* regulation remains in the Islamic finance industry. The conventional finance sector has hundreds, if not thousands, of years of experience and government regulation, whereas today's Islamic finance sector is still in its transformation stage. It is fair to say that in comparison, the development of an Islamic financial system has been slow, but Islamic finance has finally become a part of the global financial scene. To this end, the modern Islamic finance industry needs to consolidate the efforts of those who strove for its revival through prudent regulations and proactive response to emerging regulatory challenges in the industry. Therefore, in order to build and sustain the much-needed trust of diverse investors, the Islamic finance industry must strive to add social responsibility and accountability to mandate the *Shari'a* Advisory Boards.

By definition, *shari'a* advisors are specialized jurists, particularly in *shari'a*, *fiqh al-muamalah* (Islamic law of transactions), and Islamic finance and economics. They are entrusted with the duty of directing, reviewing and supervising activities related to Islamic finance in order to ensure that such business activities are in compliance with *shari'a* rules and principles. Currently, however, *shari'a* advisors are rarely held accountable or closely supervised. *Shari'a* board members' qualifications, responsibilities, ethos, commitment and social responsibility may be questionable. Since the management of a financial institution is accountable for its own organization, performance and liability, the *shari'a* scholars should also be held accountable for its organization's function. The skills and work of the *shari'a* scholars

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within a financial institution should be identified and duly regulated. They should be accountable both to the organization they represent and to the communities affected by their decisions. After all, their decisions can and do shape the Islamic finance system.

A significant problem is the manner in which advisors are appointed. The process is based on recommendations, friendships and attendance at the right conferences at the right times; the idea that advisors should have any specific qualifications in either *shari'a* or conventional banking is dismissed in many jurisdictions as an imitation of a failed Western banking system.

But perhaps a deeper problem lies in the small pool of advisors in an ever-expanding sector. Instead of training and bringing in new, young talent, the old guard is spreading itself too thin around boards across the globe. Single members are splitting their time between numerous boards—77 boards in one notable instance. This is a situation that is unlikely to change from within; remuneration makes board membership a lucrative business and gives members something akin to celebrity status as they collect appointments around the world. There is little incentive for those in power to broaden the pool of advisors. This inevitably means that board members' lack of time and commitment affect the decision-making process. Financial institutions use the names of top officials in their marketing and PR materials, ostensibly adding credibility to their institutions, but hiding the fact that the individuals probably devote little time to actually making decisions on their respective boards.

Even if we ignore the effects of this lax attitude on efficiency, risk management and profitability, what about the devout Muslim who is using the bank under the assurance that the strictest Islamic tenets are being stringently observed?. Less-than-angelic bankers do of course exist, but eventually their excesses tend to catch up with them, and they are forced to report to their superiors or to respond to government inquiries and courts. The *shari'a* advisory bodies of their Islamic counterparts, however, are generally not accountable to any supervision by superior bodies, and their resolutions are final. In light of this, some see Islamic banking as amateur, nepotistic and unreliable, regardless of its noble principles.

However, Islamic banking is not a hopeless case. As with so many other Islamic matters, Malaysia is forging ahead while many of the Middle East's bankers bury their heads in the sand. Malaysia has placed limits on board members' excesses, has improved transparency, and has nurtured educated, impartial and enthusiastic advisors, thus making its *shari'a* banking sector a world leader. Indeed the country itself is a model of enlightened business practice within an Islamic framework.

There is still time to change the Islamic banking system in the rest of the world, making it a mature, serious business open to all of the brilliant Islamic financial minds. But this will require a massive shift in the mindset of the world's *shari'a* banking sector. This chapter aims to identify the problems at the level of the *shari'a* boardroom and to suggest workable solutions for *shari'a* banking. This chapter focuses on the significance of accountability in the activities of the members of the *shari'a* board.

Corporate Governance and the Development of Islamic Finance[1]

The recent global credit crises have poised Islamic finance to become an alternative to the conventional system. The Islamic capital markets, *takaful*, and Islamic money markets have come to be regarded as fairer and more just schemes for investors and non-investors alike. Islamic finance is a system that rests on profit and loss sharing and sharing risk between all parties involved, which derives from the conception of fairness inherent to Islamic principles. But in order to work effectively and legitimately, the system requires assistance and advice from *shari'a* scholars who understand and are able to translate the teachings of the Quran generally and Islamic commercial law principles in particular into the 21st century financial and economic systems.

Islamic finance is a nascent industry, with a small share—about 1 percent—of the global market.[2] However, Islamic finance is benefiting from a number of favorable structural and cyclical drivers such as strong growth in the Gulf Cooperation Council (GCC) countries, Asia and Africa; positive demographics of young and rapidly growing populations; and growth in the number of savers/investors who prefer Islamic finance in Muslim countries, partly due to a reawakening of cultural and religious identity.

