Sharia Supervisory Board in Islamic Banks: A Critical Analysis of the Current Framework

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

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Abstract

Sharia Supervisory Boards (SSBs) are established within the structure of Islamic financial institutions (IFIs) to ensure the credibility of sharia-compliance. In sharia governance, the SSB is the main tool which IFIs apply to be presumed as sharia-compliant. However, the insertion of this body into the internal structure of the corporation can prove challenging, as this body, with its powerful authority, is unknown to the structure of the corporation. The role of sharia supervision performed by SSBs requires a high level of independence, which is significantly compromised in its current structure.

While many researchers have identified conflict of interests surrounding the structure of SSBs and proposed suggestions, this thesis rethinks the entire structure of SSBs to make them more consistent with the well-known corporate governance mechanisms. The thesis examines the nature of SSBs’ roles and concludes that these are more closely aligned gatekeeping. More specifically, their roles are similar to those of external auditors, and so the SSBs should be structured as such. This requires a separation of the SSB’s roles to be reassigned to different institutions.

Regarding the sharia standard-setting role, the thesis suggests establishing a national Sharia Standard-setting Board to be the exclusive authority for issuing sharia standards for the Islamic finance industry. This body should overcome the limitations existing within similar bodies in certain jurisdictions where SSBs are granted wide legislative authority. To assess the auditing roles of SSBs, the thesis analyses the accountability framework of sharia governance. It argues that sharia firms provide a better alternative for conducting independent external sharia auditing. Also, a regulatory authority needs to be implemented for more effective accountability and to serve the unique stakeholders of sharia-compliance. The thesis concludes by proposing an SSB-free model which promotes sharia supervision as a profession and so, in turn, the whole industry of Islamic finance.
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# Abbreviations

<table>
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<tr>
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<th>Explanation</th>
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<tbody>
<tr>
<td>AAOIFI</td>
<td>the Accounting and Auditing Organization for Islamic Financial Institutions</td>
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<tr>
<td>AICPA</td>
<td>The American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>BDC</td>
<td>The Banking Disputes Committee in Saudi Arabia</td>
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<tr>
<td>BSU</td>
<td>The Board of Senior Ulama (Scholars) in Saudi Arabia</td>
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<tr>
<td>CIFA</td>
<td>Certified Islamic Finance Analysts graduated from the Institute of Finance in Saudi Arabia</td>
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<tr>
<td>CPC</td>
<td>The Commercial Paper Committee in Saudi Arabia</td>
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<tr>
<td>CRLO</td>
<td>The Permanent Committee for Scientific Research and Legal Opinions in Saudi Arabia</td>
</tr>
<tr>
<td>CSCD</td>
<td>The Commission for the Settlement of Commercial Disputes in Saudi Arabia</td>
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<tr>
<td>CSR</td>
<td>Corporate Social Responsibility</td>
</tr>
<tr>
<td>DSN</td>
<td>The National Sharia Council in Indonesia</td>
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<tr>
<td>FASB</td>
<td>The Financial Accounting Standards Board in the U.S.A</td>
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<tr>
<td>FCA</td>
<td>The Financial Conduct Authority in the UK</td>
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<tr>
<td>FRC</td>
<td>The Financial Reporting Council in the UK</td>
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<tr>
<td>GAZT</td>
<td>The General Authority of Zakat and Tax in Saudi Arabia</td>
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<tr>
<td>GCC</td>
<td>The Gulf Cooperation Council (Bahrain, Emirates, Kuwait, Oman, Qatar and Saudi Arabia)</td>
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<tr>
<td>IAHs</td>
<td>Investment Account Holders</td>
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<tr>
<td>IAS</td>
<td>The International Accounting Standards</td>
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<tr>
<td>IDB</td>
<td>The Islamic Development Bank</td>
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<tr>
<td>IFIs</td>
<td>Islamic Financial Institutions</td>
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<tr>
<td>IFRS</td>
<td>The International Financial Reporting Standards</td>
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<td>IFSB</td>
<td>The Islamic Financial Services Board</td>
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<tr>
<td>IICRA</td>
<td>The International Islamic Centre for Reconciliation and Commercial Arbitration</td>
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<tr>
<td>IIFM</td>
<td>The International Islamic Financial Market</td>
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<tr>
<td>IIFS</td>
<td>Institutions Offering Islamic Financial Services</td>
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<tr>
<td>IIRA</td>
<td>The International Islamic Rating Agency</td>
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<tr>
<td>IOF</td>
<td>The Institute of Finance in Saudi Arabia</td>
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<tr>
<td>NCB</td>
<td>The National Commercial Bank in Saudi Arabia</td>
</tr>
<tr>
<td>NHM</td>
<td>The Bank of Nederlands Handel-Maatchappij</td>
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<tr>
<td>OECD</td>
<td>The Organisation for Economic Co-operation and Development</td>
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<tr>
<td>OIC</td>
<td>The Organisation of Islamic Conference</td>
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<tr>
<td>PCAOB</td>
<td>The Public Company Accounting Oversight Board in the U.S.A</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>PLS</td>
<td>Profit-and-loss Sharing</td>
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<td>SAC</td>
<td>The Sharia Advisory Council in Malaysia</td>
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<td>SAMA</td>
<td>The Saudi Arabian Monetary Agency</td>
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<tr>
<td>SAR</td>
<td>Saudi Arabian Riyal</td>
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<tr>
<td>SEC</td>
<td>The Securities and Exchange Commission in the U.S.A</td>
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<td>SOCPA</td>
<td>The Saudi Organization for Certified Public Accountants</td>
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<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
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<td>SSB</td>
<td>Sharia Supervisory Board</td>
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<tr>
<td>TADAWUL</td>
<td>The Saudi Stock Exchange</td>
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<tr>
<td>USD</td>
<td>United States Dollar</td>
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<td>WTO</td>
<td>The World Trade Organization</td>
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Chapter One: Introduction

1.1 Background and Importance of the Research

The opposition within Islamic law to interest-based loans has led Muslims to find alternatives to modern financial services. As a result, Islamic banking has emerged to provide financial alternatives based on sharia principles which have been used to develop its own modes of finance to substitute for interest-based loans. Consequently, the sharia governance concept has evolved as a mechanism parallel to corporate governance to ensure sharia-compliance in Islamic financial institutions (IFIs). This has resulted in the incorporation of sharia principles within the objectives of corporations. Such incorporation, however, is unfamiliar to corporation theory and has driven many discussions about the theory of corporations in the case of IFIs and sharia governance. As a new concept to corporations, sharia governance, which requires some unique mechanisms and bodies, faces challenges regarding to accommodating its framework within corporate governance. One of the biggest challenges is how the sharia supervisory board (SSB) fits into the corporate governance structure, which is the focus of this thesis.

Islamic banking commenced in the middle of the last century and received little attention until the end of that century. Since then, the Islamic financial market has expanded both horizontally, as more IFIs have been established, and, vertically, as more Islamic financial products have been invented. The interest of Islamic finance is not limited to Muslims but it also attracts non-Muslims too. Luxemburg has emerged as one of the most important centres for Islamic finance in the world.1 Recently, the UK announced that it would become the western centre for Islamic finance.2 The industry is

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1 Deloitte, 'Islamic Finance at Deloitte: No Interest but Plenty of Attention' (2016) at 3
2 Sabuhi Gard, 'Islamic Finance Gets Competitive' Investors Chronicle (London 06/11/2014)

<http://leeds.summon.serialssolutions.com/2.0.0/link/0/eLvHCXMwnV1LSwMxEB6qC0UQtD7W-iJ_YNem2UdzENFqKdhTKT5OZXeTiLBWa1f8-06mTRG1F48hECbj8M1kMljMfGiHrAHJnCppSnQW0eDaJRA4DRKaiViU8hWklMR_CAaXUXDu3hYA0fhurhtB5KE3Qq1sEHZm46eue8CV4s7F2zSwNFL2u9VxamQLrgV1zm0D9TXwuG0uhwf3j8uvxmkIlLeeRCG8_gXlJOVW61bvox6_SFS-Jm9hCUam5mr__qPiNVQRPOk5PsWr2OXc_VpQE1PdqDukuF3gZHGPbIUMGOzZ50NWMF-dqUdLQH72bUbcfOEnHqHzHlpKptlfxT5sZjaJiURsZ3ywT008dq3VsjhHntQf5CD607_1jSTnwwnFFFWDifDxJ2kQOhOKBnEQWlE9MxxOfIrMMxO1RDvN4kQkkeKqCf4KeQ5XzhzBBnoperERUAJsewXr1_6BPw6M C_APbesTo> accessed 30/07/2015
now growing and developing considerably to become an important element of the world economy. In 2017, the industry’s assets exceeded USD 2 trillion, marking an 8.3% growth in the previous year. This is estimated to surpass USD 3 trillion by 2020 and to be doubled by 2025. Although this is a modest figure compared to the world’s total financial industry, Islamic finance is continuing to gain systematic importance within several jurisdictions. Islamic financial assets to total financial assets in the regions of the Gulf Cooperation Council (GCC), Middle East and North Africa (MENA), excluding GCC, and Asia are 42%, 29.1% and 24.4% respectively. In these regions, the future of the Islamic financial market appears promising. Between 2010 and 2014, the sharia-compliant assets in these regions experienced a strong growth rate of 16%.

However, the development of the market has attracted insufficient legal attention, and the market requires essential legal improvements. It has been suggested that the lack of a clear and consistent legal framework obstructs the development of the market. The problem includes sharia supervision, which is a unique mechanism that Islamic banks use to ensure that their products are sharia-compliant. This is usually implemented by a Sharia Supervisory Board (SSB), a special board or committee that is supposed to wield superior power to the board of directors with regard to sharia-compliance issues. While this mechanism provides solutions for the prohibited financial products provided by conventional banks, its structure, in practice, creates problematic legal issues, as this body is unfamiliar to the way that governance in corporations is structured. This research aims to highlight the legal problems associated with the current practice of sharia supervision and to propose a more appropriate framework that overcomes these problems.

In addition to the growing interest of the market globally and nationally, the significance of this study is due to the need of the market for more legal academic work to promote the development of the Islamic banking industry. While this industry has

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4 Abid Shakeel, *Islamic Megabank: The Redeemer*? (Deloitte 2016) at 21
5 GCC comprises of six countries: Bahrain, Emirates, Kuwait, Oman, Qatar and Saudi Arabia.
8 Islamic Financial Services Board, *Islamic Financial Services Industry Stability Report 2018* (n 3) at 121
received considerable economic and financial academic attention, the legal academic research in this area remains limited. More specifically, sharia supervision provides the research with special significance. The legal reform of sharia supervision is, arguably, the first important step that should be taken in developing Islamic finance. Sharia supervision is the source of trust for stakeholders of sharia-compliance who rely on their belief in the independence and objectivity of the decisions of sharia supervision. Thus, this trust should be maintained and sharia supervision should not, at least from the stakeholders’ perspectives, be influenced by any non-sharia matters, such as the profitability of the bank. For sharia supervision to be independent and effective, a strong sharia governance mechanism is required. Restructuring the SSB to achieve these objectives more effectively would provide the Islamic financial market with a new, stronger legal framework, and also enhance the professionalism of the practice of sharia supervision instead of being perceived as more of a religious practice. Such a legal reform provides the basis for preparing the market to produce more reliable and creative financial products.

1.2 Aims and Objectives

This research aims to undertake a critical analysis of the SSB frameworks and practices and to explore the factors which affect its independence as well as the effectiveness of its decisions. It substantially analyses its roles and responsibility, power and authority, and the accountability framework that is established for it. The research examines the deficiencies within the current structure and the governing rules of sharia supervision. The research also compares the SSB with similar bodies and committees within corporate governance, by way of an analogy in order to suggest what could be applied to the practice of sharia supervision. This assists the production of an optimal model that is consistent with the objectives of Islamic banks through importing the internationally-accepted governance standards and professional practices.

The primary aim of this research is to answer this main question: how should the SSB be restructured to be more effective, independent and impartial for the stakeholders of sharia-compliance in IFIs?
More specifically, to address this main question, the following secondary questions will be answered:

- Why do IFIs and sharia governance require greater legal consideration?
- What is the nature of the SSBs’ roles? And how do these roles fit into the corporate governance structure?
- What are the factors that affect the impartiality and independence of the current model of SSBs?
- Why must, and how might, sharia rulings in the industry be more effectively standardised?
- What is the nature of sharia interest and how is it satisfied? How may an appropriate accountability framework for it be developed? And who is accountable, for what, and to whom?
- How might the proposed model of sharia governance improve both the professional practice of sharia supervision and the industry as a whole?

1.3 Research Context

The issues discussed in this thesis are generally theoretical in nature, concerning the concept of sharia governance and sharia supervision in IFIs. To different extents, these issues are common in the industry, which could apply to all jurisdictions. The research, however, addresses Saudi Arabia as a focus jurisdiction to provide clearer specification and be the main reference for the cases and examples discussed and analysed in the research. Nevertheless, comparisons will be drawn, to some extent, with some of the leading jurisdictions in the industry to highlight the various applications and approaches of sharia supervision and governance. This analysis and comparison are extended to the sharia governance standards set by international organisations, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).

The jurisdiction of Saudi Arabia represents an important case in the Islamic banking industry. The country is considered one of the key driving forces in the Islamic financial market. The sharia-compliant assets in the country represented 51.5% of the total
domestic banking sector and accounted for 20.4% of the whole global Islamic assets in the first half of 2017.\textsuperscript{9} It is estimated that the country will experience a significant growth in the industry and that its sharia-compliant assets will increase, both domestically and globally. From USD 343 billion in 2015, sharia-compliant assets might reach USD 766 by 2020.\textsuperscript{10} This growth is motivated by the strong demand by customers, both retail and corporate, which may increase the sharia-compliant assets in the country to 70% of the domestic assets within the banking industry by 2019.\textsuperscript{11}

In addition to the economic size of its market, the Saudi jurisdiction constitutes an important legal case as a reference. The legal system in the country is passive in regard to Islamic financial services, including sharia supervision. Its attitude toward the legal recognition of the industry represents an example of extreme legal negligence. This provides a good case for analysing the effect of legal negligence on this growing industry within an important jurisdiction.

Another factor to consider in the context of this research is its scope within the Islamic finance industry. While many of the issues discussed apply to different sectors of IFIs, such as Islamic banking, Islamic insurance, \textit{takaful}, the capital market, and other financial institutions, this research focuses mainly on Islamic banking. The banking industry was chosen for more specification and to provide clear examples in the discussion, since it is the most dominant and important sector of the Islamic finance industry. This is not to suggest that the outcome of the research does not apply to the other sectors, as the same sharia supervision framework tends to apply in all of these. However, some issues might require further analysis to ensure the framework’s accurate application in these other sectors.

1.4 Originality

As stated above, the legal aspect of Islamic finance needs more academic research to help the industry to identify an appropriate legal framework for itself. The legal structure of sharia supervision has been discussed to some extent so far, but not in

\textsuperscript{9} Ibid at 11
\textsuperscript{10} EY, \textit{World Islamic Banking Competitiveness Report 2016} (n 7) at 18, 48
\textsuperscript{11} EY, ‘World Islamic Banking Competitiveness Report 2014-2015’ (2014) at 60
sufficient depth. More specifically, the issue of independence is discussed in literature as a problem facing SSBs. The literature highlights the conflict of interests surrounding the SSB body and suggests improvements regarding its structure. This research, however, constitutes an attempt to rethink the entire practice of sharia supervision and restructure it more effectively and independently, regardless of the current structure of SSBs. In an endeavour to propose a new legal framework, the nature of the roles of SSBs will be assessed in depth, under corporate governance principles. The practice of auditing, which is a professional task that is very close in nature to sharia supervision, will be analogically compared in order to import the standards and structural components that may make it possible for sharia supervision to be accommodated more logically within the corporate governance structure and so achieve its objectives more effectively and independently. While several limited comparisons have been drawn between sharia supervision and auditing, these are not comprehensive and, more importantly, do not relate to the context of restructuring the practice of sharia supervision. This research is unprecedented in comprehensively analysing the nature of SSBs’ roles and how they fit within its structure in order to propose an alternative framework for SSBs that matches their objectives.

Furthermore, the research analyses in depth the concept of accountability within sharia governance, presenting original perspectives about the elements and players of accountability within sharia governance. Based on this discussion, the research proposes a new framework for sharia supervision that replaces SSBs.

Additionally, the focus jurisdiction, Saudi Arabia, lacks academic research that analyses and highlights the legal status of its Islamic banking field. In this context, the research discusses several issues that have been largely neglected to date in the academic field and highlights some important problems associated with Islamic banking and sharia supervision.

1.5 Methodology

A proper methodology that is consistent with the problem identified in the research is a very important step toward achieving its objectives. In theoretical research, the
relationships between the existing approaches and their relevant and contextual theories are examined.\textsuperscript{12} As mentioned before, this research is concerned with the current framework of sharia supervision within Islamic banking. This relatively new concept needs more theoretical research to improve its model and practice. Its framework must be smoothly adopted within the corporation structure. Therefore, the research is, primarily, desk-based to examine and critically analyse the existing framework of sharia supervision in order to propose a more appropriate one.

Within this theoretical research, different methodologies are followed to analyse the framework for sharia supervision. Parts of the research may be categorised as doctrinal research, which is defined by the Pearce Committee as “research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty, and, perhaps, predicts future developments”.\textsuperscript{13} The doctrinal aspect of the research encompasses discussions that explore the regulations governing Islamic banking and SSBs in certain jurisdictions, mainly Saudi Arabia.

Structural analysis is a comparative method employed in this research. One of its basic applications is to identify a common structural core between different legal systems.\textsuperscript{14} In the analysis of SSBs, the research identifies several common characteristics within the SSB structures in the industry for the critical analysis. Also, the research compares the structure of auditing with sharia supervision to identify the common characteristics of both. In this comparison, an analytical method is also employed. This involves a deep examination of certain concepts in different contexts, which might appear similar or different, to distinguish whether these differences and commonalities between the legal systems are genuine.\textsuperscript{15} This research entails an in-depth analysis of SSBs within the sharia governance framework to examine some of the

\begin{itemize}
\item \textsuperscript{12} Sanne Taekema, ‘Theoretical and Normative Frameworks for Legal Research: Putting Theory into Practice’ (2018) Law and Method 1 at 1
\item \textsuperscript{13} Terry Hutchinson and Nigel Duncan, ‘Defining and Describing What We Do: Doctrinal Legal Research’ (2012) 17 Deakin Law Review 83 at 101
\item \textsuperscript{14} Mark Van Hoecke, 'Methodology of Comparative Legal Research' (2015) Law and Method 1 at 13
\item \textsuperscript{15} Ibid at 14
\end{itemize}
differences and commonalities between this phenomenon and corporate governance, which might not appear as such.

In comparing sharia supervision and auditing, an analogical comparison is applied in the analysis. This is when two different objects, structures or forms, which do not descend from a common ancestor, are compared in order to identify any similarities between them.\(^{16}\) This comparison intellectually involves “comparing the relations and aspects between the objects and not the objects themselves”.\(^{17}\) This research compares the practices of auditing, as a well-established phenomenon which shares many of the objectives of sharia supervision, and sharia supervision, as a pre-mature practice. The aim of this comparison is to determine whether or not sufficient similarity exists to restructure the practice of sharia supervision to make it more similar to the structure of auditing. This analysis could also be categorised as normative or evaluative in nature. That is to explore whether a legal framework is effective or not; in other words, whether or not a specific structure is legally designed to achieve its objectives.\(^{18}\) This evaluative analysis requires an internal framework which is derived from the legal system subject to evaluation and an external framework, which refer to the optimal theoretical frameworks that should be applied.\(^{19}\) Here, the framework of sharia supervision would be evaluated with the governance principles generally accepted globally within corporations. Evaluative research tends to produce recommendations for improvement and corrections to the evaluative framework.\(^{20}\) To propose such recommendations, inductive reasoning is applied during the analysis. This is described as reasoning from specific cases to a general rule which is applied to help to fill the gap

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\(^{16}\) Dawn Watkins and Mandy Burton, Research Methods in Law (Routledge 2013) at 106

\(^{17}\) Ibid at 106

\(^{18}\) Taekema, 'Theoretical and Normative Frameworks for Legal Research: Putting Theory into Practice' (n 12) at 6-7


\(^{20}\) Taekema, 'Theoretical and Normative Frameworks for Legal Research: Putting Theory into Practice' (n 12) at 7
in the law and propose a general framework where a factual situation lacks legal recognition.\textsuperscript{21}

Since the research aims to identify a more appropriate method for sharia supervision to be practised, it could be categorised within the theme of reform-oriented research. According to the Pearce Committee,\textsuperscript{22} this type of research is one “which intensively evaluates the adequacy of existing rules and which recommends changes to any rules found wanting”.\textsuperscript{23} Reform-oriented research is concerned with problems within existing rules and what changes are required.

1.6 Structure of the Thesis

This research contains this chapter as a preliminary one which introduces the research by providing its background, importance, originality, methodologies, and aims and objectives. It also describes the main research idea. The remainder of the research is structured as follows:

**Chapter Two** follows the introduction and offers a theoretical and historical background to Islamic banking and its mode of finance. The chapter explains Islamic law’s position regarding the financial contracts provided by conventional banks and describes the sharia-compliant solutions to finance. The chapter tracks the history and development stages of the idea of Islamic banks. It also introduces the term “sharia governance” and presents a theoretical discussion about how it is adopted within corporation theory.

**Chapter Three** argues for the importance of having a separate, comprehensive regulation of Islamic banks. For illustration, the Islamic banks’ situation within the Saudi banking system is discussed. The chapter provides a historical background of the banking system in the country and sheds light on the paradox the country faces due to adopting an Islamic-based legal system and a conventional banking system. In this

\textsuperscript{22} After law became a well-established academic discipline in Australia, the committee reviewed the law research conducted in the Australian law schools in order to put law research in categories. Hutchinson and Duncan, ‘Defining and Describing What We Do: Doctrinal Legal Research’ (n 13) at 101
\textsuperscript{23} Ibid at 101
respect, the chapter highlights the challenges that both Islamic and conventional banks face in Saudi Arabia.

Chapter Four analyses the roles of the SSB as an important body within the sharia governance system. It examines and analyses the nature of these roles in order to compare them with corporate governance principles. It also compares SSBs with certain bodies that exercise similar functions to SSBs.

Chapter Five discusses the consistency of sharia rulings and the need for the standardisation of Islamic financial products and decisions. It describes the effect of standardisation on both sharia governance and the market, and analyses the problem of assigning the SSB the role of setting sharia standards for its relevant institutions. Also, it explores the level of standardisation needed to ensure more impartial, trustworthy decisions.

Chapter Six examines the SSB’s accountability and how it affects its independence. It highlights the factors that might cause the SSB members to experience conflict of interests. In light of the nature of sharia interest, the chapter explores how the accountability of sharia supervision should be addressed. It identifies and analyses the various players and elements of accountability within sharia supervision which need to be considered. Then, it proposes how accountability should be conducted.

Chapter Seven builds on the previous discussions and analysis to propose an SSB-free model of sharia supervision that overcomes its current defects. The chapter explains the roles of the various players within the model. It then moves on to describing the effect of the model on professionalising the practice and improving the industry. The chapter also discusses the applicability of the model and reviews the opportunities and challenges that the model may face.

Chapter Eight concludes by summarising the main ideas presented in the research.
2.1 Introduction

Islamic banking is a result of the integration of sharia principles into financial entities. This causes significant changes in the banking structures, requirements, and products offered. To produce sharia-compliant products and operations, Islamic rules have been introduced into banks. This has resulted in uniquely designed financial instruments and products which have been developed instantly to meet the financial needs. Associated with this, sharia governance has also been introduced in parallel to corporate governance in order to ensure the sustainability and credibility of the operation and products offered.

It is the aim of this chapter to highlight the historical, theoretical and theological issues surrounding Islamic banking in order to describe the context of sharia supervision. These issues provide an explanation of the foundation of the Islamic banking system that helps to understand the justifications of the need for sharia governance as well as sharia supervision as developing concepts. This will also provide a better understanding of the special characteristics and requirements of Islamic finance, which the framework of sharia governance and supervision should acknowledge and address.

2.2 Islamic Law and Interest

2.2.1 What Is Islamic Law?

Islamic law, or sharia, is a set of rules and principles that regulate all aspects of life, and to which Muslims must adhere. Muslims’ actions and behaviour are bound by the duties and practices of sharia. These duties include worship, prayers, manners and morals, marriage, inheritance, crime and commercial transactions.24 The rulings of Islamic law are derived from two main sources: the Qur’an and Sunnah.

24 Latifa M. Algaoud and Mervyn K. Lewis, Islamic Banking (Edward Elgar 2001) at 16
The first main source is the Qur’an, which is the holy book for Muslims. The Qur’an is defined as “the collection of the revelations to Prophet Mohammad”\textsuperscript{25} from Allah (God). However, it should be noted that the Qur’an is not a legal text. In fact, legal verses in Qur’an are scarce, considering the number of verses that it contains. It is estimated that only 500 of its orders can be characterised as legal rules, 20 of which are related to economic issues.\textsuperscript{26} Furthermore, the legal verses in the Qur’an tend to be general orders, without any detailed explanation. Verses like, “O you who believe! Fulfil your obligations”\textsuperscript{27} and “Allah (God) has permitted trading and forbidden riba (usury)”,\textsuperscript{28} are examples of how general the legal verses are in the Qur’an. There are several exceptions, however, regarding certain issues related to, for example, marriage and inheritance.\textsuperscript{29}

For that reason, Sunnah provides an explanation and supplement of the Qur’an. Sunnah comprises the reported sayings and actions of the Prophet Mohammad, as well as the practices that he witnessed and approved of implicitly.\textsuperscript{30} Although Sunnah is more detailed and contains further legal explanations, it is, also, general in nature. Nevertheless, the general content of these two sources combined has strengthened their impact as sustainable legal sources that are sufficiently flexible to treat and deal with various new matters that have emerged over the centuries.

The flexibility of the legal contents of these main sources means that most legal matters cannot be answered directly based on the text of the Qur’an or Sunnah. Therefore, qualified scholars of Islamic law, due to their responsibility for understanding the main sources, are required to make efforts to interpret the revealed texts, the Qur’an and Sunnah. Such an effort is called \textit{ijtihad}, which means “striving”.\textsuperscript{31} The collective effort made by scholars has established a new science called \textit{fiqh}, which literally means

\begin{itemize}
\item \textsuperscript{25} Ibid at 21
\item \textsuperscript{26} Ibid at 21
\item \textsuperscript{27} Muhammad Taqi-ud-Din Al-Hilali and Muhammad Muhsin Khan, \textit{Translation of the Meanings of the Noble Qur’an in the English Language} (King Fahd Complex for the Printing of the Holy Qur’an 1984) at 5:1
\item \textsuperscript{28} Ibid at 2:275
\item \textsuperscript{29} Mahmoud A. El-Gamal, \textit{Islamic Finance: Law, Economics, and Practice} (Cambridge University Press 2006) at 27
\item \textsuperscript{30} Ibid at 28
\item \textsuperscript{31} Frank E. Vogel, \textit{Islamic Law and Legal System: Studies of Saudi Arabia}, vol 8 (Brill 2000) at 4
\end{itemize}
“understanding”. *Fiqh* as a science is an intellectual and technical effort made by the scholars of Islamic law to develop a methodology for understanding the *Qur'an* and *Sunnah* (traditions of the Prophet) and to derive laws from them.\(^{32}\)

When applying sharia to a certain matter, scholars use different tools to decide the ruling of sharia on that particular case. *Qiyas* is one of these main tools. It is defined as analogical reasoning using past analogies with their decisions as precedents in each new situation.\(^{33}\) Scholars may reach different rulings on the same matter even when using the same tool, since logical reasoning can differ from one mind to another. The opinions of scholars, therefore, are uncertain and considered probable beliefs about God’s real judgment. Except for rulings that receive *ijma*, which means “consensus” and refers to the unanimous agreement of all qualified legal scholars of an age upon a legal ruling, there is a level of uncertainty about the opinions of Islamic law scholars.\(^{34}\)

A legal matter that is subject to *ijtihad* by a scholar is eventually categorised under one of the five rulings of Islamic law. The first ruling is prohibition. This ruling refers to an impermissible act that individuals must avoid or they will be punished. Obligatory is the second ruling in Islamic law. Disobeying the rulings under this category is punished. Punishment, however, in these two rulings does not have to be material or even in this life, as Muslims’ obedience is a moral and spiritual commitment to Islam. Actions which are recommended with no punishment if they are not performed are called recommendations. The fourth ruling is disapproved, which comprises actions that are considered wrong although no punishment will follow if they are conducted. The final ruling is neutral and involves the remaining actions that Muslims can freely choose to perform or not.\(^{35}\)

As indicated above, there is a space for different opinions within Islamic law. This started after the death of Prophet Mohammad (PBUH) when his companions and


\(^{33}\) Algaoud and Lewis, *Islamic Banking* (n 24) at 23

\(^{34}\) Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, vol 16 (Brill 2006) 32 at 32; Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (n 31) at 45

scholars discussed different interpretations of the rules of the Qur’an and Sunnah. Khan states that the different methodology of interpretation used by scholars, the use of various related disciplines such as logic, and the different circumstances faced by scholars are the three main reasons why differing opinions have developed since the death of Prophet Mohammad (PBUH). These differences rest upon the idea that no one can exclusively claim the divine truth and, therefore, the differences between scholars are welcomed in sharia provided that their opinions do not conflict with the obvious rulings of Islam. In fact, some prominent scholars have explicitly declared the right of others to adopt different opinions.

The divergence of opinions among scholars gradually developed into more organised schools, from which eventually grew four slightly different schools of thoughts in the Sunni Muslim world: Hanafi, Maliki, Shafi'i, and Hanbali. Most scholars follow one of these schools and their opinions, over the centuries, have been preserved and handed down. Different mechanisms are used by these schools to evaluate and balance their scholars’ views in order to identify which is the strongest. Through this process, schools have been developed to adopt a specific position on all matters pertaining to Islamic law.

2.2.2 Interest and the Prohibition of Riba under Islamic Law

As part of Muslims’ adherence to Islamic law, their actions must not conflict with the rules of Islamic law regarding commercial and financial transactions. This means that they must avoid any contract that is prohibited or contains prohibited terms. The practice of modern conventional banking has caused some concern among Muslims, mainly because of the attitude of Islamic law towards the interest charged on loans or other credit provided, which is viewed as a practice of riba by most scholars of Islamic law. So, what is riba and how is interest related to it?

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36 Algaoud and Lewis, Islamic Banking (n 24) at 21
37 Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 292
38 For example, Chapter Five refers to the attitude of a prominent scholars who refused to impose his religious opinions as a law to acknowledge the right of other scholars to have different interpretation.
39 Algaoud and Lewis, Islamic Banking (n 24) at 21
40 Vogel and Hayes, Islamic Law and Finance: Religion, Risk, and Return (n 34) at 33-34
Riba is an Arabic word which literally means “increasing”. The prohibition against being involved in a transaction containing riba is definite in Islamic law and strongly addressed in both the Qur'an and Sunnah. However, what constitutes the practice of riba is debated by scholars. Although the term is commonly used for “interest” in the context of Islamic banking, the technical definition of riba is far more complicated due to the different interpretations regarding what it covers. The term, as generally agreed in Islamic law, may be defined as:

“An unlawful gain derived from the quantitative inequality of the counter-values in any transaction purporting to affect the exchange of two or more species, which belong to the same genus and are governed by the same efficient cause (illa). Deferred completion of the exchange of such species, or even of species which belong to different genera but are governed by the same illa is also riba, whether or not the deferment is accompanied by an increase in any one of the exchanged counter-values”.41

Based on this definition, two important points should be noted regarding the extent of riba. First, increase is only qualified as riba if the counter-values traded: 1) belong to the same genus, and 2) are governed by the same efficient cause (illa) which is defined as “the attribute of an event that entails a particular divine ruling in all cases possessing that attribute. It is the basis for applying analogy (qiyas) to the two cases”.42 The absence of either of these two conditions qualifies the trade as a lawful sale, as indicated in the Qur’an: “Allah (God) has permitted trading and forbidden riba (usury)”.43 Second, riba prohibition is not exclusive to an increase, as the deferred exchange, even without increase, of different counter-values is riba if they are governed by the same efficient cause. Therefore, there are two different types of riba: riba al-fadl and riba al-nasi’a.44 While the former concerns what qualifies the increase to be riba, whether the exchange of 100x for 110x is riba, the latter concerns what qualifies the deferred

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41 Nabil A. Saleh and Ahmad Ajaj, Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar, and Islamic Banking, vol 2nd (Graham & Trotman 1992) at 16
42 Vogel and Hayes, Islamic Law and Finance: Religion, Risk, and Return (n 34) at 75
43 Al-Hilali and Khan, Translation of the Meanings of the Noble Qur'an in the English Language (n 27) at 2:275
44 Saleh and Ajaj, Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar, and Islamic Banking (n 41) at 16
exchange to be *riba*, whether the exchange of A for B at a later time is *riba*. In both types, the efficient cause (*illa*) plays an important role in concluding whether *riba* applies or not. In fact, determining the governing efficient cause (*illa*) has sparked a debate among scholars regarding to what *riba* applies. What is important in this context is whether or not interest is a classification of *riba*.

The practice of interest in modern banking has sparked debate, although on a far smaller scale, between modernists and conservatives regarding whether or not *riba* extends to it. Modernists offer several justifications for arguing that the interest in modern banking is not subject to the prohibition of *riba* under Islamic law.\(^4\) However, this view has received strong criticism from conservatives, as it fails to “present a consistent theory of *riba* on the basis of the rationale of prohibition specified in the *Qur’an*”.\(^5\) The conservatives’ view has been adopted by the vast majority of scholars, as reflected in the decision of the Council of the Islamic *Fiqh* Academy which considers interest as a form of *riba*.\(^6\) Therefore, interest is usually viewed as *riba* regardless of the modernists’ point of view.

Apart from economic objectives,\(^7\) morals play an important role as a reason for this prohibition compared to the free market, where capitalists have the freedom to use their capital as they see fit. Transactions law in Islam has a spiritual aspect, where the contracting parties look to satisfy God in addition to themselves which, in some cases, requires them to abandon certain transactions or terms that they think might be beneficial to them in order to please God.\(^8\) It has been inferred that one of the main

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5. Ahmad and Hassan, ‘Riba and Islamic Banking’ (n 45) at 16.


7. Some resources browse and discuss some economic rationales behind the prohibition of *riba* and the use of profit sharing contracts instead. See for example: Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (n 34) at 82-87; Algaoud and Lewis, *Islamic Banking* (n 24) at 3; Tarek Zaher and Mohammad Kabir Hassan, ‘A Comparative Literature Survey of Islamic Finance and Banking’ (2001) 10 Financial Markets, Institutions & Instruments 155 at 158-159.

objectives and rationales behind the prohibition of *riba* is that interest has a nature which creates injustice and there is a need to protect weak people from exploitation.\textsuperscript{50} Looking at the punishment for breaching, the morality aspect of banning interest is more obvious as there is no material punishment. The only punishment mentioned in relation to interest is that whoever deals with it will enter into a declared war with God and his messenger, which does not necessarily have to be in this lifetime.\textsuperscript{51} This suggests a level of morality on the ruling of interest, as there is no associated material punishment.

### 2.3 Islamic Banking: History and Features

#### 2.3.1 The Emergence and Expansion of the Islamic Banks

The strong opposition to interest existing within the modern banking system inspired the idea of Islamic banking to emerge as interest-free banks. It started as an idea in the mid-1940s when it was suggested that the banks should be re-structured in order to become profit-sharing based instead of interest-based.\textsuperscript{52} This idea was accompanied by unsuccessful experiments in Malaysia in the mid-1940s, and then in Pakistan in the late-1950s.\textsuperscript{53}

However, the Muslim Pilgrims Savings Corporation (later *Tabung Haji*) in Malaysia and *Mit Ghamr* in Egypt were two examples in the 1960s that marked the beginning of the practice of Islamic finance. The former was established to help Malaysians to perform pilgrimage by investing their savings in accordance with Islamic law. Although it was not a bank, its success promoted the idea of establishing Islamic banks in Malaysia.\textsuperscript{54} On the other hand, *Mit Ghamr*, due to political reasons, lasted fewer than four years.\textsuperscript{55} Nonetheless, it is regarded as “a pioneering experiment of putting the

\textsuperscript{50} Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (n 45) at 28; Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (n 34) at 82; Algaoud and Lewis, *Islamic Banking* (n 24) at 3
\textsuperscript{51} Aldohni, ‘The Quest for a Better Legal and Regulatory Framework for Islamic Banking’ (n 35) at 21
\textsuperscript{52} Naseem Bukhari, ‘Islamic Banking Theory, Practice and Challenges’ (2006) 1 *The Journal of Commerce* at 86
\textsuperscript{53} Algaoud and Lewis, *Islamic Banking* (n 24) at 6
\textsuperscript{54} Ibid at 6
\textsuperscript{55} Ibid at 5
Islamic principles governing financial dealings into practice". The bank marked a successful attempt to integrate the German savings banks' experience into rural Egyptian towns using Islamic financial principles, without projecting an Islamic image, for political reasons.

These successful experiences were very important as they were the first to move Islamic finance from theory into practice in the form of official financial institutions. In 1971, Islamic finance was represented in the form of a bank for the first time when Nasser Social Bank was established by the Egyptian government for social objectives, such as providing interest-free loans for the poor, scholarships for students and microcredit for small projects on a profit-share basis. This step brought more formality and confidence to Islamic finance as it was provided by a bank and sponsored by a government which enhanced the experience of Islamic finance and gave it the support it needed at that time to develop. In fact, the 1970s experienced a remarkable development in the history of Islamic finance. In addition to Nasser Social Bank, two other banks were founded in the mid-1970s, which triggered the growth of the Islamic banking industry: the Islamic Development Bank (IDB), as an international bank for Islamic countries, and Dubai Islamic Bank, as the first commercial bank. IDB was established due to an agreement between the finance ministers of the Organisation of the Islamic Conference to finance necessary projects in poorer Muslim countries, and it contributed to the spread of the Islamic banking industry by subscribing to the capital of certain Islamic commercial banks within its member countries. The case of Dubai Islamic Bank was important since it brought Islamic finance to the private sector and created, for the first time, alternative banking services for customers seeking interest-

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57 Algaoud and Lewis, *Islamic Banking* (n 24) at 5
59 Iqbal, 'Development, History and Prospects of Islamic Banking' (n 56) at 82-83
60 Kahf, *The Rise of a New Power Alliance* (n 58) at 20-21
62 Kahf, *The Rise of a New Power Alliance* (n 58) at 21
free products, an advanced step which placed Islamic banking services on a par with conventional ones. Dubai Islamic Bank was followed by other commercial and investment banks in different countries besides the United Arab Emirates, such as Kuwait, Egypt, Sudan, Jordan, Bahrain, Switzerland and the Bahamas. In fact, Islamic banks experienced an important evolution after the development of the IDB and Dubai Islamic Bank. The period from 1975 to 1990 is described as the most important in the history of the development of Islamic financial history since it heralded vital developments.

Islamic banking, after this period, became more respected and credible in the banking industry and continued to grow, with a network of supporting institutions, such as:

1. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
2. The Islamic financial Services Board (IFSB).
3. The International Islamic Financial Market (IIFM).
4. The International Islamic Rating Agency (IIRA).
5. The International Islamic Centre for Reconciliation and Commercial Arbitration (IICRA).
6. The General Council of Islamic Banks and Financial Institutions (GCIBFI).

In the 1990s, Islamic banking successfully reached a wider range of customers and was adopted by the global banks. Warde highlights five phenomena that denote the development and expansion of the Islamic banking industry during this period:

1. More conventional banks established Islamic subsidiaries and/or Islamic windows to provide sharia-compliant products.
2. Global banks outside the Islamic world, such as HSBC and Citicorp, started offering Islamic banking services.
3. Islamic banks offered their products to non-Muslim customers.

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64 Iqbal, ‘Development, History and Prospects of Islamic Banking’ (n 56) at 83
65 Ibid at 84
4. Many Islamic banks were established outside the Islamic world to serve the Islamic communities.

5. Islamic finance became an area of research interest to some global institutions, such as Harvard University, and a growing amount of research conducted by sharia scholars and advisors resulted from the cooperation between the Islamic and conventional institutions.66

Three main factors led to the success of Islamic banking in the banking industry. First, the high demand for Islamic banking services contributed to their growth, as it provided solutions for strict adherents to the principles of Islamic law regarding *riba*. It also attracted other Muslims who were interested in sharia-compliant banking services as an alternative to the conventional ones. Second, *Tabung Haji*, Nasser Social Bank and IDB were established and funded by governments which play an essential role to spread Islamic banking services. One of the main reasons for the success of the first private Islamic bank, Dubai Islamic Bank, was the close relationship between its founder and the ruling family of Dubai.67 In fact, Islamic banks could not be successful when facing hostility from the government.68 The full Islamisation of the banking systems in Pakistan in 1979, and in Sudan and Iran in 1983, was a remarkable development in the history of Islamic finance.69 Third, the oil wealth of the Gulf States had a strong impact on the expansion of Islamic banks. Although the early experiments of the industry were unrelated to the oil wealth, the fast growth that followed these experiments tended to be funded by oil-rich countries.70

During this century, Islamic banking has become more confident and respected within the financial industry. Regardless of the legal challenges that the Islamic banking industry faces today, which require more effort in order to be developed, it has a brighter future and stands on stronger ground, as it has been adopted by many

66 Warde, *Islamic Finance in The Global Economy* (n 63) at 83-84
67 Kahf, ‘The Rise of a New Power Alliance’ (n 58) at 21
68 Algaoud and Lewis, *Islamic Banking* (n 24) at 6. The failure of *Mit Ghamr* is an example of this.
69 Warde, *Islamic Finance in The Global Economy* (n 63) at 74-75
70 Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (n 45) at 10
prominent financial institutions around the world in addition to the different types of support it receives from governments.

2.3.2 Features and Principles of Islamic Banking and Finance

While interest-based loans are the main tools of finance in conventional banks, Islamic banks are prohibited from involvement in any type of interest. Instead, they use a wide range of financial products which do not conflict with the rules of Islamic law. These products are derived from four general principles which constitute the main principles of Islamic banking and finance. In other words, these principles are the main differences and distinctions between Islamic banks and conventional ones. These principles are:

**Interest-free**

As explained above, there exists a semi-consensus regarding the prohibition of interest among scholars. In Islam, making money from money is not permitted since money is viewed as a tool of exchange instead of having a value in itself. Consequently, money provided for business or personal finance is regarded as a debt and therefore is not entitled to any return.\(^{71}\) Therefore, Islamic banks are not allowed to provide interest-based loans, only interest-free financial products are offered.

**More risk**

Islam, however, encourages investment if it is related to a useful project. To gain legitimate profits, money should be paired with human effort in a productive venture whereby the risk is shared between the parties so that no one receives a predetermined return.\(^{72}\) In the Islamic banking environment, this means that banks, by providing capital, should be exposed to some level of risk by entering into a venture where the profits cannot be guaranteed. The products of Islamic banks should reflect this and will be highlighted in the next section.

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\(^{71}\) Ahmad and Hassan, 'Riba and Islamic Banking' (n 45) at 17

\(^{72}\) Ibid at 17
Gharar-free

Risk is not always welcomed in Islamic law. While profits must not be guaranteed between the contracting parties, the parties should possess perfect knowledge about the content of the contract. Otherwise, the contract might be invalid due to gharar (uncertainty). Gharar can be caused by ignorance of the object, price, number or conditions of the counter-values exchanged or the excessive uncertainty of the outcomes, as in the case of gambling. Gharar is the main reason for prohibiting most types of insurance, which led to the creation and development of cooperative-based insurance, *Takaful*. Islamic banks, in this regard, are restricted from making any financial contract that is subject to gharar.

Financing only sharia-compliant projects

The restrictions on Islamic banks are not limited to the structure of the financial contracts but also extend to the projects that need to be financed as well. Finance in Islamic banks must not support prohibited projects, such as alcohol trading, gambling or prostitution. Accordingly, Islamic banks should review projects before financing them to ensure their compatibility with Islamic law principles.

These principles are the main characteristics that differentiate Islamic banking from conventional banking. Remarkably, risk is an important factor in the structure of Islamic finance. Apart from the last principle, which concerns the validity of the project that requires financing, risk is critical to the other principles, which concern the structure of financial products. In this context, Islamic law aims to allow moderate risk where it is limited to the profitability of the project. Neither interest nor gharar are allowed under Islamic law, since the former is a risk-free contract where the lender is guaranteed a percentage of the capital provided while the latter, on the other hand, is an excessive risk contract where critical information about the content of the contract is missing.

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73 Sherin Kunhibava and Shanthy Rachagan, ‘Shariah and Law in Relation to Islamic Banking and Finance’ (2011) 26 Banking & Finance Law Review 539 at 548-549; Zaher and Hassan, ‘A Comparative Literature Survey of Islamic Finance and Banking’ (n 48) at 158
74 Algaoud and Lewis, *Islamic Banking* (n 24) at 31
75 Ahmad and Hassan, ‘Riba and Islamic Banking’ (n 45) at 19
In addition to these principles, several researchers add others, such as paying zakat, which is 2.5% in alms that is taken annually from capital, and having a sharia advisory board. While it is necessary for Islamic banks to pay the annual zakat, it is not a special feature of Islamic banking, since it is compulsory to pay this under Islamic law in relation to all individual and institutional capital. Zakat is a separate requirement that is unrelated to the financial aspect of banking. In other words, the compatibility of financial products with Islamic law is unaffected if the bank does not pay its annual zakat and, vice versa, conventional products do not become Islamic as a result of paying it. Zakat is simply a form of tax required by Islamic law and, therefore, customers seeking Islamic finance should be unaffected if the bank does not pay its annual zakat. Even investors can legalise their investments by paying zakat from their profits if the bank does not, just as they might do in other types of business. A sharia advisory board is also not an Islamic banking principle, as it is simply a mechanism for ensuring compatibility with sharia. Consequently, banks could still be Islamic even if they do not appoint a sharia board. In fact, early experiments with Islamic finance and banking did not establish sharia boards. This does not mean that a sharia board is unimportant but it is merely a way of reviewing and checking the compatibility of products, so Islamic banks could still provide sharia-compliant products if they have an acceptable alternative mechanism to ensure compatibility with sharia. Sharia boards apply the principles of Islamic finance but are not a principle themselves.

2.4 Sharia-compliant Finance

Since IFIs must avoid the traditional method of financing customers, which relies on interest-based loans, they have developed alternative sharia-compliant tools for conducting financial transactions. This was a result of the partnership between Islamic banks and sharia scholars. Warde classifies the contracts used by IFIs into three

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76 See for example: Latifa M. Algaoud and Mervyn K. Lewis, 'Islamic Critique of Conventional Financing' in Kabir Hassan and Mervyn Lewis (eds), Handbook of Islamic Banking (Handbook of Islamic Banking, Edward Elgar 2007) at 38
77 Paying zakat is the third of five pillars in Islam.
78 Some states, such as in Saudi Arabia, require businesses to pay the annual zakat.
79 Kahf, 'The Rise of a New Power Alliance’ (n 58) at 20-21
categories: equity-based or profit-and-loss sharing (PLS) products, lease-based products, and sale-based products.\(^81\) These products will be highlighted since they are subject to the consideration of sharia review and supervision.

### 2.4.1 Sale-based Products

This type of product requires the bank to enter into two sale transactions: first as a buyer from a third party, then as a seller to the client. The most popular sale-products used by banks are *murabaha*, *salam* and *istikna*.

*Murabaha*, mark-up or cost plus sale, is defined as "a sale contract wherein one party purchases an asset and then sells it to another party for an agreed mark-up on deferred payment terms".\(^82\) To apply this in Islamic banks, the bank buys the specified asset from the vendor and the title is transferred to the bank, which then sells the asset immediately to the client at a mark-up price with deferred payment.\(^83\) It is important to note that the second sale contract, where the bank sells the asset to the client, must not be conducted before the asset has actually been transferred into the bank’s ownership and possession, in the sense that the asset becomes within its risk, since Islamic law considers selling the asset before it is owned by the seller as a void sale.\(^84\) Thus, what happens is that the bank and the client sign a promise, rather than an actual sale contract, that they will conduct the sale of the specified asset in the future on a *murabaha* basis.\(^85\) The enforceability of such a promise, however, is questionable under Islamic law and not free of restrictions in the view of the Islamic law scholars who accept it. Although there is a consensus among sharia scholars that fulfilling a promise is morally binding, they differ over the question of whether it is legally binding or not.\(^86\) The Council of the Islamic Fiqh Academy adopts the view of scholars who regard a

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\(^{81}\) Warde, *Islamic Finance in The Global Economy* (n 63) at 140-145

\(^{82}\) Ken Eglinton and others, ‘Accounting and Taxation Implications of Islamic Finance Products’ in Craig R. Nethercott and David M. Eisenberg (eds), *Islamic Finance: Law and Practice* (Islamic Finance: Law and Practice, Oxford University Press 2012) at 87

\(^{83}\) Ibid at 88

\(^{84}\) Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, vol 20 (Kluwer Law International 2001) at 42

\(^{85}\) Ibid at 43

\(^{86}\) Ibid at 50
promise as legally binding. However, the promise must, according to the academy, meet the following criteria:

- It must be conditioned upon the fulfilment of an obligation.
- The promisee must already have incurred expenses on the basis of the promise.
- At least one party to the mutual promise should have the option and not be bound by the promise. This is to avoid the ordinary sale contract where the seller must have the possession of the commodity, subject to sale.\(^\text{87}\)

According to this resolution, only one party, which is usually the client, is legally bound by the promise. This view on promises has opened up and facilitated a great number of deals and products besides *murabaha*, which depends on the promise being legally enforced, as will be illustrated below. *Murabaha*, however, is the most popular product due to its convenience as a short-term investment mechanism; the flexibility of matching the fixed return in *murabaha* to the interest rate; and the advantage of avoiding more risk and management interference regarding other products.\(^\text{88}\)

Exempted from the Islamic law rule of sale, that requires the sold item to exist at the time of sale, *istikana*, commissioned manufacturing, and *salam*, forward sale, are popular contracts employed by Islamic banks.\(^\text{89}\) *Istisna* is defined as, “a contract of sale of specified items to be manufactured or constructed with an obligation on the part of manufacturer (contractor) to deliver them to the customer on completion”.\(^\text{90}\) Using an analogous structure to *murabaha*, Islamic banks in practice apply a structure that combines *istikana* and back-to-back *istikana*, or parallel *istikana*, to finance manufacturing or construction, where “under the first *istikana* the bank as seller accepts a long-term schedule of payments from its customer, while under the second *istikana* the bank as buyer pays the manufacturer over a shorter period with progress payments. The

\(^{87}\) The Council of the Islamic Fiqh Academy, ‘Resolutions N 40-41 (2/5-3/5)’ (1988) (Resolutions and Recommendations of the Council of the Islamic Fiqh Academy, Fifth Session)
\(^{88}\) Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (n 45) at 78
\(^{89}\) Warde, *Islamic Finance in The Global Economy* (n 63) at 142-143
\(^{90}\) Eglinton and others, ‘Accounting and Taxation Implications of Islamic Finance Products’ (n 82) at 103
difference between the present value of payments under the two contracts is the bank’s compensation for the finance”.\textsuperscript{91} \textit{Salam} is a similar contract, which is defined as, “the forward purchase of generically described goods for full advance payment”.\textsuperscript{92} However, \textit{salam} has more restrictions which make it less favoured by banks. For example, payment must be made in full in advance and the delivery time must be exactly determined in the \textit{salam} contract, whereas there is more flexibility in the \textit{istisna} contract.\textsuperscript{93} These restrictions, especially the necessity for full advanced payment, prevent banks from financing their customers using the same structure of \textit{istisna}. \textit{Salam} is used to finance different sectors, mainly those related to agriculture, by buying their expected commodities at a lower price so that the bank, after the delivery, can profit by selling the commodity at the market price.\textsuperscript{94} Also, the bank can combine \textit{murabaha} with \textit{salam} to finance its customers. Accordingly, the customer enters into a \textit{murabaha} contract and promises the bank that he or she will buy a specified commodity on a specific date, after which the bank enters into a \textit{salam} contract with a third party, usually a manufacturer or contractor.\textsuperscript{95}

Although sale-based products appear to be similar to interest-based loans, risk which justifies profits under Islamic law is not present in the latter. Theoretically, Islamic banks, by using sale-based products, are exposed to some level of risk associated with the ownership of commodities. The bank assumes certain risks during the process of acquiring the asset before selling it to the client, such as a sudden fall in price, defects or damage related to the commodity and the default of the client where no late fees can be imposed and the client is only liable for the agreed sale price.\textsuperscript{96} These elements of risk differentiate sale-based products from conventional loans. While it is true, however, that such products may be inconsistent with the values of Islam, since these products serve similar economic objectives to interest, they still, in the view of many sharia scholars, constitute a legitimate alternative to interest-based loans. According to

\begin{itemize}
\item \textsuperscript{91} Vogel and Hayes, \textit{Islamic Law and Finance: Religion, Risk, and Return} (n 34) at 147
\item \textsuperscript{92} Ibid at 145
\item \textsuperscript{93} Usmani, \textit{An Introduction to Islamic Finance} (n 84) at 89
\item \textsuperscript{94} Ibid at 86
\item \textsuperscript{95} Vogel and Hayes, \textit{Islamic Law and Finance: Religion, Risk, and Return} (n 34) at 127
\item \textsuperscript{96} Algaoud and Lewis, \textit{Islamic Banking} (n 24) at 53; Vogel and Hayes, \textit{Islamic Law and Finance: Religion, Risk, and Return} (n 34) at 141; Kelly Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 Boston University International Law Journal 341 at 349
\end{itemize}
Chapra, the legitimacy of sale-based products rests upon two important points: avoiding a direct lending-borrowing relationship and depending on the price of the commodity or the service sold rather than interest. This legitimacy provides Islamic banks with a useful financial tool, especially in the jurisdictions that do not recognise Islamic banking services by special regulations. It is unfair to demand that Islamic banks abandon this tool while the whole financial and banking system is based on interest.

The distinction between sale-based products and interest-based loans remains, to some extent, theoretical. In practice, many banks apply manipulative tools to reduce the risk, although minimised, to zero and open a back door to interest. It is argued that the mechanism used by some banks makes the risk related to sale-based products, especially *murabaha*, unreal and so disqualifies the bank from being a true seller due to the lack of risk that commonly exists in trade where a sale is not completely certain. Saeed analyses the risk associated with *murabaha* in practice and identifies three types of risk: risk related to goods being lost or damaged; risk related to clients refusing to buy; and risk related to payment in the case of default. He argues that banks in practice avoid and eliminate these risks by applying different mechanisms which makes *murabaha* as it is practised no different, logically, from interest.

### 2.4.2 Equity-Based and PLS Products

Under this category, the bank establishes a partnership with its entrepreneur customers in a joint venture. As Warde stated, “the bank provides finance, while the entrepreneur carries out the business venture whether trade, industry, or service, with the objective of earning profits. Profits are shared in a pre-determined ratio; losses are borne by the bank”.

Using partnership agreements, Islamic banks have developed two main types of products: *musharaka* and *mudaraba*. In *musharaka* contracts, the Islamic bank provides

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98 Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (n 34) at 141
99 Abdul Ghafar Ismail and Achmad Tohirin, ‘Islamic Law and Finance’ (2010) 26 Humanomics 178 at 191
100 Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (n 45) at 84-95
101 Warde, *Islamic Finance in The Global Economy* (n 63) at 145
the needed capital while the client provides the remaining capital for the project which both may manage, similar to a joint venture, and the profits are shared at a pre-agreed ratio while any losses are borne proportionately to the equity participation. While both the bank and the client provide the capital in *musharaka* contracts, only the bank does so in *mudaraba* and the client acts as an agent, providing the professional, managerial and technical work. As with *musharaka*, profits are based on a pre-arranged ratio and, since only the bank provides the capital in *mudaraba*, losses are borne only by it while the client loses his/her effort.

Islamic banks have developed relatively new products based on *musharaka* and *mudaraba*, which are diminishing *musharaka* and diminishing *mudaraba*. Under these contracts, the bank’s share is gradually liquidated in favour of the client who increases his/her own share gradually by buying that of the bank until the client becomes the sole owner of the project. The bank earns profits usually by renting its share to the client. Consequently, the bank’s profits under these contracts diminish, as does its share of the project. However, these contracts contain a future sale of the bank’s share to the client. A sale contract that is contingent on a future date or event is void under Islamic law. Accordingly, it is unlawful to sign the sale contract for the bank’s share at the same time as the diminishing *musharaka* or *mudaraba* contracts. To solve this, parties to the contract sign a promise that the client will buy the bank’s share in the future. The enforceability of this promise is restricted to the same conditions and requirements discussed above. Diminishing *musharaka* and *mudaraba* contracts help Islamic banks to minimise the risk by obtaining fixed returns on their leased shares in the financed projects. By decreasing their ownership of the projects, their duty as

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102 Zaher and Hassan, ‘A Comparative Literature Survey of Islamic Finance and Banking’ (n 48) at 165-166
103 Eglinton and others, ‘Accounting and Taxation Implications of Islamic Finance Products’ (n 82) at 106
104 Zaher and Hassan, ‘A Comparative Literature Survey of Islamic Finance and Banking’ (n 48) at 165
105 Vogel and Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (n 34) at 138; Warde, *Islamic Finance in The Global Economy* (n 63) at 146
106 Usmani, *An Introduction to Islamic Finance* (n 84) at 31
107 Eglinton and others, ‘Accounting and Taxation Implications of Islamic Finance Products’ (n 82) at 109
108 Usmani, *An Introduction to Islamic Finance* (n 84) at 39,73
109 Ibid at 31
owners would be, also, minimised until completely diminished when they sell their last shares to their clients.

Islamic banks use the *mudaraba* mechanism not only to finance their customers but also, conversely, to provide capital for the banks. An investment account is a form of *mudaraba*, where customers, commonly called investment account holders (IAHs), deposit their money in the bank to be invested so the profits are shared at a pre-arranged ratio with the bank.\footnote{Eglinton and others, 'Accounting and Taxation Implications of Islamic Finance Products' (n 82) at 107; Warde, *Islamic Finance in The Global Economy* (n 63) at 148} By using this type of account, Islamic banks provide an alternative to interest-bearing accounts.

“Equity finance is considered the backbone of Islamic finance”.\footnote{Gohar Bilal, 'Islamic Finance: Alternatives to the Western Model' (1999) 23 Fletcher Forum of World Affairs 145 at 157} It requires involving in a real commercial project whose profits are not guaranteed so there would be potential risk. This is consistent with the principles of Islamic finance. However, Islamic banks may find it too risky to rely substantially on equity finance products, so these products are slightly limited in use.

### 2.4.3 Lease-Based Products

Under Islamic law, leasing is technically a sale contract but over the usufruct so the rules of sale are applied.\footnote{Warde, *Islamic Finance in The Global Economy* (n 63) at 144} This type of product is called *ijara*. Under *ijara*, the bank purchases the asset in order to lease it to the client for a fixed rent over a fixed period, similar to the conventional lease contract.\footnote{Ibid at 95} Another mechanism of using *ijara* is *ijara muntahiya bi-tamlik* or a lease to own, which is similar to conventional hire purchase.\footnote{Ibid at 95} This product allows the client to purchase the asset at the end of the leasing period and its price is considered and included in the rent paid by the client (the lessee) to the bank (the lessor).\footnote{Bilal, 'Islamic Finance: Alternatives to the Western Model' (n 111) at 154}

An Islamic hire purchase contract, however, is different in certain respects from a conventional one since it must avoid any speculation which may lead to *gharar*. These
differences usually work as limitations and restrictions on banks and expose them to risk. One of the primary limitations is that the client (the lessee) is not responsible for the full rent if the commodity is lost or destroyed unless this is caused by the negligence or default of the lessee.\textsuperscript{116} Where insurance could provide a solution for conventional hire purchase to minimise such risk, it might be questionable in this context, under Islamic law.\textsuperscript{117} Another limitation concerns the validity of the future sale of the commodity. As explained above, the sale of the commodity being conditioned to a future event, such as the end of the lease term, is unlawful under Islamic law. To avoid such an unlawful transaction, a sale promise is signed between the parties to conduct the sale contract after the lease ends.\textsuperscript{118} The enforceability of such a promise is a subject of concern under Islamic law and must meet the requirements discussed earlier. Another limitation is that the lease term under Islamic hire purchase starts on the day when the client actually receives the commodity as opposed to the date when the contract is signed, as under conventional hire purchase.\textsuperscript{119}

These limitations place Islamic banks in a riskier position which reflects the requirements of Islamic finance. Despite these limitations, leasing has been a popular tool under Islamic banking due to its efficiency as a well-established tool of finance, whose procedures and mechanisms are easy to standardise; useful to the economy; and flexible with regard to the terms and price of the sale.\textsuperscript{120} The similarity with conventional hire purchase, as a well-established tool of finance in conventional banks, also has an impact on the popularity of Islamic hire purchase. Islamic hire purchase can be applied by Islamic banks using similar procedures, mechanisms and rules to those used in conventional banks. Another advantage of the similarity is that Islamic hire purchase would be allowed under the same national regulations controlling conventional hire purchase if they are flexible enough to accommodate sharia requirements and

\textsuperscript{116} Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (n 96) at 350; Zaher and Hassan, 'A Comparative Literature Survey of Islamic Finance and Banking' (n 48) at 164
\textsuperscript{117} Zaher and Hassan, 'A Comparative Literature Survey of Islamic Finance and Banking' (n 48) at 164
\textsuperscript{118} Eglinton and others, 'Accounting and Taxation Implications of Islamic Finance Products' (n 82) at 95
\textsuperscript{119} Bilal, 'Islamic Finance: Alternatives to the Western Model' (n 111) at 154; Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (n 96) at 350
\textsuperscript{120} Warde, \textit{Islamic Finance in The Global Economy} (n 63) at 145
limitations. This would be very useful for Islamic banks in jurisdictions that do not have special rules for Islamic banks, which does not tend to be the case in practice.\textsuperscript{121}

2.4.4 Sukuk

After many attempts to create sharia-compliant instruments to serve as an alternative to conventional bonds, \textit{sukuk} was introduced at the beginning of this century.\textsuperscript{122} Although both \textit{sukuk} and bonds are fully tradable\textsuperscript{123} and provide periodic returns, \textit{sukuk} represents ownership of the asset rather than a debt obligation and its returns depend, rather than on interest, on the profits or usufructs generated by the asset.\textsuperscript{124} \textit{Sukuk}, therefore, is an innovative type of sharia-compliant asset which gives its holders different rights and positions, since they are the owners of the asset.\textsuperscript{125} Wilson asserts that \textit{sukuk} should be described as Islamic investment certificates rather than Islamic bonds because of the substantial differences between bonds and \textit{sukuk}.\textsuperscript{126} The global market for \textit{sukuk} is experiencing very rapid growth, and the annual issuance of \textit{sukuk} rose from USD 60.7 billion in 2015 to USD 88.3 in 2016.\textsuperscript{127}

It should be noted that \textit{sukuk} is not a separate classification from the previous types. In fact, \textit{sukuk} could be structured as one type of the aforementioned general products. AAOIFI has identified 15 different structures of permissible \textit{sukuk}.\textsuperscript{128} It usually involves issuing a special purpose vehicle (SPV) to purchase the underlying asset from the originator, using the money raised by issuing the \textit{sukuk}.\textsuperscript{129} In \textit{ijara sukuk}, one of the major types of \textit{sukuk}, an SPV buys an asset to be leased back to the original owner and the \textit{sukuk} holders receive their returns in the form of rent until the end of the \textit{sukuk}.

\begin{thebibliography}{99}
\bibitem{121} Ibid at 144-145
\bibitem{122} Ibid at 150
\bibitem{123} With the exception of \textit{salam sukuk}, \textit{sukuk} are tradable. However, some types of \textit{sukuk} require some conditions before the trade is allowed. See The Accounting and Auditing Organization for Islamic Financial Institution, \textit{Sharia Standards} (Dar Al Maiman 2015) at 479-482
\bibitem{124} Warde, \textit{Islamic Finance in The Global Economy} (n 63) at 151
\bibitem{125} Rodney Wilson, \textit{Legal, Regulatory and Governance Issues in Islamic Finance} (Edinburgh University Press 2012) at 163
\bibitem{126} Ibid at 163
\bibitem{127} International Islamic Financial Market (IIFM), 'A Comprehensive Study of the Global Sukuk Market' (2017) at 2
\bibitem{128} The Accounting and Auditing Organization for Islamic Financial Institution, \textit{Sharia Standards} (n 123) at 467-471
\bibitem{129} Atif Hanif and Julian Johansen, 'Sukuk' in Craig R. Nethercott and David M. Eisenberg (eds), \textit{Islamic Finance: Law and Practice} (Islamic Finance: Law and Practice, Oxford University Press 2012) at 261
\end{thebibliography}
term, when the SPV is liquidated and the holders get their shares.\textsuperscript{130} Another popular type is \textit{musharaka sukuk}, where the originator partially funds the SPV along with the \textit{sukuk} holders as partners and the returns from \textit{sukuk} are the profits generated by the SPV.\textsuperscript{131} \textit{Mudaraba sukuk} is similar, apart from the fact that the SPV is fully owned by the \textit{sukuk} holders and the originator adopts the management role.\textsuperscript{132} These are the most popular types of \textit{sukuk} but \textit{murabaha, salam, istisna} and other mechanisms can also be used in the \textit{sukuk} structure.

