



## Are Current Shariah Governance Systems Efficient?

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### Abstract

This paper aims to examine the sufficiency of current Shariah governance systems with regards to both regulation and supervision. As compared to other factors, the importance of Shariah committee is a major part of the Shariah governance system and it requires a thorough assessment of its structure. The study finds that the main issues of the existing systems of Shariah governance are the absence of standardization and harmonization; lack of proper Shariah audit; the structure of the existing systems which rely solely on manpower; and the fact that a small number of Shariah scholars are controlling a vast number of Shariah committees.

**Keywords:** Shariah Governance, Islamic Finance, Shariah Committee.

### 1. Introduction

Islamic financial institutions (IFIs) differ from their conventional counterparts because of the former's compliance with Shariah (Islamic law). Hence, the transactions, processes and products of IFIs must comply with Shariah guidelines, which are derived from the Quran and Sunnah of the Prophet SAW, to be legitimate in the eyes of its stakeholders. To apply these guidelines and to mitigate any risk that may arise from non-compliance with Shariah, different countries have introduced Shariah governance framework (SGF) for IFIs. SGF is simply defined as an effective organizational arrangement to ensure that IFIs comply with Shariah requirements. Currently, the notable SGFs under which IFIs operate include those introduced by the Islamic Financial Services Board (IFSB), Bank Negara Malaysia (BNM) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

The frameworks of IFSB as well as BNM focus on few elements pertaining to Shariah scholars who are the backbone of the industry, including, firstly, the competence of Shariah scholars by establishing a fit criteria, professional training and proper assessment for them. Second is their independence through enabling scholars to issue fatwas objectively. Third is confidentiality of material information. The final component is consistency whereby all ex ante and ex post Shariah governance processes must be consistent. On the other hand, AAOIFI's framework focuses on several aspects of SGF, namely Shariah board independence; governance and audit; Shariah review; and Shariah supervisory board.

### 2. Review of Literature

Both IFSB and BNM share the same key elements in their frameworks, although BNM's approach is more practical and elaborate [1,2] as it extends the function of Shariah audit, Shariah research, Shariah review and Shariah risk management. In theory, the SGF introduced by AAOIFI as well as BNM are

comprehensive and robust as compared to other SGFs [3,4]. But practically they are yet to be evaluated [5,6,7]. In spite of their successful functioning so far, there are weaknesses that need to be addressed in order for the industry to move forward.

Generally, the Islamic financial sector lacks standardization on a global level. Hence, on the one hand, the number of existing SGFs might harm the agenda of standardization and harmonization of the IF industry. On the other hand, they are yet taken as the basic step towards reaching a robust international framework [8,9]. It is argued by many that the difference in Shariah interpretations is a hurdle in the way of standardization. But at the same time, the diversity of opinions also provides the Islamic finance industry with innovation and flexibility.

Yet, there is tremendous need for standardization if the alarming 'Shariah risk' is taken into consideration, which is a unique risk to IFIs where the investors as well as shareholders face high risk on their investments if banking procedures are not in conformity with Shariah [10]. This additional risk which is not faced by conventional financial institutions cannot be properly mitigated unless a sound SGF is in place. This will also results in global standardization and harmonization of the Islamic finance industry and will increase the investors' confidence by eliminating Shariah risk accordingly [11].

### 3. Factors Strengthening the Shariah Governance Systems

In order to strengthen the existing SGFs, some fundamental steps need to be taken. Each IFI has a Shariah department consisting of individuals who specialize in Shariah or finance only. There are rarely cases of one person specializing in Shariah and finance whereas the industry is in need of experts specializing in both fields. Put differently, Shariah scholars need to be familiar with financial practices to a certain degree and vice versa. Moreover, there are very few Islamic finance references currently available. However, it is highly anticipated that the generation of academicians who specialize in finance as well as Shariah will add considerable value to the development of IF industries [12].



Another area of concern is Shariah audit which has not reached its maturity yet. Particularly, external Shariah audit has not been implemented by many IFIs as a mandatory requirement while those who did so have not achieved the desired results. Additionally, since both Shariah audit as well as Shariah governance are founded on their conventional concepts, they lack the true Islamic essence and spirit. Similarly, Shariah related departments in IFIs are human based rather than computerized. Note that automating the departments of Shariah shall increase efficiency by decreasing costs and human errors. But before this achieved, a good step will be asking Shariah scholars who are limited in number to serve on limited Shariah committees/boards instead of occupying positions at numerous IFIs which may hinder their performance [13,14,15].

