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Corporate Governance and *Shariah* Compliance

in

Institutions Offering Islamic Financial Services

Wafik Grais and Matteo Pellegrini

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Abstract

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The structures and processes established within an Instiution Offering Islamic financial Services (IIFS) for monitoring and evaluating *Shariah* compliance rely essentially on arrangements internal to the firm. By being incorporated in the institutional structure, a Shariah Supervisory Board (SSB) has the advantage of being close to the market. Competent, independent, and empowered to approve new *Shariah*-conforming instruments, an SSB can enable innovation likely to emerge within the institution. The paper reviews the issues and options facing current arrangements for ensuring Shariah compliance by IIFS. It suggests a framework that draws on internal and external arrangements to the firm and emphasizes market discipline. In issuing its *fatwas*, an SSB could be guided by standardized contracts and practices that could be harmonized by a self-regulatory professionals' association. A framework with the suggested internal and external features could ensure adequate consistency of interpretation and enhance the enforceability of contracts before civil courts. The review of transactions would mainly be entrusted to internal review units, which would collaborate with external auditors responsible for issuing an annual opinion on whether the institution's activities met its *Shariah* requirements. This process would be sustained by reputable entities such as rating agencies, stock markets, financial media, and researchers who would channel signals to market players. This framework would enhance public understanding of the requirements of *Shariah* and lead to a more effective utilization of options available to stakeholders to achieve continuing improvements in Islamic financial services.

List of Abbreviations

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

BCBS: Basel Committee on Banking Supervision

CG: Corporate Governance

CIBAFI: General Council of Islamic Banks and Financial Institutions

ICFS: Institutions offering Conventional Financial Services

IIFS: Institutions offering Islamic Financial Services

IFSB: Islamic Financial Services Board.

IIRA: International Islamic Rating Agency

FTSE: Financial Times Stock Exchange

FSA: Financial Sector Assessment

OECD: Organization for Economic Cooperation and Development

SSB: *Shariah* Supervisory Board

I. Introduction: Corporate Governance and *Shariah* Compliance[1]

Islamic finance helped sustain economic growth throughout the Muslim world during the Middle Ages. The last three decades witnessed its revival, notably following the first oil price shock of 1973-74. Beyond the surge in liquidity, its reemergence was prompted by the introduction of innovative Islamic financial products and a demand by Muslim populations for financial services compatible with their religious beliefs. More recently, the industry has received a new impetus. It can be ascribed to an uncertain performance of western financial markets, a perception of increased risk for Gulf Cooperation Council capital in traditional financial markets, a renewed surge in oil prices, an expressed demand from Muslim communities in Western countries, and the development of managerial skills specific to Islamic financial services.[2] As a result, the global Islamic financial services industry now includes 284 institutions offering Islamic financial services (IIFS) operating in 38 countries, both Muslim and non-Muslim.[3] Islamic capital markets, mutual funds and insurance services are also developing.

The Governor of the Bahrain Monetary Agency conveyed the sense of the roots of the IIFS when he stated that "Islamic banks have grown primarily by providing services to a captive market, to people who will only deal with a financial institution that strictly adheres to Islamic principles".[4] Conducting activities in accordance with *Shariah* entails that the institution pledges: i) not to engage in interest-based debt transactions, ii) not to

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[2] According to the General Council of Islamic Banks and Financial Institutions (CIBAFI), total assets have roughly doubled in the period 1998-2001, soaring from $134 to 261 Billion. Source: http://www.islamicfi.com (last visited April 04, 2005). The figures were reported in a press release by CIBAFI dated May 8, 2005, ("CIBAFI Raises the Glance toward IFSI Growth with a Unique Statistic-Based 10-Year Strategic Plan").

[3] The term IIFS refers to Islamic financial businesses and includes finance houses, that offer retail commercial and investment services. The paper does not deal with *Takaful* (insurance) companies.

[4] As reported by *Middle-East-Online.com* on February 17, 2004. http://www.middle-east-online.com/english/bahrain/?id=8922=8922&format=0 (last visited April 11, 2005).

conduct pure financial transactions disconnected from real economic activity, iii) not to participate in transactions where there is exploitation of any party, and iv) not to participate in activities regarded as harmful to society.[5]

. Initially, IIFS developed without a clear view on the legislative and regulatory framework that would apply to them.[6] However, their conceptual foundations and operational practices derived from the principles outlined above have specific features that pose challenges to regulators and call for solutions beyond the simple extension of existing legislation and regulation applying to institutions offering conventional financial services (ICFS). To that effect, a number of countries have put in place laws and regulations for IIFS, and international bodies have been established to adapt standards applying to conventional financial services and promote harmonization of practices.[7]

Enhancing stakeholders' value is a central purpose for any business including financial services, whether conventional or Islamic. Their stability, financial performances and ability to intermediate resources will depend on stakeholders' confidence in individual institutions and the industry. A particular confidence feature in respect of Islamic financial services is the requirement of conveying to stakeholders that their financial business is conducted in conformity with their religious beliefs. Corporate governance arrangements, internal and external to the corporate entity include structures and procedures that should provide sufficient comfort the business is conducted in accordance with stated objectives, in particular compliance with *Shariah*.[8]

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[5] *Shariah* is Islamic Law extracted from the *Qur'an* and *Sunna* (sayings and deeds of the Prophet). Not to conduct financial transactions disconnected from real economic activity is sometimes referred to as "materiality". A glossary of Arabic terms is provided in Annex I.

[6] For example, in some cases the general prudential regime was extended to IIFS without recognizing any specific feature. In other cases, IIFS registered as non-bank commercial businesses. For an introduction to the principles and instruments of Islamic finance as well as regulatory arrangements applying to IIFS, refer to El-Hawary, Grais, and Iqbal (2004).

[7] These include the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), the International Islamic Financial Market (IIFM) and the Liquidity Management Center (LMC). Rather than seeking to replace existing regulation, these bodies propose solutions whenever conventional regulation fails to address the distinctiveness of the Islamic financial industry.

[8] This paper deals with CG arrangements that address issues of *Shariah* compliance. Grais and Pellegrini (2006a) provides an overview of the issues and challenges of CG for IIFS. Grais and Pellegrini (2006b) deals with IIFS' CG that address stakeholders' financial interests.

A widely adopted approach is to have independent bodies certify *Shariah* compliance by the IIFS. The reliance on independent bodies reflects the currently limited role that market discipline can play in ensuring such compliance. Hirschman contended that stakeholders generally have two ways of reacting to performance deterioration in business organizations.[9] The first is for the stakeholder to quit the organization. The other is for the stakeholder to agitate and exert influence for change from within the organization. The potential role that these two mechanisms can play in upholding conformity with *Shariah* is constrained by the perceived complexity of Islamic financial instruments and their limited "commoditization". The diversity of jurisprudence on permissible transactions, and the limited disclosure of relevant and reliable financial information compound the difficulty. In addition, market participants and other stakeholders are likely to lack sufficient knowledge of *Shariah* or of financial principles, or of both, to judge the transactions of IIFS. In line with the foregoing, compliance with *Shariah* is primarily ensured through organs internal to the IIFS. At the same time, a broader enabling institutional environment, sometime referred to as external corporate governance is being put in place.

In the following the paper reviews in section two, prevailing internal arrangements that deal with *Shariah* compliance in individual IIFS; it examines the CG issues involved, and proposes measures to strengthen their effectiveness. Section three considers external arrangements that complement the ones adopted by individual institutions to promote compliance with the *Shariah*. The concluding section summarizes the overall strengths and weaknesses of existing arrangements.

II. Internal CG Arrangements for *Shariah* Compliance

The approach most widely adopted currently is to establish independent bodies of knowledgeable agents. These bodies are usually *internal* to the institution and part of its

[9] Hirschman, A.O. (1970)

governance structure. They include *Shariah* Supervisory Boards and *Shariah* review units. The following first analyzes existing arrangements and then considers options to strengthen them.

A. Internal Arrangements

Each institution offering Islamic financial services has in-house religious advisers, who are collectively known as the *Shariah* Supervisory Board (SSB).[10] In principle, the role of the SSB covers five main areas: certifying permissible financial instruments through *fatwas* (ex-ante *Shariah* audit), verifying that transactions comply with issued *fatwas* (ex-post *Shariah* audit), calculating and paying *Zakat*, disposing of non-*Shariah* compliant earnings, and advising on the distribution of income or expenses among shareholders and investment account holders.[11] The SSB issues a report to certify that all financial transactions comply with the above-mentioned principles. This report is often an integral part of the Annual Report of the Islamic financial institution.

In practice an SSB's tasks may vary according to provisions stipulated in the articles of association of the financial institution or those stipulated by national regulators. A review of 13 IIFS shows that all SSBs were entrusted with ex-ante monitoring and the calculation of *Zakat*.[12] However, ex-post monitoring was within the exclusive competence of *Shariah* review units in at least two cases.[13] In another case, the

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[10] They exist in all Islamic countries with the exception of Iran, where compliance of the whole banking system with *Shariah* is guaranteed and monitored by the central bank.