Corporate governance aims to provide institutions with a body of rules and principles to ensure that good practice guides the overall management of an institution. Corporate governance entrails the whole process of managing a company, from structuring its incentive to ensuring that executive management serves the long-term interests of the shareholders. Islamic banks are subject to an additional layer of governance since the suitability of their investment and financing must be in strict conformity with Islamic law. For this purpose, Islamic banks employ an additional layer of governance, the *shari'a* advisory board. The complex factors involved in balancing power between the CEO, the board, the shareholders and the *shari'a* board members can be considered parts of the corporate governance framework. Tasks include auditing, confirming *shari'a* compliance, selecting officers and advisors, deciding the remuneration of management and advisors, disclosing balance sheets and off-balance information, and ensuring transparency.

Islamic finance is based on ethics, fairness and justice to all people; in principle, no one is privileged or immune from accountability. Even prophets of God have been shown to be accountable to God for their words and actions. Consider this quote from the Quran (Al-Maidah, 5:116):

> And when God will say: O Isa, son of Maryam! Did you say to men, Take me and my mother for two gods besides God he will say: Glory be to Thee, it did not befit me that I should say what I had no right to (say); if I had said it, Thou wouldst indeed have known it; Thou knowest what is in my mind, and I do not know what is in Thy mind, surely Thou art the great Knower of the unseen things.

It is important that Muslim scholars, who represent Islam in the most important issues affecting Muslims and non-Muslims alike—such as dealing with money—are accountable and equitable:

> And from among you there should be a party who invite to good and enjoin what is right and forbid the wrong, and these it is that shall be successful. (Quran, Al Imran 3:104)

The finance industry for Muslims and non-Muslims is no different from any other industry that provides professional services. Muslims have a moral responsibility to their parents, family, relatives and the entire community.[3] Almost all professionals offering consultancy and advisory services are accountable to a code of ethical conduct. They can be fired and may be prosecuted if proven incompetent or involved in fraud. However, one exception is the case of the *shari'a* advisory board. In the Islamic finance industry, there seems to be no code of ethics or accountability and no minimum qualifications required for members, nor is there any requirement of specific experience in the field of finance or Islamic law. Above all, board members do not obey any regulations, nor are they responsible to regulators to ensure that Islamic finance is a credible system, compatible with the conventional finance system.

Advisory services are common to all sectors as they ensure healthy and successful operation and preserve the integrity of the industry. Likewise, *shari'a* advisory bodies are constituted to advise on Islamic finance products and services in order to ensure a high level of *shari'a* compliance. These boards are normally composed of a number of *shari'a* scholars who provide advice and guidance on matters within their specialized field of knowledge. It is impossible to overstate the importance of these bodies, as they not only distinguish Islamic banks from conventional banks, but they also act as the bridge between people's financial aspirations and the words and interpretations of the Quran.

Considering the importance of the role of *shari'a* scholars, particularly for devout Muslims who rely on scholars' interpretations and decisions in order to invest, one would expect the *shari'a* scholars of Islamic financial institutions (IFIs) to be accountable and suitably qualified to conduct their duties in a professional manner. When one considers that *shari'a* advisory bodies can effectively shape the Islamic financial system in a world where financial failure can have globally catastrophic results, it becomes clear that *shari'a* academic and professional qualification must entail more safeguards than nepotism and back-room recommendations can provide.

Why *Shari'a* Board Members' Accountability is Vital

Muslims as believers are first and foremost accountable to the Supreme Being and also to their families and employers. They are accountable to their government, to the electorate, and to one another. This accountability may be based on oath, such as marriage vows, or may originate from lawyers, doctors, judges or many other professionals providing services to the public. The accounting industry, the brokering community, the legal community and the business community are all required to adhere to the highest level of business ethics.

The public expects and deserves accountability from the businesses and other institutions that govern and influence our lives. For instance, members of the legal profession are *accountable*, both to their clients in the regular course of business and to the public when their services further a fraud. Each business, profession and institution must have effective leadership to ensure that its members are held accountable. They should respond to public concerns with conscientious action. The same rule should apply to the Islamic finance industry where all the stakeholders must be accountable to one another and to the general public.

It is clear that the accountability of *shari'a* board members is vital in the Islamic finance industry. There are a number of specific reasons for accountability in the activities of the board. Accountability generally guarantees the confidence of investors and the public in general in the Islamic financial system. Such transparency model from the Islamic finance may also fit into the current setup of conventional financial institutions. Besides, this would also provide personal credibility to the *shari'a* board members. In addition, accountability of the *shari'a* board allows for the creation and structuring of new *shari'a*-compliant products within the global market. This will further strengthen the global respect of *shari'a* rulings on product development. Above all, accountability and transparency are key pillars of corporate governance. So, in order to remain a competitive industry within the global economy, the corporate governance framework of Islamic financial institutions must be strengthened to reflect prudent policies of accountability and transparency in the duties of the *shari'a* board.