\textbf{2.5 Corporate Governance and the Islamic Perspective}

\textbf{2.5.1 Concept, Definition, and Principles}

The term ‘corporate governance’ became prominent in developed countries after the corporation failures in the US and UK in the early 1990s and it has become a major concern for academics and regulatory bodies since the beginning of this century following the collapse of heavyweight companies in the early 2000s\textsuperscript{133} and the financial crisis of 2007-08.\textsuperscript{134} Other factors, such as the growth of institutional investors and the increased globalisation of the markets, have contributed to the prominence of the term and attracted more attention.\textsuperscript{135}

There is no generally agreed definition of corporate governance. Due to different cultures and political and legal systems, countries vary regarding the assumption about what should be the main objective of the corporation, which is eventually reflected in the way in which corporate governance is defined.\textsuperscript{136} Also, the definitions vary narrowly or broadly depending on the different viewpoints of the policy-makers, practitioners, researchers or theorists.\textsuperscript{137} One way in which the definitions differ is in relation towards

\begin{itemize}
\item \textsuperscript{130} Warde, \textit{Islamic Finance in The Global Economy} (n 63) at 150
\item \textsuperscript{131} Hanif and Johansen, ‘Sukuk’ (n 129) at 263
\item \textsuperscript{132} Ibid at 263
\item \textsuperscript{133} Such as Enron.
\item \textsuperscript{134} Karim Ginena and Azhar Hamid, \textit{Foundations of Shari’ah Governance of Islamic Banks} (Wiley 2015) at 57-58
\item \textsuperscript{135} Zamir Iqbal and Abbas Mirakhor, ‘Stakeholder Model of Governance In Islamic Economic System’ (2004) 11 Islamic Economic Studies at 43-44
\item \textsuperscript{136} Marc Goergen, \textit{International Corporate Governance} (Pearson Education 2012) at 4
\item \textsuperscript{137} J. Solomon, \textit{Corporate Governance and Accountability}, vol 4th (John Wiley and Sons 2013) at 5
\end{itemize}
which corporate governance theory the definition leans to most. Examples of definitions that represent different theories are:

- The system by which companies are directed and controlled.¹³⁸
- The ways in which suppliers of finance to corporations assure themselves of gaining a return on their investment.¹³⁹
- The system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.¹⁴⁰

Through the different streams of definitions, Nordberg lists three common issues that are addressed under the concept of corporate governance:

- How are corporations directed and monitored, and what mechanisms can we use to make them perform better?
- What mechanisms can we put in place to ensure that corporations, their managers, and directors do not destroy the value that the corporation was meant to create, or destroy the value of others with whom it conducts its affairs?
- How can we create value within the corporation itself?¹⁴¹

Generally, corporate governance refers to the framework of the corporation which ensures efficient operation. Recently, the corporate governance framework has received more attention from regulators and policy-makers because of its impact on the economy. States regulate and supervise the framework of corporate governance, amongst other things, to prevent financial crises. It has been suggested that weak corporate governance was one of the main causes of the recent financial crises that led

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¹⁴⁰ Solomon, Corporate Governance and Accountability (n 137) at 7
¹⁴¹ Donald Nordberg, Corporate Governance: Principles and Issues (SAGE 2011) at 6
to the collapse of several large companies.\textsuperscript{142} For that reason, the Organisation for Economic Co-operation and Development (OECD) issued the principles of corporate governance, and amended on a couple of occasions, to promote more effective corporate governance frameworks. According to these principles, the framework of corporate governance should:

- Promote transparent and fair markets.
- Protect and facilitate the exercise of shareholders’ rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders.
- Strengthen the stock markets and attract investment.
- Recognise the rights of stakeholders established by law or through mutual agreements.
- Ensure the timely and accurate disclosure of all material matters regarding the corporation.
- Ensure the strategic guidance, effective monitoring and board accountability of the company.\textsuperscript{143}

The development of the relatively new concept of corporate governance has had an impact on the definition’s variations. As the concept matures, this development is likely to continue to evolve in the future passively, in response to events, and also actively, through the contributions of academics, policy-makers and practitioners.\textsuperscript{144}

\subsection*{2.5.2 Theories of Corporate Governance}

In this world, where political systems and social and human thinking differ, corporations have become a global concept. As a new concept, different approaches have been used to establish an ideal framework regarding how corporations should be

\textsuperscript{142} Solomon, \emph{Corporate Governance and Accountability} (n 137) at 3-4
\textsuperscript{143} Organisation for Economic Co-operation and Development, ‘G20/OECD Principles of Corporate Governance’ (2015) at 5-6
\textsuperscript{144} Solomon, \emph{Corporate Governance and Accountability} (n 137) at 5
governed. As a result of these variations, many corporate governance theories have evolved. This section highlights the main ones.

2.5.2.1 Agency Theory

Agency theory views the relationship between shareholders and managers in a corporation as a principal-agent relationship, where the managers (the agent), should act and make decisions in the best interests of the shareholders (the principal), and maximise their wealth.\textsuperscript{145} The maximisation of the shareholders’ wealth is the focus of this view of the relationship, which led to the development of shareholder primacy theory, also known as shareholder value and shareholder wealth maximisation.\textsuperscript{146} Directors, based on this theory, should manage the company for the benefit of shareholders and to maximise their wealth.\textsuperscript{147}

However, this relationship causes the agency problem, which is “the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects”.\textsuperscript{148} The theory assumes that the powerful position that managers occupy may lead them, due to human nature, to engage in self-dealing and acting in their own interests instead of those of the owners.\textsuperscript{149} The problem of information asymmetry is also caused by this relationship, where the principal is in a disadvantaged position since the agent has access to far more information.\textsuperscript{150}

As a solution to this problem, some proponents of the theory focus on the board of directors. The board’s composition and structure should be built in such a way that they represent the shareholders’ voice; act as an intermediate agent of the shareholders; and create a buffer zone between the shareholders and managers to balance their demands and prevent any potential tension.\textsuperscript{151} Another approach to solving the agency

\textsuperscript{145} Ibid at 9
\textsuperscript{146} Andrew Keay, 'Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little?' (2011) 22 European Business Law Review 1 at 1
\textsuperscript{147} Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 The Modern Law Review 663 at 667
\textsuperscript{148} Shleifer and Vishny, 'A Survey of Corporate Governance' (n 139) at 741
\textsuperscript{150} Christine A. Mallin, \textit{Corporate Governance}, vol 4th (Oxford University Press 2013) at 17
\textsuperscript{151} Nordberg, \textit{Corporate Governance: Principles and Issues} (n 141) at 38
problem is to view the corporation as a “nexus of contracts”. Under this view, the interest of the principal is better served by adopting an incentive system for managers, which requires a complete contract containing a specification of their duties, rewards, and the rights of the shareholders to monitor their performance.152 This seeks to align the interests of the managers with those of the shareholders. Many proponents of this approach consider shareholder primacy and view the company as “a promise made by directors to shareholders that they will maximise the wealth of shareholders”.153

2.5.2.2 Stakeholder Theory

Under this theory, corporations are not only meant to maximise the wealth for their investors but also have a responsibility towards all of the people with whom the corporations have contracted or, in a broader view of the theory, towards the larger society with which the corporations directly or indirectly deal.154 In other words, corporations are accountable for a wider range of people, that includes, as well as shareholders, all stakeholders. Different views exist regarding what the term “stakeholders” includes. While shareholders, employees, suppliers, customers, creditors and local communities are most likely to be considered as falling under this term, some extend this to the general public, environment, animal species and even future generations.155 The rationale behind this theory is that, since stakeholders contribute critical resources to corporations, their interests should be taken into account and they should be valued and seen as ends and not means.156 Stakeholders, however, are not equal in the sense that they do not share the same level of importance in the view of many of the stakeholder theorists. Some value the primary stakeholders, such as

153 Keay, ‘Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model’ (n 147) at 667
154 Nordberg, Corporate Governance: Principles and Issues (n 141) at 41
155 Solomon, Corporate Governance and Accountability (n 137) at 15
shareholders, creditors, customers, suppliers and employees, more than other secondary ones, who do not have a contractual relationship with the corporation.  

While there is a wide range of stakeholders, different views exist regarding how a corporation should be managed according to this theory, which has resulted in the emergence of numerous theories associated with the theory of stakeholders. Freeman calls this theory “stakeholder theories”, since it could be unpacked into several related theories. For example, social corporate responsibility theory puts more stress on the importance of society. According to this theory, corporations have a moral obligation and managers should act in a socially responsible manner. Enlightened shareholder theory is, according to some, another stakeholder-oriented approach which recognises the interests of different stakeholders but prioritises the wealth of shareholders and puts their interests above all others. This theory is closer to the agency theory view of corporations and serves as a less extreme version.

**2.5.2.3 Stewardship Theory**

By providing an alternative assumption of managerial behaviour, stewardship theory challenges agency theory and the agency problem. It supposes that managers are far from being opportunistic and their behaviour and decisions are not derived from personal gain and self-dealing but essentially from wanting to do a good job and be good stewards for the corporation. Because of this assumption, the shareholder voice and representation on the board should not be a concern and, thus, the focus should be shifted towards building facilitative structures which “provide clear, consistent role expectations and authorise and empower senior management” to achieve high performance.

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157 Ibid at 259  
159 Solomon, Corporate Governance and Accountability (n 137) at 16  
160 Ibid at 20  
162 Ibid 51-52
2.5.3 Islamic Perspective on Corporate Governance Theories

The link between corporate governance and Islamic values and principles has been a focus of much literature. Some have gone so far as to suggest a totally different model of corporate governance based on *tawhid*, the oneness of God, which states that all stakeholders involved in the corporation are accountable to God.\(^{163}\) However, the viability of such a view that strongly contrasts with the conventional governance system is challenged, since “Islamic thinking” could suitably fit within the corporate governance theories based on the stakeholder and social approaches.\(^ {164}\)

Consistent with this, Iqbal and Mirakhor argue that the Islamic principles of ownership and contracts provide a strong basis for stakeholder theory and, therefore, the theory is strongly rooted in the view of Islam.\(^ {165}\) This argument is based on two notions regarding ownership rights in Islam. The first is that God is the real and sole owner of property while individuals are merely trustees and custodians acting as stewards. The second is that ownership is a collective right whereby the possession of a property does not give individuals the absolute and exclusive right to use it but only a priority to enjoy its resources without conflicting with social interests and rights. Consequently, owners are not allowed to act in a way that involves wasting or squandering their own property nor can they use or change it in a way that would cause harm to their neighbours. Therefore, the definition of a stakeholder in Islam is “the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm”. These two notions within the Islamic principles on ownership pay considerable attention to a wide range of stakeholders whose rights are preserved in order to promote social interests. Such a consideration justifies the role that the stakeholders should play in economic activities.

Iqbal and Mirakhor, also, draw a general view of how the governance system in Islam should protect stakeholder rights. Presumably, managers ensure that sharia

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164 Zafar Iqbal and Mervyn K. Lewis, *An Islamic Perspective on Governance* (Edward Elgar Publishing 2009) at 283
165 See Iqbal and Mirakhor, ‘Stakeholder Model of Governance In Islamic Economic System’ (n 135)
principles are followed, including promoting the rights of the stakeholders. However, deviation from these principles might occur and, therefore, it is essential to have an institutional arrangement discouraging such deviation. Hence, a well-designed governance structure is one that provides that the fiduciary duties of the managers owed to stakeholders is necessary in order to preserve stakeholder rights.

Generally, Islamic values focus on a wide range of stakeholders rather than investors, which make them more in line with stakeholder theory. However, other assessments have been made to find parallels between Islamic values and other conventional corporate governance theories. Some views do not vary much from the stakeholder approach but link it, more specifically, to the theory of corporate social responsibility. Firms under this theory are driven by moral and social obligations which are intensively considered in Islamic values and principles, the main driver of Islamic corporate governance. Stewardship theory is considered by some researchers as being more consistent with Islamic corporate governance since managers in corporations in Islam are viewed as stewards who should perform their duties according to Islamic beliefs. The agency theory’s assumption of self-dealing is not disregarded either. From the agency theory perspective, adherence to Islamic values and principles could add other elements to the agency problem, especially in IFIs. Many of the investors in these institutions are driven not only by financial returns but, also, by their investments being sharia-compliant. “Thus, while the agency problem in conventional companies arises when managers deviate from their duty to maximise the shareholders’ wealth, any divergence by the managers of IFIs from placing all of the supplied funds

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167 Masudul Alam Choudhury and Mohammad Nurul Alam, ‘Corporate Governance in Islamic Perspective’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 180 at 193
168 Iqbal and Lewis, An Islamic Perspective on Governance (n 164) at 272; Siti Normala Sheikh Obid and Babak Naysary, ‘Toward a Comprehensive Theoretical Framework for Shariah Governance in Islamic Financial Institutions’ (2014) 19 Journal of Financial Services Marketing 304 at 309
into sharia-compliant investments creates an additional source of agency problems".\textsuperscript{170} Moreover, agency problems arise in IFIs as a result of separating the cash flow and control rights in the case of savings accounts, the alternative to interest-based accounts, provided by Islamic banks.\textsuperscript{171} Depositors and IAHs have no right of control, despite the risk to which they are exposed as a result of their investments.

Providing a separate theory for Islamic corporate governance is an extreme view since Islamic corporate governance cannot be divorced or isolated from the conventional type. Islam only provides values and principles that, arguably, lean more towards the stakeholder approach but are sufficiently general to be applied even in different approaches of the corporate governance theories, such as agency theory, in order to add more ethical standards. In Islam, there is no detailed set of governance standards that stand apart from the theories and governance mechanisms of modern corporations. Therefore, combining Islamic values with corporate governance might result in an ideal structure, whereby corruption could be reduced by both the Islamic moral and ethical values as well as the conventional well-structured governance mechanisms developed in modern corporations.\textsuperscript{172}

\textbf{2.6 Sharia Governance}

\textbf{2.6.1 The Concept}

In the Islamic world, conformity with sharia has been a concern, given the rise of sharia non-compliant financial transactions introduced by the modern banking system. Therefore, research has focused on how to incorporate conformity with sharia into the modern governance system, which has resulted in the introduction of the concept of sharia governance. Basically, sharia governance is the Islamic version of corporate

\textsuperscript{170} A. Safieddine, 'Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory' (2009) 17 Corporate Governance: An International Review 142 at 144
\textsuperscript{171} Ibid at 144-145
\textsuperscript{172} Iqbal and Lewis, \textit{An Islamic Perspective on Governance} (n 164) at 312
governance. Sharia governance, however, does not replace corporate governance but adds extra governance standards to ensure compliance with sharia.

A common definition of sharia governance is that defined by IFSB, which is:

“The set of institutional and organisational arrangements through which an IIFS (Institutions offering Islamic financial services) ensures that there is effective independent oversight of shariah compliance over each of the following structures and processes:

1. Issuance of relevant shariah pronouncements/resolutions…
2. Dissemination of information on such shariah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance…
3. An internal shariah compliance review/audit for verifying that shariah compliance has been satisfied…
4. An annual shariah compliance review/audit for verifying that the internal shariah compliance review/audit has been appropriately carried out and its findings have been duly noted by the shariah board…”.

This lengthy definition, although preferred by some researchers, is criticised for being inaccurate and not comprehensive, since it ignores the external arrangements of sharia governance. Furthermore, defining sharia governance by listing and explaining certain tools and arrangements is not the best way to explain the concept. These arrangements, besides being incomprehensive, are merely instruments for achieving the objective of sharia governance and thus could be replaced if other instruments better serve this objective. Therefore, it is more accurate to employ a more general definition. In fact, IFSB, before setting its own definition, refers to another, arguably

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173 Aishath Muneeza and Rusni Hassan, 'Shari'ah Corporate Governance: The Need for a Special Governance Code' (2014) 14 Corporate Governance 120 at 120
174 Islamic Financial Services Board, 'Guiding Principles on Sharia'h Governance Systems for Institutions Offering Islamic Financial Services' (2009) at 2-4
176 Ginena and Hamid, Foundations of Shari'ah Governance of Islamic Banks (n 134) at 82
more accurate,\textsuperscript{177} definition that is used by the Islamic financial industry, which is the, “structures and processes adopted by stakeholders in the IFSI (Islamic financial services industry), from financial regulators to market players, to ensure compliance with shariah rules and principles”\textsuperscript{178} It is important that this definition considers the arrangements adopted by stakeholders other than the institution itself, such as those required by the regulators. This consideration is ignored by the Central Bank of Oman in its Islamic Banking Regulatory Framework, one of the most recent and comprehensive official sharia governance frameworks, which defines sharia governance as “a system whereby an Islamic financial institution attempts to comply with shari’a in all its activities”.\textsuperscript{179} One of the most comprehensive definitions of sharia governance that explains the concept well is that offered by Ginena: “The overall system that manages the conformity of the activities of Islamic banks and financial institutions to the precepts of shariah pertaining to transactions”.\textsuperscript{180}

The SSB does not represent the whole of sharia governance or even sharia supervision. In fact, sharia governance includes two main processes.\textsuperscript{181} The first is the internal, ex-ante, where \textit{fatwas} (pronouncements) regarding specific transactions are issued by the SSB and thereafter monitored and supervised by internal sharia review departments in terms of their day-to-day applications. The external process, ex-post, involves internal sharia auditing conducted by internal sharia audit departments to verify sharia compliance and report any misconduct to the SSB. It also involves external sharia audit which may be conducted by the SSB or external sharia firms. According to Minhas, a comprehensive sharia governance structure is based on four pillars: the management and board of directors; an independent, qualified SSB; effective sharia review and audit; and transparency and disclosure.\textsuperscript{182}

\begin{flushleft}
\textsuperscript{177} Ibid at 82
\textsuperscript{178} Islamic Financial Services Board, \textit{Guiding Principles on Shari’a Governance Systems for Institutions Offering Islamic Financial Services} (n 174) at 1
\textsuperscript{179} Central Bank of Oman, \textit{Islamic Banking Regulatory Framework} at 2.1.1
\textsuperscript{180} Ginena and Hamid, \textit{Foundations of Shari’ah Governance of Islamic Banks} (n 134) at 80
\textsuperscript{181} Abdussalam Ismail Onagun and Abdussalam Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ (2013) (Sharia Economics Conference) at 73-77
\textsuperscript{182} Imran Hussein Minhas, ‘Shari’ah Governance Model (SGM) and Its Four Basic Pillars’ (2012) 29 Journal of Islamic Banking and Finance 30 at 32
\end{flushleft}
2.6.2 *Hisba* and Sharia Governance

The concept of *hisba*, as practised in the early Islamic era, could be a source of some useful principles for the Islamic governance system and provide an inspiring theoretical basis for sharia governance. *Hisba* is generally defined by Al-Mawardi (D. 1058) as “commanding good if it appears to be abandoned and inhibiting evil when it is publicly performed”.\(^{183}\) According to this definition, *hisba* generally covers all aspects of life, including commercial and financial activities, which are the activities most closely related to sharia governance. Since the practice of *hisba* aims to establish a firm’s socioeconomic environment, in which people are encouraged to act in a moral and ethical manner, the protection of rights, especially those of consumers, is a priority.\(^{184}\) The most closely related aspect of *hisba* to modern sharia governance is its application in the market, which is concerned with preventing corruption and ensuring equal transactions by maintaining fairness, transparency and accountability.\(^{185}\) *Hisba* in the market was carried out in the early Islamic era and received attention from the Prophet Mohammed (pbuh) and his successors, who either practised or officially delegated the authority of *hisba* to others.\(^{186}\) During the early Abaasid era (750 onwards), the practice of *hisba* was institutionalised into a more sophisticated system to ensure a more sharia-compliant market.\(^{187}\) As an institution, *hisba* aims to apply “a divine code of approved social behaviour in a community”.\(^{188}\) Generally, the duty of *hisba* in the market includes the following:

- To ensure fair trading and transactions by checking the measures and weights used in business dealings
- To check and report business fraud
- To audit non-sharia compliant transactions

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\(^{184}\) Ginena and Hamid, *Foundations of Shari’ah Governance of Islamic Banks* (n 134) at 61

\(^{185}\) Ibid at 61

\(^{186}\) Ibid at 62


\(^{188}\) Abdul Rahim Abdul Rahman, 'Issues in Corporate Accountability and Governance: An Islamic Perspective' (1998) 15 The American Journal of Islamic Social Sciences 55 at 63
• To keep the market free and prevent any activity that might negatively affect the competition
• To ensure fair value trading by enforcing the sale of necessary goods when needed and preventing the hoarding of such goods if it leads to negative effects on the market.\textsuperscript{189}

The establishment of such an institution is a responsibility of either the state or the community.\textsuperscript{190} Nowadays, most of hisba's objectives are achieved by different governance systems and executed by different tools and governmental institutions, such as ministries, the central banks, supervisory bodies and regulations.\textsuperscript{191} However, this modern arrangement of hisba fails to effectively cover the issue of sharia-compliance in IFIs. This highlights the importance of sharia governance and the need for its official recognition in the Islamic world.

2.6.3 Importance of Sharia Governance

While corporate governance aims to protect different interests which vary, and depend on the nature of the relationship between the different types of stakeholders and the company, financial interests lie at the centre of these interests. Since non-financial interests are not dominant, they could be preserved by having some special governance requirements without affecting the whole structure of the corporate governance. In the case of Islamic banks and other IFIs, stakeholders have another big concern: compliance with sharia. For some stakeholders, compliance with sharia might be more important than, or at least equally important to, the financial considerations.\textsuperscript{192} Hence, it is essential to have a parallel governance structure concerned with conformity with sharia.

\textsuperscript{189} Ibid 64
\textsuperscript{191} Ginena and Hamid, \textit{Foundations of Shari'ah Governance of Islamic Banks} (n 134) at 63-64
\textsuperscript{192} This will be more highlighted in Chapter Six.
A good sharia governance structure should have proper arrangements in place for ensuring sharia-compliance, set out the guidance and duties for the different levels of management related to sharia matters and outline the functions of the different levels of sharia supervision and sharia risk management. The importance of a strong sharia governance structure may be summarised by the following points:

- Increasing the stakeholders’ trust and confidence, which in turn positively affects the institution’s stability, capacity as a financial intermediary and performance.

- Improving the disclosure mechanism regarding sharia compliance. Such an improvement would, first, increase the stakeholders’ knowledge of the sharia laws pertaining to transactions so that they can compare the extent of sharia compliance with other institutions and make informed decisions about whether or not to invest. Secondly, disclosure would decrease the amount of information asymmetry between the stakeholders and managers, increase the competition and enhance the market discipline.

- Improve the standardisation of practice which would restrict opportunistic practice and increase trust.

2.6.4 Regulatory Approaches to Sharia Governance

Despite its importance, sharia governance has not been very well regulated in the jurisdictions in which the Islamic banks operate. These jurisdictions significantly vary in terms of their level of engagement with sharia governance, ranging from complete ignorance to full commitment.

To classify the different regulatory approaches of sharia governance between jurisdictions, Ahmed identifies four characteristics. Ginena adds two further to categorise the jurisdictions, based on these six characteristics, into five categories, from

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193 Haqqi, ‘Sharia Governance in Islamic Financial Institution: An Appraisal’ (n 175) at 120-121
194 Ginena and Hamid, Foundations of Shari‘ah Governance of Islamic Banks (n 134) at 83
195 Habib Ahmed, ‘Shari‘ah Governance Regimes for Islamic Finance: Types and Appraisal’ (2011) 64 International Economics 393 at 399-400
those jurisdictions which tend to be hands-off and those that are committed.\textsuperscript{196} The first characteristic is the general presence of regulations considering the uniqueness of the IFIs. The second is having the minimum requirements for internal sharia governance, such as an internal department for sharia auditing. The third is whether the regulator requires the SSB in the Islamic financial institution. Having a centralized SSB board at the regulatory level is the fourth characteristic. The fifth is the requirement to conduct an external sharia audit by a licensed firm. The final one is whether the external sharia audit could be conducted by the regulator itself. Based on these characteristics, the approaches to regulating sharia governance are as follows (see Table 2.1 below):

1. **Hands-off**: none of these factors is required. UK and Saudi Arabia are examples of this.
2. **Nominal**: only the first factor is required. Iran is an example of this.
3. **Engaged**: The first three factors are required. Sometimes, the SSB at the regulatory level is present but in a passive way and it does not have the same authority as the next category. Qatar is an examples of this category.
4. **Proactive**: All of the factors are required apart from the last two. Malaysia is a prominent example of this.
5. **Committed**: All of the factors are required. Oman recently adopted this approach.\textsuperscript{197}

\textsuperscript{196} Ginena and Hamid, *Foundations of Shari’ah Governance of Islamic Banks* (n 134) at 119-120
\textsuperscript{197} Ibid at 120-150. More specific analysis of the SSB models is included in Chapter Four.
Table 2.1: categories and characteristics of sharia governance approaches

<table>
<thead>
<tr>
<th>Factor or Characteristic</th>
<th>Hands-off</th>
<th>Nominal</th>
<th>Engaged</th>
<th>Proactive</th>
<th>Committed</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Islamic banking laws and regulations</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Internal sharia audit</td>
<td></td>
<td></td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>SSB at the institutional level</td>
<td></td>
<td></td>
<td></td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Centralized SSB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>√</td>
</tr>
<tr>
<td>External sharia audit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory sharia audit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>√</td>
</tr>
</tbody>
</table>

Source: Ginena and Hamid, *Foundations of Shari'ah Governance of Islamic Banks* (n 134) at 121

This shows that sharia governance has not reached a standard framework yet that is widely acceptable. The legal recognition of the industry is still at a minimum in many jurisdictions, some of which are significant for the industry, such as Saudi Arabia. However, there is a tendency in the new regulations towards a more committed sharia governance model. Moreover, Oman, Bahrain, the UAE, and Pakistan have adopted some degree of legal reform in this direction, which will be referred to later in the thesis.¹⁹⁸

2.7 Conclusion

The new method of finance which has been introduced as a result of the prohibition of Interest in Islam provides certain challenges, in the view of corporation theory. These challenges arose when incorporating sharia governance into the corporation structure to satisfy the sharia-compliance requirements. The concept of sharia governance is a new, developing framework where there is a variation among jurisdictions on how it should be

¹⁹⁸ In chapters Five and Six.
legally recognised. The chapter presents these issues as fundamental in order to provide a context for further discussion about the structure of sharia supervision within the governance framework. The variation in the sharia governance approaches indicates that the sharia governance structure is incomplete and needs to be developed into a more robust, reliable one in order to provide blueprints for the legal systems wishing to adopt sharia governance. Before discussing how this development should take place, it is important to justify the need for the legal recognition of Islamic banking and sharia governance. As shown in the sharia governance approaches, some jurisdictions completely ignore sharia governance or recognise it only in a minimal way. The next chapter provides an example of an important jurisdiction of islamic finance where a hands-off approach is applied and the effect of such a legal environment on Islamic banking is assessed.
Chapter Three: Islamic Banks and the Need for Legal Recognition: The Case of Saudi Arabia

3.1 Introduction

This chapter discusses the importance of and rationales for having special regulations for the Islamic banking industry that are different from those of conventional banks. This should provide the general legal basis of sharia supervision and its governance structure. For illustration, the case of Saudi Arabia is used as a main reference in the discussions in this and the following chapters. Beside its size of the market and the economic volume which was outlined before, it represents extreme legal negligence or a hands-off attitude toward sharia governance, which provides a clearer ground for the discussion about the need for and the extent of the legal recognition of the practice.

Saudi Arabia is also an interesting case as Islamic law is a major component of the society in that country. Saudis are closely tied to Islamic principles and orders. The legal system in the country is, also, strongly influenced by Islamic law. According to the Basic Law of Governance, the highest law in the country, no law should contradict the sources of Islam. Many regulated activities are stated to be applied in a way that does not conflict with sharia rules and standards. When it comes to practice, however, Islamic law and the Saudi legal system, sometimes, fail to coincide. The obvious example of this is the banking system in that country. In its endeavour to modernise as a big oil producer, the country has adopted its banking system, within which, like most of the world’s other banking systems, interest is the cornerstone. This has created a problematic situation where both the Islamic and conventional banks suffer. Peter Wilson describes this problem as follows:

“The Saudi banking system has been beset by two problems that have relentlessly threatened its existence. One is the question of interest. The second is the country’s legal system”.

200 Peter W. Wilson, A Question of Interest: The Paralysis of Saudi Banking (Westview Press 1991) at 7
In light of these two problems, the chapter discusses the issue of recognising Islamic banks within a conventional banking system in a country whose law is based on sharia. The chapter, also, highlights the other half of the picture where the conventional banks in the country suffer to enforce their interest-based loans in the judiciary system, which is based on sharia.

3.2 Why Should Islamic Banking be Regulated?

Countries tend to regulate the banking industry with special laws and regulations that differ from those related to normal companies. Banks are usually subject to different systems of prudential regulations, structural requirements, and minimum capital ratio requirements. This is because of the unique features and characteristics of the financial industry, that demand different laws and regulations in order to make the national economy stronger as well as safer. Consequently, a separate regulator is usually established to supervise the banking sector. This section highlights the key reasons and justifications for enacting special laws and regulations for banks and assesses whether Islamic banks share the same rationales. Furthermore, it argues that Islamic banks need their own legal system that differs from the one governing conventional banks.

3.2.1 Rationales for Regulating the Banking Industry

The process associated with regulating the banking industry is not inexpensive as it may cost billions in modern economies to create a sound banking legal system. This costly process is not only borne by the states, which have to fund the regulation and supervisory tasks, but it is also costly for banks to comply with the rules and regulations imposed by the regulators of the industry. Additionally, the banks’ customers share some of this expense, as it is likely that the banks pass on to their clients some of their

201 There are supporters of the idea of a banking system that is free from regulation, whose arguments have been criticised. For more detail, please refer to Sheila C. Dow, 'Why the Banking System Should be Regulated' (1996) 106 The Economic Journal 698
202 Andrew Campbell, 'Bank Insolvency and the Interests of Creditors' (2006) 7 Journal of Banking Regulation 133 at 136
203 Dalvinder Singh, 'The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper?' (2013) 47 The International Lawyer 65 at 71
costs. Despite these expenses, the banking industry is being heavily regulated. Below are the key rationales for regulating the industry.

**Market Imperfection**

One of the most important reasons that led to bank regulation is that the environment in which the financial services are conducted is not perfect. This imperfection is due to several elements which characterise the industry and prevent the market from being fully competitive in nature. The information problem associated with the financial market is one of the most obvious elements of market imperfection. Uncertainty is an unavoidable feature in the financial market. In this market, consumers face a lack of, as well as, asymmetric information, which may lead to the agency problem and, therefore, regulation is needed to stabilise the market.

**Confidence and Stability**

Banks are the cornerstone of any financial system, so the stability of the banks means a more solid and confident financial system. Thus, states regulate the banking industry properly in a way that creates more confidence in the market. The significance of a stable, confident financial market rests on two critical features of the market. The first is the uncertainty associated with the market, as explained above. Although this uncertainty pervades all aspects of the modern economy, contracts, guarded and supported by the legal system, can provide the essential security needed for the economy to develop. However, states, as they produce their own money, might view contracts as inadequate for maintaining confidence and stability regarding the value of their money, which is better achieved by a special regulation and supervisory system which supports the evolution of the banking industry. Secondly, the banking industry is vulnerable because of the issue of externality. A bank is not made safe merely through performing well but is susceptible to fail if others do, which is called contagion.

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204 Glen Arnold, *The Financial Times Guides to Banking* (Pearson 2013) 383 at 383
205 Dow, 'Why the Banking System Should be Regulated' (n 201) at 700
207 Dow, 'Why the Banking System Should be Regulated' (n 201) at 698-699
208 The term externality refers to the situation when the social cost of failure exceeds the private cost. Arnold, *The Financial Times Guides to Banking* (n 204) at 386
risk. When there is a bank run, depositors lose confidence in the system and withdraw their money from other banks. Hence, regulations are imposed to ensure that the degree of contagion risk is minimised.\textsuperscript{209} An important objective in regulating banks is to set minimum standards in the industry to make the market trustworthy.\textsuperscript{210}

\textit{Cost}

Despite its cost, the regulation of banks can save a lot of money, time and effort. In a free banking environment, banks are inadequately monitored so consumers have to pay the cost of investigating financial services carefully. Such a cost would be substantial, considering that all consumers must experience the same process which leads to an enormous consumption of time and resources, a situation that justifies establishing regulator agencies to monitor the banks and lower the cost of contracts for consumers.\textsuperscript{211}

3.2.2 Do Islamic Banks Need their Own Regulations?

In spite of the differences between Islamic and conventional banks, they share the same rationales for regulation. Islamic banks provide banking services and operate in the same financial environment where the market is imperfect and needs to be stable in order to increase customers’ confidence. In fact, many conventional products could be redrafted to comply with sharia.\textsuperscript{212} The main feature that distinguishes Islamic banks from conventional ones is that the former complies with sharia, which requires them to apply the Islamic finance principles, explained earlier, in the products provided. Despite this, Islamic banks are recognised as banks and have the same rationales that justify the different regulations for banks. Islamic and conventional banks serve the same economic objective: to act as administrators of the economy’s payments system and as financial intermediaries.\textsuperscript{213} Since Islamic banks are classified as banks and provide what banking laws are characterised as banking services, they should be regulated as

\textsuperscript{209} Ibid at 386
\textsuperscript{210} Llewellyn, ‘The Economic Rationale for Financial Regulation’ (n 206) at 26
\textsuperscript{211} Ibid at 24
\textsuperscript{212} Aledjandro Lopez Mejia and others, ‘Regulation and Supervision of Islamic Banks’ (2014) International Monetary Fund Working Paper 14/219 at 6
\textsuperscript{213} Ahmad and Hassan, ‘Riba and Islamic Banking’ (n 45) at 21
well. The important question is whether the differences and requirements in Islamic banks rationalise special regulations that differ from the conventional banking regulations.

To answer this question, we need to consider whether the objectives of regulating banks could be achieved by applying the same banking regulations to the Islamic ones. Islamic banks must operate under a slightly different structure and adopt different financial contracts which must comply with sharia law. The principles of Islamic finance may be deemed inconsistent with the legal structure applicable to the financial sector. Therefore, there is a call that Islamic banking should have a separate legal system or, at least, apply some exceptions for its operations.\textsuperscript{214} The framework and functionality of the contracts need to be well understood by the supervisory authority. The absence of special regulations for Islamic banks usually results in tension between the supervisory authorities and Islamic banks due to the lack of understanding of the transactions and structures of Islamic banks, which therefore discourages the authorities from providing the proper support for Islamic banks when needed.\textsuperscript{215} Thus, the objectives of the banking regulations are better served by having a special supervisory system for Islamic banks. Furthermore, some Islamic financial products require special actions which might be prohibited or restricted under the banking regulations in certain jurisdictions. As explained earlier, some financial transactions require Islamic banks to be partnered by commercial enterprises or to acquire some assets to sell or lease. Such actions are either prohibited or restricted under most banking laws.\textsuperscript{216} As described below, this is the case in Saudi Arabia. Therefore, these actions need to be recognised by special regulations that not only authorise and legitimise this type of contracts but also give the supervisory authorities the necessary control to ensure the safe applications of these contracts.

Another justification of the special regulations for Islamic banks is the further risk to which Islamic banks are exposed. The nature of the contracts used by Islamic banks

\textsuperscript{214} Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 294
\textsuperscript{215} Fuad A. Al-Omar and Mohammed Abdel-Haq, Islamic Banking: Theory, Practice and Challenges (Zed 1996) at 110
\textsuperscript{216} Algaoud and Lewis, Islamic Banking (n 24) at 148
places them at a higher degree of risk than conventional ones. For example, PLS contracts are common in Islamic banks, where they make profits by engaging in real economic activities that expose them to the risk of loss.\textsuperscript{217} Wilson lists three types of additional risk to which Islamic banks are exposed as a result of providing sharia-compliant products.\textsuperscript{218} The first is sharia risk, which is the reputational risk due to the level of compliance with sharia law. The second is the ownership risk, which is associated with possessing property as required by some of these contracts, such as \textit{murabaha} and \textit{ijara}. The third is the market risk, which is the risk that banks bear as a result of participating in business, as required in \textit{musharaka} contracts. He argues that these types of risk are challenging for the central banks to manage, since these contracts need special skills to understand and he suggests that special legal consideration would assist the supervision of Islamic banks. He further argues that innovation in the Islamic banking industry could be discouraged and inhibited in an environment where both Islamic and conventional banks are supervised by the same rules, a situation that would force Islamic banks to comply with the rules by imitating conventional products.

It is important that the types of risk that Wilson highlights are considered by the banking regulators, as they could all lead to runs on banks and negatively affect the economy. Regarding ownership and market risks, this effect is direct. Banks may lose their funds as a result of buying commodities or participating in commercial projects if, for example, these commodities are damaged or the projects fail. Such risk could be alleviated if well recognised by the regulators. On the other hand, the economic effect is indirect in sharia risk, since it is mainly an ethical concern. Islamic banks are morally obligated to comply with sharia and customers are morally motivated to choose Islamic banks. However, the improper application of sharia-compliant products may cause the loss of the bank’s reputation and affect its credibility which, in turn, will cause the bank to lose funds. In this regard, a strong sharia governance is essential to ensure authentic

\begin{itemize}
\item \textsuperscript{217} Muhamed Umer Chapra and Tariqullah Khan, ‘Regulation and Supervision of Islamic Banks’ (2000) Islamic Research and Training Institute Occasional Paper 3 at 9; Wilson, \textit{Legal, Regulatory and Governance Issues in Islamic Finance} (n 125) at 3
\item \textsuperscript{218} Wilson, \textit{Legal, Regulatory and Governance Issues in Islamic Finance} (n 125) at 8-10
\end{itemize}
sharia-compliant products and prevent superficial ones that apply manipulative mechanisms which open a back-door to interest.

Investment deposits in Islamic banks, which is based on mudaraba contracts, are another area that regulators need to consider. Unlike deposits in conventional banks, Islamic banks cannot guarantee a fixed rate of return on their investment accounts. Depositors in Islamic banks are considered investors and share profits proportionate to their deposits but bear the risk of possible erosion of their capital in the case of loss. Although this type of contract contains the risk explained above, it needs special attention from the regulators since it raises an important legal issue regarding the rights of depositors. Unlike shareholders, depositors are unrepresented in the board of directors nor do they have voting or monitoring rights in spite of their investment and therefore do not receive the necessary protection.

Also, the prudential standards applicable to conventional banking might not fit the different functionality of IFIs, which adds another reason to consider a separate regulation for Islamic banking. There has been a call to set up a sharia-compliant macro-prudential framework that includes the establishment of a sharia-compliant lender of last resort and deposit insurance schemes to promote the resilience and stability of the Islamic financial system. Also, it is necessary to consider the different ratio of liquidity between conventional banks and Islamic banks, mainly due to the fact that the latter do not pay interest to their depositors. Hussain et al. argue that liquidity risk management and the financial safety net are two major challenges to the financial stability of IFIs. They suggest a special legal guidance for the Islamic financial market in order to comply with Basel III regulations and cater for the specificities of IFIs, such as capital adequacy ratios that take into account the profit-sharing feature of investment accounts with Islamic banks.

219 Chapra and Khan, 'Regulation and Supervision of Islamic Banks' (n 217) at 9
223 Hussain, Shamoradi and Turk, 'An Overview of Islamic Finance' (n 221) at 23-24
Under the conventional prudential standards, Islamic banks might find it difficult to compete with other banks. For example, most of the Islamic banks in the UK fail to join the reserve scheme partially because they do not meet the required minimum threshold to be subject to the cash ratio deposit regime, a situation that has placed Islamic banks in a less favourable situation to compete with conventional banking in an open market and also prevented them from using the central bank’s facilities.\textsuperscript{224} This is in addition to the religious restriction which affects the ability of Islamic banks to compete. While conventional banks have the freedom to consider countless ideas in the process of launching products, Islamic banks are constrained to only offer SSB approved products.\textsuperscript{225} This unfair competition environment could also be positive for Islamic banks. Conventional banks in some jurisdictions complain about the “special privileges” enjoyed by Islamic banks.\textsuperscript{226} As explained below, Islamic banks in Saudi Arabia may, exceptionally, be authorised to conduct certain illegal actions. This authorisation might be considered discriminatory by their conventional counterparts. As a result, having Islamic banks compete with conventional ones would lead to discrimination, whether positive or negative, for Islamic banks, a situation that requires special treatment that recognises their special status.\textsuperscript{227}

While the previous justifications for different regulations for Islamic banks focus on their special financial and operational aspects, the governance framework of the required sharia review process needs also to be considered in regulating Islamic banks. In the absence of such regulation, different standards and mechanisms might be applied to ensure sharia-compliance by different banks rather than constituting uniform rules for this important practice, which may lead the Islamic banking industry into chaos. Having non-standardised sharia supervision practice might lead to confusion and, consequently, customers would lose confidence in this market. The need for regulators to ensure the proper application and mechanism of sharia governance, including the practice of the SSB, is as essential as the need to ensure that the board of directors and

\textsuperscript{224} Ibid at 27
\textsuperscript{225} Warde, \textit{Islamic Finance in The Global Economy} (n 63) at 159
\textsuperscript{226} Ibid at 207
\textsuperscript{227} Ibid at 207-208
senior management are fulfilling their duties and responsibilities.\textsuperscript{228} The fact that each Islamic bank creates its own non-standardised SSB is a clear example of this. This board, with its exceptional power that sometimes overrides the power of the board of directors, has created a unique body in the structure of Islamic banks that differs from the regular structure of a company. In the absence of a regulation under which this board works, the board will be a source of annoyance and confusion for the banking market, as there are no guidelines regulating this important body. Unless regulated carefully, the existence of this body may conflict with some of the modern corporate governance standards and principles; a situation which makes applying Islamic banking principles even more challenging. There are many deficiencies regarding the current practice of the SSB due to the failure to regulate such an important practice and, indeed, this is the focus of this research which will be explored throughout the thesis. The remainder of this chapter explores the legal status of Islamic banks in Saudi Arabia.

\subsection*{3.3 History of the Saudi Banking System}

Banks and the banking system in Saudi Arabia have developed in accordance with the development of the country. Prior to its unification in 1932, there was no banking system but some banking services were introduced by foreign countries to serve their citizens in the region. Since unification, the banking system has taken various steps towards development before it gained its current shape. Four different stages can summarise the development track of the Saudi banking system: prior to 1932, when there was no political or banking system; from 1932 to 1952, when the current political system was established but no banking governing system existed; from 1952 to 1966, after the Saudi Arabian Monetary Agency (SAMA) was established; and, finally, after 1966, when the Banking Control Law was issued.

\textbf{1\textsuperscript{st} Stage: Prior to 1932}

During this period, the country had not yet been founded. There was no stable political system, and people lived a very primitive life. Apart from some parts, Saudi Arabia was never colonised since it was too poor and uninhabitable to attract the

\textsuperscript{228} Ahmed, 'Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal' (n 195) at 395
interest of colonial powers. This situation and the fact that Islamic law prohibits interest in banking transactions were referred to as the reasons why modern banking arrived relatively late compared to its emergence in the rest of the world.229

Due to the absence of a firm political system, no banking system existed at that time. However, it is recorded that some banking services were provided. The British Company, Gellatly, Hankey & Co., was the first known entity in the region to provide banking services, such as currency transfers and exchange. It entered Jeddah, in the west of the country, in 1885, to serve the small European community there.230 In 1889, the company was appointed as Lloyds Agent and continued to work until the Arabian Establishment for Trade and Shipping Ltd. (AET) took over its remaining activities, following its foundation in 1963.231 Although Gellatly, Hankey & Co. was the first recorded banking provider in the region, it has been inferred that some existing but unrecorded banking activities were being conducted by non-European groups who had businesses in the west of the region. The presence of several Indian and Jewish merchants, who may have engaged in banking functions at the ports of the Red Sea, indicates that some banking activities were carried out there.232 Some Indian and Egyptian companies have been recorded as providing banking activities, such as financing foreign trade.233

Still, banking activities were not provided by official banks. It was not until 1911 that the Imperial Ottoman Bank entered the region to serve the Turkish troops as the first bank. However, it was closed as soon as the troops left.234 Nevertheless, other banks and banking services were operating prior to the unification of the country in 1932. Two banks were formed in Hejaz, the western region of the Arabian Peninsula, for political reasons to serve the Hejazi Government at that time and, therefore, they closed after the political system changed, when King Abdulaziz, the founder of Saudi Arabia, began

230 Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 16
231 AET History <http://www.aet-lloydsagency.com/about/history> accessed 12/02/2015
232 Tschoegl, ‘Foreign Banks in Saudi Arabia: A Brief History’ (n 229) at 127
233 Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 16
234 Tschoegl, ‘Foreign Banks in Saudi Arabia: A Brief History’ (n 229) at 128
to dominate Hejaz.\textsuperscript{235} The only bank which survived to the next stage was the Bank of Nederlands Handel-Maatchappij (NHM), which was founded in 1926 and still operates under the name “Alawwal Bank”,\textsuperscript{236} which makes it the first bank in the region with a continuous presence.\textsuperscript{237} In fact, this bank played an important role in the next stage until the country developed its banking system.

\textit{2\textsuperscript{nd} Stage: 1932-1952}

The unification of the country in 1932 brought safety and stability to the region. This is a very important feature for a healthy banking environment. Prior to this, the insecurity and political instability caused the banks to terminate their services in the region. It was safer for banks to operate in the country during this period. Another important feature of this period was the discovery of oil in 1938.\textsuperscript{238} This marked the beginning of the oil boom in Saudi Arabia, which transformed it into one of the leading countries in the world for oil production. Thus, Saudi Arabia might have been expected to become a more attractive environment for banks to invest.

Despite this political and economic change, the banking system did not develop in a way that reflects this improvement. Initially, the government was unenthusiastic about hosting and regulating banking institutions because of the implication of accepting interest, which is prohibited under Islamic law. On the other hand, foreign banks were uninterested in operating in the country before civilization as the economy was too small for them.\textsuperscript{239} Thus, there was no governing banking law or central bank in the country at this stage. However, a large number of traditional money exchangers were providing basic banking activities, leaving the more complex ones to the few foreign banks which existed at that time.\textsuperscript{240}

\begin{thebibliography}{9}
\bibitem{Wilson200} Wilson, \textit{A Question of Interest: The Paralysis of Saudi Banking} (n 200) at 16
\bibitem{Wilson2016} In 2016, the bank changed its name from Saudi Hollandi Bank (SHB) to Alawwal, which means “the first”.
\bibitem{Tschoegl2029} Tschoegl, "Foreign Banks in Saudi Arabia: A Brief History" (n 229) at 128
\bibitem{Wilson200} Wilson, \textit{A Question of Interest: The Paralysis of Saudi Banking} (n 200) at 21
\bibitem{Wilson61} Wilson, ‘Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia’ (n 61) at 155
\end{thebibliography}
NHM was the most prominent bank during this period as, for several years, it was the only bank in operation.241 Some of the activities of the bank resembled the role of the central bank: assisting the country to issue its first independent currency in 1928; preserving the gold stock of the country; and receiving the oil payments.242 This was the case until SAMA was founded in 1952 to serve as the central bank of Saudi Arabia.

3rd Stage: 1952-1966

The need for a central bank in the country was obvious to the officials, especially after the increase in the country’s oil revenues and expenditure of the government due to the civilization. Thus, the government in 1951, with the help of the International Monetary Fund (IMF), entered into a reform programme to develop a modern monetary system which led to the establishment of SAMA in 1952.243 This was a very important step in improving the banking system since a central bank is one of the most important elements of modern countries’ economies.

SAMA played a very important role in improving the currency of the country. After the silver coins, issued in 1928, the government issued the country’s first gold coins in 1952, after the establishment of SAMA. Although SAMA was not authorised to issue official paper money until 1959, it started to issue pilgrim receipts in 1953. As the two holy cities in Saudi Arabia, Makkah and Madinah, received hundreds of thousands of pilgrims and visitors each year, pilgrim receipts were issued for their convenience and to relieve them of carrying heavy coins. Pilgrim receipts resembled travellers’ cheques where customers bought them in their home country and then sold them in Saudi Arabia to banks, money exchangers, or traders. However, pilgrim receipts were not exclusive to pilgrims but available to the general public and so local businesses benefited from the convenience of those receipts since paper money did not exist at that time.244

241 Tschoegl, ‘Foreign Banks in Saudi Arabia: A Brief History’ (n 229) at 128
243 Tschoegl, ‘Foreign Banks in Saudi Arabia: A Brief History’ (n 229) at 129
244 This information about SAMA in this paragraph is extracted from SAMA Historical Preview <http://www.sama.gov.sa/en-US/About/Pages/SAMAHistory.aspx> accessed 13/2/2015; Meyer-Reumann, ‘The Banking System in Saudi Arabia’ (n 240) at 215; Tschoegl, ‘Foreign Banks in Saudi Arabia: A Brief History’ (n 229) at 130
This stage also experienced the establishment of official local banks for the first time, to work and compete with the existing foreign banks. In 1953, the National Commercial Bank (NCB) was founded as the first official Saudi Bank.\textsuperscript{245} NCB was followed by the establishment of Riyadh Bank and Al Watany Bank, in 1957 and 1958, respectively. The latter, however, was forced into liquidation by SAMA, in 1960, due to insolvency and its assets were transferred to the former.\textsuperscript{246}

A new SAMA Law was issued in 1957, which is the current SAMA Law. The new law was issued due to the financial crisis that the country faced at that time to reform the previous one and give SAMA the independence and powers it needed to achieve its objectives.\textsuperscript{247}

4\textsuperscript{th} Stage: 1966 to the Present

The Banking Control Law was passed in 1966 to regulate banks' activities and strengthen the power of SAMA to license and supervise all banks operating in Saudi Arabia. The issuance of this law was the last step towards building a banking system that was consistent with the needs of a modern country.

SAMA exercised the power bestowed on it by banning foreign banks from any further growth in their branches, thereby providing an opportunity for the two existing Saudi banks at that time, NCB and Riyadh Bank, to grow rapidly.\textsuperscript{248} This situation continued until SAMA, in 1976, forced foreign banks wishing to work in the country either to operate through a local licensed agency bank or to incorporate locally and relinquish at least 60% of its ownership to a Saudi partner.\textsuperscript{249} These restrictions were recently mitigated by the government as part of its successful endeavour to join the World Trade Organization (WTO) in 2005, after 12 years of negotiations. One of the government's commitments upon its successful accession to the WTO was to reform its banking system to allow the direct branches of foreign banks to operate in the country.

\begin{footnotes}
\item[245] NCB Corporate Profile \url{http://www.alahli.com/en-us/about-us/corporate-profile/Pages/default.aspx} accessed 13/2/2015
\item[246] Tschoegl, 'Foreign Banks in Saudi Arabia: A Brief History' (n 229) at 130
\item[247] SAMA Historical Preview (n 244)
\item[248] Tschoegl, 'Foreign Banks in Saudi Arabia: A Brief History' (n 229) at 130
\item[249] Ibid at 131; Meyer-Reumann, 'The Banking System in Saudi Arabia' (n 240) at 214
\end{footnotes}
and to increase foreign ownership of banks from 40% to 60%.\textsuperscript{250} As listed on the SAMA website, there are currently 12 local banks, and 15 foreign banks have licensed branches to operate in the country.\textsuperscript{251}

It can be noted from this overview of the banking system in Saudi Arabia that several factors promoted the development of the system. The presence of foreign banks when the country was unified was a basic foundation for the banking system that the country needed at that time. The government did not find it necessary to intervene in the banking sector and establish its own system, as the foreign banks, notably NHM, were meeting the needs of the country, ranging from basic banking activities to acting as the central bank of the government. Another factor was the growing wealth of the country after the discovery of oil. The country’s revenues and expenditure increased dramatically, so it was driven to establish its own central bank. This heralded the beginning of the building of a new modern system with the necessary regulations for a healthy banking environment. Moreover, the oil boom made the country very attractive for banks that wished to finance a lot of ongoing projects that the government initiated to enhance the country. This situation, combined with the fact that most Saudis, for religious reasons, preferred to have non-interest bearing accounts, made the country among the most profitable banking environments in the world.\textsuperscript{252} Finally, pilgrims were another important factor in developing the banking system in the country. The presence of NHM in the region was initially designed to serve pilgrims arriving from Indonesia, which was a Dutch colony at that time.\textsuperscript{253} Pilgrims, also, were a motivating factor in accelerating the improvement in the banking system of the country. They were the reason why the banks were allowed to use paper notes when coins were the only sort of payment.

\textsuperscript{250} WTO General Council successfully adopts Saudi Arabia’s terms of Accession <http://www.wto.org/english/news_e/pres05_e/pr420_e.htm> accessed 17/02/2015
\textsuperscript{251} SAMA Licensed Banks <http://www.sama.gov.sa/en-US/BankingControl/Pages/LicensedBanks.aspx> accessed 25/07/2018
\textsuperscript{252} Wilson, \textit{A Question of Interest: The Paralysis of Saudi Banking} (n 200) at 9
\textsuperscript{253} Ibid at 19
3.4 Banking Laws in Saudi Arabia

The banking industry in Saudi Arabia is currently supervised by SAMA, which is the supervisory authority of banking licences and activities. There are two main laws governing this industry: the Saudi Arabian Monetary Agency Law, and the Banking Control Law. While the former is concerned with SAMA regulations, duties, and objectives, the latter regulates banking licences and activities. This section provides an overview of these laws.

3.4.1 SAMA Law

The current SAMA Law was issued by Royal Decree No.23 in 1957 and consists of 14 articles. The law includes the structure of SAMA and the authorities and duties of both its board of directors and governor. It, also, lists the three objectives for which SAMA was established. The first is to issue, support, and protect the national currency both inside and outside the country. The second is to act as the bank of the government, so SAMA is responsible for the governmental revenues and expenditure as well as the governmental investment in foreign currency. For this purpose, the law requires SAMA to establish a research centre to collect and analyse the necessary data that help to draw up the governmental economic and monetary policies. Finally, SAMA acts as a supervisory authority for the commercial banks working within the country. In this regard, the law draws on the general guidelines and duties of SAMA to monitor the commercial banks.

SAMA Law lists some of the practices that the agency is prohibited from undertaking. It is worth noting that the law requires SAMA to comply with Islamic law principles and to avoid committing any activity prohibited under Islamic law, including the paying or receiving of interest. These restrictions should preclude SAMA from actions involving interest, such as repo and reverse repo, or acting as a lender of last resort. However, SAMA does conduct these actions. Repo and reverse repo are

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254 Saudi Arabia, SAMA Law (1957) Articles 2 and 6a
255 According to Arnold, The Financial Times Guides to Banking (n 204), repo is a sale and repurchase agreement in which securities such as government bonds are sold for cash at an agreed price with a
regulated.\textsuperscript{256} Also, it acted as a lender of last resort to save several local banks from failing by placing or directing the placement of free or low cost deposits.\textsuperscript{257} These are examples of situations where the practice conflicts with the sharia commitment in the country.

### 3.4.2 Banking Control Law

In 1966, Royal Decree No.M/5 approved the issuance of the Banking Control Law, which contains 26 articles for regulating the banking services in the country. The law can be divided into three main parts. The first part describes the conditions and requirements for obtaining a banking licence, the restrictions related to the practice of banking activities, and the exclusivity of using the term “bank”. The second part is concerned with banking activities and management. It sets up the required statutory deposits that must be kept at SAMA as well as the capital adequacy ratio for banks; lists the prohibited actions and restrictions imposed on certain banking activities; and regulates some of the management and operational requirements imposed on banks. The final part gives SAMA the power to supervise the industry. SAMA is authorised to impose general rules for regulating the industry and inspecting all of the records it needs to for supervisory purposes. In this part, the law describes the procedures and penalties that SAMA may impose in cases of violation.

### 3.5 The Legal Recognition of Islamic Banks under the Banking System in Saudi Arabia

Islamic law plays a very important role in Saudi Arabia. It is stated in the Basic Law of Governance, which is considered the constitution of Saudi Arabia, that:

“The Kingdom of Saudi Arabia is a fully sovereign Islamic State. Its religion shall be Islam and its constitution shall be the book of God and the Sunnah

\textsuperscript{257} Wilson, \textit{A Question of Interest: The Paralysis of Saudi Banking} (n 200) at 48
(Traditions) of His Messenger, May God’s blessings and peace be upon him (PBUH).²⁵⁸

This article announces clearly that the Qur’a’n and Sunnah, the main sources of Islamic law, comprise the constitution of Saudi Arabia. More importantly, Article Seven of the same law declares that all laws in Saudi Arabia shall be governed by these two sources. However, in practice, some laws raise a very sensitive question in the community: do these laws conflict with any of the Islamic law principles? As important as this question is, since it is related to a constitutional issue, there is no legal mechanism such as a constitutional court to resolve it. The status of Islamic banks in Saudi Arabia is an example of the situation whereby the principles of Islamic finance are not recognised by the legal system. Unlike other countries, such as Malaysia, the banking system in Saudi Arabia is not dual, where Islamic banks are recognised by a special legal system that is different from the one regulating conventional banks. This section highlights the legal recognition of Islamic banks and its special financial transactions under the current laws.

3.5.1 Licensing Islamic Banking in Saudi Arabia: A Historical Preview

As stated before, SAMA Law requires the agency to adhere to Islamic principles and prohibits the agency from any involvement with interest. However, commercial banks are not required to do so. In fact, Islamic banks are the ones that struggled for years to obtain a banking licence.

The banking system in Saudi Arabia does not treat Islamic banking activities any differently from those of other banks. There is no special banking licence for Islamic financial activities so Islamic banks must meet the general banking requirements in order to obtain a licence. However, SAMA, for a period of time, disliked using the word “Islamic" because it implied that the other banks operating in the country, whose constitution was based on Islamic principles, were “non-Islamic". This political reason

²⁵⁸ Saudi Arabia, Basic Law of Governance Article 1
led some authors on Islamic banking to categorise Saudi Arabia among those countries with a discouraging environment for Islamic banks.259

Al Rajhi Bank is considered to have been the first Islamic bank to obtain a banking licence in the country. Although it was founded in 1957 as a money exchanger and provided some banking activities, it was not until 1988 that it received its banking licence.260 To achieve this, Al Rajhi had to fight SAMA for more than five years because it was reluctant to give a banking licence to an Islamic bank.261 The banking licence that Al Rajhi received was on condition that they would not use the word “Islamic” in the title of the bank.262

Other banks failed to obtain a licence, however. Examples are Dar Al Maal Al Islami and Albaraka Group, which were both founded in the 1980s to conduct Islamic investment and provide Islamic banking services. However, both banks continued to operate unofficially but successfully, without any difficulty, despite lacking a licence.263 Although the Banking Control Law does not allow the practising of any banking activities without a licence, SAMA ignored this situation and so created an extra-legal system for these Islamic banks, and allowed Al Rajhi Bank, before it obtained a licence, to operate outside the law.

Subsequent to licensing Al Rajhi, the bank became the most profitable bank in the country and the world’s largest Islamic commercial institution.264 Its success may have been what changed SAMA’s position towards licensing Islamic banks. Although there was no legal change in the banking law, SAMA allowed Islamic banking services to be provided. Albilad and Alinma banks are fully Islamic banks, established in 2005 and 2008, respectively. They are the most recent local banks to have been established in

259 Algaoud and Lewis, Islamic Banking (n 24) at 6; Vogel and Hayes, Islamic Law and Finance: Religion, Risk, and Return (n 34) at 12
261 Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 183
262 Wilson, ‘Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia’ (n 61) at 159
263 Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 181-182
264 Wilson, ‘Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia’ (n 61) at 159
the country. However, licensing these two banks followed a series of tolerant reactions by SAMA towards the Islamic banking services provided by the conventional banks. The high demand for Islamic banking services motivated the conventional banks to provide these activities for their customers. Conversion to Islamic banking services became a phenomenon after the first Islamic branch of NCB in 1990 enjoyed huge success, so the bank launched more Islamic branches which led other conventional banks to follow it.265 Bank Aljazira, founded in 1975, decided in 1998 to start converting into a fully Islamic Bank. In 2007 the bank declared itself a fully Islamic institution.266 NCB gradually began to convert its branches after its success in 1990. In 2005, its board of directors decided to convert all of the remaining non-Islamic branches into Islamic ones by the end of the year.267 NCB and Aljazira are the most prominent examples of the conversion phenomenon but not the only ones. Other conventional banks were intrigued by the success of those two banks so they started to open either Islamic branches or Islamic windows for Islamic banking services. At present, all conventional banks provide and offer Islamic banking and financial services to their customers.

Any discussion of SAMA’s attitude, which is a governmental institution, towards Islamic banks cannot ignore the Saudi Government’s ownership of those banks. Interestingly, the government, through its investment institutions, owns significant shares in the big Islamic financial services providers in the country. The records of the Saudi Stock Exchange (Tadawul) show that the governmental institutions’ shares in Al Rajhi Bank, Alinma bank and NCB268 are more than 10%, 25% and 64%, respectively.269 Not only does the government have this significant investment in these

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267 Mustafa, 'An Evaluation Study of the Phenomenon of the Conventional Banks Conversion into Islamic Banks: An Empirical Study about Some Saudi Banks Experience (n 265) at 70-71
268 While Al Rajhi and Alinma Banks are fully Islamic, NCB is not considered a fully Islamic bank although it has fully Islamic branches. The status of NCB will be discussed later on Chapter Five.
269 Al Rajhi Bank’s Major Shareholders and Foreigners <http://www.tadawul.com.sa/wps/portal/!ut/p/c1/lYuxDolwGAYf6f8oVMIoDFgkDfpDQ7uYDmqlAsYYfX3r5qLG3Hh35Cgw-ftw9LdhmvvZenKLnUZhtioRKKMslrJuvEUqBKg7fvjESKqlZcFPFUOKvGyzxuk1b1GUM4MIJN__kp6NY97suTSj2UuqSWbh8h-
banks, but it also takes important decisions to support and enhance the Islamic banking industry. Alinma Bank, the newest bank in Saudi Arabia, was founded by the government as an Islamic bank. Moreover, the government, collectively through its institutions, owned the majority of NCB shares when the decision to convert into fully Islamic branches was taken in 2005, which indicated the role of the government in that decision.270 Moreover, the government is seen as a major supporter of Islamic finance by hosting and sponsoring IDB.

