HANDBOOK ON ISLAM AND ECONOMIC LIFE

Handbook on Islam and Economic Life

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17. Meeting expectations: the roles and responsibilities of *Shari'ah* scholars in Islamic finance

Mohamad Akram Laldin and Hafas Furqani

INTRODUCTION

Islamic finance uses the *Shari'ah* as the backbone of its system. The *Shari'ah* not only contains the principles and foundations upon which the financial system is established, but also provides guidance for setting the industry's direction. Practically speaking, it is the *Shari'ah* scholars, in their role as interpreters of the *Shari'ah*, who are charged with guiding the industry. They have a key role to play in maintaining the credibility and integrity of the industry by requiring Islamic financial institutions (IFIs) to adhere not only to the *Shari'ah*'s technical requirements but to its values and principles as well. Their participation is, thus, vital to the industry's development.

Shari'ah scholars are faced with difficult challenges. In recognition of this state of affairs, we currently see a trend at local and international levels to develop standards and guidelines for the best practice of *Shari'ah* advisory and supervision. The framework of *Shari'ah* governance has been set up to meet that objective.

This chapter discusses the roles of *Shari'ah* scholars in the development of the Islamic finance industry and the responsibilities assigned to *Shari'ah* boards to ensure that the industry is moving in the right direction and to maintain its credibility and integrity. The recent developments in regulating the practices of *Shari'ah* supervision and institutionalizing the *Shari'ah* governance framework will also be discussed. The chapter ends by discussing some challenges faced by *Shari'ah* scholars and by *Shari'ah* governance practices.

ISLAMIC FINANCE AND *SHARI'AH* SCHOLARS

The existence of a specific group of scholars to supervise and monitor financial practices is a new development in the Islamic tradition. The phenomenon started with the establishment of Islamic financial institutions in the mid-1970s. Yahia Abdul-Rahman (2010: 75) observes that three Islamic financial institutions were set up at that time, namely: 1) Dar al-Maal al-Islami, founded by the son of the late King Faisal of Saudi Arabia, Prince Muhammad al-Faisal, who appointed Sheikh Muhammad Khater, the Grand Mufti of Egypt, to the head of a board responsible for developing financial tools and methods compliant with the *Shari'ah*; 2) Bayt al-Tamweel al-Kuwaiti – Kuwait Finance House – founded by Sheikh Bazee al-Yaseen, who chose Sheikh Muhammad Badr Abdel Basset to be his chief scholar in the law; and 3) Dallah Albaraka Group, founded by Sheikh Saleh Kamel, who appointed a group of the highest religious authorities in many countries to develop an Islamic financing code based on the *Shari'ah*. The group was later called, for the first time, the *Shari'ah* board. Since then, the appointment of a group of scholars, most of them having a *Shari'ah* background, has been necessary in the establishment of an Islamic financial institution.

In a later stage of development, the *Shari'ah* board has become institutionalized and formalized in the structure of Islamic financial institutions, and criteria for the qualifications of its members and specific guidelines regarding their authority and duties have been delineated.

For example, the OIC Fiqh Academy, in their 19th session meeting, held in Sharjah, the United Arab Emirates, on 26–30 April 2009, issued a resolution on the role of *Shari'ah* supervision in regulating the operations of Islamic banks, its importance, stipulations and operating procedures. In their Resolution no. 17 (19/3), a *Shari'ah* board is defined as:

> a group of specialist scholars in the field of Islamic jurisprudence, particularly transactional jurisprudence (*mu'amalah*), whose number will not be less than three, chosen from those who have the aptitude and knowledge of the practical realities, whose work is to pronounce verdicts and revise whatever needs to be revised, in order to confirm and ensure that all the transactions conducted by the Islamic financial institutions comply with the rulings and fundamentals of the *Shari'ah*, and to publicize the decisions to the public, and whose decisions are binding upon the Islamic financial institutions.

Likewise, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2010) produces guidelines on governance standards for Islamic financial institutions (GSIFI). In their GSIFI 1 (*Shari'a Supervisory Board: Appointment, Composition and Report*), AAOIFI defines a *Shari'ah* board as:

> specialized jurists, particularly in *fiqh mu'amalah* and Islamic finance, entrusted with the duty of directing, reviewing and supervising the activities related to

> Islamic finance in order to ensure that they are in compliance with *Shari'ah* rules and principles. The views of the *Shari'ah* advisors shall be binding in the specific area of supervision.

