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Centralisation of corporate governance framework for Islamic financial institutions

Is it a worthy cause?

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Abstract

Purpose – The purpose of this paper is to supply basic insights into the principle of *shūrā* (consultation) in Islamic banking, the idea of a centralised approach to the corporate governance of Islamic financial institutions (IFIs), the roles of a centralised Shari'ah board as the highest authority on Shari'ah issues and its distinguishing features from a de-centralised system and the advantages and disadvantages of the two governance systems.

Design/methodology/approach – In analyzing these, the paper adopts the critical legal studies approach and refers to the provisions of the Qur'an and Sunnah, *ijmā'* (consensus) of Shari'ah scholars and recent Islamic banking reports.

Findings – Despite the fact that the double-digit growth of the current US\$2tn Islamic banking industry is a promising sign for its further expansion – expecting to cross the US\$6.5tn mark by 2020 – there remains concern over the lack of standardization or rather the diversified approaches to the corporate governance of IFIs across key Islamic banking regions.

Practical implications – There has been much debate surrounding the issue of whether the Islamic banking industry requires a centralised Shari'ah board at the state level to complement the Shari'ah boards at the IFIs' individual level in providing better supervision of the Shari'ah-compliance of IFIs. The fact that the industry is already equipped with two prominent standard-setting agencies in the form of the AAOIFI, the IFSB does little to suggest that best governance practices – which centre around the themes of consistency, harmony and uniformity – are on the horizon, at least not whilst their issued standards and guidelines remain voluntary for IFIs.

Originality/value – All in all, it is aspired that this paper may assist the reader in evaluating the pros and cons of the whole concept of Shari'ah board centralisation.

Keywords Corporate governance, *Shūrā*, Central Shari'ah board, *Ikhtilāf al-fuqahā'*, Centralisation

Paper type Research paper

Introduction

While some theories could work well and productively when applied in real life, others may require certain adjustments before they actually work. In certain circumstances, application of a theory is simply not practically viable. The same applies to Islamic banking. Several practices by Islamic financial institutions (IFI) management have emerged, which do not



reflect the application of true Sharī'ah (Islamic law) principles. These were highlighted by the corporate failures suffered by a number of high-profile IFIs within the last two decades. Notable cases include the collapse of the Islamic Bank of South Africa in 1997[1], the demise of Ihlās Finance House in Turkey in 2001[2], the commercial losses of Bank Islam Malaysia Berhad in 2005[3], and the various cases of fraud that led to losses by Dubai Islamic Bank between 2004 and 2007[4]. Additionally, the 2008 global financial meltdown affected a number of IFIs such as Kuwait Finance House, Al-Rajhi Bank, Al-Hilal Bank and Noor Islamic Bank of the United Arab Emirates. The problems of the Al-Hilal Bank and Noor Islamic Bank of the United Arab Emirates prompted a bailout from the Emirate of Abu Dhabi when the crisis began affecting the Dubai Government (El Baltaji and Permatasari, 2010; Walton, 2011).

These cases, however, only represent a small fraction of the larger Islamic banking industry, which has remained unaffected by the financial crisis. This resilience was owed to two crucial ingredients of the Islamic banking system. The first is the strong foundation of Islamic banking, which prohibits, *inter alia*, the involvement of IFIs in interest-bearing and speculative financial instruments. For instance, IFIs cannot hold assets such as credit derivative swaps (CDS) or collateralised debt obligations (CDO) because such assets do not comply with the Sharī'ah. Secondly, the unique feature of the Islamic corporate governance system, which this paper will attempt to explain, shielded the majority of the IFIs from the aftermath of the financial crisis in 2008 (Ahmed, 2010; Kaye and Hassan, 2011; Sabur and Wares, 2011).

In brief, this paper focuses on explaining the concept of corporate governance from the Sharī'ah perspective. Accordingly, the paper is divided into three main segments. The first explains the origin of Islamic corporate governance, particularly focusing on the institution of *hisbah* (market surveillance) in the formulation of modern Islamic corporate governance. The second discusses the Islamic jurisprudential concept of *ikhtilāf al-fuqahā'* (differences of opinions among Sharī'ah scholars) from the context of centralisation of the Islamic corporate governance system. The third explains the comparative features of the decentralised and centralised systems of Islamic corporate governance.

