Shariah Governance: Challenges Ahead

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Abstract

Bank Negara Malaysia (BNM) had previously issued a number of statutory requirements in making the establishment of Shariah Committee (SC) of a bank mandatory via Islamic Banking Act 1983, Banking & Financial Institution Act 1989, Takaful Act 1984 and Central bank of Malaysia (Amendment) Act 2003. The establishment of SC is important as part of the governance of an Islamic Bank in order to assure the stakeholders that the Bank is doing its business in permissible manner as outlined by the Shariah. Despite the structure, there is still skepticism about the system mainly on the capacity and the capability of the SC as reported in previous publications. This paper shall identify challenges faced by the SC that had impaired their capacity and capability in achieving their objectives. Subsequently, this paper shall recommend alternative measures on issues highlighted in assisting the SC and Shariah Auditors in bridging the public expectations. This study confines to issues pertaining to Islamic Banks operating in Malaysia as published in relevant articles and the author’s personal encounter.

Keywords: Islamic Finance, Shariah Governance, Shariah Committee, Shariah Audit

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1.0 INTRODUCTION

There are reasons to believe that there are certain numbers of people still skeptical about Islamic finance due to reasons that can be traced back to lack of strong governance. As reported by Karen Remo-Listana (2009), analyst unanimously said lack of credibility and innovation is hindering leapfrog growth of Islamic finance. This is due to the fact that the industry is still stuck within the conventional banking framework, whereby there is lack of effort in bringing it closer to a Shariah-based financing. It was further reported that a member of the Islamic Finance Council of United Kingdom and Executive Board Member of Ernst & Young, Omar Shaikh, (in Karen Remo-Listana 2009) said that public is still skeptical on the product whereby the Islamic financial products does not look as different as conventional products. Additionally, Parvez Ahmad (2010) cited findings in a research by Islamic Development Bank on the attitude of customers and bankers of Islamic Financial Institutions (IFIs). He reported that 7 out of 10 do not see the difference between the profit rate and interest, and 7 out of 10 are unwilling to patronize IFIs because there is no difference with the conventional banks.

Harbhajan Singh (2008) pointed out that some level of skepticism in Islamic finance in managing the trust of the stakeholders is seen despite tremendous growth. This is directly related to weak Shariah governance to instill strong trust to the Management and the Board of Directors. In addition, credibility of Shariah scholars in moving towards better governance is discussed in detail by four international scholars namely Dr Hussain Hamid Hassan, Dr Mohammad Daud Bakar, Mr Yusuf Talal DeLorenzo and Dr Mohammad Akram Laldin in response to questions posted by Rushdi Siddiqui (2010).

Lack of expertise in the industry had lead experienced scholars to be appointed as member of Shariah Board in many Islamic financial institutions (IFI) around the world. Experienced scholars become a brand name of their own and this had in turn made some IFIs to pursuit these scholars as their Shariah Supervisory Board member (Shariah Committee member in the case of Malaysia). Wilson (2009) reported that this practice had been a widely discussed topic and there had been concern of whether
sufficient time had been devoted to discharge their responsibilities in an effective manner. While some of this accusations may not be true, challenges in the industry due to lack of expertise had more or less tarnished the image of governance of Islamic finance.

Finally, based on a survey by PricewaterhouseCoopers Malaysia that had been conducted on 15 Malaysian-based IFIs in 2010 (Mohammad Faiz Azmi 2011), the following were among the findings were noted:

- 30% disagree that there is sufficient number of staff to perform Shariah audit effectively;
- 40% disagree that Shariah audit staff are adequately trained in Shariah related audit risks and issues;
- 30% disagree that the scope of Shariah audits are comprehensive enough to cover all relevant processes in the bank;
- 70% said the Shariah scholars are not involved in the audit process;
- 50% said that the Shariah scholars does not review the audit report and does not follow up on queries with the management; and
- Only 30% agrees that there is a dispute resolution process to allow the management to resolve potential conflicts with the Shariah scholars in a structured manner.

It is apparent that while there is a lot that had been done by BNM to instill good Shariah governance in the IFIs, there are still a lot of rooms to be improved in order to provide assurance to the public. Public confidence is very important in order to propel the industry more rapidly. Based on the Shariah Governance Framework Model for IFIs issued by BNM, areas that is the most crucial is the function of Shariah Committee (SC) and the Shariah audit since these are the main support to ensure Shariah compliance.

