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5 June 2009

Online at <https://mpra.ub.uni-muenchen.de/20204/>
MPRA Paper No. 20204, posted 26 Jan 2010 01:20 UTC

THE GLOBAL UNIVERSITY IN ISLAMIC FINANCE (INCEIF)

***Shari'ah Board, The Task of Fatwa, and Ijtihad
in Islamic Economics, and Finance***

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9/28/2009**

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

In the name of Allah, the Beneficent, the Merciful

ABSTRACT

The rulings of *Mua'malat* in today's Islamic Economics, and Finance can be adapted through the process of *Ijtihad*. While the basic principles or doctrines of the *Mua'malat* are given in Shari'ah, the interpretation of these principles to suit circumstances in different times and places constitutes the *Fiqh Mua'malat*. New rulings can be reached by understanding the effective cause (*Illah*) and rationale (*hikmah*) of the original ruling and the importance of *Maslahah* (benefit) under the changed circumstances (Usul Fiqh); which is normally evaluated by the Shari'ah Board members of the concerned entity. Fatwa issuing via *Ijtihad* is used to derive laws from the basic principles of Shari'ah to address the needs of people in different places and times. The important aspect of these new rules is that they may at times change depending on the context of application. Islamic Finance contemporary practices of *Ijtihad* through various bodies like Islamic *Fiqh* Academy, have resolved the practice of *taqlid* (limitation). The doctrine of *maqasid* al-Shari'ah establishes *Maslahah* as an essential element of the ends of law, so that it becomes an important goal in framing new rules (Shari'ah parameters and guidelines) through *Ijtihad*. Thus, both the principles set by Shari'ah and use of *Ijtihad* to frame new rules has *Maslahah* or benefit of people as the underlying basis and goal.

On the other hand; the standardization of Shari'ah may become against the fundamental premise of *Ijtihad* which has existed for centuries and especially in today's finance. If rules become standards, and imposed by legal authorities, then *Ijtihad* cannot be applied towards a critical and dynamic industry like Islamic Finance today. This will eventually damage the very reason that we are

able to apply Shari'ah in all times and places, that is, *Ijtihad* is the main reason why Shari'ah is dynamic and is able to be applied in different circumstances. In addition; to standardize Shari'ah rulings may mean the precedence of one Islamic school of thought over the other, which cannot be universally acceptable. There is no doubt that the synchronization of these two views has to be done through mutual understanding and collaboration between Shari'ah scholars and various Shari'ah key board members, market leaders, and regulators. To be very clear and accurate, the question of whether Shari'ah standards can be harmonized is a matter to be dealt with by Shari'ah scholars and not market professionals or regulators. The simple reason for this is because Shari'ah scholars are specialized in their field and whether a Fatwa can be standardized or not is a matter of religious reasoning and should be taken from Shari'ah own instructions and judgments.

KEY WORDS: Fatwa¹, fatawa², Ijtihad³, Shari'ah Board, Islamic Economics Jurisprudence⁴, GCC⁵, *Ijma*,

¹ Religious decree : *Alternative spelling = Fatwah, Fatawa*

² Plural of *Fatwa*= Religious pronouncements by *Fuqaha'*.

³ Is the expending of maximum effort in the performance of an act. the word "*Ijtihad*" derived from the root word *al-juhd*, which means "exertion, effort, trouble or pain." *Al-juhd* denotes exercising one's capacity, ability, power, or strength in a correct and righteous manner. **Technically:** Ijtihad it is the effort made by the *Mujtahid* in seeking knowledge of the rules of the *Shari'ah* through rules of interpretation stipulated in Islamic jurisprudence

⁴ Fiqh = Islamic jurisprudence= the science of the Shari'ah (an important source of Islamic economics). In contrast with conventional law, *Fiqh* covers all aspects of life, be it religious, political, social, commercial or economic. The whole corpus of *Fiqh* is based primarily on interpretations of the Qur'an and the *Sunnah* and secondarily on *ijma* (consensus) and *ijtihad* (individual judgment). While the Qur'an and the *Sunnah* are immutable, *Fiqhi* pronouncements may change due to changing circumstances.

