

Shari'a Harmonization, Regulation and Supervision

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I. Introduction

The message of Islamic finance is based on justice and responsibility. In recent decades, the practices of Islamic finance have developed from simple retail banking to a wide array of products and services that provide real alternatives available to the market. During its early stages, the need for Shari'a related regulation and standardization was minimal due to the relatively simple practices and small number of operations. At its onset, the industry had just started transforming theoretical ideas into practical applications, and these needed to prove their capability to provide for modern day needs and overcome competition before transmitting into other countries.

Today, with the advent of many and complex generations of Islamic finance models and instruments, and the industry's inroads into the centers of capital markets, it has become ever more difficult to ensure Shari'a compliance of products and institutions, which is the essence of the industry. First, the complexity of products and services now requires careful attention both in formulating the necessary contracts and in all aspects of practical application. Second, Shari'a compliance is a continuous process that requires constant attention, efficient mechanisms and capable human resources.

This is why Shari'a harmonization, regulation and supervision are some of the most important aspects we may discuss for this industry. And due to the unique structure of this industry, with Shari'a scholars, regulators and business professionals sharing the responsibility to lead this industry, there is wide scope for synchronization of ideas and optimizing the way this industry is governed.

These topics are more relevant today than at any other time. With structural fractures appearing in the world financial system, Islamic finance is slowly emerging as a plausible alternative to the prevailing arrangement. Had Islamic finance been clearer in terms of standardization and development of instruments, and had it been more established in terms of regulation and sophistication of modeling, we could have seen a higher role to be played by Islamic finance over the next few years.

Nevertheless, Islamic finance is a truthful message that we are responsible to promote. We need to emphasize here that safeguarding Shari'a compliance is how Islamic finance will play a greater role in world financial markets, for Shari'a compliance is the major asset distinguishing this industry. Regulators around the world are already looking into ways in which Islamic finance can help repair the financial difficulties. We can only promote Islamic finance to its potential if all aspects of Shari'a compliance are properly defined because only Shari'a compliant conduct can lead to the stability purported by Islamic finance.

The basis of formulating Shari'a rules is no doubt the expertise of Shari'a scholars. But what is the role of the scholars in 1) harmonization of Shari'a standards and 2) implementing Shari'a governance mechanisms? And what is the role of regulators and business professionals? These are questions that will be discussed.

II. Legally enforcing Shari'a standards on Islamic financial practices

Defining the Problem:

It is important to properly delineate the possible arguments that may be put forward, whether for or against legally enforcing Shari'a standards on the industry. We will then try to reconcile between these arguments that may seem contradictory, but it will be shown that they are in fact complementary. We will start by citing the view of market leaders and regulators. Then we will cite possible counter arguments by Shari'a scholars. Finally, we will reconcile between those two views.

A. View of Market Leaders and Regulators

These two groups have repeatedly expressed the need to harmonize Shari'a standards as a precursor to the growth and stability of the industry. They articulate that the existence of defined Shari'a standards helps in formulating regulatory judgments which will lead to a well defined regulatory oversight for the industry. This will lead to higher stability and foster the growth. Consequently, the lack of clarity in Shari'a practices leads to lower mobility of these practices within the same country and across the borders, which handicaps the growth of the industry.

For example, a financing contract or arrangement may be endorsed by one Shari'a supervisory board and not endorsed by another equally prominent Shari'a authority. Recently in Jordan, a highly prominent Shari'a figure criticized the punishment imposed on a defaulting debtor in Murabaha, which goes to charity, and expressed his belief that this is nevertheless a type of Riba even though it goes to charity. This lack of stability lowers confidence in the industry and limits its mobility, applicability and growth.

They may also argue that the instability of Shari'a rulings leads to instability in Shari'a compliance. Shari'a compliance by its nature is a dynamic process that requires practice. It is not only rulings but is also a set of practices that require exercise and application. If Shari'a

standards are not uniform, then it will be difficult to define proper and universal compliance practices.

