

Global Legislation and Regulations on Islamic Banking: Innovation and Authenticity Implications

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ISLAMIC LEGAL SYSTEM IN CONTEMPORARY TIMES

Appropriate laws, regulations, and legal infrastructure have played a key role in the development of the conventional banking industry. The majority of legal systems throughout the globe are based on the principles of one or both of the two well-known legal systems, civil law and common law systems. These Western legal systems have spread around the globe through colonization and replication. The majority of Muslim countries have adopted these two Western legal systems, especially in the development of corporate and commercial legal frameworks.² Though Islamic legal tradition has a long history, commercial law related to the contemporary Islamic banking industry is at the developing stage.

The absence of a comprehensive Islamic legal system for a long time has resulted in the lack of legal infrastructure that can support the use of Islamic commercial law in contemporary times. Since the inception of Islamic finance, Islamic financial contracts have been used, but this is being done in an alien legal environment. Even if individuals agree to use Islamic contracts, the laws and courts may not be there to interpret and enforce the form of these contracts in their true

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² Habib Ahmed, "Islamic Law, Adaptability and Financial Development," *Islamic Economic Studies* 13(2), 2006, pp. 79–101.

spirit. The successful application of Islamic law to contemporary financial transactions requires appropriate supporting legal infrastructure institutions.

Today, Islamic banks face an unusual set of challenges. On one hand, the Islamic banking sector is growing at an extremely rapid pace; on the other hand, Islamic banks are forced to conform to a regulatory environment that has traditionally catered to a deep-rooted, interest-based banking system. Given the principle of permissibility, Islamic commercial law can evolve as long as the limits imposed by *shari'a* are not traversed. Contemporary *shari'a* scholars and jurists have carried out the admirable and painstaking task of modifying the classical contracts into contemporary financial contracts. But there still remains a lot of work to be carried out for development of Islamic commercial law in order to make it more relevant to modern day needs. Though Islamic law can evolve based on a rich body of legal theory and rulings, other elements and attributes of the Islamic legal system—including dispute settlement institutions—are still weak and are yet to be developed. Given the universality of Islamic law and specific injunctions on financial dealings, its evolution can help produce an alternative financial system that can benefit not only Muslims but humanity at large.

Now, I will attempt to discuss both selected existing legislation and desirable characteristics of prospective legislation on Islamic banking and their corresponding innovation and authenticity implications for the industry. In my opinion, here the term legislation should not be confined only to commercial laws but should include accounting, auditing, reporting, and supervisory guidelines where appropriate.

UNIFORM REGULATORY AND LEGAL FRAMEWORK

A uniform regulatory and legal framework that is supportive of an Islamic financial system has not yet been developed. Existing banking regulations both in Islamic and non-Islamic countries are based on the western banking model. This is why Islamic financial institutions face

difficulties in operating not only in non-Islamic countries but also in Islamic countries.³

Legal Framework

As an outcome of globalization and cross-border investments, sometimes bankers end up in huge deals that entail financing of a project through Islamic modes of finance by both conventional and Islamic financial institutions. In such instances, the conventional financial institutions are not interested in the *shari'a* compliance of the transaction; however, they are always concerned about ascertaining the enforceability of underlying contracts of the deal and legal recourse available to them in case of any future disagreement. Investors and stakeholders prefer to choose English or New York law as governing law even for Islamic banking transactions over *shari'a* law or the law of any country based on *shari'a* principles.

Unfortunately, there is a lack of harmony and standardization in the application and interpretation of *shari'a* law even among Muslim countries. It is applied and interpreted differently⁴ among different Muslim jurisdictions. This lack of standardization of *shari'a* law has promoted uncertainty among investors and professionals, when dealing in *shari'a*-complaint transactions, as to their specific rights and obligations in case of any future dispute and disagreement between parties to the contract.⁵

Shari'a law may be applied either directly as the common law of a country where there is no fully developed codified legal system, indirectly through the application of statutes based fully or partly on Islamic law, or as a source of law to fill legislative gaps when a

³ Tarek S. Zaher and M. Kabir Hassan, "Islamic Law: A Comparative Literature Survey of Islamic Finance and Banking," *Financial Markets, Institutions & Instruments* 10(4), 2001, pp.187–188.

⁴ Mahmood Faruqi, Vice Chairman, Institute of Islamic Banking & Insurance, UK, "Islamic Finance – An Overview," Speech at International Bar Association 2007 Meeting, Singapore, October 16, 2007 (manuscript on file with author). Faruqi is of the view that "there are variations amongst GCC countries, even where *Shari'a* is 'the source,' 'the principal source,' [or] 'a source' of law."

⁵ *Ibid.*

particular statute lacks the necessary provisions.⁶ For instance, in Saudi Arabia where there is no civil code, *shari'a* operates and applies directly as the common law of the country, both in commercial courts and courts of personal matters. However, in other Arab countries where there are civil legal systems in place, *shari'a* plays a lesser role and applies mainly in the field of family law such as marriage and inheritance. The following is a short survey of specific provisions of the constitutions and the civil codes of some Arab countries that have dealt with the application of the *shari'a*.

Egypt

Article 2 of the amended Egyptian Constitution, which was amended in 1980, states that: “The principles of the *shari'a* are THE main source legislation in the Arab Republic of Egypt. . .”

In 1985, the rector of Al Azhar filed a case against the president and the Egyptian parliament and others contending that the provisions of the Egyptian Civil Code—for instance, Article 226 of the Egyptian Civil Code—permitting interest were unconstitutional in view of the amended Article 2 of the constitution declaring *shari'a* as the main source of legislation. The court rejected this contention and decided that the amended Article 2 had no retrospective effect as to render existing laws unconstitutional. However, they also ruled that the amended Article 2 has imposed an obligation on the legislature to bring all future laws in conformity with the *shari'a*.⁷

Kuwait

Article 2 of the Kuwait Constitution stipulates that: “The religion of the state is Islam and the Islamic *shari'a* is a principal source legislation. . .”

It should be noted that according to this article, *shari'a* is “a principal source,” and not “the source” of legislation.

Kuwaiti courts also followed the footsteps of Egyptian courts when an argument asserting that the Kuwait Civil Procedure Code was

⁶ Saleh Majid and Faris Lenzen, “Worldwide: Application of Islamic Law in the Middle East,” December 7, 2007, available at <http://mondaq.com/article.asp?articleid=52976> (accessed March 2008).

⁷ Ibid. Saleh and Faris, while discussing the legal system of Egypt, referred to Dr. Ahmed Mahmoud Saad, *Delay Interests, Comparative Study with Islamic Law* (in Arabic), Cairo, 1986, pp. 15–32.

unconstitutional was brought before them. In 1992, the Kuwaiti Constitutional Court dismissed a claim that the Kuwait Civil Code, which permits interest, was unconstitutional and contrary to Article 2 of the constitution. The Court explained that Article 2 of the Kuwait Constitution is a political directive to the legislators to adopt provisions of *shari'a* as far as possible. Furthermore, *shari'a* is a source, not the sole source, and there is nothing to prevent the legislature from applying sources other than *shari'a*.⁸

United Arab Emirates (UAE)

In the UAE, the matter is even more complex and vague because, on the one hand, Article 7 of the UAE Constitution states the *shari'a* is “a principal source” of legislation, while on the other hand, Article 75 of the Law of the Union Supreme Court of 1973 provides that the Supreme Court shall first apply *shari'a* and other laws in force if conforming to the *shari'a* principles. It may also apply customs if such custom does not conflict with the principles of the *shari'a*.

In contrast with those constitutional provisions, the provisions of the UAE Civil Code provide that *shari'a* is “the main source of law.” Articles 1, 3 and 27 of the said Code explicitly establish this fact.

Article 1 of the Civil Code refers to *shari'a* as the first source of law in the absence of any legislative provision. Article 3 of the Code also stipulates that public policy rules are those which are not contrary to the basic principles of *shari'a*. Furthermore, Article 27 of the Civil Code provides that in cases of conflicts of law, no law contrary to *shari'a* can be applied, and public policy and morals are applicable.