As such, the author took the initiative to further explore on the challenges faced by Shariah governance, particularly the Shariah Committee (SC) and the Shariah audit, which had lead to negative comments on the industry. The author shall complement his findings with practical solutions that would, Insya Allah improvise the concerns on Shariah governance.
This paper shall be structured in the following manner: The following section presents a literature review on the subject; and section 3 illustrates the concept of governance from Islam’s point of view. Section 4 will highlights areas of concern in the current Shariah governance; Section 5 provides some practical solutions on the issues; and Section 6 concludes the paper.

2.0 LITERATURE REVIEW & METHODOLOGY

In capitalism, the main purpose of an enterprise is to make profit. In other word, the creation of business is solely to maximize the shareholders’ wealth. In Islam however, the objective of a corporation is bigger than profit maximization or shareholders’ wealth maximization. While Islam recognizes property rights, it is not absolute to the shareholders unless the rights of the stakeholders are also protected (Zamir Iqbal & Abbas Mirakhor, 2004). According to Zulkifli Hasan (2009), this is resulting from the concept of corporate governance in Islam that is based on tawhid.

Based on a research by Wafik Grais & Matteo Pellegrini (2006), currently Shariah compliance is relied upon internal structures particularly the Shariah Supervisory Board (or SC in Malaysia). SC face challenges of in terms of independency, lack of trust in handling confidential information of the institution, lack of scholars who are qualified in Shariah and finance and lack of consistency between their judgments. The said authors introduced collaboration between internal and external structure in order to reduce if not eliminate the issues while jointly achieving Shariah compliance.

Nawal Kasim, Shahul Hameed Mohamed Ibrahim & Maliah Sulaiman (2009) focused on expectation gap in Shariah auditing. Their survey had posted four questions that had been the dilemma of Shariah audit namely, whether Shariah auditing framework differ from conventional, whether scope of Shariah auditing is broader than conventional, whether Shariah auditor specialized in Shariah and accounting and whether Shariah auditor is independent from the organisation. They noted a gap whereby Shariah auditing was not seriously taken in Malaysian IFIs, calling for crucial development of comprehensive Shariah auditing framework. It was supported by an
article by Shahul Hameed Mohamed Ibrahim (2008) that had previously mentioned that Shariah auditing is an area waiting to be developed and concluded with a call for experts in both Shariah and auditing to jointly develop the framework. This joint effort shall benefit the whole of mankind in promoting human and environmental welfare.

As a caution to the readers, this paper was not written based on extensive scientific research and employing rigorous methodology in concluding the findings. The author regrouped previous findings and added in his own observation on Shariah governance which was experienced during his days as an auditor of a local Islamic bank. While no current primary research had been conducted for this paper, it may somehow give loose and outdated remarks on his findings if it has been effectively corrected.

3.0 SHARIAH GOVERNANCE

3.1 Corporate Governance in Islam

Generally, corporate governance can be simply defined as a formal system of accountability of senior management to the shareholders (Shleifer & Vishny, 1997). In a deeper term, corporate governance includes the entire network of formal and informal relations involving the corporate sector and their consequences towards the society in general (Mesnooh, 2002). As such, it is not only concern about the relationship between the senior management (as agent) and the shareholder (as the principal), but also covered a wider scope of principal i.e. the society at large. Therefore, anything that can be affected by the corporation should receive the custodianship of the corporate governance.

The concept of corporate governance is actually embedded in Islam whereby the company’s movements towards achieving its objective is properly and systematically guided and controlled in order to meet and protect stakeholders’ rights and objectives. Nevertheless, the concept of stakeholder does not only limited to worldly forms but extended towards the concept of tawhid and the oneness of God (Choudury & Hoque, 2004).
Under the concept of *tawhid*, one does not only answerable or responsible towards another living being but also to the higher authority, Allah. In the Quran, Allah made it clear via the following verse (*Quran 2:139*) among others that we are accountable of whatever we did.

*Say: Will ye dispute with us about Allah, seeing that He is our Lord and your Lord; that we are responsible for our doings and ye for yours; and that We are sincere (in our faith) in Him?*

(*Quran 2:139*)