⁵ Gulf Cooperation Council

INTRODUCTION AND LITERATURE REVIEW

Islamic laws and rules are known as *Shari'ah* and the study of them is Islamic jurisprudence. *Shari'ah* governs all aspects of Islamic matters including faith, worship, economic, social, political, and cultural aspects of Islamic societies. The rules and laws are derived from three important sources, namely the Holy Qur'an, *Sunna* (the practice and tradition of the Prophet Muhammadﷺ) and *Ijtihad* (the reasoning of qualified scholars). Further elaboration and interpretation of the rules dictated by the Holy Qur'an and *Sunna* are provided by qualified scholars in Islamic jurisprudence via *Ijtihad*, an interpretative process which is carried out within the framework of the Qur'an and *Sunna*. Modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam, and modifying them as well as removing any prohibited elements so that they are able to comply with *Shari'ah* principles. The second approach involves the application of various *Shari'ah* principles to facilitate the origination and innovation of new products and services (Warde, 2000).

Basic principles of Islamic finance

The basis of Islamic commercial law is predicated on *Fiqh al-Mua'malat* (literally the *Fiqh* of human interrelations) which advocates the principles of *Shari'ah* with respect to civil liberties, economic freedom, social equity, justice, transparency and accountability in all financial matters. In *Shari'ah*, the moral dictum that governs financial transactions and agreements is that all are permissible, provided that they do not include a prohibited gain, activity or commodity, such as *Riba*, *Gharar*, *Maysir* (gambling), specific foods and beverages and indecent activities. By integrating religious doctrine and ethical

conduct in financial transactions, Islamic finance offers an alternative framework to the Western model and sets boundaries to permissible activities (Hakim and Rashidian, 2004).

While there may only be a handful of differences between conventional and Islamic financial products, the distinctions are fundamental to the structure and the risk/return profile of these instruments. For example, Islamic finance promotes risk sharing through partnerships and eschews interest-based charges. This fundamental difference distances Islamic banking from conventional finance (Wilson, 1997). For a long time, equity financing was the dominant financial product being offered to depositors and investors (Siddiqi, 2000; Anwar, 2003). These are based on the concepts of profit-sharing in the form of *Mudarabah* and profit-and-loss sharing *Musharakah* (Ayub, 2002). Flanking these were *Murabahah* contracts that have constituted the cornerstone for working capital and short-term financing (AAOIFI, 2003; Islamic Financial Services Board, 2005a, 2005b).

As the market evolved, *Shari'ah* rules were introduced to chart the designs of debt financing. Here the challenge was particularly onerous because conventional debt is not necessarily asset-specific, whereas the *Shari'ah* requires the existence of an underlying asset or assets to back the transaction (DeLorenzo, 1997; Khan, 2000; Bahrain Monetary Agency, 2002).

Imam Shatibi's Social Theory (d. 1388AD)

The social theory contract was expounded by *Imam Shatibi*, who was a contemporary of *Imam Ibn Taimiyyah*. The two developed and applied the dynamic tenets of the *Shari'ah* to practical social, economic and institutional issues and problems of the time.

Imam Shatibi was an original thinker on the development of the *Shari'ah* in the light of individual preference and social preference and their relationship with the institutional tenets of public purpose. Imam Shatibi thus brought the Islamic discursive process (*shura* and rule making) to the centre of the very important issue of development of the *Shari'ah* through discourse, *Ijtihad* and *ijma* (Shatibi, trans. Abdullah Darraz, 1390 Higri Calendar). Imam Shatibi's preference theory, called *Al-Maslaha Wa-Istihsan*, is a forerunner of the profound concept of social wellbeing in most recent times (SEN, 1990). In the perspective of this concept, Imam Shatibi took up his principles on which the *Shari'ah* can be developed (Masud, 1994).

These principles are **(1)** universal intelligibility; **(2)** linking the possibility of action to the degree of physical efforts rendered; **(3)** adaptation of the *Shari'ah* to the natural and regional differentiation of customs and practices. By combining these attributes in the development of the *Shari'ah*, Imam Shatibi was able to deliver a comprehensive theory of social wellbeing. The social wellbeing criterion explained the aggregate view of preference in society within the tenets of the *Shari'ah*.