Hence in the UAE, the constitution recognizes *shari'a* as “a source of law,” while the Civil Code and the law of the Supreme Court of 1973 consider *shari'a* as *the* source of law. Thus the constitution, being the supreme law of the country, recognizes *shari'a* as “a source of law” instead of the main and only source of law, and all the other laws of a country are subordinate to the constitution. This inter-statutory contradiction in the UAE weakens the case for application of *shari'a* law as “the main source of law.” The UAE statute and provisions notwithstanding, when the issue relating to the extent of *shari'a* application was raised before the highest court of appeal in the UAE,

⁸ Ibid. The authors, while discussing the legal system of Kuwait, referred to W. M. Ballantyne, *Essays and Addresses on Arab Laws*, Richmond, UK: Curzon, 2000, pp. 60–64.

the court ruled that the *shari'a* is the principal source of law and above all other laws. However, the Court also ruled that it is for the legislature to implement when enacting new legislation.⁹

Saudi Arabia

In Saudi Arabia, the Basic Law of 1992 ruled that the Quran and *hadith* are the sole sources of law and that all laws and regulations must conform to *shari'a* as *shari'a* law is the common law of the country. Hence, neither any foreign judgment nor a contractual provision contrary to *shari'a* injunctions may be enforced in the Kingdom of Saudi Arabia.

The foregoing survey and review signifies the complexity of the matter and the uncertainty in the application of law in relation to *shari'a*, especially when vital issues like the validity of legal provisions relating to interest are involved. However, there is a growing assertion of *shari'a* and Islamic identity in Middle Eastern society. This may in turn invite Western lawyers to make themselves familiar with the principles of *shari'a* with the aim of finding bridges and similarities instead of pointing only to differences and diversities. In the Muslim and Arab world, it remains a desire that a unified legislation or civil code may one day apply to all Arab countries, based mainly on the principles of *shari'a*, as the *Majella*, the civil code of the Ottoman Empire, did before the First World War.¹⁰

Presently, most Islamic contracts are governed by English law, and a few by New York law.¹¹ The officials of the Financial Services Authority, UK, have deliberated the matter and have analyzed one of the famous cases in contemporary case law: The English Court of Appeal EC (2004) EWCA Civil 19:¹²

⁹ Ibid. The authors, while discussing the legal system of the UAE, referred to Saad, *Delay Interests, Comparative Study with Islamic Law*, pp. 15–32.

¹⁰ Ibid.

¹¹ Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, and Ali Ravalia, “Financial Services Authority—Islamic Finance in the UK: Regulation and Challenges,” 2007, available at http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf (last accessed on January 24, 2009).

¹² EC (2004) EWCA Civil 19 Judgment at www.hmccourts-service.gov.uk/judgmentsfiles/j2232/beximco-v-shamil.htm (accessed January 24, 2009).

When the Court of Appeal ruled that it was not possible for the case to be considered based on principles of *shari'a* law, there were two main reasons. First, there is no provision for the choice or application of a non-national system of law, such as *shari'a*. Second, because the application of *shari'a* principles was a matter of debate, even in Muslim countries.¹³

Certain scholars and practitioners have also referred to this precedent and concurred with the findings of the case. Some of them are of the view that legal practitioners should be very careful while drafting Islamic finance contracts, as usage of Arabic terms referring to an Islamic finance product and *shari'a* generally may lead to obfuscation and difficulties in proper implementation of the contract. Hence, instead of using and referring generally to the principles of *shari'a*, the *shari'a* rules governing the contract or transaction should be clearly spelled out and explicated in the contract per se. This judgment is a milestone judgment in Islamic banking legal history, as it has provided guidance on “further refinements in drafting clauses relating to representations, choice of law & situs of forum, and the governing law of the contract.”¹⁴

The Right Honorable Jack Straw MP, Lord Chancellor and Secretary of State for Justice, has also emphasized the supremacy of English law over *shari'a* law in his speech at the Islamic Finance and Trade Conference in London on October 30, 2008, by clarifying that:

Given the fact that speculation abounds on this point, let me say once again: There is nothing whatever in English law that prevents people abiding by *shari'a* principles if they wish to, provided they do not come into conflict with English law. There is no question about that. But English law will always remain supreme, and religious councils subservient to it.¹⁵

Hence, the use of English or New York law and legal infrastructure for resolution of disputes relating to the Islamic banking industry may not be considered as a permanent alternative for Islamic

¹³ Ainley et. al., “Financial Services Authority.”

¹⁴ Faruqui, “Islamic Finance,” p. 4.

¹⁵ Jack Straw, speech at Islamic Finance and Trade Conference, October 30, 2008, available at <http://www.justice.gov.uk/news/sp301008a.htm> (accessed January 24, 2009).

banking industry. The development of a distinct regulatory and legal framework for Islamic banking industry will not lead to limitation of choices available to the industry. Rather, it is the right time to realize that the Islamic banking industry as a specialized industry requires specialized legal and regulatory framework in order to address the exigencies of the industry in a proper manner. Furthermore, it will ensure the enforceability of Islamic banking contracts in their true spirit by introducing constitutional provisions, at least in all Muslim jurisdictions, guaranteeing the application of *shari'a* law for Islamic finance transactions. Ideally, the *Shari'a* Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)¹⁶ should form part of Islamic banking law. However, if any Muslim jurisdiction amends the standards in accordance with its prevalent Islamic sect/school of thought, the amendment should be permitted. Hence, distinct legislation is as inevitable for the Islamic banking industry as specialized standards and laws are for the conventional banking and insurance industry in order to ensure the smooth functioning and development of the industry.

Regulatory Framework

Currently, central banks are trying to play a leading role in the development of a regulatory framework for the Islamic banking industry. The State Bank of Pakistan, Central Bank of Bahrain, and Central Bank of Qatar are among those central banks that have issued various directives and circulars with the objective of developing an effective regulatory framework for Islamic banks. Despite all these developments, regulatory authorities and legislators of different jurisdictions have a long way to go to develop the specialized regulatory and legal frameworks needed. This fact is evident from the existing state of regulatory frameworks in different Muslim countries.

¹⁶ The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) is an international standard setting organization that issues accounting, governance, auditing, and *shari'a* standards for Islamic financial institutions. Further details are available at www.aaofii.com.

Table A¹⁷ provides a summary of salient features of Islamic banking and supervisory regimes in selected Muslim countries.

Table A: Salient Features of Islamic Banking Supervisory & Regulatory Systems in Muslim World

B a h r a i n	<ul style="list-style-type: none"> Regulated by Central Bank of Bahrain (CBB). Basel capital requirements and core principles adopted for both groups. International Accounting Standards have been adopted. Each Islamic bank should have a <i>shari'a</i> board. AAOIFI Standards are required to be complied with.¹⁸ Islamic banks are supervised by special directives of CBB. 	K u w a i t	<ul style="list-style-type: none"> Regulated by Central Bank of Kuwait (CBK). Basel capital requirements and supervisory standards adopted. International Accounting Standards have been adopted. Islamic banks are governed by Section 10 of CBK Law No. 321, 1968. Each Islamic bank should have a <i>shari'a</i> board.
Q a t a r	<ul style="list-style-type: none"> Regulated by the Central Bank of Qatar (CBQ). Separate Islamic banking law does not exist. Basel capital requirements and supervisory standards adopted. International Accounting Standards have been adopted. Islamic banks are supervised by special directives of CBQ. Each Islamic bank should have a <i>shari'a</i> board 	U A E	<ul style="list-style-type: none"> Regulated by the Central Bank of UAE. Basel capital requirements and supervisory standards adopted. International Accounting Standards adopted. Islamic banks are governed by Islamic banking law, i.e., Federal Law No. (6) of 1985 regarding Islamic Banks, Financial Institutions and Investment Companies. Each Islamic bank should have a <i>shari'a</i> board.

¹⁷ Table A has been compiled from the information provided in Table 8 of Zaher and Hassan, "Islamic Law," and websites of some central banks. Zaher and Hassan note the sources of Table 8 at p. 187 in their article.

¹⁸ Central Bank of Bahrain, *Rule Book*, Volume 2–*Islamic Banks*, Clause AU-4.1.1, Part A, Kingdom of Bahrain. According to this clause, Islamic bank licensees must comply with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). For products and activities not covered by the AAOIFI, International Financial Reporting Standards (IFRS) / International Accounting Standards (IAS) are required to be followed.