Ethics of the Conventional Financial System[4]

The conventional financial system has evolved over the last two centuries and has contributed a great deal to the development of not only the Western world, but also to a substantial number of developing countries.[5] Borrowing some of the ethics from the conventional financial system and adapting the classical *shari'a*-based ethical norms for business transactions in the modern Islamic finance industry will result in sustainable practices in the industry. In addition, the Islamic system will be able to successfully address some of the problems that the conventional system has been unable to address such as preference for profit maximization as opposed to mutual benefits in commercial transaction. Every financial system should ultimately lead to the well being of people. One of the measures that Islam has adopted to ensure greater justice for all is the principle of risk-reward sharing instead of interest in financial intermediation.

While the conventional financial system is generally considered to be superior in regard to efficiency, certain conventionally structured capital market products, such as derivatives products, have led to the current financial crises. The introduction of the minimal-risk Islamic financial system over the past 10–15 years has added a healthy dimension to the international financial system. In addition to injecting greater justice into the system, it has also helped make the financial system healthier and more stable by providing greater discipline.[6] But with the crystallization of the Islamic finance industry, it seems some of these values are gradually being eroded by untoward noticeable practices in the industry.

A large number of Islamic financial institutions have been established worldwide and Islamic financial services are now available in most parts of the world. These institutions play an important role in catering to the financial needs of a wide spectrum of society. The innovative products that they provided have not only widened the coverage of financial services but also enhanced the financial markets. Nevertheless, the Islamic finance system is still in its initial phase and thus has a long way to go before Muslims can be confident that these institutions have made headway in the realization of the *maqasid al-shari'a* (the "purposes of *shari'a*," encompassing religion, life, lineage, intellect and property).

The conventional financial system has a code of ethics and conduct to which all key personnel, including management, are accountable.[7] More importantly, the board of directors has a code of ethics and conduct, which regulates their decision-making process, as they are accountable to all the stakeholders in the company. It appears that such a similar arrangement is not available for the *shari'a* boards in Islamic financial institutions. This clear code of ethics must be adopted by the Islamic financial system in order for the Islamic financial system to become institutionalized and properly regulated, not only by its respective regulatory authorities but also by accountable *shari'a* boards. This makes it necessary to regularly evaluate the performance of modern Islamic banking and Islamic financial institutions.[8] The actions of *shari'a* board members should be transparent and members should be adequately qualified in terms of experience and ongoing education.

Shari'a Scholars

Shari'a scholars are the main component of all *shari'a* advisory bodies.[9] A *shari'a* scholar is commonly referred to as a person with experience in *shari'a* or who has a strong background in *fiqh*, *usul fiqh* and particularly *fiqh muamalat*, which outline Islamic commercial law and contracts. However, in the context of IFI, it requires scholars to have reasonable experience in and knowledge about the modern conventional banking and financial system, so that they are able to distinguish the two systems.

Shari'a scholars need to equip themselves with a proficient command of English and Arabic. This will enable them to study and discuss global financial market ethics and principles, and will also allow them to consult the Quran for the solutions to their tasks. They should be able to present and negotiate *shari'a*-compliant products with conventional finance professionals to achieve a common understanding of the two systems.

The scholar must also possess "noble," less tangible characteristics, such as trustworthiness, honesty, responsibility and accountability.[10] The scholar must be able to develop his or her knowledge and skills and have adequate exposure to the global financial market. He or she must be flexible and dynamic.

Shari'a scholars are also responsible to the investors and the clients of Islamic financial institutions, as they are among the principal stakeholders of the institutions. The scholars must also perform their roles with diligence, especially in order to ensure that the products and services offered are in compliance with the highest *shari'a* standards and requirements. *Shari'a* scholars also act as customer advocates to improve the overall *shari'a* compliance mechanism and to comply with the legal requirements and global best practices.[11]

Modern Islamic finance practices require scholars to be alert to the different needs and ever-changing circumstances, be they the legal, tax or regulatory requirements; to assess the economic implications of the products; and to be innovative in overcoming all obstacles to come up with competitive

Islamic financial products. It is vital for *shari'a* scholars to play their roles efficiently, to shape their advisory bodies effectively and to ensure the success of the industry. It is vital to demonstrate that *shari'a* can be applied ethically as well as profitably.

Role of *Shari'a* Scholars

The *shari'a* scholars play an important role in the Islamic finance business. In fact, an Islamic financial institution cannot operate without constituting an in-house *shari'a* board or outsourcing the *shari'a* advisory role to a reputable *shari'a* consultancy firm. All the stakeholders in any Islamic financial institution rely on the advisory role and decision of the *shari'a* board. Therefore, the basic duties of *shari'a* scholars in the Islamic financial institutions include:[12]

1. Advising management and shareholders on *shari'a* matters, and ensuring management accountability to the shareholders and customers;
2. Structuring new *shari'a*-compliant products to internationally-developed standards;
3. Issuing *fatwa*s for *shari'a*-compliant product development, and conducting *shari'a* audits to ensure compliance;
4. Proposing Islamic risk management tools to the management of the Islamic financial institution;
5. Strengthening the corporate governance of Islamic financial institutions;
6. Instilling Islamic finance values into financial institutions' business operations and governance;[13]
7. Ensuring Islamic ethical principles are preserved within the institution, and protecting consumers' rights from abuse and fraud;
8. Ensuring the adoption of Basel II and Pillar II, particularly in regard to the prevention of money laundering and capital adequacy issues within their institutions.[14]

Since the rulings of the *shari'a* board often represent the opinions of other scholars in their respective jurisdictions, they need to be competent and accountable for their decisions.