By combining the above principles, Imam Shatibi examined both the core and the instrumental aspects of the *Shari'ah*. According to his 'theory of meaning' of the core of the *Shari'ah* (*Usul al-Shari'ah*), Imam Shatibi dismisses the existence of conflict, contradiction and difference in the divine law, arguing that at the fundamental level there is unity. Variety and disagreement, apparent at the second level are not the intention and objective of the law' (Masud, 1994). This aspect of Shatibi's perspective on the *Shari'ah* adds a dynamic spirit to the moral law. Through such universality and the dynamic nature of the moral law, Imam Shatibi was aiming at a universal theory of social wellbeing.

Using the integrative perspective of social preference made out of the interactive preferences of members of society, Imam Shatibi thought of the

necessities of life as fundamental life-fulfilling goods. To incorporate basic needs into dynamic evolution of life-sustaining regimes, he subsequently introduced basic-needs regimes into his analysis.

These were the social needs for comfort and refinements of life. All the components, namely basic needs, comfort and refinement, were for life-fulfillment at the advancing levels of a basic-needs regime of socioeconomic development. On the basis of the dynamic basic-needs regime of socioeconomic development, Imam Shatibi constructed his social wellbeing criterion, and thereby, his theory of preference and the public purpose, *Al-Maslaha Wa-Istihsan*. These ideas proved to be far in advance of their time in the social meaning and preferences of life.

Standardization tends to be an unsavory word in the Islamic finance space. Although it has been pointed out time and time again that financial innovation is hampered by the lack of harmonized financial regulation, the different jurisdictions are more than happy to march to the beat of their own particular drummers, with a few contrarians pushing for the creation of a more global infrastructure.

After all, they say, look at where Islamic finance is today, with over US\$1 trillion in assets, having quadrupled over the last three years. This too, with a weak systemic liquidity infrastructure, a lack of tradable Islamic Money market products, and a poor secondary market for Sukuk. Think of where it could be, if we standardized.

Those not in favor would cite the creativity in coming up with their own contracts. Standardize? Why not charge interest? Why not invest in liquor? It's a slippery slope that leads to conventional finance and securitizing five times over to create the worst economic crisis since the Great Depression.

While turning Islamic finance into a McDonald's of sorts (would you like fries with that?) would be far from the ideal solution, there is room for some standardization; in the language employed in Shari'ah rulings, for instance. Standardizing the rulings would make it easier for companies to figure out what these fatawa mean and for the rulings to transcend borders more easily. Which is why the introduction of "Shari'ah Parameters", mentioned by Malaysian central bank chief Zeti Akhtar Aziz two months ago, may be more momentous than the initial reaction, or underwhelming response, would suggest. The trouble with Shari'ah rulings, Bank Negara Malaysia observed, is that nobody is quite sure what they mean or how to operationalize them. Even the bankers are not quite familiar with Islamic finance concepts and there is a lack of publicly available documents on fatawa and Shari'ah resolutions as sources of reference.

It has also been pointed out that the considerable heterogeneity of scholastic opinion about Shari'ah compliance makes it difficult to create a consistent regulatory framework and corporate governance principles.

Bank Negara went on to say that the Shari'ah Parameters are aimed at, among other things, clarifying concepts, principles and conditions of Shari'ah contracts, providing the basis for decisions on matters relating to conditions, mechanisms and implementation of Shari'ah contracts, to say nothing of facilitating Islamic finance professionals and practitioners in designing and developing Islamic financial products.

It added that the Shari'ah Parameters as standard guidance documents would provide a more comprehensive understanding of the principles and basis of adopting Shari'ah contracts for Islamic finance products thus enabling the harmonization of Islamic finance practices.

What this would mean is that a Shari'ah board could write a decision in Abu Dhabi or Bahrain, for instance, and it would translate beautifully in Malaysia. No ambiguity. No fuss. And funnily enough, a standardization in Shari'ah

rulings would not stifle the development of new products; it will in fact, act as a stimulus. While standardization should not be the be-all and end-all in the development of Islamic finance, some boundaries just make for well-tended gardens.