Islamic Finance

<p>I r a n</p>	<ul style="list-style-type: none"> Regulated by the Central Bank of Iran (Bank Jamhuri Islami Iran). Recent policy orientation toward adopting the Basel capital and supervisory standards and International Accounting Standards. Onsite and offsite supervisory methods. Bank regulation and supervision is strongly affected by monetary as well as fiscal and other government policies. Single (Islamic) banking system operating under the Usury Free Banking Act of 1983. Modes of finance are defined by this Law. No separate <i>shari'a</i> board for individual banks. 	<p>I n d o n e s i a</p>	<ul style="list-style-type: none"> Regulated by the Central Bank of Indonesia (Bank Central Republic Indonesia-BSRI). Separate Islamic banking does not exist. Islamic <i>shari'a</i> banking is covered by added section in the banking law (Act No. 10 of 1998 and Act No. 23 of 1999). Basel capital requirements and core principles adopted for both groups. International Accounting Standards adopted. Each Islamic bank should have a <i>shari'a</i> board.
<p>M a l a y s i a</p>	<ul style="list-style-type: none"> Regulated by the Central Bank of Malaysia (Bank Negara Malaysia-BNM). Ministry of Finance closely associated with supervision of Islamic banks. Onsite and offsite supervision well defined with clear objectives. Basel capital requirements and supervisory standards adopted. International Accounting Standards adopted. Islamic banks are governed by Islamic banking law, i.e., Islamic Banking Act, 1983 Separate <i>shari'a</i> boards at institutional level in the BNM and Securities Exchange Commission. Each Islamic bank should also have a <i>shari'a</i> committee. 	<p>P a k i s t a n</p>	<ul style="list-style-type: none"> Regulated by the Central Bank of Pakistan (State Bank of Pakistan-SBP). Concept of onsite and offsite supervision exists. Basel capital requirements and supervisory standards adopted. International Accounting Standards adopted. Separate Islamic banking law does not exist. Governed by Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 and 2003. However, <i>mudaraba</i> Companies law exists. Some special provisions in relation to banks carrying on business based on <i>shari'a</i> principles have been specified in Sections 27-32, Part IV of Draft Banking Act, 2006. Each Islamic bank should have a <i>shari'a</i> board. The State Bank of Pakistan also has a <i>Shari'a</i> Supervisory Board.
<p>S u d a n</p>	<ul style="list-style-type: none"> Regulated by the Central Bank of Sudan (CBS). Single (Islamic) banking system. Islamic banking law in place. Each Islamic bank should have a <i>shari'a</i> board. Furthermore, the Central Bank also has a <i>Shari'a</i> Supervisory Board. AAOIFI Standards are required to be complied with. 		

It is evident from the perusal of Table A that the essential specialized regulations for risk management, financial reporting, and product development for Islamic banking have not been enforced on

full-fledged Islamic banks or Islamic window operations of conventional banks. It is of vital importance that *shari'a*, accounting, auditing, and governance standards issued by the AAOIFI should be enforced on a mandatory basis for all those institutions carrying out Islamic banking transactions. These standards have been developed after consultation with scholars from all schools of thought in Islam, bankers, and other stakeholders from throughout the world. The implementation of the AAOIFI *Shari'a* Standards and their mandatory use for product development purposes will promote authenticity of Islamic banking, while the promulgation of the AAOIFI standards on accounting, auditing, and governance will ensure transparency and comparability of financial information, and good governance within Islamic banking industry.

As far as the development of a supervisory framework is concerned, the Islamic Financial Services Board (IFSB) has formulated various standards and guidelines on the matter, including guidance on key elements in the supervisory review process of institutions offering Islamic financial services (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds), issued in December 2007.¹⁹

Now there is a need to consolidate the guidance contributed by the experts of the industry as well as international organizations like the IFSB and the AAOIFI in order to develop a regulatory framework addressing the product development, risk management, governance, financial reporting, and operational issues of the industry, which should be enforced by the regulators including central banks. Furthermore, the AAOIFI and the IFSB standards should be developed and amended, if required, to provide a basis for the consolidated international regulatory framework for Islamic banking. Mere development of a consolidated international regulatory framework will not serve the purpose until it is enforced and adopted by the central banks and regulatory authorities across the globe, where Islamic banking is being practiced. This framework can be promulgated in the same way as the International Financial Reporting Standards (IFRS), regulations of BASEL II, and other international guidelines that are applied and enforced throughout the world.

¹⁹ The Islamic Financial Services Board (IFSB), Malaysia. Information obtained from website of IFSB, www.ifsb.org (accessed in March 2008). IFSB is an international standard-setting body that issues global prudential standards and guiding principles for the Islamic finance industry.

The development and enforcement of such a regulatory framework will ensure authenticity not only in structuring but also in the operational aspects of Islamic financial products. It will also ensure that adequate risk management policies and practices are in place in Islamic financial institutions (IFIs), which aim to address and mitigate the peculiar risks arising out of Islamic finance transactions. Furthermore, recording and reporting of Islamic finance transactions in accordance with an internationally accepted and standardized Islamic financial reporting framework will promote transparency and comparability of financial statements of IFIs across the globe.

In my opinion, the development and enforcement of regulatory frameworks, which would address the transparency and comparability issues specific to Islamic institutions, would not only further enhance the integration of Islamic markets and international financial markets but could also endorse the authenticity of Islamic financial products and contracts. For instance, IFIs are subject to different conventional financial reporting and governance frameworks. IFIs reporting under conventional standards (e.g., the IFRS regime) may not represent the true spirit of Islamic finance products and transactions. If Islamic finance contracts are drafted without giving due regard to *shari'a* principles and the financial results of such contracts are also reported in accordance with the conventional accounting standards, the authenticity of such Islamic products and contracts would be endangered and subject to suspicions. Lack of regulatory supervision of structuring and reporting of Islamic finance products also puts them in a weak position in the eyes of stakeholders as compared to their conventional counterparts, which are being properly regulated in order to ensure the fairness, robustness, and transparency of the conventional financial system.

On the other hand, a uniform regulatory and legal framework that is developed and enforced in a meticulous and rigid manner may not be suitable for each and every market and specific business environment. It will instead inhibit the development of industry. Though an arduous task, it will be a milestone in the history of Islamic banking industry if accomplished properly by the scholars, legislators, regulators, and industry experts.

DEVELOPMENT AND ENFORCEMENT OF ISLAMIC FINANCIAL STATUTES

Legal systems of most of the Muslim countries do not have specific laws or statutes that can support the unique features of Islamic financial products.²⁰ As discussed earlier, most Muslim countries currently either do not have specialized Islamic statutes or have Islamic statutes that are inconsistent with the constitution or other laws in force in those countries. This gives rise to an uncertainty regarding the enforceability of Islamic banking transactions in their true spirit.

For countries and jurisdictions having a civil law regime, it would be difficult to have Islamic financing unless new specialized Islamic banking laws are enacted. In these countries and jurisdictions, the existing rules and regulations are usually geared toward conventional banking. Hence, it would be mandatory to enact specialized Islamic banking legislation in such jurisdictions to serve as a legal foundation for Islamic banking and financial dealings and provide a level playing field for the Islamic banking industry. The Islamic banking laws passed in civil law countries like Indonesia and Pakistan, however, are worded in general terms and lack details of the different Islamic modes of financing. While Bank Indonesia is trying to fill some of the gaps through some regulations,²¹ these may not hold in the courts of law. Examples of such omissions in Indonesian law include the prohibition of trading and taking equity positions and the absence of resolutions of the double taxation in Islamic financial transactions. It is necessary for Islamic banking law or law containing provisions on Islamic finance to stipulate explicitly the constituents of permissible Islamic finance products and the penalties to be imposed for noncompliance.

At this point in time, it will not suffice if the specialized banking statutes only grant permission to Islamic banks or windows of conventional banks undertaking Islamic banking transactions to undertake trading activities by way of *murabaha*. Rather, the details of permissible forms of *murabaha* also need to be specified; for instance, a *murabaha* transaction cannot take place until the asset in question is acquired by the Islamic bank. Hence, if a dispute on a *murabaha*

²⁰ Ahmed, "Islamic Law, Adaptability and Financial Development."

