CHAPTER 2

Corporate and *Sharī'ah* Governance of Islamic Banks[1]

CHAPTER SUMMARY

This chapter discusses corporate governance, its importance to the banking sector, and some of its challenges relating to the economic and financial crisis of 2007. The chapter looks back in history at the *hisba* system and juxtaposes the OECD and Islamic principles of corporate governance. *Sharīʻah* compliance is identified as one of the key outstanding needs of Islamic banks not addressed by corporate governance codes and principles issued by organizations like the OECD; thus, an adapted corporate governance understanding is presented along with guidance on the topic by the IFSB and AAOIFI. Key stakeholders in the corporate governance of Islamic banks are identified along with their concerns and responsibilities. The chapter also defines *sharīʻah* risk as well as *sharīʻah* governance and proposes a comprehensive model for *sharīʻah* governance of Islamic banks. After identifying the possible consequences of *sharīʻah* risk, the chapter examines the causes and events of this risk in detail. The chapter closes by discussing the *sharīʻah* compliance-related responsibilities of the Board of Directors (BOD) and management. In this vein, it groups *sharīʻah*-related responsibilities of the audit and governance committee under four main domains: *sharīʻah* reporting, internal *sharīʻah* control, internal *sharīʻah* audit function, and external *sharīʻah* audit.

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2.1 CORPORATE GOVERNANCE GAINS PROMINENCE

In the first chapter we discussed the objectives of *sharīʻah* with respect to property and financial transactions and ways of achieving these objectives. This chapter extends this discussion by exploring corporate and *sharīʻah* governance of Islamic banks. Corporate governance came into the spotlight in developed countries in the early 1990s after corporations in the United States (U.S.) and the United Kingdom (UK) underperformed and left shareholders dissatisfied.

[1] Portions of this chapter were published in an earlier article. See Karim Ginena, "Sharīʻah Risk and Corporate Governance of Islamic Banks" (2014) 14(1) *Corporate Governance* 86–103.

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The East Asian crisis of the late 1990s and several prominent corporate scandals such as Enron and WorldCom were an impetus for increased consideration and understanding of the subject.[2] More recently, the worldwide economic and financial crisis that began in mid-2007 and included failures of several heavyweight financial institutions such as Lehman Brothers and Bear Stearns made corporate governance a chief concern for academics, governments, and regulators globally. Other factors that also contributed to this increased interest on the topic include the growth of institutional investors and their role in developed economies, suboptimal economic and social development resulting from substandard monitoring and control of companies, and the increased attention paid to stakeholders other than shareholders.[3] The globalization and deregulation of markets in addition to the liberalization of institutional investors' activities and the impact of these developments also contributed to the heightened interest in corporate governance.[4]

There are various definitions for corporate governance. The Organization for Economic Cooperation and Development (OECD) defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."[5]

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Since the subject is interdisciplinary, definitions differ depending on the emphasis that researchers place on the disciplines of interest, perspectives they adopt regarding the objectives of corporate governance, and mechanisms they endorse for achieving the proposed governance.[6] More specifically, these definitions disagree on the constituencies to whose benefit the corporation operates, the types of conflicts of interest that may emerge between constituencies, and the mechanisms, whether formal or informal, that could minimize these conflicts if they arise.[7]

For example, regarding the objectives of corporate governance, should corporations solely focus on the interests of shareholders or widen their perspective by taking into consideration other stakeholders in society? From the above definition we see that the OECD adopts a stakeholder rather than a shareholder perspective. Regarding the nature of the governance problem, the issue from an economics and finance standpoint relates to the separation of ownership and control of companies and is rooted in the agency problem. This assumes that shareholders are small and that their ownership is dispersed. However, if ownership is significant and control is concentrated in the hands of controlling shareholders, then the prime concern shifts from a conflict between shareholder and manager interests to a conflict between minority outside and majority inside shareholder interests. While controlling shareholders attempt to minimize shareholder/manager conflicts, they may end up initiating new conflicts of interest with minority outside shareholders should they act in their own interests at the expense of the noncontrolling minority. An example of this is shareholders who solicit rights and privileges for themselves. Corresponding with the differing objectives and conflicts of interest are diverse

[2] Jayati Sarkar and Subrata Sarkar, *Corporate Governance in India* (New Delhi: Sage Publications, 2012), 1–2.
[3] Zamir Iqbal and Abbas Mirakhor, "Stakeholders Model of Governance in Islamic Economic System" (2004) 11(2) *Islamic Economic Studies* 1–2.
[4] Ibid
[5] OECD, *Principles of Corporate Governance* (Paris: OECD Publication Service, 2004), 11.
[6] Sarkar and Sarkar, *Corporate Governance in India*, 2.
[7] Ibid., 3–4.

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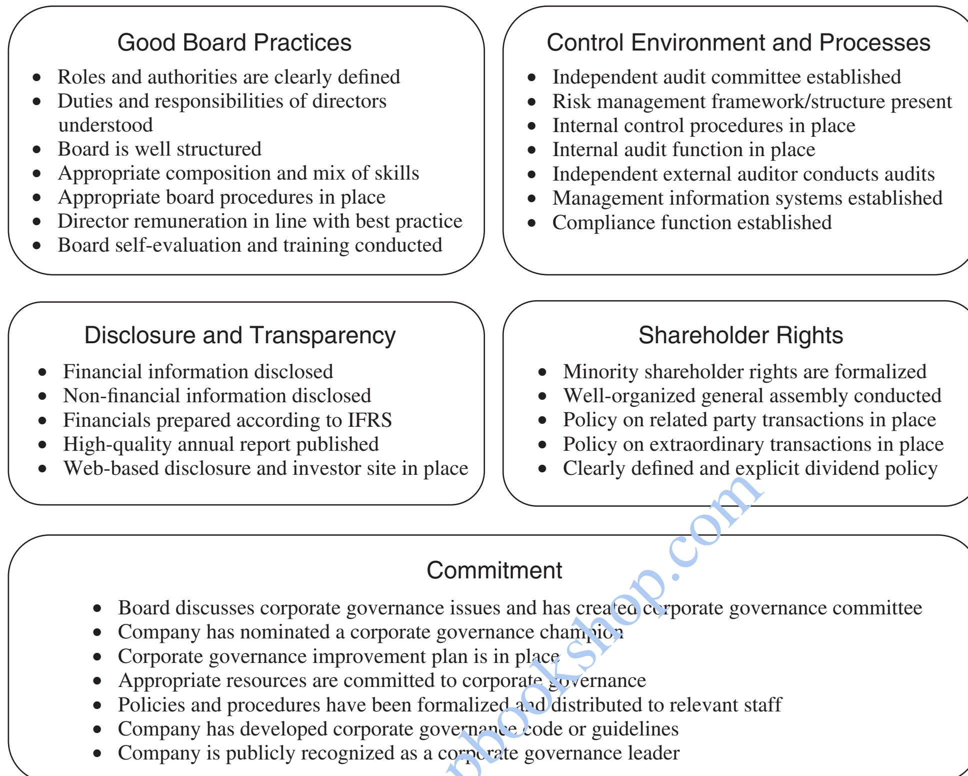

FIGURE 2.1 The five elements of good corporate governance
Source: IFC and Hawkamah, "A Corporate Governance Survey of Listed Companies and Banks Across the Middle East & North Africa," (Washington, D.C.: IFC, 2008), 11.

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internal and external mechanisms that would address these issues. These mechanisms are not "one size fits all" as their effectiveness can vary from one industry or firm to another. Furthermore, the effect of several bundled governance mechanisms can differ from country to country depending on the country's legal, regulatory, and political structure. Additionally, "ethnicity, customs, belief and value systems, religion, business ethics and the like"[8] have been argued to also have an impact on corporate governance structures.[9]

Companies committed to good corporate governance are generally reported to have an empowered BOD with good practices, a solid control environment and processes, high levels of disclosure and transparency, well-defined and protected shareholder rights, and commitment to corporate governance.[10] Figure 2.1 elaborates on the five elements of good corporate governance.

[8] Ibid., 38.
[9] Ibid., 1–43.
[10] IFC and Hawkamah, "A Corporate Governance Survey of Listed Companies and Banks Across the Middle East & North Africa," 11.

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Several international organizations have issued corporate governance principles and standards such as the OECD, the Bank for International Settlements (BIS), the World Bank Group (WBG), the International Organization of Securities Commissions (IOSCO), the European Commission, and the International Accounting Standards Board (IASB). Nevertheless, good corporate governance is a feat that is yet to be fully achieved in developed countries, let alone developing nations.

2.2 *HISBA* SYSTEM AND AN ISLAMIC PERSPECTIVE ON CORPORATE GOVERNANCE

The objective of the moral precepts of *sharī'ah* discussed in the first chapter is to heighten individual consciousness and regulate personal behavior. Such behavior in turn should serve as a solid foundation and starting point for protecting the interests of stakeholders. The root cause of bad governance according to Islamic literature is weak personal morals and internal restraint.[11] Complementing this inner dimension is an external facet advocated by *sharī'ah* and developed by *fuqha* in their writings, the *hisba* institution. Contemporary writers on corporate and *sharī'ah* governance can benefit from governance fundamentals outlined in classic *hisba* scholarship. Some of the leading figures who have written on the topic include Al-Mawardī (d. 450 AH/1058 CE), Ibn Al-Farrā' (d. 458 AH/1066 CE), Al-Ghazalī (d. 505 AH/1111 CE), Ibn Taimīyah (d. 728 AH/1327 CE), Al-Shayzarī (d. 589 AH/1193 CE), Al-Qurashī also known as Ibn Al-Ukhuwwah (d. 729 AH/1329 CE), Ibn Al-Mubarrad (d. 909 AH/1503 CE), and Al-Fāsī (d. 1096 AH/1685 CE). This section provides a brief introduction to *hisba* and its implications on corporate governance of Islamic banks.