This means that the presence of *Shari'ah* boards is significant in Islamic financial institutions and that the decisions of *Shari'ah* boards are viewed as very crucial in Islamic finance development. The *Shari'ah* board serves not only to ensure public confidence in the legitimacy of Islamic finance operations and products, but also to ensure that Islamic finance is operating and developing based on *Shari'ah* guidelines.

The *Shari'ah* board is considered the stakeholders' advocate regarding *Shari'ah* compliance. In addition, it is considered the main actor in *Shari'ah* governance. Therefore, it is important to affirm that qualified and competent *Shari'ah* advisors are appointed (Aboumouamer, 1989: 366).

Various regulators and Islamic finance institutions have placed minimum guidelines for eligibility to serve on a *Shari'ah* board; for instance, a *Shari'ah* advisor should possess necessary knowledge, expertise or experience in *fiqh al-mu'amalah* or *usul al-fiqh*, have considerable knowledge of current practices in finance and Islamic finance, and be a person of reputable character. In our observation, in order to ensure the standard of advisory services provided, a *Shari'ah* advisor should possess the following criteria:

1. considerable knowledge or mastery in *fiqh al-mu'amalah* and *usul al-fiqh*;
2. sufficient knowledge of the current Islamic and conventional finance practices;
3. deep understanding of *maqasid al-Shari'ah*;
4. the capability to derive legal rulings;
5. sufficient understanding of the issue and problem posed;
6. boldness, trustworthiness and dynamism; and
7. good reputation and good Islamic character.

In addition to the above criteria, in order to maintain the credibility of the decisions made, the members shall be practicing Muslims who are willing to frankly state what they believe. This is important, as Islamic finance is not only related to the 'legal' aspects of Islam but also part of Islam's belief system.

Having mentioned the above criteria, one of the critical issues faced by the industry today is the lack of qualified *Shari'ah* scholars. The current numbers of qualified scholars do not match the growing number of institutions that require their services. Thus, initiatives to educate, train and produce new scholars are very much welcomed and should be intensified, and Islamic financial institutions need to realize that they should make significant investments to develop the necessary human resources. In addition, the new and young scholars need to be reminded that, in addition to technical competence, they have to be proactive and dynamic to fulfill their duties in the ever challenging industry in order to develop it. Close interaction with various Islamic finance stakeholders is required to further enhance their understanding, and they should aim and strive to contribute as much as possible to the industry and to the *Shari'ah*.

As the *Shari'ah* board has now been formalized in the structure of the Islamic financial institution, another issue worth considering is the setting up of a monitoring mechanism to ensure that *Shari'ah* boards are competent and provide quality service. However, no such mechanism is available at present. Thus, it is proposed that a professional association of *Shari'ah* advisors be formed and that this body organize and ensure a continuous professional development (CPD) program for *Shari'ah* advisors, establish a standard of acceptable qualification for members and oversee the conduct of *Shari'ah* advisors. It might also be given a mandate to issue a professional certification to *Shari'ah* advisors, without which they would not be able to practice, and to approve its renewal by periodic review and screening to ensure that *Shari'ah* advisors hold the necessary professional and educational qualifications and at all times exercise competent and ethical conduct. It might also become a good forum to increase discussion and exchange of opinion among scholars as well as a means to move towards uniformity of fatwas and practices. Therefore, it is timely to consider the establishment of such a dedicated and professional body for *Shari'ah* advisors.

SHARI'AH BOARDS' ROLES AND RESPONSIBILITIES

The *Shari'ah* board is responsible for overseeing the application of different aspects of the *Shari'ah* in Islamic financial institutions. The *Shari'ah* board certifies every product, finance model and service provided by its Islamic financial institution. The ideal roles of the *Shari'ah* board involve *ex ante* and *ex post* aspects of *Shari'ah* governance, including *Shari'ah* pronouncements (fatwas), supervision (*raqabah*) and review (*mutaba'ah*) (Hasan, 2011: 35). The OIC Fiqh Academy, in its Resolution no. 17 (19/3) 2009, describes the meaning of *Shari'ah* supervision as 'issuing verdicts and *Shari'ah* rulings related to the activities of Islamic financial institutions, following up to ensure that the rulings are executed, and ensuring the sound application of the rulings'.