²¹ Reza Adirahman Djojosugito, "Relative Stability of Civil and Common Law Regimes for Islamic Banking," Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation, and Supervision, Jakarta, Indonesia, September 30–October 2, 2003.

transaction is brought before the court, the statute should provide ample guidance as to what constitutes a valid *murabaha* transaction in order to enable courts to decide the matter appropriately as per the law. Thus, there is a need for detailed codification of the law that would include the Islamic principles for financial transactions and the administrative procedures for carrying out these activities. Uncertainty and incompleteness of laws related to Islamic banking, if left to continue, will put Islamic banks in a disadvantageous legal position compared to the conventional banks.

As far as countries having a common law regime are concerned, Islamic contracts and transactions may have problems of interpretation because not enough precedents on these activities exist. Promulgation of law in this system may not be as effective as in civil law regimes because the judges have liberty to deviate from the statutes in order to meet the ends of justice. Some scholars believe that common law regimes may provide more predictable results under legal documentation for Islamic finance transactions compared to the civil law system, since the common law system will consider the provisions in a legal document with more weight irrespective of other considerations, like materiality or fairness. Consequently, there may be lower legal risk involved for Islamic banking instruments under a common law regime.²²

Taking into account the current state of affairs of the Islamic banking industry, in my opinion it is necessary that concerted endeavors should be made—particularly by Islamic countries—not only to legislate but also to enforce specialized Islamic financial and commercial law. The legislation so formulated and enforced will regulate the industry and will create a feeling among the stakeholders of the industry that an appropriate and enforceable system is available to ensure the rights and obligations of all the concerned parties. Furthermore, it will do away with the uncertainty among the stakeholders of the industry regarding the enforcement of their rights merely because of absence of relevant, well-defined laws and appropriate enforcement institutions. It will not only reduce the excessive dependency on other legal system (for instance, English and American legal systems) but will also cater to the specific needs of the industry that are not being catered to by other legal systems because those systems were not principally developed to cover the legal issues emanating from the specialized transactions of the Islamic banking

²² Ahmed, “Islamic Law, Adaptability and Financial Development.”

industry. The initiative for development of comprehensive specialized Islamic banking and financial laws taken by the Muslim countries will also facilitate the formulation of specialized laws, rules, and regulations for ensuring the legal remedies of the stakeholders of the industry in non-Muslim jurisdictions.

Appropriate measures for the development and enforcement of specialized statutes for the Islamic banking industry, if taken now and on a high-priority basis, will provide authenticity and stability to an industry appearing to be in doldrums of suspicions regarding the enforceability of existing and upcoming Islamic financial products. Specialized legal frameworks will ensure that the structuring and development of Islamic financial products are in compliance with the specialized Islamic financial law and include the features of valid Islamic financial contracts used for the development of various products. In addition, it will also ease all the uncertainty and doubts regarding the lustrous future and growth of the industry.

DEVELOPMENT OF LEGAL INFRASTRUCTURE INSTITUTIONS FOR THE ISLAMIC BANKING INDUSTRY

The lack of Islamic commercial/banking courts in most Muslim countries that can enforce Islamic financial contracts increases the legal risks of using these contracts. It has been observed that parties to Islamic finance transactions avoid using Islamic law in order to avoid the “impracticalities or the uncertainty of applying classical Islamic law.” In an environment with no Islamic banking courts, Islamic financial contracts include choice-of-law and dispute settlement clauses.²³

The implications of using the alternative of the existing legal system for dispute resolution for Islamic financial contracts depend on the type of legal system in place in the relevant jurisdiction. In civil law-based jurisdictions, laws applicable for Islamic banking transactions would have to be detailed and specific. However, even in most jurisdictions where something identified as Islamic banking law is in place, these laws mostly give general features of Islamic banking and leave the interpretation thereof to the courts. This increases legal risks and creates uncertainty as the Islamic banks define and develop Islamic

²³ Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, Boston: Kluwer Law International, 1998.

financial products and instruments themselves without being subject to any standardized statutory criteria. The problem is aggravated due to the absence of specialized courts that deal with Islamic banking matters.

On the other hand, the situation in common law jurisdictions is not that different. As discussed above, the use of English common law as the governing law for Islamic finance transactions also does not solve the problems; English law prevails over the principles of *shari'a* since *shari'a* is a non-national law and has diversified interpretations.

Serious efforts are being made in different parts of the globe to develop an effective and efficient legal system including a dispute resolution system for the Islamic services industry. In this regard, the International Islamic Center for Reconciliation and Arbitration (IICRA) has been established in the United Arab Emirates with an objective of making up the deficiency in the international dispute resolution forum for the Islamic financial services industry. Furthermore, Malaysia has taken several steps to build some legal infrastructure institutions for the Islamic financial industry.²⁴ Malaysia has not only enacted special Islamic banking statutes but also attempted to establish special benches in the High Court to deal with matters pertaining to Islamic banks. In the Commercial Division of the Kuala Lumpur High Court,²⁵ all Islamic banking (*muamalat*) cases are heard by a judge in this division, who also hears other commercial cases including those related to insurance, companies winding-up, agency, banking, intellectual property, and Specific Relief Act cases. Furthermore, to complement the court system, the Kuala Lumpur Regional Center for Arbitration (KLRCA) has been established to deal with disputes in Islamic banking and finance for both domestic and international cases. In the KLRCA, disputes arising out of any *shari'a* related financial transactions are resolved using the guidelines set out in the Rules for Arbitration of Kuala Lumpur Regional Center for Arbitration (Islamic Banking & Financial Services) — the KLRCA IBFS Rules.²⁶ These rules cover

²⁴ Zeti Akhtar Aziz, "Current Issues and Developments in Islamic Banking and Finance," Keynote Address at ASLI's Conference on Developing Islamic Banking and Capital Markets, Kuala Lumpur, Malaysia, 25 August, 2004.

²⁵ Laman Web Mahkamah Malaysia – Malaysian Court website, <http://www.kehakiman.gov.my/courts/judicialEN.shtml#thc> (accessed March 2008).

²⁶ Islamic Banking & Financial Services, *Rules for Arbitration of Kuala Lumpur Regional Center for Arbitration*, Kuala Lumpur Regional Center for

Islamic banking, Islamic finance, Islamic development finance, *takaful*, and Islamic capital market products.

However, it is a matter of concern that despite all these measures taken in the jurisdiction of Malaysia, including the Islamic Banking Act, 1983, ambiguity prevails regarding the role of the court in Islamic banking matters. The Malaysian High Court observed in *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)*-(Abdul Wahab Patail J) that:

When dealing with cases involving Islamic financing facilities, the civil court functions strictly as a civil court and does not become a *Shari'a* Court. The civil court's function, in this regard, is to render a judicially considered decision before it according to law and not apply Islamic law as if it were a *Shari'a* Court.²⁷

The development of specialized courts for the Islamic financial services sector without establishing comprehensive, corresponding laws may not be of much use. Besides legislating the specialized laws for governing the conduct of Islamic banking industry, rules relating to composition of Islamic banking courts and those governing the conduct of legal proceedings in such courts should also be framed by appropriate legislating authorities. Furthermore, appropriate amendments should also be made in the other applicable general statutes (for instance, amendments resulting in non-applicability of interest granting clauses of civil procedure codes and banking laws to Islamic finance transactions and contracts).

The existing courts may find it difficult to interpret and apply specialized Islamic banking law in its true spirit due to various reasons, including the absence of adequate precedents and laws on the subject and *shari'a* knowledge to understand the intricate product structures used by the Islamic finance industry. Hence, there is a need to establish specialized dispute settlement institutions or Islamic banking courts

Arbitration, Malaysia, available at <http://www.rcakl.org.my/GUI/pdf/Rules-for-arbitration-10.pdf> (accessed March 2008).