Etymologically *hisba* means to seek reward.[12] A person who performs this role seeks the reward of the Divine for such work and is called *muhtasib*. Terminologically speaking, Al- Mawardī defines *hisba* as "commanding good if it [such good] is explicitly forsaken [in society] and prohibiting evil if it [such evil] is performed."[13] This definition is mainly derived from the following verse: "And let there be [arising] from you a nation inviting to [all that is] good, enjoining what is right and forbidding what is wrong, and those will be the successful" (3:104). The definition provides a broad scope of application for *hisba* that is not limited to state duties, but extends to all members of society responsible for commanding good and barring reprehensible acts as vicegerents of the Divine. Hence, a social consciousness develops that helps reform society for the better and serves as a strong deterrent to individuals thinking of violating the values and practices of their social environment. In this vein, Al-Mawardī sees *hisba* as a vital component of religious affairs as it is a means for safeguarding the religion from deviance, innovation, and immorality.[14] His definition does not limit *hisba* to particular domains such as markets, but leaves its scope wide open to encompass different activities. He nevertheless differentiates between *hisba* and judiciary and divides the duties of *al-muhtasib* into three categories based on the holder of the right: the Divine, human beings, and both.[15]

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[11] Zafar Iqbal and Mervyn Lewis, *An Islamic Perspective on Governance* (Massachusetts: Edward Elgar Publishing, 2009), 306–312.

[12] Muḥammad Ibn Manẓūr, *Lisān Al-'Arab*, 3rd edn (Beirut: Dar Iḥyā Al-turāth Al-'Arabi, 1999), Vol. 3, 164.

[13] Ali Al-Mawardī, *Al-ahkām al-sultāniyya wal-wilāyāt al-dīniyya*, ed. Ahmad Al-Baghdadi (Kuwait: Dar Ibn Qutaibah, 1989), 315.

[14] Ibid., 339.

[15] Ibid., 316–319.

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Islamic jurists argue that the ruler is responsible for establishing the *hisba* institution and appointing a qualified person to lead it. Despite providing a general definition for *hisba*, Al-Mawardī distinguishes between the public official charged with fulfilling this duty and individuals who volunteer for it.[16] According to the majority of scholars, calling to good and forbidding evil is a communal obligation (*fard kifayah*).[17] A more confined definition of *hisba* is "administrative supervision performed by the state to establish an Islamic society that is capable of bringing people back to that which benefits them and distancing them from that which harms them in line with the rulings of *sharī'ah*."[18] This definition posits that *hisba* is a formal function managed by the state. It therefore requires dedicated employees who are qualified to carry out their responsibilities.

The objectives of *hisba* are numerous. In general, it seeks to protect people's religion, honor, property, rights, safety, and public funds, utilities and interests. It does so by ensuring that the rules of *sharī'ah* govern religious, financial, economic, and social activities. In doing so, it aims to establish a stable socioeconomic environment in which members of the community cooperate on doing noble acts and in being God's vicegerents on earth. With respect to the qualifications of *al-muhtasib*, Al-Mawardī says, "[the individual] has to be free, upright, with a say in matters of faith, combined with rigour and firmness, and knowledge of evident breaches of the moral code."[19]

Within the financial and economic sphere the *hisba* institution is mainly concerned with preventing corruption and supervising markets to ensure that transactions are equitable. Maintaining fairness, transparency, and accountability are, thus, important objectives of this institution. In fact *muhasabah* etymologically means to hold to account.[20] Broadly speaking, the duties of *al-muhtasib* include ensuring that scales and measures are equitable, currency is authentic, similar goods or services are grouped in the same vicinity within the market, unlawful goods and services are not sold, prohibited contracts are not executed, necessary goods and services are supplied, and competition is fair and not monopolistic.[21] Additional functions include ensuring that wages are fair, markets are clean and pathways clear, craftsmen and manufacturers abide by the rules and provide superior quality goods and services that are safe for consumers, commercial disputes are resolved, offenders are disciplined, government officers are diligent, public funds are allocated appropriately and prudently spent, and professionals are qualified to practice their vocations.[22] Al-Mawardī says:

> *Market supervisors have to deal with three kinds of workers in the market place: there are those whose work must be judged in terms of care or negligence, those whose work must be judged according to their honesty or dishonesty, and those whose work is judged by its good or poor quality.*

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[16] Ibid., 315.

[17] There are four different juristic opinions regarding this. See Ministry of Awqaf and Islamic Affairs, *Al-Mawsū'ah Al-fiqhīyah Al-Kuwaytīyah*, 2nd edn (Kuwait, Thāt Al-Salāsil, 1986), Vol. 6, 248–249.

[18] Abdul Aziz Ibn Morshed, *Niẓām Al-Ḥisbah fi Al-Islām* (Master's diss., Imam Muhammad Ibn Saud Islamic University, 1973), 16.

[19] Ali Al-Mawardī, *Al-ahkām al-sultāniyya wal-wilāyāt al-dīniyya*, trans. Wafaa Wahba (UK: Garnet Publishing, 1996), 261.

[20] Ibn Manẓūr, Lisān Al-'Arab , Vol. 3, 164.

[21] Muhammad Bishayrah, *Al-Dawr Al-Iqtiṣādī liniẓām Al-Ḥisbah fī Al-Islām Muqārinan bi'ajhizati Al-Riqābah Al-Mu'āṣirah fi Al-'Urdun* (Master's diss., Yarmouk University, 2002), 33–35.

[22] Ibid.

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> *Those judged by care or negligence are such workers as the physician or the teacher […] only those who are knowledgeable and whose method is good should be approved, while those who fall short and perform poorly should be kept from engaging in that which would corrupt souls or be detrimental to morals.*
>
> *Those evaluated on the basis of honesty and deception are the like of jewelers, tailors, bleachers, dyers, for there is a chance that they may get away with people's money. He should look for those who are honest and trustworthy among them and approve them, excluding any whose breach of faith has come to light and exposing them so that people who do not know them may not be deluded by them […]*
>
> *Those who must be evaluated on the basis of superior and inferior quality … They [market supervisors] are entitled on the whole to take them to task for poor and shoddy workmanship even in [sic] no one complains of it. If a contending party complains to him of a commissioned piece of work the worker has been used to perform that it has been shoddily and cheated in, he should respond to that with censure and reprimand […] If a loss is incurred it should be taken into account […] if no estimate or assessment is required, or any litigation involved, but only an approximate value that calls for no particular effort of scholarship, the market supervisor may impose the fine and relevant corrective punishment, for it is his responsibility to secure fair dealing and admonish against infringement.*[23]

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Prophet Muhammad (pbuh), the caliphs, and the companions carried out *hisba* functions by themselves and through the delegation of authority to individuals within the community. In one instance it is reported that the prophet dug his hand in a pile of grain that was sold in the market and found it damp from inside. He then inquired, "Owner of this grain! What is this?" He said: "The rain caught it, Messenger of Allah." He said, "Why did you not put it on top of the heap so that the people could see it! Anyone who cheats us is not one of us."[24] In another incident the prophet sent an individual by the name of Ibn Al-lutbīyyah to collect *zakāh*. When he returned from his task he said: "This is for you and that has been given to me as a gift." The prophet then stood up on the pulpit and remarked, "What is wrong with the employee whom we send [to collect *zakāh*] and when he returns he says, 'This is for you and that is for me?' Why doesn't he stay at his father's and mother's house to see whether he will be given gifts or not? By Him in Whose Hand my life is, whoever takes anything illegally will bring it on the Day of Resurrection by carrying it over his neck: if it is a camel, it will be grunting: if it is a cow, it will be mooing: and if it is a sheep it will be bleating!"[25] This incident sets an example for holding state employees accountable for their duties and prohibiting them from accepting bribes disguised as gifts, as they could lead to them relaxing the rules, providing illegitimate favors, and committing injustice by wronging people.

Given the wide-ranging duties of the prophet and his limited time, he appointed 'Umar ibn Al- Khaṭṭāb and Sa'id ibn Al-'As to oversee the markets of Medina and Makkah respectively. He also assigned a woman called Samrā' bint Nuhayk Al-Asadīyyah to supervise the

[23] Al-Mawardī, *Al-ahkām al-sultāniyya wal-wilāyāt al-dīniyya*, trans. Wafaa Wahba, 277.
[24] Muslim Ibn Al-Ḥajjāj, *Ṣaḥīḥ Muslim*, ed. Muhammad Fuad AbdulBaqi (Beirut: Dār Iḥyā Al-Turāth Al-'Arabi), Vol. 1, 99.
[25] Ibid., Vol. 3, 1463.

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markets of Medina. In doing this the prophet ensured that appropriate time and effort would be dedicated to this important task. The prophet however tested his companions before assigning them to fulfill particular tasks or roles; moreover, he would hold them accountable for their actions, as can be seen from the Ibn Al-lutbīyyah incident.

While the title of *al-muhtasib* first emerged at the end of the Umayyad era and the beginning of the Abbasid era, this role can be traced to the time of the prophet as we have previously seen.[26] *'Āmil al-sūq* or *ṣāḥib al-sūq* was the title given to the individual who regulated the marketplace.[27] A person who regulated other activities such as in the religious or social realms was also referred to as *āmil*, which means worker. It was not sufficient for this individual to be familiar with *sharī'ah*, he also needed to have a concrete understanding of lawful and unlawful practices in the market to keep guileful merchants in check.

After the death of the prophet and the accession of Abu Bakr, the caliph continued performing the *hisba* functions. Abu Bakr's reign was short and much of it was consumed in protecting the rights of the poor and needy against those who withheld their *zakāh*. After Abu Bakr, 'Umar ibn Al- Khaṭṭāb acceded to power and he was also resolute in protecting the religion and public interest. 'Umar appointed several men such as Al-Sā'ib ibn Yazīd and 'Abdullah ibn 'Utbah, and a woman named Al-Shifā' bint 'Abdullāh, to supervise the markets.[28] The third and fourth caliphs 'Uthmān ibn 'Affān and 'Alī ibn Abī Ṭālib also practiced the duties of *al-muhtasib* like the prophet and the two preceding caliphs. Uthmān assigned Al-Ḥārith ibn Al-Ḥakam to supervise the market and Ali wandered the markets reminding people of the hereafter by reciting, "That home of the Hereafter We assign to those who do not desire exaltedness upon the earth or corruption. And the [best] outcome is for the righteous" (28:83).[29]

During the Umayyad period the state increased in size and economic activity consequently flourished. *'Āmil al-sūq* had assistants who would verify that the weights and measures of traders were accurate and resolve quarrels. The eighth Ummayad caliph 'Umar ibn 'Abdul'azīz unified the weights and measures in the different territories. Permanent state markets that developed during the Ummayad era, especially in the reign of Hishām ibn 'Abdulmalik, the tenth Ummayad caliph, and the resulting economic activity led to the increased need for regulation. During the Abbasid era the functions of *hisba* became institutionalized and government regulations became much more sophisticated.[30] In Muslim Spain, it is reported that judges would sometimes take on the position of *al-muhtasib* and that prices were listed on goods to ensure that prices did not differ for different classes of society.[31] *Hisba* also played a crucial role in the Ottoman Empire, but as the empire weakened, some of its functions were taken over by other branches of government.[32]

We can observe from the aforementioned experiences that over time *hisba* progressed from the duty of one or two individuals to a formal institutional function. The changing circumstances called for such a progression. In the present day many of the regulatory financial

[26] Bishayrah, *Al-Dawr Al-Iqtiṣādī liniẓām Al-Ḥisbah fī Al-Islām Muqārinan bi'ajhizati Al-Riqābah Al-Mu'āṣirah fi Al-'Urdun,* 24.
[27] Ibid., 17.
[28] Ibid., 21.
[29] Ibid., 22–23.
[30] Ibid., 24–26.
[31] Ibn Morshed, *Niẓām Al-Ḥisbah fī Al-Islām*, 42–43.
[32] Ibid., 48.