The definition suggests that the scope of the supervision to be exercised by the *Shari'ah* board is extensive. As the industry has grown, the duties and responsibilities of *Shari'ah* boards have expanded. Their roles are no longer limited to advice and product endorsement; at present, they are also involved in product development and innovation, in addition to supervision of Islamic finance operations. On certain occasions, they also participate in developing policies and regulations for Islamic finance. This development increases the challenges facing the *Shari'ah* advisors, for they need to interact more with various people and stakeholders in the industry to understand and perform their roles better.

The range of roles and duties of *Shari'ah* advisors includes giving advice to Islamic finance institutions on matters pertaining to *Shari'ah* issues, helping to design the framework for establishment of an Islamic finance institution, monitoring the activity and procedures of the institution, developing products and underlying contracts, acting as a reference on *Shari'ah* matters to Islamic finance institutions specifically and the Islamic finance industry in general, providing training and awareness programs for Islamic finance institutions' staff, supervising the Islamic finance industry, trying to harmonize it with global practices, representing Islamic finance institutions in forums to allow for the exchange of ideas and sharing of experiences and, lastly, conducting *Shari'ah* audit exercises for the Islamic financial institutions.

The abovementioned show the wide scope of roles that *Shari'ah* advisors may play and show that the tasks before them are not at all light or trivial, so they will need all the support that can be provided. This can be done via establishment of a *Shari'ah* department or secretariat to assist the *Shari'ah* board by providing resources, collecting fatwas and Islamic finance institution reports, conducting research, assisting in the product development process and in conducting internal reviews or audits, and any other assistance that may be necessary to the *Shari'ah* board.

In discharging their duties, there are several considerations that particularly need to be observed.

First, *Shari'ah* advisors need to ensure that product development uses the acceptable principles of the *Shari'ah* and follows acceptable *Shari'ah* standards, whether those standards are developed locally or internationally. The rapid growth and advancement of Islamic finance have resulted in the development of *Shari'ah* standards and frameworks for product development by international bodies such as AAOIFI and the Islamic Financial Services Board (IFSB) or national bodies like the *Shari'ah* advisory councils of central banks and other financial institutions. Thus, the task of *Shari'ah* scholars is to ensure that these standards are upheld and followed, whenever applicable to a local situation, in order to preserve the high level of integrity of their decisions.

Second, *Shari'ah* advisors need to ensure that the decisions of the *Shari'ah* boards are understood by the practitioners so that they will be properly implemented, as they are the ones responsible for applying the decisions of the *Shari'ah* boards. Negligence and lack of understanding on the part of the practitioners may jeopardize the whole process. Apart from that, *Shari'ah* boards have a duty to educate the practitioners on *Shari'ah* principles so that both sides can mutually work for better *Shari'ah* compliance in the products, operations and conduct of the Islamic finance institutions. It is also highly desirable that *Shari'ah* scholars conduct training and engage in close interaction with officers in the institution to increase their understanding of *Shari'ah* and *fiqh mu'amalah*.

Third, *Shari'ah* scholars need to be competent to scrutinize the documents related to products and transactions, as negligence will result in noncompliance and negative legal consequences. Therefore, *Shari'ah* scholars must have sufficient knowledge about the *Shari'ah*, legal and operational aspects of the products and transactions. It is highly desirable that *Shari'ah* scholars be involved in product development from the early stages up until the contract is concluded. This will definitely require them to have a good command of languages, as they need to read and examine all the terms, conditions, clauses and secondary contracts that are set out in the contract, as well as all the supporting documents. They will need to ensure clarity in *Shari'ah* principles in the documents and that the contract is fair and just to both parties.

Fourth, *Shari'ah* advisors must have full knowledge of the purpose of the products and their technicalities. They have to ensure that the products have positive objectives and are not used as means to forbidden ends. It is also a major cause for concern if Islamic finance proceeds are not well managed or are channeled to noncompliant activities. If this is not checked, then efforts to build a *Shari'ah*-compliant system will be fruitless, as a permissible matter that leads to a prohibited matter is also prohibited. *Shari'ah* scholars must be firm and strict so as not to allow any forbidden or doubtful activity or one that involves legal trickery (*hiyal*) (Abu Ghuddah, 2008: 10).