²⁷ *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* Judgment [2008] 5 MLJ 631-660 (Abdul Wahab Patail, J).

that understand the form of the contracts so that the contracts can be interpreted and enforced accordingly. These Islamic banking courts or specialized benches of courts should be presided over by a team of judges having expertise in banking matters and *shari'a* scholars having expertise in banking matters. The specialized nature of the industry demands the inclusion of legal and religious professionals in the special courts in order to enable the courts to understand the substance of intricate and peculiar transactions in their true spirit and to decide the dispute based on the merits of the case. Hence, I reiterate that delivery of justice to the stakeholders of the Islamic finance industry can only be ensured through specialized laws and their implementation by specialized legal infrastructure.

It should be noted that the development of specialized legal institutions does not necessarily mean that a separate court or alternate dispute resolution system must be established, since the underlying objective of establishing a specialized legal system may also be well served through the establishment of Islamic banking benches of courts with the aforementioned composition and the promulgation of specialized Islamic banking substantive and procedural laws. These specialized benches of courts are recommended mainly for two reasons. First, appropriately qualified legal and *shari'a* experts will be available to understand the specialized nature and intricacy of Islamic banking transactions. Second, it will ensure the delivery of speedy justice to the Islamic banking industry as these specialized cases will not be buried under the heap of pending cases before the ordinary courts. It is vital for IFIs to have access to speedy justice since, unlike conventional banks, IFIs cannot earn interest and penalties on delayed payments from their customers. Hence, these courts will also serve as a deterrent to those customers involved in deliberate default with the intention of exploiting the inability of Islamic banks to recover interest on delayed payments.

The development of legal infrastructure institutions along with the required specialized laws and the harmonization of differences throughout the globe with regard to the establishment of a legal system for the industry will ensure the soundness and stability of the Islamic financial system. The fast-paced innovation and growth taking place in the industry without the establishment of the required legal infrastructure may lead to the collapse or downfall of the industry, as it is similar to constructing a skyscraper without laying a deep and sound foundation for the building. Taking into account the peculiarities of the industry, it cannot be handed over permanently to alien legal systems

like the American or English systems, which were not primarily designed and established to cater to the needs of the Islamic banking industry. No doubt, the reduced number of disputes arising out of Islamic banking transactions is good, but the reduction of disputes merely because of the absence of a proper redress system is not a good sign for the Islamic financial services industry. The absence of a required legal infrastructure might also be one of the causes of the high cost of Islamic financial products as compared to their conventional counterparts because of the inclusion of a premium for legal risk in the price of Islamic products. Hence, in order to ensure the competitiveness and soundness of the industry and to authenticate the existing as well as upcoming innovated products, appropriate legal infrastructure institutions should first be developed and then used by the industry for settlement of disagreements or disputes.

STANDARDIZATION AND HARMONIZATION OF *SHARI'AH* RULES AND APPLICATION THEREOF

Although the day-by-day increasing market share of the Islamic banking service industry is indicative of a bright future for the industry, lack of uniformity in the application of *shari'a* principles in Islamic countries and more particularly in the Islamic banking industry is an obstacle in the development of the industry. The diversity provided by different schools of thought on the same issue at times creates confusion in the general public, but if properly harmonized across the globe, it can become a great strength for Islamic financial services industry by offering different options suitable to the varying needs of customers.²⁸

The long history of development of *fiqh* under various schools of thought has led to a multitude of legal opinions. Though this diversity of traditional legal opinions constitutes a vast body of knowledge from which new laws can be developed and derived, the variety of rules related to economic transactions may introduce legal risks and can affect the growth of the Islamic financial industry.²⁹ Hence,

²⁸ Dr. Shamshad Akhtar, "Shariah Compliant Corporate Governance," Keynote Address at Annual Corporate Governance Conference, Dubai, 27 November, 2006.

²⁹ Ahmed, "Islamic Law, Adaptability and Financial Development."

standardization of *shari'a* principles will also help the interface of Islamic banking with conventional financial institutions.³⁰

The regulations or guidelines governing Islamic finance, including local laws or regulations and AAOIFI standards, require Islamic banks to establish *shari'a* boards and to obtain approval for every Islamic finance product offered by the bank. However, there is no internationally-accepted, central Islamic religious authority, and the *shari'a* boards of Islamic banks are not bound to follow any *shari'a* standards; therefore, sometimes the authenticity of new products becomes doubtful merely on account of lack of harmonization and standardization of *shari'a* rules across the globe. Hence, it may happen that a given Islamic finance product may not be acceptable in all jurisdictions on account of differences in interpretation of Islamic principles by different schools of thought. The harmonization of *shari'a* rules does not mean promulgation of *shari'a* rules of one school of thought, across the globe and disregarding all the others. Rather, the *shari'a* rules prescribed by any one school of thought should at least be standardized throughout the globe irrespective of the jurisdiction where they are being implemented.

It should be noted that basic rulings for all the Islamic modes of finance do not contradict each other. Rather, the secondary rulings may differ from one school of thought to another. For instance, it is mandatory to acquire the ownership of an asset before its sale to any other party in *murabaha* transactions and all schools of thought agree on this principle. However, rules relating to the mode and manner of acquisition of ownership may differ. As discussed earlier, such differences can play a vital role in the expansion of the clientele of Islamic banking industry through the innovation of new products to meet varying needs of customers belonging to different schools of thought.

The standardization of *shari'a* rules should take place both at the national and international level.³¹ The harmonization of *shari'a* rules within the national borders only, however, will not solve the problems of global Islamic financial transactions. On the international level, the standardization of *shari'a* rules can be carried out through the consolidation and harmonization of *shari'a* rules from all schools of

³⁰ M. Fahim Khan and Layachi Feddad, "The Growth of Islamic Financial Industry: Need for Setting Standards for *Shari'a* Application," Paper presented at the 6th Harvard University Forum in Islamic Finance, May 8–9, 2004.

³¹ Ahmed, "Islamic Law, Adaptability and Financial Development."

thought and enforcing them in the form of unanimously agreed upon international standards. This job has already been carried out by the AAOIFI through the issuance of *Shari'a* Standards. Besides the issuance of *shari'a* standards, the AAOIFI has also issued standards on accounting, auditing, governance, and ethics. The AAOIFI develops these standards through its two boards, the *Shari'a* Board and the Accounting & Auditing Standards Board. Since these boards are composed of members and experts of the fields from throughout the world, their standards are considered to be a consensus of experts from the field. Hence, these standards may be used for standardization and harmonization of practices of Islamic finance and banking throughout the world.³² Specifically, the AAOIFI's *Shari'a* Board includes world-renowned scholars from all schools of thought and is well known and recognized throughout the world for its well-researched and harmonized *shari'a* standards that have endorsements from renowned scholars of every school of thought from diversified parts of the world. The Islamic *Fiqh* Academy of the Organization of Islamic Countries has also played a key role for standardization of *shari'a* rulings and *fatawa*.

The issue of harmonization and standardization is not solved just through the development of standards unless their implementation both in letter and spirit is ensured. Islamic financial institutions use the AAOIFI *Shari'a* Standards either in total or in part irrespective of their mandatory enforceability and promulgation throughout the world. Some countries have already recognized these standards in their regulatory framework, and the adoption of these standards in other countries would pave the way not only for *shari'a* compliance but also product innovation.

The endeavors made by the AAOIFI can be made more worthwhile and beneficial for the Islamic industry if the standards issued by the AAOIFI are made mandatory in all the jurisdictions involved in Islamic finance transactions by the relevant national regulatory authorities. In addition, further standards should be issued by AAOIFI to provide guidance on all ambiguous and complicated contemporary issues encountered by the Islamic banking industry. Furthermore, the participation of stakeholders, including industry players and *shari'a* scholars from different schools of thought, from as many countries as possible, should be ensured in order to enhance the

³² Omar Mustafa Ansari, "Building Reliance on Islamic Finance and Banking-II," available at www.ibp.org.pk (accessed March 2008).

credibility, adaptability, and enforceability of the AAOIFI *Shari'a* Standards. Furthermore, the *fatawa* pertaining to Islamic banking industry issued by renowned *shari'a* boards, international organizations like the International Islamic *Fiqh* Academy, and distinguished *shari'a* scholars should be discussed, and if no AAOIFI standard exists on the issues underlying that *fatwa*, then a standard should be issued thereon. This measure is suggested in order to do away with contradictory *shari'a* rulings on the same subject matter in the Islamic banking industry.