The attitude towards Islamic banks of both the government and SAMA has been described as paradoxical.271 While SAMA has been more cautious about Islamic banks, the government has been more supportive and has viewed this industry as a promising one in which to invest. However, some programmes that SAMA sponsors indicate a more tolerant attitude towards Islamic banking. One of the main programmes provided by the Institute of Finance (IOF),272 established by SAMA, is the Professional Qualification in Sharia-Compliant Finance which leads trainees to become Certified Islamic Finance Analysts (CIFA). The programme description reads:

[Website links and references are provided for Alinma Bank, NCB, and the Institute of Finance.]
"The CIFA qualification consists of different modules that progress through three levels. Developed by an experienced team of Islamic finance experts with the vision to produce and nurture Islamic finance leaders in the industry around the globe… CIFA holders will have a clear grasp of how to contrast Islamic tools with traditional banking and finance, thereby competing effectively. CIFA is recognised and widely accepted by Islamic financial institutions as the modules build and integrate skills relating to the marketing, accounting, risk management, and practical application of Islamic finance".\(^{273}\)

It is clear from this description that Islamic banking has become highly respected by SAMA, and this is due to offering this type of competitive programme. It is important to note that IOF also offers other single courses for Islamic banking employees.

Islamic banks no longer face the difficulty of being licensed in the country but are required to comply with the general requirements of banks without any special consideration of their Islamic services. Although SAMA has become more objective regarding licensing Islamic banks in the country, the special requirements of Islamic banks are not considered in the Banking Control Law, which supervises banking activities. The next section examines this issue.

3.5.2 Islamic Banks and the Banking Control Law

The Banking Control Law was issued in 1966 by the Saudi government to regulate all Saudi banks. Despite the fact that some Islamic banking activities, such as Al Rajhi Money exchange, founded in 1957, were provided at that time, the law failed to recognise Islamic banking services. This negligence would not be problematic if the Islamic banking continued at this limited scale. This was not the case as, subsequent to the passing of this legislation, Saudi banks became more interested in providing Islamic banking services as a response to the citizens' demands. The Banking Control Law, however, failed to recognise the uniqueness and difference of Islamic financial services.

A specific example of this is Article Ten of the Banking Control Law. It lists the impermissible actions for banks. According to this article, no Saudi bank can be a partner in a commercial, industrial, agricultural or any other project apart from owning less than 10% shares of a company, and the bank’s investment shall not exceed 20% of its capital.\textsuperscript{274} Nevertheless, equity-based products, as previously described, require the bank to partner with its customer in the project that needs to be financed. This action obviously violates the law, as the bank becomes a partner in the project.

Moreover, the same article states that a bank is not allowed to own or rent real estate unless it is directly related to the operation of that bank or for the purpose of providing accommodation for its employees. As an exception to this prohibited action, a bank, under justified special circumstances, may own real estate after obtaining the approval of SAMA, provided that this real estate does not exceed 20% of the bank’s capital. The 20% condition seems reasonable to save banks from excessive risk. However, this clause restricts all three types of sharia-compliant finance: equity-based, sales-based, and lease-based products. In order to finance real estate, Islamic banks have to involve in owning real estate using one of these three types. To provide these financing services, Islamic banks, according to the article, need SAMA approval, which is offered only under justified special circumstances. Consequently, many of Islamic banks’ services would be provided under a special condition and the law still does not clearly recognise this necessary action for Islamic banks.

The previous restriction on real estate was eased after the issuing of the Real Estate Finance Law in 2012. It allows banks, as an exception to Article Ten of Banking Control Law, to own “dwellings for finance purposes”.\textsuperscript{275} The exemption grants permission to use Islamic finance tools, especially \textit{murabaha}, to finance housing and makes this type of finance legal. While this is a positive step towards Islamic banking’s recognition, the restrictions in Article Ten still apply to the use of other tools of Islamic finance. Consequently, some necessary actions that stamp Islamic banks as Islamic are either explicitly banned by Article Ten or require special approval.

\textsuperscript{274} Saudi Arabia, Banking Control Law (1966) Article 10
\textsuperscript{275} Saudi Arabia, Real Estate Finance Law (2012) Article 2
The analysis above shows that the law explicitly prohibits some fundamental actions that are necessary to provide Islamic financial products and some of these actions may be authorised under “justified special circumstances”. Consequently, Islamic banks are placed in a situation where they are compelled either to break the law or work under special circumstances. Nevertheless, SAMA seems to condone that some of Islamic banking activities lie outside the law. As a result, an extra-legal system has been created by the government itself.

Equally important is the issue of sharia governance, especially the SSB. The legal recognition of sharia governance and the SSB is as essential to the Islamic banking industry as the recognition of the tools of Islamic finance. The SSB is completely ignored by the legal system and only mentioned in the Financial Companies Control Law. However, it only requires financial companies, other than banks, to form their own sharia committees to ensure sharia-compliant financial contracts. The law does not explain any further details about the structure and requirements of the sharia committees or how they should operate.

### 3.6 The Dilemma of Banking Disputes in Saudi Arabia

This section highlights the issue of banking disputes in the country. It aims to address the other half of the picture where the banking system and Islamic law face a challenging relationship. On the one hand, the Basic Law of Governance states clearly that Islamic law is the governing law in Saudi Arabia and the law that the courts apply in all cases alongside the other regulations that do not conflict with Islamic law. On the other hand, interest, which is clearly prohibited under Islamic law, is a critical feature of the banking services and is commonly used in banking activities in Saudi Arabia. A problem arises when the bank and its customer disagree about the interest loan and the case goes to court. The outcome of this case is the dismissal of any claim for interest, as this is strictly prohibited. This situation has proved a nightmare for banks for many years and they were suffering due to bad loans. The government had taken several steps to try to solve the problem. This section provides a historical background to the

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277 Saudi Arabia, Basic Law of Governance Articles 7 and 48
development of the jurisdiction over banking disputes in the country and the associated legal challenges that sometimes threatened the industry and required the government to intervene.

3.6.1 Quasi-judicial Committees and the Judicial System in Saudi Arabia

Disputes in Saudi Arabia should be heard before one of these three judicial bodies: the judicial or sharia courts, the Board of Grievances, or quasi-judicial committees established to deal with special disputes. According to the Basic Law of Governance and the Law of the Judiciary, Sharia courts have general jurisdiction over all cases unless they are given exclusively to the Board of Grievances.278 The Board of Grievances was originally founded in 1954 as a division of the Council of Ministers before it became a separate body in the following year. It was recognised as an independent administrative judicial body, reporting directly to the king in 1982, and its jurisdiction relates to administrative cases.279

Other places where disputes in the country can be settled are the quasi-judicial committees. Many quasi-judicial committees existed prior to the judiciary reform of 2007, when their number was reduced dramatically. Each committee had its specific jurisdiction over specific cases upon which the other courts would not decide either because they fell beyond their jurisdiction, e.g. the Board of Grievances, or the judges were not qualified to decide these cases. These committees were not planned to fall outside the judiciary system but the circumstances led to the number of committees increasing.280 This began after the sharia courts failed to deal with certain maritime cases properly, so the government felt it necessary to establish a specialised commercial panel.281 Al-Ghdyan describes these circumstances which resulted in these committees being established:

281 Vogel, Islamic Law and Legal System: Studies of Saudi Arabia (n 31) at 302
“These committees were established as a result of the sharia courts judges’ unwillingness to apply government regulations, fearing that they may contain provisions that are not in strict compliance with the sharia law. Therefore, wherever a new regulation is issued as a response to the requirement of the country’s social and economic development, it provides for the establishment of a committee whose task is to implement its provisions”.282

The situation whereby some committees had judicial authority raised concerns about the judiciary in the country. The existence of these committees could threaten justice and question the legality and independence of the judicial system in the country.283 However, some of these committees can be regarded as administrative bodies, since their decisions can be appealed before the Board of Grievances, so their decisions are viewed as administrative rather than judicial.284 The problem with other committees, whose decisions are final and cannot be appealed, was the government’s consideration during the judiciary system reform. With the new laws issued for both sharia courts and the Board of Grievances in 2007, a manual was issued to arrange and guide the reform procedures. It transferred quasi-judicial committees to sharia courts, apart from five committees, including the Banking Dispute Committee, which were excluded temporarily until further studies could be carried out by the Supreme Council of Justice about the status of these committees in relation to the judiciary system.285 This shows that there is a real intention by the government to bring these committees under the judiciary system and to limit any further growth associated with having judicial authority outside the judicial system. So far, banking disputes still go before a special committee. In fact, banking disputes have encountered many legal challenges for a long time, mainly due to the conflict between conventional loans and sharia, which is an annoying situation about which the banks in the country have complained repeatedly.

283 Tafran, ‘Quasi-Judicial Committees in the Kingdom of Saudi Arabia: Analysis Study on the Most Important Quasi-Judicial Committees (n 280) at 165
284 Al-Ghadyan, ‘The Judiciary in Saudi Arabia’ (n 282) at 247
3.6.2 Jurisdiction over Banking Disputes Prior to the Establishment of the Banking Disputes Committee (BDC)

Several factors led banking disputes be settled outside sharia courts. First and foremost, the judges in the sharia courts were not tolerant about contracts that included any type of interest and would declare illegal and deductible from the loan any interest agreed upon in that contract. The Supreme Judicial Council declared that both sharia courts and notaries were prohibited from validating mortgage loans that included interest, as this is strictly prohibited under sharia law.286 Banks lost all cases that went to sharia courts.287 Another reason was that the sharia courts were unprepared to hear complicated cases, such as banking disputes. While the country experienced economic development in the 1960s, sharia courts continued to operate in their traditional way and the complexity and lengthiness of the court procedures made it too expensive for the banks to undertake litigations.288

The position of the banks deteriorated during the financial crisis in the country in the 1980s. Following the oil boom of the 1970s and early 1980s, many large governmental projects were financed by the banks. Banks became very attracted to financing such projects and some of the major international banks wanted to join in in order to benefit from this huge profitable opportunity, even though the banking system in the country was not a safe investment. This unusual movement in such an environment created a sense of danger. When the oil price started to drop in 1982, the government cut its spending dramatically, which had a serious effect on the governmental contractors. In turn, the contractors were unable to repay their loans, which then became bad loans for the banks. Suing the contractors was no solution, since interest would be eliminated by going to a sharia court. Instead, several contractors decided to sue the banks, claiming that the previous payments of interest to the banks were illegal, which the courts confirmed.289 Banks were in serious trouble and some of them went bankrupt.290 These

287 Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (n 200) at 132
288 Ibid at 127,132; Meyer-Reumann, 'The Banking System in Saudi Arabia' (n 240) at 230
289 For more about this crisis and its effect on banks, see Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (n 200) at 110-122
problems made it necessary to find alternative ways to settle banking disputes which led to the establishment of the Banking Dispute Committee (BDC), previously known as the Settlement of Banking Disputes.

Before the establishment of the BDC in 1987, three different judiciary systems possessed jurisdiction over banking disputes: sharia courts as the general jurisdiction, the Commission for the Settlement of Commercial Disputes (CSCD) when no negotiable instruments were disputed and the Commercial Paper Committee (CPC) when the disputes include negotiable instruments. However, banking disputes made no progress and the situation became even more complicated. These committees, too, refused to enforce any interest on loans, as they applied Islamic law principles and, also, did not help to expedite the case procedures since they tended to operate as part-time panels so some cases took years to settle. Moreover, the fact that CSCD and CPC were not the exclusive jurisdiction placed banks in a desperate position. They found themselves in cases involving three different courts and, even if the banks were successful in CSCD or CPC, debtors could still submit claims to the sharia court, refusing to recognise the jurisdiction of these committees.

In an attempt to solve the problem, the Ministry of Commerce, in its Resolution No.822 on December 1985, declared that all banking disputes should be referred to the Legal Committee within the ministry, which is the appellate committee for CPC. However, the legality of this committee was questionable. Since it was established by a ministry resolution, some lawyers stressed that this resolution could not overtake the jurisdiction granted to CSCD and CPC by the Council of Ministers’ resolution, which is a higher authority. Nevertheless, the committee did not get a chance to work because

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290 Alameldin, ‘Banking Disputes in Saudi Arabia’ (n 286) at 36
291 Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 130; Meyer-Reumann, ‘The Banking System in Saudi Arabia’ (n 240) at 231
292 Vogel, Islamic Law and Legal System: Studies of Saudi Arabia (n 31) at 303, 306; Meyer-Reumann, ‘The Banking System in Saudi Arabia’ (n 240) at 231
293 Meyer-Reumann, ‘The Banking System in Saudi Arabia’ (n 240) at 231; Wilson, A Question of Interest: The Paralysis of Saudi Banking (n 200) at 130,137
295 Turck, ‘Resolution of Disputes in Saudi Arabia’ (n 294) at 15
the government, shortly after this resolution, decided to solve the problem by creating a new body exclusively for settling banking disputes.

3.6.3 The Establishment of Banking Disputes: Did it Solve the Problem?

In its endeavour to stop the bad loans dilemma that had such a serious effect on the economy, the Council of Ministers issued Resolution No.729/8 in March 1987 to establish the Settlement of Banking Disputes Committee within SAMA, with exclusive jurisdiction over banking disputes. The resolution made it clear that the sharia courts and other committees must stop hearing banking disputes and transfer their current cases to the new committee in an attempt to solve the issue of the multitude of jurisdictions over this kind of disputes. Additionally, a circular was issued by the Minister of Justice demanding that all banking disputes that were pending in the sharia courts were transferred to the new committee. Other problems linked with banking disputes prior to the resolution was the enforcement of interest and judges’ expertise. These problems were considered by this committee. According to the resolution, the panel comprised three experts in the field of banking, who should solve the problem in “accordance with their signed agreements”, a phrase which implies that interest is enforceable. This was an attempt by the government to resolve the issue by avoiding the direct use of the word “interest”. However, the committee is not free of legal deficiencies, that raised concerns about the enforceability of its decision and even the exclusivity of its jurisdiction.

It has been questioned whether this committee is an administrative or a judicial body. The wording of the resolution fueled this argument. The committee, on the one hand, as established by the resolution, lacked a judicial character. Its name raised a question, as a “settlement” committee aimed to “settle” between parties rather than issue judicially imposed decisions. According to the resolution, complaints should be sent to the Presidency of the Council of Ministers to obtain permission for the committee

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296 Saudi Arabia, Council of Ministers Resoluton No.729/8 (1987)
297 Zuhair S. Al-Herbish, ‘Jurisdiction over Banking Disputes in Saudi Arabia’ (2011) 25 Arab Law Quarterly 221 at 222
298 Saleh Ali Al Swileh, ‘Settlement of Banking Disputes in Saudi Arabia’ (Mater, Naif Arab University for Security Sciences 2010) at 78-79
299 Turck, ‘Resolution of Disputes in Saudi Arabia’ (n 294) at 16
to hear the case. Also, the resolution states that, if no settlement has been reached between the parties, the committee should send the case to the proper court, which would be either the Board of Grievances or the shaira court. The Committee’s Regulation, which was issued later, supported this view by indicating that the committee is not actually a court, like sharia courts or Board of Grievances. On the other hand, the resolution gave the committee the judicial power to decide against litigants, freeze their bank accounts, ban travel, or seize their assets as well as request the government agencies and banks to stop dealing with particular litigants. This was supported by the Ministry of the Interior, who requested that all of the governors of the Saudi provinces and all of their agencies should help to enforce the committee’s decisions. It was also argued that the settlement was not intended as understood since the committee had the power to enforce the decisions it took and, in practice, “imposed a solution even if it was refused by one of the parties or sometimes both of them”.

These arguments remained theoretical and did not threaten the banking industry, as banks could now pursue their customers to collect loans more confidently until some banking cases found their way to the Board of Grievances, which agreed to look at them. The Board of Grievances viewed the Settlement of Banking Disputes as an administrative body and built on that when deciding its cases. The board justified its view in some of the cases brought by banks’ customers and listed the reasons why the committee should not be regarded as a judicial body. First, the members of the committee are not judges since their appointment and employment hierarchy differ from those of judges. Second, unlike the judicial body, there is no appeal mechanism in this committee but a petition for the same committee to re-examine the case, a process that resembles the one related to administrative decisions, nor are there any known procedures or rules for litigation. Third, the committee is not independent but supervised by SAMA, which operates under the Ministry of Finance. Fourth, the resolution establishing the committee does not intend to establish a judicial body since the wording

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300 Meyer-Reumann, ‘The Banking System in Saudi Arabia’ (n 240) at 233-234
301 Ibid at 234
302 Alameldin, ‘Banking Disputes in Saudi Arabia’ (n 286) at 37
303 Decision No.21 on 25/1/2008 (Board of Grievances in Saudi Arabia, Second Commercial Circle); Decision No.612 on 19/9/2010 (Board of Grievances in Saudi Arabia, Sixth Appeal Circle)
of “Resolution” that establishes it does not give it its judicial status. Some of the phrases and words in the resolution that support this are “committee”, “settle the disputes”, “find the proper solutions”, and “satisfaction of the parties”, as well as stating that the case should be referred to the proper court if the committee cannot reach a satisfactory decision for one of the parties. Finally, even foreign jurisdictions viewed this body as an administrative one when the Egyptian Appalleate Court refused to enforce a committee’s decision, as it regarded this as an administrative one.

Such decisions by the Board of Grievances ended the controversy about the status of the committee but, on the other hand, raised again the concern about the enforceability of interest loans. This time, the government acted more quickly, in order to escape any future crises.

3.6.4 Banking Disputes Committee: The Re-Establishment

Following the decisions of the Board of Grievances, that regarded the Settlement of Banking Disputes an administrative body, officials feared that the committee might fail to achieve the objectives for which it had been established because of the legal deficiencies that had been highlighted by the Board. Before these decisions became precedents, that might have ruined all of the efforts to enforce banking loans, the committee was re-established by a new Royal Resolution,304 that considers most of the legal deficiencies identified by the Board of Grievances. The new resolution aimed to reform the committee to become explicitly a judicial body so that neither sahria courts nor the Board of Grievances can intervene in banking disputes. The word “settlement” was removed from the name of the committee, which thereby became BDC, to avoid any misunderstanding regarding the status of the decisions it makes. The resolution also considers the appointment issue, making the members of the committee appointed by a royal order, like other judges. Finally, the resolution establishes an appellate body for the committee and allows all committee decisions to be appealed within 30 days.

It is clear that the resolution was issued to address the same points that the Board of Grievances had listed as the reasons depriving the committee of its judicial status. The

304 Saudi Arabia, Royal Resolution No.37441 (2012)
committee, after the new resolution, has become more eligible to issue judicial decisions. However, the independence of this committee remains an issue, as it is still operating outside the two main judicial bodies in the country: the shaira courts and the Board of Grievances. In fact, it is implied in the resolution that BDC is supervised by the Ministry of Finance, as the resolution states that the committee should send its internal rules and regulations via the Minister of Finance to the king in order to be issued officially. Although the members of BDC are now appointed by a royal order issued by the king instead of SAMA, the new resolution does not give the committee full independence and so it remains subordinate to the Ministry of Finance. Nonetheless, it is expected that the judicial system will, in some sense, adopt BDC in the future as officials have admitted that the fact that the quasi-judicial committees, including BDC, lie outside the judicial system is exceptional. As stated above, the government requested a comprehensive study to find solutions for those committees operating outside the judicial system in the country.

While the Islamic banks struggled to be recognised by the banking laws in the country, it seems that the conventional banks also had difficulties with the judicial system regarding the enforcement of interest loans. This issue has faced various legal challenges within the Islamic judicial system in the country. The attitude of Islamic law towards interest cannot be changed so the government took various actions, in an attempt to ensure that banking disputes can be adopted under the judicial system without obstacles, which eventually resulted in BDC. Yet, this is only a reconciliation effort by the government to enforce interest, which sharia courts refuse to recognise. Banking disputes have not been fully adopted within the judicial system and so challenges to BDC might arise in the future.

3.7 Conclusion

Referring to the case of Islamic banking in Saudi Arabia, this chapter argues for the need for a different regulatory system to control the Islamic banking industry. This need rests on the special transactions that Islamic banks use which require different prudential requirements, have greater risk, and involve actions that are not always allowed. Also, the requirement for a different review process in Islamic banks to ensure
compliance with sharia place more emphasis on regulating and controlling this important practice since the absence of such regulation harms the Islamic banking industry. This provides a ground for discussing the need to restructure the SSB and the framework of sharia supervision in the following chapters.

Examining the case of Saudi Arabia, whose banking system developed only relatively recently due to the absence of a resilient political system in the region, the endeavour of banking regulation was challenging for the government. On the one hand, the entire banking system worldwide is based on interest-based loans. On the other hand, Islamic law, which strictly prohibits interest, is the country’s main legal source. To thrive economically and benefit from its oil resources, the country required a strong banking system, which led it to adopt a similar banking system to the rest of the world, a situation that made conflict with Islamic law inevitable and created a paradox. First, Islamic banks and their special services and requirements lack legal recognition and, secondly, the enforcing of interest-based loans by the conventional banks poses a challenge. The latter problem is solved by either a judicial reform that adopts the enforcement of conventional loans or by converting the entire banking system into an Islamic one. The former needs a legal improvement to grant Islamic banking greater recognition.
Chapter Four: The Roles of the Sharia Supervisory Board and the Corporate Governance Structure

4.1 Introduction

While the SSB is seen as an important tool in the context of sharia governance, its framework is still unique to corporate governance. Unlike certain other mechanisms of sharia governance, the SSB, so far, has not been easily adopted within the corporate governance structure. For example, the internal sharia department fits perfectly, as AAOIFI suggests, within either the internal audit department or as a separate unit with an equivalent authority and accountability framework to that of the internal audit department. Therefore, an internal sharia audit department can be smoothly inserted into a company without shaking its governance structure. This is not the case for the SSB, whose current structure, arguably, could not be matched by any corporate governance mechanism. Therefore, it does not have, to date, a standardised model in the industry and is not legally well-recognised, although it performs a vital role in sharia governance. As a result, the SSB is peculiar to the corporate governance framework, so it is important to identify the functions of the SSB in order to analyse how they could fit as governance tools. In this regard, it is helpful to conduct analogical comparisons with the roles of other well-structured corporate governance mechanisms whose objectives are similar to those of SSBs. This chapter compares the functions of the SSB with both the board of directors and gatekeepers, especially the external auditors. This comparison will form a basis for addressing other issues in the following chapters that will help the SSB to be recognised in the modern corporate governance structure and increase the efficiency of the sharia supervision practice.

4.2 The SSB: The Emergence of the Concept

Due to the prohibition of interest in Islam and restriction being placed on Islamic banks from using the traditional method of financing ventures, they utilise sharia principles to innovate, develop and improve sharia compliant products. This approach of

305 Governance Standard No.3, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (Dar Almaiman 2015) at 910
finance requires banks to recruit and consider sharia as a new skill for dealing with the requirements and principles of the Islamic law of transactions. Therefore, sharia experts are recruited at different levels of banks to undertake the supervision, management and auditing of transactions in order to ensure compliance with sharia. The SSB is the most important mechanism used by the bank in this regard.

However, the idea of the SSB did not emerge simultaneously with the advent of Islamic banks. Early Islamic banks, such as Mit Ghamr and Nasser Social Bank, in the 1960s and 1970s, did not have SSBs or any formal sharia counselling.306 Similarly, IDB and Dubai Islamic Bank were established initially without SSBs. The banks themselves applied the principles of sharia to their transactions without forming an official relationship with sharia scholars. Later, a relationship with sharia scholars was developed by inviting them to act as consultants regarding their activities and transactions as well as seeking fatwas on specific issues.307 This marked the beginning of this new relationship between sharia scholars and the financial institutions, which later resulted in the first formal SSB in 1976, in the Faisal Islamic Bank of Egypt, which set a trend for the other Islamic banks that followed.308

During this period of a lack of, or limited, relationship between Islamic banks and sharia scholars, there was no record of sharia violations.309 This should not lead us to downplay the role of SSBs in Islamic banks nowadays. Instead, it shows the simplicity of the transactions that the Islamic banks were engaged in at that time, which was later developed from financing modest, basic agricultural projects to complex commercial ones. At some point, the banks realised that the basic analysis of sharia principles by non-experts would be insufficient, so they sought more advice from sharia scholars to ensure sharia compliance. Then, sharia consultants developed into their current form as a board.

306 Zulkifli bin Hasan, Shari’ah Governance in Islamic Banks (Edinburgh University Press 2012) at 57
307 A fatwa is an opinion based on Islamic law on a specific matter. It will be described in more detail in Chapter Five.
308 Kahf, ‘The Rise of a New Power Alliance’ (n 58) at 21-22
309 Hasan, Shari’ah Governance in Islamic Banks (n 306) at 57
The effort to institutionalise the SSB was led by three leading financial institutions: *Dar Al-Maal Al-Islami* in Geneva, Switzerland; Kuwait Finance House in Kuwait; and *Dallah Al Baraka Group* in Jeddah, Saudi Arabia. These banks developed the notion of the SSB as we know it today.\(^{310}\) It should be noted that IFIs use different names and titles for SSBs, which include:

- Sharia supervisory committee
- Sharia council
- Sharia board
- *Fatwa* and sharia supervisory board
- Sharia control committee
- Religious board
- Sharia committee
- Sharia advisory council

SSB, however, is the most common title employed in the Islamic finance industry and has been adopted by the most prominent Islamic financial organisations, such as AAOIFI and IFSB.\(^{311}\)

The definitions of the SSB can be categorised into two types. While some tend to describe the body and its entrusted roles and procedures that it actually fulfils in practice, others prefer definitions that disregard its structure and they focus on sharia supervision as the objective of SSBs.\(^{312}\) The first approach is the most common. It is adopted in the literature and by organisations like AAOIFI and IFSB. AAOIFI defines the SSB as “an independent body of specialised jurists in *fiqh al-mua’malat* (Islamic commercial jurisprudence)…entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they

\(^{310}\) Yahia Abdul-Rahman, *The Art of RF (Riba-Free) Islamic Banking and Finance: Tools and Techniques for Community-Based Banking* (John Wiley & Sons Inc 2014) at 90-91
\(^{311}\) Ginena and Hamid, *Foundations of Shari'ah Governance of Islamic Banks* (n 134) at 252-253
are in compliance with Shari’a Rules and Principles”. Garas and Pierce adopt a similar approach, defining the SSB as “a panel of shari’a scholars and experts of Islamic finance industry that starts with the IFI’s inception and continues with the IFI to ensure that all the incorporation documents, internal policy and activities are in compliance with shair’α”. While these definitions focus on the role of the body, IFSB’s definition, adopted by some of the literature, describes the body more generally as “a panel of sharia scholars acting as special advisers to the institutions”.

The other approach focuses on the objective of the body; namely, sharia supervision. Based on this, sharia supervision may be defined as “the preventive, remedial and complementary process of control, review and analysis of all the IFI’s activities, products, contracts and transactions starting from the incorporation of the IFI onwards to ensure compliance with Islamic shari’a for the purpose of generating legitimate profits (halal) and improving in the IFI’s performance”. A more specific definition of sharia supervision is provided by DeLorenzo, who defines it as “the process of ensuring that a financial product or service complies with Islamic legal precepts and principles either by its conforming, to one degree or another, to a recognised Islamic legal norm or by its not violating the same”. Although sharia supervision is not exclusive to SSBs because of the other mechanisms of sharia governance which share the same objective, the SSB is considered the cornerstone and sometimes the ultimate source and authority of sharia supervision, since all other arrangements of this phenomenon, in one way or another, are linked or referred to it.

313 Governance Standard No.1, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 885
314 See for example Hichem Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 226; Muneeza and Hassan, ‘Shari’ah Corporate Governance: The Need for a Special Governance Code’ (n 173); Bashar H. Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (2013) 61 American Journal of Comparative Law 539
316 Onagun and Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ (n 181)
317 Islamic Financial Services Board, Guiding Principles on Sharia'h Governance Systems for Institutions Offering Islamic Financial Services (n 174) at 1
318 Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 388
Defining the SSB by describing its objective, sharia supervision, and how it should be practised is more consistent with, and better serves, the aims and purpose of this research. Instead of looking at the SSB as an inevitable body that each Islamic bank must have in order to ensure sharia compliance, the research focuses on its objectives and whether these could be more effectively achieved through other arrangements. The SSB itself is merely a tool for sharia supervision, which could be undertaken by other mechanisms if these are deemed more effective. This includes a central SSB and sharia firms which should receive more attention as potential alternatives to the SSB.

4.3 Importance of the SSB

The SSB is a main pillar of sharia governance. It has been seen as a main factor in determining whether a bank is Islamic or not, and is a prerequisite for admission into the International Association of Islamic Banks (IAIB). Therefore, the importance of the SSB is built on sharia governance’s importance and has the same justifications for its significance. More specifically, the SSB gains its importance from different perspectives.

Sharia expertise is an obvious aspect of SSB’s importance. Managers have neither the sharia knowledge nor the time to acquire it so they need sharia experts to decide on sharia-compliance matters, especially given that financial products are developing quickly and require continuous sharia consultation. They have become more complex and require dedicated experts to decide on sharia-compliance matters, which resembles the need for lawyers in the finance industry. The objective of Islamic banks could not be achieved without the committed involvement of sharia scholars in the sector.

Economically, the SSB plays a significant role. It is highly feasible for Islamic banks to have SSBs. First and foremost, the interest of the stakeholders in having sharia-
compliant investment products is well preserved by having an SSB.\textsuperscript{325} It is the most important tool for ensuring sharia compliance and a source of confidence and trust for stakeholders in this regard. “The integrity of IFIs greatly depends on the status of shari’ah compliance, its impact of products, professional competence, and behavior towards, and observance of, shari’ah norms. The shari’ah board thus plays a fundamental role in ensuring and enhancing the credibility of IFIs”\textsuperscript{326}

Moreover, the SSB, despite its associated cost, can save the institution the significant expenses that may occur as a result of violating sharia.\textsuperscript{327} Sharia risk is a big concern for IFIs and can threaten their financial status. An effective, high-performing SSB can significantly reduce the sharia-compliance risk and is, to date, the best way that IFIs have found to deal with it.\textsuperscript{328} In fact, a well-performing SSB can facilitate and increase the profits.\textsuperscript{329} In addition to the previous benefits, which contribute considerably to the financial reports of IFIs, SSBs play an important indirect role in marketing. The members of SSBs have a strong social power which, itself, fuels confidence and attracts more investors and clients.\textsuperscript{330} Also, the members can participate in various events and justify why the products they have designed or approved are compliant.\textsuperscript{331}

Furthermore, the SSB brings an additional benefit to the economy by creating and inventing new financial models and products which enrich and empower the financial industry.\textsuperscript{332}

The SSB is seen as an effective tool for promoting ethics. One of the impacts of the SSB on banks is that sharia is emphasised in their systems and policies, which would


\textsuperscript{326} Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 548

\textsuperscript{327} DeLorenzo, ‘Shari’ah Supervision in Modern Islamic Finance’ (n 319) at 1

\textsuperscript{328} Yusuf Talal DeLorenzo, ‘Shari’ah Compliance Risk’ (2007) 7 Chicago Journal of International Law 397 at 400-401

\textsuperscript{329} Nathan Garas and Pierce, ‘Shari’ah Supervision of Islamic Financial Institutions’ (n 315) at 389

\textsuperscript{330} Ibid at 389

\textsuperscript{331} El-Gamal, Islamic Finance: Law, Economics, and Practice (n 29) at 11

\textsuperscript{332} Al-Khalifi, ‘The General Theory of Sharia Boards’ (n 312) at 8
promote the moral behaviour of these banks and their employees.\textsuperscript{333} This strong adherence to the Islamic moral code can counterbalance the incentive problems arising from asymmetric information and moral hazard.\textsuperscript{334} Moreover, the SSB maintains and promotes corporate social responsibility (CSR), which is reinforced by the nature of its roles, and researchers have found a positive relationship between the existence and size of the SSB and CSR.\textsuperscript{335} This is because Islamic banks would be under pressure from SSBs to be involved in and disclose more social and charitable activities. "The nature of compliance with Islamic laws and principles from an Islamic point of view entails not only assurance of compliance through issuing the Shari'ah report, but also greater involvement in CSR activities including CSR disclosures".\textsuperscript{336} Additionally, the paying of zakat by corporations to eligible people or projects is a responsibility of SSBs, to ensure that they fulfil a significant requirement of the social responsibility of these corporations.\textsuperscript{337} From the Islamic point of view, CSR is also enhanced by banning certain activities that are harmful to society. The duty of the SSB in ensuring that the institution does not invest in or facilitate investments or businesses related to gambling, alcohol or tobacco supports this view.\textsuperscript{338}

The final perspective of SSB's importance is related to the concept of wisdom which is a recent notion in the business field that combines knowledge with morality, ethics, soundness of judgment, social and environmental considerations, and right and wrong perspectives.\textsuperscript{339} "Managerial wisdom" is an important aspect of management, which managers should consider, as many corporate failures have been caused by unwise

\textsuperscript{333} Bhatti and Bhatti, 'Development in legal Issues of Corporate Governance in Islamic Finance' (n 166) at 88
\textsuperscript{334} Nasser M. Suleiman, 'Corporate Governance in Islamic Banks' (2000) 22 Society and Economy in Central and Eastern Europe 98 at 105
\textsuperscript{336} Farook, Kabir Hassan and Lanis, 'Determinants of Corporate Social Responsibility Disclosure: The Case of Islamic Banks' (n 335) at 123
\textsuperscript{337} Muneeza and Hassan, 'Shari'ah Corporate Governance: The Need for a Special Governance Code' (n 173) at 125
\textsuperscript{338} Samy Nathan and Vincent Ribière, 'From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking' (2007) 37 The Journal of Information and knowledge management systems 471 at 479
\textsuperscript{339} Ibid at 477
decisions.\textsuperscript{340} A wise corporation is the one that is committed to promoting ethical behaviour, trust, loyalty, transparency and respect for stakeholders by having wise management at all levels, especially its board of directors, which establishes wise strategies implemented by wise leaders.\textsuperscript{341} In light of this concept, the SSB brings to the institution much value which is the reason why many customers and investors choose the institution. These include: transparency, trust, ethical behaviour, credibility, as well as the philosophy, values and beliefs underlying Islam, ethics and morality.\textsuperscript{342} The SSB not only transfers the knowledge but also the Islamic wisdom that drives the operations and actions of the bank and, more importantly, increases the stakeholders' trust in the institution.\textsuperscript{343}

4.4 The Nature of the SSB Roles

The main objective for the SSB is to establish a satisfactory level of confidence among the stakeholders that the institution is acting in compliance with sharia principles in its contracts, services provided and other transactions. To achieve this objective, the SSB has various roles and responsibilities which cover a wide area, including: contracts and transactions, policies, internal rules and ethical standards and codes.\textsuperscript{344} For example, AAOIFI assigns the SSB the duty of "directing, reviewing and supervising the activities of Islamic financial institutions".\textsuperscript{345} These duties are very broad and involve a wide range of different activities.

IFSB classifies these duties in chronological order as ex-ante and ex-post, where the former takes place at the product design and development stage which includes the issuance of fatwa or sharia standards and the compliance check before it is introduced to the customers and the latter takes place after products and services have been offered to

\textsuperscript{340} Michael W. Small, ‘Wisdom and Now Managerial Wisdom: Do They Have a Place in Management Development Programs?’ (2004) 23 Journal of Management Development 751 at 760-763
\textsuperscript{341} Nathan and Ribière, ‘From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking’ (n 338) at 478
\textsuperscript{342} Ibid at 477
\textsuperscript{343} Ibid at 477, 479
\textsuperscript{344} Riyadh Al-Khalifi, ‘Fatwa and Sharia Supervision Boards in Islamic Financial Institutions between Theory and Practice’ (2005) (Islamic Financial Institutions: Reality and Future) at 295-296
\textsuperscript{345} Governance Standard No.1, The Accounting and Auditing Organization for Islamic Financial Institution, \textit{Accounting, Auditing and Governance Standards} (n 305) at 885
customers, which includes a sharia review and sharia reporting.\textsuperscript{346} Some of the literature adds an in-between or intermediate range of the SSB roles, which covers their responsibilities during the product offering stage.\textsuperscript{347} This includes addressing the issues arising from the implementation of sharia as well as sharia consultations in unforeseen situations due to regulatory requirements or customer needs.\textsuperscript{348}

Instead of the chronological category, some of the literature classifies the SSB roles based on their nature which are divided into either advisory, also known as consultation, and supervisory,\textsuperscript{349} or into advisory, compliance, sometimes known as certification, and audit.\textsuperscript{350} Addressing the nature of SSBs’ roles is consistent with the aim of this chapter, which is to provide an analysis of how efficiently these different SSB duties are being assigned. While the exact SSB roles vary, depending on the jurisdiction, the three main roles that the SSB is often responsible for are legislation, consultation and auditing. It is important to note that jurisdictions vary regarding the extent to which SSBs perform these roles. While SSBs in Saudi Arabia are exclusively responsible for these duties, other arrangements, such as national, or centralised, SSBs, have been established in certain jurisdictions to remove, to differing extents, some of these responsibilities. Such arrangements will be further analysed but, first, the roles of the SSB will be explained.

The SSB plays a very important role regarding legislation for IFIs, which includes the issuance of \textit{fatwas} and sharia policy standards. In this context, the term “legislation” is used to refer to sharia rule-making and this term is used because the SSB, in setting sharia standards, acts as a legislative authority. In the absence of a detailed code of Islamic financial contracts, the SSB is entrusted with the interpretation of sharia and, therefore, it is the duty of the SSB to issue \textit{fatwas} or religious decisions that legislate

\begin{itemize}
\item \textsuperscript{346} Islamic Financial Services Board, \textit{Guiding Principles on Shari‘ah Governance Systems for Institutions Offering Islamic Financial Services} (n 174) at 8, 9
\item \textsuperscript{347} Hiam M. Al Zaidaneen, ‘The Islamic Shari‘a Control on Islamic Banks: Views and Application’ (2013) 40 Dirasat: Shari‘a and Law Sciences 89 at 95; Ginena and Hamid, \textit{Foundations of Shari‘ah Governance of Islamic Banks} (n 134) at 332
\item \textsuperscript{348} Ginena and Hamid, \textit{Foundations of Shari‘ah Governance of Islamic Banks} (n 134) at 332
\item \textsuperscript{349} Nathan Garas and Pierce, ‘Shari‘a Supervision of Islamic Financial Institutions’ (n 315) at 395
\item \textsuperscript{350} Bedj Toufik, ‘The Role of Shari‘a Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks’ (2015) International journal of contemporary applied sciences 109 at 116; Casper, ‘Sharia Boards and Sharia Compliance in the Context of European Corporate Governance’ (n 325) at 5-6
\end{itemize}
the IFIs’ transactions before they are provided. These decisions are set up as the sharia standards for the bank and cover sharia matters with regard to all of its transactions, services and procedures. Through being the ultimate source of sharia, some SSBs play an arbitrator role in resolving any disputes that may arise between the bank and its clients regarding contracts, a role which sometimes is clearly assigned by the bank to its SSB. In addition, some SSBs are entrusted with educating the public about sharia matters regarding Islamic finance. This is similar to the role of the regulatory authorities in educating the public on the matters subject to their regulation.

The advisory or consultation task is a big component of the SSBs’ role. This type of duty includes all of the SSB tasks related to assisting the management to comply with the sharia policy and standards that are established nationally, if any, and/or by the SSB itself. SSBs are responsible for approving products, contracts and services before they are offered. This is to verify compliance with the sharia standards. The SSB scrutinises the proposals of these transactions to provide a sharia decision and make any necessary amendments. This task is advisory because the management in this process basically consults the SSB on whether these are compliant with the sharia standards or not. It resembles the advisory task for lawyers regarding whether a specific transaction is legal or not. It is also similar to the non-audit services provided by audit firms to assist corporations to comply with accounting and auditing standards. The SSBs’ advisory role includes engaging in discussions with product developers to issue guidelines and opinions and suggest ways and methods for modelling a sharia-based product to help to mitigate the sharia risk. This includes consultation on contract forms, a procedural manual for transactions, services and the innovation of new products. The SSB is also consulted by the management during the implementation

351 Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 395
352 Zaidaneen, ‘The Islamic Shari’a Control on Islamic Banks: Views and Application’ (n 347) at 95
354 Bank Albilad, Sharia Board Internal Rule Article 3
355 Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 395
356 Ginena and Hamid, Foundations of Shari’ah Governance of Islamic Banks (n 134) at 339
357 Ibid at 331, 341
358 Zaidaneen, ‘The Islamic Shari’a Control on Islamic Banks: Views and Application’ (n 347) at 95; Abdul-Rahman, The Art of RF (Riba-Free) Islamic Banking and Finance: Tools and Techniques for Community-Based Banking (n 310) at 93
stage in the case of ambiguity regarding some aspect of sharia. Advice is also sought from SSBs regarding the calculation of zakat, together with the disposal of non-sharia investments and distribution between the shareholders and IAHs. The SSB has the responsibility for training and guiding the management on how to apply sharia standards to daily transactions. This includes conducting and structuring training programs, seminars and symposia to inform the management, staff and stakeholders about sharia rulings directly related to their work.

The auditing role takes place after the products have been offered to test their level of compliance with the sharia standards. It aims to ensure that all of the services offered by the institutions comply with the requirements laid down by the SSB. The SSB reviews and audits the procedures for implementing new products and the IFI’s financial statements to verify sharia compliance. Then, the SSB issues a report of sharia certification, which usually forms an integral part of the institution’s annual report. According to AAOIFI, “shari’a review is an examination of the extent of an IFI’s compliance, in all its activities, with the shari’a. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc”. In addition to the areas mentioned in the definition, sharia audit extends also to the information technology application system to support the banking operations, the organisational structure, and the marketing initiatives undertaken by IFIs. To ensure further compliance with sharia, the SSB should have a high level of

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359 Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 395
361 Nathan and Ribière, From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking (n 338) at 476-477
362 Ginena and Hamid, Foundations of Shari’ah Governance of Islamic Banks (n 134) at 331
363 Toufik, The Role of Shari’a Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks’ (n 350) at 116
364 Nathan Garas and Pierce, Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 395
365 Grais and Pellegrini, Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options’ (n 360) at 17
366 Governance Standard No.2, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 899
authority. Although the general rule is that the SSB has no executive role or authority, intervention may occur if decisions taken by the directors could breach sharia and jeopardise the Islamic character of the bank.\textsuperscript{368} This executive authority may include the authority to request board of directors’ meetings and non-regular general assembly meetings (shareholder meetings) and suspend or cancel any non-compliant actions.\textsuperscript{369}

A question arises here regarding the type of audit for which the SSB is responsible - internal or external. Normally, IFIs establish internal review/audit departments to perform the task of internal auditing to assess compliance with the SSB rules and standards as well as assisting the SSB to perform its research, training program and auditing duties.\textsuperscript{370} AAOIFI recommends that this task should be carried out by either the internal audit department within the IFI or a separate sharia unit but, above all, that it should be independent and report directly to the board of directors.\textsuperscript{371} Nevertheless, this unit is limited to an internal review and audit role while the ultimate source of this task is usually supervised by the SSBs.\textsuperscript{372} In addition, SSBs are presumed to carry out the role of external auditor.\textsuperscript{373}

Generally, the roles listed above are the main ones with which SSBs are entrusted. In fact, institutions need these roles to be carried out in order to promote themselves as Islamic. There is a need for a legislative authority to act as the legal and ultimate source of sharia rules, assist with the continuous and accurate implementation of these rules and, finally, obtain a report verifying compliance with them. The SSB is a tool that was established to satisfy all of these requirements and assure the stakeholders of sharia-compliance. Therefore, the establishment of an SSB as a legitimate control body is perceived as vital for IFIs.\textsuperscript{374} However, this body might be an unsuitable tool for the

\textsuperscript{368} A. K. Aldohni, ‘Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?’ (PhD, University of Leeds 2008) at 103
\textsuperscript{370} Ginena and Hamid, \textit{Foundations of Shari'ah Governance of Islamic Banks} (n 134) at 191
\textsuperscript{371} Governance Standard No.3, The Accounting and Auditing Organization for Islamic Financial Institution, \textit{Accounting, Auditing and Governance Standards} (n 305) at 910
\textsuperscript{372} Grais and Pellegrini, ‘Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options’ (n 360) at 18
\textsuperscript{373} Yousuf Ash-Shubaily, ‘Sharee’ah Governance of Islamic Banks’ (2011) 53 Al-Adl Journal 145 at 149-149
\textsuperscript{374} Nadwi, ‘Analysing the Role of Shariah Supervisory Boards in Islamic Financial Institutions’ (n 324) at 2
nature of the roles it performs which might be better served by more effective ones, an issue that is analysed throughout the remainder of the thesis.

4.5 The Enforceability of the SSB’s Decisions

An issue related to the nature of the SSBs’ roles is whether their decisions are advisory or binding on the board of directors. The nature of religious decisions, or *fatwas*, as non-binding decisions, as will be explained, could have an impact on this issue. The consequence of *fatwas* being non-binding is that people, or institutions, should not be forced to adhere to them. Considering this fact, the SSB’s decisions, as merely *fatwas*, would be unenforceable so other mechanisms of compliance should be applied more strictly to offset this disadvantage.\(^{375}\)

Muneeza and Hassan argue strongly for the necessity of the SSB’s decisions to be binding in order for a real difference to exist between Islamic and conventional banks.\(^{376}\) Otherwise, an SSB would be both a waste of time and a deceptive tool in relation to the IFIs’ stakeholders, who think that the board of directors honours the SSBs’ decisions.

An SSB’s decisions are enforced either by a regulatory authority and law or through self-enforcement by the IFI itself.\(^{377}\) Some even argue that an SSB’s decision should be considered as equally binding as a judicial one.\(^{378}\) On the other hand, some support the non-binding nature of SSBs’ decisions and suggest that SSBs should only highlight different ways and alternatives to solving situations where there is a lack of compliance with sharia, and the final decision should be left to the board of directors.\(^{379}\)

These contradictory views on the nature of the SSB’s roles have a strong effect on the SSB’s authority within the bank. By making binding decisions, the SSB would have an influence on the management decisions which could be overturned if the SSB believes that those decisions contradict sharia. On these occasions, the authority given

\(^{375}\) Al-Khalifi, ‘The General Theory of Sharia Boards’ (n 312) at 23

\(^{376}\) Muneeza and Hassan, ‘Shari’ah Corporate Governance: The Need for a Special Governance Code’ (n 173) at 126

\(^{377}\) Ginena and Hamid, *Foundations of Shari’ah Governance of Islamic Banks* (n 134) at 319

\(^{378}\) Ash-Shubaily, ‘Sharee’ah Governance of Islamic Banks’ (n 373) at 174

\(^{379}\) Toufik, ‘The Role of Shari’a Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks’ (n 350) at 115; Casper, ‘Sharia Boards and Sharia Compliance in the Context of European Corporate Governance’ (n 325) at 9
to the SSB overcomes the authority of the board of directors. While this high level of authority is seen as a sharia governance tool for ensuring sharia compliance, it might be legally challenged in some jurisdictions, which makes any interference with the role of the management illegal. For example, the regulations of the Financial Conduct Authority in the UK (FCA) suggest that the SSB roles may not interfere with the management of the firm and, therefore, should be purely advisory in nature. Therefore, the advisory nature of an SSB’s decisions is sometimes adopted as a legal requirement. This means that the SSB can only provide instructions and consultations in sharia-compliance matters but its decisions are not enforceable when it comes to the management of the bank. Alternatively, SSBs may provide different sharia-compliance options from which the management may choose. However, the absence of other sharia governance mechanisms may raise a compliance concern as well as a question regarding whether the management can reject the SSB’s decision and proceed with transactions that are viewed as sharia non-compliant.

In fact, the argument about the enforceability of an SSB’s decisions is a result of combining roles with different natures, some of which need an enforcement power, such as legislation, and some of which do not, such as advisory. Assigning these duties to a single body, the SSB, has resulted in ambiguity and confusion regarding how to categorise and regard its decisions. As inferred from the name, the advisory role is not binding. Thus, to ensure sharia-compliance, the SSB should supply different sharia-compliant alternatives to the management which can then make a final selection from among these. Those who place stress on the enforceability of an SSB’s decisions look only at the legislative and auditing aspects of its roles. Surely it is necessary to force IFIs to comply with sharia rules and standards or, otherwise, all sharia governance mechanisms would be pointless. However, it might be difficult for corporate governance to adopt the structure of an SSB as an internal body with such enforcement authority. The regulatory frameworks have so far been unsuccessful in establishing a clear structure of sharia supervision and removing this confusion about the authority of SSBs.

4.6 The SSB Roles and the Need for a Clear Governance Framework

The three types of roles performed by SSBs are essential for the Islamic finance industry. Regulators of the industry should take into account that these roles, especially legislation and auditing, require a high volume of independence and objectivity which should be crucial elements to consider. Otherwise, the industry will be susceptible to failure due to the lack of confidence that a product is sharia-compliant. A lack of independence has been identified as a challenge that may constrain the ability of SSBs effectively to fulfil their responsibilities. Economically, the profitability of IFIs depends on the public trust regarding their compliance with sharia, which mainly rests upon their confidence regarding SSBs' independence. Therefore, the governance structure should consider the level of independence and the issue of conflict of interests among SSB members. Yet, the legal recognition of SSBs does not reflect this importance. The frameworks of SSBs are insufficiently developed to establish a standardised practice of sharia supervision with clear roles for SSBs, and the industry lacks standards that clearly define how SSBs should perform their tasks. SSB members have different scopes of work and duties in different institutions. This ambiguity regarding the duties and scope related to SSBs' tasks is a bad governance practice which has a negative effect on sharia-compliance. The absence of a widely-agreed professional code, which includes standards and procedures regarding how SSBs should perform their roles, negatively affects their performance. Adopting a clear definition of the

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382 Grais and Pellegrini, ‘Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options’ (n 360) at 8
385 Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 137
roles and responsibilities of SSBs would improve the practice of sharia supervision by enhancing its credibility and independence.\textsuperscript{387}

The current legal recognition of the SSB varies across different jurisdictions. They adopt different sharia governance frameworks, a situation that adds ambiguity to its roles. While some jurisdictions have developed comprehensive sharia governance frameworks at both the national and institutional levels, others adopt sharia governance frameworks only at the institutional level. Some jurisdictions, however, prefer not to regulate the practice of sharia supervision and leave this instead to IFIs’ voluntary initiatives or market influence.\textsuperscript{388} More specifically, the SSB operates under four different sharia governance models.\textsuperscript{389} First, the SSB is required only at the IFIs’ level, where each IFI establishes its own SSB according to the national legal requirements to serve as the higher legal authority in regard to sharia matters. Second, some jurisdictions establish a central SSB within the central bank in addition to the required SSBs in IFIs. To different extents, the central SSB performs supervisory and regulatory roles over the internal SSBs whose legislative role is limited to interpreting the central SSB’s guidance. Similar to this framework, the third model has a central SSB in addition to internal SSBs but is not linked to the central bank. The fourth model is the market-driven SSB, where there is no legal requirement to establish an SSB at any level but IFIs choose to do so due to the industry practices, norms, and market demands.

This level of variations in the legal recognition contributes to the uncertainty regarding the roles of SSBs. The legal status of SSBs ranges from a legal requirement by a national law to merely a contract between the board of directors and SSB members.\textsuperscript{390} Therefore, the position and role of the SSB within the sharia governance framework has not yet been clarified and does not reflect the significant role that sharia supervision performs. While the roles are specified in the contracts or internal rules of IFIs in certain jurisdictions, the framework for these roles is identified by national

\textsuperscript{388} Rihab Grassa, ‘Shariah Supervisory Systems in Islamic Finance Institutions across the OIC Member Countries’ (2015) 23 Journal of Financial Regulation and Compliance 135 at 139
\textsuperscript{389} Ginena and Hamid, Foundations of Shari’ah Governance of Islamic Banks (n 134) at 276-279
\textsuperscript{390} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 139
regulations in other jurisdictions. As a result, the SSB has different expectations regarding its roles, ranging from being the highest authority in sharia matters to being merely sharia advisors.

In some of these models, the SSB may not be the only tool for sharia supervision as some jurisdictions might establish additional tools for sharia governance which serve similar objectives to the SSB. Where these tools, such as a central SSB and sharia firms, co-exist, they remove some of the SSB’s responsibilities. If they are standardised and regulated, these tools could be as valuable to a sharia governance framework as an SSB and may even replace it.\textsuperscript{391} Otherwise, the functions of these multiple tools of sharia supervision may overlap and increase the vagueness of the situation.

Uncertainty about the SSB’s roles may exist even within the same model of governance. Although the second model of the SSB has become a common governance framework and a solution for jurisdictions seeking to advance their legal recognition of Islamic finance,\textsuperscript{392} there remain differences in the framework within the same model. The extent and scope of the central SSB supervision vary significantly and do not establish a well-standardised practice of sharia supervision.\textsuperscript{393} Moreover, while the SSB’s role of auditing is consistent with its objective of ensuring sharia-compliance, regulators appear reluctant to assign this role clearly to SSBs. Recently, some jurisdictions have required IFIs to appoint external sharia auditors. This requirement raises a question about how the SSB is viewed by the regulators. In fact, the variation in terms of requiring an external audit reflects a different perception of the real objective of SSBs and contributes to the confusion about their audit role.\textsuperscript{394}

Even the academic literature appears confused about the roles of SSBs. Different classifications of SSB’s roles have been identified by different researchers. In their survey, Garas and Pierce identify six different classifications of SSB’s roles.\textsuperscript{395} Although these different classifications do not necessarily indicate significant differences between

\textsuperscript{391} These tools will be discussed in the following chapters.
\textsuperscript{392} Recent regulations, such as Oman and UAE, tend to adopt this model which has been in effect in Malaysia, Pakistan, Indonesia, and Sudan.
\textsuperscript{393} More about the role of standardisation in central SSBs will be discussed in the next chapter.
\textsuperscript{394} The SSB and the audit role will be discussed in Chapter Six.
\textsuperscript{395} Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 394-395
the SSB’s duties, they show the different perceptions of the nature of these tasks which relate to the level of ambiguity and uncertainty surrounding these roles.

The scope of the SSB’s role is also ambiguous. The different names for “SSB”, which refer to different meanings, prompt different expectations and perceptions of the nature of the SSB’s roles. Such a situation negatively affects the performance of SSBs and contributes to their lack of independence.\textsuperscript{396} In practice, it is indicated that the SSB is not, in some cases, an effective tool for sharia governance, due to certain limitations. Although its task should ensure compliance across all products and transactions of the institutions, its authority is restricted to several issues, presented to it by the management or board of directors.\textsuperscript{397} Put differently, the management can control the scope of the SSB’s task. While the SSB can intervene outside this scope if it discovers any sharia violation, this intervention is not well-governed to ensure sustainability.

Alkhamees attributes the ambiguity of the SSB’s role to three factors.\textsuperscript{398} First, SSBs have experienced different phases of development in recent history, from being merely a marketing tool to promoting the ideology of Islamic finance through performing sharia supervision in a less formal way in a non-institutional style to becoming fully institutionalised. Second, the scope and extent of SSB supervision differ due to the existence of different levels of IFIs which range from a fully-fledged Islamic bank, gradually converting, or one that only provides Islamic products in limited windows or as additional services. Finally, sharia supervision is not recognised as an independent profession in many jurisdictions whereas the legal status of the SSBs’ roles in the few jurisdictions recognising the profession of sharia supervision is insufficient to resolve the ambiguity.

Clarifying the roles and responsibilities of the SSB would help the global banking industry to understand the practice of sharia supervision. The governance structure of this practice is still new and largely unknown in the conventional banking industry. SSBs

\textsuperscript{396} Elqari, ‘The Independence of Sharia Boards’ (n 383) at 12-13; Umar, ‘SSB’s Roles between Individual Advisory and institutional Profession’ (n 386) at 11
\textsuperscript{397} Ahmad Al-Saad, ‘The Effect of Sharia Supervision on Islamic Finance’ (2005) (Third International Conference on Islamic Economics) at 12, 22-23
\textsuperscript{398} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 137
may cut across the responsibilities of the board of directors and/or management in order to perform their job.\textsuperscript{399} The intervention of SSB members, as non-bankers, in banking-type decisions is somewhat confusing and might be difficult for the regulators to understand.\textsuperscript{400} For this reason, the existence of an SSB in the governance structure might be unwelcome unless its roles and position within the governance structure are certain and clear. It is necessary to draw a line between the different responsibilities and prevent any potential overlapping duties with the management which might affect performance or create some intra-bank tension. Also, investors will become confused over these multiple frameworks that significantly vary, although they aim to achieve the same objectives. This reflects the immaturity in the practice of the SSB compared to other roles, such as auditors, lawyers and directors, which have high levels of consistency all over the world with few differences, which do not lead to the same confusion as associated with SSBs.

While it is true that IFIs require additional governance mechanisms to ensure sharia supervision, the common response to this requirement, by basically creating SSBs, might not be ideal. Despite the importance of SSBs’ roles, squeezing a new body into the structure of the IFIs to carry out these additional roles may not be the best solution. Instead, these roles need to be smoothly injected into robust governance structures in order to achieve efficient sharia supervision. The objectives of the SSBs could be achieved through using other well-structured tools rather than creating a completely new one. To examine this possibility, the similarities and differences between the roles and objectives of SSBs and both the board of directors and gatekeepers should be analysed.

\textsuperscript{399} Howard Davies and David Green, \textit{Banking on the Future: The Fall and Rise of Central Banking} (Princeton University Press 2010) at 231
4.7 The SSB and the Board of Directors

4.7.1 The Board of Directors under Corporate Governance

The board of directors is critical to the framework of corporate governance. The theories focus on the structure, roles, representation and accountability of the board and the obvious reason for that is the importance it has as the highest layer of management and the heart of the company, whose performance substantially depends on it. Due to being a “control mechanism to monitor the powers exerted by the company’s managers”401, the board of directors requires an effective framework. This is considered as one of the main issues in corporate governance, as it deals with the most important mechanism of monitoring the company.

Many issues regarding the board of directors are discussed in detail under corporate governance. The principles of corporate governance have an impact on the framework of the accountability, structure, composition, duties and authorities of the board. Nordberg categorises the issue of the board of directors discussed within the corporate governance into five types.402 First, there are issues within the board which include its roles, responsibilities and organisation. Second, there are issues that exist between the board and senior managers and which concern, mainly, the agency problem and how executives should be remunerated and monitored. Third, there are issues between the board and shareholders which highlight the rights of shareholders to monitor and nominate directors. The fourth type discusses the power and balances of the board to offer a fair representation of the different interests of the various owners. Finally, corporate governance explores the responsibility of the board, as a representative of the corporation, regarding the different types of stakeholders.

In an effort to ensure high performance, different corporate governance frameworks adopt various approaches to these issues. One of the major differences between the board’s structure in different countries is the model of board adopted: unitary or dual. In the Anglo-Saxon style of corporate governance, it is common, and mostly required to

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401 Andrew Keay, ‘Exploring the Rationale for Board Accountability in Corporate Governance’ (2014) 29 Australian Journal of Corporate Law 115 at 120
402 Nordberg, Corporate Governance: Principles and Issues (n 141) at 115
have a one-tier board which comprises both executive and non-executive directors appointed by shareholders and responsible for all aspects of the company’s activities. Adopted in countries such as Germany, China and Norway, the two-tier board system separates the management and control by having two distinct boards: supervisory and management. The supervisory board consists of only the equivalent of non-executive directors appointed by shareholders and sometimes the other stakeholder representatives, such as trade unions or employee representatives. Its responsibility is to supervise, monitor and oversee the management board and take strategic decisions. Consisting usually of executives appointed by the supervisory board and chaired by the CEO, the management board is responsible for operating and running the day-to-day business of the company.\(^{403}\)

As one of the main issues within corporate governance, the board of directors and its roles have been well-developed both theoretically and in practice. Its legal framework has been clearly defined in commercial regulations and corporate governance codes. Under this framework, non-executives’ representation on the board and the issue of independence are significantly considered to ensure that the body is able to represent the stakeholders’ interests objectively. From a governance perspective, the SSB might share similar objectives to the board of directors. While the board of directors aims to protect, principally, the economic interests of the stakeholders, the SSB reassures the religious concerns of the stakeholders. In addition, the board of directors and the SSB, in some practices, share similar characteristics in that they are appointed by shareholders. These similarities might raise the issue of the consideration of the SSB as a board of directors to help to adopt the body within the corporate structure. To examine this consideration, the link between the roles of both boards is analysed below.

### 4.7.2 The SSB and the Roles of the Board of Directors

Generally, the board of directors is responsible for determining the company’s aims, strategies, plans, and policies; monitoring the company’s progress in achieving those

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\(^{403}\) For more about unitary and dual system, see Goergen, *International Corporate Governance* (n 136) at 90-91; Mallin, *Corporate Governance* (n 150) at 165-166; Solomon, *Corporate Governance and Accountability* (n 137) at 79
aims as well as the board performance collectively and individually as members; and appointing the management.\textsuperscript{404}

OECD identifies the major roles of the board of directors, which include the following:

- Reviewing and guiding the corporate strategy, plans, policies and procedures; setting performance objectives; monitoring implementation and corporate performance; and overseeing major expenditure.

- Monitoring the effectiveness of the company’s governance practices.

- Appointing and replacing the key executives of the company and their remunerations.

- Setting a remuneration policy that guarantees the long term interest of the company and its shareholders.

- Ensuring a formal and transparent board nomination and election process.

- Managing potential conflict of interests among the management, board members and shareholders.

- Ensuring the integrity of the corporation’s accounting and financial reporting systems.

- Overseeing the process of disclosure and communications.\textsuperscript{405}

Johnson et al. classify the responsibilities of the board of directors into three types: control, service and resource dependence.\textsuperscript{406} The first role involves controlling the management, which includes hiring and dismissal, determining the executives’ pay, and ensuring that the management does not expropriate the stakeholders’ interests. The service role entails advising the top management as well as drawing up the corporation’s strategy. The final responsibility of the board of directors is providing resources critical to the corporation’s success. The resource dependence role is based

\textsuperscript{404} Mallin, \textit{Corporate Governance} (n 150) at 169
\textsuperscript{405} Organisation for Economic Co-operation and Development, \textit{G20/OECD Principles of Corporate Governance} (n 143) at 53-57
on Pfeffer’s view of the “board as an instrument for dealing with important external organisations, by putting representatives of these institutions on the board”.407 Under this view, directors serve effectively to reduce the uncertainty resulting from external dealings as well as provide valuable resources, such as information, skills, access to more key constituents and legitimacy.408

While the service role involves, besides advising, setting the corporation’s goals and strategic directions, Nicholson and Kiel argue that the role of strategising should be a separate responsibility because it is usually perceived by the board itself or by the modern regulations to be one of the board’s substantial roles.409 In addition, they argue, that the strategic policies set up by the board have a considerable effect on the firm’s performance, which is one of the board’s responsibility.