Two notable trends can be observed in the regulators' approach towards SGF; a centralized versus decentralized approach. Malaysia is the example of a centralized SGF where the Shariah Advisory Council at the BNM level works as the central point in matters pertaining to Shariah compliance. In most of the Middle Eastern countries, a decentralized approach is adopted whereby the Shariah committee of IFI have the sole responsibility of ensuring Shariah compliance at the institutional level without resorting or referring Shariah related matters to a central authority [16]. Some of these countries, but not all, have moved towards some form of centralization and standardization by making the IFIs subject to AAOIFI standards on mandatory basis. However, in the case of Malaysia, BNM required IFIs to verify the compliance status with SGF after six months' period. This mandatory requirement will positively affect the development of existing SGF as IFIs will strive to comply with statutory requirements in order to avoid penalties. It is noteworthy that the frameworks of BNM as well as AAOIFI include the function of Shariah research aiming at conducting comprehensive Shariah research on different products and issues before submitting them to the Shariah committee [17,18,19].

The SGF issued in 2011 by BNM is a good example of a centralized approach. It has covered four key areas of Shariah governance including Shariah audit, Shariah research, Shariah review and Shariah risk. In contrast, AAOIFI focuses on Shariah review and Shariah research only while it combines the audit and review aspects. Difference exists in Shariah audit and Shariah review whereby the former is done after a longer time interval while the latter is performed on a regular/daily basis. Likewise, Shariah review aims to improve the present Shariah mechanism as it pertains to the day-to-day transactions of IFIs. Like Shariah governance, the principles on which Shariah audit is based are mainly derived from conventional audit. Hence, the various bodies dealing with governance of IFIs have been unable to introduce their own governance model consisting of and embodying the essential concepts and values of an Islamic economic system [20,21].

#### 4. Advantages of Different Shariah Governance Systems

As Islamic finance is still at a growing stage, it is always a welcome step to test different governance models and learn from each other's' experience. However, looking at its various advantages, harmonization should be achieved and targeted with the passage of time which can be achieved through a centralized SGF. A centralized SGF will increase the trust of the stakeholders, particularly the investors. It was recently observed in the famous Dana Gas *sukuk* case that the decentralized governance approach

Shariah scholars who serve various IFIs simultaneously [23,24]. Similarly, the practices of IFIs should be based on Shariah principles. Any discrepancy between these two may be the result of, firstly, either paleness or complexity of the principles making their implementation impractical. Additionally, such discrepancy is considered hypocrisy (*nifaaq*) which is forbidden according to Shariah; a Muslim must not act in contrast to his/her beliefs. Secondly, it may be due to the inability of the people to apply these values and ideologies which may be the result of an unreliable self-observation and/or inappropriate comprehension of the importance of their role [25].

The existing SGFs are not to be disapproved when adapting from non-Islamic reputable and experienced governance institutions as long as they comply with Shariah principles. Also, such adaptation is not fully efficient because of the scarcity of human resource. For instance, the principles of independence and confidentiality are difficult to be accomplished due to the small number of professionals who serve in the Shariah departments of IFIs [26,27].

#### 5. Conclusion and Future Direction

In light of the above discussion, it is strongly suggested that the Shariah committees be restructured in which academicians (specializing in both finance as well as Shariah) shall constitute a portion of the Shariah committee. On the one hand, such reformation aims at adding value to the entire system of Islamic finance considering the academicians wide-ranging knowledge and eagerness to make a difference. On the one hand, the reformation shall highly benefit these graduates to gain from the vast experience of senior Shariah committee members and at the same time ease the burden on senior members through sharing the workload with them. It will contribute in resolving many issues such as the lack of practicality, standardization and harmonization; the inadequacy of Shariah audit; and the inadequacy of senior/reputable Muslim scholars.

Therefore, it is highly recommended that regulators as well as market players do not underestimate the role academicians specialized in finance, technology and Shariah can play. It is hoped that this new generation, if trained properly, can face these challenges and they will play a major role in solving the multitude of issues existing in the present SGFs.

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negatively affected the investors' confidence by resulting in legal uncertainty and dispute between the *sukuk* holders and the company [22].

As Shariah board/committee is the backbone of Shariah governance system, it needs to be carefully assessed and structured. Yet, its composition is affected by the scarcity of

*Surrey*).

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