Origin of Islamic corporate governance: the institution of *hisbah*

Before the last two decades, the concept of corporate governance was relatively new to the Islamic banking industry. In fact, there was no specific Arabic phrase that connoted the term “corporate governance”, nor was there literature that could point out the exact origin of corporate governance in Islam (Lewis, 2005; Abu-Tapanjeh, 2009). However, it is arguable that the concept of corporate governance is evident within the Sharī'ah legal principle of *al-siyāsah al-Shariyyah*, which refers to public policy in accordance with Islamic law on matters necessary to the community such as, *inter alia*, market regulation, taxes and public security (Al-Qudsy *et al.*, 2008; Quraishi-Landes, 2015). This principle conforms to several Qur'ānic verses (e.g. 3:104, 9:71 and 5:2) that stress the need for good governance and constructive collaboration between authorities and other members of the community. The authorities include those of the state as also of companies. Members of the community, with reference to companies, would include the shareholders as well as other stakeholders. This collaborative enjoinder of best practices is also known as *hisbah*.

In general, *hisbah* refers to the practice of a group of individuals who invite the public to do good deeds and avoid the forbidden matters as set down by the Sharī'ah[5]. Accordingly, Prophet Muhammad (peace be upon him) was himself the first *muhtasib* (enforcement

officer), who initiated the practice of *ḥisbah* in the history of Islam (Al-Foul and Soliman, 2010; Mamat, 2010). This corresponds to a *ḥadīth* narrated by Abū Hurayrah (may Allah's blessings be upon him)[6].

In simple words, *ḥisbah* involves the practice of surveillance by the *muhtasibs* in enforcing the implementation of the Sharī'ah and Islamic ethical values in all aspects of the community's daily conduct. This would include prayer, fasting, municipal administration and fair-market practices (Al-Foul and Soliman, 2010; Saleh, 2009). In the latter, the *muhtasib* is responsible to inspect the bazar (market) and ensure the Sharī'ah compliance of the business transactions executed therein. This includes ensuring the use of proper weight and measures, promoting a free-market economy and fair-trading rules and preventing fraud, illegal contracts and the hoarding of necessities. It is important to note that *ḥisbah* cannot be executed arbitrarily and in disregard of the rights of the general public on the pretext of preventing the occurrence of Sharī'ah non-compliant events. The practice of *ḥisbah* should thus not be at the expense of the right to privacy or the right to property.

The practice of *ḥisbah* was followed by many companions of the Prophet (peace be upon him) and enforced by the early caliphs of Islam including Abū Bakr al-Ṣiddīq and 'Umar ibn al-Khaṭṭāb (Ibn Taymiyyah, 1967; Al-Qarnī, 1994). The latter was particularly renowned for personally patrolling the streets for the purposes of obtaining a better picture of the condition of his people and preventing crimes (Kamali, 1989; Murad, 2007). Inadvertently, Caliph 'Umar's practice extended the application of *ḥisbah* to include the prevention of criminal offences, leading to the formation of the first police institution in Islam and the development of *fiqh al-jināyāt* (Islamic criminal law).

As far as its relevance to Islamic banking is concerned, *ḥisbah* serves as an integral check-and-balance mechanism for the banking industry, especially in cognizance of the paramount importance placed on Sharī'ah compliance in IFIs' financial activities. In modern Islamic banking practices, the role of *ḥisbah* is assumed by the Sharī'ah board, whose duties include, *inter alia*, the supervision of the IFI's financial activities to ensure their full compliance with the Sharī'ah (Najjar *et al.*, 1980). Nonetheless, it is arguable that the responsibilities of a *muhtasib* do not suit a supervisory body such as the Sharī'ah board. That is because the *ḥisbah* institution normally lies under the jurisdiction of the state rather than IFIs. When *muhtasibs* are paid by the state, they remain independent from any direct connection with the industry. Having the *muhtasibs* being paid by the entity they are supposed to regulate creates moral hazard. This arrangement may induce the Sharī'ah board members to behave in a manner inconsistent with the spirit of the Sharī'ah.

Hence, in the attempt to promote better transparency in the practice of *ḥisbah* within IFIs, the industry may want to consider the formation of a specific *ḥisbah* institution dedicated to Islamic banking, which is placed under the state's jurisdiction, or an independent body that possesses industrial links with the key players of the Islamic banking industry. The latter players would include predominantly the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) or the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA–OIC). Accordingly, the proposed institution would not only provide market players with an independent authority for the issuance of Islamic banking *fatwas* (Sharī'ah opinions), but also serve as a platform to harmonise at a global level the differences in Sharī'ah opinions among the different schools of Islamic jurisprudence via the systematic collection and clarification of ambiguous Islamic banking *fatwas*. Eventually, this would assist in mitigating potential Sharī'ah non-compliance risks and market confusion as a result of the

diversity of Sharī'ah opinions in Islamic law. A later part of this section will discuss the roles and functions of such an institution and its benefits for the development of the Islamic banking industry.