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and economic functions mentioned as part of the wide-ranging activities of *al-muhtasib* are executed by ministries, central banks, and regulatory as well as supervisory bodies. Amongst other duties, these entities ensure that checks and balances are in place to protect public and private funds and rights.

The abovementioned historical account is evidence in support of the establishment of strong corporate and *sharī'ah* governance for Islamic banks. *Sharī'ah* has played a crucial role in Muslim economies and finances for many centuries. S*harī'ah*-compliant nominate contracts were also adopted by those wishing to trade in these communities. Delorenzo reports:

> *[C]ontracts described in the classical fiqh formed the basis for sophisticated trade practices throughout the Indian Ocean region for centuries, including for example an advance finance contract system that was adapted by the Europeans as a "putting out model" when they arrived to trade in the region.*[33]

However, the situation changed with the advent of interest-based banking and the establishment in the second half of the nineteenth century of branches of these banks in predominantly Muslim states. Over time financial transactions that were once conducted under the principles of *sharī'ah* became no longer *sharī'ah*-compliant. Nevertheless, with the rise of Islamic banking in the twentieth century, the role of *sharī'ah* governance in ensuring that transactions are *sharī'ah*-compliant has regained its importance.

Contemporary studies on corporate governance that have critically advanced the discipline in the last two decades have played an important role in increasing our knowledge of the topic. Such studies are appreciated, even if conducted in a context missing the *sharī'ah* element, because they contribute to our understanding of dimensions and mechanisms of governance that ultimately contribute to achieving some of the *maqāṣid* of property discussed in the first chapter. After all, both the conventional and Islamic perspectives on corporate governance commonly aim to maintain fairness, transparency, and accountability.[34] Nevertheless, a more complete understanding of the Islamic approach to corporate governance is formed by taking into consideration the *sharī'ah* dimension, which links the different *maqāṣid* of property together. The Islamic perspective is closer to the stakeholder rather than the shareholder approach due to its holistic outlook that extends beyond mere shareholder profits. The characteristics of the Islamic economic system and objectives discussed in the first chapter illustrate the breadth of this perspective. Indeed, as *sharī'ah* holds each individual accountable for their actions and considers humans vicegerents of the Divine, the Islamic approach has attempted to protect against a perfunctory box-checking form of corporate governance by instituting a strong moral backdrop for this activity. The moral foundation is aimed at guarding against

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[33] Yusuf DeLorenzo, "Shari'ah Compliance Risk" (2007) 7(2) *Chicago Journal of International Law* 406.

[34] IFSB, *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services*, http://www.ifsb.org/standard/ifsb3.pdf (accessed December 28, 2013), 16. As a correction, many authors quote the ninth president of the World Bank, James Wolfensohn, as saying, "[c]orporate governance is about promoting corporate fairness, transparency and accountability." They attribute this to an article published in the *Financial Times* on June 21, 1999. The previously mentioned quote is nowhere to be found in that article, which is entitled "Speak up for dialogue: The World Bank and the OECD recognise that the issue of corporate governance in developing countries needs more consensus-building, writes John Plender." Instead, Plender writes on page 22, "Mr Wolfensohn sees fairness, transparency and accountability as essential in a healthy democracy."

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turning corporate governance into a routine that is devoid of its intended value. Additionally, Islamic legal maxims that jurists use in the process of applying texts to new situations provide some guidance and structure that can help decision-makers in their efforts to protect the interests of multiple stakeholders. Some examples of these maxims that would broadly affect company policies and strategies include the following:

- Harm is to be removed;
- Harm may neither be inflicted nor reciprocated;
- Individual harm is to be tolerated to prevent public harm;
- The more severe of two harms is to be removed by the lesser of the two;
- Repelling harm takes precedence over acquiring benefit;
- The original ruling in transactions is that of permissibility;
- Hardship begets ease;
- Necessity makes the unlawful lawful;
- Necessity is to be estimated by its true proportion.[35]

Further support for resolving conflicts of interest that may arise when trying to satisfy the needs of numerous parties is provided by the multi-layer structure of macro *maqāṣid* – necessities, needs, embellishments – that can help decision-makers in prioritizing interests.[36]

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2.3 OECD AND ISLAMIC PRINCIPLES OF CORPORATE GOVERNANCE

In Figure 2.2 Abu-Tapanjeh juxtaposes the OECD and Islamic principles of corporate governance and concludes that the OECD principles can be found at the core of Islamic teachings. He also asserts that the Islamic principles on the issue result in a broader measure of accountability than the OECD principles since persons are not only accountable to stakeholders but also to the Divine.[37] Nevertheless, the author argues that several factors have led to Islamic teachings on the topic not being as actively practiced as desired:

> *[T]he recommended set of principles of OECD had long been existing [sic] since the early stage of Islamic civilization. But, with the globalization tendency and in filtering [sic] with the cultural, religious and social, business and political factors, lead to misplace the true ethos of Islamic civilization. Hence, in this present situation, the OECD principles have been successfully implemented and considered a very effective tool of corporate governance as compared to Islamic principles of corporate governance.*[38]

[35] See Yusuf Al-Qaradawi, *Al-Qawā'id Al-Ḥākimah li fiqh Al-Mu'āmalāt* (Cairo: Dār Al-Shurūq, 2010).
[36] Asyraf Dusuki, "Corporate Governance and Stakeholder Management: An Islamic Perspective" (2011) 15(2) *Review of Islamic Economics* 19–20.
[37] Abdussalam Abu-Tapanjeh, "Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles" (2009) 20 *Critical Perspective on Accounting* 564.
[38] Ibid., 566.

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Principle number	OECD principles and annotation	Islamic principles
1	*Insuring the basis for an effective corporate governance framework*	
	▪ Promotion of transparent and effective markets with rule of law and division of responsibilities	▪ Promotion of business within ethical framework of *Shariah* ▪ Believes in profit and loss [sharing] ▪ Primacy of justice and social welfare with social and spiritual obligations ▪ Prohibition of interest
2	*The rights of shareholders and key ownership functions*	
	▪ Basic shareholder rights ▪ Participation in decision-making at the general meetings ▪ Structures and arrangements markets [*sic*] for corporate control ▪ Ownership rights by all shareholders including institutional shareholders ▪ Consultative process between shareholders and institutional shareholders	▪ Property as trust from God ▪ Sole authority is [to] God ▪ Society as stakeholders ▪ Accountability not only to stakeholders but also to God, the ultimate owner
3	*The equitable treatment of shareholders*	
	▪ Protection to [*sic*] minority and foreign shareholders	▪ Just[ice] and fairness of value ▪ Equitable distribution of wealth to all stakeholders and disadvantages [*sic*] members in the form of *zakat* and *sadaqa* ▪ Social and individual welfare with both spiritual and moral obligation[s] ▪ Sensation [*sic*] of equality
4	*The role of stakeholders in corporate governance*	
	▪ In creating wealth, jobs and sustainability of financially sound enterprises [*sic*]	▪ Islamic accountability to *falah* and social welfare orientation ▪ *Ḥaram/Halal* dichotomy in transaction[s] ▪ Social and individual welfare from both spiritual and material [perspective] ▪ Consideration to whole community
5	*Disclosure and transparency*	
	▪ Matters regarding corporation ▪ Financial situation ▪ Performance, ownership and governance	▪ Accountability with *Shariah* compliance ▪ Socio-economic objectives related to firms' control and accountability to all its stakeholders ▪ Justice, equality, truthfulness, transparency ▪ Wider accountability with written as well as oral disclosure

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6	*The responsibilities of the board*	
	▪ Strategic guidance ▪ Monitoring of management ▪ Accountability to company and stakeholders	▪ Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success ▪ Holistic an[d] integrative guidance ▪ Negotiation and co-operation ▪ Consultation and consensus seeking for each decision with related stakeholders

FIGURE 2.2 Comparison between OECD and Islamic principles
Source: Abdussalam Abu-Tapanjeh, "Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles," *Critical Perspective on Accounting* 20, (2009): 564–565.

2.4 IMPORTANCE OF CORPORATE GOVERNANCE TO BANKING SECTOR

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While corporate governance is vital for organizations that span the whole spectrum of industries, it is especially imperative for financial institutions because they are characterized by larger information asymmetries than are found in non-financial companies and play a crucial role in the sustainability of economy.[39] According to the BCBS:

> *[f]rom a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they:*
>
> - *Set corporate objectives;*
> - *Operate the bank's business on a day-to-day basis;*
> - *Meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders;*
> - *Align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and*
> - *Protect the interests of depositors.*[40]

Banks differ from non-financial institutions in that they accept deposits. Thus, they act as fiduciary trustees with public funds and must act in the best interests of their stakeholders when dealing with their property.[41] Mismanagement of funds puts the wealth of people at stake. Also, banks provide financing and other services such as access to payment systems. According to

[39] Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," *Policy Research Working Paper Series,* No. 3404 (Washington: The World Bank, 2004), 3.
[40] BCBS, *Enhancing Corporate Governance for Banking Organizations* (Basel: Bank for International Settlements, 2006), 4.
[41] Wafik Grais and Matteo Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options" (2006) *World Bank Policy Research Paper*, No. 4052, 5.