On the national level, this objective can also be achieved through the establishment of national *shari'a* boards or councils for the Islamic finance industry. This board should not only be made responsible for the issuance of rulings but also for the codification of standards for application. Examples of national-level *shari'a* boards and authorities exist in Sudan and Malaysia. Presently, these countries are ahead of other countries in their efforts for standardization of *shari'a* rules on the national level. Other countries like Pakistan are also endeavoring to promote *shari'a* standardization through issuance of model agreements, active participation for issuance of local Islamic standards, and enhancement of the role of the *shari'a* advisory board at the central bank level.³³

From the above details, it is established that a great deal is left to be done by regulators, the legislatures, *shari'a* scholars, and international Islamic organizations to ensure that a conducive environment exists for the promotion of Islamic banking. Particular attention should be given to *shari'a* harmonization and standardization both on the national and international levels in order to build public reliance on these products and institutions. Furthermore, vigorous measures should be taken by the regulatory authorities of the jurisdictions where Islamic banking business is being carried out to ensure the compliance with such standardized *shari'a* rules in their letter and spirit. Last but not least, standardization and harmonization of *shari'a* rules applicable to the Islamic banking industry would only be useful if their application is made mandatory in all the jurisdictions carrying on Islamic banking business throughout the globe.

³³ Ahmed, "Islamic Law, Adaptability and Financial Development."

ENFORCEMENT OF *SHARI'A* LAW THROUGH COMPLIANCE ASSURANCE

Shari'a compliance assurance is one of the core contemporary challenges faced by the Islamic banks that must be tackled effectively. The success of an Islamic financial system is based on stakeholders' belief that the system is *shari'a* compliant. This very reason and the potential for reputational risk for Islamic financial institutions accentuates the need for *shari'a* compliance to ensure that the faith of stakeholders is not compromised and the system sustains and grows smoothly.³⁴

There is no doubt that even the formulation, harmonization, and standardization of *shari'a* rules may not lend stability to the Islamic financial system unless and until an effective network of checks and balances is established to ensure compliance with the system in letter and spirit. *Shari'a* compliance cannot be ensured merely on the basis of the approval of products by *shari'a* supervisory boards and *shari'a* advisors of IFIs. Hence, there is an exigency to develop and implement the framework for *shari'a* compliance assurance both on the national and international levels. This framework may be developed by consolidating the guidance provided in the relevant governance and auditing standards issued by the AAOIFI. Besides other crucial matters of interest, the following matters should be properly addressed through this framework.

Role of Dedicated and *Shari'a*-Literate Directors

Nowadays, Islamic banks, being incorporated as banking companies, carry out business in accordance with the licensing conditions imposed by their respective central banks. Most corporate laws require that a board of directors (BOD) should be entrusted with the management of an Islamic bank. Hence, the BOD is responsible for running the bank in a profitable manner and ensuring compliance with all applicable laws and regulations. *Shari'a* compliance may become the supreme objective of an Islamic bank if the directors are not only *shari'a*-literate but also committed to ensure *shari'a* compliance. It is only then that they develop the policies, procedures, and systems to ensure that the

³⁴ Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

fatawa and rulings of the *shari'a* board are implemented according to their letter and spirit at the operational and transactional levels. Therefore the possibility of *shari'a* non-compliance is ruled out or reduced to the minimum, which in turn helps reduce the reputational risk arising out of *shari'a* non-compliance.

Therefore, central banks and regulatory authorities issuing licenses to institutions for carrying out Islamic finance business should ensure that the directors, sponsors, and promoters of the Islamic financial institution are adequately *shari'a* literate, have relevant experience, and are capable and committed to conducting the business in compliance with *shari'a* rules.³⁵

Segregation of Duties

Akin to the segregation of responsibility and accountability in a conventional bank between the BOD and the management, the issue of demarcation is essential between the role and functions of the *shari'a* advisor or board (as the case may be) and the management and BOD. First and foremost, the step to be taken in this regard is to ensure the independence of *shari'a* advisors from the management or BOD. This may be ensured through explicit provisions in the applicable statutes regarding the appointment, removal, reporting, and independence requirements for *shari'a* advisors of IFIs. Central banks of various countries where Islamic banking is being practiced have issued regulations, rules, and circulars to address these issues. For instance, the State Bank of Pakistan has issued IBD Circular No. 2 on March 25, 2008, which includes provisions relating to *shari'a* advisors and *shari'a* compliance. Both the AAOIFI and the IFSB have issued governance standards and guidelines that lay down the key principles and concepts relevant to governance in IFIs. The governance principles are founded on the need for structures to enhance compliance, transparency, accountability, fairness, and the equitable treatment of stakeholders.³⁶

³⁵ Ibid.

³⁶ Accounting and Auditing Organisation for Islamic Financial Institutions, *Governance Standard for Islamic Financial Institutions No. 6: Statement on Governance Principles for Islamic Financial Institutions*, Bahrain, 2008, Para 9 at p. 53. For further details, also refer to: Islamic Financial Services Board (IFSB), *Guiding Principles on Corporate Governance for Institutions Offering*

Hence, the governance guidance available in AAOIFI and IFSB standards should be consolidated and promulgated in all the jurisdictions involved in Islamic finance business. The guidance available in these standards and guidelines is extensive and comprehensive; therefore, it can ensure that minimum requirements as to good corporate governance—including the segregation and independence of the *shari'a* board—are complied with by all the IFIs or relevant conventional financial institutions throughout the globe.

Role of *Shari'a* Board

The appointment of a *shari'a* board should be made mandatory through the inclusion of this requirement either in the specific Islamic banking law or under the special provisions embodied in a general banking law. However, mere appointment of a *shari'a* board at each IFI will not by itself contribute to the resolution of the issue in question; the roles and responsibilities of such *shari'a* advisors and boards should also be clearly explicated in the statute. Such responsibilities should include, besides their regular functions, the issuance of a *shari'a* compliance review report to all the stakeholders after carrying out the *shari'a* compliance review of the IFI in a proper manner prescribed by the regulatory authorities or statute.

Due to the faith-based nature of the Islamic banking business, it is evident that the *shari'a* advisor will review most aspects of the business. However, the involvement may vary and he may focus on the approval of the basic structure of products and other special activities rather than monitoring the day-to-day operations of the business. Hence, it is recommended that the role of *shari'a* advisors should be expanded and their extensive involvement into daily affairs of Islamic financial institutions should be ensured in order to achieve a high level of assurance as to *shari'a* compliance.

To perform these extensive responsibilities and functions effectively, there is a need to enhance the pool and capacities of *shari'a* scholars in financial businesses, as currently the most experienced *shari'a* scholars serve on *shari'a* boards of multiple institutions. The State Bank of Pakistan has taken a lead in this direction by requiring that a *shari'a* scholar should not be part of the *shari'a* board of more

Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), Malaysia, 2007.

than one bank in accordance with the requirements stipulated in the Fit and Proper Criteria.³⁷ As a result, all the eighteen licensed Islamic banking institutions have appointed their own *shari'a* advisors and new institutions are appointing new *shari'a* advisors. This policy also ensures full time availability of these advisors to guide and monitor the banks on a daily basis.³⁸

***Shari'a* Compliance Review**

It should be ensured that the *shari'a* review report issued by the *shari'a* board is based on a formal comprehensive review conducted by a competent team reporting to the *shari'a* board. The reviewing team should be comprised of *shari'a* professionals having substantial knowledge and experience relating to the application of *shari'a*, accounting, and auditing principles to Islamic financial services. If *shari'a* professionals having knowledge of these principles are unavailable due to the scarcity of such professionals, then the *shari'a* compliance review team should be comprised of both the *shari'a* professionals and banking professionals/auditors who, besides having sound knowledge of *shari'a*, have strong academic credentials, practical knowledge of banking, and strong auditing skills.