The Shari'ah Supervisory Board's (SSB) Role in Corporate Governance

The Shari'ah supervisory board is part of the internal governance structure of an IFI and appointed by shareholders of the institution. Its main function is to review and ensure that all transactions, contracts, products and applications relating to IFIs comply with Shari'ah rules and principles according to the specific fatwa, rulings and guidelines that have been issued. In order to establish a good corporate governance framework, the Shari'ah supervisory board may have to extend its jurisdiction to cover governance issues of this nature.

According to the Islamic Financial Services Board (IFSB), there is no "single model" of corporate governance that will work in every country; each country or even each organization needs to develop its own model.

From the standpoint of Islam, deeds are more significant than rhetoric, as highlighted in one verse of the Quran: *"Why do you say that which you do not do?"* Corporate governance should be practiced in the form of deeds. Only when actions speak louder than words can a good corporate culture emerge and protect the welfare of all.

AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued the Governance Standard No. 1 on the *Shari'ah*

Supervisory Board (SSB): appointment, composition and report. According to this standard, every Islamic financial institution will have an SSB which

A. is an independent body of specialized jurists in *Fiqh almu'amat* (Islamic commercial jurisprudence)

B. Is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic *Shari'ah* rules and principles

C. can issue *fatawa* and rulings which 'shall be binding on the Islamic financial institution

D. Shall consist of at least three members who are appointed by the shareholders

upon the recommendation of the board of directors (not including directors or significant shareholders of the Islamic financial institution)

E. shall prepare a report on the compliance of all contracts, transactions and dealings with the *Shari'ah* rules and principles, f. shall state that the allocation of profit and charging of losses related to investment accounts conform to the basis that has been approved by the SSB; and finally

F. shareholders may authorize the board of directors to fix the remuneration of the *Shari'ah* Supervisory Board.

The management is responsible for ensuring that the financing institution conducts its business in accordance with Islamic *Shari'ah* rules and Principles'. The responsibility of the SSB is 'to form an independent opinion on *Shari'ah* compliance.

It should be noted that the AAOIFI standard does not contain any information about the duration of a SSB membership or on the possibilities and procedures of dismissal and reappointment. Despite the AAOIFI standard, the specific rules and criteria for the selection and appointment of SSB members (regarding, for example, the relevance and the relative weight of their Islamic

and secular qualifications, their scholarly reputation and general popularity, their doctrinal strictness or intellectual flexibility, their main occupation and source of income, the duration of their SSB membership and the criteria for reappointment and so on) as well as the quantitative and qualitative dimension of their financial and non-financial rewards are not well documented in sources open to the general public. Empirical research on the selection process of SSB members and their professional careers (before, during and after the membership) is still lacking. There are also no case studies on causes and consequences of multiple memberships of individual scholars in different SSBs. Following the guidelines of AAOIFI, the board of directors suggests the candidates for the SSB and determines their remuneration. Very often the management has a strong influence on decisions of the board of directors. Therefore it is plausible to assume that top executives will have a strong influence on the composition of the SSB and on the financial and non-financial rewards for SSB members. As an independent body, the SSB is not subject to instructions by the management, the board of directors or the shareholders. SSB members are free to express their opinion and to sanction or decline banking practices, techniques, contracts, dealings and transactions.[12] This, however, does not mean that they are totally untouched by economic, social, political and intellectual trends and developments. In addition, it has to be borne in mind that SSB members had an initial motivation to accept their appointment (whatever that motivation was, whether scholarly reputation, the sake of Islam, financial reward or public visibility). If the membership of a SSB does promote the achievement of individual goals, it is a plausible assumption that the SSB members are interested in a continuing membership respondent in a reappointment. This creates a factual dependence on the board of directors which nominates SSB members and on the shareholders who appoint them. In addition, if the interests of the management are well represented in the board of directors, the SSB members have to take these into consideration. As long as

the management is supported by the board of directors and the shareholders, this boils down to the hypothesis that SSB members will not ignore the interests of the management when they apply their interpretation of *Shari'ah* principles to the activities, contracts and transactions of their Islamic bank. This does not mean that they will always find ways to accept whatever new financial product or transaction is submitted by the management. It must be a prime concern of the SSB that the Islamic character of the institution is recognized by the general public. But the SSB must also bear in mind the survival and commercial success of the institution. Given this simple set of behavioral assumptions for SSB members, a changing external environment can explain the obvious change of attitudes of SSBs towards financial innovations which imply new governance issues. The attitude of SSBs has indeed changed over the years, from being rather restrictive to becoming quite permissive.