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their assessment, certain individuals and/or entities will be entitled to financing while others will not. Such decisions have a direct impact on the growth of an economy and the expansion of particular sectors. At times of distress banks are still expected to fulfill credit and liquidity needs of the market.[42] As financial intermediaries they are obliged to manage their risks in a prudent manner because failure to do so can lead to bankruptcy and that can have a domino effect on the industry. The loss of depositors' funds and shareholders' value as a result of poor governance and several institutions' failure will eventually lead to the contraction of credit, loss of public confidence in the system, a possible bank run by the general public, and the onset of an economic crisis such as the one we recently witnessed. At such time governments will often attempt to put an end to the catastrophe by pumping public funds into the sector to save the entire financial system from collapsing.[43] Besides crippling economies, banking crises will intensify poverty and destabilize governments.[44] This explains the need for unique governance criteria to account for the distinctive nature of banks and justifies the heavy regulation of the industry by governments worldwide in order to limit the possibility of their failure, and the devastating consequences that can result from that.[45]

On the contrary, good governance of banks tends to result in efficient capital allocation by managers. It also allows managers to prudently observe the firms that they finance. This efficient mobilization and allocation of funds leads to lowering the cost of capital, boosting capital formation, and stimulates productivity growth.[46] Good governance also allows for the maintenance of a system of supervision that is both efficient and cost-effective. It helps in protecting depositors' funds, grants supervisors additional confidence to further rely on the internal processes of the bank, and can be useful at times of distress when supervisors need to resort to the BOD for additional involvement in finding apt solutions and overseeing their implementation.[47] Overall, good governance of banks not only enhances their performance and access to external finance, but also benefits the community by contributing to the well-being of people.[48]

The Basel Committee on Banking Supervision (BCBS) identifies four essential forms of oversight for banks:

> *There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances: (1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs.*[49]

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[42] IFC and Hawkamah, "A Corporate Governance Survey of Listed Companies and Banks Across the Middle East & North Africa," 62.

[43] European Commission, "Corporate Governance in Financial Institutions and Remuneration Policies," *Green Paper* (Brussels: European Commission, 2010), 4.

[44] Ross Levine, "The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence," 2.

[45] Ibid., 3.

[46] BCBS, *Enhancing Corporate Governance for Banking Organizations*, 2.

[47] Ibid., 4; BCBS, *Principles for Enhancing Corporate Governance* (Basel: Bank for International Settlements, 2010), 6.

[48] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," 10.

[49] BCBS, *Enhancing Corporate Governance for Banking Organizations*, 5.

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2.5 THE FINANCIAL CRISIS AND CORPORATE GOVERNANCE CHALLENGES

Whether adequate corporate governance principles and standards existed for financial institutions at the time of the recent financial crisis is a matter of debate. The OECD Steering Group on Corporate Governance maintains that the standards were sufficient; however, a gap arose between theory and implementation.[50] The Steering Group, in its report on the crisis, did not see an urgent need to revise the OECD corporate governance principles but identified weaknesses in practicing the principles as a factor that led to development of the crisis. It reports: "corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of the financial crisis and [...] such weaknesses extended to companies more generally."[51] The European Commission (EC) contends that the corporate governance principles addressing the financial sector, particularly banks, were sufficient but they suffered from a "lack of genuine effectiveness."[52] More specifically, the principles were too broad and thus open to interpretation, difficult to enact, did not clearly assign roles and responsibilities with respect to their implementation at the institutional and supervisory levels, were non-binding, and did not have legal implications.[53] In another report the EC asserts that tenuous corporate governance practices of financial institutions were not the main cause of the crisis, but points out that "timely and effective checks and balances in governance systems might have helped mitigate the worst aspects of the crisis."[54] It adds:

> *[B]oards and senior management of financial firms failed to understand the characteristics of the new, highly complex financial products they were dealing with and were often unaware of the aggregate exposure of their companies, and consequently largely underestimated the risk they were running. The "herd instinct" prevailed too often driving many firms into a race to inflate profit without paying proper attention to risk. In many cases, board oversight or control of management was insufficient and non-executive directors "absent" or unable to challenge executive directors. The risk management function was weak and lacking in independence. Inadequate remuneration structures for both directors and traders led to excessive risk-taking and short-termism. Shareholders too had become "accustomed to returns on equity which hugely outpaced for many years real economic growth rates" and institutional investors in particular showed too little engagement with boards of financial institutions.*[55]

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[50] OECD, *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles* (Paris: OECD Publication Service, 2010), 3.
[51] Ibid.
[52] European Commission, "Corporate Governance in Financial Institutions and Remuneration Policies," 5.
[53] Ibid., 6.
[54] European Commission, "Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices," *Commission Staff Working Document* (Brussels: European Commission, 2010), 3.
[55] Ibid.

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The EC also attributed the financial meltdown to macro- and micro-economic factors:

> *Excessive liquidity, credit and leverage in the market; the difficulty for central banks to control inflationary asset prices; the speed of diffusion of complex financial innovation (good or bad) in global financial markets; inadequate risk control and risk pricing by a series of economic agents (banks, brokers, investors) notably in relation to debt securitisation, all these factors combined with an expectation of double digit returns on the part of investors, weaknesses in supervision and ineffective governance.*[56]

On the other side of the Atlantic Ocean, the National Commission on the Causes of the Financial and Economic Crisis in the U.S. named the following as having either caused or contributed majorly to the crisis: "excessive borrowing, low mortgage standards, high leverage, securitization, a reliance on short-term funding, off-balance-sheet entities, special-purpose vehicles, over-the-counter derivatives, a lack of transparency, credit default swaps (CDS), and collateralized debt obligations (CDO)."[57] Unfortunately, the consequences of these factors and practices were not diligently communicated to stakeholders until it was too late, and this is a problem because "[i]nformation and disclosure play an important role in mitigating both fundamental market failures and their manifestations as governance failures."[58] The Commission was also quite critical of corporate governance practices and regulatory oversight:

> *While we have not been charged with making policy recommendations, the very purpose of our report has been to take stock of what happened so we can plot a new course. In our inquiry, we found dramatic breakdowns of corporate governance, profound lapses of regulatory oversight, and near fatal flaws in our financial system.*[59]

The high stakes of the lack of good governance combined with the benefits of its presence should motivate officials to regularly consider reform measures that will further improve the corporate governance of banks and be wary of falling into the trap of considering some banks too big to fail.

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2.6 DEVELOPING COUNTRIES AND CORPORATE GOVERNANCE ISSUES

Developing countries face numerous challenges that stymie the growth of prudent corporate governance. These include underdeveloped institutions for disciplining markets and guaranteeing efficiency and integrity, grave information asymmetries resulting from inadequate reporting, inefficient capital markets, relatively inexperienced market stakeholders, and weak enforcement of regulations due to political corruption and a tenuous judiciary.[60] Overcoming these obstacles is a must if these governments want to promote economic growth. Moreover, since most Islamic banks are located in developing countries, raising the level of corporate governance in these countries is vital to healthy development of these banks and the industry.

[56] Ibid.
[57] Hamid Mehran and Lindsay Mollineaux, "Corporate Governance of Financial Institutions," *Federal Reserve Bank of New York Staff Reports,* No. 539 (New York: Federal Reserve Bank of New York, 2012), 2.
[58] Ibid., 32.
[59] US Government, "The Financial Crisis Inquiry Report," http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (accessed December 28, 2013), xxvii–xxviii.
[60] Muhammad Chapra and Habib Ahmed, *Corporate Governance in Islamic Financial Institutions* (Jeddah: Islamic Development Bank, 2002), 8–9.

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2.7 CORPORATE GOVERNANCE CONCERNS FOR ISLAMIC BANKS

Islamic banks are no less disposed than conventional banks to losses or even failures that can result from corporate governance breaches; thus, they need to ensure that they practice prudent corporate governance. The downfall of Islamic Money Management Companies in Egypt in 1988–1989, the demise of the Ihlas Finance House in Turkey in 2001, and frauds which led to losses at Dubai Islamic Bank between 2004 and 2007 are instances from which the industry can learn some lessons.[61] Since corporate governance is important for enhancing efficiency, mitigating risks, increasing stability, and promoting economic development, and Islamic banks are gaining prominence as they increase in number and presence and grow in assets, further study of corporate governance practices within Islamic banks is warranted.[62] Such study should be careful to address vulnerabilities that arise due to the unique characteristics of Islamic banks. In this regard, the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have raised concerns on the issue. Areas requiring special attention including compliance with *sharī'ah,* the responsibility of being a vicegerent, Investment Account Holders' (IAH) interests (particularly unrestricted accounts), the commingling of shareholders' and unrestricted IAH's funds, the calculation of *mudarib's* profit share, and the overall profit distribution process.[63]

2.8 IFSB AND AAOIFI ISSUE GUIDANCE

To complement the standards issued by the OECD and the BCBS, and to meet the outstanding needs of Islamic financial industry, the IFSB issued in December 2006 *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (IIFS)*. The standard presents four guiding principles along with their rationale and objectives. The four guiding principles are: general governance approach of Islamic financial services, rights of IAH, compliance with Islamic *sharī'ah* rules and principles, and transparency of financial reporting in respect of investment accounts. These principles are meant to assist IIFS in identifying where governance structures and processes are required, recommend best practices, and raise the level of knowledge of stakeholders on governance.[64] Through the standard the IFSB empowers stakeholders, advocates good governance, and sets a benchmark that can be used by IIFS and regulators for monitoring purposes. Not too long before the IFSB issued its standard, AAOIFI, in late 2005, adopted Governance Standard No. 6 *Statement on Governance Principles for Islamic Financial Institutions (IFI).* The standard aims to set key concepts and principles relating to IFI governance, allow stakeholders to recognize the roles of those responsible for governance, lay a foundation for compliance or governance standards that may develop in the future, and link current and future standards. The standard enumerates six

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[61] Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options," 7–9.
[62] Ibid., 4.
[63] Madzlan Hussain, "Corporate Governance Issues in Islamic Finance" (presentation at the IFSB Seminar, Doha, Qatar, December 4, 2008). For further reading see IFSB, *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services*; Grais and Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options."
[64] IFSB, *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services*, 1.