As everyone is expected to perform their part of the deal as a stakeholder, it can be further related to the following verse (*Quran 2:177*) on fulfilling contracts. The Management as an agent is expected to manage the organization properly as part of the contract with the principal and employees are expected to provide their services to the organization. The Board of Directors are to assure that the organization is operating according to the intention of the shareholders while the *Shariah* Board ensures that the organization is running based on *Shariah* rules as well as to assure the shareholders that their investment is running in a permissible manner. As mentioned earlier, outside parties are also considered as stakeholders or interested parties of the organization and some have formal contractual obligations towards the organization. For instance, creditors are to ensure that goods are sufficiently and adequately supplied to the organization, funds are adequately and timely disbursed (in the case of trade financier), and the organization in turn have to ensure that commitments are duly paid. Debtors are to ensure that their debts are timely paid as to ensure smooth circulation of cash within the organization in order to meet its obligations towards other interested parties while the organization have to ensure that their customer received goods and services as promised either via contractual obligation or via their brand promise, advertisement, sales representatives, etc. Further, the organization has to ensure that it pays tax to the State so that the money can be channeled back to the society for development and observed all legal obligations to the State. Finally, for the society at large, the organization should contribute to the environment and to the needy as what had been done by many corporations especially the MNCs in preserving the environment and helping the needy via their CSR activities.
Righteousness is not that you turn your faces toward the east or the west, but (true) righteousness is (in) one who believes in Allah, the Last Day, the angels, the Book, and the prophets and gives wealth, in spite of love for it, to relatives, orphans, the needy, the traveler, those who ask (for help), and for freeing slaves; (and who) establishes prayer and gives zakah; (those who) fulfill the contracts which they have made; and (those who) are patient in poverty and hardship and during battle. Those are the ones who have been true, and it is those who are the righteous.

(Quran 2:177)

In relation to the concept of *tawhid* and achieving the objective of the divine law, we shall relate the responsibility of an agent towards the achievement of the *Maqasid al-Shariah* as an ultimate goal of corporate governance (Al-Ghazali 1937, in Zulkifli Hassan 2008). Putting the pillars of *Maqasid al-Shariah* as the goal will give a wider spectrum of stakeholders to the agents, all of which are very important in ensuring that we continue to live in harmony in the present life and the hereafter.

The concept of property rights in Islam was clearly listed as one of the pillars of *Maqasid al-Shariah*. *Hifz al-Mal* as it is known, clearly provides a comprehensive framework to identify, recognize, respect and protects interest and rights of every individual, community, the State and corporation. In Islam, Allah is the sole owner of all properties and human beings are trustees via the following verse (Quran 57:7). Human are given free access to acquire, use and dispose the property between humans in accordance to *Shariah* rules, but a portion to benefit from the property is also shared with the State and the society (Zamir Iqbal & Abbas Mirakhor, 2004).

> Believe in Allah and His Messenger (Muhammad SAW), and spend of that whereof He has made you trustees. And such of you as believe and spend (in Allah’s Way), theirs will be a great reward. *(Quran 57:7)*

### 4.0 CHALLENGES & THE ROOT CAUSE
Shariah Committee (SC) is given the advisory role in ensuring Shariah requirement is observed. SC is expected to give opinion in assuring compliance to Shariah to the Board of Directors, who bears the highest level of integrity in terms of Shariah compliant of an Islamic bank. Practically, as the SC is not stationed at the bank all the time, the Shariah Secretariat whom usually has knowledge in Usul Fiqh and Fiqh Muamalat shall be the first level of reference whereby they are to deliberate opinion on simple issues. Their deliberation will then be communicated to the SC. As for issues that are more complicated, it shall be communicated to the SC for research and deliberation.

In order to ensure that the products conform to Shariah, SC needs to review the feature of the product, which can be of the following different type of concept as listed by Wahbah al-Zuhaili (2002 in Zulkifli Hassan 2009):

- **Bilateral contracts** - Uqud Tamlikaat (contract of ownership), Uqud al-Mua’wadhat (exchange), Uqud Isytirak (contract of partnership) i.e. Mudharabah (passive partnership) and Musyarakah (active partnership), Uqud Tawsiqat (contract of security) i.e. Kafalah (suretyship) and Rahnu (pledge), Uqud Itlaqat (contract pertaining to do a work) i.e. Wakalah (agency) and Hiwalah (debt transfer), Uqud Taqyiydat (contract of restriction), Uqud Hifz (contract of safe custody) and Wadiah (safekeeping)

- **Unilateral contracts** - Isqatat (waiver), Ibra’ (rebate), Muqassah (setting-off debt), Wasiyyah (will), endowment and Qard (loan).