[11] A *Fatwa* is a religious edict or proclamation. It is a legal opinion issued by a qualified Muslim scholar on matters of religious belief and practice. The social nature of Islamic finance emerges most clearly in the practices of *Zakat* and *Qard Hassan*. *Zakat* is a tax on wealth, while *Qard Hasan* refers to zero-return beneficence loans made to the needy. The objective, according to the Meezan Bank of Pakistan is the "implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind".See also Briston and El-Ashker (1986) and Abdel Karim (1990).

[12] The sample reflects the accessibility of relevant information in these IIFS. Source: annual reports, articles of association, and all information posted on the websites of the following BIFSs: Bahrain Islamic Bank, Al Rajhi Banking Corporation, Bank Islam Malaysia Berhad, Jordan Islamic Bank, Kuwait Finance House, Bank Muamalat Malaysia, Shamil Bank, Bahrain, Islamic Bank of Britain, Emirates Islamic Bank, Dubai Islamic Bank, Islamic Bank Bangladesh Limited, First Islamic Investment Bank and Bank Rakyat Malaysia. Iranian IIFSs were not considered.

[13] This is the case of Al Rajhi Banking Corporation of Saudi Arabia and Dubai Islamic Bank. Such decisions may reflect the difficulties that SSBs may encounter in assessing volumes of transactions in large IIFS.

SSB could issue recommendations on how the institution could best fulfill its social role as well as promote Islamic finance.[14] In addition to internal corporate arrangements, national regulators and international standard setters implement guidelines for SSBs. These often refer to SSBs' general duty to ensure *Shariah* compliance of transactions and, less frequently, indicate areas of competence, composition and decision-making. Table I provides an overview of practices in selected countries that have introduced guidelines or legislative references on the functioning of SSBs.[15]

Table I - Regulations on Internal *Shariah* Advisory**

Country	SSB terms of reference	SSB composition	SSB decision-making	SSB appointment & dismissal	SSB Fit and Proper Criteria
Bahrain	✓	✓	unspecified	✓	✓
DIFC*	✓	✓	unspecified	✓	✓
Indonesia	✓	unspecified	unspecified	✓	✓
Jordan	✓	✓	✓	✓	unspecified
Kuwait	✓	✓	✓	unspecified	unspecified
Lebanon	✓	✓	unspecified	✓	unspecified
Malaysia	✓	unspecified	unspecified	unspecified	✓
Pakistan	✓	✓	unspecified	✓	✓
Philippines	✓	✓	unspecified	unspecified	✓
Thailand	✓	✓	unspecified	✓	✓
U.A.E.	✓	✓	unspecified	✓	unspecified

* Dubai International Financial Centre
** See Annex I for details of the legal bases and the provisions of these regulations

Source: Official Government websites and Central banks' Annual Reports.

The functioning of SSBs raises five main issues of corporate governance: independence, confidentiality, competence, consistency, and disclosure. The first

[14] The 2002 Annual SSB report of Islamic Bank Bangladesh Ltd contains suggestions on investment strategies, such as housing schemes, to help the poor and on research policy, such as the publication and translation of Islamic banking books. (www.islamibankbd.com, last visited April 18, 2005).

[15] Only those countries are included where authorities have implemented laws, acts or issued circulars and regulations on internal *Shariah* Supervisory Boards. Annex I details the legal bases and the provisions of these regulations.

concerns the *independence* of the SSB from management. Generally members of the SSB are appointed by the shareholders of the bank, represented by the Board of Directors. As such, they are employed by the financial institution, and report to the Board of Directors. Their remuneration is proposed by the management and approved by the Board. The SSB members' dual relationship with the institution as providers of remunerated services and as assessors of the nature of operations could be seen as creating a possible conflict of interest.

In principle, SSB members are required to submit an unbiased opinion in all matters pertaining to their assignment. However, their employment status generates an economic stake in the financial institution, which can negatively impact their independence. The opinions of the SSB may, for example, prohibit the bank engaging in certain profitable transactions or impose a reallocation of illicit income to charity, resulting in a poorer overall financial performance. Under these circumstances, the bank managers may be tempted to use their leverage to influence SSB members, producing what is commonly referred to as "*Fatwa* shopping" or "*Shariah* advisory *à la carte*".

In practice, the risk of such conflict of interest is mitigated by the ethical standards of the SSB members, and the high cost that a stained reputation would inflict on them and on the financial institution. Generally, members of SSBs are highly regarded *Shariah* scholars and guardians of its principles. Therefore, a less than truthful assessment and disclosure of *Shariah* compliance by an SSB would seem to be highly unlikely. In the event that it does occur and comes to light, it would seriously damage the concerned scholars' reputation and the prospect for further recourse to their services. Similarly, managerial interference in compliance assessments can lead to a loss of shareholders' and stakeholders' confidence. Management may be penalized and face dismissal. All that being said, and the heavy costs of untruthful assessments notwithstanding, a potential conflict of interest is inherent in existing corporate arrangements regarding SSBs.

The issue of *confidentiality* is intertwined with that of independence. Often, some *Shariah* scholars sit on the SSBs of more than one financial institution. This association with multiple IIFS may be seen as a strength in as much as it could enhance an SSB's independence vis-à-vis a particular institution. However, it does give the particular individual access to proprietary information of other, possibly competing institutions. Thus SSB members may find themselves in another type of potential conflict of interest. In the current practice, Malaysia has attempted to deal with this issue by discouraging jurists from sitting on the SSB of more than one IIFS. While this eliminates confidentiality concerns, the practice poses other potential problems. First, it would exacerbate lack of competence where there is a scarcity of *Fiqh al-Muamalat* jurists.[16] Second, it may prevent the formation of an efficient labor market for *Shariah* audit, by decreasing the economic appeal of the profession. Lastly, it may create a symbiotic relationship between the auditor and the financial institution that could undermine impartiality.

The third issue relates to the nature of the *competence* required of SSB members. Due to the unique role that they are called upon to fulfill, SSB members should ideally be knowledgeable in both Islamic law and commercial and accounting practices (*Fiqh al-Muamalat*). In practice, it would appear that very few scholars are well-versed in both disciplines. The issue has been addressed by including members from different backgrounds in most SSBs.[17] However, the combination of experts rather than expertise creates the challenge of overcoming different perspectives as well as the risk of potential failure of communication. Over time, the demand gap for combined *Shariah* and financial skills is likely to be reduced through public policy and normal labor market operations. Progress in this direction is already noticeable in countries where the Islamic financial industry is well established. For instance, the Securities Commission of Malaysia has certified a total of 27 individuals and 3 companies eligible for *Shariah* advisory on unit

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[16] *Fiqh al-Muamalat* literally translates into Islamic Commercial Jurisprudence

[17] AAOIFI (Governance Standard 1) recommends to include jurists of *Fiqh Al-Muamalat.*

trust funds, for a total of 24 companies offering such funds.[18] However, in countries where Islamic finance is less developed, other transitional arrangements may be needed.

The fourth issue concerns *consistency* of judgment across banks, over time, or across jurisdictions within the same bank. In essence the activities of SSBs are in the nature of creating jurisprudence by the interpretation of legal sources. It should therefore not be surprising to find conflicting opinions on the admissibility of specific financial instruments or transactions.[19] In reality, however, the diversity of opinions is less widespread than might be expected. The CIBAFI sampled about 6000 *fatwas*, and found that 90% were consistent across banks. The fact that over one hundred *Shariah* scholars around the world issued these *fatwas* would suggest an overall consistency in the interpretation of the sources.[20] Further, this high degree of consistency between the *fatwas* would also point to a substantial independence of SSBs. Nevertheless, as the industry expands, the number of conflicting *fatwas* on the permissibility of an instrument is likely to increase. This could undermine customer confidence in the industry and have repercussions on the enforceability of contracts.[21]

The last and overarching issue relates to *disclosure* of all information relating to *Shariah* advisories. In addition to the positive aspects of thus empowering stakeholders, disclosure could be the means to addressing some of the issues discussed in the preceding paragraphs. A transparent financial institution would ideally disclose the duties, decision-making process, areas of competence, and the composition of its SSB, as well publish all *fatwas* issued by the SSB. This would strengthen stakeholders' confidence in the credibility of SSB assessments. In addition, public disclosure of such information would

[18]The proportion of advisors to company seems to be quite large. Every management company must appoint at least 3 *Shariah* advisors for one company. This means that every advisor would serve on the SSBs of about two or more fund management companies. Data on *Shariah* advisors and approved instruments are available at http://www.sc.com.my (as of March 14, 2005).
[19] A typical example is the financing of leisure activities, which is frowned upon as *haram* by some Fiqh scholars. Moreover, Islamic jurisprudence is based on different schools of thought that may vary from country to country (the *Shiah* branch and the Sunni branch, which in turn includes the *Madhahib, Shafie, Hanafi, Hanbali and Maliki* traditions).
[20] As quoted in the proceedings of the Fourth Harvard University Forum on Islamic Finance, available at http://www.hifip.harvard.edu/MoreInfo.asp?news_id=34 (last visited March 14, 2005)
[21] It may be hard to invalidate contracts on grounds of a breach of *Shariah* law, if *Shariah* has no legal force in the country and there are no widely acceptable codified standards or contract specimens.

provide a forum for educating the public, thus paving the way for a larger role for market discipline in regard to *Shariah* compliance. Finally, it would decrease the costs that external agents may face in assessing the quality of internal *Shariah* supervision.