If internal *shari'a* compliance review at the financial institution level is not conducted in a proper, professional, and systematic manner by the appropriate professionals, then it is likely that compliance reviews will remain limited to the assurance of the legal form of transactions, while vetting of agreements and the operational aspects of the transaction—the substance—may remain unaudited and unchecked. This might ultimately lead to the *shari'a* board being unaware of non-compliance at the operational level. Hence in my view, reliance (if made) on the representations and disclosures made by the management regarding *shari'a* compliance does not absolve the *shari'a* board

³⁷ State Bank of Pakistan, *IBD Circular 2 of 2007*, Pakistan, 2007, available at http://www.sbp.org.pk/ibd/2007/C2_FP_Criteria.pdf (accessed in March 2008). It has prescribed Fit and Proper Criteria for *Shari'a* Advisors, vide Annexure-IV to IBD Circular No. 2 of 2004, which was revised vide IBD Circular 2 of 2007.

³⁸ Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

members of their duty to ensure *shari'a* compliance at all levels of the Islamic financial transactions execution.

Besides ensuring the expertise and professional qualifications of the compliance review team, their independence should also be ensured. Furthermore, sufficient numbers of qualified professionals and ample time should be allocated for *shari'a* compliance review in order to reap the maximum benefits of this exercise. In order to systemize the review process and to ensure transparency therein, central banks should come forward and ensure that internal *shari'a* compliance review is being properly carried out by the IFIs. In this regard, the AAOIFI has issued two governance standards on *shari'a* review with the aim of providing guidance to and facilitating both the *shari'a* advisors and internal *shari'a* audit department of IFIs in discharging their responsibility to ensure the conduct of business in conformity with *shari'a* rules and principles. These standards should either be adopted (preferred option) or used as a guideline by the central banks across the globe and made enforceable in their respective jurisdictions. The compliance with this framework may also be ensured by central banks through appropriate supervision methodologies including the inspection of IFIs after pre-defined intervals of time.

In a nutshell, it is necessary to ensure the conduct of *shari'a* compliance review in a proper, professional manner in order to avoid subsequent confusion regarding the novel products introduced by the industry. Such systematic, comprehensive, and transparent screening of Islamic financial products and transactions will lend an ipso facto authenticity to the industry.

Potential Role of External Islamic Financial Services Auditors

External auditors of the Islamic financial institutions can also play a vital role by providing services of *shari'a* compliance review and assurance to the Islamic financial services industry. The external auditors may be assigned with the task of performing *shari'a* compliance audits within a pre-defined scope. This may be considered a viable option for independent assurance of compliance with the *shari'a* terms. However, this option may have two basic weaknesses. First, if the external auditor, who is also entrusted with the task of performing a *shari'a* compliance audit, is not equipped with the necessary skills and knowledge, the output of the assignment might not be as good as may be expected from an experienced and appropriately

qualified auditor. Second, as the scope of audit is pre-defined and the matter of permissibility of a transaction is generally subject to opinions and perspectives of the *shari'a* supervisory board or the *shari'a* advisor, the independence of exercise, to some extent, remains in jeopardy.

In this regard, the AAOIFI has made commendable endeavors through issuing Auditing Standards and a Code of Ethics for Accountants and Auditors of Islamic Financial Institutions. Besides other Auditing Standards, the AAOIFI has also issued a standard on “Testing for Compliance with *Shari'a* Rules and Principles by an External Auditor.” The standard provides guidance on the testing for compliance with *shari'a* rules and principles by an external auditor in connection with the audit of financial statements of a financial institution that conducts business in conformity with Islamic *shari'a* rules and principles.³⁹

In view of the above, it is proposed that a framework for *shari'a* compliance audits of Islamic financial institutions should be developed by consolidating the guidance issued by the AAOIFI from time to time on the subject. During the process of formulating such a framework, participation of regulators, audit firms, *shari'a* scholars, and industry experts from different parts of the globe and multiple jurisdictions should be ensured. Once this framework is developed, it should be enforced by the legislators in their respective jurisdictions in order to ensure not only *shari'a* compliance but also transparency, objectivity, and professionalism in the process of conducting *shari'a* compliance audits or reviews by the auditors.

Hence, besides ensuring the proper functioning of internal *shari'a* review departments, the regulators should also issue explicit mandatory directions to IFIs for the conduct of either stand-alone *shari'a* compliance audits or for the inclusion of *shari'a* audits into the scope of their regular audits conducted by external auditors, depending upon the volume and intricacy of Islamic banking transactions undertaken by IFIs.

³⁹ Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), *Auditing Standard No. 4- Testing for Compliance with Shari'a Rules and Principles by an External Auditor*, 2003–4, pp. 35–41.

Potential Role of Islamic Rating Agencies

Islamic rating agencies can also lend further credibility to Islamic financial institutions through the issuance of *shari'a* quality ratings. In this regard, the Islamic International Rating Agency (IIRA) has made a remarkable contribution. The IIRA, besides providing other services to the Islamic banking industry, issues *shari'a* quality ratings and consequently is playing an active role in promoting and ensuring *shari'a* compliance.

The *shari'a* rating aims to provide information and independent assessments regarding the *shari'a* compliance of Islamic financial institutions or conventional institutions providing Islamic banking or financial services, as well as of Islamic financial products such as *sukuk*. *Shari'a* ratings provide independent opinions on *shari'a* compliance quality for financial institutions, securities, or financial products.

The major element characterizing Islamic financial institutions and products is that they are based on morality and religious philosophy. People prefer Islamic financial products over conventional products because of their religious legitimacy and in order to avoid *haram* (what is forbidden by the *shari'a*). Therefore, this element of religious compliance has to be measurable, and there has to be a way to evaluate such institutions or products according to the extent to which they adhere to and respect this element of legitimacy. The *shari'a* ratings aim to evaluate and determine the *shari'a* quality of IFIs and their products. Such evaluation will ultimately lead to improvement of *shari'a* quality. One of the major benefits of the availability of ratings as a marketing tool is to make sure that competition among the IFIs and issuers of Islamic financial products, for maintaining and enhancing *shari'a* compliance, will lend the required credibility and authenticity to Islamic financial institutions. *Shari'a* rating also provides a mechanism for assessing *shari'a* quality and disclosing it to the public.⁴⁰

Currently, besides the IIRA, other rating agencies are also providing rating services to the Islamic finance industry. However, the *shari'a* quality rating service provided by the IIRA is unique as

⁴⁰ Islamic International Rating Agency, *Methodology for Shari'a Quality Ratings*, Kingdom of Bahrain, May 2006, available at http://www.iirating.com/methodologies/sharia_methd_eng.pdf (accessed March 2008).

compared to the services provided by its conventional counterparts because the IIRA has been specifically established to meet the needs of the Islamic finance industry. However, the propriety of the role played by Islamic rating agencies or conventional rating agencies offering rating services for Islamic banking and finance industry should be ensured by the regulators through the issuance and enforcement of rules governing these agencies.

Role of Supervisory/Regulatory Bodies

The role of a supervisory body is as critical in ensuring the smooth functioning of the Islamic banking system as it is for ensuring the smooth functioning of the conventional banking system. The regulators or central banks (whichever the case may be) can play an effective and leading role in ensuring *shari'a* compliance. The regulator/supervisor can do so through various ways, including the issuance of regulations, the enforcement of regulations, and on-site supervision methods such as *shari'a* compliance inspection. Few central banks have used any or all of these methodologies to ensure *shari'a* compliance in the banks licensed as fully Islamic banks or Islamic windows of conventional banks.

The key element of *shari'a* supervision is a mechanism that ensures that the Islamic financial system continues to remain viable and growing without compromising the principles of *shari'a*. The central banks of Malaysia (Bank Negara) and Pakistan (State Bank of Pakistan) are two of those few central banks that are endeavoring to ensure *shari'a* compliance of Islamic banking products and transactions in their jurisdictions. Pakistan has adopted a three-tiered *shari'a* compliance approach to ensure a deeper and extensive *shari'a* compliance supervision.⁴¹ First, the State Bank of Pakistan has issued guidelines and regulations whereby all IFIs are required to have a *shari'a* board discharging duties in due course, including those required by the State Bank of Pakistan. Second, a centralized *shari'a* board has been established at the central bank level to ensure *shari'a* compliance and standardization. Finally, *shari'a* compliance inspection procedures and teams are being established to perform on-site supervision to ensure *shari'a* compliance.