### 4.1 SC as the subject matter expert

BNM via Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions had outlined that a member of SC must be an expert of Usul Fiqh and Fiqh Muamalat. While it is very important to be an expert in Shariah, we cannot discount the importance of having knowledge in banking and finance as a whole. This is due to the fact that, according to Zainal Azam Abdul Rahman (2011), the operation of today’s Islamic banking industry is still confined within the conventional banking framework. Products developed are very much similar in substance and most of it is based on debt. As such, an SC should be mindful about the nature and original spirit of these products as it could have affecting the purity of Islamic products if it is not properly restructured.
as Shariah-compliant. For instance, the Mudharabah deposits were structured to be an alternative product to fixed deposit (FD). While it was structured based on Mudharabah concept, return to the sahibul mal (depositor or investor) is still made as competitive as the FD and is short-term in nature. As such, it would pose greater risk to the IFI as the return to sahibul mal is based on floating rate while return from majority of their financing activities is based on fixed rate and long-term in nature. This finding is also noted via research done by Anouar Hassoune (2001), Abdel Hameed M Bashir (2000) and M Kabir Hassan and Abdel Hameed M Bashir (2002). Further, the Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR) should be kept as a trust by the Islamic bank, not as part of shareholders’ equity as reported in the annual report due to the fact that banks cannot conveniently dip their hands into the funds for other use.

An experienced SC member would see things from an end-to-end process. If there is amiss, they can effectively point out areas that had been left out. For example, while developing a new financing product, the marketing part of it had been unintentionally left out. An experienced SC member would be quick to realized that the marketing process had not been discussed as previously been. Therefore, he would be proactive in raising it to be discussed so that the marketing of the product is done ethically based on Shariah. On the other hand, if he is not as experienced, he would be less proactive and only use his expertise confining only to matters that had been laid before him to be discussed.

A less experienced SC member would not know in detail how things work. For instance, a Bai’ al-Inah credit card should not only be perfected at the sale and buyback process but also the modes of doing the sale and buyback. Some banks confined to the written agreement to conclude the two contracts but certain banks however, are satisfied with verbal aqad. While both conducts is acceptable by the Shariah, SC should satisfy themselves on the mechanics of both types of contracts. In other word, Shariah risk mitigation should be embedded during the development stage itself. If SC is not as meticulous, they might miss out fundamental Shariah non-compliant issue like selling the same assets concurrently to different parties at the same time by different staff.
The focus should not only be on what to do but also how to do it and how to ensure it is done. Without proper exposure to the system especially in complicated financial instruments, there is a risk that deliberation by SC may not be complete. It is easier nowadays that computerized system can assist in detecting and preventing Shariah risk. As per the previous example, the system can recommend assets that could be used for the Bai’ al-Inah transactions avoiding different personnel to use them at the same time or worse, selling assets that had been sold off for good. Nevertheless, without knowing such Shariah-compliant risk in the first place, detective and preventive rules would not be proposed to be included in the system.

As per our discussion so far, it is very important that members of SC should have knowledge and experience in the banking industry in order to critically analyze the products and processes so that their advisory role is a value added service that covers end-to-end process. The question now is whether the fast developed Islamic banking industry has sufficient number of capable Shariah scholars to be appointed as SC member? Wright (2006) quoted that there is no shortage of Shariah scholars in this world as qualifications in Shariah and Islamic jurisprudence are offered widely across the world. The challenge is to find such scholars that also have knowledge and experience in finance and banking. This is not a new issue to the industry. While young scholars are produced, there had been many discussions all over the world on the capability of them becoming SC members.

According to Wilson (2009), Hennie van Greuning & Zamir Iqbal (2008) and Hanim Hamzah (2010), shortage of quality SC members is a problem for IFIs in achieving its objectives and gaining respect from stakeholders. Therefore, some of the IFIs in the GCC took the advantage of appointing prominent Shariah scholars as their SC member. This would add value in terms of Shariah branding and at the same time giving confidence to their stakeholders. However, it was also argued that this measure had opened another floodgate whereby prominent Shariah scholars had been appointed to many SC. The issue had been reported by Reuters (2010a) and Dana El Baltaji & Haris Anwar (2010) whereby the top 20 scholars serve 621 boards globally. Questions were raised on whether these scholars could cope with the sheer load of responsibilities in many SC across many countries especially at certain level of age and serving institutions that are
robustly developed and need a very close attention. There are also calls for the industry to limit number of boards that a scholar can serve. However, Mr Yusuf Talal DeLorenzo had counter-argued that strength of a person is subjective and varies from one person to another (Rushdi Siddiqui 2010). Even time devoted to accomplish a certain task differs between an experienced scholar and a junior scholar. As such, it is unfair to judge a person’s capability based on our own capability. Apart from this, there is also skepticism raised by certain parties, notably Nadirsyah Hosen (in Greg Fealy & Sally White 2008), Foster (2009) and Mabid Ali Al-Jarhi (2010) that this may indicate the leniency of the scholars and they are appointed since they can accommodate to the needs of the IFIs. To a worse extend, their appointment had been connected to fatwa shopping by the IFIs. Nevertheless, Sheikh Nizam Yaqby refuted that the situation was exaggerated and these accusations are not based on solid ground. Banks are increasingly want the best out of their Shariah scholars and fatwa shopping is not an option (Reuters 2010b).