Despite all these potential benefits, transparency does not currently seem to be widely prevalent. Out of 13 banks reviewed, all declared the existence of an SSB within the organization and disclosed information on its composition.[22] However, only 7 made the annual report of the SSB easily accessible, and 7 did not provide detailed information on the professional background of SSB members.[23] Moreover, only two banks disclosed the *fatwas* authorizing the provision of financial services and products. Only one disclosed provisions for decision-making and interaction with other bodies of the firm. Finally, only one institution disclosed on its website the duties and obligations of the SSB.[24] The practice of limited disclosure by banks would not support building confidence in *Shariah* compliance.[25]

Besides *Shariah* Boards, most IIFS, particularly those complying with AAOIFI standards, have established *another internal Shariah review structure*, generally in the form of review units.[26] These internal *Shariah* review units are independent from other departments or are an integral part of the Internal Audit and Control Department. The array of tasks that they perform is parallel to those of audit departments -- reviewers generally use all necessary powers to ascertain that all financial transactions implemented

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[22] Source: Annual reports, articles of association, and information posted on the websites of the following IIFS: Bahrain Islamic Bank, Al Rajhi Banking Corporation, Bank Islam Malaysia Berhad, Jordan Islamic bank, Kuwait Finance House, Bank Muamalat Malaysia, Shamil Bank, Bahrain, Islamic Bank of Britain, Emirates Islamic Bank, Dubai Islamic Bank, Islamic bank Bangladesh Limited, First Islamic Investment Bank and Bank Rakyat Malaysia. Iranian IIFS were not considered.
Annex II provides an index of *Shariah* advisory disclosure for the 13 IIFS and compares desirable with effective *Shariah* related disclosure.

[23]This means that the SSB report was available on either the website or in the annual report. The proportion is 7 out of 11, because the SSBs of two recently established IIFS had not yet issued a report. In Annex III, both are counted as disclosed items.

[24] While most of this information is usually available through the Articles of Association, the SSB letter of appointment or individual *fatwas*, these documents are not easily available to customers. This is in stark contrast with BCFS that generally have on their website thorough information on their CG practices

[25] Annex III provides an index of *Shariah* advisory disclosure for the 13 IIFS mentioned in footnote 54. It compares desirable with effective *Shariah* related disclosure.

[26] AAOIFI recommends internal *Shariah* review in its Governance guidance 3. In Pakistan for example, this is dealt with in Annexure-III to IBD Circular No. 02 of 2004

by management comply with SSB rulings.[27] In some instances *Shariah* review units have exclusive competence on ex-post monitoring.[28]

These review units and SSBs face similar challenges, relating, in particular, to independence and competence. First, like SSBs and internal auditors, internal *Shariah* reviewers may be subject to a conflict of interest stemming from their employment status, with their appointment and remuneration determined by management, and their role as assessors of managerial processes and decisions. The scarcity of professionals with combined *Shariah* knowledge and financial skills also affects internal *Shariah* review departments. Like SSB members, internal *Shariah* reviewers should be knowledgeable in *Fiqh al-Muamalat*. Yet, as already observed, the scarcity of such experts is likely to bear on the quality of *Shariah* reviews in IIFS. The issue may have greater implications in this case, because *Shariah* reviewers would also be assigned to the training of other employees on the principles of *Fiqh al-Muamalat.*[29] Thus, their pronouncements and counsel could have pervasive effects throughout their respective IIFS.

B. *Strengthening Internal Arrangements for Shariah Compliance*

The actions of SSBs and *Shariah* reviewers at the individual institutional level have so far been relied upon to provide some degree of comfort in assuring IIFS's compliance with *Shariah*. However, in line with the foregoing discussions, IIFS, national regulators and international standard setters could further address the issues of: (a) independence of the SSB, (b) confidentiality of its activities, (c) competence of its members, (iv) consistency of pronouncements and (d) disclosure of *Shariah* decisions and audit.

[27] In this respect, the role of the internal review unit is limited to a complementary ex-post monitoring. This makes its task secondary, if more focused and defined, to that of SSB, which is the ultimate arbiter in matters of *Shariah* compliance.

[28] This is the case of large Islamic banks where SSB may not be able to assess large volumes of transactions. Therefore, separate *Shariah* control departments are operational. This seems to be the case in Al Rajhi Banking and Investment Corporation and Dubai Islamic Bank.

[29] According to AAOIFII Standard 3. In some cases educational activities are delegated to separate units, as for instance, in the Al Rajhi Corporation. (www.alrajhibank.com.sa, April 2005).

The issue of *independence* is common to *Shariah* review bodies. Prevailing approaches to the regulation of internal audit departments and external audit firms can provide guidance on how to ensure integrity of pronouncements on *Shariah* compliance. The literature on internal audit independence pinpoints three factors that significantly contribute to the degree of auditor independence: (i) clarity of definition of the auditor's responsibilities, (ii) the position of the auditor within the organizational structure of the institution, and (iii) the reporting authority for audit results. This would suggest that the independence of both *Shariah* advisors and reviewers could be enhanced by clearly defining their responsibilities and powers in the articles of association of the company or in a charter of independence. Their powers would include the authority to access all records and staff necessary to conduct the audit and to require management to respond formally, and in a timely manner, to significant adverse audit findings by taking appropriate corrective action. Such powers should not include operational tasks that could impair their independence.[30] Second, the organizational status of internal *Shariah* bodies should be sufficiently articulated to permit the accomplishment of audit responsibilities. This appears to be fundamental in the case of *Shariah* review units that have to deal with large volumes of transactions in conducting ex-post assessments. Third, the independence of action of SSB and *Shariah* reviewers and their ability to withstand pressures from management can be assured only as long as *Shariah* bodies functionally report, and are accountable, to an individual or entity with sufficient authority to: (a) safeguard their independence, (b) achieve a broad audit coverage, (c) ensure adequate consideration of audit reports, and (d) generate appropriate action on audit recommendations. This role is generally performed by independent directors involved in the audit committee. In the case of those IIFS with concentrated shareholding, this role may be assumed by minority shareholders' directors.[31] However, following the practice of external auditors in some jurisdictions, *Shariah* reviewers may be required to report fraud or unexplained breaches of rules directly to supervisory authorities. The latter option could be difficult to

[30] These may include preparing reports or records, developing procedures, or performing other operational duties normally reviewed by auditors.

[31] Outside directors in concentrated ownership corporations are generally appointed by the majority shareholders themselves and may not be truly independent.

implement in countries where supervisors may regard matters of *Shariah* compliance to be outside their competence.

The foregoing would require carrying existing international norms into national ones and enforcement monitoring mechanisms. The BCBS and OECD codes contain clear provisions on directors' independence designed to curb collusion opportunities between management and other internal bodies. Likewise, AAOIFI's "governance standards on the definition, appointment, composition and report of SSBs" and "Codes of Ethics" contain clear provisions on the duties and powers of SSBs that would limit a bank's discretion in the definition of SSB prerogatives and thereby deprive managers of one instrument of control.[32] In addition, they contain provisions on fixing remuneration, selection and dismissal of SSB members as well as incompatibility clauses to diffuse conflicts of interest.[33] A number of national regulators have already included such prohibitions in circulars or legislative acts, mostly in the form of fit criteria and prohibited interests for the appointment of SSB members or advisors.[34]

Following the practice of periodically rotating external auditing companies, mandatory rotation of SSBs would seem to be desirable. Proponents of this measure argue that a long-term client relationship can impair the auditor's objectivity. Therefore, by periodically interrupting such a relationship through mandatory rotation, the bank's management would be deprived of its ability to influence the auditors with the threat of terminating their mandate. In Italy, the only OECD country that implements mandatory

[32] The codes are the Code of Ethics for Accountants and Auditors of Islamic Financial Institutions and the Code of Ethics for the Employees of Islamic Financial Institutions. The SSBs' prerogatives include ex-ante and ex-post evaluation, calculation of *Zakat* and allocation of profits or charging of losses to unrestricted investment account holders.