A role that is harder to define, measure and monitor is their work toward harmonizing *fatwa*s and the global development of Islamic finance. This will happen over a long period of time, but *shari'a* advisors must still consider the work and decisions of each board. These individuals must be professionals who endorse a product after full inspection and with the satisfaction that the product is *shari'a*-compliant. Their role must include ensuring that the Islamic financial system develops as God intended. This will require strict observation of the *maqasid* (principles) of the *shari'a*.

The rapid growth and advancement of Islamic finance has been supported by the desire to develop *shari'a* standards and frameworks for product development. This has been initiated by international bodies such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) or national bodies like the *shari'a* advisory councils of central banks (e.g., in Malaysia, Pakistan and Sudan) and other financial institutions. The task of those organizations is to ensure that the standards for *shari'a* advisors are maintained and followed, in order to achieve a high level of integrity of Islamic finance ethics and principles.

Shari'a Advisory Boards

A *shari'a* advisory (or supervisory) board is composed of several *shari'a* advisors. *Shari'a* advisors are defined as follows by the AAOIFI:

> *Shari'a* advisors are specialized jurists, particularly in Fiqh Muamalah and Islamic finance, entrusted with the duty of directing, reviewing and supervising the activities related to Islamic finance in order to ensure that they are in compliance with *shari'a* rules and principles. The views of the *shari'a* advisors shall be binding in the Islamic Finance Institution (IFI) area of supervision.[15]

Therefore, unlike other advisory bodies, the decisions of *shari'a* advisory boards are binding in relation to *shari'a* matters. In this regard, they are not merely exercising an advisory role. Hence, because *shari'a* is the backbone of the industry, in certain countries or institutions this body is called a *shari'a* supervision body, as it better describes the actual and intended role of the body. For instance, the *Shari'a* Advisory Council of the Central Bank of Malaysia oversees and prevails over the *Shari'a* Advisory Committees of all other Islamic financial institutions in the country. It is the highest authority and must be referred to in any adjudication and arbitration process that involves an Islamic finance issue.[16]

Observations of the various *shari'a* advisory boards around the globe indicate that there are discrepancies in the *shari'a* governance systems. The variations are seen in *shari'a* advisory bodies' composition, accountability, procedures and powers, as well as in the qualification stipulations of *shari'a* scholars and the accountability standards applied.[17]

In some countries there is a *shari'a* advisory council at central level. The *shari'a* scholars sitting at the central level are suitably qualified and accountable to the government.[18] Since individual financial institutions employ in-house *shari'a* advisory boards, the central *shari'a* advisory council might also review the decisions or *ijtihad* made by its scholars in various financial institutions, but it does not review their qualifications or their accountability in terms of their rulings.

The Quran explains that all individuals will be challenged against their own deeds or sins; therefore, no one will be called upon to bear another person's burden.[19] Such an arrangement is not applicable in some jurisdictions, for example, where the decisions (*ijtihad*) or the qualifications and accountability of the *shari'a* advisory board at the institution level are binding and not subject to the review of higher authority. Such a predicament is based on the argument that an *ijtihad* cannot be invalidated by another *ijtihad.* In addition, the decisions of *shari'a* advisory bodies do not constitute an *ijma'* (consensus), the system operating on the basis of collective *ijtihad*, where *shari'a* scholars decide as a group. However, in the event that they cannot reach a unanimous decision, the views of the majority will prevail.

Certain countries or institutions adopt the practice of including experts from other related fields of specialization in the *shari'a* advisory board. Ideally, the composition of *shari'a* advisory boards may include experts in *shari'a*, legal, accounting and finance matters. This will assist the *shari'a* scholars in considering the macro and micro dimensions of the products and policies, and thus allowing them to reach more precise and up-to-date decisions. This is the model adopted by AAOIFI *Shari'a* Board.

There is no strict or fixed number of members on a board. The numbers instead depend on the need and extent of the services required. The AAOIFI Standard recommends at least three members on each board. The Central Bank of Malaysia recommends the same, through its Guidelines on the Governance of *Shari'a* Committees for Islamic Financial Institutions. It is pertinent for Islamic financial institutions to be aware in their selection of *shari'a* advisory board members that these individuals should complement each other in terms of experience, knowledge and qualifications to ensure the effectiveness of the institution and its decisions and to preserve its integrity.[20]

The Demand for *Shari'a* Board Members

The Islamic finance industry is in desperate need of qualified *shari'a* scholars. While in some cases, the same *shari'a* scholars sit on several *shari'a* boards across the world, others are sometimes recruited without due diligence. In fact, there are no reliable references regarding the process for selection. One *shari'a* board member may be asked to recommend two or three other members, and may generally recommend people with whom he is friends or with whom he sits in other boards. This friend may return the favor by recommending him to another board, and so on. In this way, one *shari'a* board member may sit on 77 different boards, another in 54, another in 34 and so on. Table 1 shows the top 20 *shari'a* board members and their engagements.