In addition, *Shari'ah* scholars must assess the product's economic implications to the *Ummah*. This will require them to take a *maqasid* approach. It must be remembered that Islamic finance products are supposed to provide facility to the people and not to burden them, as Islam considers wealth one of the essentials of human life. Therefore, Islamic finance has to be reviewed on a macro-scale to ensure that it is serving the *Ummah* effectively. For instance, retail products must not be neglected, although wholesale products may yield more profits. The Islamic financial system, which is commonly characterized as a moral and ethical system, must contribute effectively to overall wealth creation, growth and development, and to greater shared prosperity (Akhtar Aziz, 2005: 196).

Another aspect that needs to be considered by *Shari'ah* scholars is their role in strengthening the governance of Islamic financial institutions as well as instilling Islamic values in the financial institutions' business operations and governance (Akhtar Aziz, 2005: 205). This will include facilitating *Shari'ah* audits, ensuring Islamic and ethical management practices, protecting consumers' rights and ensuring the accountability of the financial institutions. Islamic ethics and discipline and an Islamic standard of corporate social responsibility (CSR) should be incorporated in the policies and governance of the Islamic finance institution. *Shari'ah* advisors should be role models in ethics and work performance. This will add to the Islamicity of the institution.

REGULATING THE *SHARI'AH* BOARDS: THE CASE OF MALAYSIA

In line with the development of the industry and the formalization of the *Shari'ah* board's place within it, some jurisdictions have moved to regulate *Shari'ah* boards. Malaysia, for example, regulates the establishment of *Shari'ah* boards in the Islamic finance industry and has delineated their roles and responsibilities in Islamic Banking Act 1983 and Central Banking Act 2009.

In Islamic Banking Act 1983, the existence of the *Shari'ah* board has been made a prerequisite for the establishment of an Islamic finance institution or 'Islamic window' or the transformation of a conventional institution into an Islamic finance institution. Section 3 of the Malaysian Islamic Banking Act 1983 prescribes the following:

> (1) Islamic banking business shall not be transacted in Malaysia except by a company which is in the possession of a licence in writing from the Minister authorizing it to do so.
>
> . . .
>
> (5) The Central Bank shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless the Central Bank or the Minister, as the case may be, is satisfied –
>
> *(a)* that the aims and operations of the banking business which it is desired to carry on will not involve any element which is not approved by the Religion of Islam; and
>
> *(b)* that there is, in the articles of association of the bank concerned, provision for the establishment of a Syari'ah advisory body, as

> may be approved by the Central Bank, to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.
>
> . . .
>
> (6) Any person who contravenes the provisions of this section shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment.

Thus, without a *Shari'ah* board, the establishment and operation of Islamic financial institution is null and void, according to the law. The *Shari'ah* board is made an integral part of every Islamic finance institution, and its existence cannot be compromised, as it secures public confidence and subscription to the institution and its business.

In the Central Banking Act 2009, the Malaysian authorities further reinforced the role and functions of the Shariah Advisory Council (SAC) of Bank Negara Malaysia. The SAC was accorded the status of the sole authoritative body on *Shari'ah* matters pertaining to Islamic banking, *takaful* and Islamic finance.

The government of Malaysia has made it obligatory upon the court or arbitrator to refer to the SAC for *Shari'ah* rulings and made those rulings binding upon the IFIs as well as the courts and arbitrators:

> 56. (1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall
>
> *(a)* Take into consideration any published rulings of the Shariah Advisory Council; or
>
> *(b)* Refer such question to the Shariah Advisory Council for its ruling.
>
> . . .
>
> 57. Any ruling made by the Shariah Advisory Council pursuant to a reference made under this part shall be binding on the Islamic financial institutions and the court or arbitrator making a reference . . .
>
> 58. Where the ruling given by a Shariah body or committee constituted in Malaysia by an Islamic financial institution is different from the ruling given by the Shariah Advisory Council, the ruling of the Shariah Advisory Council shall prevail.

The clear regulation on the role, function and responsibility as well as the authority of the *Shari'ah* board at the higher level of government authority and at the lower level of the financial institutions establishes a clear *Shari'ah* governance framework and will, hence, guide the development of the industry.

The regulation also gives insight to *Shari'ah* advisors that they need to appreciate the source of their mandate and fully understand the extent of their responsibility. They should not treat their existence solely as fulfilling the requirement of the law but consider it a crucial necessity with multifold contributions to make for the progress of the institution and the industry.