[33] For instance, dismissal of SSBs may only be prompted by a request of the board of directors approved by the general assembly of shareholders. This will prevent "f*atwa*-shopping". Further, the standards' provisions prohibit the appointment of "directors or significant stakeholders" as SSB members and the prohibition for *Shariah* review units to carry out operational activities (for instance, a division in the internal audit department). Depending on local circumstances, such provisions may be strengthened by introducing severe sanctions for accepting loans from the audited company, having family relationship with the audit client or having any form of direct or indirect material interest in the business. For instance, in Malaysia, the approval and dismissal of SSBs must be communicated to the central bank.

[34] Recent examples include Annexure IV to IDB Circular No. 2 of 2004 of the State Bank of Pakistan on "Fit & proper criteria for appointment of *Shariah* advisors"; Chapter 5 of Islamic Bank of Thailand Act B.E 2545 on "Advisory Council of the Islamic Bank of Thailand" and Bank Negara Malaysia's 2004 "Guidelines on the Governance of *Shariah* Committee for Islamic Financial Institutions".

rotation of external auditors, a recent review of the practice by the "Galgano Committee", instituted following the US CG scandals, recommended that "in order to safeguard an auditor's independence the audit engagement should not be immediately renewed. The exclusion of an immediate renewal of the engagement avoids any influence on the judgment of the auditors driven by a hope for renewal".[35]

Opponents of this measure abound. Summer (1998) argues that "by destroying rents from an ongoing relation, the rotation rule undermines incentives for building up a reputation of honesty". He therefore suggests that competition in the auditor market may be a better safeguard for auditors' independence. An independent review of the practice by the Bocconi University concluded that rotation compromises audit quality, which strictly depends on a good knowledge of the business and its management.[36]

Transposing such arguments into a *Shariah* framework, rotation of SSBs may lead to greater independence, but could also produce similar inefficiencies and failures in *Shariah* compliance verification in the transitional phase. Mandatory rotation of SSBs may also exacerbate inconsistency in the application of *Shariah* within the same bank. An alternative may be found in the practice of periodically rotating SSB members rather than entire boards. This would infuse fresh approaches in the SSB and may increase independence through peer review; it would not necessarily compromise the audit quality, as the continuing members would assure continuity.

Preserving *confidentiality* of information may require solutions that echo those applied to the auditing profession. For instance, *Shariah* auditors may be required to abide by codes of professional conduct. AAOIFI's Code of Ethics for Accountants and

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[35] The report grants the possibility of renewal six years after the end of the engagement. Quoted in English in FEE (2004).

[36] This report quantified the quality of audit services by the number of suspensions of partners imposed by the Consob (the Italian national commission for the 20 audit firms of listed companies). Cases of suspension normally arise when auditors do not pinpoint material misstatements. As the report states: "The number of partner suspensions in Italy, imposed during the period between 1992 and 2001 amounted to 40. The analysis of the distribution of suspensions shows how they are mainly concentrated in the first year of an appointment with a total number of 13. The number of suspensions imposed over the following years drops dramatically, from one to three a year. For more, FEE (2004).

Auditors for Islamic banks and Financial Institutions provide conduct guidelines tailored to *Fiqh al-Muamalat* professionals. Nevertheless, the applicability of such code in non-Islamic countries may be constrained by direct references to Islamic morals and *Shariah* law. A viable alternative might be for regulators to extend standard auditing profession requirements to *Shariah* auditors.

Ensuring the *competence* of SSB members and *Shariah* reviewers requires a multi-pronged approach. Short-term policies to increase the number of qualified *Shariah* advisors would include training activities in *Fiqh al-Muamalat* at the bank level, in specialized training institutes and other government-recognized or related organizations such as central banks.[37] *Fiqh al-Muamalat* degrees could be created and promoted by providing grants and certifying universities. Concurrently, the abilities of *Shariah* advisors and reviewers would be certified. The process of certification would begin at the IIFS level where managing bodies would appoint SSB members according to established criteria on expertise, education and track record that would be spelled out in the articles of association. The background of SSB members would also be disclosed in accessible information venues, such as websites and annual reports. This process may be complemented by self-regulatory professional associations or national authorities who would enforce nationwide mandatory criteria.[38] Similarly, a national registration process might be established along the lines of the certification of *Shariah* advisors implemented by the Securities Commission of Malaysia. This would have the additional advantage of a centralized and therefore standardized assessment of *Shariah* experts' skills. Besides safeguarding competence, this option may increase independence in *Shariah* audit.

Disclosure of the processes leading to *Shariah* pronouncements and related information needs to be the cornerstone of *Shariah* governance. These issues may not have received sufficient attention either from IIFS themselves or their regulators and supervisors. Therefore, policies need to be put in place that would ensure adequate

[37] Some examples include the Islamic Banking and Finance Institute of Malaysia, the Bahrain Institute of Banking and Finance, the Bangladesh Bank Training Academy and Iran's Training and Human Resource Studies Department.
[38] This is the Case of Pakistan's "Fit & proper criteria for appointment of *Shariah* advisors" that explicitly require "minimum qualification and experience".

disclosure, terms of both quality and ease of retrieval, such as through IIFS websites and annual reports. Of particular importance would be, inter alia, the SSB annual report and its *fatwas*. Informing IIFS's stakeholders on the composition, powers, competence and decision-making of SSBs would also enhance the transparency of the processes leading to *Shariah* pronouncements.

III. External Arrangements for *Shariah* Compliance

Under the prevailing current decentralized system of *Shariah* advisory, the flexibility in *Fiqh* opinions has encouraged innovation in Islamic financial products, contributing significantly to the dynamism of the industry. Nevertheless, because of the very nature of jurisprudence, interpretation of the *Shariah* by a large number of independent scholars, notably in the various SSBs gives rise to inconsistencies in the *fatwas* across SSBs, or even over time in the same SSB. Internal systems and procedures could be developed in IIFS to limit inconsistencies and explain different pronouncements. External arrangements, including mechanisms of market discipline can provide complementary channels inducing compliance with rulings and their harmonization. The following first analyzes existing external arrangements and then considers options to strengthen them.

A. *Existing External Arrangements*

The broad *Shariah* governance framework may feature (a) arrangements put in place by regulators, and (b) the presence of providers of financial information services external to the firms. Among regulatory arrangements, *centralized SSBs* are the most noteworthy. While there are significant differences across countries, centralized SSBs are usually concerned with ex-ante monitoring, mostly understood as standardization of *Shariah* interpretation, and ex-post monitoring of *Shariah* compliance. They also offer arbitration to settle *Shariah* disputes arising between members of the same SSB. In addition, a few countries have set up public rating agencies that assess financial instruments and institutions. These are meant to create a positive climate for *Shariah* compliant investments. Table II offers an overview of such regulatory institutions in key jurisdictions where Islamic finance services are offered.

Table II - External *Shariah* CG institutions by country*		
Country	Centralized SSB or High *Shariah* Authority or Fatwa Board	Islamic Rating Agency
Jordan	No	No
Malaysia	✓	✓
Sudan	✓	No
Bahrain	No †	No †
Kuwait	✓	No
Pakistan	✓	No
UAE	✓	No
Indonesia	✓	No

* See Annex III for the names and powers of these departments/authorities.
† Bahrain is the seat of the IIFM and the IIRA that respectively set standards for Islamic jurisprudence and rate Islamic instruments on an international scale.
Source: Official Government websites and Central Banks' Annual Reports.

One of the distinctive goals of these bodies is the standardization of *Shariah* practices within their jurisdictions. Countries such as Kuwait, Malaysia or Pakistan have taken significant actions in this respect, while others have not followed this route. The standardization of Islamic instruments may be a major determinant in ensuring the enforceability of Islamic financial contracts in disputes brought before civil courts that are not legally bound by the *Shariah*. Accordingly, standardization of practices would support property rights of involved stakeholders as well as sustain the development of IIFS in non-Islamic countries. However, the practice of centralized SSBs creates the possibility that one IIFS group operating in different jurisdictions may have products deemed *Shariah* compliant in one place and not in another. In addition, regulators in non-

Islamic jurisdictions would consider that matters relating to the *Shariah* are not in their purview (e.g., the UK FSA).[39]

Private mechanisms for the external governance of *Shariah* compliance are equally limited. In particular, private rating agencies have not yet developed the necessary skills or found enough incentives to monitor the IIFS' *Shariah* compliance. "Islamic rating" has so far been the exclusive domain of government-sponsored organizations such as the IIRA and the Malaysian Rating Corporation. Likewise, other external entities with an interest in Islamic finance, such as the financial media and external auditors, are still generally less concerned with assessments of *Shariah* compliance.

A notable exception is the multiplication of stock market Islamic indices whose major contribution is the identification of *halal* investments.[40] Islamic stock market indices, like the FTSE Global Islamic Index, the Dow Jones Islamic Indexes and the Indonesian *Shariah* Index, may contribute to better *Shariah* governance for publicly traded IIFS. By filtering out companies with activities that are incompatible with *Shariah,* as well as firms with unacceptable levels of debt or interest income, they contribute to reducing adverse selection in investments by IIFS, and give additional comfort on the *halal* nature of IIFS activities.[41] However, current practice is not likely to meet with a full consensus of *Shariah* scholars. Usually, these indices include companies that deal in interest because of the lack of a fully interest-free international market. While some Islamic finance scholars may find this approach acceptable, others will not, thus limiting the role of these indices in enhancing *Shariah* governance.