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reasons, referred to as the basis for governance: enhancing confidence, *shari‘ah* compliance, business model, stakeholders' interests, social responsibility, business ethics and culture. The standard also details twelve different principles:

- Principle 1: Effective *shari‘ah* compliance structures;
- Principle 2: Fair treatment of equity-holders;
- Principle 3: Equitable treatment of fund providers and other significant stakeholders;
- Principle 4: Fit and proper conditions for board and management;
- Principle 5: Effective oversight;
- Principle 6: Audit and governance committee;
- Principle 7: Risk management;
- Principle 8: Avoidance of conflicts of interest;
- Principle 9: Appropriate compensation policy oversight;
- Principle 10: Public disclosures;
- Principle 11: Code of conduct and ethics;
- Principle 12: Appropriate enforcement of governance principles and standards.[65]

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2.9 ADAPTED CORPORATE GOVERNANCE UNDERSTANDING

To meet the outstanding needs of the Islamic finance industry that were not met by definitions issued earlier by the OECD and other organizations, the IFSB has provided the following definition for corporate governance:

> *A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which:*
>
> **(i)** *the objectives of the company are set; and*
> **(ii)** *the means of attaining those objectives and monitoring performance are determined.*
>
> *In the context of IIFS, good corporate governance should encompass:*
>
> **(i)** *a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders;*
> **(ii)** *provision of proper incentives for the organs of governance such as the Board of Directors, SSB [Sharī‘ah Supervisory Board] and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and*
> **(iii)** *compliance with Islamic Sharī‘ah rules and principles.*[66]

[65] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* (Manama, Bahrain: AAOIFI, 2010), Governance Standard for Islamic Financial Institutions No. 6, 51.

[66] IFSB, *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services*, 27.

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2.10 STAKEHOLDERS OF ISLAMIC BANKS AND THEIR GOVERNANCE RESPONSIBILITIES

The IFSB standard identifies the following stakeholders or "those with vested interest" in the IIFS: employees, customers (IAHs and other depositors), suppliers, supervisors, governments, and the community.[67] AAOIFI also lists the following key stakeholders: equity holders, *sharī'ah* supervisory board, internal *sharī'ah* reviewers, IAHs, regulatory bodies, and institutions that have an interest in the safety and soundness of the financial sector.[68] Table 2.1 connects the stakeholders of Islamic banks with their corporate governance concerns and their responsibilities.[69]

Key Stakeholders in Corporate Governance of Islamic Banks

Stakeholder	Important Corporate Governance Concerns	Corporate Governance Responsibilities
Economic, Financial, and Judicial System	Protection and promotion of shareholders' rights; elimination of bribery and corruption; efficiency of legal system, independence of judiciary; enforceability of contracts and the rule of law.	Promote strong economic, business, and legal environments that are efficient, effective, and support sound corporate governance.
Government, Parliament, Supervisors/ Regulators/Central Banks	Stability and soundness of the financial system (elimination of systemic risk); regulation of banks (licensing and operations); presence of internal controls and risk management procedures; protection against financial crime; safeguarding stakeholders' interests.	Pass banking laws and regulations that cater to the specificities of Islamic banks and that help align the interests of stakeholders; require mandatory corporate governance compliance and assess the soundness of corporate practices; set rules and standards; establish minimum transparency requirements and ensure that sufficient public disclosure is provided; practice surveillance and enforcement functions e.g. monitor insider trading and prosecute offenders; monitor overall operations in general and risky behavior in particular; strengthen rights of minority shareholders; evaluate the internal *sharī'ah* control system; promote public understanding of financial system and stakeholder education; issue fit and proper criteria for *sharī'ah* supervisory board members and ensure they do not play an executive role.

[67] Ibid.
[68] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 6, 66–67.
[69] Chapra and Ahmed, *Corporate Governance in Islamic Financial Institutions*, 15–16.

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Stock Exchange	Stock exchange listing criteria; market discipline; and stakeholder confidence in exchange.	Issue clear criteria; monitor the market on continuous basis; prosecute offenders.
Standard-setting organizations ▪ IFI-specific (AAOIFI, IFSB, IIFM) ▪ Non-IFI specific (OECD, BCBS, IOSCO, GAAP, IFRS) and Banking and Industry Associations	Objective, timely, and transparent communication of information and prudent corporate governance.	Formulate uniform, clear, and transparent accounting and audit standards; issue principles and codes for corporate governance and widely disseminate them; educate stakeholders.
Shareholders	Shareholder rights; financial health of banks; compliance with laws, regulations, and *sharī'ah*; risk management; BOD and senior management's remuneration; fair and timely disclosure; stock price; profit share.	Elect BOD and SSB members; exercise other shareholder rights such as active participation in Annual General Meetings and apply pressure on directors and/or divest in case of dissatisfaction.
BOD and related committees	Profitability; good financial standing and stakeholder value; management's performance; protection of stakeholders' interests; competitive remuneration; competent *sharī'ah* supervisory board; apt internal audit and *sharī'ah* governance framework.	Select qualified senior managers; oversee management and hold them accountable; set strategies and policies; adopt robust governance structures that manage risks and enhance transparency; link incentives with stakeholder interests; maintain communication with stakeholders; cooperate with *sharī'ah* supervisory board members and monitor their performance; oversee internal audit; *sharī'ah* reporting; internal *sharī'ah* control; internal and external *sharī'ah* audit.
Sharī'ah Supervisory Board	*Sharī'ah* compliance of bank with respect to contracts, transactions, services, profit and loss allocation, and *zakāh* calculation.	Opine on the extent of *sharī'ah* compliance of the bank; issue *sharī'ah* reports to stakeholders; advise the BOD, management, and other parties on *sharī'ah*-related matters; issue *fatawa*; set *sharī'ah* rules and guidelines for processes, transactions, and services and oversee their implementation; review and approve policies, procedures, finance structures, legal documentation, etc.; oversee charitable account and the disbursement of its funds; publish their *fatawa* with supportive evidence.

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Internal Audit Function	Quality, quantity, and transparency of information; efficiency and effectiveness of systems.	Ensure that the policies set by BOD are followed by management; opine on the efficiency and effectiveness of systems.
Internal *Sharīʻah* Audit Function	*Sharīʻah* compatibility of bank; adherence to *sharīʻah* controls.	Examine *sharīʻah* controls, level of compliance with *sharīʻah* supervisory board policies, procedures, and *fatawa* through objective *sharīʻah* audits; report results; participate in enhancing *sharīʻah* compliance.
Senior Management	Efficient operations; profitability; incentive structure; interests of stakeholders.	Implement strategies and policies set by the BOD in a sound and responsible manner; create value; ensure efficient and effective governance structures; assess and manage risks; build and nurture internal *sharīʻah* control system and allocate sufficient financial and human resources to it; cultivate *sharīʻah* control culture; demonstrate commitment to *sharīʻah* compliance.
Legal and Compliance	Adhere to laws and regulations; opine on matters; maintain channels of with regulators/supervisors; deal with judiciary; draft legal documents that are *sharīʻah* compliant.	Keep abreast of laws and regulations; ensure their observance and offer advice in this regard; liaise with regulators and judiciary; update employees on legal and regulatory changes and develop mechanisms to stay in compliance with these changes; assist in investigations made by the bank; watch for insider trading and other corporate governance breaches; collaborate with *sharīʻah* supervisory board to ensure that legal documents are approved from a legal and *sharīʻah* perspective.
Employees	Performance; work ethic; skills; incentives.	Meet the goals set by management; minimize operational risk; communicate unethical practices, violations, or other weaknesses in corporate governance; demonstrate commitment to *sharīʻah* compliance.
Investment and Current Account Holders	Good service; market competitive returns; *sharīʻah* compliance; and risk management.	Act responsibly; evaluate bank performance; express opinions and/or cease conducting business with the institution if unsatisfied.
External Auditors and *Sharīʻah* Auditing/Advisory Firms	Quality, quantity, and transparency of information.	Perform examinations and communicate findings to shareholders; provide consultancy services within certain restrictions to avoid conflicts of interest.

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Rating Agencies/ Indices	Independent, objective, and reliable ratings for stakeholders; stock performance tracking.	Assess creditworthiness, corporate governance, and possibly *sharī'ah* compliance of banks.
Academics/Researchers, Analysts, Think Tanks, Public Interest Groups, Media, and the Community	Prudent corporate governance; effectiveness and reliability of *sharī'ah* compliance process; stability of financial system and the performance of activities in a socially responsible manner; stakeholder awareness of corporate governance and *sharī'ah* compliance issues.	Assess institutions' practices; highlight shortcomings; suggest improvements; monitor performance to ensure that Islamic banks act in *sharī'ah*-compliant and ethical manner; evaluate activities in the light of the *maqāṣid* of property; educate stakeholders about corporate governance and *sharī'ah* compliance and their rights and responsibilities in this regard.

TABLE 2.1 Key stakeholders in corporate governance of Islamic banks.
Source: Adapted from Chapra & Ahmed, 2002, pp. 15–16.

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2.11 CONNECTING RISK MANAGEMENT, CORPORATE GOVERNANCE, AND *SHARĪ'AH* COMPLIANCE

Previous research has established a close connection between risk management and corporate governance, integrated the former into the latter, and identified the BOD as the "ultimate risk manager."[70] McNulty et al. recognized the need for Chief Executive Officers to be assertive in engaging the BOD in risk-related discussions.[71] Such familiarity with risks, such as *sharī'ah* risk (discussed later in the chapter) is also important for the BOD for several reasons. These include giving guidance on risk management, developing a comprehensive risk management policy, cultivating a culture that underscores the importance of *sharī'ah* compliance, and adequately commenting on risk policies and controls in annual reports. Moreover, the BOD and senior management, as "agents" on behalf of stakeholders, have a fiduciary duty to ensure *sharī'ah* compliance. Thus, it becomes even more critical for them to understand the nature of *sharī'ah* risk and its extent.