Similarities between the SSB and the board of directors have been noted by several researchers. In light of these categories, Nathan and Ribiere argue that, apart from the planning and strategising role, the SSB has the same roles as the board of directors but to a narrower extent.410 Based on their argument, the SSB executes a monitoring role by controlling the religious side of the institution, which involves reviewing and approving transactions, services, products and policies as well as appointing internal sharia auditors. The service role is equivalent to the advisory task of the SSB that involves proposing sharia-compliant financial transactions, replying to any sharia-related inquiries, and training the management on how to apply Islamic rules. The resource dependence role is assumed in SSB’s right to access all of the information needed to make decisions regarding compliance matters.

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407 Jeffrey Pfeffer, ‘Size and Composition of Corporate Boards-of-Directors - The Organization and its Environment’ (1972) 17 Administrative Science Quarterly 218 at 222
410 Nathan and Ribière, ‘From Knowledge to Wisdom: The Case of Corporate Governance in Islamic Banking’ (n 338) at 476
However, it is essential to compare the roles and objectives of both boards, regardless of their structure. Arguably, the current SSB’s structure as an internal board causes confusion and lead to the drawing of somewhat inaccurate similarities. Sharing similarities with the roles of the board of directors, to some extent, does not necessarily make the SSB a board of directors in the company. Similarities may exist as a result of having a similar structure. For example, the SSB suffers from an information asymmetry problem, as does the board of directors, especially its non-executive members. Both are susceptible to building decisions based on selective information received from the management. Also, the appointment of the SSB members and the board of directors are similar in cases where SSB members are appointed by shareholders. These similarities exist mainly because of the position that the SSB occupies within the company. The issue is whether the SSB fits into the roles and objectives of the board of directors or not.

It is important in this context, therefore, to compare the objectives they serve. The board of directors is supposed to guide the company in the direction that satisfies the interests of the company and all of those interests that the company is set to serve, such asbenefitting the shareholders. Since these interests vary in importance, depending on the consideration of different jurisdictions and companies, the board of directors acts as a balance between these interests. This balance is occasionally reflected in the different stakeholder representations on the board’s membership. Even under agency theory, where the financial interest of the investors is, usually, the only prominent interest that the board of directors should represent, the board acts as a balance between the interests of investors and, on the other side, those of the management. On the other hand, the SSB does not play such a balancing role. The only interest it considers is the religious one, regardless of all other interests, including the financial one. Although the religious interest forms a part of the interests of the corporation that should be considered by the board of directors of Islamic banks, this interest is not satisfied by merely being represented on the board as a vote and being part of its balancing power and composition. Unlike other interests, sharia-compliance is

411 Nordberg, Corporate Governance: Principles and Issues (n 141) at 37
a pass-or-fail interest and so cannot be measured on a graduated scale, as can other interests. If a specific transaction violates sharia, it must not be conducted; otherwise, sharia interest is not delivered. There is no room for negotiation with other interests. Thus, the religious interest can only be satisfied by having a veto power on decisions violating sharia, regardless of other interests that these decisions may serve. This is not the case with the board of directors where the area of decisions is not simply white-or-black but contains a considerable grey area that they may move within. This is an essential difference to be considered in this comparison.

Analysing the similarities, as argued by Nathan and Ribiere, between the roles of both the SSB and the board of directors, the advisory role appears to be the most similar role that is performed by the two boards. The other roles of the board of directors do not fit within the SSB roles. The resource dependence role, assigned to the board of directors, cannot be assumed to fall under the SSB’s right to access all information since they are not alike. The right to access information aims to increase the board’s awareness of internal information in order to reduce the problem of information asymmetry. The resource dependence role, however, has nothing to do with this internal issue. Instead of dealing with internal information, the resource dependence role concerns the external resources that the directors contribute. Therefore, the resource dependence role is significantly different from the right to access information.

The monitoring role performed by the SSB, if any, is significantly narrower in terms of its scope and subject. While the board of directors monitors all aspects of the business, the SSB is limited to sharia-related matters. Even in these matters, the SSB does not have the ultimate control right, as is the case with the board of directors. The SSB’s task does not extend beyond detecting sharia violations and suggesting alternatives to non-sharia compliant products. As long as all of the alternatives are sharia compliant, choosing which option to adopt is not a duty of SSB; it is a matter for the management and board of directors. Put differently, the SSB’s role in reviewing transactions and decisions is limited, as stated earlier, to a pass-or-fail test in order to detect any terms or conditions that violate the sharia requirements while, in the case of
the board of directors, there is always an opportunity to enhance the performance of the company, so the monitoring role of the board does not cease at a certain point.

In fact, the SSB suffers from several significant limitations compared to the board of directors, which make the similarities drawn up between both boards inaccurate. If, supposedly, these similarities are assumed to be correct, how would the SSB fit within the structure of the company? Being represented as a part of the board of the directors’ roles would not satisfy sharia interest because, as discussed above, this interest needs to have a veto rather than voting power. This introduces into the discussion the hypothesis that the SSB is either another board in a two-tier board system or a sub-committee of the board of directors.

4.7.3 The SSB and the Two-tier Board System

The roles of the SSB require a high level of independence, so the members must not be considered as bank personnel or to be working under the authority of the board of directors. This leads some researchers to consider the two-tier board system as incorporating the SSB body within the corporate governance structure. To apply this system in the case of Islamic banks, the SSB might be viewed as the supervisory board, so it is inferred that the regular board of directors takes responsibility for operating as the management board. However, this implementation of the SSB as a supervisory board is not considered in all of the banks’ operations but is limited solely to sharia-related matters. In other words, IFIs are considered to be two-tier board institutions only if the matters subject to discussion are sharia-related. Otherwise, the SSB has no effect on the structure and the regular board of directors is in charge.

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412 Warde, Islamic Finance in The Global Economy (n 63) at 235
413 Aldohni, 'Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?' (n 368) At 103; Scott Morrison, 'Shariah Boards and the Corporate Governance of Islamic Banks in the United Kingdom' (2014) 10 Journal of Islamic Economics, Banking and Finance 96 at 98; Faryal Salman and Kamran Siddiqui, 'Corporate Governance in Pakistan: From the Perspective of Pakistan Institute of Corporate Governance’ (2013) 12 IUP Journal of Corporate Governance 17 at 20; Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions' (n 314) at 543
414 Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 543
415 Aldohni, 'Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector? (n 368) at 103
Before examining the concept of Islamic banks as having a two-tier board, it is essential to examine the objectives of adopting this system within the corporate governance framework. The central underlying difference between the two board models relates to whether it is desirable to have independent monitors involved in decision-management. In other words, does having both executive and non-executive directors on the same board jeopardise that board’s ability to monitor the management and provide independent advice?⁴¹⁶ It is argued that ambiguity exists regarding the role of the board in the unitary system, which assigns both supervisory and management roles to the same board.⁴¹⁷ The two-tier board system, however, creates a clear separation between the management of the day-to-day affairs of the company, which is the management board’s responsibility, and the role of supervising and monitoring the company, which is the supervisory board’s responsibility,⁴¹⁸ so the system draws a strict distinction between management and monitoring capacities to prevent conflict of interests and enhance the independent supervision of the corporation by not having executives being involved in a board with a supervisory role to play.⁴¹⁹ The separation, also, aims to improve the ethical conduct of the corporation.⁴²⁰ Aste lists other advantages of having a two-tier board system, which include quicker decisions due to the smaller size of the boards; a wider diversification of directors as a result of opening up the directorship position to more non-traditional candidates; and the role of the two-tier board system in generating good publicity and attracting foreign capital.⁴²¹

It is evident from the objective of the two-tier system that adding another board does not make a significant difference regarding the scope or nature of the roles. The aim of the two-tier board system is to enhance the independent behaviour of the directors, improve the monitoring and supervision, and manage the business more effectively. It is also an approach to reducing the number of situations where non-executives

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⁴¹⁶ Pieter-Jan Bezemer and others, ‘How Two-Tier Boards Can be More Effective’ (2014) 14 Corporate Governance 15 at 17
⁴¹⁷ Nordberg, Corporate Governance: Principles and Issues (n 141) at 83
⁴²⁰ Goergen, International Corporate Governance (n 136) at 90-91
⁴²¹ Aste, ‘Reforming French Corporate Governance: A Return to the Two-Tiered Board?’ (n 418) at 32
experience conflict regarding their respective roles. As a result, this system has little to do with the SSB. Both boards in the two-tier system share a duty to manage the whole business for the benefit of the company and, unlike the SSB, which is limited to the sphere of sharia-compliance, there is no separation within the subject matter considered. Apart from several limitations that might be placed within the scope of the management board’s authority, which require approval from the supervisory board, its management authority is unlimited as far as the business is concerned.\textsuperscript{422} Therefore, the above discussion about the conceptual differences between the nature of the roles between the SSB and the board of directors applies here as well. Apart from that, the accountability framework in the two-tier system, where the management board is supervised by the supervisory board, is inconsistent with the position that the SSB occupies within the institution. The SSB does not exercise a similar supervision over the board to be regarded as a supervisory board in sharia-related matters. The practice suggests that the members of the SSB, which is presumed to be the supervisory board when it comes to sharia-related matters, are either appointed or nominated by the board of directors, which is presumed to be the management board in this case. This is inconsistent with the appointment of the boards in the two-tier system where the supervisory board appoints the management board and is, itself, appointed by stakeholders.

From a regulatory point of view, considering the two-tier board system as an inherent element of Islamic banks is not free from legal challenges. The two-tier board system is mandatory in several countries, such as Germany and Austria, while other countries, such as France, have the freedom to choose between unitary or two-tier board systems.\textsuperscript{423} It is important for the SSB to work smoothly in different jurisdictions so its structure should be legally acceptable. Assuming that this view is free of challenges in the two-tier board jurisdictions, how can the SSB operate within the unitary board system jurisdictions?

\textsuperscript{422} Kuhne and Fuss, ‘Corporate Governance in Germany’ (n 419) at 226
Aldohni and Morrison argue that Islamic banks, as two-tier board institutions, can work in jurisdictions where a one-tier board is adopted, if there is no explicit obligation to adopt only one board, as is the case in the UK.\textsuperscript{424} It is, also, argued that, to some extent, SSB members perform a similar task to the non-executive directors in terms of monitoring and advice. While the practice of corporate governance suggests a wider separation between management and supervision, even on the same board, the SSB as a second board could make a positive contribution to enhance this separation.\textsuperscript{425} However, this implementation is associated with several challenges. First, it contradicts the above FCA’s view of the SSB as an advisory body, not qualified for any directorship position and unable to interfere with management. Second, some competence requirements for director membership may disqualify many SSB members from serving as directors. The skills they bring to the business are merely religious in nature and unrelated to the business experience expected of directors. In the UK, for example, the “Fit and Proper test for Approved Persons” required to serve as a director of a financial institution includes the factor of competence and capabilities which requires relevant experience in order to serve as a director, which may not be satisfied by many SSB members.\textsuperscript{426} Third, the fact that, in practice, a lot of SSB members have too many multi-memberships poses a legal challenge for them to be considered as directors, as jurisdictions tend to set a maximum limit on the number of directorships a person may hold.\textsuperscript{427} Finally, assuming that SSB members are qualified to be directors, they would probably fit as executives rather than non-executives in the view of FCA, as their roles involve active participation in the business.\textsuperscript{428} This contradicts the concept of the SSB as a supervisory board, which needs to be filled with only non-executives. These restrictions challenge the view of the SSB as a second board.

In practice, the sharia governance frameworks in the two-tier system do not consider the SSB as a second board. For example, the governance framework of the board of

\textsuperscript{424} Aldohni, ‘Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?’ (n 368) at 104; Morrison, ‘Shariah Boards and the Corporate Governance of Islamic Banks in the United Kingdom’ (n 413) at 99

\textsuperscript{425} Aldohni, ‘Islamic Banking in the United Kingdom: Is the Current Legal and Regulatory Framework Capable of Hosting an Islamic Banking Sector?’ (n 368) at 107

\textsuperscript{426} Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’ (n 380) at 13

\textsuperscript{427} The issue of multi-memberships in the SSB will be discussed later within confidentiality in Chapter Six.

\textsuperscript{428} Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (n 380) at 13
directors in Indonesia is based on two-tier boards: the commissioner board as a supervisory board and the board of directors as a management board.\textsuperscript{429} In the regulations of Bank Indonesia, the sharia governance framework does not treat the SSB as one of the boards of directors. A circular letter from the Bank Indonesia assigns the duties and responsibilities of the commissioner board, the board of directors and the SSB.\textsuperscript{430} This means that the governance framework of Islamic banks in Indonesia treats the SSB as a different body from either board.

The SSB has fundamental differences that make its adoption within the two-tier system challenging. In fact, considering the SSB as a second board does not result in the two-tier board system as it is known in corporate governance but, instead, a totally new model is created. The SSB cannot fit within either board. It is not intended to be an equivalent body to the management board since it does not even manage the day-to-day sharia-related matters, which are usually assigned to internal departments. Regarding the SSB as a supervisory board only on sharia-related matters alone would be both impractical and confusing. If the SSB is assumed to be the supervisory board on sharia-related matters, there would not be an equivalent body to the management board since the board of directors does not manage day-to-day sharia-related matters. In the unitary system, IFIs would end up having two boards with different jurisdictions, depending on the subject matter discussed. The management and supervisory authority would swing between the SSB, if a decision relates to sharia-compliance matters, and the normal board of directors, for other decisions. In the case of the two-tier system, there would be three boards rather than two. This would result in a newly established, impractical structure that creates confusion for the regulators and other stakeholders of IFIs as well.

\textsuperscript{429} Leni Susanti and Sulaeman Rahman Nidar, ‘Corporate Board and Firm Value: Perspective Two-Tier Board System in Indonesia’ (2016) 5 International Journal of Scientific & Technology Research 300 at 300

\textsuperscript{430} Bank Indonesia, \textit{Bank Indonesia Regulation Number: 13/9/PBI/2011 Concerning Amendment to Bank Indonesia Regulation Number 10/18/PBI/2008 Concerning Restructuring of Financing for Islamic Banks and Islamic Business Units} (2011)
4.7.4 The SSB as a Sub-committee of the Board of Directors

Nathan and Ribiere claim that the SSB’s role of monitoring and appointing internal sharia audit is equivalent to the appointing of the top management by the board of directors. This brings into the comparison the consideration of the audit committee as a sub-committee of the board. Consisting of only independent non-executive directors, an audit committee reviews the efficiency and objectivity of the reports submitted by internal auditors. To satisfy the interests of the shareholders, the audit committee has a responsibility for ensuring that an objective external audit has been conducted and, due to this important role of acting as a bridge between both internal and external audits and the board, it has been argued that the audit committee is the most important of the board’s sub-committees.

The SSB could be argued to be a possible sub-committee, similar to an audit committee. The similarities between the internal audit and sharia audit departments could support this assumption as well as the composition of both the audit committee and the SSB by non-executives. While audit committees supervise the process and receive the internal audit reports, the relation between the SSB and internal sharia audit is unclear. IFSB and AAOIFI do not agree on some of the governance standards in this regard. IFSB assigns the role of appointing the head of the internal sharia department to the board of directors and the role of the SSB is purely advisory with regard to this appointment. It seems that the SSB is only given the right to express any concern or reservation about the candidates’ profiles and qualifications. AAOIFI, on the other hand, suggests that more power should be given to the SSB as it requires its prior approval in appointing internal sharia auditors. In terms of reporting, there is a clear difference between the two organisations as they differ with regard to which body the internal sharia audit should report. The accountability framework of the internal sharia department drawn up by AAOIFI recommends that it should report to the board of

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431 Solomon, Corporate Governance and Accountability (n 137) at 186,188; Nordberg, Corporate Governance: Principles and Issues (n 141) at 121-122
432 Mallin, Corporate Governance (n 150) at 174
433 Islamic Financial Services Board, Guiding Principles on Sharia'h Governance Systems for Institutions Offering Islamic Financial Services (n 174) at 25
434 Governance Standard No.3, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 915
directors and be monitored by it.\textsuperscript{435} This suggests that the SSB has no monitoring role over the internal audit. However, IFSB states clearly that internal sharia auditors shall report to the SSB.\textsuperscript{436}

Given these differences, the governance standards set by the two organisations cannot determine an obvious relationship between the SSB and internal sharia audit. It is necessary to analyse the SSB role itself and whether it should serve as a sub-committee for sharia audit parallel to the audit committee. Before that, it is important to note that sub-committees form part of the board of directors and their members also tend to be members of the board.\textsuperscript{437} Consequently, in order for the SSB to qualify as a sub-committee, it should fit within the roles and objectives of the board, and their members should also be competent to serve as directors. Therefore, the previous arguments apply here as well and create, in addition to the following discussion, restrictions that legally challenge the idea that the SSB should be regarded as a sub-committee.

As highlighted above, the SSB performs legislation, advisory, and auditing tasks. The auditing role is presumed to be equivalent to external auditors and does not necessarily involve appointing or supervising internal auditors. In fact, this is inconsistent with the nature of the SSB’s roles and it threatens its objectivity in discharging one of its fundamental roles as an independent sharia auditor.\textsuperscript{438} The supervision of internal sharia audit should not be integrated within the SSB’s roles since it has a potentially negative effect on SSBS’ performance as independent external auditors. In contrast to the SSB, the monitory role over internal auditing is an integral part of the roles of the audit committee. While it acts as a bridge between internal and external auditors, the SSB, itself, performs the role of external sharia auditing. In fact, the duty of monitoring internal sharia audit should be assigned to an audit committee because it is the responsibility of the board of directors to monitor all aspects of the

\textsuperscript{435} Governance Standard No.3, ibid at 910
\textsuperscript{436} Islamic Financial Services Board, \textit{Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services} (n 174) at 3
\textsuperscript{437} Some regulations allow to appoint non-directors in the audit committee. As it is the case of Saudi Arabia which will be referred to in Chapter Six.
\textsuperscript{438} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 139
institution, including sharia-related matters, since sharia-compliance is an essential factor in IFIs’ performance. It is perceived that the board of directors has the ultimate responsibility for how the business is conducted.439 As the ultimate body responsible for directing and monitoring all aspects that might affect the performance of the institution, the responsibility of monitoring sharia-related matters should fall within its duty rather than that of the SSB. More specifically, internal sharia audit should be the responsibility of the audit committee. The SSB is merely an instrument provided to check the institution’s dealings from a religious perspective on behalf of the board of directors and the stakeholders, so the SSB exists to assist the board of directors in executing part of its task.

Despite the authority that the SSB holds which, sometimes, restricts the power of the board of directors, this does not justify considering the SSB as a sub-committee of the board of directors. In fact, if it were a sub-committee, it would be restricted by and subject to the board, a situation that may not satisfy sharia interest which requires a veto power. It also affects its independence since, as stated before, it must not be supervised by the board of directors. Other well-established mechanisms of corporate governance, such as lawyers and auditors, whose tasks are essential to performance, precipitate similar restrictions on the power of the board of directors. They, also, provide advice to assist the board in doing its job but are never considered as sub-committees. They are, instead, external to the institutions and provide services as gatekeepers.

4.8 The SSB and Gatekeepers

4.8.1 What are the Gatekeepers?

In modern corporations, where ownership and control are separated, owners and other stakeholders need to be assured that the managers are acting in the interest of the corporation and not abusing the power they have been given. Although the board of directors is viewed as an intermediary between the investors and management in agency theory, a more independent certification is needed for all types of stakeholders to testify that the management is effectively performing its duty. From here, the concept

439 Greuning and Iqbal, Risk Analysis for Islamic Banks (n 360) at 50
of gatekeepers arises to refer to “some form of outside or independent watchdog or monitor who screens out flaws or defects or verifies compliance with standards or procedures”.

Coffee lists some of the advantages that gatekeepers bring to the corporation and how they enhance its governance structure. These advantages include, firstly, a more accurate valuation in the market. Unless corporations can distinguish themselves from others, investors will price them based on the average quality of all other corporations, despite their actual value. Therefore, trusted gatekeepers can signal more credit to the corporation to be valued above the average quality and lower its cost of capital by providing assurance to the investors that the corporation's disclosure is accurate so the fear that their share value might be discounted will be reduced. Secondly, the board of directors cannot outperform the role of gatekeepers. Without independent gatekeepers, the board will be blind except for selective information provided by the corporation’s managers. Even independent boards were proved to be unable to detect or prevent financial misconduct, which led to the financial crises, such as the Enron crisis in the U.S. in 2001. Thirdly, gatekeepers play an important role in situations where ownership and control are separated. To reduce the information asymmetry, shareholders can rely on gatekeepers to become the trusted source of the flow of unbiased information to stakeholders and the public and help to detect and prevent problems before a crisis occurs. In addition, to ensure the accuracy and truthfulness of the statements that the company itself makes, gatekeepers could potentially present a critical view of the management or the board, to give a rounded picture of the company for investors.

The role of gatekeepers and who they are might differ slightly based on different perceptions about the concept. Some literature views the role of gatekeepers as

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440 John C. Coffee, Gatekeepers: The Professions and Corporate Governance (Oxford University Press 2006) at 2
441 Ibid at 6-9
442 This problem is called, “market for lemons” and it happens in the case when sellers overprice their poor quality goods, taking advantage of the average quality of the entire group of goods. Vice versa, reductions will affect goods with higher quality. See George A. Akerlof, 'The Market for “Lemons”: Quality Uncertainty and the Market Mechanism' (1970) 84 The Quarterly Journal of Economics 488
443 Andrew F. Tuch, 'Multiple Gatekeepers' (2010) 96 Virginia Law Review 1583 at 1595
444 Nordberg, Corporate Governance: Principles and Issues (n 141) at 56
preventing or disrupting any misconduct by withholding the support necessary for the wrongdoing to succeed.\textsuperscript{445} Based on this view, it is defined as “parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities”.\textsuperscript{446} In this view, gatekeepers are seen as a private police whose role is to prevent wrongdoing. The main characteristic of gatekeepers is the power they have to veto or block any transaction. For example, auditors are considered gatekeepers because they exercise such a veto by declining to deliver necessary opinions for the corporation when they discover a serious issue in the corporation’s financial statements. The power of veto, as the main attribute that defines gatekeepers, is wide enough to include the board of directors as gatekeepers since it can veto or withhold consent.\textsuperscript{447}

The other view focuses on the verification or certification role of gatekeepers as the providers of independent credibility and assurance to the company’s stakeholders. Coffee defines gatekeeper as “reputational intermediaries who provide verification and certification services to investors, doing essentially what investors cannot easily do for themselves”.\textsuperscript{448} This definition characterises gatekeepers as intermediaries whose job is necessary in enabling investors and the market to rely on the corporation’s own disclosure or assurance, where they otherwise might not. The power of gatekeepers arises from their reputation obtained by being a repeat player serving many clients over several years so corporations seek their positive evaluation which gives credibility to its disclosure or predictions.\textsuperscript{449} Based on this, the main role of gatekeepers as intermediaries is to rent their reputations to corporations.\textsuperscript{450} Therefore, gatekeepers include outsiders who risk their reputations by certifying the information released by the company. This includes auditors who verify the financial statements, rating agencies which evaluate the creditability of a company’s financial standing, securities analysts who provide assessment and prediction of the financial prospects of companies,

\textsuperscript{446} A. Hamdani, ‘Gatekeeper Liability’ (2003) 77 Southern California Law Review 53 at 58
\textsuperscript{447} Coffee, Gatekeepers: The Professions and Corporate Governance (n 440) at 2
\textsuperscript{448} John C. Coffee, ‘What Went Wrong? An Initial Inquiry Into the Causes of the 2008 Financial Crisis’ (2009) 9 Journal of Corporate Law Studies 1 at 1
\textsuperscript{449} Coffee, Gatekeepers: The Professions and Corporate Governance (n 440) at 2-3
\textsuperscript{450} Tuch, ‘Multiple Gatekeepers’ (n 443) at 1595
investment banks when delivering a fair opinion to appraise the fairness of a specific transaction, and lawyers, but only in the case of lending their reputations to a transaction rather than engineering it.\footnote{\ref{fn:coffee}}

These two perspectives of gatekeepers overlap.\footnote{\ref{fn:coffee}} They consider mostly the same types of gatekeepers but the reason for this consideration is slightly different. While auditors, for example, are considered gatekeepers in one view because they withhold necessary support, they are also so in the other because they lend their reputations when certifying the financial statements. The difference between these two perspectives of gatekeepers is reflected by whether to consider the board of directors as a gatekeeper because it has the veto power or not since the members, with certain exceptions, do not have the required reputational capital to lend to the institution.\footnote{\ref{fn:coffee}} Therefore, the latter perspective of gatekeepers is narrower as the board of directors is not qualified to be a gatekeeper, so it can be inferred that gatekeepers in most cases have both the veto power as well as the reputational capital. They exercise the veto power in a way that protects their reputations by withholding services that would support misconduct which might jeopardise their reputation.

\subsection*{4.8.2 The Gatekeeping Role of the SSB}

For the purpose of this discussion, the broader view of gatekeepers as holding a veto power is adopted even though it is less common in the literature.\footnote{\ref{fn:coffee}} Since sharia supervision is yet to become a profession, the SSB lacks the reputational capital required in the second view. Although there is some type of reputation among SSB members, it is different from the one required for gatekeepers. SSB members are respected as religious representatives more than being repeat players for many clients. Although this type of reputation is important for IFIs since it gives them the credibility they need to convince their stakeholders that the transactions are sharia-compliant, it is not the same reputation that characterises gatekeepers in general. The reputation of

\begin{thebibliography}{5}
\bibitem{fn:coffee} John C. Coffee, "Understanding Enron: "It's About the Gatekeepers, Stupid"" (2002) 57 The Business Lawyer 1403 at 1405
\bibitem{fn:coffee} Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 2
\bibitem{fn:coffee} Ibid at 2-3
\bibitem{fn:coffee} The academic literature of gatekeepers is mostly influenced by Coffee's works which support the narrow view of gatekeepers as reputational intermediaries rather than only a veto power.
\end{thebibliography}
gatekeepers is earned by the collective efforts of the individual professionals working in
the firm. It is a result of being repeated players so it increases by practising more
gatekeeping roles. In contrast, the reputation of the SSB is not collective and it is
individual scholars who possess the reputation, so it is a personal respect rather than
organisational or professional one. Also, this religious reputation is not necessarily a
result of repeated conducts of sharia supervision but is mainly gained by being a
scholar with sufficient knowledge of Islamic finance law who voluntarily educate the
public in religious matters. Such a reputation may be gained without any previous
experience of sharia supervision. SSB members may gain reputation by being
experienced in sharia supervision but the religious reputation is their main capital as
SSB members. Such a reputation would not be strongly affected if a transaction was
discovered as sharia non-compliant after it had been approved as sharia-compliant
since the religious reputation has been earned from sources other than being a
repeated player in sharia supervision. In fact, being remunerated for religious services
that is linked to a profitable business, as is the case in the SSB, may damage the
religious reputation as it contrasts with its non-profit nature. Therefore, the religious
reputation is different from the professional reputation required for gatekeepers where it
increases by more frequent business contracts with clients. In the absence of this
reputational requirement in the SSB, verification, as the main characteristic of
gatekeepers, should be used in this comparison.

The SSB exercises the veto power very obviously. Its refusal to endorse a specific
product would result in the bank withdrawing it.\textsuperscript{455} While its legislation and advisory
roles might not always be associated with the verification services of gatekeepers, its
audit role is highly relevant. It is conducted to ensure that transactions have been
executed in a sharia-compliant manner which is similar to the duty of external auditors
in investigating the compliance by financial statements to the adopted accounting
standards. As one of the most common gatekeepers, it might be appropriate to look at
the external audit and its similarities with sharia audit.

\textsuperscript{455} Warde, \textit{Islamic Finance in The Global Economy} (n 63) at 235
By providing independent credibility and assurance to the company’s financial statements, external auditors have been considered an important subject in corporate governance. They are seen as a solution to the agency problem. Their examination of transactions and accounts which can extend to any necessary documents should provide an external independent view of whether they represent the accurate status of the corporation. Therefore, auditors act more as insurance for shareholders and investors that the disclosed corporation’s documents are accurate.\textsuperscript{456} In the banking sector, external auditors play a more significant role as a “supervisory gatekeeper” by assisting the financial regulator to form regulatory decisions.\textsuperscript{457} The SSB in sharia governance has a similar objective to external auditors in corporate governance. In fact, sharia scholars have been described as gatekeepers who have a responsibility to resolve issues of efficiency and credibility surrounding the Islamic finance industry.\textsuperscript{458} The financial interest in Islamic banks is not the only interest of stakeholders. They also need to be assured of the religious interest as well by verifying that the banks’ transactions are sharia-compliant. The SSB provides such a certification to the stakeholders and the public that the institution complies with sharia roles and fatwas issued by its SSB as expected, which is a similar job to the external auditors.\textsuperscript{459}

As the main characteristic of gatekeepers, the power of veto can be found in external auditors who should withhold support if the accounting standards are violated to preserve the financial interests of the stakeholders. Likewise, the veto power is needed in the SSB’s roles to protect the religious interest. As explained earlier, the religious interest in IFIs should be a pass-fail test rather than being balanced with other interests. Similar to the external auditors, the SSB preserves the religious interest if there is sharia violation by refraining to provide its certification. While institutions need external auditors’ verification to add credibility to the financial statements, the credibility of the compliance with sharia in Islamic banks depends on the SSB verification.

\textsuperscript{456} Nordberg, Corporate Governance: Principles and Issues (n 141) at 56, 58
\textsuperscript{457} Singh, ‘The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper?’ (n 203) at 70
\textsuperscript{458} Sayd Farook and Mohammad Omar Farooq, ‘Sharī‘ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (2013) 5 ISRA International Journal of Islamic Finance 137 at 138
duty of auditing in the SSB should have no direct influence on the management or board’s decisions but should be limited to certifying conformity with sharia or highlighting different ways in which the management should comply.\textsuperscript{460} This is also the case with external auditors.

In addition to the above, both audits share the same objective, which is to assure the stakeholders of the status of the institution. Whether financial or religious, they share a similar mechanism as they both require high standards to be applied as a reference when deciding on the compliance of the institution’s transactions. Therefore, the assurance of compliance is a similar job for both the SSB and the external auditors. The difference between these audits lies in what types of violation they investigate. External auditors concern compliance with accounting regulations and provide verification about the accuracy of the financial statements to reflect the financial position of the institution. The verification of the SSB, however, concerns the compliance of the institution’s transactions and operations with Islamic principles to ensure accurate compliance with sharia.\textsuperscript{461} In other words, auditors investigate financial compliance while the SSB investigates sharia-compliance. This difference reflects the nature of the standards each applies and does not disqualify the SSB from being regarded as a certifying gatekeeper.

The similarities between the SSB and external auditors have been indicated in the literature. Abedl Karim concludes that both audits check the compliance status of the transactions undertaken by the institutions and publish a report for the owners to verify that the financial statements are a fair representation of the actual operations.\textsuperscript{462} Hijazy states that the role of external auditors in investigating, regularly checking the banks’ operations, and detecting any misconduct is similar to the job of the SSB.\textsuperscript{463} Elqari also

\begin{notes}
\textsuperscript{460} Toufik, ‘The Role of Shari’a Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks’ (n 350) at 115
\textsuperscript{461} Rifaat Ahmed Abdel Karim, ‘The Independence of Religious and External Auditors: The Case of Islamic Banks’ (1990) 3 Accounting, Auditing & Accountability Journal 34 at 39-40
\textsuperscript{462} Ibid at 39
\end{notes}
states that this similarity exists in which both look at the institution to give stakeholders an external independent opinion about the status of this institution.\textsuperscript{464}

Despite these similarities, considering the SSB as a gatekeeper might still be confusing, since the SSB performs its roles as a body within the institution it serves rather than as an independent outsider. Also, the SSB has various capacities, as legislator, advisor, and independent auditor. Looking to the wide picture of the audit profession, legislation and advisory roles are also performed but with different structures. While the advisory role may be provided internally or externally, legislation and audit are only provided externally. Legislation is performed by a national regulator and audit is provided by audit firms. The separation is strict to the extent that many jurisdictions prohibit the provision of audit and advisory services to the institution by the same firm.\textsuperscript{465} However, these roles are performed within the same body in sharia supervision. Combining these different roles together within an internal body creates confusion about the SSB’s roles which do not fit within and suit its structure. The current structure compromises independence, which is an important requirement for audit and for legislation as well.

Regardless of its structure, the aim in establishing the SSB is to provide independent verification of sharia-compliance to the stakeholders, which is consistent with the role of the gatekeepers. The issue of structure, however, needs to be subject to regulation in order to reflect the nature of its role which is considered in the next section.

4.9 Regulation between Audit and the SSB

More regulatory attention needs to be paid to the role of the SSB in order for it to perform an effective gatekeeping role. Regulation is essential to clarify the ambiguity and vagueness surrounding the role of the SSB. It draws boundaries and a governance framework for SSB members and other practitioners under sharia supervision. As a regulated practice, it would be easier to be understood and adopted by the market.

\textsuperscript{464} Elqari, 'The Independence of Sharia Boards' (n 383) at 8
\textsuperscript{465} The separation between audit and advisory services was adopted after Enron as it was one of the main causes of it. More to be highlighted in Chapter Six.
The similarity between sharia audit and the role of external auditors draws attention to its regulatory framework. External auditing is a well-recognised profession worldwide and has received well-regulatory efforts to improve its practice as an independent gatekeeper. Its well-structured system has been suggested to be the ideal method of social auditing, which resembles sharia auditing in its non-financial objective. Similarly, sharia supervision needs to be more independent and effective by following a similar framework that applies to external auditors.

Before discussing how to regulate SSBs, it is necessary to identify the meaning of regulation and its application in the audit as a practice with a similar objective. In fact, regulation is a disputed concept for which the literature does not have an agreed definition. It is a political concept contested by different groups and ideologies that employ the concept in different ways depending on their political position. However, it is not the purpose of this discussion to approach the theoretical issues surrounding regulation. What is important in this context is to understand what regulation involves in order to explain how it should be employed in relation to sharia supervision.

Baldwin et al. list three definitions for regulation, ranging from a narrow to a broad meaning. The first refers to the process of setting standards and the mechanisms for monitoring, enforcing and ensuring compliance with them, which is typically done by a public agency. This definition represents the "command and control" type of regulation and is the backbone of regulation. Similarly, Selznick identifies the central meaning of regulation as the "sustained and focused control exercised by a public agency over activities that are valued by a community". The second meaning is wider and includes some alternative instruments of regulation. Governments may rely on incentive-based

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468 Robert Baldwin, Colin Scott and Christopher Hood, A Reader on Regulation (Oxford University Press 1998) at 3-4
methods as a less intervention-oriented form of regulation to mitigate the direct interference. Examples of this regulatory instrument are disclosure requirements, market rights, and other incentives that benefit from the competitive markets where consumers react to changes quickly. 470 This includes, for example, taxes, government contracts rather than commands, and government ownership. 471 The third meaning is even broader and does not require regulation necessarily in order to be a state-product or part of any institutional arrangement. Based on this meaning, regulation could even be unintentional. It includes, in addition to the meanings outlined above, all of the mechanisms of social control, such as social norms and behaviour that can modify and affect the market.

The above meanings consider the tools and mechanisms used for regulation that include direct orders forms, incentive-based methods, and mechanisms of social control. These meanings provide a small degree of understanding about the components of regulation and what its process should involve. From another angle, regulation is defined by identifying the minimum components it must contain. Accordingly, regulation is performed by at least three capacities. 472 The first is the capacity of setting standards which reflect the state’s preferred choice of rules. The second is the capacity of information-gathering or monitoring to obtain an updated status of the system. The third is the capacity for behaviour-modification to change the system that presently applies. The last capacity applies to regulated individuals and institutions. Regulating an activity or practice may be inadequate to protect relevant stakeholders but it needs to be comprehensive to control practitioners as well. Therefore, promoting and regulating the profession is also considered within the meaning of regulation. 473 Regulatory agencies issue rules and standards to protect and promote professions as one of their objectives.

473 Philip O’Regan, ‘Regulation, the Public Interest and the Establishment of an Accounting Supervisory Body’ (2010) 14 Journal of Management & Governance 297 at 300
It can be said that regulation has a dual process. The first is ex-ante where rules and standards are passed and applied. This process represents the standard setting component of regulation. The other two components are performed in the ex-post process which ensures compliance with and the accurate application of the standards. Therefore, regulating an activity is not merely achieved by passing a law. Control is also an integral part of regulation, where protection of the activity must be ensured by monitoring and continuing assessment. The ex-post element provides a public accountability framework as part of the regulation.

Within the definitions of regulation, public agency is stated to be an important tool of regulation for standard-setting, enforcement, and supervision. It is “a non-departmental public organisation mainly involved with role making, which may also be responsible for fact finding, monitoring adjudication, and enforcement” and has become a highly popular regulatory governance tool since the 1990s. Regulatory agencies have become a modern typical tool of governance and one of the most important indicators in the scope and depth of regulatory activities in modern societies.

In the audit and accounting profession, which involve a similar practice to sharia supervision, regulatory agencies play an important role in the governance of the practice. In the U.S., the Financial Accounting Standards Board (FASB) acts as a legislative body for setting accounting standards which are recognised as authoritative by the Securities and Exchange Commission (SEC) over public companies and also by the American Institute of Certified Public Accountants (AICPA). The latter is another regulatory agency in the auditing and accounting governance regime which represents the autonomy of the profession whose responsibility includes setting ethical standards for the profession, supervising exams, and promoting educational programmes for professionals. Moreover, it sets the auditing standards for non-public companies. After Enron and other corporate collapses in 2001, the audit governance framework was reinforced by establishing the Public Company Accounting Oversight Board (PCAOB),

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474 Selznick, 'Focusing Organizational Research on Regulation' (n 469) at 364
475 Levi-Faur, 'Regulation and Regulatory Governance’ (n 467) at 11
476 Ibid at 11
477 About the FASB <http://www.fasb.org/facts/> accessed 26/04/2017
478 About the AICPA <http://www.aicpa.org/About/Pages/default.aspx> accessed 26/04/2017
which was among the reactions to the crisis introduced by the Sarbanes-Oxley Act. The board is established to set independent auditing standards and oversee audit compliance by public corporations. These three agencies (FASB, AICPA, and PCAOB) function as an integrated system in the U.S. to supervise the accounting and audit profession.

The accounting and auditing regulatory system in the UK has followed the unified regulatory model where the Financial Reporting Council (FRC) is the single independent regulator for the accounting and auditing profession. The main roles for the FRC in this regard include setting its own accounting standards as well as implementing the International Financial Reporting Standards (IFRS); consulting on and implementing the International Standards on Auditing (ISA); setting ethical standards for auditors; ensuring discipline and compliance with the standards and regulations; and supervising the profession through its recognised professional bodies. Similarly, the Saudi Organization for Certified Public Accountants (SOCPA) is the regulatory body that develops and promotes the accounting and auditing profession. Its responsibilities include reviewing and developing accounting and auditing standards; supervising compliance with the standards and the law; and regulating the issues surrounding the profession.

The responsibilities that these agencies hold to govern the accounting and auditing profession fall, mainly, within three main categories. First, the agencies regulate and standardise the practice. They exercise power, ex-ante, by issuing accounting standards and other regulations governing the financial reporting for accountants to follow. Ex-ante regulation is also exercised in the issuing of the auditing standards and

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479 O’Regan, ‘Regulation, the Public Interest and the Establishment of an Accounting Supervisory Body’ (n 473) at 298
483 Who We Are What We Do <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Who-we-are-What-we-do.pdf> accessed 27/04/2017
other regulations concerning audit practice. The standards could be the products of the agencies, as is the case in the U.S., where FASB issues the accounting standards, and PCAOB and AICPA issue the auditing standards. In the UK, as mentioned above, the agency adopts IFRS and ISA standards as the main standards. Apart from the U.S., this is the case with most jurisdictions. These standards were widely accepted globally after the EU adoption of IFRS in 2005 and the reform of ISA after that. In Saudi Arabia, SOCPA set up a conversion programme for the international standards in 2012 which ended at the beginning of 2018.

The second responsibility is overseeing and supervising compliance with the standards and regulations. The agencies set up disciplinary schemes to ensure that the accounting and auditing standards have been followed and play a policing role to deter any violation. Put differently, an accountability framework is established where accounting and auditing firms are accountable to these agencies which exercise a control power by investigating, obtaining reports, and taking disciplinary action against deviant firms.

Third, agencies play a role in sponsoring the profession. This includes setting up ethical standards, membership requirements, exams, training programmes and other policies that promote the accounting and auditing practice and profession.

While capital markets need to be regulated, it is important to regulate and control the practice of auditing as one of the main tools for governing the behaviour of capital markets. The regulatory agencies were established to enhance the role of external auditors as an important tool of corporate governance. They act as an additional and independent layer of governance to ensure accurate reporting in order to provide greater protection for stakeholders. In the case of the SSB, the analysis of its role shows that it has characteristics of regulation and acts as a semi-regulatory authority by

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performing both ex-ante and ex-post of the regulation process. This means that each IFI
has its own regulatory power. As argued, the SSB is a gatekeeper in the context of
sharia governance, whose role is similar to the gatekeeping role of auditors. This
analogy provides a grounding analysis of the feasibility of having a regulatory agency
for sharia supervision to regulate and control the practice. More specifically, this
analysis should highlight the possible role of such an agency in standardisation,
supervision and control, as well as promoting sharia supervision as a professional
practice, which will be discussed after this chapter.

4.10 Conclusion

The roles that the SSB performs are essential to sharia governance to monitor
sharia-related matters. To the structure of the corporate governance, however, the SSB
is a strange body. Concentrating the role of legislation, auditing and advising in an
internal body is not the solution to ensuring effective sharia supervision. Instead, these
roles should be analysed more carefully to identify the most appropriate mechanism that
suits the structure of corporate governance.

The high volume of work on the SSB suggests the need to restructure its framework.
It is almost impossible to manage all of the tasks with which the SSB is entrusted:
setting up and continuously updating sharia legal and ethical codes to comply with;
advising and approving products, services, transactions, and the process of
implementation to be compliant with these codes; and auditing and reviewing the
institution’s dealings to ensure compliance. Combining these tasks together creates
uncertainty about the nature of SSB decisions and whether these should be advisory or
enforceable, a situation that confuses regulators over how to consider the SSB in legal
terms. This situation exists even in Islamic jurisdictions where Islamic banks have a
relatively higher legal recognition. The structural framework of the SSB is not
standardised and has different models that different jurisdictions adopt which creates
confusion about the position and the roles of this body. Moreover, the current SSB
structure threatens the independence needed to perform its role of legislation and
auditing. Therefore, the roles of the SSB should be examined in order to be fitted within
a well-known body in corporate governance that has a similar objective to the SSB.
It can be seen that the consideration of the SSB as a board of directors is inappropriate within the corporate governance structure. The roles and objectives of the SSB could not suitably fit into the board of directors’ roles and objectives because of the significant differences between these two boards. Regardless of these theoretical differences, the SSB could not practically be set up as a board in the two-tier system since it matches neither of the two boards. Moreover, the two-tier board system would pose many legal challenges for Islamic banks operating in the unitary system jurisdictions. Similarly, there are legal and theoretical challenges to regarding the SSB as a sub-committee of the board which would make sharia supervision ineffective. While this discussion concerns only the roles and objectives of both boards, the accountability framework, which will be discussed later, is also subject to a possible comparison.

Combining different roles makes it challenging to compare the SSB with only one body. However, looking at the wide picture of the audit profession, there are similar analogies between the roles it performs and those performed by the SSB. Considering the auditing role of the SSB, it should be a gatekeeper, like external auditors. Non-audit services provided by external audit are similar to the advisory role of the SSB. The role performed by the national organisations to legislate and standardise the profession of auditing is akin to the SSB’s legislative role.

Since the respective roles of the SSB and audit are similar, the structure of audit could provide a better framework for the SSB to be accepted within the corporate structure more easily rather than a totally new body. This means that the roles of the SSB should be separated. The next chapter examines the role of legislation and how it should be incorporated in this model of the SSB.
Chapter Five: The Need for a Sharia Standard-setting Board

5.1 Introduction

One of the roles assigned to the SSB is to legislate and set sharia standards with which IFIs should comply. As a component of regulation, standard setting gives each SSB legislative authority over its relevant institution, a situation that is associated with negative effects for the Islamic finance industry. The inconsistency in the sharia standards in the industry and the existence of conflict of interests are two consequences of each SSB setting its own standards. Taking into account the different interpretations of the Islamic sources as an inherent feature of Islamic law, the impact of these consequences would be even greater. As a result, the sharia governance framework would not be strong enough to ensure sharia-compliance for its stakeholders. Within this situation, more discipline is a necessity.

This chapter explains the weaknesses of the governance structure that result from individual SSBs performing a legislative role. For a stronger regulatory framework, a sharia standard-setting board is proposed. The feasibility of having such a board is examined in the chapter. This includes the effects, challenges, and level of standardisation. Although efforts have been to establish a standardisation board nationally and internationally, its roles have limitations, which are laid out in this chapter.

The chapter, also, reviews a recent case of NCB’s IPO, where there was controversy over whether subscription is permitted under Islamic law or not, to highlight some of the negative impacts of failing to standardise the Islamic banking industry.

It should be noted that the meaning of standardisation in this chapter concerns the sharia rules and principles. Although standardisation in Islamic finance might cover other financial regulations for Islamic finance such as prudential requirements, these are not the main concern of this chapter since they are outside the scope of the SSB’s legislative role which mainly concerns the issuing of fatwas and setting of sharia standards for IFIs.
5.2 Consistency of Fatwas in the Social and Legal Contexts

As explained earlier, *ijtihad* is a tool used for the interpretation of Islamic law which usually leads to different opinions regarding sharia. Disagreement is inevitable in Islamic law, which makes it unsystematic and non-uniform.\(^{489}\) This is not a disadvantage as it provides the flexibility to apply Islamic law in different cases in different circumstances all the time. To express a sharia opinion on a specific case, a *fatwa* is issued, which is a “non-binding legal opinion issued in response to a legal problem”.\(^{490}\) Although not binding, it plays an important role in conservative Muslim societies.

By default, issuing *fatwa* in Islamic law enables scholars with sufficient knowledge of sharia and a good understanding of the legal matter subject to the *fatwa* to make a decision. Despite the fact that *fatwa* is purely informative and non-binding, it is deeply respected by Muslims, as it is seen as an interpretation of God’s law.\(^{491}\) In the case of Saudi Arabia, social and cultural norms are significantly influenced in accordance with local *fatwas*. These *fatwas* are commonly used in relation to the understanding of the connection between religion, society, and the state.\(^{492}\) In the past, most *fatwas* were issued by an individual *mufti*, a person who issues *fatwas*. The power of *fatwas* in Muslim societies as well as political systems led governments to seek some control over this activity so they tend to appoint a grand *mufti* as the ultimate source of *fatwas*.\(^{493}\) When *fatwa* institutions, that is where the same *fatwa* is signed by more than one *mufti*, emerged in the 20th century in the Islamic world as a result of modernisation, many Islamic states established their own *fatwa* institutions.\(^{494}\) These institutions reinforce the

\(^{490}\) Khaled Abou El Fadl, *Speaking in God’s Name: Islamic Law, Authority and Women* (Oneworld 2001) at 300
\(^{491}\) Muhammad Khalid Masud, Brinkley Messick and David S. Powers, ‘Muftis, Fatwas, and Islamic Legal Interpretation’ in Muhammad Khalid Masud, Brinkley Messick and David S. Powers (eds), *Islamic Legal Interpretation: Muftis and their Fatwas* (Islamic Legal Interpretation: Muftis and their Fatwas, Harvard University Press 1996) at 19
\(^{492}\) Muhammad K. Al-Atawneh, *Wahhabi Islam Facing the Challenges of Modernity: Dar Al-Ifta in the Modern Saudi State* (Studies in Islamic Law and Society, Brill 2010) at xiv
\(^{493}\) Masud, Messick and Powers, ‘Muftis, Fatwas, and Islamic Legal Interpretation’ (n 491) at 9,27
\(^{494}\) Al-Atawneh, *Wahhabi Islam Facing the Challenges of Modernity: Dar Al-Ifta in the Modern Saudi State* (n 492) at 6-8
social power of states and give them some control over the behaviour of Muslim societies. A political State could influence these institutions to issue *fatwas* that are in accordance with the former’s political interests.

In Saudi Arabia, the first *fatwa* institution was established in 1953, when Dar Al-Ifta, the institute of *fatwa*, was founded under the name of Dar Al-Ifta and the Supervision of Religious Affairs, and was later restructured, in 1962, as part of “King Faisal Ten Point Programme” to reform the religious institutions and create greater cooperation between the government and *muftis*. After Royal Order No.A/137 in 1971, the current structure of *fatwa* institutions was established. The order created two *fatwa* agencies. The first is the Board of Senior Ulama, scholars, (BSU), whose members are Islamic law scholars, appointed by the King. The BSU’s job is to issue sharia-based opinions on matters submitted by the King as well as advise the King on matters related to common law issues. The other agency is a branch of BSU and its members are selected from within it. It is called the Permanent Committee for Scientific Research and Legal Opinions (CRLO) and is responsible for preparing the issues to be discussed at BSU as well as issuing *fatwas* for individuals.

As stated above, *fatwa* in Islam is not binding and this is consistent with the advisory role granted to BSU by the Royal Order. However, as the highest religious authority in a state whose main source of law is sharia, BSU has a strong influence on public affairs. Its impact extends to the judiciary system, where most judges, respectfully, issue decisions in accordance with BSU’s *fatwas*. The fact that the Supreme Council of Justice, for a long time, had among its members many scholars who were also members of BSU has given BSU greater influence over judicial decisions. A further impact is that some state laws and regulations were initially BSU decisions. The power of BSU was further reinforced in 2010 by Royal Order No.B/13876, which grants

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495 Ibid at 9-10
496 Saudi Arabia, Royal Order No.A/137 (1971)
497 Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (n 31) at 115-116
498 Al-Atawneh, *Wahhabi Islam Facing the Challenges of Modernity: Dar Al-Ifta in the Modern Saudi State* (n 492) at 30-31
499 Ibid at 21
the exclusive right to issue public fatwas to members of BSU or those who have been given permission to do so.\textsuperscript{500}

However, controlling social public fatwas leads to many challenges. Individuals view neither BSU nor CRLO as the exclusive source of fatwas and may rather consult, for different reasons, any Islamic law scholar. It has been predicted that the Royal Order would fail to impose a monopoly on the issue of fatwas since it is impossible to control the media and outlets through which public fatwas can spread.\textsuperscript{501} Nowadays, public fatwas are still being disseminated through different channels, including social media, TV programmes, and radio stations. Moreover, such a control over issuing fatwas restricts the religious choices in personal matters. The flexibility under Islamic law gives sharia scholars room to develop different interpretations of the Islamic sources which provide religious choices for Muslims with different ideologies, cultures, and backgrounds. For example, liberal Muslims find it hard to accept conservative interpretations on issues concerning the relationship between different genders, dress codes for women, and the permissibility of certain social events and occasions. Sharia scholars are part of society and their fatwas reflect the social divergence which might be significant and represents the different backgrounds within society.\textsuperscript{502} A fair representative of this divergence would not be achieved by having a body with the exclusive source of social fatwas.

In the legal context, consistency refers to the codification of Islamic law which is “the process by which the various rulings of Sharia of a particular subject matter (property, torts, family law, etc.) are collected and restated in a succinct manner to form a legal code that has full effect within a given political jurisdiction”.\textsuperscript{503} This process might be less problematic than controlling social public fatwas. Given the wide range of opinions that result from different interpretations of the sources of Islamic law, some aspects of

\textsuperscript{500} Saudi Arabia, Royal Order No.B/13876 (2010)
\textsuperscript{501} Madawi Al-Rasheed, ‘Saudi Arabia: The Obsession of Multiplicity Fatwas’ Al-Quds al-Arabi (London 2010 Aug 23) <http://www.alqudsalarabi.info/index.asp?f_name=data\2010\2010\08\22qt78.htm> accessed 13/05/2015
\textsuperscript{502} Haider Ala Hamoudi, ‘Ressurecting Islam or Cementing Social Hierarchy? Reexamining the Codification of “Islamic” Personal Status Law’ (2016) 33 Arizona Journal of International and Comparative Law 329 at 333
\textsuperscript{503} Tarek A. Elgawhary, ‘Codification of Law’ (2013) <http://www.oxfordislamicstudies.com/article/opr/t349/e0033> accessed 09/06/2017 at 1
sharia law need to be codified to guarantee consistency and harmony in the judicial decisions. It is better for the legal system to govern sharia opinions by having a level of codification where a specific opinion, out of several, is adopted into a statute to be the ultimate legal reference.504 This adds greater clarity to the legal system rather than seeking a judgement from the broad range of views and interpretations to be found within different Islamic law sources.

Historically, there have been several endeavours to codify Islamic law. An early attempt at codification was made in the eighth century by an adviser to an Abbassid Caliph who argued that codification is necessary to overcome civil conflicts in courts resulting from the divergence of opinions in Islamic law.505 Although the political authority refused the proposal, the same Caliph and his successors tried unsuccessfully to convince some of the prominent scholars at that time.506 Malik B. Anas (D. 796), one of the four scholars whose opinions and methods are followed by many sunni Muslims, refused to impose his opinions stated in his book *Al-Muwatta* over the whole Islamic state when he was offered the opportunity to do so.507 The religious reactions were negative about these attempts since they were strongly supportive of and welcomed the differences in opinions within Islamic law. They viewed that imposing an opinion contradicts the freedom to interpret Islamic sources granted to qualified scholars. Codification was deemed to be a restriction on the application of Islamic law on Muslims from different geographical and cultural backgrounds. In his response to the proposal regarding standardisation, Malik argued that qualified scholars should have the freedom to disagree in order to ensure the continuity of *ijtihad*. He referred these differences to the way in which people differ in their thoughts and the impact of societies on such differences.508

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504 Bakar, 'The Shari'a Supervisory Board and Issues of Shari'a Rulings and their Harmonisation in Islamic Banking and Finance' (n 489) at 87
505 Elgawhary, 'Codification of Law' (n 503) 1; Najmaldeen K. Kareem Zanki, 'Codification of Islamic Law Premises of History and Debates of Contemporary Muslim Scholars' (2014) 4 International Journal of Humanities and Social Science 127 at 128
506 Zanki, 'Codification of Islamic Law Premises of History and Debates of Contemporary Muslim Scholars' (n 505) at 128
507 Abou El Fadl, *Speaking in God's Name: Islamic Law, Authority and Women* (n 490) at 10
508 Zanki, 'Codification of Islamic Law Premises of History and Debates of Contemporary Muslim Scholars' (n 505) at 134
The development of the political state brought about more civilisation and modernity to the different aspects of people’s lives. Sharia scholars adopted different approaches to the application of Islamic principles and rules in modern life. Such a situation increased the divergence of opinions, including the juristic judgements. The freedom of judicial opinions led to many situations of conflict of opinions, which confused the political authority.\textsuperscript{509} To reduce this severe divergence, the four different schools of \textit{fiqh} were seen as a solution. Depending on the geographical area, each region has a dominant school to which most of its scholars and judges belong. As a form of codification, each school was officially adopted in that region to become its judicial reference.\textsuperscript{510}

Under the Ottoman Empire, the codification of Islamic law took several positive steps. Although the \textit{Hanafi} doctrine was its judicial and legal reference, more advanced phases were followed to overcome the diversity within the same doctrine and achieve a unified code of law. The effort at codification matured by issuing two purely sharia-based codes: its famous code of law, \textit{Majallat Al-Ahkam Al-Adliyah}, completed in 1877, which covers commercial transactions, oaths, and court procedures; and the Ottoman Law of Family Rights, issued in 1917, which became the first family code based on sharia.\textsuperscript{511} The former was a pioneering step towards modernising Islamic law from its classical text into a more technical legal text.\textsuperscript{512}

Today, the majority of Muslim states tend to adopt a codified Islamic law for certain legal aspects.\textsuperscript{513} In general, family law is derived from Islamic legal principles. This is not the case in Saudi Arabia. Although Islamic law is the main legal and judicial source, it has not been codified into a set of clear legal rules. In its early days, it was announced that a royal desire to codify Islamic law opinions from the different school of thoughts

\textsuperscript{509} Ibid at 129  
\textsuperscript{510} Ibid at 129  
\textsuperscript{511} For more about the history of Islamic law codification refer to: Elgawhary, ‘Codification of Law’ (n 503) at 2-5; Zanki, ‘Codification of Islamic Law Premises of History and Debates of Contemporary Muslim Scholars’ (n 505) at 128-133  
\textsuperscript{512} Abdulwahab Abu-Sulaiman and Mohammed Ali, \textit{A Study of Majallat Al-Ahkam Al-Shar’ia by Ahmed Alqari} (Tihama 1981) at 28  
\textsuperscript{513} Sebghatullah Qazi Zada and Mohd Ziaolhaq Qazi Zada, 'Codification of Islamic Law in the Muslim World: Trends and Practices' (2016) 6 Journal of Applied Environmental and Biological Sciences 160 at 166
had been challenged by its lengthy process and disagreement by prominent sharia scholars and, instead, a set of classical *fiqh* books in the *Hanbali* School was designated to be the judicial and legal reference. The same set of books was used by the Chief Judge in Macca, Ahmed Alqari, as a framework for producing a civil code similar to that issued during the Ottoman Empire but in the Hanbali School of *fiqh*. However, this codification was not officially adopted. In fact, the scholars’ attitudes towards codification was and remains controversial and the main obstacle, so that codification has not occurred, to date. This does not mean that Islamic law has no effect on Saudi laws and rules. They are inspired by it and many laws clearly state that the application must not contradict Islamic principles. However, many areas of law, such as family, civil, and criminal, are not codified but controlled by the traditional Islamic law sources which are subject to different interpretations.

In the modernisation approach of a state, the codification of law is seen as inevitable. Recently, a sharia committee has been established in order to design a compilation of the Code of Judicial Rulings on legal cases that meet the judiciary need. This aims to establish an obligatory judicial reference to control the severe divergence of judicial opinions whose negative impact might have caused political concern.

Through the brief overview of the historical stages of Islamic law codification outlined above, it may be inferred that the political authority prefers to frame the islamic legal sources rather than have the freedom of judicial opinions. Among the disruption that this freedom might bring is economic instability. In a situation where laws have a very wide area of expectation, rights and duties are poorly-protected. The parties to a contract, for example, are unable to guarantee their rights even if well-written because it is difficult to expect the legal grounding that different judges would treat the terms and conditions of the contract. This negatively affects the credibility of the economic environment and

514 Abu-Sulaiman and Ali, *A Study of Majallat Al-Ahkam Al-Shar‘ia by Ahmed Alqari* (n 512) at 29
515 Ibid at 30
516 For more about the argument of codification of Islamic law in Saudi Arabia, refer to Haitham H. Osta, ‘Modernization, Codification and the Judicial Analysis: Exploring Predictability in Law in Shari‘a Courts in Saudi Arabia’ (PhD, University of Washington 2015) at 63-85
shakes its stability. Therefore, the economic factor is an essential incentive for codification and, therefore, commercial codification attracts greater attention. In the Ottoman Empire, its first sharia code was designed for commercial transactions and issued several years before the family one. Similarly, the effort of the codification carried out by Ahmed Alqari disregards the criminal or family aspects of law. The importance of legal consistency regarding economic aspects provides a basis for its importance in the context of Islamic finance as well. Inconsistency in Islamic finance could lead to a similar result, especially when the sharia-compliant asset occupies a considerable percentage of the capital market and economy, such as is the case in Saudi Arabia. The remaining parts of this chapter discuss this issue specifically.

5.3 Independence and the Role of Legislation in the SSB

Independence is an essential feature for any institution or body performing the role of legislation. It has to be free from any pressure that could influence the objectivity of its decisions. Regulated persons may try to influence the legislative authority to tailor rules and regulations that better serve their interests. Therefore, independence is crucial in the legal framework and the regulator must be fully independent from the regulated.\(^{518}\) Within the meaning of regulation, autonomy is considered a major characteristic of the regulatory agencies, enabling them to rule-make and shape their preferences regarding regulatory choices independently.\(^{519}\) In the Islamic finance industry, the SSB plays a major role in setting sharia standards. The analysis of the role of the SSB shows that it satisfies the components of regulation and acts as a regulatory authority role by performing both ex-ante and ex-post action in relation to the regulation process. This means that each IFI has its own regulatory power. In certain jurisdictions, as the case of Saudi Arabia, the SSB is the sole and final authority for sharia standards for its relevant IFI. By performing such a duty, the SSB faces a strong conflict of interest case that puts its independence at stake.

\(^{518}\) Tina Mak and others, ‘Audit, Accountability and an Auditor's Ethical Dilemma: A Case Study of HIH Insurance’ (2005) 13 Asian Review of Accounting 18 at 21

\(^{519}\) Levi-Faur, ‘Regulation and Regulatory Governance’ (n 467) at 11-12
One of the aspects of conflict of interest that arises is in the employment relationship between SSB members and IFIs. This relationship puts SSB members under pressure from the management to achieve financial interests which might compromise sharia principles. Whether their appointment is assigned to shareholders or the board of directors, the members of SSBs are lack of independence they need to objectively issue sharia standards. The management may exercise an indirect interference due to the power they have on the board and shareholders in reappointing, compensating, and even modifying the contracts between the IFI and SSB members to put them in a less advantage situation. Therefore, the impartiality of the standards established by an SSB may be affected by their financial interests. When a specific standard or fatwa prevents an IFI from conducting a profitable transaction, the members could be put under pressure to modify the standard. Therefore, the decision might not be taken objectively but tends to assist the achievement of economic objectives over strong compliance with sharia.

If poorly-governed, the different interpretations of Islamic law may facilitate what is called “fatwa shopping”. This happens when “a firm contacts various sharia advisors to find an affable opinion as to the Islamic nature of a transaction”. This could be defined as “the process of searching for suitable religious opinions”. SSB members may shop for a fatwa that better suits the financial interests of the IFI, regardless of their own beliefs. Under the employment relationship, SSB members have financial interests in IFIs which might compromise their sharia-compliance. This will lead to a more permissive approach, where the members give more weight to economic factors over sharia principles and adopt controversial opinions that facilitate the design of conventional products even though more genuine sharia-compliant ones might be

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520 Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (n 314) at 229
521 These issues of conflict of interests will be highlighted in the next chapter.
522 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 6
524 Nadirsyah Hosen, ‘Online Fatwa in Indonesia: From Fatwa Shopping to Googling A Kiai’ in Greg Fealy and Sally White (eds), Expressing Islam : Religious Life and Politics in Indonesia (Expressing Islam : Religious Life and Politics in Indonesia, Institute of Southeast Asian Studies ISEAS 2008) at 159
available. This would be preferred by the management since it would be easier for them to operate with products similar to those offered by the conventional banks instead of issuing products that the market may find strange and take time to be absorbed and understood. Consequently, IFIs would tend to hire members who are willing to provide opinions that are more convenient in the management’s point of view, instead of more qualified ones. One investment banker working for a major Western financial organisation explains:

"We create the same type of products that we do for the conventional markets. We then phone up a sharia scholar for a fatwa [seal of approval, confirming the product is shari’ah compliant]. If he doesn't give it to us, we phone up another scholar, offer him a sum of money for his services and ask him for a fatwa. We do this until we get sharia compliance. Then we are free to distribute the product as Islamic".