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[39] In Malaysia, for instance, the judicial system has agreed to resort to the Central Bank's *Shariah Council* for opinions on the permissibility of Islamic financial instruments, whenever a court case brought before it may require it. It would be hard to replicate such a scheme in other countries, where regulators may not want to get involved in *Shariah* issues.

[40] *Halal* conveys goodness and by extension has taken the meaning of "permissible".

[41] In the case of Dow Jones Islamic Indexes, excluded businesses include: alcohol, conventional financial services (banking, insurance, etc.), entertainment (casinos/gambling, cinema, pornography, hotels, etc.), tobacco manufacturers, pork-related products and defense and weapons companies. Companies classified in other industry groups may also be excluded if they are deemed to have material ownership of or revenues from the businesses mentioned above.

B. *Strengthening External Arrangements for Shariah Compliance*

Recent literature and practice have focused on establishing external CG structures to ensure effective *Shariah* audit. In proposing the externalization of *Shariah* advisory, Chapra and Habib (2002) suggest that chartered audit firms should acquire the necessary knowledge to undertake *Shariah* audit. This process is already underway as evidenced by the increasing number of independent consulting companies and law firms offering *Shariah* advisory services.[42] In addition to reducing internal audit costs in the Islamic financial institution, the use of such services would possibly give the institution access to a broader range of expertise. In addition, the public may perceive chartered *Shariah* audit companies as more independent from the institution's management. It is not certain, however, that switching to external *Shariah* audit would bring tangible guarantees of *Shariah* compliance. Potential for "*Shariah* advisory *à la carte*" would not end with the externalization of services. In addition, externalization will not improve, and may in fact worsen, the accuracy of *Shariah* audit. Internal auditors are generally familiar with the records systems, policies and procedures of the institution and can provide quick responses to managers. The result could be a more detailed and exhaustive internal audit.

. The idea of external firms undertaking *Shariah* audit presents some advantages if it is viewed as complementing internal *Shariah* audit. *Shariah* audit firms would perform a role similar to that of their counterparts in conventional finance, thus introducing an additional layer in the *Shariah* verification process. Such a system would obviously entail a clear separation of pre-audit and post-audit functions. Complementary internal and external audit would apply only to post-audit, while the internal pre-audit unit, the SSB, would have the sole authority to issue *fatwas*. Internal audit by the SSB would have an independent appraisal function, including the review of *Shariah* verification systems and controls, while external *Shariah* auditors would have a statutory responsibility to express an independent opinion on *Shariah* compliance. To avoid duplication, the latter function could be performed by *Shariah* departments set up by existing chartered auditors. (Table

[42] For example: http://www.yasaar.org/rationale.htm, & http://www.islamic-banking.com/shariah/index.php

III shows how internal and external *Shariah* review may be differentiated and illustrates the merit of specialization.

Table III – Comparison of Internal and External *Shariah* Review		
	Internal *Shariah* Review Unit	External *Shariah* auditing firm
Focus	Provides exhaustive internal review, and train employees on *Shariah* related matters. It responds to managerial concerns over upholding *Shariah* conformance of all transactions	Primarily provides an independent certification as to the reasonableness of financial information provided to shareholders and stakeholders. It responds to regulators' and stakeholders' desire for an independent appraisal of *Shariah* compliance
Activities	Assess compliance of *all* transactions with the *fatwas* issued by the SSB. To this effect, it creates systems of control and assessment.	Assess the information provided by the managers and present statements according to relevant *Shariah* accounting standards. It uses *samples* of transactions to evaluate truthfulness of compliance and expresses an opinion on financial statements
Manage-ment	Reports to management administratively. Builds relationships throughout the organization to ensure concerns are identified and resolved in a timely manner.	Primarily reports to the audit committee on financials and internal control.
Board of directors/ Audit Committee	Reports directly to the audit committee. Provides opinions on the organization's business risks, financial statements, system of internal control, and level of compliance with laws, regulations, and policies.	Attests to the audit committee the accuracy of the financial reports and attests on management's assessment on internal controls over financial reporting. Provides updates on pending accounting pronouncements and their potential impact on the organization.
Independ-ence	Should demonstrate organizational independence and objectivity in work approach, but is not independent of the organization. (Is independent of the activity audited, but is integral to the organization.)	It is organizationally and managerially independent of the organization.
Results	Identifies problems, make recommendations, and helps facilitate resolutions.	Meets statutory requirements and provides necessary adjustments to meet financial accuracy.
Risk	Identifies and qualifies key business risks to estimate probability of occurrence and impact on business. Makes appropriate recommendations as a result of the risk assessment.	Identifies key transactions and exposures for financial statements.

Fraud	Includes fraud detection steps in audit programs. Investigates the allegations of fraud. Reviews fraud prevention controls and detection processes put in place by management and makes recommendations for improvement.	Includes fraud detection steps in audit plan. Gathers information necessary to identify risks of material misstatement due to fraud, by inquiring of management and others within the entity about the risks of fraud. Considers the results of the analytical procedures performed in planning the audit and fraud risk factors.
Recomm-endations	Communicates to management in the audit reports recommendations for corrective action.	Communicates recommendations for corrective action.
*Adapted from table in Richards (2002).		

A framework of co-existing internal and external *Shariah* audits as described above does not help to resolve the difficulties caused by inconsistencies in the body of *fatwas*. In an effort to alleviate this problem, some jurisdictions have moved towards a system of centralized SSBs. The latter carry the expectation of harmonization of permissible financial instruments through adjudicating disputes between *Shariah* advisors and by standardizing existing practices. However, the ongoing globalization of Islamic finance as well as constraints on its applicability in secular countries limits the feasibility of this approach. To circumvent these limitations, Khan and Feddad (2004) recommend the gradual international codification and standardization of *fatwas*. This duty may be delegated to an existing international organization, whose mission already involves the promotion of harmonization and convergence of *Shariah* interpretations.[43] Alternatively, a new self-regulating non-profit association of *Fiqh al-Muamalat* experts may be created. However, despite its apparent advantages, the creation of a global *Shariah* regulator is likely to meet with resistance, specifically from jurists who regard Islamic *Fiqh* as a pluralist body of knowledge. Also, the centralization of competences in a global regulator may undermine product innovation and financial engineering.[44]

[43] AAOIFI's mission statements declare that "the powers of (AAOIFI's) Shari'a Board include, among others, the following: achieving harmonization and convergence in the concepts and application among the Shari'a supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the fatwas and applications by these institutions, thereby providing a pro-active role for the Shari'a supervisory boards of Islamic financial institutions and central banks (…)" Likewise IIFM's "role includes the promotion of harmonization and convergence of Shariah interpretations in developing Islamic banking products and practices that are universally acceptable". Sources: www.aaoifi.com and www.iifm.net/

[44] This would obviously depend on the degree of powers transferred to such an organization. For instance, the State Bank of Pakistan has issued "Essentials of Islamic modes of financing" to ensure compliance with minimum *Shariah* standards, which do not present an obstacle to innovation and yet contribute to harmonizing permissible contracts. For more www.sbp.org.pk.

Over-reliance on the public sector for regulating *Shariah* matters may also present other difficulties, such as the reluctance of authorities in a large number of jurisdictions, to be involved in what they would consider private religious matters. In such situations, the private sector could fill the gap and play a more decisive role in the *Shariah* compliance process. The focus would be on consolidating the *Shariah* related information infrastructure by creating new processes or strengthening the exiting infrastructure. Next to external *Shariah* audit firms, representational agents that normally channel financial information to the public may acquire new skills and assess IIFS's compliance with Islamic finance rules.

In the future, key players in this field may be the private rating agencies. One may anticipate that they would gradually develop skills to evaluate *Shariah* compliance and make this information readily available to investors using their existing dissemination infrastructure. Their coverage may also include companies in which IIFS have a stake. This would create a positive climate for *Shariah* compliant investments, particularly for partnership and venture capital transactions. It is noteworthy that some leading rating companies have included "religious supervision" as an item in their reports on IIFS.[45] However, this is often limited to a summary statement on the existence of a SSB and the conclusions of the SSB annual reports. Eventually, one may envisage a more articulate contribution through the adoption of *Shariah* compliance indicators that would quantify *Shariah* disclosure, profit-sharing and Z*akat.*[46] In addition, Islamic market indices may prove important. One may expect that current criticisms about their use will diminish with the development of the industry. With the progressive increase of *halal* products, filters may be tightened to meet with greater scholarly approval.

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[45] This is notably the case of Capital Intelligence bank reports.

[46] Shahul et al. (2004) propose the creation of two (disclosure and performance) "Islamicity Indices". They quantify, among other things, *Shariah* compliance, corporate governance practices, social and environmental impact, profit-sharing performance and *zakat* performance.

