

The Role of Key Functions of Shari'ah Governance in Islamic Financial Institutions (IFIs)

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Abstract

A solid governance in Islamic financial institutions (IFIs) is reflected in their efficient and sound operations. Due to the significant role of Shari'ah governance in enhancing and developing the operations and transactions of IFIs according to Shari'ah rules and principles, every IFI must have a sound Shari'ah governance framework. The key players of this governance should be defined and mentioned clearly. This paper discusses the role of key functions of Shari'ah governance in IFIs such as the Shari'ah Supervisory Board (SSB), Shari'ah review and Shari'ah audit. Moreover, this paper provides brief information about models of Shari'ah governance worldwide. The main objective of this study is to provide a clear insight about the key elements of Shari'ah governance in IFIs. In order to give this clear insight of the Shari'ah governance models, this study describes radically different models of Shari'ah governance, and focuses on their similarities and differences.

Keywords: Governance, Shari'ah, Supervision, Review, Audit.

دور الوظائف الأساسية للحوكمة الشرعية في المؤسسات المالية الإسلامية

ملخص البحث

تعكس الحوكمة الشرعية الرشيدة في المؤسسات المالية الإسلامية في كفاءة وفعالية أنشطتها ومعاملاتها القائمة على هذه الحوكمة. ونظرا للدور المهم للحوكمة الشرعية في تقوية وتطوير أنشطة المؤسسات المالية الإسلامية ومعاملاتها حسب أحكام الشريعة ومبادئها، لكل واحدة من هذه المؤسسات ينبغي أن يكون إطار سليم للحوكمة الشرعية، وكذلك لا بد من توصيف وتوضيح تلك الجهات التي يكون لها دور فعال في هذه الحوكمة. هذه الورقة تناقش دور الوظائف المهمة والفاعلة للحوكمة الشرعية في المؤسسات المالية الإسلامية، منها الهيئة الشرعية والمراجعة الشرعية والتدقيق الشرعي. علاوة على ذلك، هذه الدراسة تعطي رؤية شاملة لأنواع الحوكمة الشرعية السائدة في العالم، وتهدف إلى إعطاء تصور واضح لأهم وظائف وواجبات الحوكمة الشرعية في المؤسسات المالية الإسلامية. ولإعطاء تصور واضح حول نماذج للحوكمة الشرعية، هذه الدراسة تبين أنواعا متعددة لهذه الحوكمة وتركز في بيان أوجه تشابهها وتباينها. كلمات مفتاحية: الشريعة، الحوكمة، الشريعة، الرقابة، المراجعة، التدقيق.

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| 1. Introduction | 98 | For proper <i>Shari'ah</i> compliance, the corporate governance in <i>Shari'ah</i> requires a further layer of governance. Every Islamic Financial Institution (IFI) must have organizational arrangements to supervise the <i>Shari'ah</i> compliance matters of their activities (Hassan, 2011, 63). The role of the <i>Shari'ah</i> governance in IFIs is to enhance and promote the mission of the Board of Directors (BOD) and <i>Shari'ah</i> Supervisory Board (SSB) to support the purpose of <i>Shari'ah</i> compliance (ISRA, 2016, 730). The function of <i>Shari'ah</i> governance is not only to serve the stakeholders' interests but also to guarantee that all operations of the IFIs are compliant to the tenets, conditions, and principles espoused by <i>Shari'ah</i> (Hassan et al., 2013, 2). Therefore, every IFI must have a sound and proper framework for <i>Shari'ah</i> governance. Moreover, every IFI must have the key functions of <i>Shari'ah</i> governance to ensure a high-quality process of the <i>Shari'ah</i> |
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compliance process. This paper shall discuss the functions that include *Shari'ah* supervisory board, *Shari'ah* review and *Shari'ah* audit.

In this chapter, some important points are highlighted and examined, which are: the conceptual framework of *Shari'ah* governance, significance of *Shari'ah* governance, functions of *Shari'ah* governance system, role of *Shari'ah* board, international standard setting agencies, and the *Shari'ah* governance process. This paper also will discuss different models of *Shari'ah* governance of IFIs in various countries.