Changing Attitudes of Shari'ah Supervisory Boards

The early years of Islamic finance – the 1970s and 1980s – can be characterized as high expectations and little experience. When Islamic finance was introduced, not only to Muslims but also to the rest of the world, it was often heralded as a unique financial system based on Qur'an and *Sunna*. It claimed superiority over the conventional *Riba* based system with respect to allocation, distribution and stability. This claim was put forward not only by Muslim economists but also by Islamic banking groups such as Dar al-Maal al-Islami. During these initial years, most *shari'a* scholars were not very familiar with techniques, contracts and procedures of modern (conventional) financial institutions and markets, and they were trained neither in economics and finance nor in contemporary

business law. The economic world of traditional Islamic law was based on trade,

handicrafts and agriculture, but not on industrial production, resource extraction, personal

and commercial services, multiple currencies on fiat money, international capital

flows, global competition, and so on.

To underline the distinctiveness and the divine origin on the one hand, and owing to

a lack of knowledge and experience on the other, SSB members often referred to the early

Islamic period and recommended old legal constructs without much sophistication. This

early approach was retrospective and in many ways restrictive. It created tensions

between *shari'a* scholars (and ideological proponents of Islamic finance) and the management

of Islamic banks. Islamic bank managers had to struggle with too conservative SSBs which did not sanction financial instruments deemed necessary by the management.

Executives designed products and techniques which were better adapted to an economy which had become much more diversified than that of Arabia in the formative

years of Islamic commercial law.⁵ Trade-related contracts do not go well with the needs

of the manufacturing and (non-trade) service sector. It may be owing to a lack of more

appropriate financing instruments that disputable commodity transactions were quite

common in this period. In the early years of Islamic finance it was a formidable challenge to adapt the commercial law of past centuries to the needs of complex and diversified modern economies.

After a decade Islamic banks had firmly established themselves in market niches. They heavily relied on trade-related modes of finance. Profit and loss sharing arrangements were extremely rare because of high transaction and monitoring costs, the danger of adverse selection (attracting projects with above-average probabilities of loss) and insufficient demand from the entrepreneurial customers. The discrepancy between the ideology and the practice of Islamic banking became increasingly visible.

With the passing of time it had become apparent that traditional contracts could not be applied directly but had to be modified considerably (as with *musharaka* for continuing concerns instead of terminated deals) and that some of the most highly esteemed contracts (*mudaraba*, *musharaka*) implied an adverse selection and were in low demand, while new instruments had to be designed for new and more complex financing tasks which were unknown to the traditional Islamic law (for example, project or infrastructure financing,

financing of working capital, consumer finance). Furthermore, instruments for a more efficient liquidity management and the development of interest-free capital (and money) markets were in urgent need.

During the 1980s, *shari'a* scholars had accumulated more practical knowledge and had

to recognize (together with Muslim economists) that the banking practice deviated widely

from the ideological ideal. SSBs were confronted with requests – growing in number and

urgency – of Islamic bank executives to sanction modifications of traditional contracts

and financial innovations.

Other changes in the environment of Islamic finance have occurred. While most Islamic

banks held monopoly positions in their countries during the 1970s and 1980s, this has

changed considerably since the mid-1990s. Today customers have a choice between several

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Islamic financial institutions in many Islamic countries (such as Bahrain, the United Arab

Emirates, Sudan, Pakistan and Malaysia). In addition, in many countries, conventional

banks do offer Islamic products or have established Islamic subsidiaries.