Section IV. Conclusion

Overall, current practice to ensure Shariah compliance relies essentially on internal corporate structures, in particular SSBs. These certainly offer stakeholders a level of comfort. Nevertheless, they face a number of challenges relating to their independence, the confidentiality of institution-specific proprietary information, the limited availability of professionals with both *Shariah* scholarship and financial skills, and the need for consistency in pronouncements between the various SSBs. A few jurisdictions have tried to address some of these issues by introducing an external institutional infrastructure. This, however, creates potential difficulties arising out of inconsistent pronouncements for IIFS groups operating in different jurisdictions, and may be problematic for regulators in non-Islamic countries. Market solutions to offer services that would promote *Shariah* compliance are still minimal.

Figure I: Effective framework to monitor and assess *Shariah* compliance

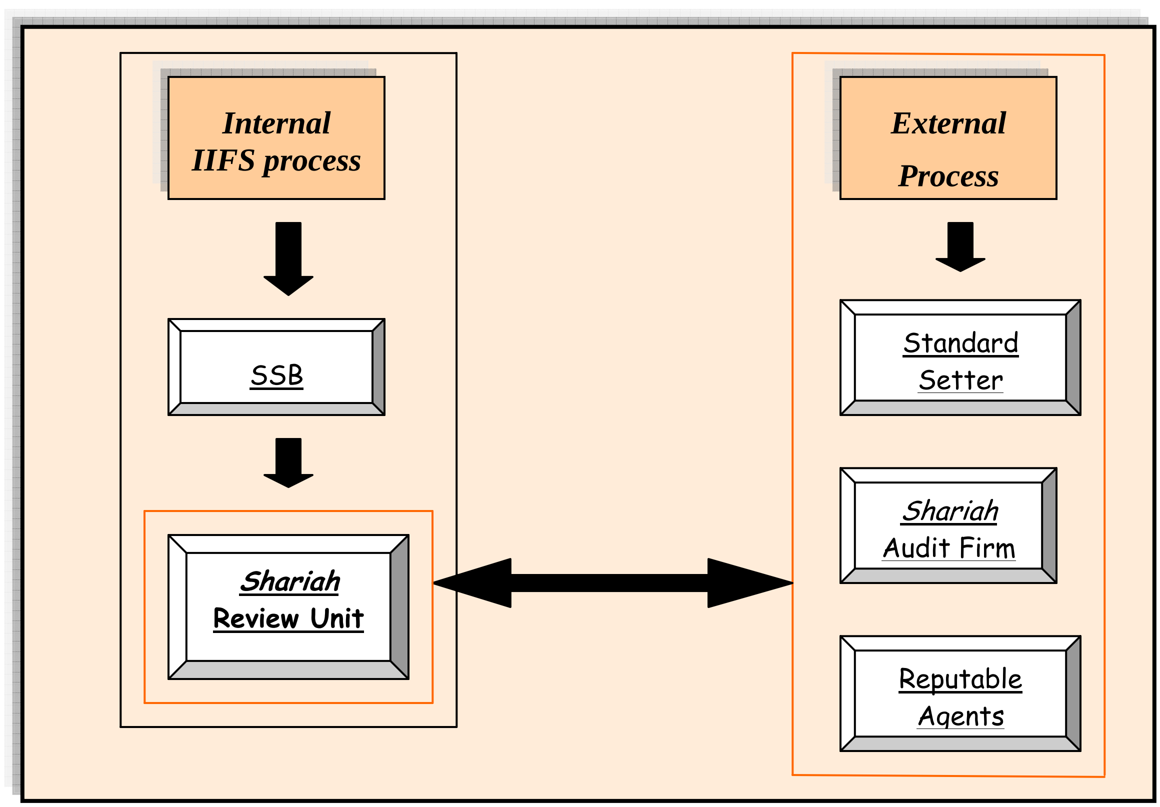

Figure 1 summarizes structures and processes internal and external to an IIFS that can jointly provide an effective framework to monitor and assess *Shariah* compliance. Such a framework can be instrumental in enhancing stakeholders' confidence. It would enable innovation that can generally be expected to emerge mainly within the firm, where a sufficiently competent and independent SSB would be empowered to approve new *Shariah* conforming instruments. In issuing its fatwas, the SSB can be guided by standardized contracts and practices consistent with principles emerging from external arrangements, notably from international standard-setting official or self-regulatory bodies. The review of transactions would mainly be entrusted to internal review units, which would collaborate with external auditors, responsible for issuing an annual opinion on whether the IIFS activities meet its *Shariah* requirements. This process would be sustained by reputable agents, like rating agencies, stock markets, financial media, and researchers who would channel signals to market players. Such a framework including structures and processes internal and external to the IIFS can be expected to enhance public understanding of the requirements of *Shariah.* It would be conducive to the development of market discipline as it would permit an effective utilization of exit and participatory actions.

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Annex I: Glossary of Arabic Terms

Amana (Demand deposits)	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value and earn no return.
Fatwa	Legal opinion issued by a qualified scholar on matters of religious belief and practice.
Fiqh (Islamic jurisprudence)	It refers to Islamic jurisprudence that covers all aspects of life: religious, political, social and economic. *Fiqh* is mainly based on interpretations of the *Qur'an* and *Sunna* (sayings and deeds of the prophet).
Fiqh al-Muamalat	Islamic Commercial Jurisprudence.
Gharar	Literally, : uncertainty, hazard, chance or risk. Technically, sale of a thing which is not present at hand; or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, such as fish in water or a bird in the air.
Halal	That which is permissible according to *Shariah* Law.
Haram	Unlawful according to the *Shariah*. It indicates transactions which are not permissible under Islamic law.
Hibah	Literally gift. A gift awarded voluntarily in return for a loan.
Ju'ala (Service charge)	A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties. This mode usually applies to transactions such as consultations and professional services, fund placements and trust services.
Kifala	It is a pledge given to a creditor that the debtor will pay the debt, fine, or liability. A third party becomes surety for the payment of the debt if unpaid by the person originally liable.
Mudaraba (Trustee finance contract)	*Rabb -al- mal* (capital's owner) provides the entire capital needed to finance a project while the entrepreneur offers his labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by *rabb-al-mal*. The liability of the entrepreneur is limited only to his time and effort.
Murabaha (Mark–up financing)	The seller informs the buyer of his cost of acquiring or producing a specified product. The profit margin is then negotiated between them. The total cost is usually paid in installments.
Musharaka (Equity participation)	The bank enters into an equity partnership agreement with one or more partners to jointly finance an investment project. Profits (and losses) are shared strictly in relation to the respective capital contributions.
Qard Hassan (Beneficence loans)	These are zero-return loans that the *Qur'an* encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
Quran	Islamic scriptures believed by Muslims to be God's revelation to the Prophet.
Riba'	Literally, an excess or increase. Technically, an increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party.
Shariah (Islamic Law)	The Islamic Law extracted from the *Qur'an* and *Sunna* (sayings and deeds of the Prophet).
Sunna	Deeds of the Prophet.
Takaful	Arabic name for insurance based on *Shariah* rules. An Islamic Insurance is a collective protection scheme. It literally means solidarity. *Takaful* reflects solidarity and is akin to mutual insurance.
Umma	Community of the faithful within Islam
Wadiah	A safe custody contract between the depositor (customer) and the custodian (bank).
Wikala	An Agency contract which may include in its terms a fee for the agent. Same contract can also be used to give a power of attorney to someone to represent another's interests.
Zakat	Religious tax to be deducted from wealth to be paid to the needy.

Compiled from El-Hawary, Grais, and Iqbal (2004) and the glossary of the IIFM website (www.iifm.net).