They may conclude that harmonization of Shari'a standards reduces transaction costs to the industry and to the regulators, helps the formation of efficient regulatory oversight, enhances the process of Shari'a compliance, and contributes to confidence and growth in the industry.

This view is also shared by potential jurisdictions which have not yet been widely penetrated by Islamic finance. In a speech on opening the ways for Islamic finance to operate in the state of New York, The Vice President of the Reserve Bank of New York, Mr. William Rutledge, stated that "Although we are certainly in no position to take a stance on issues of Shari'a interpretation, it is more important that we become more familiar with the principles and practices unique to Islamic finance in order to make our supervisory and regulatory judgments." He then expressed the inefficiency of "individual regulators dealing with specific issues as they are reported."

Similarly, I quote Mr. John B. Taylor, under secretary of the (U.S.) Treasury for International Affairs as saying "...the lack of uniformity of standards for "Islamic banking" practices across Islamic countries makes it difficult to apply the same prudential regulatory standards (e.g., capital adequacy requirements) across the board. This calls for more harmonization of Islamic banking practices, which in turn calls for harmonization of Shari'a standards at the national and international levels."

B. View of Shari'a Scholars

Shari'a scholars, on the other hand, may have a different opinion on full and total harmonization of Shari'a standards. These are some views taken from what Shari'a scholars have written:

1- The standardization of Shari'a may become against the fundamental premise of *Ijtihad* which has existed for centuries. *Ijtihad* is the process of deducting Shari'a rules from their authentic sources. It is a continuous process used by the highest authorities in Shari'a. If rules become standard, and imposed by legal authorities, then *Ijtihad* cannot be applied anymore. This will eventually damage the very reason that we are able to apply Shari'a in all times and places, that is, *Ijtihad* is the main reason why Shari'a is dynamic and is able to be applied in different circumstances.

2- There are different schools of thought in Shari'a and these schools of thought differ in their opinions in many specific rulings although they agree on most important Shari'a issues. To standardize Shari'a rulings may mean the precedence of one school of thought over the other, which cannot be universally acceptable.

C. How to bring together those two views (The need for harmonization and the difficulties arising from existence of different schools of thought and the necessity of *Ijtihad*).

There is no doubt that the synchronization of these two views has to be done through mutual understanding and collaboration between Shari'a scholars and market leaders and regulators. To be very clear and accurate, the question of whether Shari'a standards can be harmonized is a matter to be dealt with by Shari'a scholars and not market professionals or regulators. The simple reason for this is because Shari'a 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'a's own instructions and judgments.

It will be helpful to produce comprehensive explanation of the difficulties that lack of harmonization is causing to the industry. It is suggested that regulators undertake the role of comprehensively explaining the drawbacks and the opportunities lost by Islamic finance as a consequence of lack of standardization. When sickness occurs, it is trivial to discover its existence. However, it is through proper diagnosis of the causes of sickness that future sicknesses can be avoided. Similarly, everyone in this industry knows about the difficulties caused by the lack of standardization. Everyone is asking for standardization. However, more advanced explanations are needed to show the essence of these difficulties. This information will help Shari'a scholars to expedite the standardization process.

Business leaders should also collaborate to facilitate the scholars' task through providing Shari'a scholars with all information and to provide needed expertise in order to proceed with the task. The effort must be mutual.

There have indeed been very positive steps towards harmonization of Shari'a standards. The AAOIFI has put great efforts into formulating Shari'a standards and started a training program to educate the market about these standards. There have been other milestone initiatives by the IFSB and IIFM. Although these initiatives incorporate great quality, there has not yet been the required influence by these initiatives similar to the influence of the Basel Committee on prudential regulatory issues for conventional institutions.

