SHARIAH COMPLIANCE FEATURES OF ISLAMIC FINANCIAL INSTITUTIONS AND ITS CHALLENGES

Saleh Md. Arman
Lecturer, Business Administration, Manarat International University (Bangladesh)

Abstract
To comply with the Shariah rules and regulations, Islamic Financial Institutions have formed Shariah Supervisory Board (SSB). The duty of SSB is to monitor and regulate the ongoing activities of Islamic Financial Institutions in accordance with the Islamic laws and jurisdictions. The study has discussed the philosophy of Islamic Finance, Shariah Supervisory Boards and its features and external arrangement of Shariah compliances. The functioning of SSBs raises five main issues which are independence, confidentiality, competence, consistency, and disclosure. This study also indicated some missing dimensions in the domain of Shariah compliance features and suggested some possible measurement.

Keyword: Shariah Supervisory Board (SSB).

INTRODUCTION:
To comply with the Shariah rules and regulations, Islamic Financial Institutions have formed Shariah Supervisory Board (SSB). The approach most widely adopted currently is to establish independent bodies of knowledgeable agents. These bodies are usually internal to the institution and part of its governance structure. They include Shariah Supervisory Boards and Shariah review units. The duty of SSB is to monitor and regulate the ongoing activities of Islamic Financial Institutions in accordance with the Islamic laws and jurisdictions.

The study has discussed the philosophy of Islamic Finance, Shariah Supervisory Boards and its features and external arrangement of Shariah compliances. The functioning of SSBs raises five main issues which are independence, confidentiality, competence, consistency, and disclosure. This study also indicated some missing dimensions in the domain of Shariah compliance features and suggested some possible measurement.

SUMMARY OF PHILOSOPHY OF ISLAMIC FINANCE:

<table>
<thead>
<tr>
<th>Issues</th>
<th>Implications</th>
<th>Indicators</th>
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<tbody>
<tr>
<td>More Participation in terms of quality and quantity in the production process.</td>
<td>Proper (right and full) utilization of resources rather merely full utilization of resources.</td>
<td>High Employment of land labor, capital and entrepreneurship skill.</td>
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Adl (Justice)
Production based transaction  Qualitative production in high quantity.  Higher GDP
Efficiency in production in terms of time and utilization of resources.  Minimum Cost of Production  Lower Inflation

**Ihsan (More than Justice):**

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<tr>
<th>Diversification of risk</th>
<th>Reducing moral hazard and adverse selection problem through creating incentive and monitoring mechanism.</th>
<th>Lower rate of default and Bankrupt. Immunization against recession.</th>
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<tr>
<td>More circulation of wealth (fruits of transaction), Collective welfare</td>
<td>Equitable distribution</td>
<td>Poverty reduction</td>
</tr>
<tr>
<td>Main streaming the marginal producer</td>
<td>Market expansion,</td>
<td>Stability in business cycle.</td>
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**SHARIAH SUPERVISORY BOARD (SSB) IN AN ISLAMIC BANK:**

Arrangements for Shariah Compliance:

The Shariah unit issues a report to certify that all financial transactions comply with the above-mentioned principles. This report is often an integral part of the Annual Report of the Islamic financial institution. In practice, Shariah unit’s tasks may vary according to provisions stipulated in the articles of association of the financial institution or those stipulated by national regulators.

In another case, the unit could issue recommendations on how the institution could best fulfill its social role as well as promote Islamic finance. These often refer to SSBs’ general duty to ensure Shariah compliance of transactions and, less frequently, indicate areas of competence, composition and decision-making. The functioning of SSBs raises five main issues of corporate governance: independence, confidentiality, competence, consistency, and disclosure.

**Independence:**

The first concerns the independence of the SSB from management.

**Content**

The SSB members’ dual relationship with the institution as providers of remunerated services and as assessors of the nature of operations could be seen as creating a possible conflict of interest.

As such, they are employed by the financial institution, and report to the Board of Directors. Their remuneration is proposed by the management and approved by the Board. Their employment status generates an economic
stake in the financial institution, which can negatively impact their independence

| Confidentiality: |
| The issue of *confidentiality* is intertwined with that of independence. |

| Content |
| Often, some *Shariah* scholars sit on the SSBs of more than one financial institution. This association with multiple IIFS may be seen as a strength in as much as it could enhance an SSB’s independence vis-à-vis a particular institution. However, it does give the particular individual access to proprietary information of other, possibly competing institutions. Thus SSB members may find themselves in another type of potential conflict of interest. |

| Competence: |
| Due to the unique role that they are called upon to fulfill, SSB members should ideally be knowledgeable in both Islamic law and commercial and accounting practices (*Fiqh al-Muamalat*). In practice, it would appear that very few scholars are well-versed in both Disciplines. |

| Consistency: |
| This issue concerns *consistency* of judgment across banks, over time, or across jurisdictions within the same bank. In essence the activities of SSBs are in the nature of creating jurisprudence by the interpretation of legal sources. It should therefore not be surprising to find conflicting opinions on the admissibility of specific financial instruments or transactions. |
**Disclosure:**