Annex II: Mission statements of IIFS and ICFS

IIFS	Mission statements, objectives or vision	ICFS	Mission statements, objectives or vision
Jordan Islamic Bank, Jordan	(The bank's goals are) commitment to providing banking services based on compliance with the rules and principles of the glorious Islamic *Shariah* in all our activities to serve our community as a whole, and commitment to equally serve the interests of all related parties including shareholders, depositors, and employees. (website)	*Mizuho Financial Group, Japan*	(Our) (…) basic principles of the consolidation are: 1) offer a wide range of the highest quality financial services to our customers 2) maximize shareholders' value and, as the leader of Japan's financial services industry, earn the trust of society at large, 3) offer attractive and rewarding job opportunities for employees (...)
Bank Islam Malaysia Berhad	The Corporate Mission of the Bank is to seek to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process (The Bank's) Corporate Objective is to provide its customers with Islamic Banking facilities and services of the highest possible quality; to attain viability and sufficient level of profitability to sustain growth; to develop and foster a competent and innovative management imbibed with high standards of integrity and Islamic banking professionalism; to develop a motivated workforce inculcated with appropriate work ethics fully committed to the Bank and to offer efficient and courteous service to customers; to constantly strive to protect its shareholders' interest; to be always conscious of its responsibilities and duties as an Islamic corporate citizen.	*Norges Bank, Norway*	The company's primary objective must be to maximize shareholders' long-term returns. There must be a clearly defined business strategy that is anchored in the board of directors. The company must present accurate, adequate and timely information concerning its financial position and other relevant information. The company's board of directors shall protect the interests of all shareholders and shall be accountable for the decisions made by the board. The board of directors shall supervise the day-to-day management and company activities, and shall ensure a proper organization of these activities, including adequate internal control systems.
Kuwait Finance House, Kuwait	In accordance with the Islamic principles, KFH ensures that while working with the public professionally, the company guarantees an honorable relationship with its client base and the Muslim community as a whole	*Coastal Federal Bank, USA*	Our basic corporate objective (is) maximizing the value of our shareholders' investment

Faisal Islamic Bank of Egypt	The ultimate goal being to eventually institute an elaborate and comprehensive banking system based on the rules of Islamic Shari'ah which meets the needs of all those concerned… shareholders-clients-employees.	*Deutsche Bank, Germany*	**Mission: We compete to be the leading global provider of financial solutions for demanding clients creating exceptional value for our shareholders and people.**
Bank Muamalat Berhad, Malaysia	To build the bank into a modern, dynamic and strong Islamic Bank that would play a role in providing a viable alternative to the conventional system, that will contribute to the development of Modern Malaysia.	*Commonwealth Bank, Australia*	The key financial objective of the Bank is to have Total Shareholder Return in the top quartile of our Australian listed peers over each rolling five year period.
Badr-Forte bank, Russia	To contribute to the globalization of Islamic Banking as the principal institution within the Russian Federation implementing Islamic financial and economic concepts, which offer a unique solution for social justice and harmony in our contemporary society	*BBVA Group, Spain*	The seven corporate principles are as follows: Focus on the customer as the centre of business; creation of shareholder value through business activity; teamwork as the engine in the creation of value; a management style that generates enthusiasm; ethical behavior and personal integrity as a way of understanding and conducting business; innovation as the engine of progress; and corporate social responsibility as an intrinsic part of development.
AlBaraka Islamic Bank, (Bahrain and Pakistan)	We strive to be a premier regional Islamic bank, dedicated to the economic and social development of our target markets, maximizing our clients and shareholders value, and focusing on the human resource development in an environment of creativity and innovation. Albaraka is committed to develop and promote an integrated Islamic Financial System. Compliance with the rules and principles of Islamic Sharia is the core of the banking and financial activities of the Bank. To this end, the Bank has successfully sought the advice and expertise of Islamic scholars acclaimed for their knowledge and piety from all over the Islamic world to guide is path and monitor its performance (website)	*BNP Paribas, France*	BNP Paribas founds its corporate project on three commitments: 1) toward its customers, BNP Paribas undertakes to give first priority to their satisfaction and to constantly improving the quality of their welcome and of the services offered, 2) toward its shareholders, BNP Paribas undertakes to put value creation at the very heart of its options, 3) toward its employees, BNP Paribas undertakes to ensure a dynamic and stimulating management of careers and remuneration by developing employee share-ownership and promoting social dialogue. The respect of these commitments is guaranteed by the team spirit of all the bank's employees and their adherence to a code of ethics founded on transparency, professionalism and quality
Dubai Islamic Bank, UAE	(The) Objectives of the Bank (are): 1) Providing banking services of the highest standards according to Islamic	*Jyske Bank A/S, Denmark*	(…) The Jyske Bank Group is managed and operated as a business. At the same time, we attach great importance to

	Shariah without dealing in riba (interest on money) and by using the-state-of-the-art technology in computer, telecommunication and information system 2) Investing funds prudently to achieve optimum and not maximum profits, for the mutual benefit of customers and the bank. 3) Coordination, cooperation and integration with other financial bodies that apply Islamic *Shariah* in their dealings, in order to support creating a base and regulations for an Islamic financial system. 3) Development of the Islamic society in all fields of the economy by investing in industries, agriculture, commerce, and real estate in order provide job opportunities. 4) Promotion of social benevolence through its Islamic methods, particularly through Zakat. 5) Contributing to the welfare of society in line with the five main tenets of Islam, namely protection of life, purity of mind, property, honour and social justice. 6) Promoting the savings habit and encouraging people to invest wisely within the parameters of Islamic *Shariah* through investment and finance instruments to suit individual requirements. 7) Making available the necessary capital for entrepreneurs for the establishment of economic projects and creation of alternative instruments for finance according to Islamic *Shariah*.		treating the three groups of stakeholders – shareholders, customers and employees – with equal respect. (…) Our objective is to provide our shareholders with a satisfactory long-term return on their investment. Thus, the aim is for Jyske Bank every year to be one of the top-performing Danish banks based on the level of our earnings. Jyske Bank is thus an excellent choice for shareholders who want to make a long-term investment and who do not attach great importance to decisions which generate only short-term price increases.
Islamic Bank of Thailand, Thailand	(The bank's goals are): to maintain the role of a bank that is not tied up with interest; to strengthen the business; to carry out social and organizational stability; to provide an excellent service; and to well direct and supervise the community development	*RHB Group, Malaysia*	Mission: To become the most admired Malaysian financial services company by providing excellent customer services, enhancing shareholder value, providing challenging career and learning opportunities for employees, demonstrating responsibility for society.
ABC Islamic Bank (E.C.)	Our mission is to uphold our carefully formulated *Islamic principles* in the quest for *mutual prosperity for our clients and the Bank*. In pursuit of our mission, we commit the Bank to the purest forms of Islamic banking products and services from a	*HSBC Canada, Canada*	HSBC in Canada is committed to being Canada's leading international financial services organization, a leader in chosen markets, and recognized by its clients as proactive, responsive, competitive and secure. To achieve a superior long term

	Shari'a perspective. We remain demonstrably *independent from the conventional sector* and recognize the *importance of Islam's social objectives* in conducting business. We are committed to delivering a *level of service* that matches, or exceeds, the market practice internationally. To do so, we seek to employ the best available human resources and the technology to apply the *highest professional, moral and ethical standards*.		return for our shareholder we will efficiently deliver a differentiated client experience which reflects our commitment to excellence in sales, service and products, and which is delivered by highly motivated and well qualified employees, working as a team. Through managing for value, HSBC in Canada is committed to making a world of difference to its clients, employees, communities and shareholders
Meezan Bank Limited, Pakistan	Establish Islamic banking as banking of first choice to facilitate the implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind. To be a premier Islamic bank, offering a one-stop shop for innovative value added products and services to our customers within the bounds of *Shariah*, while optimizing the stakeholders' value through an organizational culture based on learning, fairness, respect for individual enterprise and performance.(website)	*Barclays Group, UK*	Barclays aims to be one of the most admired financial services organizations in the world; in the eyes of our shareholders, our customers, our colleagues and the communities in which we work. The best measure of our long term performance is the total return we give to our shareholders - the increase in the price of our shares, assuming that any dividends are used to buy more shares, known as 'Total Shareholder Return'.

Source: Extracts of corporate mission and goals obtained from websites or annual reports.

Annex III: Legal Basis and Nature of Regulations on Internal SSBs in Selected Countries

Country	Legal base for SSB	SSB competences as spelled out by existing laws	SSB composition	SSB decision making	SSB Appointment and Dismissal rules	Fit and proper criteria for SSB members
Bahrain	*BMA Rulebook - Volume 2- Islamic Banks - The BMA (2005) and all AAOIFI standards*	General duty to verify *Shariah* compliance and issue an annual report. Binding advice The shareholders shall decide how SSB will discharge this duty.	Al least three members (according to AAOIFI)	Unspecified (to be decided by shareholders)	Appointed by Shareholders. Dismissal is proposed by Board and approved by shareholders (according to AAOIFI standards)	Conflict of interest and competence clauses (According to AAOIFI governance standards).
DIFC*	*Law regulating Islamic financial business, DIFC Law No. 13 of 2004 and the Islamic Financial Business Module of the DFSA Rulebook*	Oversees and advises on *Shariah* compliance. Specific duties to be established and documented by the BIFS.	No less than three members.	Unspecified.	Appointed and dismissed by the bank's governing body	They must be competent (based on previous experience and qualifications) and are not directors or controllers of the BIFS
Indonesia	*Act No. 7 of 1992 as amended by Act 10 of 1998, Regulation 4/1/PBI/2002.*	General obligation to verify *Shariah* compliance (duties as stipulated by National *Shariah* Board and established by in bank's articles of association).	Unspecified.	Unspecified.	Any appointment or replacement of SSB members must be reported to Bank Indonesia and approved by the National *Shariah* Board.	Documentary evidence on SSB members' previous experience to be submitted to Bank Indonesia's Board of Governors.
Jordan	*Art. 58 of Law 28 of 2000 as amended by temporary Law No.46 of 2003.*	Ex ante audit (*fatwas*), ex-post audit, opinions on *Shariah* matters referred to it.	No less than three members.	By unanimous or majority vote. Its votes are valid only if a majority of members is present.	Appointed by the general assembly of shareholders. Discharged only through a reasoned decision taken by 2/3 of the board of directors and endorsed by the general assembly. Changes have to be notified to the Central Bank.	Unspecified.
Kuwait	*Art 93 of Law No. 32 of 1968.*	General obligation to verify *Shariah* compliance of banking operations.	No less than three members.	By unanimity. In case of conflict the matter is referred to the Fatwa Board.	Unspecified	Unspecified
Lebanon	*Law No. 575 on*	Certification of *Shariah*	Three members.	Unspecified.	Appointment for a	Unspecified (experts' background