The previously provided IFSB corporate governance definition clearly illustrates the relevance of *sharī'ah* compliance to the governance of Islamic banks. In this vein, the IFSB adds:

[70] Fred Kaen, "Risk Management, Corporate Governance, and the Public Corporation" in *Risk Management: Challenges and Opportunity*, 2nd edn, ed. Michael Frenkel et al. (Germany: Springer, 2005), 423–436; Michael McCrae and Lee Balthazor, "Integrating Risk Management into Corporate Governance: The Turnbull Guidance" (2000) 2(3) *Risk Management: An International Journal* 35–45; Hennie van Greuning and Sonja Bratanovic, *Analyzing and Managing Banking Risk: A framework for assessing corporate governance and financial risk*, 3rd edn (Washington, DC: World Bank Publications, 2009), 64.
[71] Terry McNulty, Chris Florackis, and Phil Ormrod, "Boards of Directors and Financial Risk during the Credit Crisis" (2013) 21(1) *Corporate Governance: An International Review* 58–78.

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> *Sharīʻah compliance is critical to IIFSs' operations and such compliance requirements must permeate throughout the organisation and their [sic] products and activities. As a majority of the fund providers use Sharīʻah-compliant banking services as a matter of principle, their perception regarding IIFSs' compliance with Sharīʻah rules and principles is of great importance to their sustainability. In this regard, Sharīʻah compliance is considered as falling within a higher priority category in relation to other identified risks. If IIFS do not comply with Sharīʻah rules and principles, their transactions must be cancelled and income generated from them shall be considered as illegitimate.*[72]

In its basis for governance, AAOIFI mentions that there are social and religious dimensions worthy of consideration. The standard-setter states:

> *An IFI exists due to its ability to conduct its commercial activity in accordance with Shari'a[h] … An IFI has been established to assist investors in using funds in a beneficial manner consistent with Shari'a[h] … an IFI must have mechanisms to comply with Shari'a[h] in all their financial and other dealings.*[73]

Since *sharīʻah* compliance is the main differentiating factor of Islamic banks and a major point of attraction for consumers, stakeholders need reassurance that *sharīʻah* adherence claims made by such banks are true.[74] A look at statements issued by Islamic banks in which they outline their visions, missions, and values reveals that these banks clearly promise to adhere to the precepts of *sharīʻah*.

> *Qatar Islamic Bank*
>
> *A leading, innovative and global Islamic bank adhering to the highest Shari'a[h] and ethical principles; meeting international banking standards; partnering the development of the global economy and participating in the advancement of the society.*[75]
>
> *Bank Islam*
>
> *To continually develop and innovate universally accepted financial solutions in line with Syariah [or sharīʻah] Principles […]*[76]

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[72] IFSB, *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, http://www.ifsb.org/standard/ifsb1.pdf (accessed January 15, 2014), 26.
[73] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 6, 54–55.
[74] Chapra and Ahmed, *Corporate Governance in Islamic Financial Institutions*, 123; Wafik Grais and Matteo Pellegrini, "Corporate Governance and Stakeholders' Financial Interests in Institutions Offering Islamic Financial Services" (2006) *World Bank Policy Research Paper*, No. 4053, 2; Wafik Grais and Matteo Pellegrini, "Corporate Governance and Shariah Compliance in Institutions offering Islamic Financial Services" (2006) *World Bank Policy Research Paper*, No. 4054, 5.
[75] Qatar Islamic Bank, http://www.qib.com.qa/en/footer/about-us/mission-vision-values.aspx (accessed January 14, 2014).
[76] Bank Islam, http://www.bankislam.com.my/en/pages/VisionMissionCoreValues.aspx?tabs=1 (accessed January 14, 2014).

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Meezan Bank

To be a premier Islamic bank, offering a one-stop shop for innovative value-added products and services to our customers within the bounds of Shariah, while optimizing the stakeholders value through an organizational culture based on learning, fairness, respect for individual enterprise and performance.[77]

Kuwait Finance House

To be the Leading Islamic Financial Institution in the World by Providing Competitive and Shari'a[h] Compliant Banking, Financing and Investment Products to Exceed the Expectations of Our Customers, to Motivate Our Employees and to Meet the Objectives of Our Shareholders. [78]

Al Rajhi Bank

To be [the] most successful bank admired for its innovative service, people, technology and Sharia[h] compliant products, both locally and internationally.[79]

Al Baraka Bank

To meet the financial needs of communities across the world by conducting business ethically in accordance with our beliefs, practicing the highest professional standards and sharing the mutual benefits with the customers, staff and shareholders who participate in our business success.[80]

Jordan Islamic Bank

Commitment to providing banking services based on compliance with the rules and principles of the glorious Islamic Sharia[h] in all our activities to serve our community as a whole.[81]

Islamic Bank of Britain

Everything IBB does is in line with Islamic values; conducting economic activity in a fair, ethical and socially responsible manner. [82]

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Islamic banking consumers can be grouped into four market segments: religiously driven, ethically motivated, economically focused, and both religiously and economically

[77] Meezan Bank, http://www.meezanbank.com/vision.aspx (accessed January 14, 2014).
[78] Kuwait Finance House, http://www.kfh.com/en/commercial/cars/used-cars/ (accessed January 14, 2014).
[79] Al Rajhi Bank, http://www.alrajhibank.com.sa/en/about-us/pages/vision-mission-and-values.aspx (accessed January 14, 2014).
[80] Al Baraka Bank, http://www.albaraka.com/default.asp?action=category&id=8 (accessed January 14, 2014).
[81] Jordan Islamic Bank, http://www.jordanislamicbank.com/en/?427dacca3edd8203f5aceefbb0667278fc4d0aabc776c3 (accessed January 14, 2014).
[82] Islamic Bank of Britain, http://www.islamic-bank.com/useful-info-tools/about-us/our-vision-and-values/ (accessed January 14, 2014).

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directed.[83] The first segment has strong religious conviction and tends to be loyal to the Islamic bank with which it has established a relationship irrespective of the financial returns paid by such bank compared to other Islamic banks. The second segment agrees with the ethical dimensions of Islamic banking, but is not concerned with religious considerations. The third market segment bases its decisions solely on the financial returns of the Islamic bank. The final market segment, while driven by religious values, is willing to switch between Islamic banks based on financial return considerations. These individuals do not consciously make decisions based on the ethical dimension, as they consider this aspect covered by the umbrella of laws regulating Islamic banking.

We argue that each of these market segments needs to consider *sharīʻah* compliance when coming to a decision about transacting with a particular Islamic bank. This is obvious for the first and last market segments, but some elaboration is needed for the other two groups. As far as the ethical market segment is concerned, *sharīʻah* precepts regulating Islamic banking are the reason why these banks cannot engage in unethical transactions. Without *sharīʻah* compliance there would be no assurance that these Islamic banks will follow ethical principles that guide their dealings. With respect to the economically driven segment, which does not consider religious values in making its decision, it should take *sharīʻah* compliance into consideration because non-compliance exposes the bank to "fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities."[84]

Compliance with *sharīʻah* is also essential to meet the expectations of stakeholders, other than consumers, whom we have listed earlier. In short, while strong financial performance is sought, it must only be achieved through *sharīʻah*-compliant operations. To enable Islamic banks to achieve such compliance, the IFSB requires these institutions to have in place adequate systems and controls.[85] The IFSB also observes the importance of multiple parties contributing toward this objective and the need for guidance that holistically addresses the issue:

> *Comprehensive guidance on the Sharīʻah Governance System would enable all stakeholders to understand and perform their roles in achieving the Sharīʻah governance objectives and help to promote soundness and stability of the IFSI [Islamic Financial Services Industry]. Therefore, while Sharīʻah boards are expected to play a leading role in ensuring sound Sharīʻah governance, it is also reasonable to expect other organs of governance in an IIFS to share in upholding the Sharīʻah Governance System by executing their functions well and recognising the importance of complementing the work of the Sharīʻah board. In this respect, IIFS*

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[83] Rusnah Muhamad, "Market Segmentation and the Shari'ah Compliancy Process in Islamic Banking Institutions" (2011) *International Shari'ah Research Academy for Islamic Finance Research* Paper, No. 21, 9–10.
[84] IFSB, *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering only Islamic Financial Services*, 26.
[85] Ibid.

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are expected to view the implementation of a Sharī'ah Governance System from a comprehensive perspective.[86]

2.12 *SHARĪ'AH* GOVERNANCE MODEL

Sharī'ah governance can be defined as the overall system that manages the conformity of the activities of Islamic banks and financial institutions to the precepts of *sharī'ah* pertaining to transactions. To this end, we propose a model that maintains *sharī'ah* compliance through structural arrangements that are both internal and external to the institution. The internal arrangements include a robust internal *sharī'ah* control system, internal *sharī'ah* audit function, BOD, and related committees such as the governance committee, senior management, legal, compliance, and internal audit functions. External structural arrangements include the *sharī'ah* supervisory board, external audit firms, *sharī'ah* audit and advisory firms, standard-setting organizations that are IFI-specific such as AAOIFI and non-IFI-specific such as the OECD, banking and industry associations, rating agencies, and indices.

At the heart of institutional arrangements are the legal, regulatory, judicial, and legislative systems, which play a vital role in setting the foundation for prudent *sharī'ah* governance and monitoring its functioning. These systems are crucial for passing Islamic banking laws that will take into consideration *sharī'ah* aspects, establishing and maintaining stakeholders' confidence with respect to *sharī'ah* compliance, maintaining market discipline, promoting standardization, establishing the rule of law, and delivering justice. In this vein, arrangements include an independent judiciary, banking laws and regulations, a centralized *sharī'ah* supervisory board, a regulatory *sharī'ah* audit, stock exchange rules and regulations such as listing criteria, and banking and Islamic finance arbitration.

Besides the abovementioned stakeholders who play a big role in monitoring the effectiveness and efficiency of *sharī'ah* governance, there are other important stakeholders to consider who are not part of the previous arrangements. These have also been mentioned earlier in the stakeholder table and include shareholders, investment and current account holders, employees, analysts, academics and researchers, think tanks, public interest groups, media, and the community. Such stakeholders can apply different forms of pressure on Islamic banks, thereby inducing market discipline in regard to *sharī'ah* compliance. These parties, if shareholders, could also divest from Islamic banks, if not satisfied with their *sharī'ah* compliance track records. Stakeholders affect structural and institutional arrangements, but they are similarly influenced by these arrangements. Thus, there is two-way impact in effect here. Figure 2.3 displays the proposed *sharī'ah* governance model. The coming chapters focus on different aspects of the model.