***Ikhtilāf al-Fuqahā'* and the Islamic corporate governance system**

Ikhtilāf al-fuqahā' (or difference of opinion among Sharī'ah scholars) is a common phenomenon in the science of Islamic jurisprudence, which has occurred since the time of the companions of the Prophet (peace be upon him). There are many reasons for it. Frequently, it is because of a certain degree of ambiguity in the texts of the Qur'ān and Sunnah. Sometimes it is because of the lack of a text on a specific issue. Sometimes, it arises from disagreement over the admissibility of a class of evidence or of a specific item of evidence, for example, disagreement regarding the authenticity of a *ḥadīth* or the relative strength of opposing narrations. Different schools of jurisprudence developed different methodologies for systematically approaching all these matters of disagreement (Al-Shāṭibī, 2012; Lahsasna, 2014); Madkur, 1973; Mahaiyadin and Abd Aziz, 2004).

These differences of methodology led to differences of opinion among Sharī'ah scholars pertaining to subsidiary Sharī'ah issues (*furū'*). Dissenting opinions are not permissible regarding core issues of Islamic belief or issues known to every Muslim by necessity, for example, the obligation to pray five times a day and the prohibition of adultery. Likewise, an opinion that opposes an unambiguous authentic Sharī'ah text is invalid. Examples of subsidiary issues about which jurists differ include the recitation of *qunūt* (additional supplication) during the *fajr* (morning) prayer and the obligation of a creditor to pay *zakāh* on an uncollected debt. The differing views regarding such issues are valid as they are not core issues and the evidence about them is open to differing interpretations.

Caliph 'Umar ibn 'Abd al-'Azīz opined that the diversity of opinions in *fiqh* (jurisprudence) presents mankind with a wider range of solutions to their problems. Many prominent Sharī'ah scholars endorsed this view, for example, Imām Aḥmad, Imām Al-Shāṭibī, Shaykh Wahbah Az-Zuhaili, Ibn 'Abd al-Barr (1994) and Ibn Hajar (Ibn 'Abd Al-Barr and Ibn 'Abd Allah, 1994; Majlis Ugama Islam Singapura, 2014). Although there is other evidence for this view, its supporters frequently cite a *ḥadīth* that would conclusively support it if it were authentic[7].

However, numerous Sharī'ah scholars, including Imām Al-Nawawī, Imām Al-Suyūtī, Shaykh Al-Albānī and Shaykh Zakariyyā Al-Anṣārī, have pointed out that this *ḥadīth* is not authentic. In fact, it cannot be traced in any of the early collections of *ḥadīth* (Al-Albani, 1995). Further, Ibn Hazm, a prominent scholar of the Zahirī's school of Islamic jurisprudence, opined that it was unreasonable to associate blessings with diversity – especially when uniformity, in general, indicates strength[8].

On the other hand, Imām Al-Nawawī opined that although the elements of diversity and uniformity contradict one another, several verses in the Qur'ān proved the ability of both elements to coexist (Al-Nawawī and Syarif, 1992). For instance, the Qur'ān (28:73) stipulates, “And of His mercy He has made for you the night and the day, that you may rest therein, and that you may seek of His grace, and that you may give thanks”. Although the night connotes a mercy from God, the day does not infer a punishment. In other words, what may appear as a contradiction between opposing elements does not necessarily invoke negative consequences.

Diversity of Sharī'ah opinions in Islamic banking

Regarding the diversity of Sharī'ah opinions in Islamic banking, modern Sharī'ah jurists and industry experts opine that it enriches the Sharī'ah by providing society with various solutions and alternatives to a wide range of issues. What's more, it encourages further

innovation of Islamic financial products and services in enabling the industry to compete with its Western counterparts (Dar and Azami, 2011; Nursyamsiah and Kayadibi, 2012). For example, *bay' al-inah* (sale and buy-back), *wa'd* (promise), *bay' bi thaman ājil* (deferred payment sale), *tawarruq* (tripartite sale) and *shukūk* (Islamic investment certificates) are some of the by-products of the financial innovations in the industry that have resulted from this diversity.

Dr Mohamed Ali Elgari, a prominent Islamic banking scholar and IFI Shari'ah board member, opined that the adoption of a centralised Islamic corporate governance system would undermine the versatility and egalitarian nature of the Shari'ah[9]. It is arguable that his opinion corresponds to several provisions of the Qur'an[10] and Sunnah[11]. Shari'ah scholars have also argued that the centralisation of Islamic banking *fatwas* could serve against the principle of *ijtihad* (legal reasoning) in the Shari'ah, which allows scholars to interpret Shari'ah rulings based on circumstances that can differ according to the presence of variable factors such as legal, political or socio-economic conditions (Shaharuddin, 2010; Ahmed, 2011). Consequently, any standardisation effort could lead to the closing of the gates of *ijtihad*. That would discourage creativity and flexibility in the determination of new Shari'ah ruling. It would transform the industry into a rigid financial regime that remains obsolete regardless of the significance of the above variable factors (Schacht, 1967; Zaidi, 2008; Hassan and Mahlkecht, 2011; Bourheraoua, 2016).