Having one *shari'a* board member sit on 77 boards is neither efficient nor effective. If we assume that the average number of transactions per year for each IFI is 150, one member is responsible for 11,500 transactions per year. How would the member have the time to travel to and from one IFI to another, and see other clients for further sittings in other boards, either as a member or as the board's chairman? What about finding time to pray and perform normal Islamic duties, to read the news, to keep up to date with global financial developments and to monitor indices? And what about doing research and developing new products? These are, of course, rhetorical questions. Nobody can fulfill any one of these duties to any acceptable standard while so overcommitted. This problem raises serious ethical questions about the *shari'a* compliance of the products with which the board member has been involved. If the products are indeed compliant, we can assume that the member was not needed to fulfill the board's duties, as his or her contribution would be minimal.

A compelling drive for scholars to sit on quite so many boards is the attainment of individual wealth, power and influence. But as we have seen above, the more boards a scholar attends, the less time each IFI is granted individually and thus there will almost inevitably be mistakes. Whatever the individual scholars' reasons are for sitting on numerous *shari'a* boards, the current situation has gone far beyond an acceptable level, to the point where it damages the principles for which Islamic finance stands.

A client who wanted to raise money through Islamic finance for real estate development consulted the author on this matter. The client had 50 percent of the money needed for a project and was offered the remainder by a well-known IFI, whose *shari'a* board members include one of the top 20 from Table 1. The IFI offered a *tawarruq* deal (in fact it was a fixed-interest loan re-named as *tawarruq*) whose multitude of hidden costs made the overall deal more expensive than a fixed-interest loan from a conventional bank. The bank confirmed that each transaction had been examined and approved by the *shari'a* scholars, and the bank manager used the names of the *shari'a* board team to market the products. From this information alone it is clear that important deals that the bank offers are not in accordance to the *fatwa*s passed by the *shari'a* board because no *shari'a* board would approve such deals. The boards are likely not aware of such practices, they are likely not consulted on any deals and they do not have the time to do even a random audit of the transactions conducted by the IFIs. Because of the lack of accountability, *shari'a* board members are engaged in many IFIs and become merely names used for marketing products. This is a fundamental failure of "*shari'a* compliance." Are excessive marketing and profit maximization the reasons IFIs recruit *shari'a* board members who are popular, busy and do

Table 1. Top 20 *Shari'a* Scholars' Engagements across Countries and Regions

#	Scholar Name	ZA	LK	MY	AU	US	UK	CH	DE	NL	JP	GCC/MENA	Sum
1	Sh. Nizam Yacobi			1		7	8	2				59	77
2	Sh. Dr Abdul Satar Abu Ghuddah				3	6	2					61	72
3	Dr Mohammed Ali El Ghari		2	1	4	2	2	3	1		50	64	
4	Sh. Abdullah Al Manee'a											37	37
5	Dr Abdula Aziz Al-Qasser						2					35	37
6	Dr Mohammed Daud Baker		1	2	2	5	3		1		1	22	35
7	Dr Hussain Hassan Hassan						2	1				26	29
8	Dr Essa Zaki Essa											25	25
9	Sh. Dr Ajeel Al-Nashmi											24	24
10	Dr Ali Mohuddin Al'Qurra Daghi					2						21	23
11	Sh. Dr Khalid Mathour											20	19
12	Dr Muhammed Imran Usmani	1			2	7	1		1	1		8	19
13	Sh. Esam Mohammed Ishaq		1		2	1						14	18
14	Sh. Dr Esam Khalifa Al-Enizi					2						15	17
15	Sh. Dr Mohammed Abdul Razak Al-Tababae			1								15	16
16	Justice Muhammed Taqi Usmani	1	1	1								10	16
17	Sh. Ahmed Bazie Al-Yaseen											13	13
18	Prof. Abdulla Mohammed Al-Mulaq					1						11	12
19	Dr Yusuf Abdulla Al-Shubailil			1		1						9	11
20	Sh. Dr Mohammed Sultan Al-Olamaa											9	11

Source: Funds @ Works 2009, www.funds-at-work.com

Notes: ZA: South Africa; LK: Sri Lanka; MY: Malaysia; AU: Australia; US: United States; UK: United Kingdom; CH: Switzerland; DE: Germany; NL: Netherlands; JP: Japan; GCC: Gulf Cooperation Council; MENA: Middle East and North Africa Region.

not have time to look carefully at the transactions labeled *shari'a* compliant? It is clear these kinds of practices would not be allowed in the conventional banking system.

Education

It is also clear that there is no program in place for educating and training the new generation of *shari'a* board members. Shareholders and clients of IFIs expect their investment to be protected by professionals adhering to strict standards of corporate governance. There must be corporate governance protecting the Islamic finance system from abuse and fraud, so that the IFIs are directed, controlled and forced to adopt structures and processes that incorporate the values of fairness, transparency and accountability.

