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# مجلة بيت المشورة

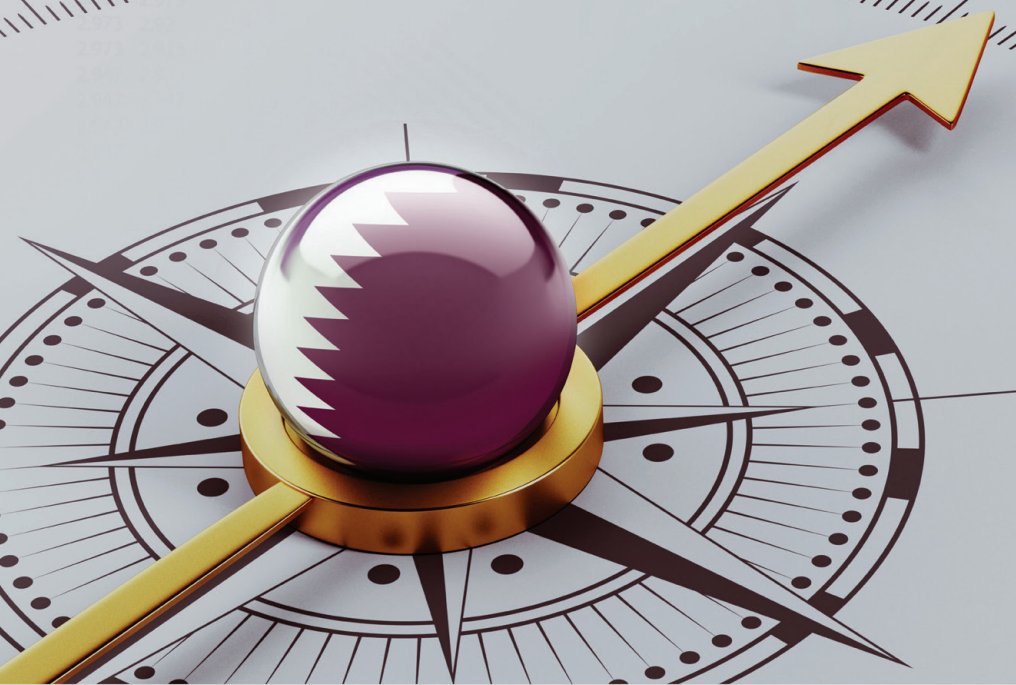
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# مجلة بيت المشورة

مجلة محكمة دولية تعنى بالاقتصاد و الصيرفة الإسلامية

الجهة المصدرة



شركة بيت المشورة للاستشارات المالية  
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## Elements Constituting the Best Practice of Shari'ah Governance in Islamic Finance

### عناصر الممارسة المثلى للحوكمة الشرعية في التمويل الإسلامي

By Mohammed Muslehuddin Musab

*MSC Islamic Finance*

(سَلِّمَ البحث للنشر في ٥ / ٢ / ٢٠١٥ م، واعتمد للنشر في ٢٠ / ٣ / ٢٠١٥ م)

بسم الله الرحمن الرحيم

### ملخص

لقد أظهرت ممارسة المؤسسات المالية الإسلامية على المستوى العالمي نماذج متعددة ومتنوعة في تنفيذ الحوكمة الشرعية الإسلامية، وذلك لكي ينسجم التمويل الإسلامي مع الهيكل القانوني والتنظيمي المطبق في الأنظمة، ظمة القضائية المختلفة متماشيا مع المستوى التنموي للمؤسسة المالية الإسلامية، وتوقعات العملاء ووضع السوق. وهذا المقال يبحث عن العناصر التي تشكل الممارسة المثلى للحوكمة الشرعية في التمويل الإسلامي.

### *Abstract*

The practice of Islamic Finance Institutions (IFIs) at global level, so far and so on, has come up with multiple and variant models of Shari'ah governance, so that it can fit in the legal and regulatory structure of different jurisdictions in line with the development level of IFI, client expectations and market conditions. The essay explores the elements that constitute the best practice of Shari'ah governance in Islamic Finance.