It is arguable that any effort to standardise *fatwas* in *mu'amalat* (commercial transactions) presents an unnecessary move that deprives societies from applying fatwas that fit their legal, economic and socio-political circumstances. In addition, it defeats the purpose of *maqāsid al-Shari'ah* (objectives of Islamic law), namely, the preservation of public interest (Hassan and Mahlkecht, 2011; Zuhaili, 2013). Moreover, the General Council for Islamic Banks and Financial Institutions (CIBAFI) has also reported that out of a set of 6,000 fatwas issued by IFIs worldwide, inconsistent fatwas across the globe only accounted for 10 per cent or approximately 600 fatwas (Grais and Pellegrini, 2006; Devi, 2008). In other words, strong evidence exists to indicate the existence of a near consensus among Shari'ah scholars on a majority of Shari'ah issues in Islamic banking.

On the other hand, it is arguable that the diversity of Islamic banking fatwas around the globe confuses stakeholders about the actual Shari'ah compliance status of an Islamic financial product or service. Thus, the proposal to centralise Islamic banking fatwas can provide a working solution in mitigating the risk of controversy or the irregularity of fatwas as a result of the diversity of Shari'ah opinions.

Islamic corporate governance system: decentralised and centralised models

The following discussions compare the features of the different Islamic corporate governance models adopted by IFIs around the world, namely, the decentralised and centralised systems.

Decentralised corporate governance system

A decentralised corporate governance system can provide IFIs with greater flexibility in adopting fatwas and policies that best fit their respective business environments and legal systems. It can also allow IFIs the freedom to create financial products and services that not only conform to a country's market appetite, but also are unrestrained by the Shari'ah rulings of a particular school of Islamic jurisprudence. This is exemplified in the United Kingdom where the then Financial Services Authority (FSA) granted IFIs the freedom to adopt any Islamic corporate governance model or the Shari'ah rulings of any school of Islamic jurisprudence. That is because Shari'ah compliance was not an issue for it, and it, thus,

regarded it as an issue solely for the IFIs themselves (Wilson, 2009; Belouafi and Chachi, 2014; Lahsasna, 2014)[12]. Nonetheless, as IFIs' business involves the act of receiving money and extending it in financing, these activities fell within the definition of a credit institution under the EU Banking Consolidation Directive (Article 4 of 2006). Thus, they remain subject to similar authorisation requirements as their Western counterparts including the "fit-and-proper test" of the board of directors (BOD) members and employees, liquidity requirements and adequacy of capital (Ainley *et al.*, 2007; Islamic Financial Services Board (IFSB), 2014, 2015).

Despite the flexibility offered by the decentralised corporate governance system, it also exhibits several significant weaknesses that can threaten the stability of the global Islamic banking industry and public goodwill towards it. Firstly, although this system grants every IFI the autonomy to choose Islamic banking fatwas that suit both their legal environment and business interests, it is arguable that such freedom can lead to uncertainty and confusion among stakeholders such as investors and customers. This might arise in respect of the actual Shari'ah compliance status of the IFIs' products and services because of the difference in the Shari'ah rulings adopted by the IFIs, which may differ from one IFI to another (Goud *et al.*, 2014; Thomson Reuters, 2014). Simply put, a product approved by an IFI's Shari'ah board may not necessarily be approved as an underlying model for another IFI's product – a fine example is the controversial Islamic financial instrument of *bay' al-'inah*, which has impeded the consolidation of Islamic banking standards at both national and international levels.

This contention corresponds to the findings by Shaharuddin *et al.* (2012) that out of the fatwas issued by the regulatory bodies in the GCC and Malaysia, these Islamic banking powerhouses only reached a consensus in respect of two Islamic financial products, namely, *musharakah mutanāqishah* (diminishing partnership) and asset securitisation[13]. Furthermore, there also exists a 100 per cent difference in fatwas on *bay' al-'inah*, *bay' al-ma'dum* (sale and purchase contract over non-existent commodity), *da' wa ta'ajjal* (the writing off of part of the debt by the creditor when the debtor settles the balance of his debt earlier than the maturity date), future contracts and *ujrah* (fee) for *kafalah* (guarantees). There is a 60 per cent and 40 per cent difference on *bay' al-wafa* (sale with the seller's right to repurchase the commodity by refunding the purchase price) and *bay' al-dayn* (sale of debt), respectively (Shaharuddin *et al.*, 2012). By and large, these findings demonstrate the absence of uniformity in Islamic banking fatwas adopted by IFIs within these key Islamic banking markets.