2. *Shari'ah* Supervisory Board

2.1 Definition of *Shari'ah* Supervisory Board

AAOIFI GS-1 para (2) (2015, 885) defines the SSB as "an independent body of specialized jurists in *Fiqh al-Mu'amalat*." Moreover, AAOIFI adds that the SSB might include a member who is an expert in the field of Islamic finance and in knowledge of Islamic commercial jurisprudence. The primary duties of the *Shari'ah* Supervisory Board are reviewing, directing, and supervising the transactions of the institutions to guarantee that they are in accordance with *Shari'ah* rules. Members of SSB will select one of them to be a supervisor to assist the board in performing its duties. The definition of AAOIFI of the SSB emphasizes more on the process and procedure of SSB work and the requirements of the SSB's members as well. Abu Ghudda (2001, 3) defines the term *Shari'ah* supervision as "... a process of review, investigation and analysis of all works, actions and behaviours that are conducted by the institution to ensure its compliance with *Shari'ah*. To do so, the SSB uses appropriate tools and approaches to detect errors, provide legitimate solutions for these errors, and submit its reports to the relevant parties, including *Shari'ah* opinions, decisions, recommendations and guidance for generating legitimate profits (*Halal*) and improvements in the future". The definition of Abu Ghudda focuses more on the duties and responsibilities of SSB members in the IFIs, unlike the definition of AAOIFI, which focuses more on the process and requirement of appointing an SSB member. However, the definition of Abu Ghudda fails to mention the requirements of the SSB such as being an expert in *fiqh and uşul al-fiqh* and

so on. Another suitable definition is given by *Majma' al-Fiqh al-Islami* (Islamic Fiqh Academy) in Jeddah, which says "Ḥay'at al-Raqābah al-Shar'īyyah is a group of specialized scholars in Islamic law, specifically in the law of transactions, whose number is not less than three. They possess scholarly competence and practical knowledge to issue *fatāwā* (formal legal opinions) and review all transactions of the institution to ensure they are in conformity with the rulings and principles of *Shari'ah*. Their reports are submitted to the general assembly, and their resolutions are mandatory upon the institution" (Majma' al-Fiqh al-Islami, 2009, 1). This definition is wider than the previous two definitions as it includes three main elements: competency, roles and composition of the SSB. Garas and Pierce (2010, 387) try to widen the definition of the SSB using different elements. Therefore, they define the term as "the preventive, remedial and complementary process of control, review and analysis of all the IFI's activities, products, contracts and transactions, starting from the incorporation of the IFI onwards, to ensure compliance with Islamic *Shari'ah* for the purposes of generating legitimate (*halal*) profits and improving the IFI's performance." This definition of SSB includes more elements of the SSB's duties, such as reviewing and analysis of all the transactions and products of IFIs from an early stage until the end. However, this definition fails to mention the necessary qualifications and requirements of the SSB which are mentioned by other definitions.

This study tries to build its own definition of the SSB which is a "Comprehensive organ whose functions include review, investigation, and evaluation of all products, transactions, activities and businesses conducted by the IFIs to ensure *Shari'ah* compliance; and this responsibility is performed by qualified experts and *Shari'ah* scholars who possess appropriate tools and vested knowledge."

2.2 Appointment of *Shari'ah* Board Members

Every IFI should have an SSB who will be appointed by the shareholders during the AGM with a recommendation from the BOD. The shareholders of IFIs may authorize the BOD to fix the remuneration of SSB (AAOIFI GS-1, 2015, 885). For example, in Malaysia, BNM lays out that the appointment of