The above situation casts doubt on the independence of sharia scholars and whether they can fairly set sharia principles or not. Giving IFIs the freedom to hire members to serve on their SSB threatens the objectivity of the decisions taken. The diversity in sharia opinions may be manipulated to seek more profit at the cost of losing the spirit of the law. Consequently, sharia interest is compromised and the credibility of the IFIs would then be at stake. Stakeholders might be inadequately assured of sharia-compliance, which is a negative effect for the industry. SSB members have already been “accused of being bankers” window dressing and of over-stretching the rules of shari'ah to provide easy fatwa for the new breed of bankers.

Management interference, however, is not free from challenges. It could be highly costly as it undermines the reputation and trust of the IFI among its stakeholders as well

525 Ahmed, 'Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal' (n 195) at 405
528 Khan, 'Setting Standards for Shariah Application in The Islamic Financial Industry' (n 32) at 288
529 Kahf, 'The Rise of a New Power Alliance' (n 58) at 27
as the potential punitive consequences.\textsuperscript{530} Despite that, the process of setting sharia standards needs to be governed to ensure a high level of independence and objectivity.

Conflict of interests does not occur in an SSB by merely setting sharia standards for its relevant IFI, as independence is also undermined by combining the role of \textit{fatwa} as a legislative tool in Islamic law with auditing. Having the SSB also operate as external sharia auditors and check sharia-compliance brings its impartiality and objectivity into question.\textsuperscript{531} This combination creates an inefficient supervision model in sharia governance. In the process of regulation, rule-making and monitoring/enforcement, the mechanisms need not be located in a single institution to ensure greater independence.\textsuperscript{532} In Islamic finance, the separation between the two roles is essential to avoid modifying the \textit{fatwas} issued by the SSB if there is slippage on the part of the executive managers.\textsuperscript{533} If an issue regarding sharia compliance is found, there is a possibility of stretching the role or standard set by the same board to make such an operation permissible. This might be done by a permissive interpretation of the issued standard or its modification by the same board to regard the subject matter as permitted. The different interpretations of Islamic law may provide a ground for this.

Considering the objective of the SSB, discussed in the previous chapter, verifying sharia-compliance does not necessarily involve setting-sharia standards. In fact, the legislative role was originally assigned to the SSB due to an urgent need for Islamic banks, in the early days, to have a reference to a sharia code in order to produce sharia-compliant products and ensure that their operations were compliant. The lack of such a code was a genuine reason for IFIs appointing an SSB to do this job at that time and the negative effect of the combined roles might be compromised because of the immaturity of the industry and its limited spread. Then, the industry experienced a revolutionary development. The SSB made a sound contribution to the efforts to market Islamic finance and helped it to grow. However, this has not been associated with the

\textsuperscript{530} Grais and Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (n 387) at 6
\textsuperscript{532} Baldwin, Scott and Hood, \textit{A Reader on Regulation} (n 468) at 3
\textsuperscript{533} Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 228
There is a need to reconsider the legislative role performed by the SSB within a more robust governance structure. Therefore, there were calls for a reconsideration of the current SSB roles since these roles were assigned in the past, when the circumstances required specific duties to be undertaken by the SSB. The development and spread of Islamic finance should end the past-multi roles of the SSB that combine *fatwa* and certification. These duties should be clearly separated to avoid the perception among the stakeholders that the SSB lacks independence.

The process of setting sharia standards by the SSB involves an obvious situation of conflict of interest. This duty needs to be reconsidered and governed in a more efficient way. In fact, some jurisdictions have recognised, partially, that the SSB should not perform a legislative role and they have taken a relatively more advanced step towards standardisation. However, there are still limitations related to the current practice of standardisation and the next section provides a critical overview of this.

### 5.4 Limitations on the Current Practices of Standardisation

Due to the issue of conflict of interest that involves individual SSBs performing the role of setting sharia standards, various approaches to standardisation have been adopted to minimise their legislative authority. Standardisation is enforced, to different levels, by different legal tools in different jurisdictions. The current legal frameworks that govern the process of sharia standardisation contain limitations which do not effectively wipe out the conflict of interests in the SSB.

As explained before, the SSB is governed by four different models, where jurisdictions vary to regulate sharia supervision between being totally decentralised to different levels of centralised models of governance. Adopted to different extents by some Gulf Cooperation Council (GCC) jurisdictions, the decentralised model does not have any national authority to undertake sharia supervision. Saudi Arabia represents

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534 Al-Saad, 'The Effect of Sharia Supervision on Islamic Finance' (n 397) at 10-11
535 Elqari, 'The Independence of Sharia Boards' (n 383) at 17
the extreme form of this model where the jurisdiction does not have any governance
regulation regarding the practice of the SSB and IFIs have the total freedom to create
their own sharia governance structure. There is no legal form for enforcing sharia
standards in the industry and each SSB enjoys complete authority to set its own sharia
standards for its relevant IFI. In this case, inconsistency in the decisions is obvious and
the SSB is exposed to a high level of conflict of interests.

The other GCC jurisdictions take a less decentralised form by placing some aspects
of the governing roles found in the SSB into IFIs, as is the case in Qatar,\textsuperscript{537} Kuwait,\textsuperscript{538} and Bahrain.\textsuperscript{539} Although these jurisdictions have established a type of high authority of
sharia supervision, this authority is too limited to be considered a regulatory authority
over sharia supervision. The regulation, therefore, is limited and does little to solve the
conflict of interest associated with the inconsistency and lack of standardisation. In
Kuwait, the law refers disputes or conflicts between SSB members to the Fatwa Board
in the Ministry of Awqaf (endowment) and Islamic Affairs, whose authority should be the
ultimate one on that matter.\textsuperscript{540} Otherwise, there is no supervisory authority over the role
of the SSB. Sharia standards could be set by individual SSBs without interference if the
members could reach a decision. The authority given to the Fatwa Board is too limited
and does not qualify it to be a national SSB. It lacks important supervisory authority to
regulate and control the practice of sharia supervision and only performs a very limited
role in standardisation, which is arbitration in the case of conflict. Provided that there is
no dispute between SSB members over a particular subject matter, any previous
decision that has been taken on the same matter by the Fatwa Board is not binding and
so the SSB is not required to comply with it. In fact, the Fatwa Board’s role of
standardisation is purely theoretical and rarely occurs in practice. Since the SSB takes
its decisions based on majority votes, situations where conflict between SSB members
could not be resolved are not envisaged.\textsuperscript{541} In Qatar, the situation is similar, where

\textsuperscript{537} Qatar, Qatar Central Bank (QCB) Law (2012) Articles 106-108
\textsuperscript{538} Kuwait, Central Bank of Kuwait (CBK) Law (2003) Article 93
\textsuperscript{539} Central Bank of Bahrain (CBB), \textit{CBB Rulebook Volume 2: Islamic Banks} (2010)
\textsuperscript{540} Kuwait, Central Bank of Kuwait (CBK) Law Article 93
\textsuperscript{541} Abdulbari Mashal, ‘Shari’ah Regulation by Central Bank on Islamic Financial Institutions’ (2005)
(Islamic Financial Institutions, Current Aspects and Future Prospects) at 541-542
disputes should be referred to the Supreme Sharia Council of the Ministry of Awqaf. Bahrain does have a national SSB in its central bank. However, this board serves only the central bank to ensure the compliance of its own products. The board has no oversight authority whatsoever regarding the practice of SSBs in Bahraini IFIs and, therefore, is not a regulatory agency.

In the centralised model, a higher sharia supervision authority is established within the sharia governance structure to enforce sharia rules. With different roles and duties for their national SSBs, this model is common in Southeast Asian countries, of which Malaysia is a prominent example. Generally, central SSBs are concerned with standardisation, compliance and arbitration to settle sharia disputes between SSB members. The literature also adds the cooperative role of a central SSB to set training programmes for Islamic finance practitioners. Recently, an increasing number of jurisdictions have adopted the centralised model in their sharia governance framework. After a long lull, Oman established the High Authority for Sharia Supervision in 2012 as a regulatory authority for SSBs. The cabinet in UAE was legally authorised in 1985 to form a Higher Sharia Authority attached to the Ministry of Justice and Islamic Affairs to regulate sharia-compliance practice in the financial industry. However, the cabinet waited until 2016 to establish the Authority. Despite the fact that the federal law states that the Authority should be attached to the Ministry of Justice and Islamic Affairs, the responsibility for forming and restructuring this authority was assigned to the Central Bank of the UAE. In 2015, Bahrain announced that its Central Bank would

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542 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 232
543 Ibid at 231
545 Grais and Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (n 360) at 19
546 Nathan Garas and Pierce, 'Shari'a Supervision of Islamic Financial Institutions' (n 315) at 391
547 Ginena and Hamid, Foundations of Shari'ah Governance of Islamic Banks (n 134) at 143-144
548 UAE, Federal Law No 6 Regarding Islamic Banks, Financial Institutions and Investment Companies (1985) Article 5
establish a central sharia board to supervise the Islamic finance sector in the country. These examples are very recent and there are insufficient data to analyse the legal framework and its effect on the standardisation role of the central SSBs in these jurisdictions.

A National SSB is a positive step taken by certain jurisdictions to make the sharia governance structure more robust in their Islamic finance sectors. The soundness and reliability of sharia governance depends heavily on the independence of the SSB and the consistency of the pronouncements or sharia rulings between SSBs within a state or region. Recently, AAOIFI recommended, within its governance standards, the establishment of a national SSB in the sharia governance structure to achieve a greater level of standardisation. Although standardisation is the main objective of these regulatory agencies, national SSBs are given insufficient authority to standardise the practice fully. Most of national SSBs do not have effective authority over SSBs and their main purpose is to advise the central banks or security commissions on sharia matters and resolve conflict of opinions between SSB members.

Sudan and Pakistan are among the few jurisdictions which allow only Islamic banks to operate in their financial industry. However, the standardisation in these countries is insufficiently developed effectively to govern the process of setting sharia standards. Sudan established the Higher Sharia Supervisory Board in 1992 as the first country to introduce a national SSB. The objective of the national authority is to standardise the practice in the Islamic finance industry and ensure the sharia-compliance of the central bank’s own products. However, it seems that the legislative authority given to the national SSB described by the law is limited to arbitration and resolving conflicts.

Geti sources:
551 Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (n 314) at 229
553 Grassa, ‘Sharia Supervisory Systems in Islamic Finance Institutions across the OIC Member Countries’ (n 388) at 146
554 Khwla Alnobani and Abdullah Siddiqi, Governance of Islamic Financial Institutes (Sabic Research Chair Programme for Islamic Finance Industry, Imam Muhammad Ibn Saud Islamic University 2016) at 82-83
between members of individual SSBs. While decisions are taken by majority vote, conflicts that need to be referred to the national SSB are rare. The governance framework grants the SSB at the institutional level the authority to play a legislative role in its relevant institution in addition to its duty to conduct sharia audit to assure the stakeholders of sharia compliance. Such a combination of roles exposes the SSB members to conflict of interests. The situation in Pakistan is similar. There is a national SSB affiliated with the State Bank of Pakistan (SBP) that supervises sharia-compliance of the bank’s own products and resolves any conflict in sharia opinions that may arise from the institutions. As a compromise for independence, dual membership on this board and the SSB at the institutional level is allowed. Also, the sharia governance framework assigns individual SSBs legislative authority over their relevant IFIs as well as providing a sharia-compliance check.

A more advanced application of standardisation is applied in Malaysia and Indonesia. In Malaysia, the Sharia Advisory Council (SAC) has been established within the central bank, mainly to function as “the ascertainment of Islamic law for the purpose of Islamic financial businesses”. Kunhibava discusses the “ascertainment” role through the Malaysian court’s interpretation of its meaning in different cases. The court differentiates between the ascertainment and determination of the law. Accordingly, SAC is not authorised to issue new roles and standards but merely to explain and ascertain Islamic law regarding a particular issue. Such a role should not extend to cover the application of this issue and deciding whether the transactions executed between the parties were sharia-compliant or not. The court considers this matter to be its own responsibility and the SAC is only an expert whose ruling, although

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556 Central Bank of Sudan, Improve Corporate Governance in Banking and Financial Institutions (2009). It should be noted that the Higher Sharia Supervisory Board has issued Sharia Guidance. See The Higher Sharia Supervisory Board in Sudan, Sharia Guidance for Banking and Financial Industry Issued by the Higher Sharia Supervisory Board (Central Bank of Sudan 2006). However, in light of the authority given to individual SSBs, it is not clear whether or not this guidance is obligatory.
559 State Bank of Pakistan, Shari'ah Governance Framework for Islamic Banking Institutions (2014) at 3
560 Malaysia, Central Bank of Malaysia Act (2009) Section 51
legally binding on the court, is purely to ascertain sharia-compliance regarding the specific issue, while the court has a judicial function to examine the compliance issue more widely.

This role is insufficient to ensure effective standardisation. Although SAC is recognised as the sole authority over Islamic financial products in Malaysia, it has a limited role of standardisation, mainly involving approving products sent to it by individual SSBs. The governance framework requires SSB members to comply with, respect, and not publicly criticise any of the SAC’s published rulings.\textsuperscript{562} However, this requirement is within the context of the professional ethics standards whose objective seems to govern the professional behaviour of the the SSB’s members if the outcome of the SAC’s decision contradicts their point of view. In fact, the authority given to the SSB includes a legislative role. In the absence of enforceable comprehensive sharia principles and standards, individual SSBs play a role in determining sharia rules. In order to obtain product approval or sharia guidance from SAC, the SSB needs to provide the supportive sharia opinions.\textsuperscript{563} The SAC’s decisions might be strongly influenced by the sharia opinions provided by the SSB to support its point of view. The arguments provided by the SSB, whose objectivity is questioned as it is not fully independent from its relevant IFI, might be a major factor in the SAC’s approval. \textit{Fatwa} shopping might be utilised by the SSB to influence SAC and facilitate certain decisions. Moreover, the legislative authority given to the SSB, although limited, compromises its independence, since the SSB is also responsible for sharia audit.\textsuperscript{564} Combining the duty of rule-making and auditing in the SSB would increase its conflict of interest status. Additional conflict of interest situations might arise if an SSB member is appointed as a director in the board. The governance framework expresses its preference for this dual membership because it results in a better understanding between the SSB and the board.\textsuperscript{565}

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\textsuperscript{562} Bank Negara Malaysia, \textit{Sharia Governance Framework for Islamic Financial Institutions} (2010) at 20-21
\textsuperscript{563} Ibid at 34-35
\textsuperscript{564} Ibid at 34-35
\textsuperscript{565} Ibid at 10-11
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corporation is an important responsibility which leads to a liability issue. This responsibility, as a director, affects the objectivity of the member’s sharia ruling.

In Indonesia, the National Sharia Council (DSN) is affiliated with Majelis Ulamas of Indonesia and responsible for interpreting fatwas regarding Islamic banks, providing input to the framework of fatwa implementation.\textsuperscript{566} The Indonesian regulations require strict compliance to the sharia principles issued by DSN. Besides an ex-post duty which involves ensuring sharia-compliant operations, the ex-ante role given to the SSB is purely to advise IFIs on how to comply with DSN’s Sharia Principles.\textsuperscript{567} It is inferred that the SSB in Indonesia does not have the authority to make the rules but only to help, as sharia experts, IFIs regarding the issue of sharia-compliance. Fatwas containing comprehensive guidance relating to Islamic finance are issued by DSN.\textsuperscript{568} The requirement of strict compliance to the legislative authority is an advanced step to ensure a more independent process of sharia standardisation. However, unlike Malaysia,\textsuperscript{569} members of the national sharia board are permitted to serve on the SSB at the institutional level, with some restrictions.\textsuperscript{570} This dual membership, as explained before, compromises independence since it creates a possible conflict of interest among legislators whose employment interest with their relevant IFIs could affect their objectivity when legislating. Also, members may perform a combined role of legislating and auditing, which has a further negative effect on their independent status.

From the overview above, it seems that the industry has not yet achieved the mature practice of standardisation. There remain limitations which undermine the independence and objectivity of setting sharia standards. While establishing a national SSB positively contributes to standardisation, more improvement is needed to develop and govern the rule-making structure and so reflect greater independence and objectivity. The inclusion of the word “advisory” in the title of the central SSBs reflects indirectly that these

\textsuperscript{566} Grassa, 'Shariah Supervisory System in Islamic Financial Institutions' (n 544) at 340
\textsuperscript{568} Tim Lindsey, 'Between Piety and Prudence : State Syariah and the Regulation of Islamic Banking in Indonesia' (2012) 34 Sydney Law Review 107 at 115
\textsuperscript{569} Bank Negara Malaysia, \textit{Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions} (2005) No.19
\textsuperscript{570} Grassa, 'Shariah Supervisory System in Islamic Financial Institutions' (n 544) at 346
authorities have an advisory function and the industry may opt not to follow their
decisions, a situation that has a negative effect on the credibility of these authorities.\textsuperscript{571} Another concern is the participation of SSB members in international organisations such
as AAOIFI and IFSB and/or national SSBs. Where it is allowed, IFIs might appoint these
members in their SSBs due to the shortage of sharia scholars in Islamic finance. This
would compromise the independence since the same members would: determine the
IFIs’ Islamic framework; drive public opinion; and give advice to IFIs.\textsuperscript{572} To foster the
role of standardisation further, more governance aspects need to be considered in the
structure of national SSBs. The board should have the highest level of autonomy and
not be affiliated with an administration that might substitute sharia interest for another.
The affiliation with the central banks under the dual system, where both Islamic and
conventional banking operate, might put the members of national SSBs under pressure
by the central banks to prioritise interests other than sharia-related ones for economic or
political reasons. The Indonesian model, where its national SSB is affiliated to Majelis
Ulama of Indonesia, a religious body concerning Islamic law, ensures that sharia
interest is prioritised. This model could be adopted in Saudi Arabia by establishing a
national SSB affiliated with BSU. The governance framework should seriously consider
the independence of members who need to be restricted from serving in any of the
regulated institutions or in a public position that might affect their objectivity and
independent status.

These regulatory agencies should adopt comprehensive sharia guidance which
entails enforceable sharia standards to be applied by IFIs. To avoid conflict of interests,
these regulatory agencies should be considered the sole legislative authority and
substitute any legislative role that might be performed at the institutional level. This level
of standardisation could be viewed as impractical, since codifying Islamic law might
affect its flexibility and ability to satisfy the variable needs of the industry. This issue will
be discussed further in the next section.

\textsuperscript{571} Ibid at 344
\textsuperscript{572} Volker Nienhaus, ‘Governance of Islamic Banks’ in Kabir Hassan and Mervyn Lewis (eds), \textit{Handbook of Islamic Banking} (Handbook of Islamic Banking, Edward Elgar 2007) at 140
5.5 Standardisation and the Issue of Practicality

Islamic law is derived from different interpretations of its sources. Therefore, it is not a definite set of rules but, instead, provides general principles that must be followed. These principles might be very wide in order to ensure flexibility of application in different circumstances. In light of different interpretations of Islamic law, standardisation might be considered an impractical approach to apply. While the previous experience of the general codification of Islamic law explained before proves otherwise, the case of Islamic finance is, arguably, special and needs careful consideration. The rapid growth of the industry and the nature of the financial products that require constant development need flexible *ijtihad* to supply the industry with its needed sharia-compliant products. Therefore, standardisation might be viewed as a restriction on the practice of Islamic finance.

It has been argued that the necessity for standardising conventional banking is not applicable to Islamic principles. IFIs need to use a more creative way to find sharia-compliant financial solutions, free of interest.⁵⁷³ So innovation might be reduced due to standardisation, where IFIs must strictly follow a set of standards instead of referring to a wider range of general principles that provide more room to offer innovative new products.⁵⁷⁴ An executive of an IFI argued, during an interview, that standardisation could work only in theory and that it is almost impossible to apply a standardised set of sharia rules to the whole industry. According to him, the effect of the non-standardised industry is exaggerated. Only a small fraction of opinions are subject to differences between scholars in the industry, which creates the necessary room for fostering innovation and adapting to changes in the market.⁵⁷⁵

The above view disregards the discipline that the financial market seeks by regulation. The total inconsistency of sharia opinions increases the conflict of interests. As mitigation, some prefer a semi-standardised model. Despite its limitations, explained

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⁵⁷³ Rahail Ali and Mustafa Kamal, ‘Standardising Islamic Financing Possibility or Pipe Dream?’ (2009) 10 Business Law International 19 at 19
⁵⁷⁴ Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 20
above, some researchers express a preference for the Malaysian standardisation model as a balanced model that lies somewhere between the diversity in sharia opinions which provides flexibility to the industry on the one hand and standardisation on the other. According to this view, the model adopts unstandardised sharia opinions in an organised way by having a high authority which should prevent the exploitation of the diversity within sharia. Another proposal for balanced standardisation between detailed sharia standards and total freedom of opinion suggests that the tools and methodology of *ijtihad* should be standardised, which would increase the degree of consistency within the industry. If the methods and tools were to be standardised, this would, however, leave plenty of room for SSBs to legislate their own sharia standards. This level of standardisation might place restrictions on sharia members from having complete freedom of interpretation, but the issue of conflict of interests associated with giving the SSB the authority to set its own sharia standards remains.

The environment in which different opinions are allowed may be preferred in order to allow room for innovation in Islamic financial products but this would cause chaos by producing inconsistency and divergence. In fact, innovation could be achieved through standardisation, which would help to clarify the role of IFIs and enable them to operate in a more organised way. Standardisation makes sharia standards better understood by the market since they will become an integral part of daily financial life. Therefore, IFIs would have more opportunity to focus on innovation which would be the major instruments of competition between IFIs and lead to greater prosperity in the market. Efforts made by IFIs to set standards would be dedicated to innovate products based on the compulsory sharia standards and, therefore, make them more focused on making a profit.

The industry needs a governance mechanism to enforce a specific set of Islamic principles to achieve harmony. In fact, the different interpretations of Islamic law is not a

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576 Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 300; Ginena and Hamid, *Foundations of Shari’ah Governance of Islamic Banks* (n 134) at 134
578 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 15
579 Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 139
unique feature. Any other law is also subject to such a diversity of interpretations. Legal scholars may have different interpretations and adopt different perspectives of legal theories. For example, corporate governance theories are subject to differences between theorists. However, several authoritative mechanisms are usually used to enforce a specific interpretation which is not the case in Islamic finance.\footnote{Aldohni, 'The Quest for a Better Legal and Regulatory Framework for Islamic Banking' (n 35) at 31} This marks Islamic finance with a great diversity that affects its governance. There is also room for different interpretations and implementations in auditing and accounting practice.\footnote{David J. Cooper and Keith Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (2006) 31 Accounting, Organizations and Society 415 at 428} However, the practice is standardised in such a way that discipline is preserved. The different implementations give the institutions the flexibility to apply it in different circumstances. In public policy, public institutions are a natural response in situations where conflict of interests exists to prioritise these interests.\footnote{Frank J. Sorauf, 'The Public Interest Reconsidered' (1957) 19 The Journal of Politics 616 at 631} The previous chapter provided an overview of such institutions in the auditing profession. By analogy, different opinions could be treated in the same manner. A national sharia standard-setting board may be established to put sharia interest above others, taking into consideration the overall needs and requirements of the Islamic finance industry.

The detailed level of standards needed for a more objective and effective sharia governance framework might be difficult to tailor. It is not expected for standardisation to be comprehensive to a level that identifies singular correct answers in many areas.\footnote{Christopher M. Bruner, \textit{Re-Imagining Offshore Finance: Market-Dominant Small Jurisdictions in a Globalizing Financial World} (Oxford University Press 2016) at 94} Generally, there should be a codification that allows flexibility and the systematic application of the rule. On the other hand, it should eliminate the need for individual SSBs to play a role in setting sharia standards. Flexibility needs to be highly maintained in standardisation. The literature offers guidelines on how sharia principles in Islamic finance should be standardised. Since standardising all disagreements is not straightforward, it is suggested that harmonisation should be created on the basis of the objectives of Islamic law rather than a micro-juristic opinion. Put differently, codification should be based on “the law as it ought to be” rather than “the law as it is”, and to achieve this, the standardisation should be supported by the objectives and philosophy
of Islamic law. Expressing the objectives of the standards is an effective way of achieving the specification of the rule and satisfying flexibility as well. The industry would have obvious rules to comply with but not in a very literal or precise way that might damage the flexibility. Compliance is maintained as long as the action is consistent with the expressed objectives of sharia. It might be helpful to disclose the reasoning why a specific opinion was adopted to help the IFIs, sharia auditors, and sharia advisors to understand the context and objectives of each sharia standard. This would work as a guideline for dealing with new issues that have not yet been determined by the national sharia board.

Overall, standardisation should be generalised to allow institutions discretionary room for the institution’s own actions. Generalisation ensures greater flexibility in application. In his proposed model of standardisation, Mashal projects that standardisation should be at a level that satisfies an appropriate but not absolute uniformity in applications. He suggests that standards should have the flexibility to cover a wide range of applications in different situations and to create a pattern that includes different applications. He recommends including an experimental period to test the newly-issued standards to overcome gaps and difficulties in application that IFIs may face, especially at the beginning. After that, the applicability and generalization of the standards should be determined.

Flexibility might also be preserved by formulating the standards to include different perspectives as potentially applicable. The idea of standardisation does not necessarily mean that one view must be put aside to give way to another contradictory one but, in many cases, these two different views could be jointly applied in order for both to be acceptable as sharia standards.

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584 Bakar, ‘The Shari’a Supervisory Board and Issues of Shari’a Rulings and their Harmonisation in Islamic Banking and Finance’ (n 489) at 87
586 Mashal, ‘Shari’ah Regulation by Central Bank on Islamic Financial Institutions’ (n 541) at 550-553
587 Bakar, ‘The Shari’a Supervisory Board and Issues of Shari’a Rulings and their Harmonisation in Islamic Banking and Finance’ (n 489) at 88
The main issue with the level of standardisation is that the rule-making authority should be removed from the SSB. Most of the above guidelines remain theoretical and do not concern a specific model to govern standardisation. When the industry becomes fully standardised by independent regulatory authorities, such as national SSBs, it is helpful to consider these guidelines during the process of setting sharia standards. To increase the practicality, the standards need to be tested over time in practice. This requires frequent reviews and assessments of the standards to meet the variable needs of the financial industry. To ensure greater consistency, institutions may be forced to seek approval from the national SSB for their newly-designed products, a similar procedure to the current requirement in Malaysia. Seeking such approval, however, should not be supported by merely sharia opinions since this involves a role of legislation, as explained before. It should rather explain the relevance of the newly-designed products to the published sharia standards. Such a procedure preserves the sole authority of legislation to the national SSB.

5.6 The Market’s Need for Standardisation

Standardisation also provides the market with more stability and credibility. Stakeholders’ confidence is an important factor in ensuring the success of the industry. In a situation where each SSB creates its own jurisprudence and adopts its own standards, inconsistency is likely to be the case in the industry. It could reach such a level that the same bank adopts conflicting standards over time or in different jurisdictions within the same banks.\(^{588}\) Inconsistency is classified as one of the greatest challenges facing the Islamic finance industry because of the confusion it can create among customers and stakeholders.\(^ {589}\) The same products may have significantly different points of views between scholars in different banks due to different factors


\(^{589}\) Hamza, ‘Sharia Governance in Islamic Banks: Effectiveness and Supervision Model’ (n 314) at 230
which can influence their decisions. Consistency, therefore, is important in promoting customers' confidence, contract enforceability, and market efficiency.\(^{590}\)

As the situation of inconsistency increases, the repercussions regarding the enforceability of the contracts increase and the stakeholders' confidence is damaged. Incoherent decisions can undermine the legal certainty and shake the customers' confidence regarding the authenticity of the industry, a situation that may lead to a critical mass and systemic instability in the industry, which lead to a possible failure.\(^{591}\) In the absence of clear sharia standards, contradictory opinions may be argued by different SSBs as being sharia-compliant to prove the legitimacy of their decisions, a situation that would confuse the stakeholders and shake their trust in the industry and the SSB itself.\(^{592}\) Also, in an environment where contradictory standards are deemed to be compliant within the same jurisdiction, sharia auditing, which is the main tool used to assure stakeholders that the interest of sharia is preserved, would not be straightforward but would become a source of confusion among auditors and other stakeholders. Moreover, the lack of standardisation causes uncertainty about the enforceability of the contracts and permissibility of the products. Consistency of interpretation would enhance the enforceability of contracts before the civil courts. They might not consider the opinion of the relevant SSB and decide that the contract is non-sharia compliant and impermissible, a situation that increases the sharia risk and leads to vagueness regarding the legal rights existing between IFIs and their customers.\(^{593}\)

Consistency creates discipline which is an important factor that the market needs. It might be very difficult for the market to adopt inefficient players only because of the believers' willingness to pay a premium to protect their faith.\(^{594}\) Currently, there might be sufficient confidence among stakeholders that IFIs satisfy their religious interest, so the

\(^{590}\) Grais and Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (n 360) at 20-21
\(^{591}\) Morrison, 'Shariah Boards and the Corporate Governance of Islamic Banks in the United Kingdom' (n 413) at 98
\(^{592}\) Umar, 'SSB's Roles between Individual Advisory and institutional Profession' (n 386) at 16
\(^{593}\) Jabbar, 'The Islamic Financial Services Industry: The Sharia Board's Governance Framework' (n 558) at 299
\(^{594}\) Khan, 'Setting Standards for Shariah Application in The Islamic Financial Industry' (n 32) at 288
market can endure the cost of inconsistency and uncertainty. At some point, stakeholders may lose this confidence due to doubt whether the SSB is the protector of their interest and IFIs might, eventually, find the price of inconsistency too high to pay. In many instances, inconsistency has caused confusion in the industry, which may have shaken the confidence of its stakeholders. A prominent case which caused such confusion occurred when the Fiqh Academy of the Organisation of Islamic Conference (OIC) declared that financial products based on tawarruq, the monetisation of commodities, as commonly practised by certain IFIs, were not sharia-compliant, notwithstanding their previous authentication by the relevant SSBs. In Saudi Arabia, a recent disruption in the financial industry could be linked to inconsistency in the Islamic rules relating to the collection of zakat. Instead of corporate tax, Saudi firms are subject to an annual Islamic tax, zakat. At the beginning of 2018, major Saudi banks disclosed that the General Authority of Zakat and Tax (GAZT) had been seeking additional zakat payments from them for several years, dating back as far as 2002, which in some cases exceeded half of a bank’s annual net profit, a situation that had a negative impact on the banks. One of the Islamic banks issued a statement explaining that the dispute regarding the additional payments of zakat between the bank and GAZT was mainly due to the different sharia perspectives adopted on the zakat base, where the view of the bank’s SSB is that the claimed payments do not fall within the obligatory zakat. Although this issue is not specific to Islamic banks but generally related to tax issues, it provides an example of the effect of inconsistency on the sharia rulings in the market. A more relevant example is highlighted at the end of this chapter.

595 Wilson, Legal, Regulatory and Governance Issues in Islamic Finance (n 125) at 10
596 Jabbar, ‘The Islamic Financial Services Industry: The Sharia Board's Governance Framework’ (n 558) at 299
598 Explanation of Bank Alinma Regarding the Claims of GAZT (2018) <https://www.alinma.com/wps/portal/alinma/Alinma/MenuPages/TheBank/News/NewsItem_ar/explanation_ofinmabankregardingzakatcommissionclaims/!ut/p/z1/pZFPU81wEMU_DUebDZQavRVhydr-R2QeEpvTgb05ChTTppsA6f3AadD4hyG-783uz7-2iDUok_RNcGqEkrSw_XPmvXjxmEBAY7j1QVcRtgOMYYbRugXC-M4dz1w8lyOvB_5kgbB-8gmCoYey_-jhnq56DbAjuj8C0nKkop2W0LmCqQsQ0obFOQXMISbgia8afhWSHmemq0qSI1XltgWVJS11zQ1y77NBt5gaM1GAP0owiTB58CFa_wJwE8gmp5W3lbJlva7Mee5_AfBL-XC6C_U5vNvt0i2uWc40085B2s_HOMkq-70AHmqZxuFK8YMYW0Yyd9BY6lDdq2K71nUclkgsrcrH9DjIPk4YI1giyAeAtkTU/dz/d5/L0IHskovdoRNQURrQUVnQSEhLzROVkvUyXYII/> accessed 15/4/2018
In fact, the market did have to pay a high cost as a result of losing customers’ confidence. A prominent internationally-known sharia adviser declared in 2009 that 85% of the *sukuk* in the global financial market were not sharia-compliant and involved, in one way or another, a form of interest.\textsuperscript{599} The comment he made was in the context that he had withdrawn his own previously issued approval of *sukuk*. His statement indicates a problem related to the governance of setting sharia standards. After the statement, the demand for *sukuk* declined despite its previous authentication by the respective SSB and the whole industry was affected.\textsuperscript{600}

Standardisation would provide the market with discipline and a systematic operation that creates a more stable market and helps to develop its growth. While financial products have globally become less diverse in order to attract more customers, the customers and other stakeholders of Islamic finance need to be enticed in the same way by providing more standardised products.\textsuperscript{601} Having a special code of sharia standards would be valuable to sharia-compliance stakeholders, who would be able easily to measure the level of compliance and evaluate IFIs under a similar environment. Also, cross-border Islamic investments would find it easier to seek and utilise guaranteed sharia-compliant corporations. In addition, standardisation helps to create a more competitive environment, which is an important factor for the market. Different sharia standards will place IFIs within the same jurisdictions under different legal environments which can endanger certainty. Implementing a standardised sharia dynamics would place IFIs under the same circumstances and restrictions where they can fairly compete with no major effect.\textsuperscript{602}

These situations demonstrate the significance of standardisation and its effect on the marketability and acceptability of Islamic finance. The consistency and uniformity of Islamic financial products within the same jurisdiction would help to increase and

\textsuperscript{599} Abdullah almaneea, '85% of Traded Sukuk in the Global Market are Riba-based' *Alriyadh* (27/10/2009) <http://www.alriyadh.com/469474> accessed 08/06/2017

\textsuperscript{600} Jabbar, 'The Islamic Financial Services Industry: The Sharia Board's Governance Framework' (n 558) at 299

\textsuperscript{601} Rahmat Hakim, 'Harmonization of Shariah Rulings in Islamic Finance: An Analysis' (2013) 7 Hukum dan Ekonomi (Law and Economics) Journal 267 at 268

\textsuperscript{602} Ahmeen, 'The Governance Standards of Sharia Supervision' (n 384) at 13; Muneez and Hassan, 'Shari'ah Corporate Governance: The Need for a Special Governance Code' (n 173) at 125
reinforce the credibility of IFIs. The standards and decisions set by an independent national board are deemed more credible by stakeholders than the ones made by internal SSBs. As the above instances show, if the SSB’s decision conflicts with a more known sharia scholar or authority such as OIC, the stakeholders’ credibility about sharia compliance and their trust of the relevant IFIs would be negatively affected. Inconsistency may lead to the issuance of strange fatwas in the industry which threatens the credibility of these products in the eyes of Muslim communities, and hence the development and the stability of the industry in general. Customers not only want stamped products; their strong commitment to sharia might lead them to doubt the credibility of a fatwa if they feel that their duty of commitment has not been discharged. In light of the different interpretations, declaring the standards and Islamic rulings that the IFIs may use in their products would give clients more satisfaction.

The supervision by the central banks of IFIs would be more effective and less costly if the sharia rulings were consistent. As argued in Chapter Three, IFIs require special financial regulations since they might face challenges by operating under conventional financial regulations. Also, competing with the conventional financial institutions would be difficult under regulations that ignore the nature of Islamic finance requirements. Standardisation would pave the way for the creation of an Islamic financial market as a secondary market to help IFIs to operate under a similar environment. It could help the financial regulators to understand Islamic finance better and so react accordingly. The role of national SSBs could be extended to cooperate with the financial regulators and other standard setters. Such cooperation is necessary to help the regulators to understand the needs and special requirements of the Islamic finance industry. National SSBs would represent IFIs in their special requirements regarding sharia-compliance and help the financial regulators to tailor convenient regulations for the Islamic finance markets. This cooperation may also extend to helping the financial regulators to set

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603 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 230
604 Grassa, 'Sharia Supervisory System in Islamic Financial Institutions' (n 544) at 343
605 Khan, 'Setting Standards for Shariah Application in The Islamic Financial Industry' (n 32) at 294
607 Chapra and Ahmed, 'Corporate Governance in Islamic Financial Institutions' (n 222) at 81
guidelines and rules for dealing internationally with foreign IFIs who might adopt different sharia standards or with conventional financial institutions. The lack of standardisation is, also, seen as an obstacle to the financial and monetary regulation in the industry. The financial regulators tend to adopt certain international standards to secure the financial markets, such as Basle Accords. However, the global Islamic finance industry faces challenges related to developing prudential regulatory standards across IFIs in different jurisdictions due to the lack of uniformity within the practice of Islamic finance. 608

Standardisation by a national board would make the process of sharia standard setting more institutionalised rather than leaving it to individual efforts. This is an important factor for improving the industry and keeping it long-standing. In fact, the instability of opinions is one of the major obstacles to the development of the industry. Many opinions have been subjected to change once the members have been replaced, a situation that calls for a better mechanism for ensuring as much consistency over time as possible. 609 National SSBs should be able to revise and develop standards through collective dialogue and deliberation. 610 They would be able to assess the market needs more generally and efficiently before setting the standards and creating a national sharia policy. Also, the complexity of the market requires sophistication in the process of setting standards. National SSBs would be better equipped to do this job efficiently while individual SSBs may set standards that might harm the industry due to their obstructed view of the market.

When sukuk emerged as an alternative to conventional bonds, the Central Bank of Bahrain issued sukuk valued at 40 million Bahraini Dinar (more than USD100 million). The issued structure of sukuk was authenticated by its SSB. Later, two prominent SSB members withdrew their approval of such a structure after they discovered that the structure was artificially sharia-compliant. 611 They confessed that they had not

608 Hakim, ‘Harmonization of Shariah Rulings in Islamic Finance: An Analysis’ (n 601) at 272
609 Almuzeini, ‘Business Practices According to Islamic Legislation in Islamic Financial Institutions’ (n 577) at 8
610 Schneiberg and Bartley, ‘Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century’ (n 585) at 42
611 Hamed Merah, Ijarah Sukuk: Fiqh, Rooting, and Application (Dar Almaiman 2008) at 397-404
examined the format in depth and had ignored major facts which affected the decision. As a new product at that time, it was challenging for a regular SSB to examine a complicated structure in depth. New complicated products are susceptible to a similar situation. Recently, short selling was approved to be introduced into the capital market in Saudi Arabia. It is defined as “the action of selling borrowed securities; provided that the investor returns them to the lender within an agreed upon period”. The process of short selling is questioned as a sharia-compliant action and might evoke different reactions from different SSBs. An executive from a Saudi IFI stated that its SSB was working to design a compliant version of a short selling product. The individual efforts of such a complicated financial operation may result in contradicting views, followed by negative consequences in the market due to the absence of clear standards that deal efficiently with new issues. Because of the institutional shortage in the industry, the solutions sought to overcome its obstacles are temporary rather than strategic. New structures would be subject to more efficient examination by an equipped standard-setting board that could deal with new issues and publish relevant standards. Also, the process of central standardisation should involve a careful assessment and analysis of the market. Therefore, the standards would be tailored to be more suitable for the overall industry. For example, the different environments in which sharia-compliant products are offered need to be carefully analysed in order to apply proper standards in each one. Fatwas might differ considering whether the sharia principle is applied in a fully-fledged Islamic institution, gradually converting, an Islamic window within a conventional institution, or just sharia-compliant products within non-compliant ones. In such a situation, each sector might need some exceptions or special considerations to apply sharia rules due to its unique circumstances. What is deemed proper for Islamic windows to provide as a compliant product might not be a

612 Almaneea, ‘85% of Traded Sukuk in the Global Market are Riba-based’ (n 599)
615 An Executive in Albilad Capital States that a Sharia-compliant Version of Short Selling is being Designed (2017) <http://www.argaam.com/ar/article/articledetail/id/485185> accessed 02/08/2017
616 Almuzeini, ‘Business Practices According to Islamic Legislation in Islamic Financial Institutions’ (n 577) at 9
617 Ibid at 19
satisfactory sharia-compliant product in fully-fledged Islamic institutions. In the absence of a high legislation authority, the industry would be subject to greater diversification and inconsistency. Individual SSBs might not set the proper standards for each sector and many sharia standards might be improperly applied and used interchangeably across these different sectors. The fact that many sharia members simultaneously work in SSBs in different sectors could increase this chance. This situation of great inconsistency would be very confusing to the market.

Another aspect of standardisation is the cost associated with having SSBs to set standards in every IFI. This would be very costly, particularly for smaller banks. The cost is reduced when Islamic principles are clear to practitioners and investors and IFIs will not have to have a lengthy, costly process for obtaining sharia approval from their SSBs. As a result, the transaction cost to the industry as well as to the regulators will be reduced. Also, standardisation reduces the chances of sharia risk since sharia rules would be clearer and easier to comply with.

Overall, standardisation is important for improving the industry and bringing more satisfaction to the stakeholders. It provides the market with a better environment. In fact, the advantages of standardisation for the market have led IFIs to apply several strategies for achieving greater consistency. In the absence of an efficient comprehensive standardisation framework, IFIs recruit the same SSB members as a strategy of standardisation that helps to minimise inconsistency. However, such a mechanism is not an effective tool of governance and would not solve the issue. It rather creates a monopolistic behaviour where the circles of the IFIs could have an influence over the members of the SSB. Such a situation would increase the conflict of interests where IFIs would find it easier to control the few scholars who could monopolise the practice and influence the outcome of sharia decisions to better serve the IFIs’ perspectives. Also, it is costly for each IFI to recruit its own legislative body. Instead, these members should be recruited to a central SSB and enforce their

618 Chapra and Ahmed, 'Corporate Governance in Islamic Financial Institutions' (n 222) at 81
619 Ali and Kamal, 'Standardising Islamic Financing Possibility or Pipe Dream?' (n 573) at 20
620 Hakim, 'Harmonization of Shariah Rulings in Islamic Finance: An Analysis' (n 601) at 272
621 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 230
decisions and standards among IFIs. In fact, multi-membership has negative effects on confidentiality and conflict of interests, which will be discussed later.\footnote{In Chapter Six}

5.7 The Level of Standardisation: National or International

Standardisation seems to be an obvious need in the industry. The discussion goes beyond whether to standardise the sharia principles and rules or not. The feasibility of international harmonisation has become a subject in the context of the standardisation discussion, especially with the rise of international organisations concerned with such issues, like AAOIFI. The enforcement of international standards, however, remains an issue, especially in the absence of effective national mechanisms for standardisation.

International harmonisation has become a trend in the legal framework in different disciplines. They tend to abandon the traditional scheme of standardisation where the national bodies have the exclusive authority to set standards and turn toward a new form which increasingly relies on regulatory bodies that are external to the state.\footnote{Schneiberg and Bartley, 'Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century' (n 585) at 42} Globalisation requires less diversity in these rules for practical and economic reasons. In the accounting and auditing field, the international harmonisation of the standards with the adoption of IFRS is seen as a huge achievement in terms of overcoming different cultural, legal, regulatory, and economic priorities among nations.\footnote{Rosemary Peavler, 'IFRS and FASB - What are Financial Reporting Standards? The Accounting Standards and Standard Setting Bodies' (2016) <https://www.thebalance.com/g00/ifrs-and-fasb-what-are-financial-reporting-standards-392948?i10c.referrer=https%3A%2F%2Fwww.google.co.uk%2F> accessed 23/03/2017} It came as a result of the global financial interconnection between individuals, institutions, and governments.\footnote{Cooper and Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (n 581) at 430} The divergence in the standards between jurisdictions could be a critical challenge for companies wishing to expand their business internationally and could restrict the international trade as well. Where these are not obligatory, companies prefer to adopt the international standards to enhance their foreign exposure; increase
customer recognition; secure foreign capital; and reduce the political cost of international transactions.\textsuperscript{626}

The situation in Islamic finance is no different. It is the sharia-compliant version of these dealings and, so, exposed to the same circumstances. Therefore, the same result could be inferred in the Islamic industry. Harmonising sharia standards internationally could offer an economic advantage for IFIs, as it improves their international exposure and increases the understanding of customers who are interested in engaging in sharia-compliant businesses cross-borders. They will find it safer to invest in foreign IFIs as these institutions have more consistent sharia products. The cost of international transactions will therefore be reduced. Without a level of international standardisation, products and then the whole industry would see major inconsistency between different jurisdictions.

Jabbar lists some justifications for having an international level of harmonisation that covers the whole industry.\textsuperscript{627} First, it is a practical way to market and promote financial sharia-compliant products across different jurisdictions. Second, it would be easier to assess the level of compliance by the rating agencies. Third, more certainty and confidence about the legal rights to products would be obtained. Fourth, the development and growth of the industry would be more promising. Fifth, international standards would mitigate political considerations which may be exercised to influence sharia standards.

The global growth of Islamic industry is extraordinary and needs to be maintained through standardisation.\textsuperscript{628} The lack of standardisation is seen as the major barrier to the cross-border sale of Islamic financial products.\textsuperscript{629} The International Organization of Securities Commissions Report states that harmonisation is an essential factor in

\footnotesize{\textsuperscript{626} Samir M. El-Gazzar, Philip M. Finn and Rudy Jacob, "An Empirical Investigation of Multinational Firms' Compliance with International Accounting Standards' (1999) 34 The International Journal of Accounting 239 at 239-241
\textsuperscript{627} Jabbar, "The Islamic Financial Services Industry: The Sharia Board's Governance Framework" (n 558) at 300
\textsuperscript{628} Ali and Kamal, "Standardising Islamic Financing Possibility or Pipe Dream?" (n 573) at 19
enhancing the spread of Islamic finance globally. Duplicate sharia standards applied cross-border create a challenge to the acceptance of the Islamic financial market globally as it would not be perceived as an integral market, which obstructs the flow of international Islamic finance. A non-standardised industry creates a possibility that one group of IFIs operating in different jurisdictions may have products that are deemed sharia-compliant in one jurisdiction but not in another. Moreover, international harmonisation would satisfy the need for a greater plurality of approaches and widen the scope for scholarly knowledge and intellectual depth in the process of setting sharia standards.

Also, international harmonisation helps IFIs in non-Islamic or secular jurisdictions. It provides a legal reference to the financial authorities in these jurisdictions. For example, the English courts in different cases have held that the term "sharia law" could not be a governing law since the rules of sharia are insufficiently precisely determined to govern commercial and financial transactions. Sharia law as a non-country law might not be considered by the Rome Convention, which provides that the choice of law should be a law of a particular country. Financial authorities and courts cannot judge between different interpretations within Islamic law. They would be in a neutral objective position that refrains from taking any religious point of view to ensure that they are in an equal position regarding all different religious and cultural backgrounds. The absence of definite references to Islamic finance law has challenged the industry in these jurisdictions. Harmonisation would be a major determinant for ensuring the enforceability of the contracts as civil courts could depend on these standards in disputes which would contribute to the development of Islamic finance globally.

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630 International Organization of Securities Commissions (IOSCO), ‘Analysis of The Application of IOSCO’s Objectives And Principles of Securities Regulation For Islamic Securities Products’ (2008) at 9
631 Antonio and Rusydiana, ‘What is the Future Outlook of Shariah Harmonization?’ (n 606) at 4
632 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 16
633 Hakim, ‘Harmonization of Shariah Rulings in Islamic Finance: An Analysis’ (n 601) at 274
634 Ercanbrack, ‘The Regulation of Islamic Finance in the United Kingdom’ (n 380) at 76
635 Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 567
636 Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’ (n 380) at 13
637 Ercanbrack, ‘The Regulation of Islamic Finance in the United Kingdom’ (n 380) at 73
638 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 16
an IFI in non-Islamic jurisdictions adopts a unified set of international sharia standards as a superior reference, the courts may find it justifiable as a referencing law which could be easily defined, especially if these standards are adopted by some Islamic countries which would meet the requirements of the Rome Convention. Without a doubt, enforcement is better assured through explicit reference to well-defined standards.

In his proposal for standardisation, Mashal argues that the international standards should substitute the need to establish a national SSB for standardisation.\textsuperscript{639} However, international standards could be too general to have a consistent market. International harmonisation does not replace the need to have a national board for the local assessment of application. Applying certain international standards might cause difficulties due to the different legal requirements, geographical regions, or cultural backgrounds. These different circumstances may require the different tailoring of standards. Therefore, the international standards need to be sufficiently general to cover as many cases as possible. Individual jurisdictions should be given the room to differ regarding the level of specification and requirement for application. Therefore, a national agency should adopt and tailor these standards according to the local needs. In fact, it is inferred from other experiences that international harmonisation does not mean total consistency cross-nations but that there should be a room for different interpretations driven by the cultural differences. Although the aim of the international accounting and auditing standards is to provide consistency within audit practice globally, total consistency is too difficult to achieve, given the different regulatory requirements and cultural backgrounds that each nation has.\textsuperscript{640} Due to these variations, harmonisation in the global auditing practice is not absolute since the international standards are usually tailored nationally to suit the local circumstances.\textsuperscript{641}

Probably a more practical proposal is provided by Khan who suggests that standardisation should take two forms; nationally, where each country should clearly standardise the legal opinions followed by its IFIs to clarify any ambiguity for

\textsuperscript{639} Mashal, 'Shari'ah Regulation by Central Bank on Islamic Financial Institutions' (n 541) at 553
\textsuperscript{640} Kleinman, Lin and Palmon, 'Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes' (n 485) at 65-66
\textsuperscript{641} Ibid at 72
stakeholders; and globally to mitigate the effect of the diversification between different jurisdictions by establishing international coordination to standardise the different approaches.\textsuperscript{642} The proposal suggests that the international effort of standardisation should provide jurisdictions with a defined regulatory framework and standards to apply regarding monitoring, supervision, and assessment.

There are some positive efforts toward global standardisation which might be helpful to build on. OIC, recognised by a large majority of scholars, could be a possible player in this approach.\textsuperscript{643} However, this organisation is concerned with general issues of Islamic law and is not exclusively applied in the Islamic finance industry. AAOIFI, IFSB, and IIFM are more sophisticated organisations which specialise in Islamic finance. In addition to sharia, accounting, governance, prudential, and ethical standards are the concern of these organisations. These standards also help to harmonise sharia principles. Sharia standards, the main issue considered in this chapter, are more comprehensively considered by AAOIFI, which has issued, to date, 57 sharia standards.\textsuperscript{644} Not all jurisdictions that are members of AAOIF have adopted sharia standards as mandatory as there are many only use them as guidelines.\textsuperscript{645} It is expected that many countries will eventually adopt the AAOIFI standards in response to the rapid growth of their Islamic financial systems and the need to resolve conflicts between the legal opinions issued by SSBs.\textsuperscript{646} However, the mere adoption of the standards could not be effective with a lack of a national governance mechanism. A national SSB must be established in order to provide national legitimacy; adopt more detailed or additional standards for local applications; and set modifications or exceptions to certain standards, if necessary. As seen above, the current practice of national SSBs needs a stronger and more effective role for standardisation which should substitute any similar role performed within IFIs. Compliance with the standards and accountability framework is another concern that needs to be addressed nationally and will be discussed in the following chapters.

\textsuperscript{642} Khan, 'Setting Standards for Shariah Application in The Islamic Financial Industry' (n 32) at 303-304
\textsuperscript{643} Hakim, 'Harmonization of Shariah Rulings in Islamic Finance: An Analysis' (n 601) at 273
\textsuperscript{644} Issued Sharia Standards <http://aaoifi.com/issued-standards-4/?lang=en> accessed 06/09/2018
\textsuperscript{645} Adoption of AAOIFI Standards <http://aaoifi.com/ adoption-of-aaoifi-standards/?lang=en> accessed 06/09/2018
\textsuperscript{646} Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions' (n 314) at 570
5.8 Challenges Related to Standardisation

Despite its benefits, the way to achieve standardisation may not be easy. The efforts toward standardisation need to address and overcome certain obstacles and challenges. Political and legal recognition is one of these challenges. IFIs in non-Islamic and secular jurisdictions might have difficulties adopting international sharia standards due to their special legal requirements which make the application of certain standards inappropriate. Legal restrictions could be the main challenge in this regard. The special requirements of Islamic finance, which sometimes needs tailored rules different from the conventional ones, may not exist in these jurisdictions. While the differences could be mitigated by having a national SSB authority and special legal frameworks, this could be a sensitive issue in secular states. Therefore, some sharia standards set by international organisations might not be legally applicable in these jurisdictions.

In such a situation, there are two possible solutions. First, the international organisations could adopt parallel standards for such jurisdictions that face challenges in adopting the regular standards. However, these parallel standards might not work consistently in every jurisdiction due to their different legal frameworks and rules governing the industry. An alternative solution could be to establish a self-regulating non-profit association composed of Islamic finance experts to promote the harmonisation and convergence of sharia interpretations. This solution could be an ideal approach, especially for non-Islamic jurisdictions.

In fact, standardisation might face a similar challenge even in some Islamic states which consider such an issue a private religious matter, in which they prefer there to be little or no interference. Saudi Arabia is an example of an Islamic state which politically does not prefer to interfere in any legal arrangement regarding Islamic finance. In the absence of a strong governance framework of standardisation, IFIs in these jurisdictions may agree to standardise their sharia principles and rules by establishing a private mechanism as a reference for standardisation.

647 Morrison, ‘Shariah Boards and the Corporate Governance of Islamic Banks in the United Kingdom’ (n 413) at 102
648 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 20
Another obstacle is the resistance to standardisation by some sharia scholars. They might oppose the monopoly of Islamic law interpretation. In their view, standardisation would damage *ijtihad*, which is the feature that enables Islamic law to survive in all times and places. Making a view from one doctrine dominant over another might not be universally acceptable. A prominent SSB member explained his personal view of why even national harmonisation is unacceptable. First, it would lead to restricting *fatwas* to only a few scholars, which creates a monopoly, a situation that is inconsistent with the Islamic principles that give qualified scholars with different understandings the freedom to interpret Islamic sources. Second, harmonising Islamic finance standards is not a practical approach due to the variable nature of the products which change rapidly and make it difficult for only one authority to issue standards.

The issue of practicality has been discussed and it has been argued that standardisation is necessary for the discipline and prosperity of the industry. The claim that standardisation damages *ijtihad* is inaccurate. Standardisation does not end the religious concept of *ijtihad* and the freedom for qualified scholars to make different interpretations of Islamic law. It only adopts an appropriate opinion for a formal application which is a necessary arrangement. Other sharia perspectives are still considered in other forms and might prevail to be adopted after all. The practice of adopting one opinion over another is even practised in one way or another as it is the way in which OIC adopts the opinion of its majority of scholars. In fact, standardisation could improve *ijtihad* in Islamic finance subjects in a more effective way. Sharia experts’ efforts would be collectively organised in authorities and organisations, which would ensure a better quality of decisions, especially if they are equipped with experts from other disciplines.

As indicated earlier, the issue of codification in Islamic law is controversial in Saudi Arabia. Scholars who oppose codification are mainly influenced by the conservative

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649 Ibid at 20
650 Hakim, ‘Harmonization of Shariah Rulings in Islamic Finance: An Analysis’ (n 601) at 272
651 Ibid at 272
652 Ash-Shubaily, ‘Sharee’ah Governance of Islamic Banks’ (n 373) at 163-164
This makes setting standards in Saudi Arabia more challenging because it confronts the central religious opposition to standardisation. The religious and political authorities might eventually give more consideration to the benefits of standardisation to outweigh any other concerns.

5.9 The Case Study of NCB’s IPO

Three billion shares owned by Public Investment Fund, a Saudi governmental institution, representing 15% of the NCB’s shares, were offered in the market for Saudi individual investors during the period from 19 October 2014 to 2 November 2014. In addition, two billion shares owned by the same governmental institution, representing 10% of the NCB’s shares, were allocated to the Public Pension Agency, another governmental institution, generating a total of five billion shares, constituting the NCB’s IPO, approved by the Capital Market Authority’s (CMA) Board in Saudi Arabia in 21/09/2014. This USD 6 billion IPO was the biggest not only in Saudi Arabia but also in the Arab financial world and the second biggest in the world in 2014 after Alibaba.

The IPO sparked a huge, controversial debate in Saudi society regarding whether or not NCB is Islamic. Society is strongly tied by Islamic rules so arguments about the IPO’s compliance with sharia were raised. The opportunity for this profitable investment was a strong incentive for buying NCB shares, so the discussion spread nationwide via social media. Many people were seeking different sharia scholars’ opinions and their justifications before deciding whether or not to buy NCB shares.

5.9.1 A Brief History of NCB

In 1953, a Saudi Royal Decree was issued to establish NCB as the first Saudi licensed bank in the country. Initially, NCB was formed as a general partnership

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653 Zanki, ‘Codification of Islamic Law Premises of History and Debates of Contemporary Muslim Scholars’ (n 505) at 134
656 Although 1953 marked the official declaration of the bank, the origin of the bank is Al-Kaki and Bin Mahfouz Co. which was established in 1937 after a merger of two money changing firms. A third joined in
following a merger of two currency houses: Saleh and Abdulaziz Kaki, and the Salem bin Mahfouz Company. Then, it was converted into a limited joint stock company in 1997. By 1999, the Saudi government, represented by the Public Investment Fund and the General Organization for Social Insurance, owned the majority of NCB's shares.\footnote{NCB: Our History <http://www.alahli.com/en-us/about-us/corporate-profile/Pages/AlAhli-History.aspx> accessed 13/11/2014} Prior to offering its NCB shares to the public, the two Saudi governmental institutions held 79.29% of the shares.\footnote{NCB's Prospectus 2014 <http://www.cma.org.sa/En/prospectuses/NCB_Main_EN_V.5.pdf> accessed 13/11/2014} As mentioned earlier, NCB was the first to decide to convert some of its branches into Islamic services and, in 2005, the board decided to convert all of the remaining ones.

5.9.2 NCB’s Sharia Board

Three sharia members comprise NCB’s SSB, which is responsible for approving sharia-compliant products in the bank. The board is supported by the Sharia Group, which is an internal department of the bank that assists with other sharia-related day-to-day requirements.\footnote{NCB: Sharia Committee <http://www.alahli.com/en-us/about-us/corporate-profile/Pages/Sharia-Committee.aspx#Shariahgroup> accessed 13/11/2014} The members do not exclusively serve on NCB’s Sharia Board as they participate in many sharia boards and committees, both nationally and internationally. Some banks share exactly the same sharia board members. Table 5.1 shows the membership of the NCB’s sharia members in the other national bank’s sharia boards at that time. The table demonstrates that 9 out of 12 banks had at least two members of NCB’s SSB. Abdullah Almaneea, chair of NCB’s SSB, is the chair of all of the sharia boards of which he is a member.

The body of the SSB, according to the bank, is independent. However, its authority is derived from the bank’s board of directors.\footnote{NCB's Prospectus 2014 (n 658)
Table 5.1: Membership of NCB’s Sharia Board in the national banks’ sharia boards (As of May 2014)\(^{661}\)

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
<th>Chair Role</th>
<th>Member Role</th>
<th>Other Member Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>NCB</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>The Saudi British Bank (SABB)</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Saudi Investment Bank (SAIB)</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Alinma Bank</td>
<td></td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Banque Saudi Fransi</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Riyad Bank</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Samba</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Saudi Hollandi Bank (SHB) (Currently known as Alawwal Bank)</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Al Rajhi Bank</td>
<td></td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Arab National Bank (ANB)</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Bank Albilad</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Bank Aljazira</td>
<td>Chair</td>
<td>Member</td>
<td></td>
</tr>
</tbody>
</table>

5.9.3 The Controversies Related to NCB’s IPO

Many Saudis wanted to know, as before every IPO takes place in Saudi Arabia, whether it is permitted, under Islamic law, to buy shares in NCB. Although NCB declared all its branches would be converted into Islamic banks, the problem with non-compliant assets persisted.

Many scholars, including several prominent members of other SSBs, declared that participation in the NCB’s IPO is not permitted since it has too many sharia non-compliant assets. Publicly, this view was received very well, especially after some members of CRLO issued a fatwa, only a few days before the IPO, declaring that participating in NCB’s IPO is not permitted under sharia. Although CRLO decisions are not legally binding, they are highly respected and it is hard to criticise them publicly. On the same day as the CRLO’s fatwa, a statement legalising the IPO under sharia was issued by NCB’s Sharia Board. These conflicting statements made this IPO a controversial topic in the country. The Grand Mufti, who is also chair of both BSU and CRLO, was asked about the IPO during an interview. The Mufti, whose opinion is respectfully followed, especially by other official sharia scholars, stated that people should not participate in any IPO of a company that deals with interest, indicating that NCB’s IPO is not permitted under sharia. Then, the chair of NCB’s SSB declared, during an interview, that the statement that NCB’s SSB issued to defend the IPO is meaningless in light of the official statement issued by CRLO and the opinion of the

662 Fatwa No.26302 (The Permanent Committee for Scientific Research and Legal Opinions in Saudi Arabia 2014)
663 Since NCB is not fully Islamic, some decisions, as the decision of the IPO, do not have to pass its SSB.
664 NCB Sharia Board’s Statement about the Legality of NCB’s IPO (2014) <http://www.alahli.com/ar-sa/about-us/news/Pages/%D8%A8%D9%8A%D8%A7%D9%86%20%D8%A7%D9%84%D9%87%D9%8A%D8%A6%D8%A9%20%D8%A7%D9%84%D8%B4%D8%B1%D8%B9%D9%8A%D8%A9%20%D9%81%D9%8A%20%D8%A7%D9%84%D8%A8%D9%86%D9%83%20%D8%A7%D9%84%D8%A3%20%D9%87%D9%84%D9%8A%20%D8%A7%D9%84%D8%AA%20%D8%AC%D8%A7%D8%B1%D9%8A%20%D8%A8%D8%B4%D8%A3%20%D9%85%D8%B4%D8%B1%D9%88%D8%B9%D9%8A%D8%A9%20%D8%A7%D9%84%D8%A5%D9%83%D8%AA%D8%AA%D8%A7%D8%A8%20%D9%81%D9%8A%20%D8%A3%20%D3%97%20%D9%85%20%D8%A7%D9%84%D8%A8%D9%86%D9%83.pdf> accessed 12/11/2014
665 Grand Mufti and NCB’s IPO (Interview) <https://www.youtube.com/watch?v=0_tkxfUClY> accessed 13/11/2014
666 The chairman of the NCB’s SSB is a member of both BSU and CRLO.
Mufti, since the statement conflicts with the highest authority of fatwa in the country.\textsuperscript{667} This declaration came a few days after an interview during which he justified NCB’s IPO as being sharia-compliant and defended its SSB’s statement.\textsuperscript{668}

The argument about NCB’s IPO relates to two main points. The first is whether or not NCB’s assets are sharia-compliant. Although there was no doubt that NCB had interest-based assets and profits, the argument focused on whether the interest could be tolerated. The statement of NCB’s SSB argued that the interest paid by the government for its bonds to the bank should be deducted by the same percentage it owned in the bank because interest paid by the beneficiary itself is lawful. This would make the remaining percentage of interest sufficiently small to invest in the bank.\textsuperscript{669} Some legal experts have challenged this justification as it ignores an obvious legal principle; that corporations are separate legal entities from their owners or other individuals. Even though the bank is majority-owned by the government, it is, by law, a separate legal entity that has a separate existence from its shareholders. Therefore, regardless of its ownership in the bank, the government is not the beneficiary when paying the bank interest since it pays a different person, namely the corporation.\textsuperscript{670} Furthermore, Muhamad Alosaimi, a prominent SSB member, issued a statement challenging the justification of the decision taken by NCB’s SSB. His statement argued that, in spite of deducting the interest paid by the government, NCB still holds too many non-sharia compliant assets based on the criteria that NCB’s SSB sets for the investment of NCB’s Islamic Mutual Funds, so this IPO should not be permitted even if the same SSB’s criteria were to be applied.\textsuperscript{671}

\textsuperscript{667} Abdullah Almaneea Bans NCB’s IPO (Interview) <https://www.youtube.com/watch?v=IKcyUd8Jbhk> accessed 13/11/2014
\textsuperscript{668} Abdullah Almaneea on Friday Interview <https://www.youtube.com/watch?v=CjJ_A___fGA> accessed 13/11/2014
\textsuperscript{669} Some scholars tend to permit investing in a company whose interest-based earnings do not exceed a specific percentage of the total company earnings as long as the investor purifies the percentage of the interest-based earnings by giving it to charity. For example, NCB’s SSB sets up Sharia Criteria for NCB Global Growth and Income Fund. It prohibits investing in a company whose non-sharia based earnings exceed 5% of its total earnings.
\textsuperscript{670} Badr Aljaafari, ‘Discussing the Opinion of NCB’s Sharia Committee Regarding Government Bonds’ (Twitter) <https://twitter.com/BadrAljaafari/status/52316542574856016> accessed 13/11/2014
\textsuperscript{671} Muhamad Alosaimi, ‘Discussing the Statement of NCB’s Sharia Commitee’ (Twitter) <https://twitter.com/MuhamadAlosaimi/status/523532917721427969> accessed 13/11/2014
The second point related to the argument is whether the intention to convert into a fully Islamic bank justifies the investment. According to the SSB’s statement, the bank had passed a plan and demonstrated a serious intention to convert, which alone, according to some scholars, justifies investing in the bank. Alosaimi, in his statement, argues that the bank should have shown more of a serious move toward conversion by applying clear standards such as those set up by AAOIFI, which imposes a strict time limit for conversion.