In addition, *Shari'ah* scholars should be involved in laying the foundation stone of an institution and should advise the institution on many aspects, including its policies and rules, in order to make it *Shari'ah* compliant and of an Islamic mould. The institution's articles of association or letters of appointment to the *Shari'ah* board should explicitly state that all of its policies have to be Islamic and *Shari'ah* compliant and, thus, the *Shari'ah* scholar needs to be engaged to ensure that such objectives are achieved. Thus, the *Shari'ah* advisory board's duty is not restricted to monitoring the chain of *Shari'ah* compliance but, rather, extends to promoting the Islamicity of the institution and its practices.

All the duties of the *Shari'ah* board and its members should be stated clearly in their letter of appointment or the terms of reference for their appointment and, upon acceptance by the *Shari'ah* scholar, it shall constitute a binding contract of service between him or her and the institution. Negligence in the performance of their duties shall make *Shari'ah* advisors answerable to the respective authority in the institution that appointed them. Therefore, upon acceptance of the appointment, *Shari'ah* scholars must endeavor to perform their duties with due care and diligence and keep in mind that they are accountable to Allah and to the other stakeholders. The institutions shall assess the work of the *Shari'ah* advisors and take necessary steps to ensure that they provide quality service.

The tremendous growth of the industry has seen rapid progress in product development as well as regulatory requirements. However, further development of legal aspects is still needed, as there are insufficient laws to cater to the needs of Islamic finance. The industry avidly welcomes and appreciates any new laws or policies friendly to the industry and the amendment or reform of existing laws to accommodate the practices and progress of Islamic finance. The neutrality of certain taxes for a certain period in certain jurisdictions to institutions offering Islamic finance services is one of the key elements to the further development of Islamic finance industries.

It is crucial for *Shari'ah* scholars to have adequate knowledge of the relevant laws and assess whether they form obstacles to or provide opportunities for Islamic finance services. For instance, *Shari'ah* advisors need to be aware of the new Malaysian move of deregulation or liberalization of a certain fraction of the financial industry and evaluate its impact on the Islamic finance industry. This is especially needed in countries that adopt a dual system, as they have both Islamic and civil law and two financial systems, conventional and Islamic. Thus, *Shari'ah* advisors must always be up to date and alert to the development of laws, especially laws that are relevant to Islamic finance operations. They should also propose new laws that are beneficial and crucial for the industry's wellbeing and growth and propose amendments to laws that are not *Shari'ah*-friendly for Islamic finance practices. This will require *Shari'ah* advisors to participate in the national sphere and for the benefit of the overall industry and not merely provide services to individual institutions.

Other than that, *Shari'ah* advisors need to scrutinize legal documents related to Islamic finance operations and products. They must ensure that they satisfy all the relevant *Shari'ah* and contractual principles, ensure a fair and equitable deal is made between the parties and clearly outline all their rights and obligations. Thus, *Shari'ah* scholars need to learn and have sufficient understanding of legal jargon or, if they don't, seek assistance in reading those documents and only approve them after being satisfied that they are in line with *Shari'ah* requirements and clearly describe the transaction that ought to take place.

Recent developments in Islamic finance and laws have highlighted the need for clarity in Islamic finance legal documents, standard contracts and terminologies of Islamic finance. Clarity of Islamic finance legal documents is very important so as to ensure that no disputes arise between the parties and that the terms and conditions of the contract will be honored. That will also assist judges in understanding the transactions and providing just resolution to the parties. This is highly crucial if no dedicated *Shari'ah* or Islamic finance court is available in the jurisdiction or if Islamic finance cases are decided by a judge who is not well versed in the *Shari'ah*. Standard contracts and terminologies are also considered to be crucial in the industry, as they will boost understanding of, and uniformity in, Islamic finance practices, increase the speed of Islamic offerings and avoid disputes between parties.

SHARI'AH GOVERNANCE FRAMEWORK

There is a current trend toward formalizing the role played by *Shari'ah* scholars in Islamic finance within a systematic structure of *Shari'ah* governance. This tendency is rooted in the view that the *Shari'ah* board plays an important role in achieving the *Shari'ah*-compliance goal in Islamic financial institution practices.