Dr Nedal Alchaar raise his concern on a potential conflict of interest or competitiveness risk resulting from information leakage if number of local IFI served by a particular scholar is not limited (Dana El Baltaji & Haris Anwar 2010). In Malaysia however, IFIs have to follow strict regulations of BNM in appointing SC members. Scholars serving a local bank or appointed as SAC member of BNM cannot serve as an SC member of another bank. This is to control conflict of interest and confidentiality issues that may arise between banks. Perhaps, the hikmah behind this rule is giving the opportunity for young scholars to serve as SC members. However, Sheikh Hussain Hamid Hassan counter-argued that conflict of interest issue should not arise among the scholars as they are governed strictly by the Shariah (Rushdi Siddiqui 2010).

While it is a noble effort by BNM to introduce such regulations, it would be good if each IFIs were to have at least one senior scholar as their SC member and the rest of the junior scholars can learn from them. This would be a more effective succession plan of scholars. Despite the regulation and the fact that most of quality local scholars are taken, it is still plausible for IFIs to have a senior scholar as their SC member by appointing qualified foreign scholars. The regulations however does not limit on number of foreign boards that this scholar is representing.
4.2 Capacity of SC to ensure that Shariah is observed

As we can see from the Shariah Governance Framework, it is clear that the SC only have the Shariah Secretariat reporting to them. SC and Shariah Secretariat could within their capacity issue judgment on the permissibility of the business. They however, do not have the capacity to assure the Board of Directors and the stakeholders that business had been carried in a permissible manner. Let us revisit the case of Bai’ al-Inah credit card.

As previously mentioned, banks may conclude the Bai’ al-Inah contracts in writing or verbally. While both are acceptable, the issue now boils down on whether the contracts had been properly concluded. In other word, since this is a sell and buyback agreement in facilitating the credit limit of the credit card, customers may wonder as to why they need to conclude such contracts since their intention is to get a credit card. It is crucial for contracting parties to have a proper intention i.e. buy and sellback or sell and buyback if they do not want to invalidate the contract (Saiful Azhar Rosly & Mahmood Sanusi, 2001). Therefore, it is up to the officer attending the customer to properly explain on the transactions so that the customer have a pure view about Islamic financing, not as a hilah for a riba in disguised transactions. Further, the signing of the contracts must be in proper order or the verbal contract is properly done. While these had been explicitly outlined in the product manual, the issue would be how could the SC satisfy themselves and others that such verbal aqad had been properly conducted? Practically, SC members are non-executive members of the bank and the Shariah Secretariat is not sanctioned to conduct such verification.

Even with limited resources, SC is made to assure stakeholders in the annual report that business was conducted by IFIs in accordance to the Shariah. Rationale for this assurance is the credibility in assuring permissibility lies with the scholars (Wilson 2009) whom have the utmost knowledge in Shariah within the IFI. Nevertheless, the central issue is still on limited resources and their assurance is only partial and questionable. This is due to the fact that they do not have direct access to other sections of the governance that could have direct contact with the operation such as internal...
audit and risk management. Questions may rise on whether the SC has been given appropriate authority to ensure compliance to the Shariah is observed or they are just a reference for Shariah matter and a mere product approving body.

4.3 SC’s proficiency and familiarity with legal terms

Based on Section 20 (b) and (c) of GPS1 issued by BNM, SC is expected to endorse and validate all relevant documentations and this includes the term and condition, the product manual, marketing advertisement, sales illustration and brochures used to describe the product. SC have to meticulously vet and endorse all documents involved including the terms and conditions contained in the proposal forms, legal documentations product manuals, marketing materials like advertisements, sales illustrations, brochures and so on. They should be able to read the fine prints and items hidden between the lines.

As most of the banking documentations are in English, SC members are expected to be proficient in English apart from Arabic. However, if the documents are printed in multiple languages especially advertising materials, it is not necessary for them to know all other languages but they should ensure that there is a disclaimer whereby in the event of conflict of information between the documents, the version which they thoroughly checked should prevail.

Apart from being proficient in English, the SC members may also require to be familiar with the terms, jargons and writing style of legal documentations. If the product is developed from scratch based on Shariah, issues arising from the legal documentation may not be as serious as the documentation is been developed based on the concept. The issues arise when the original conventional product is being converted into Shariah compliant product whereby terms might have changed but the spirit and the nature of the transaction may not reflect the true Shariah-compliant documentation. It may sound easy as majority of products in Malaysia is based on Bay concept or Uqud Tamlikaat but one size does not necessarily fits all. As such, checking of the documentations should be beyond the proper use of terminology and avoidance of certain taboo words like interest, repayment, borrower, and so on but it should be understood that trading is
absolutely different kind of transaction from money renting. For instance, it is a practice of banks to have a facility agreement or an offer letter to state the summary of financing prior to the conclusion of legal documentations. The issue would be, would this be acceptable to have such document detailing the tenure, profit rate, financing sum and instalment amount for a *Bai al-Inah* financing since it is a standard practice of a conventional counter product?