Indeed, the bindingness and non-bindingness of Islamic banking fatwas have attracted significant concern in the West. This is especially so in countries with growing Muslim populations such as Canada, the USA and the United Kingdom with promising prospects for the development of Islamic banking markets (Schmid, 2013; Alrifai, 2015; Thomson Reuters, 2016a). For example, the UK's Financial Conduct Authority (FCA) abstains from interfering with IFIs' fatwa issuance processes or the suitability of their Shari'ah board members, but it demands that IFIs ensure that the stakeholders understand the Shari'ah-compliance basis underlying an Islamic financial product or service (Ainley *et al.*, 2007; Financial Conduct Authority, 2013). As the diversity of Shari'ah opinions remains a regular feature of the Islamic legal system, it presents yet another layer of complications for financial regulators such as the FCA in ensuring the consistency and predictability of fatwas in the UK's Islamic banking industry. Arguably, a centralised corporate governance approach could provide a viable solution that could assist Western bankers, investors and customers in understanding the concept of Islamic banking better.

Secondly, in the absence of a national Shari'ah board or strong legislation that makes Islamic banking fatwas binding, the IFI's BOD retains the right to refuse any decisions taken by the Shari'ah board deemed as counter-productive to the IFI's profit-oriented objectives. According to a study by Daoud (1996), there is a 50–50 division among IFIs with

regard to the legal status of Shari'ah rulings issued by their Shari'ah boards owing to imprecise regulatory frameworks. As, as noted earlier, neither the AAOIFI nor the IFSB's Shari'ah standards are binding on IFIs, the BOD remains the ultimate decision-making authority that possesses the prerogative to implement or refuse the fatwas of the IFI's Shari'ah board. In the worse-case scenario, the BOD could even leverage its authoritative position and alter the fatwas to accommodate its interests. This is not surprising considering the fact that, in most jurisdictions, the BOD appoints the IFI's Shari'ah board members (Gooden, 2001; Di Mauro *et al.*, 2013). Alternately, the concern over job security or contract renewal of their Shari'ah board directorships can also turn a Shari'ah board into a silent and weak Shari'ah board (Lahsasna, 2014).

Thirdly, the absence of centralised and standardised fatwas and corporate governance standards can expose the industry to a growing list of Shari'ah non-compliance risks including the multiple Shari'ah board directorship practice. As the occupation of multiple Shari'ah board positions inflicts additional burdens and strains on Shari'ah board members, it is arguable that the practice can impair their Shari'ah governance oversight and hinder the provision of an effective Shari'ah compliance supervision over the IFI's financial operations (Jiraporn *et al.*, 2009; Adams and Ferreira, 2012). The decentralised Islamic corporate governance system does not impose a restriction on Shari'ah board members in respect of the number of board directorship they may hold (Thomson Reuters, 2010; Hasan and Sabirzyanov, 2015). In contrast, a number of countries which adopted the centralised Islamic corporate governance system, such as Malaysia and Sudan, have begun to prohibit the practice of multiple Shari'ah board directorships. The objective of this stricture is to ensure that the IFI's Shari'ah board members will only dedicate their time and attention to the affairs of their main employer [Islamic Financial Services Board (IFSB), 2009; Islamic Development Bank, 2013].

There are additional factors that continue to contribute towards the instability of the global Islamic banking industry. These include the strong influence of secular laws on the governing legislation for Islamic banking in most countries. Also, the lack of dedicated Islamic banking legislation and structured Islamic corporate governance frameworks in key jurisdictions such as Saudi Arabia, Qatar, Iran and the United Arab Emirates remain focal challenges (Deloitte, 2010; Abdul Majid and Ghazal, 2012; Hasan and Sabirzyanov, 2015). Dar *et al.* (2016) highlighted that 77 per cent of 2,170 respondents in 43 countries, comprising academicians and professionals in the financial services industry, favoured the establishment of a centralised Shari'ah board. Of those, 71 per cent viewed the central bank as responsible for setting up and maintaining this board (Dar *et al.*, 2016). This is similar to the industry report by Deloitte (2010), which highlighted that 57 per cent of the executives, practitioners and policymakers of the Islamic banking industry in the Middle East expressed a preference for the adoption of a centralised Islamic corporate governance system over the decentralised. This was attributed to the latter's weaknesses in regulating the inconsistencies of Islamic banking fatwas, conflict of interest issues and the practice of Shari'ah arbitrage, or the re-engineering of an interest-bearing financial instrument into one that closely resembles a Shari'ah-compliant financial instrument.