Sharī'ah committee members must be made by the BOD upon the recommendation of its nomination committee with the prior written approval of BNM (BNM, 2010, 5-9). In Pakistan, the State Bank of Pakistan (SBP) states that the BOD has the responsibility of appointing the SSB to advise it on all *Sharī'ah* issues and assist in developing a sound *Sharī'ah* compliance framework. Moreover, the BOD has the duty to approve the terms of reference (TOR) and to fix the SSB's remuneration in the case of local IFIs. In the case of foreign banks with Islamic banking branches, the appointing of the SSB must be made by the country manager or the chief executive officer of the bank (SBP, 2014, 2). As a result, there are some differences between AAOIFI, Malaysia and Pakistan in appointing the members of SSB. For example, in AAOIFI the shareholders have the right to appoint members of the SSB during the AGM with a recommendation of the BOD. However, Malaysia is stricter in appointing SSB members, as the appointment of *Sharī'ah* board members must be made by the BOD. Moreover, every Islamic bank must obtain approval from BNM in order to appoint members of the SSB. Pakistan has a different way in appointing the members of the SSB for foreign banks with Islamic branches. Only the county manager or the CEO of the bank has the right to appoint the members of the SSB.

2.3 Composition of Sharī'ah Board

IFIs vary from one country to another in the composition of the *Sharī'ah* supervisory board (SSB) members. Numerous IFIs hire three to six members for the SSB, which comply with the AAOIFI GS No.1 and IFSB-10 (ISRA, 2016, 731).

According to AAOIFI GS-1, the *Sharī'ah* board should comprise of at least three *Sharī'ah* scholars (AAOIFI GS-1, 2015, 886). However, in Malaysia, BNM requires the IFIs to appoint at least five members of the SSB with a *Sharī'ah* Secretariat to improve the effectiveness of the SSB (BNM, 2010).

In Pakistan, members of the *Sharī'ah* board should consist of a minimum of three *Sharī'ah* scholars at the IFI level, while the SSB of the State Bank of Pakistan (SBP) consists of two *Sharī'ah* scholars and three experts in the fields of legal framework, banking, and accounting (Ayub, 2007; SBP, 2014, 2).

To sum up, according to AAOIFI as well as in Pakistan, every IFI is required to appoint at least three *Sharī'ah* scholars to be members of the *Sharī'ah* board for the purpose of *Sharī'ah* compliance. However, in Malaysia, there is the condition that there should be a minimum of five *Sharī'ah* scholars, and every IFI is required to appoint a *Sharī'ah* secretariat to enhance the role of the SSB. Although, three *Sharī'ah* scholars may enhance the public confidence in IFIs and improve the quality of work, there is no ideal number of *Sharī'ah* scholars in the SSB (Garas & Pierce, 2010).

2.4 Qualification of Sharī'ah Board Members

There are some requirements which must be fulfilled by every member of the *Sharī'ah* supervisory board, such as he/she should have sufficient knowledge, expertise or experience in the rules of Islamic law of transaction (*Fiqh al-Mu'āmalāt*) and principles of Islamic jurisprudence (*Uṣūl al-fiqh*). Additionally, the member should possess enough knowledge, expertise or experience in finance, banking, law, or any other related discipline. Furthermore, a *Sharī'ah* advisor should have strong Islamic ethical values (Hassan et al., 2013).

AAOIFI GS-1 Para 2 (2015, 886) lays out that a member of the *Sharī'ah* board must be an expert *Fiqh al-Mu'āmalāt* (Islamic Law of Transaction). Moreover, the *Sharī'ah* board may include a member who is an expert in the field of Islamic banking and finance with knowledge of Islamic commercial jurisprudence. In Malaysia, BNM (2010) states that a member of the SSB should possess, at a minimum, a degree in *Sharī'ah*, which includes *uṣūl al-fiqh* and *al-mu'āmalāt* from a recognised university. Furthermore, the *Sharī'ah* board may include experts from different backgrounds such as finance and law to support and enhance *Sharī'ah* deliberations (ISRA, 2016, 738).

To sum up, AAOIFI and Malaysia have almost the same requirements for the qualification of SSB members in terms of having deep experience in *Sharī'ah* knowledge, especially in *Fiqh al-Mu'āmalāt*. Furthermore, both of them allow experts from various fields to be appointed as members in the SSB.

3. Sharī'ah Review

All IFIs are required to have *Sharī'ah* review and internal *Sharī'ah* review functions to ensure all activities and transactions are in line with *Sharī'ah* rules and principles (ISRA, 2016, 742).