Shari'ah governance essentially refers to structures and processes adopted by Islamic financial institutions to ensure compliance with *Shari'ah* rules and principles. *Shari'ah* governance is a very critical area in Islamic finance and is no less important than corporate governance to any institution. However, *Shari'ah* governance is particular to Islamic finance, as it is the mechanism which determines the 'Islamicity' of any particular Islamic business or financial institution as well as the system as a whole. *Shari'ah* governance ensures that the industry is at all times in accord with the *Shari'ah* by ensuring the legitimacy of the products offered and supervising the products sold and applied in the market.

The significance of *Shari'ah* governance transpires via its role of ensuring the confidence of the Islamic finance industry in the eyes of the public. Effective *Shari'ah* governance requires the setting up of a clear and comprehensive framework to regulate the Islamic finance industry and guide its development. Fundamental to this process is definition of its main actors, namely the *Shari'ah* advisors, and their responsibilities as well as the roles that they need to undertake for the wellbeing of the whole Islamic finance sector. Other aspects of *Shari'ah* governance are supporting initiatives that can assist in enhancing a *Shari'ah* advisor's performance, such as legitimate mandate, *Shari'ah* secretariat, *Shari'ah* research and others.

At the international level, the *Shari'ah* governance standards and guidelines issued by AAOIFI and the IFSB set international standards on the structure of *Shari'ah* governance, the roles and responsibilities of the *Shari'ah* board and the criteria for appointment to it.

The IFSB has issued *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services*, known as *IFSB 10*. The guidelines, which commenced in December 2009, serve as a practical framework to the best services and practices by *Shari'ah* boards. The IFSB (2009) defines the *Shari'ah* governance system as 'the set of institutional and organizational arrangements through which an Islamic financial institution ensures that there is effective independent oversight of *Shari'ah* compliance'. The framework highlights the components of a sound *Shari'ah* governance system that should be in place in any Islamic financial institution. It aims to facilitate better understanding of *Shari'ah* governance issues and provide enhanced transparency in terms of issuance of *Shari'ah* rulings and the audit and review process for compliance with those rulings. It also provides a basis for greater harmonization of *Shari'ah* governance structures and procedures across jurisdictions.

Likewise, AAOIFI has published seven governance standards for Islamic financial institutions (GSIFI), with GSIFI 1 focusing on *Shari'ah* supervisory boards, their appointment, composition and annual report. Those standards provide guidelines for a general approach to *Shari'ah* governance and instill the elements of competence, independence, confidentiality and consistency in *Shari'ah* boards' practices.

In some jurisdictions, such as Malaysia, a formal *Shari'ah* governance framework has been put in place at the national level to achieve *Shari'ah* compliance in Islamic finance practices. Malaysia has also defined the *Shari'ah* board's authority, role and responsibility in the national act.

The Central Bank of Malaysia has detailed the role of the *Shari'ah* board, together with that of the board of directors and the IFI's management, in the *Shari'ah Governance Framework for Islamic Financial Institutions*, which took effect on 1 January 2011 (Bank Negara Malaysia, 2011). That framework eases the task of *Shari'ah* boards and allows them to know the extent of their responsibilities.

However, in certain jurisdictions such guidelines are not available, and a clear framework on *Shari'ah* governance is nowhere to be found. This creates some uneasiness among industry players and leaves *Shari'ah* advisors without clear guidelines to follow. *Shari'ah* advisors, with other industry players, should push forward this agenda and request a *Shari'ah* governance framework.

The trend to make the *Shari'ah* board a formal institutional component of the Islamic financial system would not only support the development of the industry but make it more effective and efficient, especially in solving the issue of the legitimacy of fatwas on financial products.

The practice of *Shari'ah* governance would, nevertheless, vary across jurisdictions in line with local needs and tastes. In general, we can observe two distinct approaches in the world. In the first, the *Shari'ah* board is structured at the central and lower level. At the highest level, the authorities set up a central *Shari'ah* board, and each Islamic financial institution sets up a *Shari'ah* committee for itself. This group can be further subdivided into 1) countries that have established a distinct *Shari'ah* board on Islamic finance at the central bank; and 2) countries that have a general higher *Shari'ah* authority at some other government office, to which Islamic finance issues can be referred.