Centralised corporate governance system

The IFSB recognises the different Shari'ah viewpoints within the industry, given the varying nature of the legal systems and '*urf*' (customs) of the respective countries. Despite that it also acknowledges the importance for the industry to establish a suitable platform to enhance understanding and resolve the ongoing differences that can contribute to the destabilisation of the entire industry [Islamic Financial Services Board (IFSB), 2006, 2009]. Accordingly, it is arguable that a centralised Islamic corporate governance system provides

a universal and more comprehensive platform for the exercise of a systematic *ijtihād* instead of an “arbitrary opinion-making” environment represented by a decentralised system (Thirulqādrī, 2007; Bourheraoua, 2016). This contention is based on the following rationale.

Firstly, although the national Shari‘ah board serves as the highest Shari‘ah authority for the IFIs in a country, its presence does not mean that the Shari‘ah board at the individual IFI level loses its authority to issue fatwas on Islamic financial products and services. On the contrary, the regulatory framework within the centralised Islamic corporate governance system allows the IFI’s Shari‘ah board to issue fatwas on newly invented financial instruments and the Shari‘ah compliance assurance of the IFI’s overall financial operations (Bank Negara Malaysia, 2011; Shaharuddin *et al.*, 2012). In other words, the national Shari‘ah board merely functions as a mediation platform to promote consistency and uniformity in the adoption of Islamic banking fatwas and corporate governance standards between the two different levels of Shari‘ah boards. The IFI’s Shari‘ah board continues to enjoy the prerogative to develop suitable fatwas that correspond to the guidelines issued by the national Shari‘ah board (Goud *et al.*, 2014; Laldin and Furqani, 2015).

This requirement is reflected in the policies of several countries that have since adopted the centralised Islamic corporate governance system but have also mandated the establishment of an in-house Shari‘ah board in all IFIs. For example, in the United Arab Emirates (1985), Article 6 of the Federal Law No. (6) of 1985 requires the formation of an in-house Shari‘ah board in all IFIs in the country. Its duties include the alignment of the IFI’s financial operations with the Shari‘ah. In Malaysia, Section 30 of the Islamic Financial Services Act (2013; IFSA 2013) mandates the formation of a similar institution. It also allows banks that possess more than one entity licensed to conduct Islamic banking business to establish a single Shari‘ah board to supervise the overall Shari‘ah compliance of all the bank’s financial activities. It is arguable that such an approach can assist in liberalising the local Islamic banking market as well as mitigating the prospect of market confusion caused by the presence of variable factors such as *‘urf* and school of thought orientation. This would increase stakeholders’ confidence and advance industry’s effort to standardise Islamic banking fatwas across borders (Akhtar, 2006; Bloomberg, 2014; Thomson Reuters, 2014).

Secondly, a centralised Islamic corporate governance system does not necessarily mean elimination of all variant Shari‘ah opinions for every Islamic financial product and service in the market. In fact, the centralisation policy administered in countries such as Malaysia and Pakistan suggests that the scope for flexibility remains. For example, in the last ten years, Malaysia has welcomed three international IFIs into its Islamic banking market, namely, Al-Rajhi Bank, Kuwait Finance House and Asian Finance Bank. IFSA 2013 mandates that IFIs must adhere to the fatwas issued by the Shari‘ah Advisory Council (SAC). However, the law also recognises the fatwas of different schools of Islamic jurisprudence and grants a certain degree of flexibility to international IFIs to adopt fatwas issued by their respective Shari‘ah boards, which are subjected to the SAC’s prior approval (see, Principle 1.8 of Shari‘ah Governance Framework for Islamic Financial Institutions, Bank Negara Malaysia, 2011).

For instance, the SAC allowed Al-Rajhi Bank to offer an Islamic financial scheme based on the *musharakah mutanāqishah* principle in lieu of *bay’ bithaman ājil* (BBA). It also allowed it to offer deposit accounts based on *qard* (loan) and *muḍārabah* principles instead of *wadiah* (safekeeping) – which are akin to the Islamic banking principles commonly adopted by IFIs in the GCC region (Bank Negara Malaysia, 2010; Hassan and Mahlkecht, 2011). Similarly, in Pakistan, its Islamic banking industry, which mainly subscribes to the opinions of the Hanafi’s school, has also implemented a liberal approach in the adoption of Islamic banking fatwas from the other schools of Islamic jurisprudence. For instance, the Shari‘ah Advisory Forum (SAF) of the State Bank of Pakistan has already approved a number of the

AAOIFT's Islamic banking standards, which comprise a combination of Sharī'ah opinions from the different schools of Islamic jurisprudence. It did so after evaluating their practicability from the context of the country's regulatory framework and public interest. These include the Sharī'ah Standard No. 03 (Defaults in Payment by a Debtor), No. 08 (*Murābahah* to the Purchase Order), No. 09 (*Ijārah* and *Ijārah Muntahiyah bi al-Tamlīk*) and No. 13 (*Muḍārabah*) (Dar and Azami, 2012). On the basis of the above examples from Malaysia and Pakistan, it is arguable that the "harmonisation" of Islamic banking fatwas and corporate governance standards can also serve as a fitting theme to the concept of a centralised Islamic corporate governance system.