Furthermore, in

countries with few restrictions on international capital movements, the range of Islamic

products is enhanced by internationally operating Islamic financial institutions. In sum, competition has increased substantially between the conventional and the Islamic finance sector as well as within the Islamic sector. Also, with the growth of the Islamic financial sector, central banks and regulatory authorities paid more attention to this sector. These institutions, which previously dealt with conventional banks, strongly supported the activities of organizations such as AAOIFI, and established in the early 2000s the Islamic Financial Services Board (IFSB) in Kuala Lumpur, in order to create a coherent legal and regulatory framework.

The standardization of Islamic contracts and techniques implies that the importance of the individual SSBs of Islamic banks is considerably reduced, at least for established (standard) transactions. When standard techniques are part of everyday life, financial innovations become the major instrument for Islamic banks in their competition amongst each other and with Islamic products or subsidiaries of conventional banks. Standardization of traditional techniques and financial innovations as the main vehicle of competition does have far-reaching implications for the role and relevance of SSBs:

- a. Standardization curtails the importance of individual SSBs for the 'daily business' of Islamic banks.
- b. Financial innovations are basically designed and engineered by the management and put forward to the SSB for a *shari'a* assessment.
- c. In a highly competitive environment, the prosperity of a bank will depend crucially on its innovative potential.
- d. If an SSB wants to maintain its importance, its members must adopt an attitude towards financial engineering and product innovations which is less retrospective and restrictive but more prospective and permissive. Innovations create new business opportunities, as long as the innovator has a competitive edge. When imitation sets in, temporary 'monopoly profits' (or 'innovation rents') will dwindle away. Therefore neither the management nor the SSB has an interest in too much disclosure of the Islamic qualities of financial innovations as this could speed up imitation by other banks. Islamic banking is by its character more complicated (because it has to meet the requirements of the secular and the Islamic legal system) and less transparent than conventional banking. The need to keep 'Islamic business secrets' makes it even

more opaque than *riba*-based banking. Credibility of the Islamic qualities of the products

and transactions is achieved, not by disclosure, but by the reputation and public

recognition of the members of the SSB.

The technical details of new transactions and innovative products can be quite complicated.

A well-founded *shari'a* analysis and assessment requires much financial expertise

by the *shari'a* experts. Distinguished and well-known *shari'a* scholars with a profound

understanding of financial techniques are in short supply. This explains why the names of

some outstanding *shari'a* scholars are found in the SSBs of several Islamic financial institutions,

and in addition in advisory boards or committees of regulatory authorities and *Governance of Islamic banks* 139

standard-setting organizations (such as AAOIFI or IFSB). This raises several governance

issues at the macro or policy level. For example, if prominent members of SSBs determine

the Islamic framework of Islamic banks, set the tone of public opinion and give advice to

regulatory agencies, how will the independence of regulators be assured?

It seems that SSBs no longer impede the progress of financial technology.

Instead, a

legalistic view has become dominant which deconstructs complex financial techniques,

products and contracts into a number of more basic components which resemble (or are identical with) legal figures of the traditional Islamic commercial law. The *shari'a* quality of these components is then assessed for each component separately. If no objections are raised against a component, the total product is sanctioned. This method seemingly supports financial engineering and product innovation in the Islamic segment of the financial market, but it has one very serious weakness: elements which are perfectly legitimate separately may interact in such a way that the result comes into contradiction of fundamental principles of Islamic law. The dispute over the legitimacy of banking practices in Pakistan is a well documented historical case, and questionable public debt issues in the form of *sukuks* are more recent examples.

Besides the structural (external) factors for the change from a rather restrictive to a very permissive attitude of SSBs, some personal (internal) factors may also be of relevance.

First, if membership of an SSB is desirable for a *shari'a* expert, he will avoid as far as possible whatever may endanger his reappointment. The attraction of SSB membership can have various reasons, ranging from idealistic objectives (participating in the shaping of

the Islamic finance system) to material considerations (substantial financial compensation for SSB members).