Malaysia, Sudan and Pakistan are among the countries in the first group. Bank Negara Malaysia (BNM) established the Shariah Advisory Council (SAC) in 1997, the Central Bank of Sudan established the *Shari'ah* High Supervisory Board (SHSB) in 1993, and the State Bank of Pakistan established the *Shari'ah* Board as the sole authority in matters pertaining to Islamic finance at the highest level of authority. Kuwait, Qatar and Indonesia are among the countries in the second group. Kuwait established the *Shari'ah* Board of the Ministry of Awqaf and Islamic Affairs, Qatar set up the Supreme *Shari'ah* Council of the Ministry of Awqaf, and Indonesia established the National *Shari'ah* Board (Dewan Syari'ah Nasional) in 1999 under the auspices of Majelis Ulama Indonesia (the Indonesian Council of Ulama).[1]

In the second approach, the *Shari'ah* supervision is organized only at the lower level of the Islamic financial institutions. Unlike the previous model, in such jurisdictions there is no specific higher authority for supervision of Islamic finance. *Shari'ah* advisory and supervision are done at the level of each financial institution by its appointed *Shari'ah* committee. Saudi Arabia and Bangladesh are among the countries that adopt this approach.

These differences reflect the lack of a common framework among the countries on the practices as well as structure of *Shari'ah* governance. They also show that, while we may have international guiding standards such as those of AAOIFI and the IFSB, there is no 'one size fits all', as the taste and practices, as well as level of industry development, differ across countries.

Nevertheless, coming back to the *Shari'ah* advisors themselves, the various jurisdictions generally share the same expectations on the fundamental criteria and core values *Shari'ah* boards should possess in order for a comprehensive *Shari'ah* governance system to be established. Those are the elements of competence, independence, confidentiality and consistency. The installation of these elements has been elaborated in the IFSB's *Guiding Principles on Shari'ah Governance Systems*, AAOIFI's *GSIFI* and BNM's *Shari'ah Governance Framework for Islamic Financial Institutions*.

Those elements are very significant to ensure the best practices and conduct of *Shari'ah* boards, but the processes and procedures for installing them may differ in different markets and jurisdictions. At present, different models of *Shari'ah* boards and *Shari'ah* advisory practices are operating in various jurisdictions, and different processes and procedures have been adopted for *Shari'ah* governance. Certain jurisdictions have instituted central regulation, while some have taken a voluntary tack, and others have adopted a hybrid approach. Nevertheless, guidelines for the best practices are greatly needed so that *Shari'ah* advisory services can be further enhanced and respected.

SOME CHALLENGES

Expectations regarding the role played by *Shari'ah* boards and the services they provide continue to increase in tandem with the industry's tremendous growth. Apart from the various tasks that the *Shari'ah* boards need to undertake, there remain challenges to providing better service and living up to expectations. Some of the challenges are as follows:

1. In the next phase of Islamic finance development, scholars who have integrated knowledge of both the *Shari'ah* and modern economics and finance are urgently needed. It has been observed that not many scholars are well versed in both the *Shari'ah* and finance. There should

be systematic effort to solve this problem. Over the last two decades, we have seen positive developments in the form of a massive and systematic effort to develop curricula that integrate the *Shari'ah* and modern finance in order to produce good human capital for the next generation in Islamic finance development.

2. There is disproportionate growth between the Islamic finance industry and the number of *Shari'ah* experts. In general, there is an inadequate supply of *Shari'ah* scholars to serve the Islamic financial industry. A report from Funds@Work by Murat Unal (2011) found that overall there are 1141 *Shari'ah* advisory board positions available in 28 countries, with an average board size of 3.33 scholars per board. Nevertheless in practice we see the top ten scholars hold 450 out of 1141 board positions that are available and represent 39.44 percent of the global Islamic finance industry. This has also resulted in one *Shari'ah* advisor sitting on a staggering 85 boards, while another sits on 79. This state of affairs has led to criticism of the integrity of the *Shari'ah* advisors and the credibility of the quality of service they can render. Apart from the issue of possible conflict of interest, it is nigh physically impossible for a single scholar to service so many accounts. The figure conveys a message to regulators on the need to place some limitations on the number of memberships that one individual can be expected to handle effectively. More importantly, it poses a challenge to the relevant authorities to invest in producing new *Shari'ah* scholars and providing them with the necessary exposure and experience to be competent for the tasks that they have to undertake.
3. The sophisticated development of the industry creates a challenge to synchronize between the *Shari'ah* and the relevant country's legal system and regulations, as they impinge upon product development as well as operational issues. Replication of conventional products and structures creates legal issues at the conceptual and practical levels. The Central Bank of Malaysia has recognized this problem and has set up the Law Harmonization Committee to create a legal system conducive to the development of the Islamic finance industry in order to achieve certainty and enforceability of Islamic finance contracts under Malaysian law. The committee has the task of harmonizing the law of the country in financial matters with *Shari'ah* law. The *Shari'ah* scholars are challenged both to identify the gaps in laws and to provide solutions to harmonize them.
4. Innovation in providing Islamic-based services and products remains one of the biggest challenges in the Islamic finance industry. We have heard, and continue to hear, critical voices questioning the genuineness and integrity of Islamic finance products and services. Many