5.9.4 The Outcomes of the IPO

The public reaction to this IPO is important for measuring the effectiveness and credibility of this non-standardised industry. Investors had to choose between two difficult options. On the one hand, NCB was a very profitable investment opportunity. According to its prospectus, NCB’s share return was 19% in the financial year preceding the IPO. Also, the share price had been set significantly under its market value so it was a good investment for the middle classes wishing to make profits. On the other hand, fatwas prohibiting the IPO were widely adopted among sharia scholars. This was a tough choice in a society where people strongly adhere to their religious beliefs.

The outcomes of the IPO (Table 5.2) reveal interesting data. The IPO was only 50% covered until the 11th day after it was made public. Surprisingly, this percentage grew dramatically on the 12th day to around 210% and continued to rise dramatically until the IPO closed, with 2301% coverage. One could not have predicted these percentages after 11 days of weak turnout. Banks played an important role in facilitating many loans to finance the purchase of NCB shares. Possibly, excessive soft loans were offered to balance the weak outcomes of the participants in one of the most important IPOs in the country.

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672 NCB’s Prospectus 2014 (n 658)
Although NCB’s IPO ended up with high coverage, the number of participants was relatively small. Despite the total of SAR 311 billion (more than USD 82.5 billion) collected, only 1.26 million people participated in this IPO. The result was very weak compared with the previous IPOs of Islamic banks, whose activities were unproblematic from the sharia perspective. In Albilad Bank’s IPO in 2005, more than 8.85 million participated, making a total of SAR 7,750 million (more than USD 2 billion). In 2008, 8.8 million participated in another Islamic bank’s IPO, Alinma Bank, for a total of SAR 18,270 million (more than USD 4.8 billion). There were around seven times more participants in each bank compared with NCB. Taking into consideration that, unlike NCB, Albilad and Alinma banks were not operating prior to their IPO so they could not prove their profitability, the number of participants in NCB’s IPO was very weak for such a profitable investment, especially when compared with the take-up in the other banks mentioned above. In this regard, a Saudi analyst stated, “If NCB was an Islamic IPO, the number of subscribers would have definitely been very high. Clients in the region prefer Islamic services. It’s a big deal for the region, especially Saudis”.

677 Daria Solovieva, 'Fatwa No Barrier to Saudi Arabia’s $6 Billion Bank IPO' (n 674)
### Table 5.2: Progress of NCB’s IPO

<table>
<thead>
<tr>
<th>Date (2014)</th>
<th>% of coverage</th>
<th>Number of Participants (*1000)</th>
<th>Money Collected (*1000,000) SAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>19-20/10</td>
<td>6.1%</td>
<td>166</td>
<td>824</td>
</tr>
<tr>
<td>21/10</td>
<td>10.2%</td>
<td>266</td>
<td>1380</td>
</tr>
<tr>
<td>22/10</td>
<td>13.9%</td>
<td>355</td>
<td>1880</td>
</tr>
<tr>
<td>23/10</td>
<td>18%</td>
<td>432</td>
<td>2290</td>
</tr>
<tr>
<td>24-26/10</td>
<td>22.3%</td>
<td>551</td>
<td>3010</td>
</tr>
<tr>
<td>27/10</td>
<td>27.2%</td>
<td>611</td>
<td>3680</td>
</tr>
<tr>
<td>28/10</td>
<td>35.4%</td>
<td>684</td>
<td>4780</td>
</tr>
<tr>
<td>29/10</td>
<td>50.3%</td>
<td>757</td>
<td>6790</td>
</tr>
<tr>
<td>30/10</td>
<td>210%</td>
<td>857</td>
<td>28340</td>
</tr>
<tr>
<td>31/10</td>
<td>281.1%</td>
<td>904</td>
<td>37950</td>
</tr>
<tr>
<td>1/11</td>
<td>480.8%</td>
<td>947</td>
<td>64910</td>
</tr>
<tr>
<td>2/11</td>
<td>2307%</td>
<td>1260</td>
<td>311000</td>
</tr>
</tbody>
</table>

### 5.9.5 Lessons from the Case

The case of NCB highlights very important issues regarding standardisation. In this case, both profits and moral motivations were apparently present and measured in society. Despite the high profit motivation of the IPO, the number of subscribers was small because many doubted the legitimacy of this investment and so considered it morally unacceptable for them to subscribe. The indefinite legitimacy obviously caused public and market confusion. Therefore, the call for a mechanism to govern Islamic banking standards should receive more attention after this case.

The important question in the case is not whether NCB’s assets are Islamic or not but how to determine whether they are. Clearly, the absence of rules and regulations defining and governing Islamic banking services was the real issue. The adoption of

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standards determining clear procedures for banks that wish to convert to Islamic ones would provide an important legal tool for the case to measure how serious NCB was in its endeavour to convert. Such guidelines are of interest to certain jurisdictions, like Qatar, that have recently adopted a system of sharia governance.\textsuperscript{679} It was explained earlier that national standardisation should place special focus on the different environments, including converting banks, which was a subject of difference between scholars in this case.

The case reveals the need for a disciplined environment such as the financial market for standardisation. While the differences in opinions within sharia is one of sharia’s advantages, the market needs some level of consistency of opinion to avoid unpredictability being caused by the wide level of sharia divergence. In this case, the percentage of acceptable interest was subject to disagreement, so the decision was strongly affected by this factor. Would it have been the same if the industry had a mechanism for standardising sharia opinions? For example, if the percentage of acceptable interest to invest in companies was standardised, would sharia scholars still disagree in the same way that confused the investors?

Another important issue the case raises is the credibility of the SSB. Despite the IPO being declared a sharia-compliant investment by the sharia scholars closest to the bank, the statement issued by NCB’s SSB did not receive widespread public acceptance. Although this case alone is insufficient to draw a conclusion about the credibility level of the SSB, it should raise a concern regarding the impartiality of SSB members when issuing decisions for their relevant institutions. This case also shows that, where the impartiality of the SSB’s decisions is questioned, the public’s trust might be significantly affected. Thus, stricter governance mechanisms of the process of setting sharia standards need to be imposed in the industry. An independent national Sharia Standard-setting Board seems an ideal solution.

The Islamic banking industry has been legally ignored for a long time in Saudi Arabia. This case might attract greater attention to this issue. It would be better for the

\textsuperscript{679} Qatar, Qatar Central Bank (QCB) Law Article 111
market as well as the public if the industry were to be standardised. Standardisation is part of the legal recognition of the industry that the country needs in order to gain more trust and thus to continue as a promising industry. Otherwise, the public’s trust could be lost.

5.10 Conclusion

Autonomy should be strongly maintained in the process of rule-making. Under the framework of sharia governance, the method for setting sharia standards needs more governance to ensure a higher level of objectivity and independence. The current practices where the SSB is given, to different extents, the authority of legislation and setting sharia standards for its relevant IFIs creates a situation of conflict of interest. Being hired by IFIs, sharia members have a great financial interest which might lead them to shop for fatwas and choose an opinion that does not reflect sharia interests in the best way. Also, the SSB members, in most cases, combine ex-ante and ex-post roles which is a compromise of independence. Therefore, giving the individual IFIs the right to legislate, even on a small scale, would weaken the sharia governance structure. Consequently, stakeholders might doubt the legitimacy of sharia-compliance.

Therefore, the process of setting sharia standards needs to be assigned solely to an independent national Sharia Standard-setting Board. Individual SSBs should not participate in such a role. Although some jurisdictions tend to form a national SSB, there are limitations to its role as a sole authority for setting sharia standards and individual SSBs are somehow involved in such a role. There is a need for a stronger governance framework for these agencies to be the sole and final responsibility for independent standardisation. This leads to more legitimate sharia decisions. Moreover, this would benefit the market since it would enforce a standardised set of sharia rules. The standardised market provides more discipline and a systematic operation, so the stakeholders will have greater clarity about sharia products, which will positively affect their trust. Strong national governance over standardisation would eventually ensure a more standardised market globally. This has been a concern for the Islamic finance market, which has established several organisations for the sake of standardisation.
However, the effect of these international organisations remains minimal without a strong mechanism being enforced nationally.

In many cases, the market was susceptible to the weak governance of the process of setting sharia standards. Recently, the market has experienced several instances in this regard, some of which were remarkably large, such as the case of sukuk in Bahrain and NCB’s IPO, which were highlighted in this chapter.

Standardising sharia rules in the Islamic finance industry would have a positive effect on the market and facilitate its growth globally. It provides IFIs in non-Islamic and secular jurisdictions with greater legitimacy. However, there might be political challenges associated with its legal recognition. Religiously, standardisation might also face opposition from the conservative school of Islamic law, which is against codification. The considerable growth of the industry might eventually require a reconsideration of the benefits of harmonisation to overcome these concerns.
Chapter Six: Sharia-compliance and the Accountability Framework

6.1 Introduction

It was highlighted earlier that the role of the SSB falls into three categories: setting sharia standards, providing sharia assurance, and acting as counsel to the company regarding sharia-compliance matters. The previous chapter discussed the role of setting sharia standards and why the SSB should not be authorised to perform this role. Instead, it has been argued that this should be the responsibility of a national independent Sharia Standard-setting Board. This chapter focuses on the other primary role of the SSB, which relates to sharia auditing. The perceived SSB role as sharia auditors makes it necessary to study and analyse its position regarding how sharia interest could be assured for the stakeholders.

For a more comprehensive examination of the audit role, the accountability framework in IFIs needs to be analysed to clarify the structure within which the audit should be conducted. Thus, a more explicit picture about how external sharia auditing should be provided to assure stakeholders about sharia-compliance can be drawn. This assurance requires a clear accountability framework in order to achieve this goal more effectively. To reach this, it is essential to identify why accountability is important in sharia governance, who is accountable, for what, to whom, and how. The analysis also includes an assessment of the current situation.

Accountability is a concept that cannot merely be used interchangeably to achieve different objectives. While a specific framework is sufficient to promote accountability in certain areas, it might work less well regarding other objectives due to different priorities. Implementing the accountability framework applied in corporate governance might not be appropriate for sharia governance. Therefore, the analysis of accountability within sharia governance needs to be examined in light of its own objectives and priorities, which are not necessarily similar to those in corporate governance.

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Arguably, sharia auditing faces two major problems: the lack of accountability and the lack of professionalism in conducting sufficient sharia audit which satisfies the interests of stakeholders. In this chapter, the former will be analysed in depth to explore what is actually desired in the accountability framework and so achieve more effective sharia supervision. The proposed framework should promote more professionalised practice, a matter that will be discussed in the next chapter.

6.2 The Meaning of Accountability

Despite its importance, accountability is a concept whose meaning has not been identified very well and certainly not with precision. In the corporate governance context, the concept has been used frequently but it lacks clarity regarding what the concept involves compared to its use in other contexts. This might be problematic when assessing an accountability framework because promoting accountability without precisely clarifying its meaning within its context may lead to the desired objectives and goals not being satisfied. Keay and Loughrey argue that accountability needs to be clearly explained because a lack of clarity makes assessment of whether a particular mechanism promotes accountability difficult, and which might lead to the adoption of poorly-designed accountability mechanisms. They explain that a sufficient accountable framework for some acts may not necessarily be satisfactory for others and may actually undermine them due to the existence of different goals and objectives. Thus, each action requires a separate assessment regarding what precisely is needed to promote its own accountability framework.

Bovens describes accountability as a concept which could refer to a very general meaning as a virtue indicating a positive quality of organisations or a narrower meaning as a mechanism of the institutional relation or arrangement to hold an agent accountable to another agent or institution. As a virtue, the concept is difficult to define. Different languages, ideologies, times, and cultures have had an impact on how

681 Andrew Keay, Board Accountability in Corporate Governance (Routledge 2015) at 25-26, 28
682 Keay and Loughrey, ‘The Framework for Board Accountability in Corporate Governance’ (n 680) at 256, 264-265
683 Mark Bovens, ‘Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism’ (2010) 33 West European Politics 946 at 947-948
to define and understand accountability.\textsuperscript{684} It could be viewed from different perspectives due to the different social and cultural theories that describe the concept.\textsuperscript{685} These different perspectives make it impossible to produce a single agreed-upon definition of the general concept of accountability.\textsuperscript{686} The efforts in this regard result in a loosely-defined concept that covers many elements which are considered “umbrella concepts” in themselves, such as clarity, transparency, responsibility, involvement, deliberation, and participation.\textsuperscript{687} Sometimes, accountability is seen as a synonym for good governance.\textsuperscript{688} These concepts could be used as synonyms and may overlap with the concept of accountability but do not precisely describe it and many of them are, indeed, mechanisms used to achieve accountability.\textsuperscript{689}

For example, transparency and responsibility might, on occasions, be used interchangeably with accountability. However, this is somehow problematic since accountability has a broader meaning. Concerning transparency, it is seen as an important element of accountability. However, accountability involves more than revealing or reporting facts.\textsuperscript{690} Transparency alone could be meaningless for stakeholders since it may not necessarily lead to accurate or examined information. Therefore, transparency must be connected to accountability as one of its mechanisms for achieving meaningful information that has been subject to careful examination.\textsuperscript{691} The situation is similar for the concept of responsibility, as it is seen as an essential part of accountability. Responsibility involves responding to the issues in question which is

\begin{footnotesize}
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\item Amanda Sinclair, ‘The Chameleon of Accountability: Forms and Discourses’ (1995) 20 Accounting, Organizations and Society 219 at 219-222
\item Christopher Hood, ‘Accountability and Transparency: Siamese Twins, Matching Parts, Awkward Couple?’ (2010) 33 West European Politics 989 at 989
\item Bovens, ‘Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism’ (n 683) at 950
\item Ibid at 949-950
\item Keay, Board Accountability in Corporate Governance (n 681) at 38-39
\item Keay and Loughrey, ‘The Framework for Board Accountability in Corporate Governance’ (n 680) at 274
\end{enumerate}
\end{footnotesize}
an important aspect of accountability. As argued by Mulgan, accountability is an expanding concept which used to refer to a relatively limited meaning of being part of the concept of responsibility but its current meaning has expanded to cover responsibility as part of its meaning.

In the religious context, accountability is a common term used to describe the relationship between individuals and God. It is perceived as a vertical perspective process where answerability is owed to the proper authority in the higher parts of the order. In Islam, the concept has deep roots and is used to describe the relationship with God and the responsibility for individuals’ actions. Accountability, therefore, is a reference to the responsibility of Muslims to fulfil their duties as described by Islamic law. The reference to this meaning is drawn, in many instances, from the main sources of sharia. In the Quran, many verses describe accountability in general as relating to “one’s obligation to account to God on all matters pertaining to human endeavour for which every Muslim is accountable”. It also touches more specifically upon financial accountability, where fulfilling the financial trust placed on someone is strongly stressed. In Sunnah, the term has an identical usage. Prophet Mohammad (PBUH) stressed the accountability of individuals in different sayings. Prominent examples of his sayings in this regard are, “beware that every one of you is a shepherd and everyone is answerable with regard to his folks…” and “beware that every one of you is a guardian and every one of you shall be questioned with regard to his trust”.

Translations should be taken into account when accountability is discussed in different languages. In fact, one of the reasons for the vague meaning of accountability

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692 Keay, *Board Accountability in Corporate Governance* (n 681) at 42-43
694 Hood, ‘Accountability and Transparency: Siamese Twins, Matching Parts, Awkward Couple?’ (n 685) at 999
695 Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 141
696 Iqbal and Lewis, *An Islamic Perspective on Governance* (n 164) at 257
697 Ibid at 257
699 Ibid at 3
might be the language factor and its use in English, which cannot be easily translated into other languages as they may lack the precise terms to describe it. Generally, answerability, questioning, and responsibility are common synonyms of accountability in the main sources of sharia law. They are, actually, the closest words in the Arabic language that can be used interchangeably to translate the term “accountability”. In Arabic, the words mas‘ūliya or musā‘ala could be used to describe accountability, as they refer to the same root in Arabic (sa‘ala) which means to ask or question. In the Saudi Corporate Governance Regulations, these two Arabic words are used to refer to questioning, liability, and responsibility, and are translated as “accountability” in the English version.

Due to the difficulty of identifying a precise meaning of accountability, referring the concept to the process and mechanisms to be achieved might be a more practical way to analyse its effectiveness in a specific area. The above explanation might help to perceive the concept in general but, in the end, the analysis needs to be applied as clearly as possible. It is also the aim of this chapter to examine accountability as a mechanism and a process to be applied within the sharia governance framework.

Bovens describes accountability in this sense as a passive phenomenon, which is defined as “a relationship between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences”. Keay describes the mechanism of accountability as a process which involves four stages: reporting, explaining and justifying, questioning, and the possibility of the imposition of consequences, which could be positive or negative. The first stage is “informative accountability”. The accountable person or entity must report their conduct to their accountability reference point. The accountability relation does not exist without the obligation to disclose information about the procedures and outcomes of the conduct.

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700 Keay, *Board Accountability in Corporate Governance* (n 681) at 38; Hood, ‘Accountability and Transparency: Siamese Twins, Matching Parts, Awkward Couple?’ (n 685) at 989
701 Capital Market Authority (CMA), *Corporate Governance Regulations (2017)* Articles 3,5,73,76
702 Bovens, ‘Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism’ (n 683) at 951
703 Keay, *Board Accountability in Corporate Governance* (n 681) at 43-47
704 Kaler, ‘Responsibility, Accountability and Governance’ (n 688) at 328
and report any failure or incident associated with performing the task.\textsuperscript{705} In the second stage, the actor must provide an explanation as well as justification of the conduct which might be even more crucial if it has not been done according to the accepted values and standards. This is to ensure that nothing has been done to satisfy interests other than those of the accountees, which are usually the stakeholders in the corporate governance case.\textsuperscript{706} In the questioning stage, which might be called the answerability stage, the actor's reasons are questioned, debated and interrogated to ensure the adequacy of the information and legitimacy of the conduct.\textsuperscript{707} The final stage concerns the consequences, which are the result of passing judgement either approving or condemning the conduct.\textsuperscript{708} This stage is called "coercive accountability"\textsuperscript{709} or "responsibility accountability"\textsuperscript{710} and strengthens the accountability by including the responsibility element in the concept to make it possible to hold the actor accountable.\textsuperscript{711} It might be described as the "weapon" of supervision in corporate governance.\textsuperscript{712} Coercive accountability represents a strong accountability form, where the possibility of punishment could produce a more effective accountability framework along with informative accountability.\textsuperscript{713} The punishments include fines, disciplinary measures, civil remedies, or even penal sanctions.\textsuperscript{714}

To examine the accountability framework in sharia auditing, these stages provide helpful guidelines regarding how accountability should be conducted but several questions need to be answered before doing this. First, why is accountability important in sharia auditing? Second, who is accountable? This touches on the SSB and discusses its position and eligibility within the accountability framework. Third, for what

\textsuperscript{705} Bovens, 'Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism' (n 683) at 952
\textsuperscript{706} Keay, \textit{Board Accountability in Corporate Governance} (n 681) at 45
\textsuperscript{707} Bovens, 'Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism' (n 683) at 952
\textsuperscript{708} Ibid at 952
\textsuperscript{709} Kaler, 'Responsibility, Accountability and Governance' (n 688) at 329-330
\textsuperscript{710} Stephen Bottomley, \textit{The Constitutional Corporation: Rethinking Corporate Governance} (Routledge Ltd 2016) at 81
\textsuperscript{711} Ibid at 81
\textsuperscript{712} Keay, \textit{Board Accountability in Corporate Governance} (n 681) at 65
\textsuperscript{713} Kaler, 'Responsibility, Accountability and Governance' (n 688) at 330
\textsuperscript{714} Bovens, 'Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism' (n 683) at 952
is accountability to be rendered and to whom should it be required? This is important in identifying the stakeholders in sharia, the accountees, in order to draw up the desired accountability framework that is suitable for the specific purpose. After that, the stages of accountability are applied to discuss how the framework should protect the sharia interest.

6.3 Why Accountability?

6.3.1 Corporate Governance, Accountability, and Auditing

Accountability is an important concept in corporate governance. As stated above, it may not always be differentiated from good governance. It is linked and regarded as a part of many corporate governance definitions. It is stated that governance, not only corporate governance, always assumes accountability. Enron and other scandals, which were caused mainly by a failure linked to accountability issues, prove that stronger accountability strengthens the governance structure.

Financial auditing and reporting are very closely linked to accountability. The American Audit Association (AAA) defines audit as a “systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users”. As described in the Report of the Committee on the Financial Aspects of Corporate Governance, commonly known as the Cadbury Report, auditing is one of the main cornerstones of corporate governance because it provides a very important tool for ensuring that the required checks and balances are carried out. While the board is given a high level of authority in order to be more flexible in running the company, there is a need for

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715 Keay, Board Accountability in Corporate Governance (n 681) at 22-24
717 Keay, Board Accountability in Corporate Governance (n 681) at 21
718 Kaler, ‘Responsibility, Accountability and Governance’ (n 688) at 328
720 Cadbury and Committee on the Financial Aspects of Corporate Governance, Report of the Committee on the Financial Aspects of Corporate Governance (n 138) at 5.1
accountability to balance this authority and correct errors.\textsuperscript{721} This balance requires the use of sound audit practices where auditors are deemed independent and so protective of the shareholders’ interests.\textsuperscript{722} In fact, accountability exists very intensively in the role of external auditors.\textsuperscript{723} The role of auditing constitutes a key component in the accountability process where it goes beyond being an independent tool for verifying the reporting stage of accountability to providing the basis for other stages: explanation, questioning, and even holding accountors responsible.\textsuperscript{724} The connection between accountability and external auditors could not be clearer after Enron, where most of the legal reforms, such as Sarbanes-Oxley Act in the US, focus on the practice of external auditors. It is suggested that a failure to audit properly was a major cause of the collapse of Enron in 2001.\textsuperscript{725} Since then, significant steps have been taken to improve the effectiveness and independence of the audit function within the corporate governance frameworks, including the Sarbanes-Oxley Act (2002) in the US and the Smith Report (FRC 2003) in the UK, which were issued in response to the collapse of Enron and many other large corporations.\textsuperscript{726}

6.3.2 The Rationales for Sharia Auditing

Accountability and auditing share similar rationales. Many see the need to address agency problems as the primary rationale for accountability.\textsuperscript{727} Even outside the agency theory, accountability remains crucial. Shareholders need to know that their agents are acting appropriately and with clear motivation, and accountability might demonstrate situations of conflict of interest.\textsuperscript{728} Also, accountability aims to reinforce a trustworthy relationship between shareholders and the management regardless of the basis of this

\begin{thebibliography}{99}
\bibitem{721} Keay and Loughrey, ‘The Framework for Board Accountability in Corporate Governance’ (n 680) at 262
\bibitem{723} Dan A. Bavly, \textit{Corporate Governance and Accountability: What Role for the Regulator, Director and Auditor?} (Greenwood Press 1999) at 15
\bibitem{724} Bottomley, \textit{The Constitutional Corporation: Rethinking Corporate Governance} (n 710) at 95
\bibitem{725} Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 25-30
\bibitem{726} J. Solomon, \textit{Directions for Corporate Governance} (The Association of Chartered Certified Accountants 2009) at 18
\bibitem{727} Keay, ‘Exploring the Rationale for Board Accountability in Corporate Governance’ (n 401) at 122
\bibitem{728} Keay, \textit{Board Accountability in Corporate Governance} (n 681) at 82
\end{thebibliography}
relationship. It is unlikely that all shareholders will have the same level of confidence in their agents.\textsuperscript{729} Similarly, external audit is one of the main tools used within the corporate governance framework to protect the interests of stakeholders. Their independent position should provide objective opinions about the accuracy and credibility of the financial statements of the company. In the principal-agent relationship, different motivations and information asymmetries exist and impact the level of trust between the principals and agents. In such a situation, auditing is seen as a tool for aligning the interests of the agents with those of the principals and bringing more trust and credibility to their relationship by providing independent checks on the information presented by the agents.\textsuperscript{730} The credibility brought by external auditors is not exclusive to this relationship. In fact, auditing is characterised as a “link of trust” between the management and all other stakeholders whose relationship relies on audited information in the financial statements.\textsuperscript{731} In public companies, many use and refer to the information in the financial statements which makes external auditing a valuable source of trust to them.

In sharia governance, sharia auditing has been introduced as a similar tool to conventional auditing. The concept has not been defined in a way that has attracted unanimous support.\textsuperscript{732} This might be due to the lack of professional practice of sharia auditing and the negligence regarding this important function. Bank Negara Malaysia defines sharia auditing as “the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for sharia compliance”.\textsuperscript{733} A widely accepted definition of sharia auditing has been proposed by

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\textsuperscript{729} Ibaid at 82  \\
\textsuperscript{731} Davor Filipovic and Ivica Filipovic, 'External Auditing and Audit Committee as Mechanisms in Corporate Governance' (2008) (4th International Conference An Enterprise Odyssey: Tourism - Governance and Entrepreneurship) at 1095-1096  \\
\textsuperscript{732} Lahsasna, Ibrahim and Alhabshi, ‘Shariah Audit: Evidence & Methodology in Islamic Finance’ (n 698) at 6  \\
\textsuperscript{733} Bank Negara Malaysia, Sharia Governance Framework for Islamic Financial Institutions (n 562) at 23
\end{flushleft}
Haniffa, who describes it as “a systematic process of objectively obtaining and evaluating evidence regarding assertions about religious and socio-economic actions and events, in order to ascertain the degree of correspondence between those assertions and the applicable financial reporting framework, including the criteria specified based on shariah principles as recommended by SSB, and communicating the results to all interested parties”.\(^{734}\) Theoretically, sharia auditing is essential in the framework of sharia governance, to be used by IFIs as a mechanism for preventing actions that are not sharia-compliant which might lead to greater sharia risk.\(^{735}\) For stakeholders, sharia auditing provides an independent certification that an IFI has an effective internal control system in order to comply with the sharia standards.\(^{736}\) Additionally, sharia auditing is essential to protect the legal, image, and reputational risks that might arise for IFIs due to sharia non-compliance and whose effects could reach the entire industry.\(^{737}\)

Similar to conventional auditing, sharia governance needs auditing to protect sharia interests and provide a source of trust and comfort to the stakeholders by assuring them of sharia-compliance.\(^{738}\) To enhance the accountability framework, sharia auditing is essential, as it increases the stakeholders’ faith in the company.\(^{739}\) In fact, the agency problem exists in sharia governance. The management might not be strongly committed to ensuring sharia-compliance operations. Therefore, the stakeholders depend on the SSB as independent sharia auditors to protect the interest of sharia from any deviation. The SSB is delegated the power of ensuring that the company does not commit any sharia violation. However, the SSB, in its current position as an internal board within the company, creates a two-fold agency problem which might be similar to the relationship that exists between shareholders and the board of directors. Put differently, the agency

\(^{734}\) Haniffa, 'Auditing Islamic Financial Institutions' (n 531) at 303  
\(^{737}\) Haniffa, 'Auditing Islamic Financial Institutions' (n 531) at 303  
\(^{738}\) Greuning and Iqbal, Risk Analysis for Islamic Banks (n 360) 52,184  
problem in sharia governance extends to include, in addition to the owners and management, other stakeholders of sharia as important elements of the sharia governance structure. This emphasises a more “stakeholder accountability” form, where the stakeholders are more valued than in the traditional accountability, which is addressed mainly to shareholders. Arguably, sharia auditing should be given even more value in sharia governance because the protection of sharia interest demands the mechanism of auditing more than do financial interests. Several reasons, I would argue, might explain this.

First, although certification is the objective of both audits, the scope and aim of this certification differs between the sharia audit and the financial one. Considering the scope, sharia auditing is wider and broader. To satisfy sharia interest, the whole institution, not only the financial statements, should be audited. A sharia review is defined by AAOIFI as “an examination of the extent of an IFI’s compliance, in all its activities, with the sharia. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc". Accordingly to Najeeb and Ibrahim, sharia review is another term for sharia auditing and the AAOIFI’s definition is the most reflective definition of sharia auditing, which includes a wide range of functions. Due to its broader scope, sharia auditing needs to be considered as a more comprehensive tool which requires a wider range of qualifications. The purpose of certification is also different in the case of sharia auditing. Certification within financial audit concerns only the accuracy of the financial statements to represent the fair and true status of the company without any fraud or misleading information. It does not provide opinions about the economy, future validity, efficiency,
or effectiveness of the management. Put differently, the financial status and performance do not lie within the scope of the conventional audit. Therefore, financial audit does not decide how satisfactory the financial interest which is left to be evaluated and measured by the stakeholders after the auditors have ensured that the statements are accurate. However, sharia auditing is supposed to certify the status of the company regarding its compliance with sharia. To satisfy sharia interest, sharia auditors should report to the stakeholders an opinion about the religious validity of the company based on the specified sharia principles. Unlike the case of the financial audit in relation to financial performance, the stakeholders of sharia depend completely on the opinion of sharia auditors regarding the company’s sharia status, so stakeholders of sharia rely more strongly on sharia auditing, which should be reflected in sharia governance.

Second, the nature of sharia interest offers little choice of mechanisms that might be used to protect the interest. Some tools used to safeguard the financial interest might not be suitable for protecting sharia interest. To protect financial interest, incentive-based mechanisms might be set to spur the management to act in a way that promotes the owners’ wealth. For example, performance-related remuneration might work effectively to incentivise the management to work in the best interest of the shareholders. Such a mechanism, along with auditing, would back up and reinforce the trust and confidence produced by the agency problem. However, the situation regarding sharia interest is quite different because the payment incentive might not achieve its objective of aligning the interests of the executives with those of sharia. As argued before, sharia interest is a pass-or-fail interest, where an institution is either sharia-compliant or not. Unlike financial interest, evaluating compliance on a scale could not be a satisfactory measure for sharia stakeholders, so it is impractical to set incentives for the management based on the level of compliance.

Third, compared with financial interest, it is more difficult to determine whether the sharia interest has been satisfied or not. Auditing might be the only effective tool available to ensure this. The management might find it easier to divert from sharia

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746 Audit Quality Forum, ‘Agency Theory and the Role of Audit’ (n 730) at 6
interest than from the financial one. This is because corporations, including IFIs, are usually established mainly to generate a profit and increase the shareholders’ wealth. The whole setting of the company’s governance structure is set up in this direction and it is not easy for the management intentionally to direct the company toward a completely different direction to provide the managers with absolute personal interests. The financial interest of the company should be noticeable by shareholders through, mainly, the distribution of dividends and capital growth. Diversion would be noticeable even by other stakeholders. For instance, before the Enron Scandal became public, its employees were questioning the company’s accounting practice.\footnote{Voicu Dan Dragomir, ‘Accountability in the Name of Global Corporate Governance: A Historical Perspective’ (2008) (4th International Conference of Association of Economic Universities of South and Eastern Europe and the Black Sea Region (ASECU)) at 185} There is, of course, room for manipulation to achieve personal interests, which is why auditing and other mechanisms are used but it is not usually easy to completely divert the company away from the financial interest. In IFIs, the financial interest is still the main objective. It is inaccurate, as some scholars argue, that IFIs belong to the broader sector of non-profit organisations.\footnote{Hasan Basri, A. K. Siti Nabiha and M. Shabri Abd Majid, ‘Accounting and Accountability in Religious Organizations: An Islamic Contemporary Scholars’ Perspective’ (2016) 18 Gadjah Mada International Journal of Business 207 at 213} They could not be classified as religious institutions whose main goal is to promote religious values since they, like other financial institutions, seek profits to increase their shareholders’ wealth. The presence of sharia is only a condition for achieving the financial interest. For the stakeholders, sharia interest is not tangible because there is a very fine difference between sharia-compliance and non-compliance. The only indication to stakeholders that the interest has been satisfied is certification by experts. Sharia supervision is primarily designed for stakeholders of sharia who lack the necessary skills and knowledge to evaluate the level of sharia-compliance of the IFI.\footnote{Toufik, ‘The Role of Shari’a Supervisory Board in Ensuring Good Corporate Governance Practice in Islamic Banks’ (n 350) at 114-115} Without the expert certification, the company could easily be directed to act against the interest of sharia.

Fourth, unlike the financial interest, owners/shareholders might be less interested in sharia-compliance than other stakeholders, as will be explained later. As non-owners, these stakeholders do not have the protective tools given to shareholders who can hold

the board responsible for negligence via, for example, derivative actions. Audited reports are the best way for stakeholders to ensure that their interests are satisfied. Whereas these reports are a valuable resource for non-owners in corporate governance, they are more necessary in sharia governance because non-owners are likely to be more interested in sharia-compliance. This requires more consideration of sharia auditing as the most effective tool for protecting the interests of non-owners who are, in all probability, the main group of stakeholders.

In addition to the agency problem, legitimacy is an important rationale of accountability. It provides a justification for the existence of an entity and the assumption that its action lies within the accepted norms, values or beliefs. Accountability provides greater legitimacy power by increasing the confidence in the relationship through putting in place more transparent procedures.

The legitimacy of sharia auditing is questioned due to the ambiguity and vagueness surrounding the role of auditing by the SSB. Sharia auditing is improperly conducted as a result of the lack of an effective mechanism. The practice of sharia auditing does not reflect its importance as a crucial tool within sharia governance. The SSB is assumed to perform the role of sharia auditing despite its defective structure and lack of independence. It supervises the work of internal audit and conducts the review function which gives it a similar role to the external auditors. AAOIFI entrusts the SSB with the role of reviewing and ensuring compliance. In fact, in the jurisdictions where a central SSB exists to issue sharia standards, auditing is usually the focus of the role of the SSB within IFIs. This is the case in Malaysia and Indonesia. However,

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750 Keay and Loughrey, 'The Framework for Board Accountability in Corporate Governance' (n 680) 262
751 Mark C. Suchman, 'Managing Legitimacy: Strategic and Institutional Approaches' (1995) 20 The Academy of Management Review 571 at 573-574
752 Bovens, 'Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism' (n 683) at 954
753 Onagun and Mikail, 'Shari'ah Governance System: A Need for Professional Approach' (n 181) at 79
754 Najeeb and Ibrahim, 'Professionalizing the Role of Shari'ah Auditors: How Malaysia Can Generate Economic Benefits' (n 735) at 94
755 Ash-Shubaily, 'Sharee'ah Governance of Islamic Banks' (n 373) at 149
756 Governance Standard No.1, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 885
757 Onagun and Mikail, 'Shari'ah Governance System: A Need for Professional Approach' (n 181) at 73
although the SSB should certify sharia-compliance, it is rare that it conducts any ex-post review in this regard.\textsuperscript{760} Usually, this is entrusted to internal auditors alone.\textsuperscript{761} Even when sharia auditing is conducted by the SSB, auditing is not given the time and effort it needs. Certification reports are usually issued without a thorough audit, if an audit is even conducted.\textsuperscript{762} Due to its broader scope, sharia auditing requires more dedicated time than conventional auditing.\textsuperscript{763} However, the volume of work given to SSB’s members whose job is only part-time, and who may have multi-memberships of sharia boards, means that the need for a sharia audit is ignored. In practice, the role of setting sharia standards along with advising the institution on sharia issues constitutes the majority of the SSB’s work.\textsuperscript{764} Involvement in sharia auditing usually happens in the case of internal disputes over sharia issues which need the SSB intervention.\textsuperscript{765} In comparison, the practice of external financial auditing is well-governed which creates a functional gap between the reports of the external auditors and the SSB.\textsuperscript{766} This suggests the need to enhance the accountability framework in sharia audit for greater legitimisation. Alkahmees argues that the poor accountability framework in the SSB, even in jurisdictions with more advanced sharia governance frameworks, is linked to SSBs’ lack of legal standing within IFIs.\textsuperscript{767}

Linked with legitimacy is the idea that accountability is an important justification for power.\textsuperscript{768} The level of discretionary power that someone possesses is significant in

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\bibitem{BankNegaraMalaysia} Bank Negara Malaysia, \textit{Sharia Governance Framework for Islamic Financial Institutions} (n 562) at 11, 23
\bibitem{BankIndonesia} Bank Indonesia, \textit{Bank Indonesia Regulation Number: 11/3/PBI/2009 - Sharia Commercial Bank Articles} 47, 53
\bibitem{NajeebIbrahim} Najeeb and Ibrahim, ‘Professionalizing the Role of Shari’ah Auditors: How Malaysia Can Generate Economic Benefits’ (n 735) at 94
\bibitem{GinenaHamid} Ginena and Hamid, \textit{Foundations of Shari’ah Governance of Islamic Banks} (n 134) at 250
\bibitem{LahsasnaIbrahim} Lahsasna, Ibrahim and Alhabshi, ‘Shariah Audit: Evidence & Methodology in Islamic Finance’ (n 698) at 8
\bibitem{Umar} Umar, ‘SSB’s Roles between Individual Advisory and institutional Profession’ (n 386) at 15
\bibitem{Malkawi} Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 561
\bibitem{AbdulRahman} Abdul Rahman, ‘Shariah Audit for Islamic Financial Services: The Needs and Challenges’ (n 762) at 7
\bibitem{Alkhamees} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 141
\bibitem{Keay} Keay, \textit{Board Accountability in Corporate Governance} (n 681) at 96
\end{thebibliography}
determining that individual’s degree of accountability.\footnote{Keay and Loughrey, 'The Framework for Board Accountability in Corporate Governance' (n 680) at 260} To legitimise this power and protect stakeholders from any abuse of it, a system of accountability is required.\footnote{Cary Coglianese, 'Legitimacy and Corporate Governance' (2007) 32 Delaware Journal of Corporate Law 159 at 160} This applies to the SSB as a superior body within a company regarding sharia matters. The decision taken by SSBs has a very strong impact on the business. Such power should be partnered with a strong system of accountability.

Public interest is another rationale for accountability since the public has a legitimate expectation that companies are managed properly.\footnote{Keay, Board Accountability in Corporate Governance (n 681) at 105} In sharia-compliance, the public and community as a whole is a genuine stakeholder. This will be explained later in this chapter.

The above discussion provides justifications of the need for more consideration of accountability within sharia governance. The framework of accountability should take into account the unique requirements and players regarding sharia interest. As part of this analysis, the question of “who” is discussed below in order to investigate whose responsibility it is to ensure sharia-compliance. This analysis assesses how the SSB fits into this responsibility.

6.4 Who is Accountable for Sharia-compliance?

6.4.1 Sharia-compliance and the Responsibility of the Board of Directors

One of the ambiguous areas in the Islamic finance is whose responsibility it is to ensure sharia-compliance. In the literature, it is unclear whether this responsibility lies with the SSB or the board of directors.\footnote{Alkhamees, 'The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance' (n 323) at 142} In Chapter Four, I argued that the board of directors should be responsible for sharia matters since it is ultimately responsible for all matters in the company, which include sharia-compliance as an important factor in any IFI. The SSB is a panel of experts who help IFIs to comply with sharia rules and principles. The responsibility of the board for ensuring sharia-compliance is implied by...
the AAOIF’s suggestion that there should be a clear statement by the management that ensuring compliance with sharia rules and principles is among its responsibilities.\textsuperscript{773}

The responsibility of the board towards sharia-compliance, however, does not mean that the board should be directly involved in sharia auditing but it must ensure that a proper sharia governance framework is established and effectively applied. This responsibility is similar to its responsibility to ensure effective auditing. An audit committee is usually formed as a sub-committee of the board to ensure the proper conduct of auditing.\textsuperscript{774} This includes ensuring that external auditors, as expert gatekeepers, conduct an independent audit for the stakeholders.

It is necessary to enhance the responsibility of the board for stronger sharia governance. For this purpose, some regulations, such as those in Malaysia, suggest that a member of the SSB should be appointed to the board of directors.\textsuperscript{775} However, this strategy might prove impractical. It has been argued that sharia members might not always fit, legally, as a member of the board of directors.\textsuperscript{776} Moreover, appointing a sharia member to the board might be insufficient to provide the attention necessary to protect the interest of sharia. Similarly, IFSB suggests that a governance committee shall be formed and may include a member of the SSB.\textsuperscript{777} This may compromise independence. Sharia experts appointed to sub-committees should have no relationship with the external auditors. Alternatively, the supervision of the process of sharia auditing should be assigned to the auditing committee. In its governance standards, AAOIFI assigns the duty of reviewing compliance with the sharia rules and principles to the audit and governance committee of IFIs.\textsuperscript{778} This will bring more attention to the sharia governance framework. Independent directors on the audit committee should play an

\begin{footnotesize}
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\item \textsuperscript{773} Governance Standard No.1, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 887-888
\item \textsuperscript{774} Saudi Arabia, for example, requires the board to form an audit committee. Saudi Arabia, Companies Law (2015) Article 101
\item \textsuperscript{775} Bank Negara Malaysia, Sharia Governance Framework for Islamic Financial Institutions (n 562) at 10
\item \textsuperscript{776} This was discussed in Chapter Four.
\item \textsuperscript{777} Islamic Financial Services Board, ‘Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services’ (2006) at 3
\item \textsuperscript{778} Governance Standard No.4, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 927
\end{itemize}
\end{footnotesize}
important role in ensuring the independence of the sharia review process.\textsuperscript{779} It can also ensure more impartial supervision since the independent status of the auditing committee is highly regarded. In Saudi Arabia, no executive directors, current or previous executives in the last two years, or current or previous employees of the external auditors in the last two years are allowed to be members of the auditing committee.\textsuperscript{780} Such attention to the issue of the independence of the auditing committee would enhance the sharia governance framework. Where regulations allow the appointment of non-directors to the audit committee, such as is the case in Saudi Arabia,\textsuperscript{781} an expert in sharia auditing, with no relationship to the external auditors, should be ideally appointed.

6.4.2 The SSB as a Tool for Auditing: The Issue of Conflict of Interests

While enhancing the responsibility of the board to ensure sharia-compliance would strengthen the accountability framework of sharia supervision, it would be insufficient without using an effective tool for sharia auditing. The concern is whether the SSB is still an appropriate tool for assuring the stakeholders of sharia-compliance. The issue of conflict of interests is a long-standing one, which the literature addresses in the SSB. Such an issue negatively affects the role of the SSB as independent auditors.

Independence requires the ability to act with objectivity, integrity, impartiality, and free from conflict of interests.\textsuperscript{782} The structure of SSBs is somewhat confusing. The fact that IFIs adopt the SSB as a board within the company has raised concerns regarding the SSB’s independence. As discussed earlier, it cannot be regarded as a board parallel to the board of directors. Although the need for SSB’s independence from the board is indisputable, the SSB is regarded as subordinate to the board of directors, a position that compromises its independence.\textsuperscript{783} Even in cases where the SSB reports to the shareholders, the board of directors, as this section explores, has sufficient power to

\textsuperscript{779} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 11
\textsuperscript{780} Capital Market Authority (CMA), Corporate Governance Regulations Article 54
\textsuperscript{781} Saudi Arabia, Companies Law Article 101; Capital Market Authority (CMA), Corporate Governance Regulations Article 54
\textsuperscript{782} Graeme Wines, ‘Auditor Independence’ (2011) 27 Managerial Auditing Journal 5 at 7
\textsuperscript{783} Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 295
threaten the independence and objectivity of SSBs. This happens as a result of assigning an internal board to conduct a gatekeeping role.

In the previous chapter, the issue of independence is discussed with regard to the legislative role of SSBs. Related to this discussion, which applies here as well, is the case of combining the legislative role with auditing. As suggested, the legislative role should be completely removed from SSBs to avoid conflict of interests in combining such rules. This leaves the SSB with advisory and audit roles only. Still, there arise issues related to conflict of interests associated with the SSB’s role as auditors, which are reviewed below.

*Issues surrounding appointments*

There are several methods related to the appointment of SSB members:

- By the board of directors.
- By the board of directors and approved by the central authority, central banks or national SSBs.
- By the shareholders, based on the recommendations of the board.
- By the shareholders and approved by the central authority.784

AAOIFI and IFSB suggest that members of SSBs should be appointed by the shareholders upon nomination by the board.785

While giving shareholders the authority to appoint SSB members provides SSBs with a stronger position, independence is not necessarily maintained. The board might have a strong influence on the shareholders’ decisions.786 Shareholders usually

784 Grassa, ‘Shariah Supervisory Systems in Islamic Finance Institutions across the OIC Member Countries’ (n 388) at 147
785 Governance Standard No.1, The Accounting and Auditing Organization for Islamic Financial Institution, *Accounting, Auditing and Governance Standards* (n 305) at 885; Islamic Financial Services Board, *Guiding Principles on Sharia’h Governance Systems for Institutions Offering Islamic Financial Services* (n 174) at 23
786 Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 563
approve the board’s nominations, without objection.\textsuperscript{787} The board’s decision about the appointment of SSBs is, commonly, influenced by the management.\textsuperscript{788} This places the independence of SSBs in danger. The authority of the shareholders over appointments would be even more minimal, where the ownership of IFIs is concentrated. In this case, only a few shareholders have control of and representation on the board, whose influence on SSBs would be stronger due to the minimal role of the other shareholders. This type of ownership is common in Saudi Arabia.\textsuperscript{789} Therefore, the appointment approach of seeking final approval from the regulatory body may help to reduce the influence of a few individuals on appointment.\textsuperscript{790}

Still, the management and board have a strong influence on the appointment and reappointment of SSB members. Presumably, the members of SSBs who are interested in reappointment may prioritise their personal goals rather than sharia principles and try to avoid as far as possible whatever may endanger their reappointment.\textsuperscript{791} To ensure reappointment, doubtful products may be approved as sharia-compliant to satisfy the interest of the management. To avoid such a conflict, it is suggested that contracts between IFIs and SSB members should be temporary.\textsuperscript{792} A long-term client relationship impairs objectivity by enabling the management to build a strong relationship with the auditors which may be diverted in order to serve other interests.\textsuperscript{793} Rotation is a tool used by regulators to enhance the independence of external auditors. Mandatory rotation would eliminate the interest of external auditors with regards to reappointment. Hence, the influence of the management on them would be minimised. Before Enron, the idea of audit rotation attracted little legal attention.\textsuperscript{794} Rotation now is a common

\textsuperscript{787} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 146
\textsuperscript{788} Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 137
\textsuperscript{789} Based on the information about ownership available in Tadawul.
\textsuperscript{790} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 149
\textsuperscript{791} Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 140
\textsuperscript{792} Elqari, ‘The Independence of Sharia Boards’ (n 383) at 15-16
\textsuperscript{793} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 12
\textsuperscript{794} Bavly, Corporate Governance and Accountability: What Role for the Regulator, Director and Auditor? (n 723) At 172-173
regulatory requirement for audit firms in many jurisdictions, such as the US,\textsuperscript{795} the European Union,\textsuperscript{796} and Saudi Arabia as well.\textsuperscript{797} Rotation, however, has been criticised for its negative impact on audit quality, since a lengthy relationship increases the understanding of the client’s business.\textsuperscript{798} In response to this, FRC finds that the impact of rotation on the quality of the auditing has been unexpectedly limited and audit firms have become more experienced due to rotation.\textsuperscript{799} In the SSB, rotation has received little attention as a practice for minimising conflict of interests. Rotation could reduce the management’s power to influence SSB’s decisions through periodically interrupting the relationship. SSB rotation, however, has been criticised, as it may cause inconsistency in the application of sharia, so individual members’ rotation alone is suggested.\textsuperscript{800} However, such a criticism considers legislation as a role of SSBs. As argued in the last chapter, this should not be assigned to SSBs. If SSBs only perform sharia audit, there would be little concern about the inconsistency of sharia application due to SSB rotation. Individual rotation is suggested by AAOIFI, which recommends rotating at least one member of the SSB every five years.\textsuperscript{801} Yet, jurisdictions, generally, do not adopt rotation.\textsuperscript{802} Recently, Oman has taken a progressive step of limiting the number of renewable terms of SSB members to two three-year terms.\textsuperscript{803}

The dismissal of SSB members is another area where conflict of interests may arise. It is suggested that the authority to dismiss is given to the shareholders at the request of the board of directors.\textsuperscript{804} Nevertheless, the power of the management may be exercised to influence the board to dismiss members of the SSB, which puts SSB members at risk.

\textsuperscript{795} U.S.A, Sarbanes-Oxley Act (2002) Section (203)
\textsuperscript{796} European Union, The Statutory Auditors and Third Country Auditors Regulations (2016) Part 3
\textsuperscript{797} Saudi Arabia, Companies Law Article 133
\textsuperscript{798} Gelb, ‘Corporate Governance and the Independence Myth’ (n 480) at 154; Nopmanee Tepalagul and Ling Lin, ‘Auditor Independence and Audit Quality: A Literature Review’ (2015) 30 Journal of Accounting, Auditing & Finance 101 at 108
\textsuperscript{799} Financial Reporting Council (FRC), ‘Audit Tenders: Notes on Best Practice’ (2017) at 5
\textsuperscript{800} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 12-13
\textsuperscript{801} Governance Standard No.5, The Accounting and Auditing Organization for Islamic Financial Institution, Accounting, Auditing and Governance Standards (n 305) at 944
\textsuperscript{802} Ginena and Hamid, Foundations of Shari’ah Governance of Islamic Banks (n 134) at 305
\textsuperscript{803} Central Bank of Oman, Islamic Banking Regulatory Framework at 2.2.4.1
\textsuperscript{804} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 12
of being dismissed if their opinions about sharia-compliance conflict with the interest of the management.

Remuneration

Generally, the remuneration of the SSB is proposed by the management and approved by the board, which creates a conflict of interests in situations where the management may put pressure on the SSB by controlling the remuneration.\textsuperscript{805} Currently, the way in which the members of the SSB are remunerated negatively impacts on their credibility as far as moral beliefs and religious values are concerned and this requires more regulatory attention.\textsuperscript{806}

Some argue that independence is achieved as long as remuneration is not associated with the content of SSB’s decisions, so there should be no conflict of interests if a member is remunerated based on the number of meetings attended or via a lump sum.\textsuperscript{807} Some add that, in order to avoid conflict of interests, remuneration should not be in the form of salary or linked to the performance or profitability of the IFI, and needs to be disclosed in the financial statements.\textsuperscript{808} Fixed remuneration could be the best way to diffuse conflict of interests.\textsuperscript{809}

Regardless of how the SSB members are remunerated, the assumption of the employment relationship with IFIs creates a conflict of interests. The issue of SSB remuneration lacks of policy standards regarding how SSBs should be remunerated and by whom.\textsuperscript{810} In the absence of such rules, remuneration is surrounded by ambiguity in terms of how and how much SSB members are paid. Where this is not obligatory, IFIs may not disclose such information, as is the case in Saudi banks. This lack of supervision of remuneration puts SSB members under pressure from the management. They can exercise their power to control the remuneration in order to influence SSB’s

\textsuperscript{805} Ibid at 6
\textsuperscript{806} Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 563
\textsuperscript{807} Ash-Shubaili, ‘Sharee’ah Governance of Islamic Banks’ (n 373) at 172
\textsuperscript{808} Elqari, ‘The Independence of Sharia Boards’ (n 383) at 18
\textsuperscript{809} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 12
\textsuperscript{810} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 147
decisions. Critics accuse IFIs of paying high remuneration to SSBs in exchange for doubtful religious validity.\(^\text{811}\) Therefore, it is suggested that shareholders must take responsibility for determining SSB remuneration.\(^\text{812}\)

**Ownership and other financial interests**

The regulations related to external audit do not tolerate any factor that negatively affects the independence of external auditors from the management. If a conflict of interests arises, such as combining audit with non-audit services, trust will be lost.\(^\text{813}\) Therefore, restrictions are placed on auditors to avoid any potential conflict with their clients that could impair the audit objectivity. For example, external auditors in Saudi Arabia are not allowed to audit a firm if they have: ownership of the business; direct or relatives’ employment or board membership; business partnerships with the board members, executives, or big shareholders; or contracts that might affect the independence of the audit such as advisory services.\(^\text{814}\) Similar restrictions should be imposed on SSB’s members by AAOIFI\(^\text{815}\) and IFSB,\(^\text{816}\) and are, to some extent, considered in some jurisdictions such Malaysia.\(^\text{817}\) In fact, this type of conflict is considered within Islamic law. Commercial partners are not allowed to witness in favour of their partnership which could be applied to SSB members who have financial interests in the entity.\(^\text{818}\)

The percentage of auditors’ ownership of their clients is subject to variations in different jurisdictions. In the US, AICPA’s Code of Professional Conduct sets 5% as the threshold for auditors’ ownership of the client.\(^\text{819}\) However, SEC prohibits any direct

\(^{811}\) Ibid at 147
\(^{812}\) Ginena and Hamid, *Foundations of Shari’ah Governance of Islamic Banks* (n 134) at 307
\(^{813}\) Gelb, ‘Corporate Governance and the Independence Myth’ (n 480) at 152
\(^{814}\) Saudi Organization of Certified Public Accountants (SOCPA), *Executive Regulations for Certified Public Accountants Regulations* (1994) Article 5
\(^{815}\) Governance Standard No.5, The Accounting and Auditing Organization for Islamic Financial Institution, *Accounting, Auditing and Governance Standards* (n 305) at 943-944
\(^{816}\) Islamic Financial Services Board, *Guiding Principles on Sharia’h Governance Systems for Institutions Offering Islamic Financial Services* (n 174) at 15
\(^{817}\) Bank Negara Malaysia, *Sharia Governance Framework for Islamic Financial Institutions* (n 562) at 31-32
\(^{818}\) Ash-Shubaily, ‘Sharee’ah Governance of Islamic Banks’ (n 373) at 160
\(^{819}\) American Institute of Certified Public Accountants (AICPA), *Code of Professional Conduct* (2014) at 1.240.10
financial interest of an auditor in the client, a public company, which includes stock ownership.\textsuperscript{820} Direct ownership also disqualifies external auditors in the UK from acting.\textsuperscript{821} In Saudi Arabia, external auditors are only prohibited from having “material ownership” of the client.\textsuperscript{822} Generally, a 1% ownership of the client constitutes material ownership.\textsuperscript{823}

SSB ownership receives little attention. A few rules and regulations consider setting limits on SSB ownership. For example, IFSB and the Malaysian Shariah Governance Framework consider a 5% ownership of the relevant IFIs to disqualify members to serve on the IFI.\textsuperscript{824} Ash-Shubaily argues that SSB members should be restricted only from material ownership, which is 5% or more, since this is the legally identified percentage of ownership that must be disclosed by publicly-owned firms in some jurisdictions like Saudi Arabia.\textsuperscript{825} However, even ownership less than 5% could be too high. It is a legal requirement to disclose this percentage of ownership because owners with this percentage could have sufficient power to influence the value of the shares of the company. Less than this could rarely attract public attention. Yet, the situation of conflict of interests is not related to public attention. It could happen even with less than 5% ownership, especially if the company is large, as is the case with Saudi banks. As the biggest economy in the region, there are only 12 local banks in Saudi Arabia, and only four of these are fully Islamic. Compared to the number of banks in the regions, there is a concentrated market involving large banks. Therefore, owning even less than 5% could constitute a considerable conflict of interests. Indeed, even one share, surely, constitutes a potential conflict of interests. Generally, auditors’ ownership of the client is expected to affect negatively the perceived independence.\textsuperscript{826}

\begin{itemize}
\item \textsuperscript{820}U.S. Securities and Exchange Commission (SEC), \textit{Rule 210.2-01 Qualifications of Accountants} (2001) at (c)(1)
\item \textsuperscript{821}Financial Reporting Council (FRC), \textit{Revised Ethical Standard} (2016) Part B Section 2.3D; The Institute of Chartered Accountants in England and Wales (ICAEW), \textit{Code of Ethics B} (2009) Section 290.104
\item \textsuperscript{822}Saudi Organization of Certified Public Accountants (SOCPA), \textit{Ethics Standards} (1994) Rule 101
\item \textsuperscript{823}SOCPA’s Ethics Committee, \textit{Opinions and Interpretations of Ethics Committee} (1998) at 2043
\item \textsuperscript{824}Bank Negara Malaysia, \textit{Sharia Governance Framework for Islamic Financial Institutions} (n 562) at 32
\item \textsuperscript{825}Ash-Shubaily, ‘Sharee’ah Governance of Islamic Banks’ (n 373) at 160
\item \textsuperscript{826}Linda Elizabeth DeAngelo, ‘Auditor Independence, ‘Low Balling’, and Disclosure Regulation’ (1981) 3 Journal of Accounting and Economics 113 at 123
\end{itemize}
The credit facility provided to SSB members by IFIs is another area that needs legal restrictions. Credit facilities for both personal and commercial use negatively impact on independence. In Saudi Arabia, external auditors are not allowed to perform an audit if they have a credit relationship with the company.827 Only a few jurisdictions place restrictions on SSB members accessing the credit facilities of their relevant IFIs.828

Some IFIs intentionally appoint one SSB member to an executive position to create a cooperative environment between the management and the SSB. This has been the practice among certain Saudi IFIs. Such an approach significantly constitutes a conflict of interests. The employment relationship and self-interest as an executive would have an effect on the objectivity of auditing. An empirical study shows that SSB executive positions significantly increase the conflict of interests in the SSB.829 In the external audit, the employment relationship is considered a threat. To ensure a high level of independence, many regulations impose a cooling-off period, where external auditors are prohibited from working for a previous client.830 The employment relationship receives little legal attention in the SSB. Restrictions on SSB employment are rarely found in sharia governance regulations. Such a restriction can be found in Oman, where no SSB membership is allowed for current employees or those who were employed by the organisation during the last financial year.831

**Combining audit with non-audit services**

Some situations of conflict of interests in the SSB occur due to the content of the roles it performs. Related to this issue is the combination of audit and legislation, discussed before. Similarly, providing an advisory role along with auditing could compromise objectivity.

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827 Saudi Organization of Certified Public Accountants (SOCPA), *Ethics Standards* Rule 101
828 Alkhamees, 'The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance' (n 323) at 148
829 Samy Nathan Garas, 'The Conflicts of Interest inside the Shari’a Supervisory Board' (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management 88 at 97-98
831 Central Bank of Oman, *Islamic Banking Regulatory Framework* at 2.2.4.21
In the accounting and auditing profession, combining audit with non-audit services has been subjected to a thorough discussion. Such combination is proven that it significantly impairs the independence of the external auditors.\textsuperscript{832} Coffee argues that audit firms’ provision of non-audit services along with audit was the major cause of gatekeepers’ failure and the collapse of Enron and WorldCom.\textsuperscript{833} He describes how non-audit services were used by managers as a bribe to secure auditors’ acquiescence. This issue was solved by the Sarbanes-Oxley Act which limits most consulting services to non-audit clients only.\textsuperscript{834} Similarly, the International Ethics Standards Board of Accountants (IESBA) addresses the issue of providing non-audit services to clients.\textsuperscript{835} Many jurisdictions apply such a prohibition, such as the UK,\textsuperscript{836} EU,\textsuperscript{837} and Saudi Arabia.\textsuperscript{838}

The issue of this combination is not identical in the case of SSBs. Audit and non-audit services are not provided as separate services by SSBs. The members are hired to perform the roles of issuing \textit{fatwas} (legislation), sharia audit, and consultation collectively. Hence, there is not a separate fee for each service. Nevertheless, the combination of audit with non-audit services is still a concern. If the audit is conducted by the same body that has engineered and approved the products, it is likely that the audit would be lenient. Also, it has been argued that even internal auditors should not be allowed to provide consultation to the management because this action, combined with auditing, would negatively affect their objectivity due to potential attempts to please

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\textsuperscript{832} Richard G. Brody, Christine M. Haynes and Craig G. White, ‘The Impact of Audit Reforms on Objectivity during the Performance of Non-Audit Services’ (2014) 29 Managerial Auditing Journal 222 at 225  \\
\textsuperscript{833} Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 65-66. The issue of providing non-audit services by audit firms have been discussed deeply throughout the book.  \\
\textsuperscript{834} Brody, Haynes and White, ‘The Impact of Audit Reforms on Objectivity during the Performance of Non-Audit Services’ (n 832) at 225  \\
\textsuperscript{835} Wines, ‘Auditor Independence’ (n 782) at 37  \\
\textsuperscript{836} Financial Reporting Council (FRC), \textit{Revised Ethical Standard} Part B Section 5.167R  \\
\textsuperscript{837} European Union, Regulation No 537/2014 (2014) Article 5  \\
\textsuperscript{838} Saudi Organization of Certified Public Accountants (SOCPA), \textit{Executive Regulations for Certified Public Accountants Regulations} Article 5
\end{flushright}
Similarly, this could be the case for SSBs assuming the employment relationship and other conflict of interests mentioned above.

**Confidentiality**

Sitting on more than one SSB exposes the members to the possibility of breaching confidentiality by possessing confidential information, and so constitutes a possible conflict of interests. The regulations in many jurisdictions do not place any limit on the number of SSBs on which individual scholars may serve. The practice shows that an individual may serve on a vast number of SSBs. A study on SSB membership, published in 2011, reveals an interesting number of SSB memberships among sharia scholars. According to this study, a scholar may be a member of as many as 101 SSBs. The top 20 scholars have 621 board memberships collectively. The study shows that SSB membership is highly concentrated, whereby the top 10 members represent 39.44% of all SSB memberships and the top 100 members represent 83.52%. In Saudi Arabia, the study finds that the top five members represent 56.58% of the SSBs in the country and hold 28, 27, 12, 11, and 8 positions, respectively.

Multi-membership can cause what is called “separate-matter conflict”, whereby a member of different SSBs may possess confidential information from one IFI that is relevant to a matter in another. Whether disclosing the information or not, the SSB member of these IFIs would end up breaching a duty to one of them. This applies to auditing and advisory roles, where both expose the members to inside material information.