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[86] IFSB, *Guiding Principles on Sharī'ah Governance for Institutions Offering Islamic Financial Services*, http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf (accessed January 15, 2014), 5.

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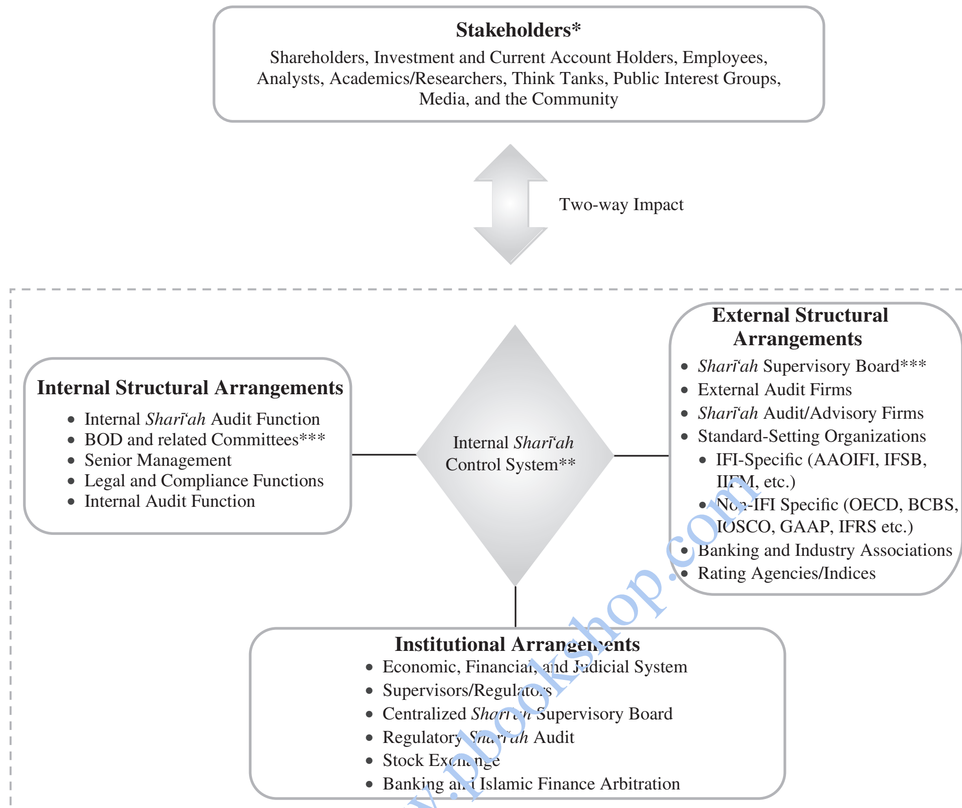

* Refers to stakeholders who are not already mentioned in the internal, external, or institutional arrangements, but who still have an interest in *Sharī'ah* governance.
** This is an internal structural arrangement; however, due to its significance and the effect of external and institutional arrangements on it, it has been brought to the forefront.
*** Can be viewed as either internal or external depending on the perspective one adopts. The main point here is that the independence of members in making their decisions is crucial and must be maintained.

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FIGURE 2.3 *Sharīʿah* governance model for Islamic banks

Attempts have been made in the past to define and elaborate on *sharīʿah* governance. For instance, the IFSB has defined the *sharīʿah* governance system as follows:

> *The set of institutional and organisational arrangements through which an IIFS [Institution offering Islamic Financial Services] ensures that there is effective independent oversight of Sharīʿah compliance over each of the following structures and processes:*

1. *Issuance of relevant Sharīʿah pronouncements/resolutions…*
2. *Dissemination of information on such Sharīʿah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance …*
3. *An internal Sharīʿah compliance review/audit for verifying that Sharī`ah compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified …*

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4. *An annual Sharī‘ah compliance review/audit verifying that the internal Sharī‘ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Sharī‘ah board [...]* [87]

The IFSB also reported that the industry has described the *sharī‘ah* governance system as

structures and processes adopted by stakeholders in the IFSI (from financial regulators to market players) to ensure compliance with Sharī‘ah rules and principles [...][88]

The latter definition used by the industry is arguably more suitable than the qualified definition adopted by the IFSB, the reason being that it is more comprehensive and accurate. The internal arrangements of an Islamic bank, while being fundamental for assessing and contributing to *sharī‘ah* compliance, are only one part of the complete *sharī‘ah* governance system. The IFSB definition makes no mention of external arrangements which contribute to *sharī‘ah* governance. Moreover, institutional arrangements are mentioned without elaboration of what exactly these arrangements entail. In order for a more holistic understanding of *sharī‘ah* governance to prevail, it would be advisable for the IFSB to consider revising its definition and expanding it to address the limitations mentioned herein.

AAOIFI's governance standards # 1–4 address the *sharī‘ah* supervisory board, *sharī‘ah* review, internal *sharī‘ah* review, and the audit and governance committee while overlooking several aspects detailed earlier. AAOIFI provides some general guidance when it states: "an IFI must have mechanisms to comply with Shari'a[h] in all their financial and other dealings."[89] It adds: "[a]n IFI should establish an effective structure for ensuring Shari'a[h] compliance."[90] Such a structure should cover the effectiveness of the role played by BOD, SSB, management and auditors in so far as they relate to Shari'a[h] compliance. The term "auditors" here can be understood to refer to external auditors; however, close inspection of the standards shows that the term is used in reference to internal auditors since "internal Shari'a[h] review may be carried out by the internal audit department/internal control department."[91] AAOIFI recognizes internal *sharī‘ah* review as "an integral part of the organs of governance."[92] However, in discussing the governance structures of an IFI, AAOIFI makes no explicit mention of *sharī‘ah* governance:

- ***(i)*** *A structure through which the governance objectives of the IFI are set, and the means of attaining those objectives and monitoring performance are determined.*
- ***(ii)*** *Mechanisms in place for efficient use of resources and equally to require accountability for the stewardship of resources.*
- ***(iii)*** *The system by which the IFI is directed and managed while encouraging it to create value, provide accountability and establish control systems that commensurate with risk.*
- ***(iv)*** *A system of checks and balances for ensuring that those charged with governance act in the best interests of the IFI's stakeholders for producing long-term*

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[87] Ibid., 2–3.
[88] IFSB, *Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services*, 1.
[89] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 6, 55.
[90] Ibid., 56.
[91] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 3, 22.
[92] Ibid

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> *value to the IFI's stakeholders while maintaining the highest standards of ethics and professional confessional [sic] conduct.*[93]

There is a need for AAOIFI to revisit these structures and explicitly acknowledge *sharī'ah* governance as a separate structure. Additionally, as with the IFSB, AAOIFI needs to adopt a more comprehensive understanding of *sharī'ah* governance that extends beyond the boundaries of the institution because such a holistic understanding is in the best interest of stakeholders and the industry.

2.13 IMPORTANCE OF *SHARĪ'AH* GOVERNANCE

In light of the above, robust *sharī'ah* governance is needed to augment the trust and confidence of stakeholders of Islamic banks.[94] Such confidence would directly impact the stability of institutions, their capacity to function as financial intermediaries, and their performance.[95] Strong *sharī'ah* governance would also help improve stakeholders' knowledge and understanding of the laws of *sharī'ah* pertaining to transactions and allow them to make informed decisions on their relationship with their banks. Thus, they would be in a better position to decide if they want to invest or divest, based on timely, accurate, and adequate *sharī'ah* disclosures.[96] Moreover, they would also be more capable of comparing the extent of *sharī'ah* compliance of different banks against each other. Such efforts would decrease information asymmetries between managers and stakeholders, increase competition, and enhance market discipline.[97] Furthermore, the standardization of practices would largely limit avenues for opportunistic behavior by Islamic banks and their managers, since *sharī'ah* non-compliance can shake the public's confidence in the credibility of the Islamic bank, thereby resulting in fund withdrawals.[98]

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2.14 *SHARĪ'AH* SUPERVISION VS GOVERNANCE

In differentiating *sharī'ah* supervision from *sharī'ah* governance we posit that *sharī'ah* supervision addresses some elements of the internal and external arrangements discussed earlier, whereas *sharī'ah* governance is much broader as it focuses on the whole system in its totality including the institutional arrangements. While the internal measures play a vital role, other components cannot be ignored as doing so presents an incomplete system that could result in superficial and

[93] Ibid., Governance Standard for Islamic Financial Institutions No. 6, 61–62.

[94] IFSB, *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services*, 23–25.

[95] Wafik Grais and Matteo Pellegrini, "Corporate Governance and Sharī'ah Compliance in Institutions Offering Islamic Financial Services" (2006) *World Bank Policy Research Paper*, No. 4054, 5.

[96] IFSB, Guiding Principles on Sharī'ah Governance for Institutions Offering Islamic Financial Services, 21; IFSB, *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services*, 25; IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*, http://www.ifsb.org/standard/ifsb4.pdf (accessed January 15, 2014), 3.

[97] Grais and Pellegrini, "Corporate Governance and Sharī'ah Compliance in Institutions Offering Islamic Financial Services," 25–26.

[98] IDB and IFSB, *Islamic Financial Services Industry Development: Ten-year Framework and Strategies,* http://www.irtipms.org/PubText/237.pdf (accessed January 15, 2014), 16.

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questionable *sharī'ah* compliance practices. The objective here is a holistic system wherein different organs collaborate to produce the desired effect, and not mere box-checking.

Much of the literature to date has focused on the *sharī'ah* supervisory board. While being of great importance, this entity is one of many parts of the system. Hence, its title is not synonymous with *sharī'ah* governance. Nevertheless, it has commonly been portrayed as such. An array of different titles has been used to refer to this organ. These titles are a reflection of the different perspectives that authors have on various aspects pertaining to this entity such as its form, reporting structure, etc. It is, however, important for academics and the industry alike to reach a common understanding of fundamental concepts, such as *sharī'ah* governance, in order to prevent substandard practices that negatively impact the development of the industry and to protect the interests of stakeholders. Nevertheless, an element of flexibility is needed to accommodate the unique circumstances and realities of different jurisdictions, as no single model will be suitable for all jurisdictions.