The practical function of corporate governance is to put in place a system that will bring to bear a company's business objectives such as increasing shareholder value and offering efficient, accountable services to clients and to the public at large, whilst managing risk. IFIs share the same practical and business objectives, but are subject to an additional layer of compliance with *shari'a* rules and principles. The objectives of IFI are not only to offer Islamic finance services but also to make a profit in a socially responsible manner.

Sitting on a board demands competence and an understanding of both complex economic concepts and immutable Quranic tenets. The current generation of board members is aging and educating the next generation is vital.

Challenges for *Shari'a* Advisors

Islamic finance is still in its early stages compared to the conventional system, which has valuable experience developed from hundreds of years of practice; the newness of Islamic finance requires *shari'a* scholars to academically and ethically equip themselves well. They need to develop their skills quickly and in line with the rapid advancement of the industry in the increased liquidity and fast development of capital market products.[21] Furthermore, there are still many challenges and weaknesses that need to be settled by contemporary *shari'a* scholars. These challenges include the following:

1. There is a lack of knowledge and understanding among *shari'a* scholars about the global economic system, along with insufficient understanding of the structure, objectives and implications of the products and policies.
2. There is a shortage of new and young scholars. The absence of new *shari'a* scholars is one of the industry's current concerns and has been caused largely by the nepotistic attitude prevalent since the emergence of the industry. Fixing it will require all the relevant authorities to invest in developing and training *shari'a* scholars, as well as maximizing the

efforts of the existing and senior scholars as mentors to guide the young talents to assume their role as catalysts for the further development of the Islamic finance industry. One solution is to expose the young talents to the modern operations and the global practices of Islamic finance in conjunction with providing a solid *shari'a* background. One of the suggested training methods is to allow a junior scholar to attend and participate in the meetings of *shari'a* advisory bodies. However, in order to erode the culture of scholars serving on multiple boards, these young scholars should be encouraged to become deeply involved with and committed to a single board.[22]

3. Innovation of products is key to the development and survival of the Islamic financial system, both regulatory and legal. There is the increasing challenge of balancing monetary and *shari'a* objectives and financial and tax requirements in product development.
4. To ensure clear and transparent decision-making procedures, as well as the independence of *shari'a* scholars, clear and transparent procedures of appointments, qualification and accountability of *shari'a* board members should be guaranteed.
5. Privacy and confidentiality must be assured, as the absence of full disclosure on the part of the financial institutions can prove to be detrimental to the legitimacy of products and can affect the rights of customers.

Not surprisingly, all this brings us back to accountability. *Shari'a* scholars must realize and initiate their responsibilities. Such efforts will, however, fail without the firm support of investors and industry players. AAOIFI recommended that *shari'a* supervisors serve under the company's board of directors and not the management. *Shari'a* board members should be elected by the shareholders in order to ensure the integrity of the board. Scholars must be able to perform their roles without fear of conflicts of interest. It is important to highlight that the development of any banking system is closely associated with distribution and accuracy of information. *Shari'a* standards issued by international bodies such as the AAOIFI, the Islamic Financial Services Board (IFSB) and the Islamic Fiqh Academy are vital.

In December 2009, the Islamic Financial Services Board (IFSB) issued the *Guiding Principles on Shari'ah Governance System for Institutions Offering Islamic Financial Services* (IFSB-10), which is expected to:

1. Complement other prudential standards issued by the IFSB by highlighting in more detail to the supervisory authorities in particular, and the industry's other stakeholders in general, the components of a sound *shari'a* governance system, especially with regard to the competence, independence, confidentiality and consistency of *Shari'a* boards;

2. Facilitate better understanding of *shari'a* governance issues and how stakeholders should satisfy themselves that an appropriate and effective *shari'a* governance system is in place;
3. Provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with *shari'a* rulings; and
4. Provide greater harmonization of the *shari'a* governance structures and procedures across jurisdictions, especially since there are increasing numbers of institutions offering only Islamic Financial Services (IIFS) with cross-border operations.[23]

IFSB-10 emphasizes the need to complement existing international standards of corporate governance systems in order to promote a sound and stable Islamic financial system. In Appendix 5 of IFSB-10, there is an assessment process for the accountability of the *shari'a* board.[24] These are significant regulatory reforms introduced recently to reposition the Islamic finance industry in the global economy. Principle 1.2 of IFSB-10 provides for clear terms of reference regarding the mandate and responsibility of the *shari'a* board. The board is required to have in place well-defined operating procedures and lines of reporting, and must be familiar with professional ethics and conduct. IFSB-10 provides:

> In order for the *Shari'ah* board to have a precise chain of command and accountability toward the respective stakeholders of the IIFS, it has to be equipped with:
>
> (i) a mandate that grants it appropriate powers to carry out its role and functions;
> (ii) well-organized operating procedures with regard to meetings, the recording of meetings, decision-making processes and to whom its decisions will be passed for effective implementation, including processes to review those decisions whenever necessary; and
> (iii) a sound code of ethics and conduct that would enhance the integrity, professionalism and credibility of the members of the *Shari'ah* board.[25]

The above principles are meant to complement the *Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services* (IFSB-9) issued in December 2009. Principles of good business conduct are needed to protect investor interests and to enhance the integrity of the institutions concerned. It is also a requirement under *shari'a* that companies observe principles of ethical business conduct. Furthermore, the principles of certainty and transparency strengthen the validity of a *shari'a*-compliant contract.