The function of the *Sharī'ah* reviewer is to examine the extent of the Islamic financial institution's compliance with *Sharī'ah* rules in their activities. The examination should include agreements, contracts, policies, products, transactions, memorandum, and articles of association, financial statements, reports, etc. (AAOIFI, GS-2, 2015, 899). In Malaysia, BNM (2010) states that the *Sharī'ah* reviewer has the duty to report to the SSB and the management, and all findings of *Sharī'ah* non-compliance should be reported to the BOD and SSB.

AAOIFI governance standards state some procedures which must be performed by the *Sharī'ah* reviewer. These encompass planning review procedures, executing review procedures, documenting reports, preparing and reviewing working papers, procedures in documenting conclusions, and preparing the *Sharī'ah* review report (AAOIFI GS-2, 2015, 890).

The *Sharī'ah* review function requires a sound *Sharī'ah* internal control system to be efficient. Moreover, the function of the *Sharī'ah* review requires competent internal auditors to review all stages of the *Sharī'ah* governance system such as the conception of products, product design, product documentation, product testing, product implementation, and product review (ISRA, 2016).

The *Sharī'ah* reviewer plays a significant role in IFIs by ensuring that all businesses and activities performed in IFIs are *Sharī'ah* compliant.

4. Internal Sharī'ah Review

As stated by AAOIFI GS-3 (2015, 909), the internal *Sharī'ah* review should be executed within an independent department in the IFIs. Also, the primary aim of the internal *Sharī'ah* review is to provide assurance that the management of an IFI is performing its duty with regards to the execution of *Sharī'ah* rules. Thus the internal *Sharī'ah* review has a significant role of the key players of the *Sharī'ah* governance of the IFIs. Moreover, the internal *Sharī'ah* review should be

performed in accordance with the IFIs' policies. Internal *Sharī'ah* reviewers need to have full communication with all levels of the SSB, management and external auditors, in order to promote the organizational position of the internal *Sharī'ah* review. In addition, the employees of the internal *Sharī'ah* review department must have sufficient educational backgrounds and training pertaining to the internal *Sharī'ah* review. The head of the internal *Sharī'ah* review department should set up appropriate criteria to fulfil the necessary requirements (AAOIFI GS-3, 2015, 910).

The function of the internal *Sharī'ah* review should include an investigation and assessment of the sufficiency and effectiveness of the Islamic financial institution's system of internal *Sharī'ah* quality and control of performance when executing their responsibilities. AAOIFI requires the internal *Sharī'ah* reviewer to execute his responsibility in four stages: planning documentation, examination and evaluating internal *Sharī'ah* review information, reporting, and following-up. The head of the internal *Sharī'ah* review unit has the responsibility to manage the internal *Sharī'ah* review properly by setting up plans to perform the duties. Moreover, the head should provide written policies and procedures to lead the members of the department. The internal *Sharī'ah* review should include establishing a program in order to train and develop the staff of the internal *Sharī'ah* review. The IFIs are required to provide assurance that the staff of the internal *Sharī'ah* review are qualified and experienced. Furthermore, the IFIs should continue to train and develop the staff in the required disciplines, especially in *Fiqh al-Mu'āmalāt* (AAOIFI, 2015, 890).

The qualified internal *Sharī'ah* reviewer has a significant function in assisting the SSB members to approve that all transactions conducted by the IFIs are in line with *Sharī'ah* rules and principles.

5. Sharī'ah Audit

The *Sharī'ah* audit function is to assure that all businesses and operations executed by IFIs are in line with *Sharī'ah* rules and principles. The SGF-BNM section 7.7 defines the function of the *Sharī'ah* audit as "the periodical assessment conducted from time to

time, to provide an independent assessment and objective assurance designed to add value, and improve the degree of compliance in relation to IFIs' business operation, with the main objective of ensuring a sound and effective internal control system for *Shari'ah* compliance".

The definition implies that the function of the *Shari'ah* audit is to verify a step-by-step audit process and procedure to enhance the level of compliance with *Shari'ah* principles (ISRA, 2016, 743).