## Introduction

The success of an institution heavily depends on the strong and efficient corporate governance<sup>(1)</sup>. The matter of corporate governance becomes more crucial and complex in the context of Islamic Finance as it has to address the issues related to Shari'ah compliance besides the other traditional requirements of any conventional financial institution. Therefore, the system of Shari'ah governance has been introduced as an integral unit of the corporate governance of Islamic Financial Institutions (IFIs) to address the issues pertaining to the Shari'ah compliance.

## Complementary feature of Shari'ah governance<sup>(2)</sup>

The International Financial Services Board (IFSB) , an international standard setting body of regulatory and supervisory agencies, in guiding principle IFSB10- has illustrated how the Shari'ah governance System can complement the existing governance, control and compliance functions of a financial institution, the same follows<sup>(3)</sup>

Functions	Typical Financial institution	Additions in IFI
Governance	Board of Directors	Shari'ah Board
Control	Internal auditor External auditor	ISRU <sup>(A)</sup> External Shari'ah review
Compliance	Regulatory and financial compliance officers, unit or department	ISCU <sup>(B)</sup>

However, the practice of IFIs at global level, so far and so on, has come up with multiple and variant models of Shari'ah governance, so that it can fit in the legal and regulatory structure of different jurisdictions in line with the development level of IFI, client expectations and market conditions. Therefore, the structure suggested above can be taken into consideration for best practice of Shari'ah governance.

The essay further explores the elements that constitute the best practice of Shari'ah governance in Islamic Finance.

## Flexible nature of Shari'ah accords with the heterogeneous legal and regulatory frameworks

An explorative research revealed that Islamic Finance from regulatory overview differs from one jurisdiction to another; Malaysia has mixed legal environment, GCC has Islamic (in Saudi Arabia) and mixed legal environment and UK has non-Islamic legal environment. Nevertheless, the Shari'ah governance also has five major approaches; reactive approach in UK, passive approach in Saudi Arabia, minimalist approach in Bahrain, Dubai and Qatar, pro-active approach

1) Umer Chapra M. and Ahmed H. (2006) , cites the corporate governance as defined by OECD : "the set of relationships between a company's management, its board, it's shareholders and other stakeholders". (See: IRTI, Research Paper 6: Corporate Governance of Islamic Financial Institution; Page: 13)

2) IFSB10- defines Shari'ah governance as the set of institutional and organizational arrangements through which an Institution offering Islamic Financial Services (IIFS) ensures that there is effective independent oversight of Shari'ah compliance over each of the related structures and process. (See: IFSB10-; Page: 2)

3) IFSB10-; Page: 4.

in Malaysia and Interventionist approach in Pakistan <sup>(4)</sup> (and Sudan) <sup>(5)</sup>. Similarly, Dr. Rodney Wilson (September 2009) mentions that Iran has enacted the Law of Interest Free Banking in 1983, but there is no reference is made to Shari'ah governance in the law, consequently, the banks do not have Shari'ah board and no reference is made to Shari'ah compliance in the financial reports<sup>(6)</sup>.

In fact, it is the flexible nature of Shari'ah, which refers to the comprehensive divine guidance for all times and regions, that has enable the Shari'ah governance to respond to the different models of legal and regulatory frameworks across the globe.

### ***No Hard and Fast Rules***

Although the Shari'ah governance is growing in the context of variant global structures of legal and regulatory framework, nevertheless the standardization of practice will bring harmony and speed up the growth of Islamic Finance by resolving a number of potential conflicts like, whether the pronouncements of Shari'ah boards are binding or non binding? To what extent the Shari'ah boards should be privatized? Whether the Shari'ah boards are advisory, supervisory or executive? Etc.

Since the standardization cannot be done through hard and fast rules, therefore the international standard setting bodies like IFSB and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as well as Organization for Economic Co-operation and Development (OECD) and Islamic Development Bank (IDB) advocate "no single model" and "no single cure" approach and suggest some guidelines and principles in this regard<sup>(7)</sup> which provides elements for best practice of Shari'ah guidance, the same follows:

#### **• *Harmonization of Fatwa***

The IFSB and researchers at IDB agree that difference in Shari'ah opinion is a permanent feature of the Islamic financial service industry and it is majorly due to the political climate, laws of the country, the regulatory and supervisory framework, but this leads to a confusion regarding the Shari'ah compatibility of the financial products of one region to another and sometime in the same region. Therefore, IFSB and researchers at IDB prescribe that a kind of harmonization should be brought by permitting the diversity in practice rather than principle<sup>(8)</sup>. This can play a vital role in enhancing the Shari'ah governance at both the regional and international levels.