observers consider this pragmatic approach to developing Islamic finance by replicating and modifying conventional structures to be incompatible with the industry's future sustainability. There is an emerging consciousness that more effort must be put into inculcating 'Islamic values' such as '*adl* (fairness and justice), *ihsan* (benevolence), *amanah* (trust), *ta'awun* (mutual help), *ukhuwwah* (brotherhood) and so on into Islamic financial products and operations and charting the industry's overall direction. This poses a challenge for *Shari'ah* scholars to move the industry to the next stage: from negative screening to more active participation and the proposal of genuine ideas for creating a 'good' financial system. This will require *Shari'ah* advisors to be more bold and proactive in conducting research and product development.

5. *Shari'ah* governance requires the service of the *Shari'ah* board to be effective and efficient. The development of the industry has engendered enormous *Shari'ah* issues. *Shari'ah* boards are challenged to provide speedy and timely *Shari'ah* solutions to those issues. *Shari'ah* boards should not rush in making *ijtihad* or giving *Shari'ah* rulings or prohibiting or permitting a matter without clear understanding. When an issue is intricate and complicated, any decision about it will have to be based upon in-depth research and discussion. In addition to discussions within *Shari'ah* boards, more discussion forums among *Shari'ah* scholars across the world are needed for sharing views, opinions and experiences in the effort to produce good *Shari'ah* decisions.
6. Apart from that, *Shari'ah* governance also requires the *Shari'ah* board to maintain a balance between transparency and confidentiality. While clear and transparent procedures for decision making need to be maintained at the highest level, the *Shari'ah* board must also make sure that confidential information received in the course of their duties remains confidential. Despite that, information not considered confidential, such as *Shari'ah* rules and principles and the reports and resolutions of the *Shari'ah* board, could be disclosed to the public. It is important to note that the absence of full disclosure on the part of financial institutions could prove to be detrimental to the legitimacy of products and affect the rights of customers. Also, reluctance to share information will not help to reduce the knowledge gap in the industry, the result of which is that the unique features of Islamic finance and its products are not well understood and appreciated.

CONCLUSIONS

Shari'ah governance is an integral part of the industry that aims to guide the proper direction of Islamic finance development. The *Shari'ah* governance framework as outlined by the IFSB, AAOIFI and the Central Bank of Malaysia identifies *Shari'ah* boards and *Shari'ah* advisors as the key components in ensuring *Shari'ah* compliance and, hence, the integrity and credibility of the industry.

This chapter has outlined several challenges faced by *Shari'ah* boards in ensuring good *Shari'ah* governance practices. Overall, *Shari'ah* boards need to undertake a variety of tasks and fulfill a variety of responsibilities to their respective Islamic finance institutions as well as to the industry as a whole. The industry looks to them for effective contributions and commitment in line with their position as *Shari'ah* experts and *Shari'ah* guardians in the Islamic finance system. Nevertheless, it is essential that *Shari'ah* advisors continuously enhance their competence, caliber and knowledge and prepare themselves to face all their responsibilities and challenges while ensuring that the proper *Shari'ah* governance framework is in place.

NOTE

1. Nevertheless, Indonesia has stipulated that any central bank regulation pertaining to *Shari'ah* matters must refer to the fatwas (decisions) made by the National *Shari'ah* Board. Likewise, the appointment of a *Shari'ah* committee at the financial institution level is subject to their approval. The *Shari'ah* board at the financial institution level will be responsible to both the National *Shari'ah* Board and the Central Bank of Indonesia, to each of which they will submit a report on the findings of their *Shari'ah* supervision.

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