	"Establishing Islamic Banks in Lebanon".	compliance and proposals for properly achieving bank's objectives pursuant to the *Shariah.*			renewable three- year period.	must be in Islamic law, doctrine and banking and financial operations).
Malaysia	*Islamic Banking Act of 1983 and Central Bank of Malaysia Act 1958 (Revised 1994) and Guidelines on the Governance of Shariah Committees (2004)*	Binding advice *Shariah* on compliance of banking operations for Islamic Banks. The Central *Shariah* Advisory Council is the ultimate arbiter.	Unspecified.	Unspecified.	Unspecified.	There are several incompatibility clauses.
Pakistan	*IBD Circular No. 02 of 2004.*	General obligation to verify *Shariah* compliance of banking operations. The SSB must submit an annual report to shareholders.	Only one advisor required. A board may be set up at the bank's discretion.	Unspecified.	Appointment must be approved by State Bank of Pakistan.	They are compulsory and relate to minimum qualification and experience, track record, solvency, financial integrity, honesty and reputation and conflicts of interests.
Philippines	*Republic Act No. 6848 and Manual of Regulations for Banks-Implementing Rules and Regulations of Republic Act No. 6848*	It offers advice and undertakes reviews on matters relating to *Shariah* compliance.	At least three but no more than five members.	Unspecified.	Unspecified.	SSB members must be Islamic scholars and jurists of comparative law.
Thailand	*Islamic Bank of Thailand Act B.E 2545.*	It has "the authority and duty to give advice and recommendations to the Board of Directors concerning Islamic principles related to the operation of the bank".	Not more than 4 members	At least half of the SSB members form a quorum and decisions are taken by majority vote.	SSB members have a two-year tenure and may be reappointed. They are appointed and removed by the board of directors.	Financial integrity, competence, honesty and conflicts of interests.
UAE	*Federal Law No. 6 of 1985*	General obligation to verify *Shariah* compliance of banking operations. Detailed competences to be established by the bank.	No less than three	To be decided in the articles of association of the bank	SSB members must be approved by the Higher *Shariah* Authority	Unspecified
∗ Dubai International Financial Centre						
Source: Official country websites and central bank Annual Reports						

Annex IV: External *Shariah* CG institutions by country

Source: Official country websites and central bank Annual Reports

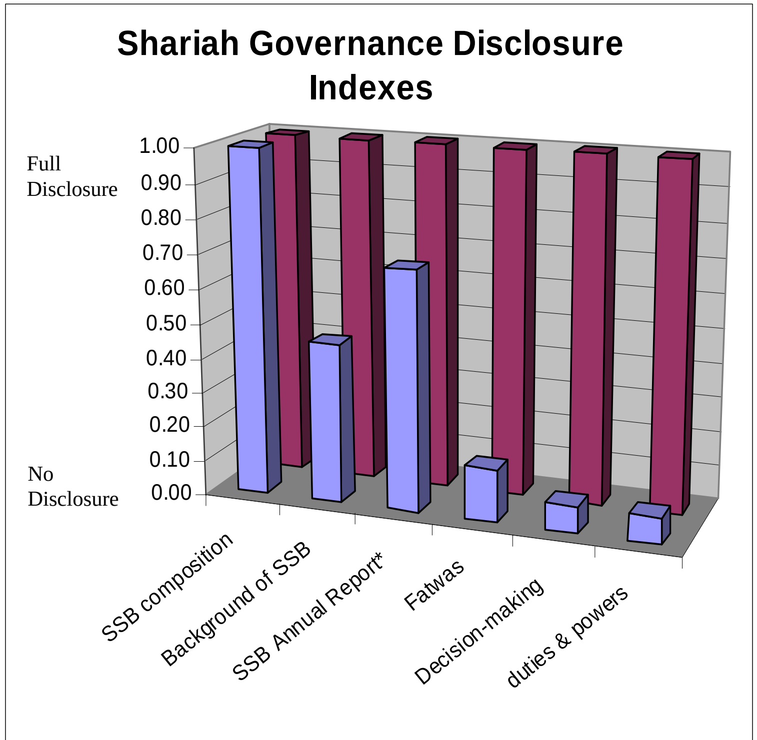
Country	*Separate* Islamic Banking & *Takaful* Department at CB	Centralized SSB or High *Shariah* Authority or *Fatwa* Board	Islamic Rating Agency	*Separate* Islamic Capital Market Department within Securities regulator
Bahrain	Yes, Islamic Financial Institutions Supervision Directorate	No, but the International Islamic Financial Market is to promote the harmonization and convergence of *Shariah* interpretations in developing Islamic banking products and practices which are universally acceptable	No, but International Islamic Rating Agency operates in Bahrain	No
Indonesia	Yes, the Directorate of *Shariah* Banking	Yes, the *National Shariah Board* is authorized to issue *fatw*as concerning products, services and operations of BIFS. It also recommends *Shariah* advisors to BIFS	No	
Jordan	No	No	No	No
Kuwait	No	The *Fatwa Board* in the Ministry of *Awqaf* and Islamic Affairs is the final authority on *Shariah* disputes. Its advice is binding when it arbitrates on disputes between members of the same SSB	No	No
Malaysia	Yes, Regulation Department –Islamic Banking and *Takaful*	Yes. The *Shariah Council* advises central bank on *Shariah* matters and is the ultimate arbiter in *Shariah* interpretation disputes. The directives issued by BNM in consultation with the *Shariah* Council have binding authority over Banks with Islamic windows.	Yes, Malaysian Rating Corporation - Islamic Capital Market Department	Yes, Malaysian SEC- Islamic Capital Market Department. The SEC also has its own *Shariah* Advisory Board
Sudan	N/A, the whole financial regulatory system is Islamic	Yes, the *Shariah High Supervisory Board* is responsible for fatwas, contract specimen, arbitrage, consultations relating to Islamic legal aspects, training, research, lectures, and seminars	No	N/A, the whole financial regulatory system is Islamic
Pakistan	Yes, Islamic Banking Department	Yes, the *Shariah Board* of the State Bank is to advise the central banks on matters of *Shariah*. It also produces specimen of permissible Islamic Financial contract to ensure compliance with minimum *Shariah* standards	No	No, but several departments share Islamic finance portfolio
UAE	No	Yes, the *Higher Shariah Authority*, attached to the Ministry of Justice and Islamic Affairs, is the final arbiter on *Shariah* matters. It is also responsible of *Shariah* supervision	No	No

Source: Official country websites and central bank Annual Reports

Annex V: *Shariah* Governance disclosure Indexes in 13 IIFS*

IIFS	*SSB comp-osition*	*Back-ground of SSB*	*SSB Annual Report**	*Fa-twas*	*Decision making*	*Duties & powers*
A	1	1	1	0	0	0
B	1	0	1	0	0	0
C	1	0	1	0	0	0
D	1	0	1	1	0	0
E	1	0	0	0	0	0
F	1	0	0	0	1	0
G	1	0	1	0	0	0
H	1	1	1	1	0	0
I	1	1	0	0	0	1
L	1	1	1	0	0	0
M	1	1	1	0	0	0
N	1	1	1	0	0	0
O	1	0	0	0	0	0
Effective Disclosure	**1.00**	**0.46**	**0.69**	**0.15**	**0.08**	**0.08**
Desirable disclosure	1.00	1.00	1.00	1.00	1.00	1.00

*The 6 indexes are calculated by attributing a 1 to every item that is disclosed and a 0 to items that are not disclosed by the 13 IIFS specified in footnote 54, in information venues such as annual reports and websites. The average across IIFS for every item is then taken to calculate the effective disclosure index. The desirable disclosure index is 1 assuming that ideally every IIFS in the sample ought to disclose information on *Shariah* Governance processes and structures.
** Two IIFS had never issued a SSB report due to their recent establishment. Nevertheless, the items are counted as disclosed due to the IIFS overall high level of disclosure



	SSB composition	Background of SSB	SSB Annual Report*	Fatwas	Decision-making	duties & powers
Effective Disclosure Index	1.00	0.46	0.69	0.15	0.08	0.08
Desirable disclosure	1.00	1.00	1.00	1.00	1.00	1.00