In Oman, Central Bank of Oman (CBO) (2012, 23) states that the *Shari'ah* audit has the function of helping the internal *Shari'ah* reviewer and the SSB in providing their views about the *Shari'ah* compliance of the institution's activities and operations. Therefore, the duty of the *Shari'ah* audit should be performed by independent internal auditors or qualified external auditors, while the management of the institution carries out the *Shari'ah* review (Abdul Rahman, 1998). The findings of the *Shari'ah* reviewer must be reported to the SSB and management, while the *Shari'ah* audit findings should be sent to the audit committee and the SSB (ISRA, 2016). The *Shari'ah* audit plays a significant role in evaluating the extent of compliance with *Shari'ah* rules and principles.

As stated in CBO (2012, 24), the scope of the *Shari'ah* audit function should include an examination and evaluation of the efficiency of the IFIs' system of *Shari'ah* compliance and the extent of performance in executing responsibilities. The *Shari'ah* audit is a vital function that not only assists the *Shari'ah* review but also enhances the stakeholders' confidence in all transactions and operations of IFIs which are compliant with *Shari'ah* principles (ISRA, 2016).

To sum up, the *Shari'ah* auditor is responsible to help the *Shari'ah* board members and the internal *Shari'ah* reviewer through providing their opinion on the extent of *Shari'ah* compliance in the institution.

Table 4.3 The Comparison between Internal *Shari'ah* Reviewer, *Shari'ah* Compliance Unit and *Shari'ah* Audit Unit:

| | Internal <i>Shari'ah</i> reviewer | <i>Shari'ah</i> audit unit | <i>Shari'ah</i> compliance unit |
|-----------------------------------|--|---|---------------------------------------|
| Roles and responsibilities | 1. Leads the <i>Shari'ah</i> compliance unit | 1. Inspects and evaluates the extent of | 1. Assists the management in ensuring |

| | | | |
|-------------------------|---|---|---|
| | and the <i>Shari'ah</i> audit unit of the IFI. | compliance with <i>Shari'ah</i> rules. | compliance with <i>Shari'ah</i> rules as manifested by the SSB's <i>fatwa</i> and guidelines. |
| | 2. Provides <i>Shari'ah</i> guidance and direction on day-to-day matters to the IFI's management. | 2. Includes all business operations, and activities of the institute; examines the extent of compliance with <i>Shari'ah</i> rules, <i>fatwa</i> , guidelines and instructions issued by the SSB through actual audit of the business transactions; and submits its report to the SSB of the bank and a copy to the Audit Committee of the board. | 2. Observes the regular Management Information System (MIS) and confirmations coming from business departments relating to <i>Shari'ah</i> compliance. Should be involved before the management approves new products or transactions |
| | 3. Publishes minimum one research paper every year in an international journal. | | |
| | 4. Spends a significant amount of time training the staff on <i>Shari'ah</i> compliance. | | |
| Fit and criteria | Experience of at least five years; and possesses knowledge and experience of banking business and <i>Shari'ah</i> (<i>fiqh al mu'amalat</i>) in particular. | Should have a sound education in <i>Shari'ah</i> rules in general and <i>fiqh al-mu'amalat</i> . | Should have a sound education in banking and understanding of <i>Shari'ah</i> rules in general and <i>fiqh al-mu'amalat</i> . |

The table above demonstrates the comparison between three functions of *Shari'ah* governance in Islamic banks- the internal *Shari'ah* reviewer, *Shari'ah* audit unit and the *Shari'ah* compliance unit in terms of responsibilities and qualifications. First, in terms of qualifications, the Internal *Shari'ah* reviewer should have 5 years of experience in aspects of Islamic banking and finance which is more than the requirements of the other two functions. On the other hand, the regulator did not mention the requirements of experience for the *Shari'ah* audit and *Shari'ah* compliance units. Second, in terms of scope and responsibilities, the internal *Shari'ah* reviewer is considered to be the leader of the *Shari'ah* staff in the Islamic banks and he has more responsibilities and roles than the other two functions. For example, the internal *Shari'ah* reviewer must train the staff of the *Shari'ah* audit and *Shari'ah* compliance units as well

as all staff of the bank in *Shari'ah* knowledge. Moreover, he is required to publish at least one paper in an international journal yearly. While the job of the *Shari'ah* compliance unit is to report to the management to assure compliance with *Shari'ah* in all businesses and activities. Therefore, their job requires them to be involved before the management approves or proceeds with a new product or transaction. The *Shari'ah* audit unit is required to support the internal *Shari'ah* reviewer and the SSB in designing and expressing the views of *Shari'ah* compliance of the institution. Therefore, the unit will evaluate and inspect levels of compliance of the institution with *Shari'ah* rules and instructions issued by the SSB.