#### **• «Fit and Proper» Test**

The IFSB3- and IFSB10- mention that competence of effective Shari'ah governance requires to set-out the criteria for appointing the members of Shari'ah board in terms of qualification, experience, professional training and system of mentoring whereby more experienced members can pass on their knowledge to newer and usually younger member. This will enhance the

4) Regulatory Framework of Shari'ah Governance System; Page: 84-82.

5) Shari'ah Governance for Islamic Financial Institutions; available at: <http://www.global-islamic-finance.com/12/2011/Shari'ah-governance-for-islamic.html>

6) IBIT

7) Refer: IFSB3-; Page: 11, IFSB10-; Page: 4, Corporate Governance of Islamic Financial Institutions: Page: 148.

8) IFSB3-; Page: 10, IFSB10-; Page: 8, 7, Corporate Governance in Islamic Financial Institutions; Page: 31.



confidence in Shari'ah scholars in Shari'ah boards<sup>(9)</sup>.

- ***Stronger internal bonding***

The Shari'ah governance is an integral unit of corporate governance, so IFSB10- suggest the burden of ensuring sound and effective Shari'ah governance should not be limited to the Shari'ah board member alone, rather every stakeholder in IFI should take part in carrying out their due responsibility. This can be done by developing the mechanism and cooperation for obtaining rulings from Shari'ah scholars as well as implementing it as suggested in principle 3.1 of IFSB3<sup>(10)</sup>.

- ***Transparency and public disclosure***

The IFSB3- in principles 3.2 and part 4 focuses on the issue of transparency and public disclosure. The IFSB requires IFIs to comply with Shari'ah compliance ruling and make it available to the public along with the adequate and timely disclosure of relevant information on Investment Accounts. The same is stressed in IFSB10- under Appendix2.<sup>(11)</sup>

- ***Interdisciplinary board members***

In addition to the above, the appointment of interdisciplinary board members will contribute a lot to achieve the all the above elements for better Shari'ah governance. Since, the interdisciplinary board members will issue more acceptable Fatwa and fill the specialization gaps as well as the issues become more transparent.

- ***Coordination and cooperation between international standard providers***

Based on the legal and regulatory conditions, the Shari'ah boards are sometime considered to be supervisory or advisory, and only the universal accepted Shari'ah pronouncement has been considered to be binding and executable<sup>(12)</sup>. However, the issue can be solved by developing coordination and cooperation between international standard providers like AAOIFI, OIC Fiqh Academy and IFSB, since each of them complements the efforts and remits of other.

9) IFSB3-; Page: 11, IFSB10-; Page: 12 ,11.

10) IFSB3-; Page: 12 ,11, IFSB10-; Page: 9 ,4 and 10.

11) IFSB3-; Page: 13 ,12 and 14, IFSB10-; Page: 26 ,25.

12) Refer: Regulatory framework of Shari'ah Governance System; Page: 111 ,110.

### ***Conclusion:***

The paper was an effort to extract the elements assuring the best practice of Shari'ah governance in IFIs, it's observed that the standard setting bodies are playing their respective role and providing guidelines, however the implementation of those guidelines and principals remains a challenge, seldom due to the political ambience of the state.

The standard setting bodies should synthesize and add to the foregoing elements in order to optimize the governance of IFIs which is increasingly gaining the market share with a good momentum, while expanding the circle to engulf different streams of legitimate (halal) food, legitimate tourism, legitimate and modest fashion, legitimate entertainment, etc.

Eventually a coherent framework is required to ensure the continuity of the coordination between all the newly explored streams.

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### ***End Notes***

- 1) Internal Shari'ah review/audit/unit/department is deployed for internal Shari'ah audit and reporting.
- 2) Internal Shari'ah compliance unit/department is assigned to external auditor/Shari'ah firm for verifying the internal Shari'ah compliance review/audit as well as to provide annual statement and detailed report.