Certain banks are very strict in terms of documentation and imposed that the documentation used by the lawyers must be procured from them. Others are somehow flexible whereby lawyers can draft their own documentations. As such, it would be difficult for the bank to control the contents of the documentations. Whichever method applied, IFIs should be mindful that lapses preparation of documents may result in implementation of the contract not as intended. Previous cases like *Affin Bank vs Zulkifli Abdullah (2006)* had taught us how the lack of *Shariah* structuring in financing (or rather refinancing) documentations, which should have taken a different approach from conventional financing, had lead us to court.

**4.4 Effectiveness of the *Shariah* audit framework**

The only party that has the capacity and capability of checking on the implementation of *Shariah* requirements within the framework is internal audit. With strict guidelines on auditors as imposed by their strong fraternity, the Institute of Internal Auditors (IIA), reliance can be place upon them in ensuring that the *Shariah* guidelines are followed. Nevertheless, two main issues remained questionable.

Firstly, most auditors in the financial institutions are trained in finance, conventional finance to be exact. Since not many of them had been formally trained in *Fiqh Muamalat* or *Usul Fiqh*, their knowledge in Islamic finance is very limited. The focus may still be based on risk and little emphasize would be put on compliance to *Shariah*, as a branch of compliance risk. As such, outcome of their audit may be questionable whether their coverage had been rigorous enough to cover all aspects of *Shariah* concerns.
While it is important for Shariah auditors to have knowledge in *Fiqh Muamalat* and *Usul Fiqh*, let us not forget that it is equally important that the auditors are equipped with necessary skills in performing audit. The author’s finding is similar to those finding by *Wafik Grais & Matteo Pellegrini (2006)* and *Shahul Hameed Mohamed Ibrahim (2008)*, whereby background in either Shariah or auditing alone is not sufficient in conducting Shariah audit. For instance, looking at the *Bai’ al-Inah* credit card highlighted before, the contract can be concluded in writing or verbally. If it is in writing, the evidence can be physically sighted. It is not sufficient to just sight the documents but to also check on the performance of the contract. This is where the sampling skill of an auditor comes into action. However, if the contract is concluded verbally, it would be challenging for the checking of the performance of the contract. Phone recordings of the contract have to be traced among thousands, if not millions of phone calls of the bank and it have to be matched with all the contracts that is being examined. This is where the auditing skills kicks-in whereby it is neither impossible nor difficult for an experienced auditor to trace such contracts.

It can be argued that auditors can work together with the *Shariah Secretariat* and the SC to accomplish their goal. This would however pose the second issue i.e. whether they can have adequate access to the *Shariah Secretariat* and SC, and vice versa. Without formal connection between the auditors and the SC, it would be challenging for the auditors to procure their expertise. Further, there is no absolute reporting line between the auditors and the SC, there is a possibility that their observation on *Shariah* issues would not be effectively communicated to the SC. In this case, even if the auditors are adequately competent in *Shariah* and independent in their reporting, there is no guarantee that there will be no gap or filters between their findings and the SC. Therefore, there is a possibility whereby in certain cases, the auditors may not be able to assure the Board on performance of a product is in accordance to the *Shariah* but at the same time the SC may assure the stakeholders that everything is in order, despite their limitations as previously discussed.

### 4.5 SC’s position within the Governance structure
In the Governance framework, the SC has the Shariah oversight accountability on Shariah related matters to the Board whom in turn having the overall oversight on the Shariah governance structure and Shariah compliance. The Board also has the Board Audit Committee and the Board Risk Management Committee, which consist certain members of the Board to support them in the Governance structure. Although having a direct access to the Board, the SC does not have a say at the Board level. Further, they may not have access to issues pertaining to Shariah compliance and risk highlighted by the internal auditors or the risk managers.

Although the Shariah Secretariat directly reports to the SC and have the function to conduct research and review on Shariah, the effectiveness of the Shariah Secretariat is questionable as they are not required to undertake specialized training in doing rigorous audits and reviews as the internal auditors had went through. On top of that, the Management may see that the Shariah Secretariat reports to the SC, a “lesser level” committee as compared to the reporting matrix of the internal audit. Therefore, access to certain level of information in doing their review may be limited.