That reconciliation must come from an authoritative Shari'a congregation. Despite the difficulties expressed by Shari'a scholars, as we explained earlier, the discourse of Shari'a scholars has been encouraging the process of harmonization. I would like to refer here to a statement by a prominent scholar at the seventh AAOIFI conference of Shari'a Boards of Islamic Financial Institutions, translated from Arabic:

“It is imperative when a Shari'a ruling on a specific issue is being presented [at a Shari'a supervisory board meeting] that the differences in opinion [among schools of thought] be mentioned, and that these differences have to be presented with sincerity as they are. However, there must be no objection if the Shari'a board member subsequently gives precedence to an opinion which he thinks is the more correct or the one more submissive to the benefits (masalih) or to the current economic systems. This is indeed the better approach. And it is not troublesome

if Shari'a board members disagree between the two opinions given that the difference [between schools of thought] has been properly described as it is."

He then goes on to say:

".. Shari'a boards have to be represented by one supreme Shari'a board where each Shari'a board is represented by one of its members, and then this universal board bears the responsibility of supervising the activities and Fatwas of the rest of the Shari'a boards and to invite its members for uniform periodic meetings. The AAOIFI has to work on facilitating this task from a financial and logistic perspective."

In one of its publications, the AAOIFI¹ makes a similar suggestion, to introduce a supreme Shari'a board that serves all Shari'a boards of financial institutions. Among the roles of the suggested, the supreme Shari'a board is to facilitate harmonization of Fatwas of different Shari'a boards in order to lessen the scope for differences and to assist in proper application of the Fatwas.

A similar setup has been already applied in Indonesia. The Indonesian Council of Ulema has a National Shari'a Board responsible for issuing Fatwas which are considered binding on the remaining Shari'a boards. The Shari'a boards of individual banks have to refer to the National Shari'a Board for the final Fatwas. The national board includes the highest authorities in Shari'a. However, Shari'a board members of individual banks have to be highly qualified in order to understand the Fatwa, the source of the Fatwa and to produce contracts and agreements in compliance with the Fatwa.

The Indonesian model may not be applicable in other areas. But the suggestion to include a diversity of members, one from each individual Shari'a board, may significantly lessen the scope for differences and seems to be compatible with market consensus. This remains to be seen in practice. But the efforts have to be pursued.

We can conclude that, in spite of the difficulties, there is agreement, as we have demonstrated, between regulators, market professionals, Shari'a scholars and Shari'a congregations like AAOIFI that harmonization is desirable because it is for the benefit of the industry. The major problem is therefore not the intention, but the mechanism to achieve this harmonization. All market participants have a role to play for the progress of harmonization.

III. Should Regulators Supervise Shari'a Supervisory Boards?

We can now talk about the regulation of Shari'a Supervisory Boards. Shari'a Supervisory Boards are necessary whether Shari'a rules are standardized or not. We can thus inquire into the need to supervise them. In order to properly answer this question, we must examine the nature of Shari'a compliance and the interrelationships that govern the Shari'a compliance mechanism.

¹ Certified Shari'a Advisor and Auditor (CSAA) Textbook, AAOIFI, p.326

The dynamics of Shari'a compliance can involve a complex and delicate process of synchronizing business ideas and Shari'a compliance. Shari'a compliance allows very wide alternatives, but not all these alternatives are desirable business ideas. And when certain business ideas are seen desirable, these must be checked for Shari'a compliance. After ideas have been synchronized, then the documentation has to be formulated. The process of adopting and applying these ideas requires comprehensive rules and procedures and continuous auditing and monitoring of the system in order to ensure systematic and sequential application.

The complexity is compounded by the existence of multiple **interrelationships** between different departments. The **Shari'a Supervisory Board** of an Islamic institution is required to have strong relationships with **management, external auditor** and the **Audit and Review Committee**. Significant discretion will be exercised within these relationships due to the wide range of issues possibly raised about Shari'a.