6. Comparative and Analysis of Models of *Shari'ah* Governance

The SSB plays a vital role in supervising and mentoring the operations and activities of IFIs to ensure *Shari'ah* compliance. Currently, the practice of the *Shari'ah* governance framework is more centralized in Sudan, Pakistan and Malaysia than in GCC countries (Hamza, 2013, 235). The implementation of *Shari'ah* governance in the finance industry differs from one country to another. They can be grouped into three major models: centralized model, self-regulation model, and hybrid model. (Hasan and Sabirzyanov, 2015, 244).

6.1 Centralized Model

In this model, the central *Shari'ah* board (CSB) has unlimited power relating to matters of *Shari'ah* in the IFIs. Therefore, all announcements of the CSB are considered binding and compulsory to all IFIs of the country. However, in the case of a contradiction between *Shari'ah* decisions made by the SSB and *Shari'ah* decisions made by the CSB, the latter's resolution will prevail, and SSB should modify its resolution (Hassan et al., 2013; Abdul-Rahman, 2010).

The government in a country must regulate and specify the *Shari'ah* governance structure as well as its process and functions. Every country in this model has its own features and characteristics of the *Shari'ah* governance structure. However, generally they have the same structure of jurisdiction. Usually, the government

has the authority to appoint members of the central *Shari'ah* board, which represents the highest level in the *Shari'ah* governance structure. Moreover, each IFI has its own *Shari'ah* committee or SSB, which is appointed by the BOD or by the AGM of the shareholders of a respective institution (Hasan Z., 2010). The countries which adopt this type of *Shari'ah* governance have a different process of appointing members of the CSB, which is subjected to some restrictions and parameters (Hasan & Sabirzyanov, 2015, 245).

In Oman, the central financial authority is the Central Bank. The *Shari'ah* governance framework has established HSSA (Higher *Shari'ah* Supervisory Authority) at the CBO to assess all Islamic banks in Oman. Moreover, all IFIs in Oman must have its own *Shari'ah* supervisory board (CBO, 2012; CBO, 2013, 8). Therefore, it can be said that Oman adopts the centralized model of the *Shari'ah* governance framework. In Malaysia, members of the CSB must be individuals and the number of CSB members should be at least five. Moreover, a member of the CSB must be appointed for a specific term, and this term can be renewed after its ending (BNM, 2009; BNM, 2010). Appointment of SSB members of IFIs in Malaysia has similar restrictions and parameters as the appointment of members of the CSB. On the other hand, the reader can find some differences, for example, SSB members should be individuals, and the number of SSB should be at least three or five, while the number of SSB members can be one in some other countries. Moreover, there is a fixed tenure for a member of the SSB, and this tenure is renewable after its ending. Usually, the appointment of SSB members should be approved by the CSB (BNM, 2010; Hassan et al., 2013, 16). In Oman, members of the CSB must be assigned for a maximum period of four years, and this can be renewed after its ending. Whereas, SSB members must be assigned for a maximum period of three years, which can be renewed for another 3-year term (CBO, 2012, 2).

In this model, there are some requirements which must be fulfilled by the *Shari'ah* advisory board members for them to be a member in the CSB or SSB. The requirements include that the *Shari'ah* advisor should have sufficient knowledge, expertise or

experience in the rules of the principles of Islamic jurisprudence (*Uṣūl al-Fiqh*) and Islamic commercial law (*Fiqh al-Muʾāmalāt*). Also, he should possess enough knowledge, expertise or experience in finance, banking, law or other related disciplines. Furthermore, a *Sharīʿah* advisor should have strong Islamic ethical values. Additionally, the candidate for a *Sharīʿah* advisor role should neither be a principal shareholder, nor hold an executive position of the same category. Regarding integrity, the *Sharīʿah* advisor should not be involved in fraud or any criminal activity against the principles of *Sharīʿah* (BNM, 2010; Hassan et al., 2013, 16).