Some might argue that since the SC member is paid by the IFIs, their level of independency may be impaired. They may want the management to be pleased with them and keep employing them. As such, they may be lenient on certain issues pertaining to the Shariah. This had lead to what is termed by Mahmoud El-Gamal (2006) as Shariah arbitrage. Wilson (2009) however counter-argued that there is little evidence of such arbitrage in practice, and indeed it could be regarded as implausible that the sort of bank clients or investors wanting Shariah compliance would shop around for the least restrictive fatwa. The author is of the same opinion with the counter-argument by comparing the structure with internal audit and risk management. These professions are required to be independent from the Management in order to assist the organization in achieving its objectives. Further, the Shariah scholars are believers and they are to answer to the higher authority in the afterlife if they do not discharge their responsibility in a proper manner.

Zulkifli Hassan (2009) commented that the SC does not have standard guidelines in discharging their responsibilities. It is based on the practice whereby the Shariah
Secretariat will hand over materials to be reviewed or deliberated and the outcome shall be delivered. Their role is more on advisory rather than assurance, despite their comments in the annual report in assuring the stakeholders on the permissibility of the IFIs operation.

Finally, the issue of mere compliance inherited via the corporate governance may pose a problem in achieving the objective of the Shariah governance. People had find ways to achieve the requirements of the corporate governance but not the objective of it. Therefore, in a number of cases, corporate governance had failed to properly function.

5.0 RECOMMENDATIONS

BNM had done a very good job in coming up with guidelines for IFIs in order to control their operations while giving the credibility to grow further. It is certainly a boost to the industry to gain respect and to be more resilient. Nevertheless, as the industry move into the next stage of its life cycle, certainly there are things that can be improved. This section shall forward some of the recommendations in order to address issues as highlighted above.

5.1 Slight change to the Governance structure

As highlighted, issues raised to the Board of Audit Committee and Board of Risk Management pertaining Shariah audit and Shariah risk may not surface to the SC. It is important for SC to know what is happening within the organization because end of the day, they are the ones to sign off the annual report in assuring the stakeholders on the compliancy of the institution. As such, it would be a bold move for BNM to make it mandatory for banks to appoint at least one members of the SC as a member of the Board, Board of Internal Audit and Board of Risk Management. By doing this, issues highlighted are effectively and directly communicated to the SC. This would also give them opportunity to give opinions and have a say in the Board meeting on issues pertaining Shariah. This would enable them to be closer to the organization rather than merely playing an advisory role.
Each member of the SC appointed to various Boards is to have the responsibility to report back to other members of SC during the SC meeting. The members should sit more frequently as to brief each other on the happenings of the institution.

Another alternative would be for the Chief Internal Auditor (CIA) and the Chief Risk Officer (CRO) to have a session with SC before the Board of Audit Committee and Board of Risk Management meeting. This would ensure issues pertaining to Shariah compliant and risk are communicated to the SC. Subsequent to the Board meetings, extract of the minutes on Shariah matters are to be circulated to the SC for their information. Concerns by the SC on Shariah compliant and risk are to be compiled and communicated to the respective board via CIA and CRO. Outcomes of the deliberations by the Boards are to be followed closely by the Company Secretary and communicated to the SC.

Finally, another alternative would be to require SC members and the Shariah Secretariat to be in attendance during all Board, Board Audit Committee and Board Risk Management meetings. The SC members would have a better picture about the ex-post implementation of Shariah rulings. All the Boards would also have the opportunity to consult the SC member on Shariah matters on the spot.

5.2 Appointment of SC member

BNM can consider relaxing the regulation of appointing Shariah scholars to SC of multiple banks. Perhaps for a start, BNM can allow Shariah scholars who are not on BNM’s SAC to be on SC of maximum two banks. This would encourage local banks to get local senior scholars as their SC member and act as mentor to the junior scholars, in line with the comment made by Amr Mohamed El Tiby (2011) whereby transfer of knowledge to the next generation should be given priority. This practice would be market driven whereby senior scholars would not only act as mentor to add value on bank’s governance but their goodwill will add value in terms of reputation of the banks.

In order for scholars to complement each other in terms of knowledge, it would be wise for IFIs to appoint scholars of different background such as legal, finance, economics,
etc. While their core competency is in Shariah, having an exposure or a second competency in another field would be an added advantage. This would reduce the risk in documentation, structuring the financial products, and so on.