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839 Brody, Haynes and White, 'The Impact of Audit Reforms on Objectivity during the Performance of Non-Audit Services' (n 832) at 132
840 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 230
841 Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions' (n 314) at 571
842 Murat Ünal, 'The Small World of Islamic Finance: Shariah Scholars and Governance - A Network Analytic Perspective' (2011) at 5
843 Ibid at 12
844 Ibid at 13
845 Ibid at 18
846 Jabbar, 'The Islamic Financial Services Industry: The Sharia Board's Governance Framework' (n 558) at 299-300
information might exacerbate the conflict of interests. The possession of confidential information about contracts, operations, and documentation places the SSB members in a strong position, similar to that of the board of directors. The case of multi-directorships, however, is usually regulated by the corporate governance, where restrictions are set on the number of directorships that individuals can hold. In Saudi Arabia, directors are not allowed to have more than five memberships of public companies at the same time, and this is provided that the companies concerned are not in competition. More specifically, directors in the banking industry are not allowed to serve more than one bank in the country at the same time. While directors can only serve one of the 12 operating Saudi banks, only one bank clearly bans its SSB members from holding multiple memberships. In the remaining 11 banks, there are 43 SSB seats, with the top three occupying 25 seats. This represents more than 58% of the SSB membership in these banks. This does not include SSBs in other IFIs, such as sharia-compliant insurance, takaful, or mutual funds.

To avoid this situation, regulations in some countries tend to disallow multi-membership. Malaysia, Nigeria, and Oman apply such a restriction. This is similar to the restriction imposed on multiple directorships in the field of corporate governance. However, the imposition of a strict limitation on multi-memberships could create a situation of scarcity in the industry, due to the limited numbers of qualified scholars in the field. Distinguished, well-known sharia scholars who can serve in SSBs are in short supply, which explains this high number of SSB memberships. This highlights

847 Grais and Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (n 387) at 7
848 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 230
849 Saudi Arabia, Companies Law Article 72; Capital Market Authority (CMA), Corporate Governance Regulations Articles 17, 20
850 Saudi Arabian Monetary Agency (SAMA), Principles of Corporate Governance for Banks Operating in Saudi Arabia (2014) No.21
852 Based on data available on the banks' websites.
853 Bank Negara Malaysia, Sharia Governance Framework for Islamic Financial Institutions (n 562) at 32; Grassa, 'Shariah Supervisory Systems in Islamic Finance Institutions across the OIC Member Countries' (n 388) at 154
854 Ahmeen, 'The Governance Standards of Shariah Supervision' (n 384) at 12
855 Nienhaus, 'Governance of Islamic Banks' (n 572) at 139
the need to professionalise the practice, which would be explored both below and in the next chapter.

The above situations of conflict of interests explain the need for more legal attention to preserve the independence of SSB members. Neglecting this, such as is the case in Saudi Arabia, or even a weak consideration of a regulatory framework for the SSB places the credibility of SSB members under question, which threatens the industry as a whole. The debate about the independence of SSBs is not a new one. However, it has become essential, with the rapid development and spread of Islamic finance globally, which requires the legal reform of the practice. In the absence of a strong regulatory framework that enhances the independent status of SSBs, ethics and moral beliefs play a strong role in preventing conflict of interests. A failure regarding sharia-compliance could be extremely costly for sharia scholars’ reputations, as they are presumed to be the guardians of sharia principles.\textsuperscript{856} They are seen as invulnerable to conflict of interests because they relaise their accountability to God. However, this is insufficient to preserve the interests of the stakeholders. The industry, still, might be vulnerable to sharia risk. A failure regarding sharia-compliance would be too difficult to discover due to the absence of effective regulations.\textsuperscript{857} Parallel to auditing firm, the next section discusses sharia firms as an alternative to the SSB for conducting sharia audit more independently.

6.4.3 External Sharia Audit and the SSB Alternatives: Is it Time for Sharia Firms?

Given the issue of conflict of interests surrounding SSBs, this section explores sharia firms as a more objective and independent tool. The movement towards sharia firms in place of SSBs satisfies the concept of gatekeeping more than SSBs. Currently, the development of external sharia auditing is at a point where it is obligatory only in a few jurisdictions. Similarly, this was the case in the early 20\textsuperscript{th} century with regard to external financial audit.\textsuperscript{858} Its development was usually scandal-driven.\textsuperscript{859} In many

\textsuperscript{856} Grais and Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (n 387) at 6
\textsuperscript{857} Kasim and Sanusi, 'Emerging Issues for Auditing in Islamic Financial Institutions: Emperical Evidence from Malaysia' (n 745) at 11
\textsuperscript{858} Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 112
corporate collapses and crises, the issue of the lack of auditors’ independence was discussed as a main cause and prompted regulatory reforms.\footnote{Ibid at 139} This should draw more attention to the need to develop external sharia auditing to avoid any risk associated with a lack of sharia-compliance. Because of the similarities between these roles, it is useful for this analysis to consider, very briefly, the historical evolution of external auditors as gatekeepers.

In the early stage of the concept of corporations, the size of corporations and the number of owners might not require strict auditing. In the mid-19th century, audit was conducted by the shareholders, the principals, themselves.\footnote{Bottomley, \textit{The Constitutional Corporation: Rethinking Corporate Governance} (n 710) at 96} To increase the sophistication, business owners employed bookkeepers to perform the necessary audit.\footnote{Audit Quality Forum, 'Agency Theory and the Role of Audit' (n 730) at 8} Later, it became more practical for shareholders to depend on expert auditors to undertake this task. Based on Ronald Coase’s insight, a firm makes products and services internally until it is less costly to rely on the market.\footnote{Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 108} This explains the shift towards relying on gatekeepers for auditing.\footnote{Tuch, 'Multiple Gatekeepers' (n 443) at 1592} The idea of depending on reputable expert gatekeepers, which include external auditors, has developed to help investors to obtain verification more effectively.\footnote{Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (n 445) at 94} The trust and confidence provided to the stakeholders by external auditors is essential for companies to maintain. At the beginning, companies were not obliged to appoint external auditors but it was an initiative for assuring others of the reliability of their statements.\footnote{Coffee, \textit{Gatekeepers: The Professions and Corporate Governance} (n 440) at 112} Before it became obligatory, the idea of external audit was challenged by resistance from certain firms and practitioners.\footnote{Ibid at 116}

The transfer of auditing from the shareholders to professional auditors appointed by directors has highlighted the need for independence among the auditors.\footnote{Mak and others, 'Audit, Accountability and an Auditor’s Ethical Dilemma: A Case Study of HIH Insurance' (n 518) at 21} Due to the
lack of trust and confidence regarding the management carrying out the audit function, independent experts are hired to perform audit for shareholders. Therefore, auditors are also the agents of the shareholders so the agency problem may arise. Independent auditors will be more impartial when auditing the company’s profiles and will place limits on the power given to the management and the board. In the auditing profession, independence is a precious asset and is the only sound basis for an auditor-client relationship. Without independence, the value of audit is meaningless. Therefore, a high level of independence is maintained in the regulations concerning external auditors.

In this historical preview, inference can be made that, to some extent, SSBs are on a similar track towards the development of external auditors. As illustrated earlier with regard to the history of SSBs, they did not exist in the early stage of Islamic banks. They was later introduced as an internal panel of experts to ensure sharia-compliance. At that time, external sharia auditors were not a requirement due to the limited size of the industry and its basic operation. In 1990, Abdel Karim argued against the need for external sharia auditing due to the limited size of the industry, where all transactions need to be reviewed, unlike external financial audit where only samples are reviewed. He continued that sample auditing might become inevitable in future due to the significant increase in the number of Islamic transactions, after which external audit might become necessary. This argument reflected the need for sharia auditing at an early stage of Islamic finance. Even conventional audit experienced this stage, where there was only an internal audit. Nowadays, however, there is an increasing call for external sharia audit. The weak performance of the auditing and the independent status of SSBs have been questioned. The role of auditing performed by SSBs is insufficient to assure the stakeholders and give them confidence regarding sharia-compliance. External audit is not required by most of the regulatory frameworks despite the current

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869 Audit Quality Forum, 'Agency Theory and the Role of Audit' (n 730) at 9-10
872 Abdel Karim, 'The Independence of Religious and External Auditors: The Case of Islamic Banks' (n 461) at 39-40
873 Haqqi, 'Sharia Governance in Islamic Financial Institution: An Appraisal' (n 175) at 125-126
development in the industry and the introduction of more sophisticated products which require more effective external sharia auditing than ever before. The need for external auditing to ensure sharia-compliance is consistent with the current social movement, where societies trust nothing and audit everything, when previously they used to audit nothing and trust everything. Therefore, Sharia auditing needs to have a similar function to conventional financial auditing.

As a response to this need, new consultancy businesses have evolved to serve the Islamic finance industry, called sharia firms. External sharia firms have evolved as a tool of sharia supervision. This type of firm provides services, including: consultation and training, internal sharia auditing as outsourcing, and external sharia auditing. Having external sharia firms to conduct external sharia auditing enables the stakeholders to receive stronger assurance about the independent sharia-compliance verification. Where operating, sharia firms tend to be an optional tool used by IFIs rather than a legal requirement. This might be parallel to the stage of development of external financial audit where it was only a voluntary initiative by companies. However, there is increased legal attention regarding requiring external sharia auditing. In Malaysia, external sharia auditing is required only in circumstances where the central bank, upon assessment, deems this necessary. Only recently has external audit been introduced as a regular requirement in some jurisdictions, such as Oman and Pakistan. Bahrain has

874 Grassa, 'Sharia Supervisory System in Islamic Financial Institutions' (n 544) at 345
877 Nathan Garas and Pierce, 'Shari'a Supervision of Islamic Financial Institutions' (n 315) at 390-393
878 Ginena and Hamid, Foundations of Shan’ah Governance of Islamic Banks (n 134) at 364-365
879 Ibid at 367
880 Bank Negara Malaysia, Sharia Governance Framework for Islamic Financial Institutions (n 562) at 25
881 Central Bank of Oman, Islamic Banking Regulatory Framework Title 3
882 Shahzad, Saeed and Ehsan, ‘Shariah Audit and Supervision in Shariah Governance Framework: Exploratory Study of Islamic Banks in Pakistan’ (n 736) at 110-111
announced that, by 2020, it will be mandatory to have an external sharia-compliance audit report.\textsuperscript{883}

An important question arises here: will sharia firms avoid the situations of conflict of interests that exist in SSBs? In fact, many of these situations may apply to sharia firms as well. They are also present in conventional financial audit. However, these situations have less impact due to the regulations surrounding the profession. Supervisory regulators and ethical codes could be effective in reducing these situations. While absolute independence is a myth and impossible to achieve, sharia firms, parallel to audit firms, may help to alleviate this problem, supported by the fact that the idea of gatekeepers provides the most ideal solution, to date, to the issue of conflict of interests in auditing. Regulations that ensure independence could be applied for sharia firms. Rotation, duration, financial or employment interests are well-regulated in such a way that independence is highly maintained.

It is true, however, that these regulations could also be imposed on SSBs to ensure greater independence, so the need for sharia firms as an alternative to SSBs remains in question. However, it should be noted that regulations alone cannot be sufficiently effective to ensure independence. While there are instances of conflict of interests in firms similar to those in the SSB, these instances would be significantly reduced in the case of firms. The adoption of sharia firms as an alternative to SSBs would create a professional environment that creates more value than the tool itself. Such an environment will ensure more independent practice of sharia auditing. Therefore, an assessment of the value that sharia firms may bring to improve independence should be considered here.

Arguably, moving to sharia firms would enhance independence in different ways. First, it would satisfy the gatekeeping role and its structure to build more reputational capital that could play an important role in achieving greater independence from clients. For sharia members, their reputation could establish resistance to pressure from the

management. However, the current structure and characteristics of SSBs are insufficient to assume the gatekeeping role. As argued in Chapter Four, the reputation that SSB members enjoy is different from the reputational capital of gatekeepers. Therefore, this reputation is more adequately and effectively maintained by sharia firms as gatekeepers. Since external gatekeepers are expecting to pursue their verification job in the future, they will have a stronger incentive to preserve their reputation and honesty than insiders, who engage in fewer frequent transactions and direct financial stakes. This reputational capital, built up by firms, is very valuable, as it creates a barrier to achieving personal goals that might harm such valuable assets. Therefore, protecting their reputation works as an incentive for maintaining the independence of the gatekeepers. There is always, of course, a possibility that the gatekeepers will get too close to the management, as was the case with Enron. Thus, effective regulation should consider such a possibility. In all circumstances, this would not be comparable to the current structure of SSBs, which is surrounded by a closer relationship and more significant conflict of interests. Also, this close relationship is usually built through the non-audit services provided by audit firms to the company. While financial non-audit services may be comprehensive and cover the whole business, the scope of sharia advice would be restricted to sharia-compliance issues alone. Therefore, sharia firms would have less room to engage in the provision of advisory services than audit firms and thus would be less likely to have a close relationship with the management.

Second, sharia firms would put an end to dealing with individuals as external sharia auditors. Individuality is more susceptible to conflict of interests as it places members in a weaker position when engaging with IFIs. Professionalisation is essential in today’s world, where there has been a shift in the market towards empowering those clients who can offer sufficiently significant fees to impair the independence and objectivity of the auditors. Therefore, sharia firms would help to create a stronger sovereignty and more powerful status for external sharia auditors as professionals who, in turn, ensure

884 Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 229
885 Tuch, 'Multiple Gatekeepers' (n 443) at 1595-1596
886 Audit Quality Forum, 'Agency Theory and the Role of Audit' (n 730) at 10
887 Coffee, Gatekeepers: The Professions and Corporate Governance (n 440) at 163
greater sharia-compliance. Acting as a team of sharia auditors in a firm would also create a stronger accountability framework. Instead of individuals dealing with their clients, sharia auditors in the firm would consider other factors, such as the other sharia auditors in the team, and the hierarchical superiors. This framework would create stronger resistance to any possible diversion. Such multiple sources of accountability have been shown to increase the pressure on auditors and enhance accountability.\textsuperscript{889} Other factors within the firm could play an important role in accountability, such as career advancement and other incentives.\textsuperscript{890} These elements motivate more objective behaviour to ensure sharia-compliance.

Third, sharia firms would create a stronger legal recognition of sharia auditing as a profession which brings more ethical and legal standards. Improving sharia supervision as a profession would be important in enhancing independence. For example, a code of ethics would be applied to sharia auditors to regulate and ensure more independent professional practice. While AAOIFI has issued one for accountants and auditors in the industry of Islamic finance, there is a lack of a code of ethics for SSB members. This may negatively affect the SSB independence.

Finally, sharia firms would improve the profession by drawing a clear separation between internal and external auditing.\textsuperscript{891} Currently, these two duties are not clearly divided, which compromises the SSB independence. In effective accountability frameworks, a strategy of the separation of the power of different decision-makers is implemented.\textsuperscript{892} The introduction of sharia firms serves this purpose. A clearer line between internal and external reviews would be drawn so the process would become easier and more systematic. While IFIs have the authority to appoint external auditors from different sharia firms, their influence on the sharia supervisors as independent gatekeepers would not be the same as on internal SSBs. This separation is essential also due to the issue of liability surrounding sharia non-compliance, which would be

\textsuperscript{890} Ibid at 168
\textsuperscript{891} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 18
\textsuperscript{892} Bottomley, The Constitutional Corporation: Rethinking Corporate Governance (n 710) at 90
assigned more easily. Also, the gatekeeping role, if well-governed, could have a significant effect in deterring misconduct. While this deterrence could be directly implemented by public gatekeepers, such as regulators, market gatekeepers such as lawyers, auditors, and underwriters, whose detection of misconduct depends on private incentives, could be an effective complement to direct deterrence which reduces its cost. 893

Along with regulations that could be imposed to enhance the independence of sharia auditors, the above factors, brought about by moving towards sharia firms as external auditors, would minimise any potential conflict of interests to which SSBs are exposed. Below is an illustration of how sharia firms could alleviate conflict of interests in light of these three factors.

Concerning appointment issues, the absence of sharia firms places a burden on the board of directors and management to find qualified members to serve on the SSB. In such a situation, IFIs may tend to appoint prominent names, regardless of the quality of sharia assurance they might bring. Therefore, central authority approval, that some regulations require, is essential to verify the eligibility of the members to conduct sharia auditing due to the lack of professionalism in the industry. This approval works like licencing members to serve as sharia auditors in order to assure the stakeholders of the eligibility of sharia auditors. In the absence of a professional record, prominent scholars’ names might be equivalent to the big four audit firms. In the end, the industry applies a similar process to that followed to appoint external financial auditors. Instead of acquiring regulatory approval for the appointment, audit firms are already licensed and presumed eligible to conduct audit by their relevant regulator. This saves time due to repeated inquiries to approve the appointment of external auditors. Similarly, adopting sharia firms as external sharia auditors should include this process of appointment, which ensures a higher level of independence. Moreover, by being a stronger party in the contract than SSB members, sharia firms would be able to include terms that preserve their independence and objectivity in order to avoid harming their reputational

capital. For example, punitive consequences for dismissal may be imposed in the contract and should restrict the freedom of the management regarding termination.

Regarding remuneration, sharia auditors would be more independent, operating as sharia firms rather than individuals. In the case of SSBs, the members get paid individually. However, more independence is achieved by a team of auditors who would share the income compared to solo practitioners, since income sharing reduces the efficiency of attempted corruption.\footnote{Ibid at 72} The reputational capital that gatekeepers possess is so valuable that it would not be sacrificed for a single client for a modest fee.\footnote{Coffee, 'Understanding Enron: "It's About the Gatekeepers, Stupid"' (n 451) at 1405; Stephanie Ben-Ishai, 'Corporate Gatekeeper Liability in Canada' (2007) 42 Texas International Law Journal 441 at 444} Moreover, sharia firms would reduce the power of the management to exert pressure on SSB members regarding remuneration. A sophisticated market would be established and the price would be determined accordingly. Instead of contracting individuals, IFIs would contract firms, which are in a more powerful position to determine the price. The pressure is far less to prioritise anything other than sharia interest.

Sharia firms would not experience confidentiality as a big issue. Acting as a firm, rather than individuals, would reduce the issue of confidentiality which affects SSBs mainly because of the presumption that they are affiliated with IFIs. Instead, sharia firms would have independent sovereignty, under which sharia auditors would be considered outsiders. Furthermore, a code of ethics should provide an effective solution regarding confidentiality.\footnote{Grais and Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (n 387) at 13} Also, sharia firms would provide solutions to the issue of poor quality sharia auditing associated with the excessive number of SSB memberships, which can amount to more than 100. Under no circumstances can an individual audit this number of companies while working part-time. Sharia firms which have qualified sharia auditors, assistants, and facilities could do this more effectively. More importantly, sharia firms would open the door for more individuals to join the profession and put an end to the scarcity of sharia experts in the industry. In fact, professionalising sharia supervision, which will be discussed further in the next chapter, would improve the practice.
Yet, sharia firms would not be free of challenges regarding conflict of interests. Concerns regarding the independence of external financial auditors, such as combining auditing and consultation at the same time, might be transferred to sharia firms. Therefore, similar restrictions regulating the practice of auditing need to be applied. It is suggested that the contemporary practice of auditing and the standards regarding independence is very useful to apply to sharia auditors, especially given the similarities between auditing and SSBs.\textsuperscript{897} The independence of gatekeepers, especially external auditors, has attracted intensive legal attention recently, which might be utilised in sharia firms. In all cases, sharia firms would enjoy a more independent status than SSBs.

\textbf{6.5 Accountability to Whom? Identifying the Stakeholders of Sharia Governance}

Identifying the stakeholders of sharia-compliance is a key issue in the accountability framework. Neglecting this issue usually results in importing an accountability framework that is not designed to achieve the same objectives. Consequently, accountability may be rendered to the persons who are less interested in sharia-compliance. In corporate governance, an accountability framework is applied to the shareholders to call the management to account for the performance more than the customers, whose main right is to refuse to make a purchase.\textsuperscript{898} Under sharia governance, stakeholders need to be given a different consideration and this should be reflected in the accountability framework. For an effective accountability framework, an analysis of sharia stakeholders and their interests needs to be carefully illustrated to identify important elements of accountability in sharia governance: for what? And to whom?

The discussion of to whom accountability is rendered often requires clarification of for what the accountability is conducted. These two questions are usually joined in accountability analysis.\textsuperscript{899} In the relevant literature, the question of “for what?” in sharia-compliance accountability is, arguably, mixed with accountability to God. The discussion

\textsuperscript{897} Elqari, ‘The Independence of Sharia Boards’ (n 383) at 8
\textsuperscript{898} Mulgan, "Accountability": An Ever-Expanding Concept?" (n 693) at 569
\textsuperscript{899} Colin Scott, 'Accountability in the Regulatory State' (2000) 27 Journal of Law and Society 38 at 42
about the stakeholders of IFIs refers to God, among other stakeholders. This is because Muslims believe that all actions, including financial transactions, are noted, so they must account to God for all matters. The application of this accountability means that stakeholders’ interests are not the priority but God’s will. It has been said that the most important stakeholder in IFIs is Islam itself.

However, it is somewhat inaccurate to consider God and Islam as stakeholders, among others, in IFIs while they are, in fact, the subject of accountability. This is so important to clarify in order to strengthen the position of stakeholders and not compare them with God as accountees. The consideration of God’s interest compared with those of other stakeholders might confuse the picture of sharia governance stakeholders. Satisfying God and the adherence to Islamic principles is a priority interest for the sharia-compliance stakeholders themselves and it is exactly what classifies them as stakeholders. Their interest is to prioritise Islam or God, among other interests. The aim of IFIs and their stakeholders is to be obedient to God’s will in their financial dealings. They might avoid transactions which are beneficial for both parties in order to please God and adhere to Islamic rulings, so executives, as the representatives of the shareholders, might contract customers or other stakeholders in a transaction which does not maximise the financial interest of either party, in order to please God. Accountability to God, as discussed in the literature, refers to the adherence to the rules and principles of Islamic law which is, in fact, what accountability in IFIs is about. Therefore, satisfying God should be the subject of the accountability in sharia governance, which answers the question “for what”?

God, Islam, or even sharia rulings are still insufficient to identify a clear reference to accountability in sharia governance, since they are too general subjects. As thoroughly discussed in the previous chapter, Islamic law is subject to different interpretations and understandings among Muslim scholars, a situation that makes adherence to sharia a

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900 Kasim and Sanusi, ‘Emerging Issues for Auditing in Islamic Financial Institutions: Emperical Evidence from Malaysia’ (n 745) at 12; Yaacob, ‘Issues and Challenges of Shari’ah Audit in Islamic Financial Institutions: A Contemporary View’ (n 536) at 2676
901 Basri, Nabiha and Majid, ‘Accounting and Accountability in Religious Organizations: An Islamic Contemporary Scholars’ Perspective’ (n 748) at 213, 218
902 Chapra and Ahmed, ‘Corporate Governance in Islamic Financial Institutions’ (n 222) at 14
903 Aldohni, ‘The Quest for a Better Legal and Regulatory Framework for Islamic Banking’ (n 35) at 17
controversial matter. However, the proposed standardisation mechanism, which grants national SSBs the exclusive authority to set enforceable sharia standards, would be a suitable reference for accountability in sharia governance. IFIs would be accountable for God’s will and Islamic principles based on the collective understanding of the members of the central SSB.

The question of “to whom” the directors are accountable in corporate governance is mainly affected by the approach to maximising the shareholders’ value. However, there should be a broader range of accountability that includes, in addition to shareholders as the main accountees, all persons who are affected by the conduct. Accountability might be extended in corporate governance to be rendered to, besides the shareholders, creditors, regulatory agencies such as stock exchanges and securities commissions, and consumers.

The situation within IFIs is more complex. IFIs require the same governance mechanisms that are applied in conventional institutions but, as a result of their sharia-compliant operations, they have different groups of stakeholders to consider. Therefore, the interests of these stakeholders in sharia need to be independently considered. The following examination reveals that stakeholders in IFIs should be given a different weight and consideration from how they are considered in corporate governance.

Ahmed argues that the owners of IFIs constitute the most important stakeholders of IFIs, followed by depositors. However, this might be inaccurate if sharia interest is considered. Owners, the most widely recognised group of stakeholders in corporate governance, might not be the most interested stakeholders in sharia-compliance. They might invest in an IFI for purely economic reasons without any consideration of the Islamic values to which the IFI is committed. In his classification of IFIs’ investors, Abdel

904 Keay and Loughrey, 'The Framework for Board Accountability in Corporate Governance' (n 680) at 270-272
905 Bottomley, The Constitutional Corporation: Rethinking Corporate Governance (n 710) at 82
907 Ahmed, 'Shari’ah Governance Regimes for Islamic Finance: Types and Appraisal' (n 195) at 398
Karim states that investors who are unconcerned whether or not their return is sharia-compliant are probably the majority owners while investors with a strong commitment to Islamic finance values who invest in IFIs based on this commitment might be minority shareholders.  

Economically, Islamic banks might appear very attractive to investors. Islamic banks are not allowed to give their depositors any interest in return for their deposits, which is a positive factor that enhances the stability of the banks. The prohibition on interest provides Islamic banks with the advantage of having a large amount of demand deposits which do not pay any interest. A recent report shows that demand deposits form more than 61% of the holdings of Saudi banks. This, comparatively, very high percentage places banks in a better situation to be more profitable because of the low cost of lending. It can be inferred that the conservative attitude of depositors in Saudi Arabia and their commitment to sharia principles provide the banks with this high profitability. Consequently, investors might find Islamic banks a good investment in their portfolio. Profit might be the only incentives for many shareholders in Islamic banks whose owners could even include non-Muslims.

Examining the ownership in Islamic banks in Saudi Arabia, sharia is not usually the main drive for all investors. For example, the government of Saudi Arabia is the biggest shareholder in two of the Islamic banks but its shares in all conventional banks constitute 10-64%. This indicates that sharia interest is not the main driver for the government in its decision where to invest. However, it might be argued that the government might have political or economic reasons other than profitability to invest in banks. This makes the government investment unusual, so it might not be a proper

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908 Abdel Karim, ‘The Independence of Religious and External Auditors: The Case of Islamic Banks’ (n 461) at 41
909 Hajer Zarrouk, Khoutem Ben Jedidia and Mouna Moulahi, ‘Is Islamic Bank Profitability Driven by Same Forces as Conventional Banks?’ (2016) 9 International Journal of Islamic and Middle Eastern Finance and Management 46 at 56
911 Based on the information available in Tadawul.
912 There are two main rationales behind the government ownership in banks. The first is economic to enable the government through its financial institutions to push into financial and economic development. The second is political to provide employment, subsidies, and finance politically desirable projects. See Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, ‘Government Ownership of Banks’
case to depend on. Therefore, I identified the largest 17 shareholders, after excluding any government investment, in the four Islamic banks in Saudi Arabia. At least 8 of these shareholders also hold non-sharia investments. Many of these investors are mutual funds, based in countries like England, Norway, Luxemburg, Germany and the US, where it is probable that these investments are purely profit-driven.913

While the shareholders in an IFI who care about their sharia-compliant investment might be in the minority, customers driven by religious commitment usually form the majority of an IFI’s customers.914 These customers could be categorised as depositors, IAHs,915 and consumers, who would be the borrowers in conventional banks.916 It is highly likely that these customers are religiously-driven. Arguably, they have the strongest interest in sharia-compliance of all the stakeholders. This is obvious in the case of IAHs and consumers, who would see Islamic banks as a solution to avoid dealing with directly receiving or paying interest in other banks. They benefit from the products offered as alternatives to interest-based loans or saving accounts. For them, satisfying their religious interest is more important than accessing interest-based products at a lower cost, if any.

Depositors are also an important group of stakeholders in Islamic banks. Despite the fact that conventional banks provide an option of interest-free banking accounts, depositors still have a big interest in Islamic banks. The condemnation of the payment of interest is not limited to the parties who directly pay or receive it but extends to include the witnesses and notaries to the agreements.917 It is inferred, therefore, by many scholars, that the prohibition of interest in Islam is extended to any facilitator to


913 For this analysis, I used the companies’ disclosed information available on Tadawul, the Saudi Stock exchange, as well as Thomson One Banker database. For simplicity, I only considered investments in conventional banks as a non-sharia investment.

914 Abdel Karim, ‘The Independence of Religious and External Auditors: The Case of Islamic Banks’ (n 461) at 42

915 Islamic banks create a special group of stakeholders. Instead of receiving interest on their deposit, IAHs share profit and loss like shareholders. Chapter Two explained the Islamic basis of this deposit.

916 It might be more accurate to use “consumers” rather than “borrowers” as Islamic banks do not provide loans but act as mediators to facilitate purchases.

917 Algaoud and Lewis, *Islamic Banking* (n 24) at 36
this "sinful action", which includes depositors.\textsuperscript{918} The Islamic Fiqh Council, associated with the Muslim World League, has declared that it is prohibited to deal with conventional banks while there is a sharia-compliant alternative.\textsuperscript{919} In Saudi Arabia, the Permanent Committee of Fatwa, the official institution of fatwa in the country, also adopts this opinion,\textsuperscript{920} so depositors who affiliate themselves with these fatwas would have a strong interest in Islamic banks, even though they could avoid receiving interest in conventional banks. Thus, Islamic banks would be their only choice.

The presumption of indirect dealing with interest as facilitators also applies to the employees and suppliers of Islamic banks. Employees may engage directly in writing or witnessing the payment of interest, which is clearly prohibited. Rather, they would be classified as supporting an interest-based institution. Official fatwas in Saudi Arabia on this specific matter have been issued to declare that it is unlawful to work in conventional banks.\textsuperscript{921} Similar to depositors, the suppliers of Islamic banks may have a strong interest in sharia-compliance. They could be committed to avoiding facilitating a prohibited action even at a higher financial cost. However, employees and suppliers, albeit committed to sharia, may have less interest than other stakeholders. They may find other employers or contracting parties outside the banking industry which could fulfil both their financial and religious interests.

\textsuperscript{918} Mustafa Alzarqa, 'Banks: Their Transactions, Deposits, and Interests' (2003) 1 Islamic Fiqh Council Journal 135 at 144-145,151-155

\textsuperscript{919} The Resolution of Muslim World League Council Regarding the Spread of Interest-based Banks and Receiving Interests <http://www.kantakji.com/riba/%D9%82%D8%B1%D8%A7%D8%B1-%D9%85%D8%AC%D9%85%D8%B9-%D8%B1%D8%A7%D8%A8%D8%B7%D8%A9-%D8%A7%D9%84%D8%B9%D8%A7%D9%84%D9%85-%D8%A7%D9%84%D8%A5%D8%B3%D9%84%D8%A7%D9%85%D9%8A-%D8%A8%D8%B4%D8%A3%D9%86-%D9%85%D9%88%D8%B6%D9%88%D8%B9-%D8%AA%D9%81%D8%B4%D9%8A-%D8%A7%D9%84%D9%85%D8%B5%D8%A7%D8%B1%D9%81-%D8%A7%D9%84%D8%B1%D8%A9%D9%88%D9%8A%D8%A9-%D9%88%D8%AD%D9%83%D9%85-%D8%A3%D8%AE%D8%B0-%D9%81%D9%88%D8%A7%D8%A6%D8%AF%D9%87%D8%A7.aspx> accessed 27/11/2017

\textsuperscript{920} Fatwa of The Permenant Committee No.4997 <http://www.alifta.net/Fatawa/FatawaSubjects.aspx?languagename=en&View=Page&HajjEntryID=0&HajjEntryName=&RamadanEntryID=0&RamadanEntryName=&NodeID=4714&PageID=4878&SectionID=7&SubjectPageTitlesID=4932&MarkIndex=17&#Depositingmoneyinusuriousbanks> accessed 28/11/2017

\textsuperscript{921} See for example, Fatwa of The Permenant Committee No.5317 <http://www.alifta.net/Fatawa/FatawaSubjects.aspx?languagename=en&View=Page&HajjEntryID=0&HajjEntryName=&RamadanEntryID=0&RamadanEntryName=&NodeID=4712&PageID=5487&SectionID=7&SubjectPageTitlesID=5540&MarkIndex=16#Isworkinginbanks,especially> accessed 28/11/2017
Accountability to the community is discussed as a main stakeholder in IFIs. Many individuals, civil societies and organisations in the community desire a sharia-compliant financial system.\footnote{Ahmed, ‘Shari’ah Governance Regimes for Islamic Finance: Types and Appraisal’ (n 195) at 398; Yaacob, ‘Issues and Challenges of Shari’ah Audit in Islamic Financial Institutions: A Contemporary View’ (n 536) at 2676} It is narrated that the Prophet Muhammed (PBUH) said, “A time will come over people when not a one of them will remain other than consumers of interest; and even those who do not consume it will be affected by its dust”.\footnote{Shaykh Yusuf Talal DeLorenzo, ‘Introduction to Understanding Riba’ in Abdulkader Thomas (ed), \textit{Interest in Islamic Economics: Understanding Riba} (Interest in Islamic Economics: Understanding Riba, Routledge 2006) at 1} For Muslims, this constitutes a warning about the spread of interest in the community, where earnings cannot be completely pure of interest. Accordingly, the community, as a stakeholder of sharia interest, has a concern about interest becoming mingled with other sharia-compliant earnings.

The above discussion illustrates that the stakeholders of sharia governance should not be treated similarly to those in corporate governance, where the owners are the main consideration. The significance of other stakeholders in sharia governance suggests that a different weight and consideration needs to be allocated. Therefore, it might be challenging to apply the same framework to corporate governance, where the accountability is mainly rendered to the shareholders. The traditional mechanisms of accountability used in the financial services might not produce greater stakeholder-oriented accountability, which needs a broader range to enhance stakeholders’ inclusivity.\footnote{Brennan and Solomon, ‘Corporate Governance, Accountability and Mechanisms of Accountability: An Overview’ (n 741) at 892} The remaining part of this chapter discusses this issue and proposes how accountability should be conducted to protect the special interests of sharia stakeholders.

6.6 How Accountability Should be Demonstrated?

6.6.1 The Lack of Protective Tools for Stakeholders of Sharia Interest

The discussion of the stakeholders of sharia-compliance, considered above, shows that their interests are weighted differently from those of stakeholders in corporate
governance. Shareholders are not the stakeholders who most need protection. They may have less interest in sharia-compliance than other stakeholders. Yet, shareholders have access to more protective tools, through their voice and exit strategies. Other stakeholders, with a stronger interest in sharia, may not possess these tools. An exit strategy is not always easily available to these stakeholders. When sharia violations emerge, they may be bound by a contractual relationship. For example, consumers, the borrowers in conventional banks, might be in a desperate situation if the contract with the IFI is found to be non-sharia compliant.

Voice and exit tools, however, are not meant to serve the nature of sharia interest. Sharia-compliance operations may require a different treatment in order to protect the stakeholders. Usually, sharia interest, as explained earlier in Chapter Four, needs a veto power in order to be protected. The majority needed to steer the management towards better sharia-compliance behaviour may not be possessed by the shareholders who are committed to sharia. Therefore, the best thing they can do is to sell their shares. Selling shares, however, might be ineffective as this might occur too late to act as a protective tool. Sharia violation might be discovered too late, since it is usually too difficult for non-experts to identify. While voice and exit, at least to some extent, could protect the sharia interest of shareholders, these are rarely available to other stakeholders.

In the literature, little attention has been paid to how to protect sharia interest. It tends to analyse the financial interests of these stakeholders. More specifically, protecting the financial interests of IAHs, as a unique group of stakeholders, has been the focus in the literature. Protecting the financial rights of IAHs is a dilemma for IFIs,

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925 Abdel Karim, 'The Independence of Religious and External Auditors: The Case of Islamic Banks' (n 461) at 40-41
926 Chapra and Ahmed, 'Corporate Governance in Islamic Financial Institutions' (n 222) at 44
due to the absence of loan-based structures within Islamic finance. IAIs do not have the shareholders’ rights or the protection of the lenders. They lack internal corporate protection tools, as they are unrepresented on the board and have no voting rights. They also lack legal protection as creditors, since the mudaraba mechanism is applied instead of loans, so they lose their position as being the first claimants to the bank assets. Voice representation is suggested to protect the financial interests of IAIs. Other options include extending shareholders’ rights to include IAIs, setting up a deposit insurance scheme to protect them, or creating a governance structure that caters to the IAIs’ specific needs, such as having a body of representatives to act as intermediaries. However, these mechanisms are designed to protect financial interests and may be ineffective with regard to sharia.

The voice strategy is used as a tool to protect some stakeholders in corporate governance. For example, some systems enhance accountability to employees as stakeholders by giving them similar voting power to shareholders through representation on the board. However, this mechanism has attracted criticism for constituting an ineffective and impractical approach within corporate governance. In sharia governance, as discussed, sharia stakeholders are protected by the veto power, not the voting approach. Also, it is impractical to apply voting for consumers, who are the main stakeholders. In the specific case of banking, regulators may follow different approaches to protect the financial interest of the depositors including deposit insurance schemes. Sharia-compliance, however, needs effective ex-ante and ex-post supervision which is better satisfied by a regulatory agency.

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928 El-Gamal, 'Islamic Bank Corporate Governance and Regulation: A Call for Mutualization' (n 927) at 16
929 ‘Ibid at 1
930 Chapra and Ahmed, 'Corporate Governance in Islamic Financial Institutions’ (n 222) at 44-45
931 Grais and Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (n 360) at 26-27
933 Mosunova, 'The Content of Accountability in Corporate Governance’ (n 741) at 123
934 Campbell, 'Bank Insolvency and the Interests of Creditors' (n 202) at 139
6.6.2 The Need for an Effective Regulatory Agency to Protect Sharia Interest

Whereas accountability in the corporate governance framework is designed to ultimately satisfy financial interests, it is, in sharia governance, for the God’s will, based on sharia rules and principles. Sharia scholars are responsible to God to provide clarifications regarding these rules and principles. The general presumption is that these scholars are trustworthy and credible for this job. However, undertaking this job in the business context may undermine this credibility due to the conflict of interests surrounding sharia scholars sitting on SSBs. Financial auditors are exposed to a similar concern regarding credibility. When performing external audit, auditors act as agents of the stakeholders, so there is a concern regarding trust and confidence, similar to that existing in the director-shareholder relationship, a situation that prompts the question of who is auditing the auditors. Therefore, there is a need to strengthen the accountability framework in sharia governance to restore the credibility of sharia auditors. As is the case with audit firms, where there is a regulatory authority, sharia auditors should be made accountable to a higher independent authority to increase the confidence regarding sharia-compliance.

Generally, regulators are essential within the accountability framework in the market. Corporate activities require government supervision as a source of accountability to improve efficiency. Having a regulatory authority would implement legal accountability as an additional form of accountability where there is accountability to the regulators with regard to compliance with the legal norms. In legal accountability, an outsider party would have the controlling power to impose legal obligations or sanctions. Regulatory agencies in the market play an essential role in governing and protecting the interests of the stakeholders. In fact, institutional checks are a corporate governance tool that is used to provide stakeholders with protection of their interests, since such

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935 Audit Quality Forum, 'Agency Theory and the Role of Audit' (n 730) at 10
936 Bavly, Corporate Governance and Accountability: What Role for the Regulator, Director and Auditor? (n 723) at 15
937 Keay and Loughrey, ‘The Framework for Board Accountability in Corporate Governance’ (n 680) at 268,276
protection would ensure a stronger, well-developed market.\textsuperscript{939} In a well-functioning financial system, regulators act on behalf of the society at large.\textsuperscript{940} They can be an effective actor in ensuring that their interests are appropriately considered by imposing requirements which reinforce the weak position of stakeholders and help to maintain greater trust and confidence.\textsuperscript{941} In the accounting profession, the primary purpose of the regulatory bodies is to enhance the public’s confidence in the financial reporting.\textsuperscript{942}

In sharia governance, there is a need to apply such protection through a regulatory authority, especially since the interest of the public is more salient. Implementing a regulatory authority within the accountability framework would enhance the efficiency of sharia supervision. Recently, IFSB stressed the role of a supervisory authority in determining whether an IFI applies a robust sharia governance system that ensures an effective independent oversight of sharia-compliance.\textsuperscript{943} Such an authority would play an important role in promoting sharia audit.\textsuperscript{944} Also, an independent regulator would provide the effective protection that the wide range of stakeholders needs. Its powerful position should provide the necessary protection for stakeholders who might not be very well recognised at the bank level.\textsuperscript{945} It would represent the broad range of stakeholders of sharia-compliance and become a stakeholder itself. With its powerful regulatory authority, it should set up a strong sharia governance framework in order to reinforce the trust between stakeholders and IFIs. This makes the regulatory authority a dual element in the accountability framework, where it is a stakeholder as well as responsible for sharia-compliance. This may provide an answer to both questions regarding accountability: who is accountable? and to whom?

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\textsuperscript{939} Chapra and Ahmed, ‘Corporate Governance in Islamic Financial Institutions’ (n 222) at 28-29
\textsuperscript{940} Ahmed, ‘Shari’ah Governance Regimes for Islamic Finance: Types and Appraisal’ (n 195) at 399
\textsuperscript{941} Audit Quality Forum, ‘Agency Theory and the Role of Audit’ (n 730) at 10
\textsuperscript{942} M. Canning and B. O’Dwyer, ‘Institutional Work and Regulatory Change in the Accounting Profession’ (2016) 54 Accounting, Organizations and Society 1 at 1
\textsuperscript{943} Islamic Financial Services Board, ‘Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR)’ (2015) CPIFR 16
\textsuperscript{944} Yazkhiruni Yahya and Nur Mazilah Mahzan, ‘The Role of Internal Auditing in Ensuring Governance in Islamic Financial Institution (IFI)’ (2012) (3rd International Conference on Business and Economic Research) at 1640
\textsuperscript{945} Ahmed, ‘Shari’ah Governance Regimes for Islamic Finance: Types and Appraisal’ (n 195) at 405
\end{flushleft}
The discussion about the need for a regulator within the accountability framework in sharia governance should consider the four accountability elements (reporting, explaining, questioning, and the possibility of consequences) to assess how they are better off with such a regulator. The regulator would be necessary to implement the rights of stakeholders to be accounted to through acting on their behalf. Currently, SSBs at both levels are seen as responsible for protecting the rights of all stakeholders of sharia-compliance based on its role as the guarantor of the sharia-compliance of the business.\textsuperscript{946} The role of the national SSBs, however, is insufficiently effective to act as a regulatory authority. The standardisation of sharia rules and principles, although inadequate, as discussed in the last chapter, is their main objective. Where there exists a sharia governance framework, the central bank usually acts as a regulator. Regardless of the source of authority, the regulator should enhance the four elements of accountability.

Concerning transparency as a main factor of accountability, which touches upon reporting and explaining, the practice suggests that it is weak and insufficient to inform stakeholders of the level of sharia-compliance. The issue of sharia-compliance disclosure has not received sufficient attention either from IFIs or regulators.\textsuperscript{947} Transparency in sharia compliance does not seem to be widely prevalent and the disclosure of the SSBs’ decisions and their process is very weak, which threatens stakeholders’ confidence.\textsuperscript{948} In fact, some prominent SSB members argue against the disclosure of sharia violations within an IFI, since these could be solved internally, without threatening its reputation.\textsuperscript{949} This completely neglects the right of stakeholders to be informed and protected. In practice, there is a significant number of IFIs which do not submit a sharia report to the general assembly.\textsuperscript{950} If submitted, the items disclosed in sharia reports are usually very limited, where many important ones are missed. For example, it is rare for the reasoning and arguments underlying the SSB’s opinions to be

\textsuperscript{946} Greuning and Iqbal, \textit{Risk Analysis for Islamic Banks} (n 360) at 52
\textsuperscript{947} Onagun and Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ (n 181) at 74
\textsuperscript{948} Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 8-9,14-15
\textsuperscript{949} Elqari, ‘Legal Jurisdiction and Criminal Protection for Sharia Boards’ (n 353) at 9
\textsuperscript{950} Malkawi, ‘Shari‘ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 562
made available.\textsuperscript{951} Also, the criteria for the selection and appointment of SSB members as well as the quantitative and qualitative dimension of the SSB’s financial and non-financial rewards are not clearly disclosed publicly.\textsuperscript{952} In Malaysia, where there is an advanced sharia governance framework, sharia reports consist of only a short statement that the relevant IFI is in compliance with sharia.\textsuperscript{953}

The literature assigns several reasons to the lack of transparency regarding sharia applications in the industry. First, the lack of standardisation promotes the non-disclosure of sharia applications. Scholars might choose not to disclose their disagreements with other scholars.\textsuperscript{954} Second, the nature of Islamic banking, which requires innovation, may be added as a reason for the lack of transparency regarding sharia applications. The severe competition in the industry inhibits the disclosure of innovative sharia-compliant products.\textsuperscript{955} Usually, Islamic banking is less transparent than conventional banking, due to a concern that too much disclosure might promote the imitation of sharia-compliant products by other IFIs.\textsuperscript{956} Third, the ignorance about sharia among stakeholders is also another reason for non-disclosure.\textsuperscript{957} Understanding detailed sharia reports might be too difficult for non-experts, which reduces the need for sharia reports. This leads to the fourth reason, which is the credibility of the sharia supervision within IFIs. To increase the customers’ trust, IFIs tend to appoint religiously reputable members to their SSBs. In sharia-compliance, credibility is achieved not by more disclosure but by the reputation of SSB members.\textsuperscript{958} Fifth, another reason for the non-disclosure of the sharia findings is that Islamic banking is in an early stage, where

\textsuperscript{951} Casper, ‘Sharia Boards and Sharia Compliance in the Context of European Corporate Governance’ (n 325) at 6; Farook and Farooq, ‘Shari’ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (n 458) at 153
\textsuperscript{952} Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 137
\textsuperscript{954} Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 290
\textsuperscript{955} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 143
\textsuperscript{956} Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 139
\textsuperscript{957} Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 290
\textsuperscript{958} Nienhaus, ‘Governance of Islamic Banks’ (n 572) at 139
sharia observations might not only harm the specific IFI but even the whole industry. Sixth, the sensitivity of the issue of sharia-compliance could be another reason for the low level of disclosure. Regulators in Muslim countries might be reluctant to take action against IFIs which might be deemed as taking action against the whole Islamic finance industry. This might be attributed, to some extent, to the final reason, which is the very little legal attention being paid to disclosure. The industry lacks legal consequences for non-disclosure, which might also be reflected by the lack of economic incentives for disclosure. The imposition of legal consequences for non-disclosure would encourage IFIs to achieve a higher level of transparency. As a result, IFIs with a higher level of transparency would be more attractive to stakeholders of sharia governance.

The last reason, which is the lack of enforceable regulations for transparency, is very important when considering the role of the regulator in the industry to enhance the transparency of sharia-compliance legally by imposing items for mandatory disclosure in sharia reports or other means. Other reasons might be temporary and could change over time or are caused by the weak accountability framework of sharia supervision and the lack of professional practice regarding sharia auditing. Therefore, these factors could be deterred by imposing regulations that reinforce the accountability framework where transparency is strongly promoted.

Greater transparency regarding sharia-compliance would bring advantages to both the stakeholders and the industry as a whole. This includes, first, increasing stakeholder confidence. The existence of the agency problem and consequently information asymmetry in sharia governance makes transparency an essential requirement for increasing trust and confidence. Second, it would educate the public and minimise the ignorance about the industry, thereby giving the public a broader role in supervising

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961 Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions' (n 314) at 562
962 Obid and Naysary, 'Toward a Comprehensive Theoretical Framework for Shariah Governance in Islamic Financial Institutions' (n 168) at 308
This would reinforce the status of the public and other poorly-protected stakeholders. Third, it would be very important to protect the interest of the public and other stakeholders. Greater transparency would provide the stakeholders, including the public, with useful information about the extent of sharia-compliance. In Islamic societies, such information is essential, since it provides an indication of the level of compliance with various Islamic obligations. For example, it is in the interest of the public in Muslim societies that zakat is properly calculated and distributed. Therefore, information regarding this obligation should be disclosed. The high level of transparency would provide a basis for a more competitive environment, where IFIs would compete for more creative sharia-compliant products and services. Such an environment strengthens the position of the stakeholders and provides greater protection over their interests. Finally, there are some economic advantages associated with greater transparency. For example, the cost of assessing the quality of internal sharia audit would decrease. Also, greater transparency, as indicated earlier, would attract more stakeholders and provide an economic incentive to IFIs.

For more effective transparency, it is suggested that sharia reports should follow the process and procedures of financial audit. For example, sharia reports should include non-compliance instances, and the management’s failure to address certain issues regarding sharia application. Mulyana and Ibrahim suggest that the ideal sharia audit report should contain:

- The objective of the sharia audit.
- The process and procedures followed when undertaking a sharia audit.
- An opinion regarding the extent of sharia-compliance.
- Details about the breaches and violations of sharia principles.

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963 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 8-9
964 Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 562
965 Iqbal and Lewis, An Islamic Perspective on Governance (n 164) at 276-277
966 Mulyany and Ibrahim, ‘Shari’ah Audit for Islamic Financial Institutions (IFIs): Perceptions of Accounting Academicians, Audit Practitioners and Shari’ah Scholars in Malaysia’ (n 953) at 20-21
967 Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) at 9
968 Onagun and Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ (n 181) at 78-79
• Implications.
• Recommendations for improvement.\textsuperscript{969}

The transparency and disclosure requirements also need to reflect the unique requirements of sharia governance. For example, the percentage of non-sharia compliant earnings and how these earnings were distributed should be disclosed.\textsuperscript{970} Another example is the unique competitive environment within the industry due to the need for innovative products. To minimise the competition drawback due to the disclosure of sharia-compliance, reporting can be limited to the general principles utilised to design the specific products, without stating the exact details.\textsuperscript{971}

The role of the regulator is not limited to imposing disclosure requirements but extends to playing an important role in enhancing other elements of accountability. Sharia knowledge is essential for the reporting, explaining, and questioning elements of accountability. However, the knowledge of stakeholders might be insufficient to protect their interests due to the difficulties associated with understanding certain sharia rulings. Therefore, it is necessary to have a legal authority which has the required expertise to understand sharia reports and other disclosed sharia explanations, and also to question any doubtful sharia-compliance issues. This legal authority would, therefore, act on behalf of the stakeholders to ensure sharia-compliance. While such a role is played by other regulators in the market, it is more demanding in sharia governance. It was explained before that, unlike in the case of corporate governance, stakeholders other than shareholders are more likely to be the most interested group of stakeholders but the least protected ones. Also, the protective tools within corporate governance provided to shareholders, such as voice and exit, cannot work effectively to protect sharia stakeholders. In such a case, the regulatory authority would provide an effective

\textsuperscript{969} Mulyany and Ibrahim, ‘Shari’ah Audit for Islamic Financial Institutions (IFIs): Perceptions of Accounting Academicians, Audit Practitioners and Shari’ah Scholars in Malaysia’ (n 953) at 20
\textsuperscript{970} Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 143
\textsuperscript{971} Farook and Farooq, ‘Sharī‘ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (n 458) at 156
platform for the elements of accountability to be implemented in sharia governance along with the sharia expertise needed to protect sharia stakeholders.

The regulatory authority would also implement the possibility of consequences as an element of accountability. In the context of stakeholder accountability, there might be some questions about certain elements of accountability. While reporting and probably explaining and questioning could be provided through the internet and other networks, the possibility of judgement and sanctioning is often lacking for stakeholders.972 Again, the protective tools provided to shareholders in corporate governance, as the main group of stakeholders, such as voting to hold directors accountable, would be unavailable to other stakeholders as a more superior group in sharia governance. Therefore, these stakeholders need a regulator to represent and protect their interests through its power to impose sanctions. Moreover, having a regulatory authority to impose traditional sanctions would foster public supervision via other mechanisms, such as social pressure (naming and shaming), and advocate consumers and groups, who would have the tools to exert political, economic, and legal pressure.973

It might be useful to refer to the application of such elements of accountability in the accounting and auditing profession. In the US and Canada, regulatory authorities related to accounting conduct regular inspections of accounting firms, which involve reviewing a sample of the firm’s audit engagement and evaluating the firm’s quality control.974 This is also applied in other jurisdictions, such as the UK 975 and Saudi Arabia.976 In many jurisdictions, the regulatory authority issues a critique of the performance of audit firms following these inspections.977 Some would allow even foreign regulators to conduct such inspections.978 In cases of non-compliance, the

972 Bovens, 'Analysing and Assessing Accountability: A Conceptual Framework' (n 688) at 457
973 Schneiberg and Bartley, 'Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century' (n 585) at 42
974 Gorman, 'Professional Self-regulation in North America: The Cases of Law and Accounting: Professional Self-regulation' (n 888) at 500-501
975 Audit Quality Review <https://www.frc.org.uk/auditors/audit-quality-review> accessed 23/1/2018
977 Kleinman, Lin and Palmon, 'Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes' (n 485) at 62
978 Ibid at 76
authority can impose penalties, which include the suspension or loss of the licence to practise.979 The idea of auditing the auditor aims to check the quality of the auditor's work and ensure it is sufficient to meet and protect the public objectives.980

In sharia governance, there is a need to implement a similar authority to act as an enforcement of the law and impose sanctions and other consequences on sharia firms and IFIs. Such behaviour would increase the awareness of the level of sharia-compliance and give the public and other stakeholders an effective supervisory role that they are currently lacking. The framework of sharia supervision lacks legal liability as far as SSB members are concerned; they should be held liable in cases of negligence.981 The issue of liability in the case of non-compliance with sharia is ambiguous and vague. Insufficient sharia review, the non-reporting of sharia violations, and negligence of conducting sharia supervision are instances of negligence which might harm the reputation of the industry.982 Therefore, it is important to draw a framework whereby the wrongdoers, including sharia supervisors, could be held liable.

Relevant to this discussion is the extent of monitoring and enforcement that the regulator should exercise and undertake; more specifically, whether regulators should only exercise ex-post scrutiny, such as imposing sanctions or there is a need for ex-ante scrutiny as well. In fact, the former predominates.983 It should be noted that ex-ante does not substitute for ex-post.984 It only works as an additional form to enhance accountability. It includes official inspections, regulating activities and input prior to misconduct, and the efforts to prevent misconduct.985 It is argued that ex-ante provides

979 Gorman, ‘Professional Self-regulation in North America: The Cases of Law and Accounting: Professional Self-regulation’ (n 888) at 496
980 Singh, ‘The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper?’ (n 203) at 92-93
981 Nazih Hammad, Understanding Islamic Law in Contemporary Banking and Financial Transactions: New Approach (Dar Alkalam 2007) at 372-377
982 Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 142
983 Laura A. Dickinson, ‘Privatization and Accountability’ (2011) 7 Annual Review of Law and Social Science 101 at 105
984 Keay and Loughrey, ‘The Framework for Board Accountability in Corporate Governance’ (n 680) at 269
985 Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (n 445) at 57
a prophylactic effect, which serves the purpose of accountability. The process of accountability should involve the prevention and anticipation of misconduct to adjust the norms when necessary. This would enable the regulatory body to exercise greater scrutiny over institutions to ensure a stronger form of accountability. Also, ex-ante may be helpful if the issue is highly complex, too costly to evaluate, or the consequences may appear too late. In such cases, ex-ante would help to lower non-compliance instances.

Ex-ante, however might involve some limitations. Regulators might be reluctant to exercise ex-ante. They might prefer not to exercise ex-ante in an attempt to avoid any responsibility for authorising certain actions that might lead to the accountor being held liable. Also, there is a concern that the accountor may use ex-ante to shift its accountability burden. In this case, it is suggested that sufficiently high ex-post punishments may deter the accountor from using ex-ante to escape liability and deviate from its duties.

Ex-ante accountability has several applications in the sharia governance framework in certain jurisdictions. For example, national SSBs in Indonesia, Pakistan, and Malaysia have a responsibility to approve products before they are offered on the market. As the practice of sharia supervision is developing, the desire for more ex-ante might become persistent and more demanding. The practice needs more guidance from the regulator in order to properly conduct its duties. While the practice matures, the regulator may exercise less ex-ante accountability.

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987 Bovens, 'Analysing and Assessing Accountability: A Conceptual Framework' (n 688) at 453
988 Richard Mulgan, Holding Power to Account: Accountability in Modern Democracies (Palgrave Macmillan 2003) at 19-20
990 Keay and Loughrey, 'The Framework for Board Accountability in Corporate Governance' (n 680) at 276
992 Ahmed, 'Shari’ah Governance Regimes for Islamic Finance: Types and Appraisal' (n 195) at 401
To sum up, the weak position of sharia stakeholders demands an effective regulatory authority to fill the gap and create stronger accountability by enforcing more comprehensive sharia reports, and implementing explanatory and question stages of accountability. As a law enforcement agency, the regulator would implement consequences more effectively. The chance of preventing non-sharia compliant actions would increase due to having an accountability framework that demands more reporting requirements and imposes consequences for violations. Such a framework of accountability would provide better protection for the interests of sharia stakeholders.

6.6.3 The Regulatory Authority and Hisba Institutions

The concept of *hisba* was introduced previously as an ethical arrangement for ensuring sharia-compliance that serves, to some extent, the objectives of sharia governance in Islamic banks. The application of *hisba* is intended to cover many aspects, including financial transactions. Some view sharia auditors, such as SSBs, as a modern application of *hisba* in banks.\(^9\) This argument implies that the historical practice of *hisba* in the market, which involved the authority to withdraw the licences from violators of sharia, which sometimes extended to money exchange services, could be applicable to SSBs.\(^4\) The argument continues that SSBs have the capacity to act as *muhtasib*, the person who performs *hisba* and could be characterised as the Islamic version of an ombudsman, which involves: the authority to hear complaints inside or outside the corporation regarding the compliance status of its transactions; the authority

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94 Zaidaneen, ‘The Islamic Shari’ah Control on Islamic Banks: Views and Application’ (n 347) at 93; Lahsasna, Ibrahim and Alhabshi, ‘Shariah Audit: Evidence & Methodology in Islamic Finance’ (n 698) at 5
to investigate the matter and take adequate actions; and the authority to prohibit staff from engaging in non-sharia compliant transactions.\textsuperscript{995}

However, applying \textit{hisba} to SSBs or sharia firms is somewhat inappropriate. While similarities exist, to some extent, between these two institutions, the source of authority in \textit{hisba} is significantly different and inapplicable to private services such as SSBs or sharia firms. \textit{Hisba} institutions are defined as “a public service paid by the government to perform the role of market supervision to ensure sharia compliance. It should have the power to rectify any sharia violation, enforce sharia rules and sanctioning violators”.\textsuperscript{996} Through \textit{hisba} institutions, it is the aim of the Islamic state to exercise comprehensive control over economic and social practices.\textsuperscript{997} It is not necessary, however, for \textit{hisba} institutions to be under the state authority as it could be an independent non-governmental organisation but the independence factor is crucial and \textit{Muhtasib} is expected to be fully independent of the market, both in fact and in appearance.\textsuperscript{998} Therefore, \textit{hisba} does not apply to the nature of SSBs, where the members are appointed and paid privately to ensure sharia-compliance.\textsuperscript{999}

\textit{Hisba} institutions were mainly established to protect the religious interest of society as a whole from any deviance.\textsuperscript{1000} Therefore, implementing an independent regulator to ensure sharia-compliance would be a more accurate contemporary application of \textit{hisba} in the field of Islamic finance. Under this authority, both the roles of \textit{hisba} and its public authority, as an independent source of supervision, would be applicable. In fact, such an authority would be consistent with certain theoretical approaches that stress the importance of the political power to enforce desirable behaviour. Ibn Khaldoon, a well-known sociologist (D. 1406), argues that, without the political will to implement laws

\begin{thebibliography}{999}
\bibitem{995} Muneeza and Hassan, ‘Shari’ah Corporate Governance: The Need for a Special Governance Code’ (n 173) at 126
\bibitem{997} Iqbal and Lewis, \textit{An Islamic Perspective on Governance} (n 164) at 263
\bibitem{998} Yaacob, 'Issues and Challenges of Shari'ah Audit in Islamic Financial Institutions: A Contemporary View' (n 536) at 2674-2675
\bibitem{999} Alkhamees, 'The Impact of Shari'ah Governance Practices on Shari'ah Compliance in Contemporary Islamic Finance' (n 323) at 140
\bibitem{1000} Yahya and Mahzan, 'The Role of Internal Auditing in Ensuring Governance in Islamic Financial Institution (IFI)' (n 944) at 1639
\end{thebibliography}
effectively, moral norms, including sharia, cannot be reflected in societies, which might lead to chaos.\footnote{Ibn Khaldun, \textit{Muqaddimah: An Introduction to History} (3 edn, Maktabat al-Madrasah and Dar al-Kitab al-Lubnani 1967) at 337} Therefore, the political authority needs to be responsible for checking all morally objectionable behaviour, dishonesty, fraud, and unfairness that are harmful to socio-economic development.\footnote{Chapra and Ahmed, ‘Corporate Governance in Islamic Financial Institutions’ (n 222) at 30} Nowadays, this is reflected in the legal institutions, which play an important role in preventing undesirable behaviour, where individuals otherwise may behave in a way that undermines the foundations of the system, leading to social chaos and economic collapse.\footnote{Douglass C. North, \textit{Structure and Change in Economic History} (Norton 1981) at 53-54}

\section*{6.7 Conclusion}

In this chapter, the accountability framework for the auditing role of SSBs has been examined. Accountability is an important concept in corporate governance and it has received insufficient analysis within sharia governance. The analysis shows that the framework needs to be strengthened by employing sharia firms and a regulatory authority to facilitate better sharia supervision and auditing practice to reinforce the four elements of accountability and provide improved protection for sharia stakeholders.

The nature of sharia interest has unique characteristics that may not be protected by the same traditional tools available within corporate governance. Sharia auditing might be the only tool to provide such protection. Currently, the practice of external sharia auditing, if conducted at all, is very weak and does not reflect its importance within sharia governance which, as argued, might exceed the importance of financial auditing. The accountability framework proposed in this chapter would promote better performance of sharia auditing as a protective tool.

In this framework, the responsibility owed to the board of directors for ensuring sharia-compliance should be similar to that related to external auditing. The board should ensure that the appropriate governance mechanism is available to conduct an objective independent audit. Regarding sharia-compliance assurance, the task is usually entrusted to SSBs. However, the lack of independence with regard to auditing,
as illustrated in the chapter, is problematic. The chapter suggests that sharia firms would conduct sharia audit in a more professional and objective manner, and suit the role of gatekeepers better than SSBs in conducting the auditing role.

In sharia governance, the protection of stakeholders need not be similar to that under corporate governance. The protective tools provided mainly to shareholders cannot effectively protect sharia interest. Moreover, unlike corporate governance, shareholders are usually less interested in sharia-compliance than other stakeholders. In this unique situation, it is essential to insert a regulatory authority into the accountability framework as an actor on behalf of the stakeholders. It would implement the four elements of accountability more effectively through its authoritative power and the necessary knowledge of sharia that would otherwise be difficult for the stakeholders to understand. Moreover, it would be a contemporary application of the *hisba* institution that has historically been practised in Islamic states.
Chapter Seven: SSB-free Islamic Banks: Toward a More Efficient Sharia Governance Model

7.1 Introduction

In the previous chapters, the roles of the SSB have been discussed and analysed. Suggestions have been made regarding reassigning these roles to different institutions in order to ensure more objective and effective sharia supervision. This chapter describes how the combination of these institutions could form an SSB-free bank model as a new sharia governance framework which redefines and reassigns the roles of sharia supervision more professionally.