⁴¹ Akhtar, "Current Issues and Developments in Islamic Banking and Finance."

Hence, all the regulatory authorities and central banks in jurisdictions where Islamic financial products are offered by the banks, should establish effective supervisory frameworks to ensure *shari'a* compliance. This is not required merely for promotion of a faith-based banking system; it will also protect Islamic banking customers and stakeholders (regardless of their religious allegiance) from all possible malpractices by Islamic bankers or financial engineers. The *shari'a*, which is the base of this faith-based banking system, never permits the exploitation of any stakeholder involved in Islamic finance transactions; hence, ensuring *shari'a* compliance will result in a just and transparent financial system and better economic conditions, which are some of the core objectives of a central bank.

STANDARDIZATION OF DOCUMENTATION

The documentation of contracts made in a specific and explicit manner is one of the key determinants of growth and stability in financial markets. The benefits accruing from standardized and lacunae-free documentation for financial contracts have been highlighted by various experts.⁴² Standardized documentation enhances predictability and certainty about the characteristics of the financial contracts. It may enable the parties to the contract to comprehend and enforce their rights and obligations under the contract, which results in enhanced confidence to enter the market and transact. The whole process of negotiating different aspects of a transaction becomes more simplified and streamlined. Negotiations are more specific on the issues that are unique and specific to the particular transaction rather than on the general and common aspects of the contract. This in turn helps the parties to the contract to focus on the prospective risks of the transaction and to include provisions in the contract to mitigate the risk. Furthermore, the administration and execution of a contract becomes easy due to standardization.

The manifest virtues of standardized documentation are cost reduction, enhanced protection against legal risk, and guidance in interpretation from reported precedents. Some argue against standardization as it would dent the “sovereignty” of the individual *fiqhi* schools, leading to a dilution of heritage and of identity itself. Furthermore, some also consider the phenomenon of standardization as

⁴² Ahmed, “Islamic Law, Adaptability and Financial Development.”

an obstacle to innovation in the industry. This is not limited to *shari'a* scholars, as regulators also wish to have their exclusive regulatory mechanism for Islamic institutions and products and to compete for regulatory arbitrage regionally and internationally.⁴³ Bankers and lawyers are no exception to it. However, the situation has started changing gradually now as standardization of *sukuk* and other vital general banking documentation is being promoted on the international level.

Internationally, efforts for standardization of trading agreements between interbank participants are currently being carried out by the International Islamic Financial Market (IIFM). The principal objective of the IIFM is to encourage self-regulation for the development and promotion of the Islamic capital and money market sector.⁴⁴ The IIFM objectives also include the issuance of trading guidelines, best practice procedures, and standardization of financial contracts leading to swift authentic product innovation and infrastructure development. In this regard, the IIFM has recently developed milestone documents like the Master *Murabaha* Agreement and the Master Agency Agreement for purchase of commodities.

In a nutshell, it is the duty of all the stakeholders of the industry and especially the regulators and professionals (i.e., lawyers, *shari'a* scholars, and bankers) to endeavor to maintain a balance between innovation and authenticity in the development of the Islamic banking industry. Appropriate precautions should be taken to ensure that standardized contracts should not get entrenched and rigid; rather, they should be flexible enough to adjust to changing businesses and environments. The flexibility is desirable at both the transactional and market levels.

STANDARDIZATION OF ACCOUNTING AND REPORTING REQUIREMENTS

The rapid expansion of the Islamic financial services industry that started in the 1970s was not initially accompanied by the creation of a set of internationally recognized accounting rules. As a result, Islamic financial institutions started accounting for Islamic finance products

⁴³ Faruqi, "Islamic Finance—An Overview."

⁴⁴ International Islamic Financial Market (IIFM), Kingdom of Bahrain, 2008. Information obtained from <http://www.iifm.net/> (accessed March 2008).

according to their own interpretations and accounting solutions mainly based on the best accounting practices. These varied accounting and reporting practices resulted in less transparent and noncomparable financial statements within the same industry. The stakeholders of the industry realized that development of well established and recognized sound accounting procedures and standards consistent with Islamic laws was inevitable for the Islamic banking industry. Hence, the AAOIFI was established to standardize and develop the accounting and financial reporting practices best suited to Islamic finance products.⁴⁵ Western accounting procedures were inadequate due to differences in the nature of Islamic financial products. Well-defined procedures and standards are necessary not only for information disclosure, building investors' confidence, and monitoring, but also for integration of Islamic markets with the international markets.⁴⁶ However again, the development of these standards alone will not solve the problem; enforcement is mandatory to achieve these objectives.

Therefore the application of already tested accounting and auditing standards (i.e., AAOIFI Standards) should be enforced and encouraged in the jurisdictions where Islamic banking is practiced. The standards can alleviate the burden on regulators facing the peculiar supervisory challenges imposed by Islamic banking. However, these standards should be revised and developed in a manner that should not eliminate the liberty of industry players to innovate and develop the industry while prescribing the boundaries for the industry. In addition, the participation by stakeholders in this industry in the development of standards should be increased in order to ensure and promote the flexibility, comprehensiveness, and effectiveness of Islamic standards.

CONCLUSION

Islamic banking is not only growing rapidly, it is also gaining international recognition day by day. Even non-Muslim jurisdictions

⁴⁵Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems," IMF Working Paper, WP/07/175, Monetary and Capital Markets Department, International Monetary Fund, 2007. Available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07175.pdf> (accessed March 2008).

⁴⁶Zaher and Hassan, "Islamic Law: A Comparative Literature Survey of Islamic Finance and Banking."

have started taking an interest in this banking system. However, the industry is still in its nascent stages of growth as compared to the conventional banking industry; hence, the challenges encountered by the industry are also high as compared to those faced by the conventional banking industry. Though the rapid growth of the industry is a positive indication, it also simultaneously poses great risks for the long-term sustenance of the industry. Hence, there is a need for the appropriate and timely identification and resolution of core issues in the industry. One of the greatest challenges encountered by the industry is the preservation of the originality and authenticity of the Islamic banking industry. Unfortunately, there are instances where the Islamic banking industry is mirror-imaging conventional banking products that are altered to be *shari'a* compliant. These sorts of practices, if undertaken improperly and incautiously, put questions on the authenticity of Islamic banking products. Furthermore, the IFIs and their clientele appear to be in a situation where they do not have any specific forum having special expertise for the resolution of disputes arising out of Islamic banking transactions/deals.

In this regard, commendable endeavors have been made by *shari'a* scholars, industry experts and international organizations like the Islamic *Fiqh* Academy of the OIC. Now all the stakeholders of the industry are required to join hands and make concerted endeavors to resolve the core challenges of the industry, including the harmonization and standardization of *shari'a* rules and the development and enforcement of regulatory and legal frameworks specific to the Islamic banking industry. These challenges can only be properly addressed if the regulators and legislators come forward and play a vital role in the development and enforcement of specialized statutes, regulations, and legal infrastructure institutions. As far as the guidance on the subject is concerned, it is available not only in the form of researches and *fatawa* issued by the experts but also in the form of guidelines and standards issued by organizations like the AAOIFI and the IFSB.

What is required now is that all these guidelines, researches, *fatawa*, and standards be consolidated, if required, and agreed to by the regulators and legislators across the globe. The consensus on regulatory and legal frameworks and standards should permit the regulators and legislators to cater to the specific economic and legal needs of their respective jurisdictions while simultaneously promoting the standardization of *shari'a*, legal, and supervisory guidelines across the globe. The development and enforcement of specialized statutes and the establishment of legal infrastructure institutions will lend a level of

comfort to the stakeholders by reducing the legal risks encountered by the industry, and it may ultimately enable the IFIs to offer Islamic banking products at competitive prices. In a nutshell, if legal and regulatory issues encountered by the industry are addressed in a proper manner and resolved on a priority basis, it will not only guarantee the long term sustenance and rapid growth of the industry but will also support the ongoing product innovation in the industry by providing assurances to the stakeholders as to the *shari'a* compliance and legal enforceability of Islamic banking products.