Finally, BNM can also initiate an international certification for scholars before they are deemed fit to serve the IFIs. BNM can take the accounting or legal profession as a guide whereby scholars are to have certain level of education before allowing them to sit for professional exam. Exams are based on application of knowledge whereby their expertise is put to test in problem solving. In order to keep them abreast with the development of the industry, they are required to attend certified trainings, seminars or conferences and part of their continuation of professional development is to give lectures in seminars or to contribute researched articles on the industry.

5.3 Strengthening the Shariah audit function

In line with the certification of the scholars, Shariah auditors should also be certified. Certification can come from a joint effort between champions in Islamic financial training and the audit fraternity. For instance, certification issued by IIA and INCEIF would give a high credibility to the auditors as both institutions are champions in their own industry. Perhaps the modules should cover Muamalat, finance, accounting, law and so on. Candidates that have basic qualification in any module would be exempted from taking the module. Level of the certification would vary to show level of competency of the member. For instance, member who had just passed all papers would be conferred with basic membership and until he satisfies a certain level of experience as Shariah auditor in a bank, then he would be conferred to a higher level membership. Membership fees are to be maintained by members as to be channeled for the purpose of research in Shariah auditing. And like the scholars, members have to maintain certain amount of CPD points in order to keep them abreast with the development of the industry. In order to maximize their internal resources, Shariah auditors should be given free access to the Shariah Secretariat and the SC as a point of reference.

With the certification, BNM can start to market the expertise to overseas. Malaysia can be a hub of Shariah auditing experts where there is a large pool of competent talents. It
can be extended whereby BNM can start granting license for individuals operating Shariah auditing firms and again Malaysia can be an outsourcing hub for Shariah auditing.

6.0 CONCLUSION

The concept of corporate governance is actually embedded in Islam whereby the company’s movements towards achieving its objective is properly and systematically guided and controlled in order to meet and protect stakeholders’ rights and objectives. Stakeholder does not only limited to worldly forms but extended towards the concept of tawhid and the oneness of God. One does not only answerable or responsible towards another living being but also to the higher authority, Allah. In achieving the objective of the divine law, we shall relate the responsibility of an agent towards the achievement of the Maqasid al-Shariah as an ultimate goal of corporate governance to ensure that we continue to live in harmony in the present life and the hereafter.

There are certain numbers of people still skeptical about Islamic finance due to reasons that can be traced back to lack of strong governance. It is due to challenges faced by Shariah governance, particularly the Shariah Committee (SC) and the Shariah audit, which had lead to negative comments on the industry. It was also noted that Shariah auditing was not seriously taken in Malaysian IFIs, calling for crucial development of comprehensive Shariah auditing framework.

BNM had outlined that a member of SC must be an expert of Usul Fiqh and Fiqh Muamalat. However, we cannot discount the importance of having knowledge in banking and finance as a whole. Shortage of quality SC members is a problem for IFIs in achieving its objectives and gaining respect from stakeholders. Therefore, some of the IFIs in the GCC took the advantage of appointing prominent Shariah scholars as their SC member, which would add value in terms of Shariah branding and giving confidence to their stakeholders. Another issue would be the capability of SC to have an oversight on Shariah compliance due to lack of resources in Shariah auditing and risk management. Thirdly, the issue revolves around their proficiency in English and familiarity with the terms, jargons and writing style of legal documentations. Checking of the
documentations should be thorough and beyond the proper use of terminology and avoidance of certain taboo words and realign trading away from money renting. The next issue highlighted is on the knowledge of Shariah auditors in Fiqh Muamalat and their access to the SC. The author calls for the gap to be bridged and certification made for competent auditors.

It is important for SC to know what is happening within the organization because end of the day, they are the ones to sign off the annual report in assuring the stakeholders on the compliancy of the institution. As such, it is recommended that at least one members of the SC is appointed as a member of the Board, Board of Internal Audit and Board of Risk Management so that issues highlighted are effectively and directly communicated to the SC. The author further suggested for regulation in appointing Shariah scholars to SC of multiple banks to be relaxed. This would encourage local banks to get local senior scholars as their SC member and act as mentor to the junior scholars.

As a caution to the readers, this paper was not written based on extensive scientific research and employing rigorous methodology in concluding the findings. The author regrouped previous findings and added in his own observation on Shariah governance which was experienced during his days as an auditor of a local Islamic bank. While no current primary research had been conducted for this paper, it may somehow give loose and outdated remarks on his findings if it has been effectively corrected. Perhaps future research in this area can address this shortcoming and it would also be a good exploration in commercializing Shariah audit.

Allah knows best, Wallahu a’lam.
6.0 REFERENCES


Affin Bank Berhad vs Zulkifli Abdullah [2006] 3 MLJ 67


7.0 BIBLIOGRAPHY