The introduction of this model would provide some benefits beyond having effective sharia supervision. The lack of professional practice among sharia supervisors as well as the impractical application of this religious practice could be obstacles to the market. This chapter discusses how this new model would help to overcome such challenges. It should be noted that it is not the aim of the chapter to thoroughly address and analyse the issues of professionalisation and practicality in the industry. It is limited solely to how the proposed model might push the industry toward more professionalised and applicable practice.

7.2 The Model Explained

In the SSB-free model of sharia governance, the roles of the traditional SSB should be separated and assigned to different institutions and mechanisms which need to be established in the governance framework. This includes a Sharia Standard-setting Board, a regulatory authority, sharia firms, internal mechanisms within IFIs, and international agencies. Below is a brief description of the roles of each of these within the model.

Hamid and Mishaal view SSB-free banks as the future of the Islamic finance industry when it achieves a satisfactory level of sharia governance.\textsuperscript{1004} This proposed model is

\textsuperscript{1004} Ginena and Hamid, \textit{Foundations of Shari'ah Governance of Islamic Banks} (n 134) at 280; Mashal, 'Shari'ah Regulation by Central Bank on Islamic Financial Institutions' (n 541) at 548-549
an attempt to create a comprehensive framework for sharia supervision that involves all the roles of SSBs and enhances the accountability and standardisation framework.

**Sharia Standard-setting Board**

A sharia Standard-setting Board needs to be established in this model to satisfy the standardisation need explained in Chapter Five. The main role of this board is to set sharia standards which are to be applied by IFIs. Its authority should be similar to that of the central SSBs, which exist in certain jurisdictions. However, to overcome the limitations related to standardisation within central SSBs, this board needs to be more comprehensive and eliminate any role of setting sharia standards which is done by internal bodies within IFIs. The board should be responsible for issuing a detailed set of the adopted opinions of sharia rules and principles regarding Islamic finance issues. Disclosure of the process of setting standards is very important to ensure objectivity and a degree of certainty. In accounting, the standard setters have been criticised for the volume of important work that has been conducted informally as unwritten procedures, which have negatively affected objectivity.\(^{1005}\) Therefore, it is also important to disclose the reasoning behind the adoption of these opinions, to increase transparency. This would provide clearer guidance and a better understanding of the objectives of the standards when they are applied to design or review sharia-compliant products. The board, based on regular assessments of the industry, should update the standards with any necessary additions or amendments.

As discussed before, it is ideal to adopt the sharia standards set by international organisations such as AAOIFI to promote greater harmonisation globally. In this case, national boards would be important for assessing the applicability of the standards nationally and making any necessary amendments, if needed.

In short, a Sharia Standard-setting Board offers an alternative to internal SSBs within IFIs for issuing *fatwas* and ensuring sharia standards. The board needs to be fully independent and, ideally, disassociated from governmental institutions such as central

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\(^{1005}\) Cooper and Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (n 581) at 426
banks. It may be associated with religious-based establishments, as that should not have an effect on its objectivity and independence. In Saudi Arabia, for example, such a board could be established and appointed by BSU, the highest religious authority in the country, whose members are appointed by the King. Its independent status and religious commitment would provide stakeholders with an assurance that the Sharia Standard-setting Board had been established objectively and would effectively protect their religious interests.

**The Regulator**

The need for a regulatory authority was justified in the previous chapter. The role of such an authority in the model is to complement the Sharia Standard-setting Board. While the board concerns sharia rulings, the regulator would be the law enforcement body and set the technical regulatory instruments. Therefore, the regulator, preferably, should be established as a governmental or semi-governmental authority and given legal authority to conduct its duties. Trebilcock categorises the regulatory instruments that should be employed by the regulator into either input or output regulations.\(^{1006}\) Input regulations include licensing, and mandatory continuing education and periodic requalification. Output regulations include civil liability, standard-setting and enforcement, and the disciplinary process. Applying these instruments, the regulator would have four main roles which aim to enhance the sharia governance and accountability framework as well as promote more professional practice. These roles are:

1. Licensing sharia firms, sharia auditors, and other specialised practitioners in the industry.
2. Promoting the profession of sharia auditors and other specialised practitioners by setting up the qualification and competence requirements for them, and grant certificates. Continuing education may be imposed on professionals and sharia firms by requiring a set of training hours for employees.

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3. Imposing legal rules in the industry, such as codes for governance, transparency, ethics, and accounting and auditing standards for sharia-compliant transactions.
4. Adopting disciplinary schemes.

With such a central supervision, the industry would be more regulated which could lead to a concern about competition being inhibited due to the greater regulation. Consequently, innovation would be affected.\textsuperscript{1007} However, less regulation could be a concern as well. Due to the lack of regulation, the current practice of the industry applies certain strategies that have negative effects on competition and innovation. For example, the multi-membership of SSBs constrains the designing of innovative products. Having the same members of SSBs to supervise the compliance of products in different IFIs would probably lead to the production of similar products. As a result, less innovative products would be launched. In regulated jurisdictions, however, multi-membership is usually restricted, so regulation does not always limit competition. Yet, it is important to address the issue of competition when introducing a new regulatory framework in the industry. While traditional command-and-control regulations may be assumed to suppress competition, new, more flexible forms of regulation have been introduced recently to foster competition by adopting more engaged, coordinated, and intervening strategies.\textsuperscript{1008} These new forms should be considered by the regulator in the industry where innovation is essential for competition.

\textit{Sharia Firms}

It has been argued that the structure of SSBs as an insider body is inconsistent with its gatekeeping role that verifies sharia-compliance within IFIs. Alternatively, sharia firms were suggested to conduct the sharia auditing and verification role. These firms may provide consultation and advisory services with some restrictions regarding the issue of conflict of interests. This includes, for example, restrictions on combining auditing and non-auditing services for the same client. For more efficient practice and an enhanced

\textsuperscript{1007} Nienhaus, 'Governance of Islamic Banks' (n 572) at 142
\textsuperscript{1008} Schneiberg and Bartley, 'Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century' (n 585) at 42-43
model, it is important that the legal framework of sharia firms considers the ideal attributes of gatekeepers, which are described by Goergen as:

1. Be independent from the companies they supervise.
2. Have access to the information required to carry out their duties.
3. Be free from conflict of interests.
4. Have the necessary skills to carry out their duties.
5. Have the correct incentives which may include reputation and legal liability.
6. Have sufficient power to force companies to disclose the information required to fulfil their duties and prevent any wrongdoing.
7. Provide meaningful, reliable third-party verification and certification for investors and other stakeholders or users to assess the quality of the corporation.¹⁰⁰⁹

An important issue, related to external sharia auditing in this model, is whether this task should be conducted by the audit firms due to their expertise in auditing or by the newly-formed sharia firms. There is a call to enable audit firms to conduct sharia auditing after acquiring the necessary knowledge about sharia, since they have already acquired the necessary accounting and auditing skills.¹⁰¹⁰ However, audit firms may not be the ideal choice for conducting sharia audit. The scope of sharia auditing is different, as it concerns sharia aspects.¹⁰¹¹ While financial audit focuses on financial aspects and, more specifically, the accuracy of financial statements, sharia audit concern the sharia-compliance of the organisation’s overall activities and operations.¹⁰¹² This includes a wider scope to review, including the policies, processes and procedures, contracts and agreements, financial statements and reporting, human resource management, social activities and contributions, marketing and advertising, reports and circulars, zakat

¹⁰⁰⁹ Goergen, International Corporate Governance (n 136) at 194-195
¹⁰¹⁰ Yaacob, 'Issues and Challenges of Shari'ah Audit in Islamic Financial Institutions: A Contemporary View' (n 536) at 2674
¹⁰¹¹ Malkawi, 'Shari'ah Board in the Governance Structure of Islamic Financial Institutions' (n 314) at 560
¹⁰¹² Shafii, Abidin and Salleh, 'Integrated Internal-External Shariah Audit Model: A Proposal towards the Enhancement of Shariah Assurance Practices in Islamic Financial Institutions' (n 959) at 3
calculation and payment, and IT systems.\textsuperscript{1013} It could be said that, instead of auditing only financial statements, sharia auditing covers the whole institution, including its objectives, processes, personnel, and financial and non-financial aspects,\textsuperscript{1014} so audit firms might not be equipped to conduct sharia audit effectively.\textsuperscript{1015} Moreover, sharia advisory services which require sharia expertise would be better offered by specialised sharia firms rather than audit firms.

Sharia firms would provide a more specialised service in the market. It might be more practical at the beginning to get audit firms involved, to some extent, and benefit from their experience of auditing. However, separate sharia firms, as more specialised gatekeepers, are better for the industry. Tuch argues that, with multidisciplinary firms, misconduct would be less optimally deterred.\textsuperscript{1016} Instead, he continues, multiple gatekeepers, where services intersect, overlap, and complement each other due to their broken boundaries, would be more efficient. Consequently, a web of gatekeepers would be created, to cross-check each other. In light of this argument, separate sharia firms to conduct sharia audit along with the financial audit conducted by audit firms would enhance the multiple gatekeepers’ network and increase the efficiency of the auditing practice.

Cost might be argued to be an issue to challenge the idea of sharia firms conducting external audit. The same argument has been employed to challenge the idea of gatekeepers. In fact, the concept of gatekeepers economically reduces the cost since they will build up greater knowledge of the transaction structures and standard forms which enable them to provide cheaper services than the corporation itself where the transactional flow is weaker.\textsuperscript{1017} Also, it is unfair to assess the cost from one perspective. Independent audit may be mainly regarded by managers as an additional cost but other stakeholders, on the other hand, find it justifiable and effective to protect

\begin{footnotesize}\begin{enumerate}
\item[1013] Najeeb and Ibrahim, ‘Professionalizing the Role of Shari'ah Auditors: How Malaysia Can Generate Economic Benefits’ (n 735) at 94
\item[1014] Onagun and Mikail, ‘Shari'ah Governance System: A Need for Professional Approach’ (n 181) at 78
\item[1015] Kasim and Sanusi, ‘Emerging Issues for Auditing in Islamic Financial Institutions: Empirical Evidence from Malaysia’ (n 745) at 12
\item[1016] Tuch, ‘Multiple Gatekeepers’ (n 443) at 1601-1602
\item[1017] Ibid at 1593-1594
\end{enumerate}\end{footnotesize}
their interests.\textsuperscript{1018} From their perspective, the premium fees paid for the services provided by gatekeepers aim to provide trust and deter negligence and corruption.\textsuperscript{1019} This also applies to independent regulators and Sharia Standard-setting Boards, whose benefits exceed their associated costs.

In the specific case of sharia firms as gatekeepers, cost should not be a big issue. IFIs are already paying a high remuneration to their own SSB, so the cost is only made more efficient in protecting the interests of the stakeholders. In fact, sharia firms reduce the cost of internal audit and provide the benefit of exposure to a variety range of expertise.\textsuperscript{1020} Taking into consideration the role of the regulatory authority in regulating the profession and the official recognition of the practice, the cost of searching for Islamic finance experts would be reduced for IFIs as well, since there would be officially licensed experts from whom the IFIs can choose. Moreover, it is argued that the professional discipline, which this model aims to enhance, could reduce the cost associated with regulation.\textsuperscript{1021}

**Internal Mechanisms within IFIs**

It has been argued that the ultimate responsibility for sharia-compliance within IFIs rests with the board of directors, which must ensure that the appropriate governance mechanisms are in place to assure the stakeholders of compliance. Among these mechanisms are the internal audit and the audit committee. While internal sharia audit is already in effect in IFIs, there is a need to consider sharia audit within the responsibility of audit committees. As stated before, experts in sharia auditing should preferably be appointed to the committee, whether they are independent directors or, where it is allowed, non-director members.

\textsuperscript{1018} P. D. Wedemeyer, 'A Perspective on the PCAOB-Past and Future' (2014) 28 Accounting Horizons 937 at 938
\textsuperscript{1019} Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (n 445) at 97
\textsuperscript{1020} Abdul Rahman, ‘Shariah Audit for Islamic Financial Services: The Needs and Challenges’ (n 762) at 5-6
\textsuperscript{1021} Coffee, *Gatekeepers: The Professions and Corporate Governance* (n 440) at 156
International Agencies in the Model

International agencies play a key role in developing internationally acceptable standards and strengthening the industry structure; specifically, IDB, AAOIFI, IFSB, IIFM, and IIRA.\(^\text{1022}\)

These agencies cover different aspects and their roles may overlap. AAOIFI and IFSB complement each other in standard-setting for the industry globally. In addition to sharia and governance standards, AAOIFI attempts to design accounting and auditing standards suitable for IFIs' operations to complement, rather than conflict with, the International Accounting Standards (IAS) and fill the gap regarding Islamic financial transactions.\(^\text{1023}\) IFSB serves as an international standard-setter to ensure a sound, stable industry that promotes a more transparent, developed sharia-compliant market in the fields of banking, capital market, and insurance.\(^\text{1024}\) While AAOIFI complements IAS, IFSB does the same with the Basel Committee.\(^\text{1025}\) The aim of IIFM is to ensure a sharia-compliant capital market.\(^\text{1026}\) While the main objective of IDB is to enhance the economic development and social progress of its members, the promotion of the Islamic financial industry and institutions is included among its objectives.\(^\text{1027}\) Similar to international rating agencies such as Fitch, Moody’s, and Standard & Poor’s, IIRA provides ratings regarding the solvency, sharia-compliance, and corporate governance of IFIs.\(^\text{1028}\) Since sharia-compliance does not lie within the scope of the international rating agencies, IIRA aims to fill this gap.\(^\text{1029}\) It is argued that international rating agencies may conduct inaccurate rating of IFIs due to a lack of understanding of Islamic

\(^{1022}\) Mohammed El Qorchi, 'Islamic Finance Gears Up' (2005) 42 Finance & Development 46 at 48
\(^{1023}\) Greuning and Iqbal, \textit{Risk Analysis for Islamic Banks} (n 360) at 58
\(^{1024}\) Bouheni and Ammi, 'Banking Governance: What's Special About Islamic Banks?' (n 588) at 1628
\(^{1025}\) Greuning and Iqbal, \textit{Risk Analysis for Islamic Banks} (n 360) at 59
\(^{1026}\) Christos Alexakis and Alexandros Tsikouras, 'Islamic Finance: Regulatory Framework - Challenges Lying Ahead' (2009) 2 International Journal of Islamic and Middle Eastern Finance and Management 90 at 94
\(^{1027}\) Ibid at 93
\(^{1028}\) Bouheni and Ammi, 'Banking Governance: What's Special About Islamic Banks?' (n 588) at 1629
\(^{1029}\) Alexakis and Tsikouras, 'Islamic Finance: Regulatory Framework - Challenges Lying Ahead' (n 1026) at 99
finance products, such as *sukuk*, which justifies the importance of a specialised rating agency.\(^{1030}\)

However, the effect of these international agencies remains limited, without formal adoption by national jurisdictions. For example, after more than two decades, AAOIFI standards are only adopted by a few jurisdictions compared to the large number of members.\(^{1031}\) In accounting, the predominant problem is not the lack of sound standards but the lack of enforcement of the principles underlying these standards.\(^{1032}\) This underlines the need for an effective national authority for the enforcement of sharia governance.

There are calls to improve these agencies so that they become more professional and effective. The limited effect of these agencies has been attributed to the lack of necessary skills; the lack of incentives for ensuring sharia-compliance; and the salient politically-driven effect of these agencies, which tend to be government-sponsored.\(^{1033}\)

The diagram below demonstrates the SSB-free model of sharia governance and illustrates the arrangement of these different institutions within the sharia governance framework.

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\(^{1031}\) Najeeb and Ibrahim, ‘Professionalizing the Role of Shari’ah Auditors: How Malaysia Can Generate Economic Benefits’ (n 735) 101

\(^{1032}\) Greuning and Iqbal, *Risk Analysis for Islamic Banks* (n 360) 211

\(^{1033}\) Grais and Pellegrini, ‘Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services’ (n 387) 17
Figure 7.1 SSB-free Model of Sharia Governance
7.3 The Effect of the Model on the Industry and Sharia Supervision as a Profession

7.3.1 Competence and Professional Practice

One of the main objectives of the SSB-free model is to regulate the supervision of the Islamic finance industry more efficiently. Promoting and regulating the profession are also issues considered in regulation.1034 Improving sharia supervision to become a well-regulated profession where sharia supervisors are sufficiently qualified would improve sharia governance.1035 In the model, the different roles would be separated, with clearer boundaries between them. The separation of standard-setting and sharia auditing should promote sharia supervision as an organised profession and contribute to greater efficiency and success.1036 This would rearrange and simplify the complex relationship between the management and sharia advisors. The management would have a responsibility for accurately implementing the sharia standards set by the Sharia Standard-setting Board. In addition to its advisory role in assisting IFIs to implement the standards, sharia firms would certify the accuracy of such implementation. The board of directors would be responsible for ensuring a better internal governance framework to ensure that the corporation’s transactions and operations are sharia-compliant.

The introduction of sharia firms as a main player in the governance framework would be valuable in enhancing sharia supervision as a profession. In accounting, it has been argued that accounting firms have a substantial impact in constructing the professional attitude and identity of accountants.1037 Similarly, the greater involvement of sharia firms in the industry would push towards more professionalised practice of sharia supervision and eventually to recognise the practice as a profession. Parallel to audit firms, the practice of sharia auditing and supervision would be conducted more professionally by well-constructed firms, which would make a valuable contribution to promoting the identity of the profession.

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1034 O'Regan, 'Regulation, the Public Interest and the Establishment of an Accounting Supervisory Body' (n 473) at 300
1035 Ahmed, 'Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal' (n 195) at 406
1036 Umar, 'SSB's Roles between Individual Advisory and institutional Profession' (n 386) at 27
1037 Cooper and Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (n 581) at 432-433
The practice of sharia supervision would be significantly improved by having a well-performing regulator, responsible for promoting and protecting the profession as well as overseeing it as one of its main duties. This would improve the profession due to the regulator’s authority to impose ethical standards which regulate the practice of firms. These standards play an important role in protecting ethics, competence, independence, and accountability.\textsuperscript{1038} The ethical codes within sharia audit is weak due to the lack of enforceable mechanisms and tools that measure the performance of the practice,\textsuperscript{1039} so it is essential to have a code of ethics for sharia auditors to push towards an institutional profession.\textsuperscript{1040}

Also, the regulator plays an important role in promoting the profession by representing the practitioners against others more effectively. The power and authority of the regulator would provide a greater protection for the profession. Professional bodies have played a key role in protecting the autonomy of their relevant professions.\textsuperscript{1041} Also, the professional bodies for lawyers and accountants were valuable and heavily involved in solving overlapping issues, such as taxation, which have been disputed between these two professions.\textsuperscript{1042}

Competence is one of the most important issues of the profession, which requires special consideration in sharia supervision. It is defined as the “human abilities to perform certain tasks in an organization as well as the capabilities of certain organizations to perform functions for sustainability purpose”.\textsuperscript{1043} Competence has been an issue in modern Islamic finance since its early formation in the 1970s.\textsuperscript{1044} In the investigation of the competence requirements for SSB membership across Islamic jurisdictions conducted by Grassa, it seems that many jurisdictions do not impose any

\textsuperscript{1039} Shafii, Abidin and Salleh, 'Integrated Internal-External Shariah Audit Model: A Proposal towards the Enhancement of Shariah Assurance Practices in Islamic Financial Institutions' (n 959) at 2
\textsuperscript{1040} Umar, 'SSB's Roles between Individual Advisory and Institutional Profession' (n 386) at 17
\textsuperscript{1041} Coffee, Gatekeepers: The Professions and Corporate Governance (n 440) at 104
\textsuperscript{1042} Cooper and Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (n 581) at 420
\textsuperscript{1043} Nor Aishah Mohd Ali and others, 'Knowledge for Shari‘ah Auditors Competency in Islamic Financial Institutions' (2016) 7 International Journal of Trade, Economics and Finance 113 at 115
\textsuperscript{1044} Yaacob, 'Issues and Challenges of Shari‘ah Audit in Islamic Financial Institutions: A Contemporary View' (n 536) at 2675
requirement. If mentioned, the requirements generally include expertise in Islamic law regarding financial transactions, an acceptable reputation, good character, and strong moral values. These requirements are too general and hard to measure. Even the requirement of sharia expertise needs to be specified more clearly, since it is very broad and may be insufficient to supervise the complexity of Islamic finance operations. Sometimes, the requirement for an academic certificate in sharia, albeit general, is not specified.

With the rapid development of the industry vertically, by developing more sharia-compliant products and financial solutions, and horizontally, by the wider geographical spread, the industry is being challenged by the scarcity of experts and its inability to supply a sufficient number of qualified sharia supervisors. The industry is not yet capable of producing a sufficient number of sharia experts with the required knowledge of banking and financial operations who are able to conduct a complex, technical transformation from conventional operations into a sharia-compliant system. Sharia scholars might be abundant but may lack special expertise in Islamic finance, which might not be found even among distinguished sharia scholars. Under this situation of a lack of competence, IFIs may take advantage of the commercial and financial ignorance of sharia scholars by failing to reveal certain necessary documents or by deceptive presentations relating to the matter.

Therefore, a more specific identification of the required expertise of Islamic finance is required, and it is not enough to require only general expertise in sharia. In fact, Islamic law needs to develop new theories regarding Islamic banking and finance in order to be able to instruct and supply the industry with professional experts.

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1045 Grassa, 'Sharia Supervisory Systems in Islamic Finance Institutions across the OIC Member Countries' (n 388) at 147-154
1046 Al-Khalifi, 'Fatwa and Sharia Supervision Boards in Islamic Financial Institutions between Theory and Practice' (n 344) at 306
1047 Bilal Rasul, 'Identifying the Main Regulatory Challenges for Islamic Finance', QFinance: The Ultimate Resource (QFinance: The Ultimate Resource, Bloomsbury 2012) at 367
1048 Kasim and Sanusi, 'Emerging Issues for Auditing in Islamic Financial Institutions: Emperical Evidence from Malaysia' (n 745) at 11
1049 BenZeghiba, 'Boards of Fatwa and Legal Control of Financial Institutions: Reality and Perspectives' (n 322) at 24
1050 Umar, 'SSB's Roles between Individual Advisory and institutional Profession' (n 386) at 12-13
1051 Ibid at 17
there has been some high quality research in this field, religious education remains traditional and a more systematic approach is needed to integrate Islamic finance research into its curriculum.\textsuperscript{1052} There is a need to consider the specialised sharia knowledge applied in Islamic banking, as well as the necessary knowledge and understanding of accounting and auditing, law, and economics.\textsuperscript{1053} These groups of knowledge should be combined in order to form more applicable theories of Islamic finance on which professionals can rely in practice. Islamic finance is required to foster an educational environment that combines advanced higher education, research, and a peer-evaluation mechanism that earns confidence in a specialised profession and would be able to address real world problems.\textsuperscript{1054}

In addition to knowledge, skills need to be identified as an important requirement. Candidates need to develop skills and competencies regarding practical applications so they can become problem solvers rather than followers of instructions.\textsuperscript{1055} For example, auditing skills are essential for sharia auditors but the practice suggests that these skills are at a very low level.\textsuperscript{1056} Also, speaking a foreign language, specifically English, is sometimes an important skill for sharia members, which is rarely found among SSB members in Saudi Arabia.\textsuperscript{1057} English, as a universal language, is used intensively in the business worldwide so the ability to use English is deemed a substantial skill for anyone involved in commercial activities. Sharia decisions regarding these activities might fundamentally rely on understanding contracts and other legal documents written in English, where translation could constitute an additional cost and might not deliver the meaning accurately.

\textsuperscript{1052} Farook and Farooq, ‘Sharī‘ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (n 458) at 149
\textsuperscript{1053} Abdul Rahman, ‘Shariah Audit for Islamic Financial Services: The Needs and Challenges’ (n 762) at 12; Reem M. Asaad, ‘The Regulatory Framework of Islamic Banking in Saudi Arabia’ (2007) (Financial Services in Saudi Arabia) at 8
\textsuperscript{1054} Farook and Farooq, ‘Sharī‘ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (n 458) at 151
\textsuperscript{1056} Ali and others, ‘Knowledge for Sharī‘ah Auditors Competency in Islamic Financial Institutions’ (n 1043) at 118
\textsuperscript{1057} Asaad, ‘The Regulatory Framework of Islamic Banking in Saudi Arabia’ (n 1053) at 8
Due to the lack of expertise in these areas among sharia scholars and supervisors, some IFIs may rely on a combination of experts in different disciplines to overcome this problem. Some view interdisciplinary representation on an SSB as a useful strategy which reflects the needs of the industry. However, this has been criticised that the combination of experts rather than expertise might challenge communication due to the different perspectives these experts might have. Sharia supervision in Islamic finance, like other professions, needs to form its own competence which should be designed to include the necessary knowledge from different disciplines instead of combining experts from different specialties to be represented in the SSB. Competent experts should understand all of the necessary knowledge and skills related to the industry to be able to take decisions.

In the SSB-free model, the practice of sharia supervision would be restructured in order to make it more competent. Currently, it is too difficult to find enough qualified scholars to set sharia standards in every IFI. Alternatively, having a single authority to standardise the industry would help to overcome the issue of the scarcity of experts since only a few are needed to set sharia standards for the whole jurisdiction. This would ensure that competent experts had spent sufficient time on issuing the standards instead of having members holding too many memberships. The model could accommodate more smoothly other expertise if needed in some complex cases. In the case of large audit firms, other experts may be called in to obtain more comprehensive perspectives. Sharia Standard-setting Boards, regulators, and sharia firms could be structured to have other expertise that might be helpful to these institutions.

The importance of the role of the regulator in promoting competence is obvious in this model. The industry lacks competence requirements compared to other finance professionals who are required by their respective professional bodies to undertake robust and transparent tests regarding their ability, credibility, and integrity. Similarly, there is a need to adopt and recognise an international standardised charter for

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1058 Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 569
1059 Greuning and Iqbal, Risk Analysis for Islamic Banks (n 360) at 190
1060 Bavly, Corporate Governance and Accountability: What Role for the Regulator, Director and Auditor? (n 723) at 171
1061 Onagun and Mikail, ‘Shari’ah Governance System: A Need for Professional Approach’ (n 181) at 71
performing sharia audit similar to those employed in the fields of accounting and finance.\textsuperscript{1062} AAOIFI could play a role similar to other international professional bodies in establishing a transparent set of standards and criteria to be qualified as a legitimate expert in the field.\textsuperscript{1063} This role would be ineffective without formal adoption by the national regulator in different jurisdictions. It is important for the industry to have certified sharia auditors to increase the professionalism within the practice.\textsuperscript{1064} Due to the lack of official standards for qualifying sharia practitioners, a number of scholars have gained prominence without undergoing substantive scrutiny, leaving the new entrants, who may have more meaningful education and training, challenged to be admitted as sharia supervisors.\textsuperscript{1065} Also, continuing educational programmes could be imposed on professionals. Some regulators require a specific number of hours annually that professionals must spend on continuing education.\textsuperscript{1066}

Recently, the educational needs of sharia auditors have received more attention in different institutions.\textsuperscript{1067} There are several diplomas and certificates available that attempt to provide qualified sharia auditors for the market. For example, AAOIFI, the International Center for Education in Islamic Finance (INICEF), the Chartered Institute of Management Accountants (CIMA), the London School of Business and Finance (LSBF), the Bahrain Institute of Banking and Finance (BIBF), and the Ethica Institute of Islamic finance are some of the institutions that provide training programmes and certificates for sharia auditors.\textsuperscript{1068}

Theoretically, these diploma and training programmes are important in developing the profession. However, these may add little value to the practice and supply the

\begin{thebibliography}{9}
\bibitem{1062} Khan, 'Setting Standards for Shariah Application in The Islamic Financial Industry' (n 32) at 305
\bibitem{1063} Farook and Farooq, 'Shari'ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance' (n 458) at 153-154
\bibitem{1064} Zurina Shafii and others, 'Shariah Audit Certification Contents: Views of Regulators, Shariah Committee, Shariah Reviewers and Undergraduate Students' (2014) 6 International Journal of Economics and Finance 210 at 218
\bibitem{1065} Farook and Farooq, 'Shari'ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance' (n 458) at 141
\bibitem{1066} Adam M. Dodek, 'Regulating Law Firms in Canada' (2011) 90 Canadian Bar Review 381 at 403-404
\bibitem{1067} Yaacob, 'Issues and Challenges of Shari'ah Audit in Islamic Financial Institutions: A Contemporary View' (n 536) at 2676
\bibitem{1068} Najeeb and Ibrahim, 'Professionalizing the Role of Shari'ah Auditors: How Malaysia Can Generate Economic Benefits' (n 735) at 98-99
\end{thebibliography}
industry with its actual need for professionals. Despite these programmes, there is a
gap in the market for professional candidates who can efficiently provide sharia
auditing.\textsuperscript{1069} This is not to suggest that these programmes are poorly designed or have
inadequate modules. Islamic finance lacks a clear definition and scope of sharia
auditing which creates a gap between the desired and the actual needs of sharia
audit.\textsuperscript{1070} This is in contrast to the case of financial auditing, where there exists a clear
scope and guidelines.\textsuperscript{1071} In order to supply the industry with more qualified
practitioners, the current programmes need to be built on a clear set of competence
requirements and clearer identification of the role and scope of sharia auditors, adopted
formally by national regulators.

\textbf{7.3.2 Improving the Industry}

The SSB-free model would strengthen the industry with more sustainable institutions
that would work consistently to improve and institutionalise the market. The industry
would be served by more professional institutions which provide sophisticated services.
Consequently, the market would not be influenced by a single group or individuals but
rather there would be a plurality of decisions and diffusion of power, similar to the typical
governance structure in auditing.\textsuperscript{1072} Sharia supervision would be more publicly oriented
and would apply more transparent processes and procedures. Additional layers of
governance would be created to enhance the trust given to sharia auditors, as they
would act as gatekeepers and increase the confidence of the stakeholders regarding
the accuracy of the reports that companies disclose. This would complicate any attempt
to divert from sharia interest compared to the situation where individual SSBs set sharia
standards and simultaneously certify sharia-compliance for their relevant IFIs.

The value of formally adopting a regulatory authority for the industry includes:

- Increasing the confidence in sharia auditing.

\textsuperscript{1069} Ibid at 99-100
\textsuperscript{1070} Kasim, Ibrahim and Sulaiman, 'Shariah Auditing in Islamic Financial Institutions: Exploring the Gap
    between the "Desired" and the "Actual"' (n 875) at 133
\textsuperscript{1071} Yaacob and Donglah, 'Shariah Audit in Islamic Financial Institutions: The Postgraduates' Perspective'
    (n 739) at 226
\textsuperscript{1072} Cooper and Robson, 'Accounting, Professions and Regulation: Locating the Sites of
    Professionalization' (n 581) at 425
• Increasing the accountability and enhancing the corporate governance within IFIs.
• Improving the legislative and regulatory activities to adopt a more applicable sharia-compliant system.
• Setting and improving ethical standards.
• Ensuring that sharia auditors possess a satisfactory level of qualification.
• Protecting the rights and monitoring the integrity of professionals.
• Increasing the awareness of the industry by organising and hosting conferences and workshops, and providing the public with valuable reports on the industry.\textsuperscript{1073}

In the model, national and international agencies would coordinate to improve the industry, as their roles would be complementary and balanced. In accounting, international agencies have been established due to the increasing finance, interconnection between economies, and the crucial role of financial flows.\textsuperscript{1074} However, cross-border dealing might pose a challenge for local IFIs due to the different standards applied in different jurisdictions. In such a situation, the national authorities play an important role in assessing the standards in different jurisdictions and setting guidelines for IFIs on how to deal in these jurisdictions in a way that ensure compliance. In the EU, this role is played by the European Group of Auditors’ Oversight Bodies (EGAOB) in auditing practice.\textsuperscript{1075} Also, the effects of certain international agencies go hand in hand with national ones. For example, the national agencies would ensure a transparent structure as well as a standardised practice and create a good environment for international rating agencies to provide their services. In return, the rating agencies would create a competitive environment between IFIs to ensure a higher level of sharia-compliance within the jurisdiction.\textsuperscript{1076} They would, also, make a valuable contribution to

\textsuperscript{1073} Umar, ‘SSB’s Roles between Individual Advisory and institutional Profession’ (n 386) at 26; Khan, ‘Setting Standards for Shariah Application in The Islamic Financial Industry’ (n 32) at 305-306
\textsuperscript{1074} Cooper and Robson, ‘Accounting, Professions and Regulation: Locating theSites of Professionalization’ (n 581) at 430
\textsuperscript{1075} Kleinman, Lin and Palmon, ‘Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes’ (n 485) at 67
\textsuperscript{1076} Greuning and Iqbal, \textit{Risk Analysis for Islamic Banks} (n 360) at 190-191
the level of transparency and disclosure beyond the mandatory ones.\textsuperscript{1077} As a result, the market discipline would increase which would reduce the burden on the national regulators.\textsuperscript{1078}

Sharia firms may play a role in enhancing the regulation and standardising the practice of the industry. By providing professional services in multinational jurisdictions, sharia firms would be exposed to different practices which might help the national regulator or Sharia Standard-setting Board to set better standards, procedures, and practices.

The consistency of the practice is essential for the market. The SSB-free model is similar to that applied in auditing, which has been developed over time ideally to suit the market. It provides checks and balances between different decision-makers and enhances the credibility of the decisions made. Also, this similarity makes it easier and more suitable for the market to adopt. A consistent market would also enhance the public understanding of Islamic finance and therefore stakeholders would play a more effective role in the industry.\textsuperscript{1079} In return, people would be more educated and informed about Islamic finance which creates a marketing tool and potential greater demand for sharia-compliant products.\textsuperscript{1080} Moreover, consistency would facilitate more sustainability for other stakeholders, such as rating agencies, the stock markets, the financial media, and researchers.\textsuperscript{1081} The role of the latter is required to develop the industry. There is a call to enhance the relationship between the industry and academic institutions to ensure that the industry becomes more acceptable on a worldwide scale.\textsuperscript{1082} However, studying an inconsistent industry would only produce limited results. For a more generalised and accurate analysis, academia needs consistency and also more accessible data, which would be better provided through more transparent institutions in a well-oriented governance model. Hence, the model would facilitate more effective

\begin{thebibliography}{10}
\bibitem{1077} Ibid at 211
\bibitem{1078} Ibid at 47
\bibitem{1079} Ibid at 192-193
\bibitem{1080} Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (n 314) at 230
\bibitem{1081} Grais and Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options' (n 360) at 21
\bibitem{1082} Natt, Alhabshi and Zainal, 'A Proposed Framework for Human Capital Development in the Islamic Financial Services Industry' (n 1055) at 18
\end{thebibliography}
research that would in turn contribute towards more improvements and to be applicable to the industry globally.

7.4 Applicability of the Model: Opportunities and Challenges

One of the challenges facing the developing industry of Islamic finance is the lack of legal recognition among the jurisdictions. This is mainly due to the lack of a standard model under which the industry is governed. Also, the current practice of Islamic finance depends on SSBs as the cornerstone of sharia governance. In addition to the governance issues surrounding their structure, the nature of SSBs as a religious board within IFIs could be an obstacle to its adoption in the worldwide secular jurisdictions. These jurisdictions might not understand and recognise the existence of such a powerful board as additional to the board of directors.

Arguably, the SSB-free model would provide the industry with a standardised governance structure that is easier to apply globally. The industry would be governed globally by a similar accountability framework to that employed by other professions that already exist in the market, which makes it easier to adopt. Islamic finance would be practised and recognised internationally as a profession with known references. The peculiarity of the structure of SSBs as an internal board is substituted by well-known institutions, such as gatekeepers, standard-setting boards, and regulators. This would make the industry appear more oriented and professional. Currently, the market depends heavily on the reputation of certain well-known names who participate in various SSBs. However, the respect and reputation asset of sharia scholars is limited locally and may be insufficient to satisfy stakeholders in the global market.\textsuperscript{1083}

Alternatively, this model applies the governance structure of gatekeepers, specifically external auditors, as a more applicable model for enhancing reputation globally. The SSB-free model has a similar governance structure to the globally accepted corporate governance frameworks, which makes it more applicable.

\textsuperscript{1083} Alkhamenees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 143
However, the model might face political challenges in certain jurisdictions, such as secular ones. Legal recognition and a standardised framework are essential for drawing a clear scope of sharia auditing and legally enabling sharia firms to operate more effectively. Without the political will, reforming sharia governance would be challenged. In this regard, a question of secularism might be raised: is sharia governance merely a religious matter? Sharia governance should be perceived purely as a mechanism for ensuring that the sharia-compliance procedures are properly applied. There may be some religious aspects of this which could be left to Islamic scholars to determine, while the regulators focus on making the structure more efficient, trustworthy and solid. If a religious-based action becomes an important component of the market that could threaten its stability, it is essential for the regulators to supervise this behaviour. This could be done without interfering in determining what this religious action should be but focusing on how to apply it properly.

The issue of regarding sharia governance as religious in nature also applies to Islamic and non-secular jurisdictions. Politically, government may hesitate to adopt changes in the current framework of sharia governance due to the sensitivity of the issue. In the case of Saudi Arabia, the political willingness to formally adopt a sharia governance framework is very low, as shown in Chapter Three. The country ignores the regulation of the Islamic banking industry because it considers such an issue a very subtle one that might have political consequences, so it prefers not to interfere or be involved in determining whether or not a particular bank or a transaction is Islamic, and leave the industry to follow informal, unwritten standards.

In light of these political obstacles, the model might not have any regulatory authority and/or Sharia Standard-setting Board. In Chapter Five, possible solutions were suggested in respect of the issue of the lack of standardisation and the obstacles to establishing a Sharia Standard-setting Board in secular jurisdictions. Similarly, private self-regulatory agencies could be established in these jurisdictions, if applicable, as an alternative to the regulatory agency in order to provide a source of trust for the

1084 Nathan Garas and Pierce, ‘Shari’a Supervision of Islamic Financial Institutions’ (n 315) at 393
1085 Mushtak Parker, ‘Issues in Regulating Islamic Finance’ (2011) 21 Central Banking 60 at 63
stakeholders and enhance the accountability framework. International agencies could play an important role in supporting and recognising self-regulatory agencies in their relevant jurisdictions. Also, IFIs in non-Islamic jurisdictions may rely on other possible mechanisms for effective enforcement. For example, international arbitration centres for Islamic finance disputes would be significant in removing many of the obstacles for the IFIs in these jurisdictions. In this regard, IICRA was established in Dubai as an international, independent, non-profit organisation to settle all financial and commercial disputes arising between financial and business institutions that choose to apply Islamic law and sharia principles.\textsuperscript{1086} Such a centre is valuable for the industry where IFIs from different jurisdictions may incorporate an arbitration clause in the agreements and refer to the centre to seek resolutions in the case of disputes.\textsuperscript{1087} IFIs in non-Islamic jurisdictions may refer to this centre as a tool of enforcement.

The governance reform might be rejected by other players in the industry as well. Important stakeholders, such as IFIs and practitioners, have shown little interest in improving the auditing practice in the industry.\textsuperscript{1088} They may have an interest in retaining the status quo. Also, some sharia scholars might challenge and resist the SSB-free model. As highlighted in Chapter Five, standardisation might be resisted by more conservative scholars. Since the model restricts their influence in the industry and increases their accountability, scholars might challenge the model. Increasing accountability could be perceived as a way of showing less respect to sharia scholars or doubting their credibility.\textsuperscript{1089} Additionally, the religious institutions might oppose the reform and modernisation of sharia education. It is broadly accepted by many religious establishments that the fundamental issue has already been identified, so the necessity of adopting a new approach or perspective is minimal.\textsuperscript{1090}

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1086 About IICRA \<http://www.iicra.com/iicra/en/page/details/page_id/76070bbb02830110772a8fd81756a777> accessed 25/2/2018
1087 Malkawi, ‘Shari’ah Board in the Governance Structure of Islamic Financial Institutions’ (n 314) at 568
1088 Lahsasna, Ibrahim and Alhabshi, ‘Shariah Audit: Evidence & Methodology in Islamic Finance’ (n 698) at 21
1089 Alkhamees, ‘The Impact of Shari’ah Governance Practices on Shari’ah Compliance in Contemporary Islamic Finance’ (n 323) at 143
1090 Farook and Farooq, ‘Shari’ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance’ (n 458) at 149
\end{flushright}
The application of an SSB-free model might be challenged by the absence of a market leader in the Islamic finance industry. It might be too hard to influence a specific sharia governance model as a standard model to be applied in the industry. The relatively advanced sharia governance models, such as the Malaysian model, have had only a limited effect in the market and have not become a standard model for sharia governance. As explained earlier, the AAOIFI sharia standards are only adopted by a few jurisdictions. Samra argues that, while many jurisdictions are now competing to become the market leader in the industry, such as Dubai and London, it is important for the industry to settle around a clear market leader location in order to stimulate governance standards. Some analysis concludes that the industry is missing a strategic leader that could enforce a harmonised and standardised set of best practices. In this regard, Saudi Arabia might have a good opportunity to influence the industry and overcome these challenges if there exists the political will to change its attitude towards the adoption of a legal framework. Jurisdictions that introduced legislation into the industry more recently could have the advantage of being able to build upon the experiences of other jurisdictions and the work of international organisations. This is manifest in Oman, which recently adopted a relatively advanced sharia governance model. In Saudi Arabia, its recent, ambitious 2030 Vision aims to take advantage of its strengths as the heart of the Islamic and Arab world, an investment powerhouse, and a hub connecting three continents. This provides a strong basis for adopting an advanced model of sharia governance. Due to its extensive sharia-compliant assets, operations, and other facilities, such as sharia scholars, Saudi Arabia could be a good candidate for becoming a successful hub for Islamic finance and take the lead in implementing an effective legal framework which could influence the industry globally. The data presented in the introduction shows that the country hosts the majority of the industry, as it possesses more than 1/5 of the market and its sharia-compliant assets represent more than 50% of its total assets. This significant market

1091 Emily Samra, 'Corporate Governance in Islamic Financial Institutions' (2016) International Immersion Program Papers <https://chicagounbound.uchicago.edu/international_immersion_program_papers/20/> accessed 5/11/2017 at 11
1092 Tahir, Thought Leadership: The Neglected Essence of Islamic Finance (n 6) at 8
1093 Wilson, Legal, Regulatory and Governance Issues in Islamic Finance (n 125) at 112
1094 Saudi Arabia, Saudi Vision 2030 (2016) at 9
size could strongly influence its legal framework. In addition to the size of its market, the country hosts the IDB, which plays a key role in developing the market. Also, the country is considered a fundamental religious location, which also has an influence on the market. In addition to hosting the holiest Muslim sites, which might be of symbolic significance, a significant number of sharia scholars are based there, who are members of SSBs globally. Data from 2010 shows that Saudi universities supplied around half of all SSB members globally.  

These advantages that the country possesses could be employed to achieve its vision, thereby making it the potential leader of the industry in a move towards a more standardised form of sharia governance.

### 7.5 Conclusion

The SSB-free model, along with more effective and recognised international Islamic finance organisations, would constitute a dynamic sharia governance model. Harmonised standards would be set by international agencies for a more consistent practice; a sharia Standard-setting Board and the regulatory authority would work to tailor and enforce national standards; the process of designing sharia-compliant products would be conducted by internal experts within IFIs as well as the advisory services provided by sharia firms; and internal sharia review units along with external sharia firms would be entrusted with sharia auditing and the issuing of statements regarding sharia-compliance. This process would be sustained by reputable agents, like rating agencies, the stock markets, the financial media, and researchers. Such a framework would also enhance the supply of professionals in the industry as well as the public understanding of the requirements of sharia, which provides a way for stakeholders to play a more effective role in sharia governance.

The model could constitute a positive addition to the effort to professionalise the practice. There would be clearly assigned roles provided to professionals who would be adequately certified to act as practitioners. By creating a well-oriented environment, the model would contribute towards developing Islamic finance theories, which would help to improve the competence requirements of sharia practitioners in the industry.

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1095 Ünal, *The Small World of Islamic Finance: Shariah Scholars and Governance - A Network Analytic Perspective* (n 842) at 26
become more practical. Such an environment would also help the market to thrive and become more sustainable and competitive. Globally, the model would become more applicable, especially in the secular jurisdiction, due to its similarity to other governance models applied by other professions, such as auditing. Sharia supervision would be perceived as a well-defined profession rather than merely a religious practice. However, adopting a globally standardised model might be challenged politically and by some of the other important players in the industry. While these challenges apply to Saudi Arabia, the country has a strong potential to influence the industry towards achieving this standardised governance model.
Chapter Eight: Conclusion

In this thesis, the role of sharia supervision performed by the SSB has been examined. The main issue explored in the thesis was how the SSB should be restructured to be more effective, independent and impartial for sharia-compliance stakeholders in IFIs. For this analysis, the SSB structure, position, and roles have been critically analysed in light of corporate governance principles. The research highlighted the legal issues surrounding the body of the SSB and the problems related to the lack of legal consideration, independence, and consistency of sharia governance. Throughout the research, suggestions have been made regarding restructuring the governance model for sharia supervision in order to strengthen the sharia governance framework. The research proposes an SSB-free model which aims to provide a stronger governance and accountability framework for protecting the sharia interests of its stakeholders.

As explained in Chapter One, the discussion undertaken in the thesis was mainly theoretical in nature in order to critically analyse the current SSB model and how it might be restructured to fit within companies’ structures and better serve its sharia-compliance objective. While such a discussion is generally applicable to the whole industry and not specific to any particular jurisdiction, the situation in Saudi Arabia has been highlighted in order to clarify several important points, and the jurisdiction was employed to bring out several issues for discussion and to provide case studies. Several other leading jurisdictions have also been discussed in order to compare the sharia supervision practices. The main findings of the research is summarised below.

The Need for Legal Recognition of Islamic Banking

Chapter Two described how the attitude of Islamic law toward interest, which challenges modern banking, has contributed to the emergence of Islamic banking. This type of banking complies with the Islamic principles and employs sharia-compliant financial instruments. The introduction of Islamic banking into the market has brought discussion of the Islamic perspective and especially in relation to several corporate governance theories. Instead of a separate Islamic theory of corporate governance, the
chapter argued that Islamic values could be consistent with some of the views proposed in corporate governance theories, such as stakeholder and stewardship theories. However, IFIs need an additional governance framework to supervise sharia-compliance. This has resulted in sharia governance, where the SSB is an important aspect of it.

Chapter Three argues that in addition to that Islamic banking shares with conventional ones the same rationales that justify a separate legal system, it has unique requirements that demand special regulations for the industry that cater for its services and operations. Since many well-known sharia-compliant products are commonly restricted in banking regulations, the objectives of Islamic finance would be better served by a separate legal system or, at least, by applying certain exceptions regarding its operations. Special regulations offer many advantages, including: increasing the understanding of the industry for more effective supervision; addressing more effectively the special types of risk to which the industry is exposed; and addressing the special prudential requirements of the industry.

Islamic banks need the special legal recognition to provide its unique banking services free of challenges. In the case of Saudi Arabia, a conservative Islamic state, Islamic banks face legal challenges due to the lack of legal recognition of the industry. Despite the fact that its culture and legal system have strong Islamic roots that challenge, to some extent, conventional banking, Islamic banking, also, has encountered legal challenges. In the past, Islamic banking had to fight to exist. Also, the current banking system does not recognise the unique requirements of Islamic banking. Such a paradox makes analysing the attitude of Saudi Arabia toward Islamic banking an interesting case.

**Rethinking the SSB Role toward Gatekeeping**

SSBs, as the most important tool in sharia governance requirements, demand special legal attention which is highlighted in Chapter Four. Due to the development and complexity of Islamic finance operations, sharia supervision and religious expertise are important in assisting executives in management and gaining the trust of stakeholders
of sharia-compliance, which in turn provides economic and ethical values to IFIs. While some tools of sharia supervision could be inserted smoothly into the corporate governance structure, the SSB is not a well-known body in such a structure, and so is not easily adopted. In order to accommodate the SSB within the structure of the corporation, the nature of its roles should be examined regardless of its structure. The analysis in this chapter showed that the SSB performs three main roles: setting sharia standards (or legislation as sometimes used in the thesis), sharia advice, and sharia auditing.

Assigning all these roles to the SSB, the chapter argues, is impractical and ineffective. While these roles are essential within the sharia governance structure, combining them into a single body within the corporation creates confusion and negatively affects the enforceability of the SSBs' decisions from a legal perspective, which might result in a meaningless sharia-compliant system. The roles of sharia-standard setting and sharia auditing require a high level of independence which is insufficiently provided by the different sharia governance frameworks. There are significant variations in the level of legal recognition of SSBs by different jurisdictions. Such a lack of legal recognition of the SSB does not reflect its importance in sharia governance. There is a need to have a standardised model that lays down the clear scope of the roles and responsibilities of sharia supervision that can be easily incorporated into the structure of the corporation. Such a model is required to enable more effective regulatory supervision and increase the confidence of the stakeholders of sharia-compliance, which would eventually help the industry to thrive.

To incorporate the roles of SSBs more effectively within the structure of corporations, the chapter compared and analysed the link between SSBs and similar potential mechanisms; more specifically, the board of directors and the gatekeepers. The structure of the SSB as an internal, powerful body may have led some researchers to draw a link between it and the board of directors. However, their objectives and functions are not common. While the board of directors guides the company and acts as a balance between the different interests and players within it, SSBs are supposed to represent solely the religious interest. Such an interest cannot be compromised or
negotiated in favour of other interests, since it could only be satisfied by a pass-or-fail test, and could not be satisfied by voting representation or negotiation. Not only the objectives but also the roles differ significantly between the two bodies. If SSBs perform a similar role to that of the board of directors, it does so only on a very limited scale that does not qualify the SSB to be considered as a board of directors. Structure-wise, the SSB could not be considered a board of directors unless a two-tier board system is considered, as is the case in some of the literature. However, the SSB is inconsistent with the objectives of the two-tier board system, which is mainly to provide a clearer separation between supervision and management. Therefore, the two-tier board system is designed to promote more effective management, which is not the objective of the existence of the SSB as it simply is not its role. In fact, the SSB faces structural as well as legal challenges if it is to be considered as a board, not only in the unitary system but also in the two-tier one. Even IFIs operating under the two-tier board system do not consider the SSB a second board. Thus, regarding the SSB as a board would not result in a two-tier system but in a totally different model that is new to corporate governance. The idea of regarding the SSB as an audit committee within the board was also raised and disputed. Audit committees are still part of the board of directors which, as stated, has different roles and objectives to the SSB. In addition to the different nature of these roles, the SSB demands a more independent position from the board of directors and less interference over internal auditing compared to the position of the audit committee.

In fact, the SSBs’ objectives and roles fit within the function of gatekeeping more suitably. Although the reputational capital of SSBs is merely religious and inconsistent with the professional reputation required for gatekeepers, which is part of the structural issue with which this thesis deals, SSBs’ roles satisfy the less common view of gatekeepers, which considers the veto power assigned to them. More specifically, the objectives of SSBs under sharia governance is parallel to the roles played by external auditors within corporate governance in assuring stakeholders of the credibility of the company by exercising its veto power and withholding support if any misconduct or violations are found. However, the view of SSBs as a gatekeeper might be unclear due to their lack of clear structure and professional practice. SSBs combine different roles within one body, whereas different roles are well-separated and regulated in the audit
profession. Therefore, the issue of sharia supervision requires more regulatory attention to effectively reflect its gatekeeping role and for it to be regulated as such. The regulatory structure of auditing, as a well-oriented profession, could be taken as the ideal model that will serve sharia supervision more efficiently. The components of regulation are well-recognised within the audit regulatory authorities, where both ex-ante and ex-post scrutiny is performed to supervise the practice and promote the profession. In the case of sharia supervision within IFIs, each institution establishes its own regulatory authority, an SSB, and this might undermine the industry from being standardised and well-protected.

**Fatwa and the Process of Setting Sharia Standards Should be Independent from IFIs**

The need for *fatwa*, as a main role assigned to SSBs, to be effectively standardised in the industry was discussed in Chapter Five. Modernity requires legal codification of the Islamic principles. Non-codification, especially in commercial aspects, may result in economic disruption which makes codification politically desirable and provides a basis for the economic justification of standardisation within the Islamic finance industry. Today, there is a tendency to move toward more codification where many Islamic jurisdictions adopt a codified set of Islamic law in some areas, mostly family law. This practice, however, is controversial in the case in Saudi Arabia which constitutes a challenge toward standardisation in Islamic finance.

The assessment of the standardisation process within the sharia governance framework undertaken in the chapter showed that the current structure of SSBs contains many factors that compromise its independence to legislate. Conflict of interests exists in the perceived employment relationship between SSB members and IFIs as well as the combination of the roles of legislation with auditing within SSBs. The management, due to their powerful position, may exercise some influence over SSB members and put them under pressure to engage in so-called "fatwa shopping" to satisfy the management. While the legislation role was assigned historically to SSBs due to the relatively simple operations and lack of a governing Islamic code for the industry, the process of setting sharia standards should now become more standardised
and assigned to a national SSB. Although this step has been taken by some jurisdictions, the current practice of central standardisation, where it exists, suffers from several limitations, which allow internal SSBs a wide space in which to perform, to different extents, the role of legislation. The review of some of the most advanced practices of central standardisation, such as those in Malaysia and Indonesia, showed that SSBs are still exposed to conflict of interests where they can perform a legislative role as part of their overall role. For greater independence, the legal framework of sharia standard-setting should be totally assigned to an independent national board without any involvement of the internal SSBs.

It might be argued, however, that this approach is impractical, as central standardisation might inhibit innovation and flexibility, which is required for the development of the industry. Some suggest a semi-standardised model as a compromise between a standardised and non-standardised industry. However, central standardisation could be achieved without compromising the flexibility and innovation that the industry needs, as is the case with other standardised practices. Moreover, it would provide the industry with the discipline which is essential in order to avoid chaos. Absolute standardisation, however, may not be preferred nor achievable. It should be at a sufficient level to provide the industry with the harmony and discipline it needs. In fact, central standardisation could preserve, or even, promote flexibility and innovation if an effective governance process of standardisation is applied. In this process, it is important to preclude the regulated, such as IFIs, from exercising any regulatory authority.

More efficient and independent standard-setting process would supply the market with more confident stakeholders who would not lose their trust in the market very easily. Also, central standardisation provides the advantage of making the industry more acceptable and marketable to investors. Moreover, supervision would be more effective and practical as well as less costly. Central standardisation is also better equipped and more credible to deal with new, complex issues by setting more suitable standards for the whole industry. In fact, these advantages are recognised by the industry, where IFIs
try to apply some standardisation strategies which, however, could undermine the SSBs’ independence if not administered by a central authority.

The importance of standardisation was reflected in the case of the IPO of NCB discussed in the chapter. It showed that in the absence of standardisation, the independence of the SSB is questioned. Also, disagreements between sharia experts regarding whether or not a specific product or bank is Islamic may have negative economic effects.

Standardisation is not only essential nationally. International harmonisation has become a trend in different disciplines, especially accounting and auditing fields, due to globalisation. In addition to the economic advantages, which also exist within the industry of Islamic finance, that led these disciplines to embrace international harmonisation, there are other justifications for international standardisation that promote the industry globally even in non-Islamic jurisdictions. Examples of international efforts toward standardisation were reviewed in the chapter and the lack of national enforcement mechanisms was identified as the main limitation on these efforts.

Standardisation, however, is not free from challenges. The political attitude in secular jurisdictions and even in some Islamic ones such as Saudi Arabia, which prefers not to interfere in such a legal arrangement, could be an obstacle to enforcing a set of sharia standards in the industry. International organisations and non-governmental institutions could be solutions. Another obstacle identified in the chapter was the attitude of certain conservative religious establishments and schools toward standardisation.

**Addressing the Accountability Framework in the Role of Auditing in the SSB**

The auditing role of SSBs was analysed in Chapter Six. The accountability framework of this practice within sharia governance is weak and has received little attention. For a proper framework, accountability needs to be addressed within its context, sharia governance in this case. Accountability, as a mechanism consisting of four stages (reporting, explaining and justifying, questioning, and the possibility of the imposition of consequences) was identified as a more suitable definition for the context
of the analysis. This included examining important questions regarding accountability for sharia-compliance within sharia governance: why, who, for what, to whom, and how.

The rationales for accountability in sharia-compliance rest upon the need for independent sharia auditing with a strong and efficient accountability framework to protect sharia interest more reliably. While accountability is essential in financial audit, sharia auditing is deemed more important within sharia governance for several reasons highlighted in the chapter which generally concern the nature of sharia interest and the weak position of its stakeholders. This requires greater attention to be paid to the accountability framework for sharia auditors. Legitimacy, power, and public interest are also justifications for having an efficient accountability framework within sharia governance.

Regarding identification of the accountors for sharia-compliance, the board of directors, as the body that is ultimately responsible for the operations of its company, was identified as the main accountor. Its responsibility should be similar to that which it has in financial auditing, which is to ensure that an appropriate mechanism has been effectively implemented to protect the interest of stakeholders. In this regard, some tend to prefer the appointment of sharia experts as representatives of the sharia interest. However, such an approach would not serve the interest of sharia effectively.

The current framework of sharia supervision identifies SSBs among the main accountors of sharia-compliance. The lack of independence in SSBs, however, limits and restricts them from being an effective tool for sharia auditing. Many issues of conflict of interests can arise within this structure and negatively affect the SSB's independent status as an important feature of auditing. Issues of conflict of interests surrounding SSBs include appointments, remuneration, combining audit with legislation and consultation, ownership and other financial interests of sharia members in the institutions, and confidentiality. These issues, although important in protecting sharia-compliance interest, are weakly addressed in the regulations concerning SSBs. Alternatively, sharia firms could be a more effective tool to provide sharia auditing. In fact, the historical review of the development stages of financial audit showed that sharia auditing is undergoing a similar experience to financial auditing, where it has
developed from being totally dependent and internal to being independent and external. Recently, sharia firms have become more recognised as an independent gatekeeper within the sharia audit framework. Although the issues of conflict of interests surrounding the SSB structure could be addressed in the legislation, sharia firms would be more effective in enhancing the independent status of sharia auditors in order to better: satisfy their gatekeeping roles; promote sharia auditing as a profession; and bring more collective efforts rather than individuality of practice. The movement toward sharia firms should then minimise the instances of conflict of interests within the SSB structure.

The subject of accountability, or the question of “accountability for what?” has been identified to be God’s will or Islam, as perceived by credible scholars. This question is usually mixed with the question “accountability to whom?” where God’s will is, inaccurately, considered as a stakeholder instead of being the subject of accountability.

The question of “accountability to whom?” involved identifying the stakeholders of sharia-compliance. The stakeholders’ weight in corporate governance should be reconsidered in sharia governance. Unlike the case with corporate governance, investors might not be the strongest stakeholders. Also, customers are more likely to have more interest in sharia-compliance. The case with employees, suppliers, and society as a whole is similar, where they have a stronger interest in sharia governance than do their counterparts within corporate governance. Therefore, stakeholders in sharia governance need to be assessed differently in order to reflect their importance and ensure there exists the proper protective tool for their sharia interest. While many studies focus on how to protect the financial interests of the unique group of IFIs’ stakeholders, IAHs, the protection of sharia interest is not well-recognised. Since sharia governance has different priorities for its stakeholders compared with corporate governance, the protective tools set under corporate governance might not serve well in relation to sharia governance. Voice and exit strategies, for example, are inconsistent with the nature of sharia interest. Therefore, implementing a regulatory authority to effectively protect sharia-compliance was suggested in order to conduct the required institutional checks and protect the stakeholders. This would enhance the accountability
framework by having legal accountability as an additional form of accountability. The regulatory authority would act as a powerful representative of the stakeholders of sharia interest, who lack the necessary protective tools. With the regulator, the four accountability elements would be enforced more effectively: transparency, which is a very weak practice in the industry, would be imposed with more effective regulations; supervision would be undertaken by those who are more knowledgeable and this would reflect the complex nature of Islamic finance rulings and make it possible to conduct the questioning stage of accountability more effectively; the power to impose consequences would also be satisfied by such a regulator. Within the accounting and auditing fields, the regulatory authorities have positively contributed to the accountability framework and also help to implement the elements of accountability. In addition to its ex-post role of reviewing, the role of the regulator might involve some ex-ante role, which could help to prevent misconduct.

The regulatory authority would also satisfy the role of the hisba institution, which is historically practised in Islamic states, more effectively than the SSB does. In fact, the SSB is not eligible to be regarded as a hisba institution, since it is a private rather than a public institution. The regulator would also be in a better position to protect the public as an essential group of sharia-compliance stakeholders in sharia governance.

**The Proposal of an SSB-free Model**

Chapter Seven concludes the thesis by proposing an SSB-free model of sharia supervision. As an effective tool that fits with the corporate governance principles, the structure of auditing was suggested for sharia supervision. Following the audit model, this requires the separation of the roles of SSBs. The SSB-free model redefines the SSB’s roles, separates them, and assigns them to new collaborating institutions, which legislate, supervise, audit, and provide non-audit services. These institutions include a national Sharia Standard-setting Board to set sharia standards; a national regulator to supervise, legislate, and enforce the regulations for the industry as well as the profession; and sharia firms to conduct independent external audit and non-audit services and satisfy the requirements of the gatekeeping role within sharia governance. Moreover, the internal mechanisms of IFIs should be developed to adopt these changes
and deal with sharia auditing in a similar way to financial auditing. These arrangements would facilitate the work of the international institutions in the industry which in return would provide benefits for the local markets.

This model would improve the practice of sharia supervision. Sharia firms and effective regulators would develop the practice of sharia supervision to become more professional. Also, competence requirements would be defined and developed more clearly to supply the industry with more qualified professionals and help to develop theories, skills, and practice in Islamic finance and sharia supervision.

In addition, the SSB-free model would improve the industry and introduce more sophisticated institutions to the practice. Therefore, the industry would be more transparent, trustworthy, consistent, and attractive for investment. This new model would, also, be more relevant to the market. Rather than acting as an internal religious body, SSBs would be replaced with well-known institutions, which are already familiar to corporate governance. This would mitigate the perception of sharia governance as a religious matter and help it to become perceived as a governance mechanism.

Despite its applicability, the model might face several potential challenges. It might be challenged by the lack of political will to adopt this governance model in secular or, even in some Islamic jurisdictions, where government interference in the Islamic finance industry might be deemed problematic. In these jurisdictions, international agencies, private self-regulatory agencies, and arbitration might be sought as alternatives to any missing institution within the model. In addition to the political challenge, some important players in the industry, such as the IFIs and sharia scholars might reject the SSB-free model, since it restricts their powerful position within the industry.

Arguably, the model needs an economically strong jurisdiction that could influence the industry to make this model the standard governance model for IFIs and achieve its advantages. Saudi Arabia has economic and political factors to be a good candidate for legally influencing the market if the political will exists to recognise sharia governance. As has happened in other countries in the region, such as Kuwait, UAE, and Oman,
policymakers in Saudi Arabia might reach a conclusion that legislation in the industry is inevitable and should not be neglected.

**Suggestions for Further Research**

Overall, the discussions in this thesis brought forth some new thoughts and analysis in relation to the sharia supervision framework which resulted in the proposal for SSB-free banks. It provides the ground for further analysis and assessment in this area. For example, sharia firms, as newly-emerging institutions, could be further highlighted to examine how they should contribute to sharia supervision as independent gatekeepers. Additionally, the accountability framework analysed in this thesis could be further assessed within sharia governance to reflect IFIs other than Islamic banks. While the analysis of accountability in this research focused on Islamic banking, other IFIs, such as insurance or investment companies in the capital markets, might need a slightly different analysis, especially with regard to their stakeholders. Such analysis would provide a more comprehensive view of accountability within sharia governance.
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