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<tr>
<th>Content</th>
<th>The last and overarching issue relates to disclosure of all information relating to Shariah advisories.</th>
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<tbody>
<tr>
<td>Disclosure of the processes leading to Shariah pronouncements and related information needs to be the cornerstone of Shariah governance. These issues have not yet received sufficient attention either from IIFS themselves or their regulators and supervisors.</td>
<td>This practice of limited disclosure by banks would not support building confidence in Shariah compliance</td>
</tr>
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</table>

In addition to internal corporate arrangements, national regulators and international standard setters implement guidelines for SSBs.

**EXTERNAL ARRANGEMENTS FOR SHARIAH COMPLIANCE:**

Because of the very nature of jurisprudence, interpretation of the Shariah by a large number of independent scholars, notably in the various SSBs gives rise to inconsistencies in the fatwas across SSBs, or even over time in the same SSB.

Internal systems and procedures could be developed in IIFS to limit inconsistencies and explain different pronouncements. External arrangements, including mechanisms of market discipline can provide complementary channels inducing compliance with rulings and their harmonization.

In addition to reducing internal audit costs in the Islamic financial institution, the use of such services would possibly give the institution access to a broader range of expertise. In addition, the public may perceive chartered Shariah audit companies as more independent from the institution’s management.

The broad and external Shariah governance framework may feature
(a) Arrangements put in place by regulators
(b) The presence of providers of financial information services external to the firms.

Among regulatory arrangements, centralized SSBs are the most noteworthy.
| Function of Centralized Sharia Board | Centralized SSBs are usually concerned with ex-ante monitoring, mostly understood as standardization of Shariah interpretation, and ex-post monitoring of Shariah compliance.

They also offer arbitration to settle Shariah disputes arising between members of the same SSB.

However, the practice of centralized SSBs creates the possibility that one IIFS group operating in different jurisdictions may have products deemed Shariah compliant in one place and not in another. |
| --- | --- |
| Public Rating agencies | A few countries have set up public rating agencies that assess financial instruments and institutions. These are meant to create a positive climate for Shariah compliant investments.

By filtering out companies with activities that are incompatible with Shariah, as well as firms with unacceptable levels of debt or interest income, they contribute to reducing adverse selection in investments by IIFS, and give additional comfort on the halal nature of IIFS activities.4

Private mechanisms for the external governance of Shariah compliance are equally limited. In particular, private rating agencies have not yet developed the necessary skills or found enough incentives to monitor the IIFS’ Shariah compliance. |
| Financial Media | Likewise, other external entities with an interest in Islamic finance, such as the financial media and external auditors, are still generally less concerned with assessments of Shariah compliance. |

One of the distinctive goals of these bodies is the standardization of Shariah practices within their jurisdictions. Countries such as Kuwait, Malaysia or Pakistan have taken significant actions in this respect, while others have not followed this route.

The standardization of Islamic instruments may be a major determinant in ensuring the enforceability of Islamic financial contracts in disputes brought before civil courts that are not legally bound by the Shariah.

Accordingly, standardization of practices would support property rights of involved stakeholders as well as sustain the development of IIFS in non-Islamic countries.

458 The idea of external firms undertaking Shariah audit presents some advantages if it is viewed as complementing internal Shariah audit. Shariah audit firms would perform a role similar to that of their counterparts in conventional finance, thus introducing an additional layer in the Shariah
verification process. Such a system would obviously entail a clear separation of pre-audit and post-audit functions.

Complementary internal and external audit would apply only to post-audit, while the internal pre-audit unit, the SSB, would have the sole authority to issue fatwas. Internal audit by the SSB would have an independent appraisal function, including the review of Shariah verification systems and controls, while external Shariah auditors would have a statutory responsibility to express an independent opinion on Shariah compliance. To avoid duplication, the latter function could be performed by Shariah departments set up by existing chartered auditors.