In some countries, such as Malaysia, Nigeria and Oman, there are some additional restrictions relating to the appointment of the members of the SSB. For instance, a member of the CSB cannot be a member of the SSB of an IFI governed by the CSB (Hassan et al., 2013; Dauda, 2013). In addition, a member of the SSB cannot be a member in two IFIs in the same category. For example, a member of the SSB of an Islamic bank is not allowed to be a member in another Islamic bank at the same time. On the other hand, the *Sharīʿah* advisor can be a member of the SSB in a *takaful* company or a fund management company at the same time (Hasan A., 2007; Hasan Z., 2010; Wilson, 2011; CBO, 2012).

6.2 Self-regulation Model

This type of *Sharīʿah* governance is more common than other models in the Islamic finance industry. In general, the number of countries that have adopted this model of *Sharīʿah* governance is more than the number of countries which have adopted the centralized model (Hasan & Sabirzyanov, 2015, 247).

There are some factors which can justify this issue. One of them is that some countries do not possess legislation for Islamic finance. Therefore, the governments do not recognize Islamic finance as a separate sector. Besides that, some countries, despite the fact that they have special provisions to accommodate Islamic finance, are secular in nature. Thus, the financial authority of a country cannot create a CSB, which is a religious body. Additionally, some countries like to adopt approaches that allow more flexibility and rely more on market discipline and best

practices (Hassan et al., 2013). The requirements of the *Sharīʿah* advisor in the countries that have adopted the self-regulation model are like those countries which use the centralized model. However, the self-regulation model has fewer restrictions than the centralized model (Laldin, 2008; Hassan et al., 2013; Zaidi, 2008).

Some countries with this type of *Sharīʿah* governance have added some more restrictions for a *Sharīʿah* advisor to be a member in the SSB. For example, the candidate for a *Sharīʿah* advisor role in the SSB should not be a principal shareholder or hold an executive position in an IFI of the same category. Moreover, a member of the SSB should not be a member of the BOD of any other IFI of the same group (Wilson, 2011; Hassan et al., 2013). It is worth mentioning that, in general, in the self-regulation model the functions of the SSB are almost the same as those countries which adopt the centralized model in terms of supervising and monitoring the *Sharīʿah* matters in the IFIs (Hasan & Sabirzyanov, 2015, 248).

6.3 Hybrid Model

Currently, this type of *Sharīʿah* governance is practiced in Bahrain. The Central Bank of Bahrain (CBB) has its own CSB. However, the CSB of CBB possesses limited functions such as advice and supervision on issues related to *Sharīʿah* rules (Hasan Z., 2010). The CSB at the central level has the responsibility to serve and supervise the *Sharīʿah* compliance of its products only. There is no restriction on members of the CSB from serving in any IFI and they also can serve more than one financial institution (Hamza, 2013, 232). The regulations in Bahrain have emphasised a reference to AAOIFI Governance Standards for IFIs (AAOIFI, 2005), which means the CSB of the CBB has no supreme authority over IFIs with regards to *Sharīʿah* principles in Islamic finance. In Bahrain, IFIs are required to follow the standards of AAOIFI on matters pertaining to *Sharīʿah* governance. Furthermore, the functions and process of the *Sharīʿah* governance system, as well as the requirements for the selection of *Sharīʿah* scholars in the SSB at IFIs, are almost the same as those requirements in the self-regulation model and the centralized model (Hasan Z., 2010). AAOIFI plays a vital role in harmonizing the concepts and applications among the SSBs of different IFIs.

Moreover, AAOIFI aims to prevent any dispute between the SSBs of various IFIs (Hamza, 2013).