The IFSB has issued multiple Standards, Guiding Principles and Technical Notes for the Islamic financial services industry. As of December 2011, IFSB has issued the following Guiding Principles and technical Notes:

1. Risk Management (IFSB-1)
2. Capital Adequacy (IFSB-2)
3. Corporate Governance (IFSB-3)
4. Transparency and Market Discipline (IFSB-4)
5. Supervisory Review Process (IFSB-5)
6. Recognition of Ratings on *shari'a*-Compliant Financial Instruments Development of Islamic Money Markets (TN-1)
7. Governance for Collective Investment Schemes (IFSB-6)
8. Special Issues in Capital Adequacy (IFSB-7)
9. Governance for *Takaful* (Islamic Insurance) Undertakings (IFSB-8)
10. Conduct of Business (IFSB-9)
11. Shar 'ah Governance Systems (IFSB-10)
12. Solvency Requirements for *Takaful* (Islamic Insurance) (IFSB-11).

At first glance those drafts look like impressive examples of deep-rooted, all-encompassing guidelines, and are indeed the result of much discussion and many hours of work. Unfortunately, there is no reference to the number of boards a *shari'a* member can serve in IFSB-3 and IFSB-10, which are directly related to *shari'a* governance.

Conclusion

As the Islamic finance industry develops further, there is a growing need for standardization and professionalism across the industry. Coupled with this is the importance of adopting internationally recognized and robust corporate governance systems that incorporate transparent, fair and ethical working practices. Islamic financial institutions are well placed in this context, since at the heart of Islamic law is a vision of social development, which requires all individuals and businesses to conduct themselves ethically and in a socially responsible manner. The "Guiding Principles" demonstrate how closely aligned the basic principles of corporate governance are with *shari'a* rules and doctrines, and consequently how IFIs are well placed to offer shareholders opportunities to participate in a broader goal of corporate social responsibility.

The prospects for the Islamic finance industry are very bright but the task ahead is challenging. This task includes *shari'a* and regulatory issues and the process of integrating the Islamic finance industry into the global financial system. It requires not only the active participation of the *shari'a* advisors, but also that of regulators, practitioners, economists and legal experts if a complete and comprehensive system is to be developed. Islamic finance, as one aspect of human life, is a form of *ibadah* (worship) if it is conducted in accordance with the rule of the God. As such, it has to be upheld by all players in the Islamic finance industry. The ultimate reminder is the prophetic saying: "Every one of you is guardian and each of you is responsible for the things or people that are under your care."[26]

The IFSB guide fails to include accountability and qualifications for *shari'a* board members, although accountability is the most important issue. Since the IFSB members are part of the institutions that offer Islamic finance services, it is in their interest to regulate the industry and gain the confidence of the general public and the industry.

The IFI's selection of *shari'a* board members should be made based on the candidate's education in Islamic finance studies, requiring at least a master's degree, but preferably a doctorate. Members should be experts with a *shari'a* background or those who possess good knowledge of *fiqh* and *usul fiqh* (Islamic Law), and legal, accounting and finance matters. The scholar should have a good command of English and Arabic, and possess characteristics such as trustworthiness, integrity, honesty and responsibility. The scholar must have had adequate exposure to the global financial market, and be flexible, dynamic and prepared to face additional challenges. To ensure full attention to each institution, the scholar should not be engaged with many other Islamic financial institutions. This will also help resolve confidentiality and conflicts-of-interest issues. A scholar should accept personal accountability to the organization, its shareholders and the customers of the organization he represents. In short, the *shari'a* board member should be an individual of the highest caliber, both professionally and personally.

The Central Bank of Malaysia's approach must be considered seriously because of their more than 25 years of experience operating an Islamic finance system parallel to the conventional system. They recommend that the appointment of *shari'a* board members have the approval of their central bank, the Bank Negara Malaysia. Islamic banks in Malaysia then ensure that the members are not sitting on several *shari'a* boards. They scrutinize the proposed member's qualifications, experience in Islamic jurisprudence (*usul-al-Fiqh*) and Islamic commercial law (*muamalat*), and they see whether the member is unfit to serve or has been disqualified, and that there is no conflict between the Islamic financial institutions.

The detrimental effects of *shari'a* board members who sit on many IFIs are numerous. This raises questions about the credibility of Islamic finance worldwide and reduces confidence amongst investors and the general public. It makes the Islamic finance system incomparable with the conventional system in terms of transparency, ethics, fairness, justice and honesty. Finally, it puts *shari'a* board members under extreme pressure, which could lead to very expensive mistakes, both in their *fatwa*s and auditing, eventually leading to the loss of confidence in their rulings.