The Internal Shari'a Control department is the most essential element of Shari'a compliance outside of the Shari'a supervisory board and is the mirror through which the Shari'a supervisory board images the financial institution or product. This department needs to have an authoritative relationship within the institution and must fulfill the conditions of knowledge and independence among many other conditions like integrity and availability of resources. It must also possess appropriate relationships with the Shari'a supervisory board, management and must have access to any information it requires in order to ensure proper Shari'a compliance.

The elements that have to be considered to ensure proper Shari'a compliance include:

- Shari'a Board membership and Qualifications
- Shari'a Board meetings
- Shari'a Board's relationships
- Information available to Shari'a Boards
- Shari'a Board annual report
- Internal Shari'a Control membership and Qualifications
- Rules and procedures of Shari'a control

- Reports of Shari'a control
- Information available to Shari'a control
- Violations and mistakes dealt with by Shari'a control
- Payment and treatment of Zakah
- Accounting regulations
- Social image and objectives
- Training and human resources

- Modes of financing
- Distribution of income
- Social environment within the institution
- Other considerations

As an Islamic rating agency, we have seen many Shari'a compliance failures; some of them can reach the level of embarrassment. For example, we have seen financial institutions with insufficient number of people on their Shari'a supervisory boards or internal control departments. We have also seen cases where internal Shari'a control departments discover obvious mistakes but their plea is unheard within the institution, with the Shari'a Supervisory Board unable to resolve the issues. Some mistakes are very common within the market. For example, not many Internal Shari'a Control departments have a reporting line to the Audit and Review Committee of an Islamic financial institution although this is an essential element of compliance and is purported by AAOIFI's governance standards.

The complex process of Shari'a compliance requires monitoring by an independent third party whose work will complement the role of the Shari'a board of the institution. We at the Islamic International Rating Agency have formulated a comprehensive system for rating Islamic financial institutions in terms of Shari'a compliance. In Shari'a Quality Rating, we consider all of the factors stated above as well as specific issues that may arise within each institution. Shari'a Quality Rating can also be applied to products like Sukuk. The opinion expressed in this rating achieves its value from the Shari'a scholars in our Shari'a Supervisory Board who set out the criteria of our rating and collaborate with us in issuing the final rating decision and rating report. This opinion is reviewed on a periodic basis for any changes in Shari'a compliance elements which will be reflected in an adjusted rating grade.

The role of Shari'a boards will be complemented with the insight provided by Shari'a Quality Rating into the mechanisms in place at an institution to comply with Shari'a. The insight provided by the rating complements by encouraging appropriate application of Shari'a principles, including the degree of cooperation with the entity's Shari'a board. The rating is delivered to the management of a rated entity with a detailed report exploring the mechanisms of Shari'a compliance at the institution. It is available to all Islamic institutions at a reasonable cost.

IV. Conclusion

We can conclude that both Shari'a scholars and market leaders and regulators agree on the fact that Shari'a standards must be standardized for the benefit of this industry. The process of harmonization of Shari'a standards requires close collaboration between Shari'a scholars and market leaders and regulators. This collaboration must include a clear separation of responsibilities and the attempt by each party to comprehensively convince the other party of its needs in order to maintain proper emphasis for the achievement of the widely agreed goals. The

regulators in particular should facilitate communication within the market as an intermediary in order to achieve those goals.

We believe that a priority should be to form a supreme Shari'a body that will act as a reference point to individual Shari'a boards and to the market as a whole.

The regulation of Shari'a Supervisory Boards from a governance perspective is encouraged but is not enough to ensure high levels of Shari'a compliance in the industry. Just concentrating on supervising Shari'a boards from a governance perspective lacks sufficient sophistication in relation to the intended goal because Shari'a compliance is a more complex process than the existence of governed Shari'a supervisory boards.

Because Shari'a compliance is a big and delicate responsibility, and is necessary to ensure continuation of the industry, we need to maintain Shari'a compliance by subjecting products and institutions to Shari'a rating. Such a comprehensive rating approach should act as an additional medium of control that complements regulator supervision of Islamic products and institutions. This approach will reduce transaction costs in the market and will help both the market and regulators.