Thirdly, although the reliance on a single Sharī'ah board can risk compromising an IFI's overall Sharī'ah compliance processes, a national Sharī'ah board can arguably benefit the IFI through the provision of the necessary standards and templates of Islamic financial products for the IFI to use. This manages the uncertainty issue that arises from the complexity of certain financial instruments as well as lowering their issuance cost by reducing the need to create them *de novo* (Bank Negara Malaysia, 2007; Goud *et al.*, 2014). At the same time, its presence can also alleviate the roles and responsibilities of the Sharī'ah boards at the IFI level. As a result, Sharī'ah boards can concentrate on other aspects of Sharī'ah compliance such as the development of an internal Sharī'ah compliance framework, internal Sharī'ah compliance monitoring, product innovation and the provision of Sharī'ah trainings to employees. Thus, the centralised Islamic corporate governance system warrants a comprehensive Sharī'ah compliance assurance at both the national and IFI levels.

Some GCC countries considered the idea of a national Sharī'ah board in harmonizing the differences of Sharī'ah opinions to be unnecessary. This may be based on the fact that the governing law of most of the countries within the region is Islamic law. Still, it is arguable that the adoption of a centralised Islamic corporate governance system could assist in accommodating prospective investors to the market, especially those unfamiliar with the concepts and principles of Islamic banking. This is because it would provide a more structured and comprehensive Islamic corporate governance framework as compared to the decentralised Islamic corporate governance system. This was recently demonstrated by Oman – the last nation among the GCC to introduce Islamic banking. It has begun to benefit from its newly adopted centralised Islamic corporate governance approach (Thomson Reuters, 2015; Soualhi, 2016; Thomson Reuters, 2016b). Not only has the system accelerated the growth of Islamic financial products and services in the country, it also reduced the overall operational costs for Sharī'ah compliance of all its IFIs (Thomson Reuters and Dubai Chamber of Commerce and Industry, 2013; Viszaino, 2014). Oman adopted a corporate governance framework for its Islamic banking market only in the third-quarter of 2014. Its rapid development and quick learning from advanced Islamic banking markets caught the industry by surprise. It outperformed established market players such as the United Arab Emirates and the Maldives in terms of the strength of its overall Islamic corporate governance framework (see Figure 1). Furthermore, the performance of the top five countries, Kuwait, Bahrain, Malaysia, Pakistan and Sudan, reemphasises the fact that the centralised Islamic corporate governance approach represents a stable and viable corporate governance framework for the Islamic banking system.

Conclusion

The Islamic corporate governance system differs from its Western counterparts in the sense that its purpose lies in upholding the principles of *maqāṣid al-Sharī'ah* throughout the IFI's financial operations. However, in recent years, the inconsistency of

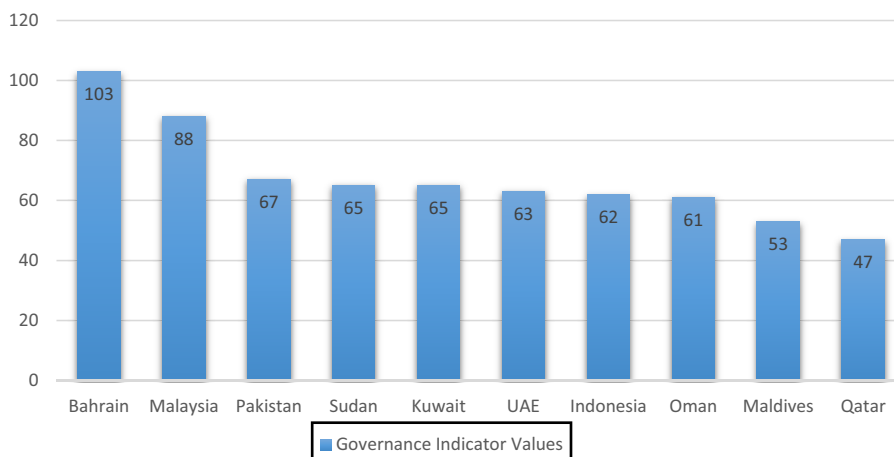


Figure 1.
Ranking of countries
according to the
standards of good
practices in Islamic
banking with regards
to regulations,
corporate governance
and Shari'ah
governance

Source: Adapted from Thomson Reuters (2016b)