Second, it seems that a sufficiently large number of clients of Islamic banks and public opinion leaders do not require a very strict adherence to instruments and techniques of the traditional Islamic business law. They are satisfied with the observance of legal minimum requirements. The ideological impetus of the early years has become a minority position. If this is a correct picture of the public and political environment in many Muslim countries, then a too restrictive stance of SSB members could provoke much public criticism which would endanger the reputation of SSB members and put them in a defensive position. This is a serious problem particularly if other (more) eminent *shari'a* scholars outside the given SSB approve similar techniques or products. External and internal factors can explain why SSBs have adopted a more permissive attitude towards financial innovations. This seems to be the best way to maintain the importance of the SSB and its individual members. If the bulk of Islamic financial techniques and products become standardized, an SSB is relevant only with respect to nonstandard products and procedures, and these are usually financial innovations. A

restrictive stance against innovations which are proposed by the Islamic bank's management

could cause a conflict with the management, the board of directors and also with

shareholders who want a 'progressive' or innovative bank or see a threat to the profitability

of the bank. Without innovative products, the bank may suffer a competitive setback,

and the relevant question becomes what the SSB is good for. It is welcome only if it does

not block, but facilitates, innovations.

The SSB is a unique element in the governance structure of Islamic banks (compared

to conventional banks) which follows its own logic. Its members are no advocates for the

interests of Islamic depositors:

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a. SSBs have sanctioned smoothing techniques which give much discretionary power to

the management and imply various distribution conflicts (between shareholders and

Islamic depositors as well as among different 'generations' of depositors).

b. The members of the SSBs, though formally independent, do have many strong incentives

to foster good relations with the management of the Islamic bank, at least if they

are interested in continuing membership of the SSB. One implication is that SSBs

nowadays have become definitely permissive with regard to financial innovations.

c. The SSB issues statements and reports on the Islamic qualities of the transactions and products of its Islamic bank. But when it comes to the specifics of the financial innovations,

the informational content of these publications is very limited.

d. It is not despite, but because of, the activities of SSBs that the economic (and ideological)

distinctiveness of Islamic banking becomes blurred.

Although the SSBs are unique elements in the governance structure, they do not contribute

to the solution of old governance problems. Instead, they add new governance issues at the macro and political level.

RESEARCH OBJECTIVES

CONCLUSIONS, RECCOMENDATIONS, AND FUTURE OUTLOOK

When we have fundamental differences in fatawa issued around the world, we are not really building a well-structured system. We invite much market distortion manifesting itself in cross border arbitrage, market arbitrage, legal arbitrage and, most dangerously, Shari'ah arbitrage, which could at some point lead to faith arbitrage. We have to always remember that this system is driven by faith. It's not driven by transactions. It's driven by how we believe transactions should be made and executed.

So when we have a system that is not consistent and has varied interpretations and pronouncements, we run the risk of imbalances and instability. This is not a system that we would like to build. So we have to endeavor to reach consensus and this is exactly what regulatory bodies like AAOIFI does. Their Shari'ah board consists of all major sects in Islam. What we try to do is come up with a structure that is acceptable to all those schools of thoughts.

It was also noted in AAOIFI standard that Shari'ah Supervisory Boards should not limit their role to the issuance of fatawa on the permissibility of (i.e. the Sukuk structure, or any other Islamic financial product or instrument but should continue to oversee the actual means of implementation at every stage of the product's life.

We need to do screening of all the products available in the market and evaluate the adherence of those products and the compatibility to Shari'ah principles and rules. We will identify those products that are in violation and we will voice it out to the public. We will also try to talk to the concerned parties about those products and perhaps provide some form of advice and share with them ways to modify those products so that they are completely Shari'ah compliant.

It is not AAOIFI's role to be the watchdog of the industry. They are, after all, a standard issuing body. However, I believe there is a huge gap in the market regarding what is Shari'ah compliant and what is not. And we thought we can take advantage of our superior Shari'ah board members to watch the market and identify what is Shari'ah compliant and what is not. We believe that AAOIFI could take on that role temporarily; they're not going to be the watchdog for the industry forever.