6.4 Analysis of the Models

Table 3.7 Difference between Centralized, Decentralized and Hybrid Models

| | Centralized model | Decentralized model | Hybrid model |
|--|---------------------|---------------------|---------------|
| SSB at the national (regulator) level | Yes | No | Yes |
| SSB for each IFI | | No | Yes |
| In case of dispute among SSB of IFIs refer to | CSB at central bank | Particular body | AAOIFI |
| Approval of new product | CSB+SSB (normal) | SSB (fast) | SSB (fast) |
| Member of SSB can serve in more than two Islamic banks | No | Yes | Yes |
| <i>Ijtihad</i> | Limited | Open | Open |
| <i>Fatwa</i> | centralized | decentralized | decentralized |

It is obvious that every model of *Sharī'ah* governance has its own way of achieving a high level of efficiency in an effort to standardize the Islamic finance industry. In the centralized model, harmonization and standardization are accomplished by the regulatory intervention of the central banks through the selection of the *Sharī'ah* board. According to Oseni (2009), in the centralized model, the disagreement will be referred to the CBS, and resolution will be made by the way of arbitration, litigation or mediation, which will assist in managing disputes in a more effective way while taking into consideration the *Sharī'ah* opinion on every particular dispute.

In the decentralized model the existence of prominent scholars on various boards may help to achieve more consistency in *Sharī'ah* opinions (Ibrahim, 2012). Moreover, in the self-regulatory

approach, each bank has its own SSB which is independent from the Central Bank authority. Therefore, it is hard to manage the conflicts of interest and accomplish consensus in *Sharī'ah* views (Hasan Z., 2010; Abdul-Rahman, 2010).

In the centralized model, the *Sharī'ah* pronouncement of the CSB is binding on SSBs. This may restrict the independence of *ijtihad* for the *Sharī'ah* scholars at the IFI level and they will not be able to present a different view due to the pronouncement of the CSB. However, in the self-regulatory approach the members of the SSB are not bound to apply any pronouncement made by the CSB. Therefore, the members of the SSB have more room to provide their opinions and the possibility of *ijtihad* is more (Hasan & Sabirzyanov, 2015; Hamza, 2013).

In the decentralized model, having *Sharī'ah* approval for a new product depends on the SSB only, while in the centralized model the launching of a new product requires *Sharī'ah* approval from two bodies, the SSB and the CSB. Therefore, launching a new product in the market is faster in the decentralized model compared to the centralized model, (Hasan & Sabirzyanov, 2015, 250).

Both models, decentralized and centralized, play a vital role in achieving a high level of efficiency in harmonizing and standardizing the Islamic finance industry. However, there is no optimal model that can fit all countries due to diversity in the structure of *Sharī'ah* governance and its implementation.

7. Conclusion

The findings of this study demonstrate that:

- 1- There is a need to have sound *Sharī'ah* governance to ensure an effective internal control system of the *Sharī'ah* governance in IFIs.
- 2- Islamic banks cannot be successful without implementing a proper *Sharī'ah* governance. An effective *Sharī'ah* governance should enhance the confidence of the shareholders and the public that all the products and activities are in line with *Sharī'ah* rules. The SSB has an important responsibility in ensuring *Sharī'ah* compliance in the institutions.

- 3- There are some similarities between conventional financial institutions and IFIs in term of organizational arrangements for the corporate governance framework. However, IFIs require additional institutional arrangements in the form of the SSB, internal or external *Shari'ah* review unit and *Shari'ah* compliance unit in order to ensure *Shari'ah* compliance in the institution.
- 4- The AAOIFI governance standards and the IFSB guiding principles have a crucial role in enhancing the harmonization among IFIs worldwide. However, there are some issues between AAOIFI governance standards and the IFSB-10 standard, which need to be settled. All IFIs are required to issue a *Shari'ah* report based on particular requirements.
- 5- All main players of *Shari'ah* governance have a fundamental duty in building and promoting the confidence of the shareholders that all operations, businesses, and practices are in accordance with the requirements of *Shari'ah*. Sound *Shari'ah* governance requires additional integration between the CSB and SSB of IFIs to enhance the *Shari'ah* compliance process in the IFIs. There is no optimal model that fits all countries due to the diversity in the structure of *Shari'ah* governance and its implementation. To sum up, there is a need to study these issues further to improve the current *Shari'ah* governance practice in order for its role to be performed properly and effectively.

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