Islamic banking fatwas and standards has caused confusion among consumers and subjected the industry to heavy scrutiny from Shari'ah scholars and banking practitioners (Deloitte, 2010; Adeyemo and Oloso, 2013; Harrison and Estelami, 2015). AAOIFI and the IFSB acknowledged the differing viewpoints among the IFIs' Shari'ah boards given the diverse legal systems that operate in the jurisdictions where they operate [Islamic Financial Services Board (IFSB), 2009]. However, the growing list of pressing issues such as the independence of the Shari'ah board, conflict of laws and schools of Islamic jurisprudence, education and qualification of the IFI's Shari'ah board members, non-standardised Shari'ah rulings and guidelines, fatwa shopping and the interlocking Shari'ah board directorship practice continue to pose significant challenges to the industry. *Ikhtilaf* in relation to the permissibility or non-permissibility of certain Islamic financial products may already be an "already-solved" issue if the notion of Shari'ah compliance is only viewed from the angle of the products' compliance with the Shari'ah. This, of course, is a shallow perspective. It would be pragmatic if Shari'ah compliance assurance in Islamic banking seeks to encompass a wider field well beyond the financial products offered by IFIs. This may include the Shari'ah compliance of the employees' conduct or business practices.

Notes

1. The Islamic Bank of South Africa suffered from a lack of regulatory supervision, weak risk management, numerous loans to insiders, unsound management and a debt of between R50 and R70 million (US\$47 and US\$65 million) (Okeahalam, 1998).
2. Ihlal Finance, the largest IFI in Turkey, was forced to cease operation owing to financial distress and a weak corporate governance framework (Ali, 2007; Dar and Azami, 2012).
3. The Malaysian maiden Islamic bank encountered losses totalling US\$142 million in 2005 owing to unsound corporate governance practices, namely, inappropriate composition of its Shari'ah board, with none of its members familiar with banking operations, as well as a lack of sound and proper credit and debt collection policies (Mushtak, 2005; MalaysiaKini, 2006).

4. Dubai Islamic Bank lost nearly US\$501 million due to fraud cases involving two of its former executives who were arrested along with another seven, with analysts citing weak internal controls (Walton, 2011).
5. The prominent Sharī'ah jurist Ibn Qayyim Al-Jawziyyah stressed the religious value of good governance from this perspective, saying, "God sent His message and His Books to lead people with justice[. . .]. Therefore, if a just leadership is established through any means, then therein is the Way of God" (Ibn al-Qayyim, 1991). Also, see Ziadeh (1963), Hamarneh (1964) and Ibn Taymiyyah (1967).
6. The Messenger of God (peace be upon him) passed by a pile of grain. He put his fingers in it and felt wetness. He said, "O owner of the grain! What is this?" He replied, "It was rained upon, O Messenger of God". He said, "Why not put it on top of the food so people can see it?" Then he said, "Whoever cheats, he is not one of us". This ḥadīth is ṣaḥīḥ (Al-Tirmidhī, 1986, Vol. 3, Book 12, Ḥadīth No. 1315).
7. "The diversity among the Muslims is a blessing", reported in Al-Nawawī's commentary of the book of *Waḥf* in *Ṣaḥīḥ Muslim* (Al-Nawawī, 1996). Also, see Al-Zuhaili (1999) and Ibn 'Abd Al-Barr and Ibn 'Abd Allah (1994).
8. "And obey God and His Apostle and do not quarrel for then you will be weak in hearts and your power will depart, and be patient[. . .]" (Qur'ān, 8:46). Also, see Al-Āmidī (1985).
9. However, he also noted that in the absence of consistency and predictability of *fatwas*, the Islamic banking industry "will have no hope of meeting international standards and growing beyond its niche status" (Mushtak, 2005). Also, see Waquar (2009).
10. "[. . .]God intends every facility for you. He does not want to put you in difficulties[. . .]" (Qur'ān, 2:185); "[. . .]God does not wish to place you in a difficulty, but to purify you, and to complete His favour to you, that you may be grateful[. . .]" (Qur'ān, 5:6).
11. 'Ā'ishah recounted, "Whenever Prophet Muhammad (peace be upon him) was given a choice between two matters, he would [always] choose the easiest as long as it was not sinful to do so; but if it was sinful, he was most strict in avoiding it". This ḥadīth is ṣaḥīḥ (Al-Nawawī, 1999, Book 1, Ḥadīth No. 641).
12. The FSA was replaced in April 2013 with two new regulators, namely, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA; Masters, 2013).
13. The research collected data from six entities comprising three regulatory bodies and three IFIs, namely, the Shariah Advisory Council (SAC) of the Securities Commission Malaysia, the AAOIFI, the International Islamic *Fiqh* Academy, Kuwait Finance House; Dallah Al-Baraka and Dubai Islamic Bank (Shaharuddin *et al.*, 2012).

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