We live in a unique time of the Islamic Finance Industry. Although it is a huge initiative that will no doubt be full of challenges, we think it is desperately

needed in the market, especially nowadays where we have a golden opportunity to present a wonderful well-structured system

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ALLAH KNOWS BEST

(ALLAH A'ALAM)

والله أعلم

APPENDIX ONE

This section explains some Arabic words and terms occurring in this project paper.

Arbun is a non-refundable deposit to secure the right to cancel or proceed with a sale during a certain period of time.

Bai al-Dayn means the sale of debt or a liability at a discount or negotiated price.

Bai al-Inah is a contract that involves the sale and buy back of assets by a seller.

Bai bi-thaman Ajil is deferred payment sale by installments.

Bai'muajjal is deferred payment sale.

Bai Salam is pre-paid purchase.

Bay (Bai) is a comprehensive term that applies to sale transactions, exchange.

Fiqh is Islamic jurisprudence, the science of religious law, which is the interpretation of the Sacred Law, *Shari'ah*.

Gharar is uncertainty, speculation.

Hadith (plural *a hadith*) is the technical term for the source related to the *Sunna*, the sayings and doings – of the Prophet, his traditions.

Halal means permitted according to *Shari'ah*.

Haram means forbidden according to *Shari'ah*.

Hiyal (plural of *hila*) are 'permissions' or legal manipulations, evasions.

Ijarah contract is a leasing contract.

Ijarah wal iqtina'a is a lease-purchase contract, whereby the client has the option of purchasing the item.

Ijma means consensus among jurists based on the Holy Qur'an and *sunna*, and one of the four sources of law in Sunni Islam.

Ijtihad means the act of independent reasoning by a qualified jurist in order to reach new legal rules.

Islam is submission or surrender to the will of God.

Istijrar refers to a sale in which an asset is supplied on a continuing basis at an agreed price payable at a future date.

Istisnaa is a contract to manufacture.

Ju'alah is the stipulated price (commission) for performing any service.

Kafalah is a contract of guarantee or taking of responsibility for a liability provided by a guarantor, *kafeel*.

Maysir means gambling, from a pre-Islamic game of hazard.

Mudarabah contract is a trustee financing contract, where one party, the financier, entrusts funds to the other party, the entrepreneur, for undertaking an activity.

Mudarib means an entrepreneur or a manager of a *Mudarabah* project.

Murabahah is resale with a stated profit; for example the bank purchases a certain asset and sells it to the client on the basis of a cost plus mark-up profit principle.

Musharakah contract is an equity participation contract, whereby two or more partners contribute with funds to carry out an investment.

Muslim is one who professes the faith of Islam or is born to a Muslim family.

Nisab is the minimum acceptable standard of living.

Qard hasan is a benevolent loan (interest-free).

Qiyas means analogical deduction.

Qur'an is the Holy Book, the revealed word of God, followed by all Muslims.

Rabb al-mal refers to the owner of capital or financier in a *Mudarabah* partnership agreement (also *sahib al-mal*).

Riba is literally 'excess' or 'increase', and covers both interest and usury.

Shari'ah is Islamic religious law derived from the Holy Qur'an and the *sunna*.

Shirkah (or *sharika*) is a society or partnership.

Sukuk is a freely tradable Islamic participation certificate based on the ownership and exchange of an approved asset.

Sunna is a source of information concerning the practices of the Prophet Muhammad and his Companions, and is the second most authoritative source of Islamic law.

Suwar (pl. Surat) is a chapter of the Holy Qur'an. There are 114 *Surat* of varying length and in all references to the Holy Qur'an (for example 30:39) the first number refers to the *sura* and the second to the *ayah* or verse.

Tabarru means charity or donation. In *takaful*, it is a voluntary pooled fund for the benefit of all members.

Takaful refers to mutual support which is the basis of the concept of insurance or solidarity among Muslims.

Ulama are the learned class, especially those learned in religious matters.

Ummah means the community; the body of Muslims.

Wadiyah means safe custody or deposit.

Wakalah involves a contract of agency on a fee-for-services basis with an agent, *wakil*.

Waqf is a trust or pious foundation.

Zakat is a religious levy or almsgiving as required in the Holy Qur'an and is one of the five pillars of Islam.