Conversely, achieving accountability will have far-reaching advantages. Those IFIs whose aims are to profit from new and ethical systems by engaging *shari'a* boards acting for publicity's sake will find it difficult to maintain credibility; they will have to take extra care in engaging *shari'a* board members who are accountable and qualified to make their institutions credible. The authenticity, credibility, seriousness and trustworthiness of *shari'a* board members will improve. Accountability strengthens global respect for *fatwas* issued for product development compliant with the *shari'a*. It introduces *shari'a* auditing standards to the global financial market and strengthens the corporate governance of Islamic financial institutions. It embeds Islamic finance values into financial institutions' business operations and governance and ensures Islamic ethical principles are preserved within the global market. It protects consumers' rights from abuse and fraud from the conventional finance monopoly. It ensures the adoption of Basel II and Pillar II, particularly money laundering and capital adequacy issues within their institutions. The conventional financial system has a code of ethics and conduct to which all personnel, including management, are accountable; therefore, for the Islamic financial system to compete with the conventional financial system, it is imperative to have a code of ethics and conduct, particularly for the *shari'a* boards. This makes it necessary to regularly evaluate the performance of Islamic financial institutions, and have the *shari'a* board members transparent, accountable and adequately qualified.

Endnotes

1. For further information, consult Nasser Al-Saidi, in the *Encyclopaedia of Islamic finance*, ed. Aly Khorshid (Euromoney, 2009) and in Al-Saidi's presentation on *shari'a* compliance on corporate governance, Dubai 2007.
2. Ernst & Young, *Islamic Funds & Investments Report. Post Crisis: Waking up to an investor-driven world*, 2010.
3. Aly Khorshid, *Islamic Insurance: A modern approach to Islamic banking* (Routledge, 2007), 11.
4. M. Umer Chapra, *Encyclopaedia of Islamic finance*. Chapra is an Advisor at the Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia.
5. Aly Khorshid, *Encyclopedia of Islamic Finance*, 352.
6. Sunil Kumar, "Risk structures of Islamic Finance contracts," *Encyclopedia of Islamic Finance*.
7. "The Responsibilities of the Board," *OECD Principles of Corporate Governance* (2004).

8. Aly Khorshid, *Encyclopaedia of Islamic Finance*, 28.
9. Mohammed Akram Laldin, *Encyclopaedia of Islamic Finance*, 195.
10. For further elaboration on the required characteristic of *shari'a* advisors, see Amin Muhammad Ali Qattan, *Hai'at Riqabah: Ikhtiyar A'adhauha wa Dhawabituha*, AAOIFI, 7th *shari'a* Conference, May 27–28, 2008, Bahrain, pages 4–6.
11. Yusuf Talal De Lorenzo, Islamic Scholar, *shari'a* board member, AAOIFI.
12. Mohammed Akram Laldin, *Encyclopaedia of Islamic Finance*, 198.
13. Zeti Akhtar Aziz, Governor Bank Negara Malaysia.
14. Aly Khorshid, *Encyclopaedia of Islamic Finance*, 115.
15. AAOFI, *Auditing and Governance Standards for Islamic Financial Institutions Governance Standard* (2004–2005), 5.
16. Bank Negara Malaysia, *Guidelines on the Governance of Shari'a Committee for the Islamic Financial Institutions*, 3.
17. Shamsad Akhtar, *Shari'a Compliant Corporate Governance*, keynote address delivered at the Annual Corporate Governance Conference Dubai on November 27, 2006. See the "Shari'a Compliance Framework–Countrywide table," 7.
18. Such arrangement can be found in Malaysia, Pakistan and Sudan where the Central *Shari'a* Advisory Council exists at the Central Bank level. However, the role of the Central SAC might vary from one country to another.
19. No bearer of burden shall bear the burden of another (Quran, Surat Al-Ana'm 6:164).
20. Muhammad Yunus Al Birqdar, *Dhawabit Ikhtiyar A'adha' Hai'at Al Riqabah Al Shari'iyyah fil Muassasat Al Maliyah Al Islamiyah*, AAOIFI, 7th Shari'a Conference, 27–28 May 2008, Bahrain, 17.
21. Mohammed Daud Bakar, *Encyclopaedia of Islamic Finance*, 131.
22. There is an index issued by Filaka/Dow Jones listing over 100 *shari'a* scholars from different parts of the world with their qualifications and portfolio, and Funds@work issues a survey of 200 *shari'a* scholars and their engagements.
23. Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance System for Institutions Offering Islamic Financial Services* (IFSB-10), December 2009, 1.
24. IFSB-10, 31.
25. Paragraph 20, Principle 1.2 of IFSB-10, 9.
26. Imam Al Bukhari, *Sahih Al Bukhari,* Volume 3, Book 41, *Hadith* 592.