MISSING DIMENSIONS IN THE DOMAIN OF SHARIAH COMPLIANCE STRUCTURE:

- All the Shariah bodies are concerned about the permissibility of the transactions but hardly consider about the profitability of the Bank and showed poor performance regarding the innovation of halal liquidity instruments. For instance, treasury bills and other marketable instruments.
- Shariah Supervisory Boards keep watch only against the munkars ie Ribs, Mayasir, Garar, Haram transactions but these bodies don’t monitor nor evaluate the performances of that particular Bank or Islamic Banking industry as a whole in achieving macroeconomic, and socio economic goals ie price stability, reducing unemployment, increasing economic growth, poverty alleviation, economic development, moral upliftment etc which are termed as Marufs in sharia. In other words they monitor only means of transactions not ends of transactions, which are also purpose of Islamic Banking. Huge lack of concentration and skill is present here.
- Market mechanisms, market structures, incentives are not vivid and adequate in Shariah auditing profession.
- There is no effort to establish public rating agencies regarding sharia compliant institutions and instruments.
- The lack of prescribed global standards for Islamic Finance Law is disabling the banking community to create a truly global product line. The conventional banking system globally places huge importance on data protection and zero tolerance on money laundering. This is an example where a global standard can govern the smooth functioning of the conventional banking system.
- The lack of awareness especially among Muslim people about the practicality and knowhow of Islamic banking is a widespread issue that needs to be addressed.
- The lack of a uniform regulatory and legal framework globally is a major drawback within Islamic banking.
- The shortage of scholars and qualified managers locally and internationally shows a lack of adequate manpower to run the Islamic banking system.
- The absence of a strong Branch network even among countries that have adopted the Islamic banking system shows the lack of growth and encouragement for Islamic banking.
- There is no system of international codification and standardization of fatwas. This would help to achieve harmonization and convergence of Shariah interpretations.
SOME SUGGESTION:

In order to operate and grow in the global market effectively, the following suggestions are desirable.

- The creation of a global association of Shariah boards is essential to equip various Shariah scholars with the knowledge and skills to develop new Islamic banking products and to ensure continued growth in the Islamic banking industry.
- It is vital that adequate promotion of the Islamic banking industry products takes place on a regular basis in order to generate interest and loyalty from Muslims and non-Muslims. The promotion of various products can take place through advertisement, awareness, road shows, speeches, programs and various print and visual media for targeting potential customer base. This will help to spark awareness on Islamic banking among Non-Muslims as well.
- Though it is hard and not practicable in the near future, the banking system in various Muslim countries should transfer to the Islamic Banking system. Similar to the recent unrest in the Middle East, if one Muslim country adopts the Islamic banking industry then other countries can follow suit and reap the rewards of the Islamic banking industry.
- The proponents of Islamic banking must educate and negotiate with government regulators to clear some of the complexity regarding the operational viability of Islamic financial instruments in an economy and create a favorable environment for the smooth functioning of the Islamic financial system.
- It is essential that the latest technological developments are incorporated into Islamic banking so that Islamic banking can also provide the convenience offered by conventional banking system. Example the development of telephone and internet banking has seen a dramatic shift in the way people conduct their banking needs in the conventional banking system. Thus Islamic banking must also incorporate these ideas into their product portfolio to attract additional interest in the system and to offer convenience to the various users.
- Sharing the knowledge on Islamic banking system within the countries that is working to develop the system.
- The research and development effort that develops new services that is compliant with Islamic teachings needs to be improved. Currently the research and development effort in this area is inadequate and not in a position to develop innovative products necessary for the expansion of the Islamic banking industry.
- For the growth of Islamic banking in the near future it is important that the existing Islamic banks form mergers with each other and form strategic alliances with other major banks like HSBC to compete on the same level similar to a bank in the conventional banking system.
CONCLUSION:

In a nutshell, this study makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banking is an area that has mushroomed to become an increasingly substantial segment within the global financial market. It has been recognized as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim world and offering a wide range of financial products and services.

Although the assets of the largest Islamic bank are equal to only 1 percent of the assets of the largest bank in the world, Islamic banking is one of the fastest growing industries, having posted double-digit annual growth rates for almost 30 years.

From the ongoing recession, we have understood that the bank's role is no longer to give and collect money but to be a true entrepreneur who engages in the effective management of a business and share in the risks associated with the business. We should present Islamic Banking as a viable alternative to avoid all the financial catastrophes.

It can be concluded that the market for Islamic banking shows rich potential and has reached its mature stage. But as discussed throughout this study, there are several problems and challenges within Islamic banking in relation to its operations, regulations, clarity of its concepts and the practicality. All these issues must be addressed and a viable solution must be found immediately to secure the future of Islamic banking.