2.15 *SHARĪ'AH* RISK DEFINITION

The BCBS defines operational risk as "the risk of financial loss or damage resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk."[99] An operational risk unique to Islamic banks and financial institutions is *sharī'ah* risk. This is defined by Bälz to be "the chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic law."[100] Archer and Haron refer to it as *sharī'ah* compliance risk and define it as "the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel."[101] The IFSB terms it *sharī'ah* non-compliance risk and declares that it is "the risk that arises from an IIFS's failure to comply with the *Sharī'ah* rules and principles determined by the *Sharī'ah* Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate."[102]

Sharī'ah risk may be defined as the risk of financial losses that an Islamic financial institution may experience as a result of non-compliance in activities with *sharī'ah* precepts, as ascertained by the *sharī'ah* supervisory board or the pertinent authority in the relevant jurisdiction. Non-financial or non-material losses are not included in this definition because we are concerned with quantifying monetary damages. Nevertheless, Muslims believe that losses on the spiritual front will diminish the blessings of God, having a consequent impact on the financial position of the IFI.[103] However, it is very difficult, if not impossible, to quantify these losses. That said, spiritual blemishes which emerge due to the negligence of those responsible for *sharī'ah* governance are worthy of blame.

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[99] Basel Committee on Banking Supervision (BCBS), *Principles for the Sound Management of Operational Risk* (Basel: BCBS, 2011), 5.

[100] Kilian Bälz, "Sharia Risk? How Islamic Finance has Transformed Islamic Contract Law," http://www.law.harvard.edu/programs/ilsp/publications/balz.pdf (accessed January 15, 2014), 23.

[101] Simon Archer and Abdullah Haron, "Operational Risk Exposures of Islamic Banks," in *Islamic Finance: The Regulatory Challenge*, ed. Simon Archer and Rifaat Abdel Karim (Singapore: John Wiley & Sons, 2007), 124.

[102] IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*, 22.

[103] Muhamad, "Market Segmentation and the Shari'ah Compliancy Process in Islamic Banking Institutions," 29.

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2.16 *SHARĪʻAH* RISK AND POSSIBLE IMPLICATIONS

2.16.1 Credit Risk

If not managed appropriately, *sharīʻah* risk may reduce the confidence of stakeholders such as customers, shareholders, depositors, and employees who realize that the institution is not living up to its commitments.[104] This may result in customers breaching their financing contracts with the Islamic bank, thereby resulting in credit risk. Such breaches may happen if customers are unwilling to meet their obligations for three possible reasons: the belief that the contract that they had entered into has been voided on *sharīʻah* grounds, non-confidence in the institution's practices, or the feeling of being betrayed by the institution. Should the contract be nullified due to *sharīʻah* violations, then this would lead to the emergence of unlawful income and the exclusion of the corresponding transaction's profits from the bank's income.[105] Such funds would then be transferred to an account that is supervised by the SSB, and appropriated by them to charitable causes.

2.16.2 Legal and Compliance Risk

Sharīʻah risk can lead to legal and compliance risk. These two types of risks are often considered synonymous. However, legal risk often relates to failure to adhere to contractual obligations and the unenforceability of contracts, while compliance risk often relates to failure to adhere to laws and regulations. BCBS defines legal risk as "the possibility that lawsuits, adverse judgments or contracts that turn out to be unenforceable can disrupt or adversely affect the operations or condition of the bank."[106] Perhaps a more detailed definition is "the risk of loss to an institution which is primarily caused by a defective transaction; or a claim (including a defense to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss […]; or failing to take appropriate measures to protect assets […] owned by the institution; or change in law."[107] On the other hand, the BCBS defines compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities."[108]

An Islamic bank that claims in its memorandum and/or articles of association that it adheres to the tenets of *sharīʻah* yet fails to deliver on its claim may find itself facing lawsuits from stakeholders that are unhappy with the false advertising and/or the non-commitment of the institution to its claims. For example, in the UK, making false statements about provision of services is an offence under the Trade Descriptions Act of 1968. Likewise, making misleading or untrue representations of products or services in order to make money is an offence under the Fraud Act of 2006. This is an example of a *sharīʻah* risk leading to a legal risk. Other examples include

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[104] IDB and IFSB, *Islamic Financial Services Industry Development: Ten-year Framework and Strategies*, 1; 16.
[105] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 1, 7.
[106] BCBS, *Customer Due Diligence for Banks* (Basel: Bank for International Settlements, 2001), 4.
[107] Roger McCormick, *Legal Risks in the Financial Market*, 2nd edn (Oxford: Oxford University Press, 2010), 479.
[108] BCBS, *Compliance and the Compliance Function in Banks* (Basel: Bank for International Settlements, 2005), 7.

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uncertainty in interpreting certain *sharī'ah* clauses in courts and the possible unenforceability of *sharī'ah* contracts in secular law jurisdictions which negatively affects market discipline.[109]

Sharī'ah risk can also lead to compliance risk, an example being a bank that fails to set up prudent internal *sharī'ah* governance arrangements even though it is required by the regulator to do so. In such case the bank may be fined for its contraventions or even lose its license to operate. The Malaysian Islamic Financial Services Act of 2013 requires IFIs to comply with *sharī'ah* at all times. It also requires IFIs, when becoming aware of *sharī'ah* non-compliant activity, to (a) immediately notify the central bank; (b) cease carrying on such non-compliant activity; and (c) within 30 days of becoming aware of the non-compliance submit a plan for rectifying the situation. Those who contravene these guidelines commit an offence and upon conviction are liable to imprisonment for a term not exceeding eight years or a fine not exceeding 25 million ringgit (approximately US$8 million) or both.

2.16.3 Reputational Risk

Reputational risk is "the potential that adverse publicity regarding a bank's business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution."[110] The activities of banks involve the general public to a great extent. Hence, earning and preserving their trust and confidence is crucial for banking success.[111] IFIs in particular cannot afford to lose their credibility when it comes to abiding by *sharī'ah* in their operations and transactions because such credibility is at the core of their business. The activities of banks involve the general public to a great extent.

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2.16.4 Market Risk

If an Islamic bank owns investments in stocks and they become *sharī'ah* non-compliant for some reason, such as the debt-to-market capitalization ratio exceeding 30%, then the bank is under an obligation to liquidate these equities. This may occur at a time when the equities are valued at less than the price of purchase, thereby leading to losses. While some SSB members may allow a limited time period for market conditions to improve in order to minimize the losses, such a period may not be sufficient especially during an economic downturn.

In summary, *sharī'ah* risk may result in fund withdrawals, higher costs to attract deposits, direct and indirect financial losses,[112] liquidity issues, bank runs, bank failure, and financial

[109] Yusuf DeLorenzo and Michael McMillen, "Law and Islamic Finance: An Interactive Analysis" in *Islamic Finance: The Regulatory Challenge*, ed. Simon Archer and Rifaat Abdel Karim (Singapore: John Wiley & Sons, 2007), 179–183; IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*, 33.

[110] BCBS, *Customer Due Diligence for Banks*, 4.

[111] Stergios Leventis, Panagiotis Dimitropoulos, and Stephen Owusu-Ansah, "Corporate Governance and Accounting Conservatism: Evidence from the banking industry" (2013) 21(3) *Corporate Governance: An International Review* 265.

[112] Direct losses are losses that reduce profits thereby affecting equity holders, investment account holders, and possibly even current account holders if the bank becomes insolvent and cannot repay funds. Indirect losses are declines in the share price of a publicly listed corporation that affect equity holders. See Dalia El Hawary, Wafik Grais, and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated" (2004) World Bank Policy Research Paper, No. 3227, 20.

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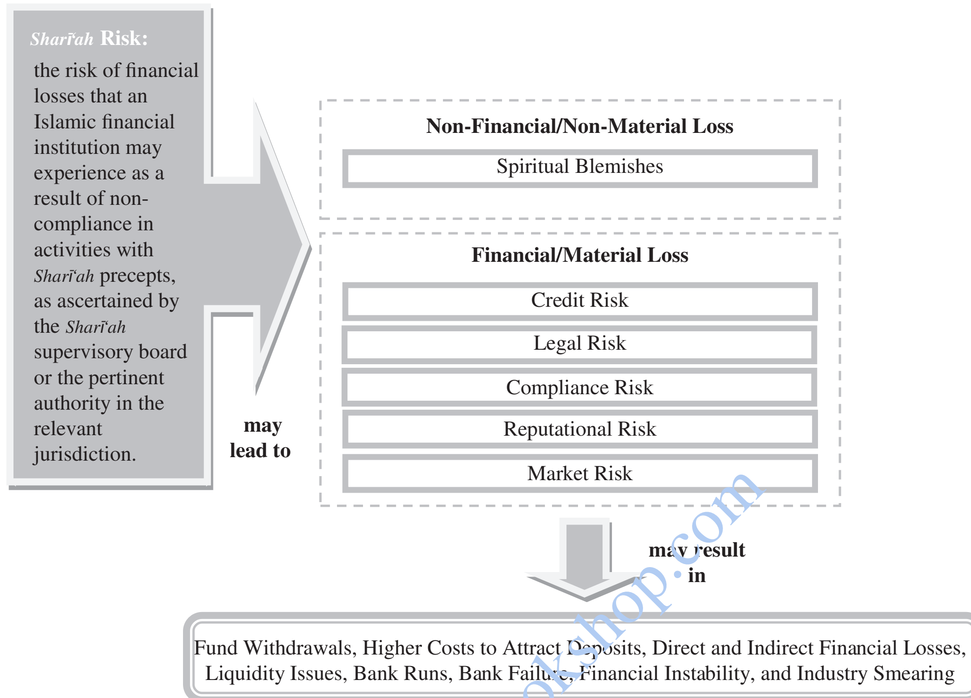

FIGURE 2.4 Possible implications of *Sharīʿah* risk
Source: Karim Ginena, "Sharīʿah Risk and Corporate Governance of Islamic Banks," *Corporate Governance* 14, No. 1, (2014): 92.

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instability, depending on the size of the Islamic banking industry in the country.[113] It may also tarnish the reputation of this industry, which is driven by the trust of stakeholders.[114] Figure 2.4 illustrates the possible implications of *sharīʿah* risk.

[113] Ahmad Ali, "The Emerging Islamic Financial Architecture: The Way Ahead" in *Islamic Finance: Dynamics and Development: Proceedings of the Fifth Harvard University Forum on Islamic Finance* (Cambridge, MA: Center for Middle Eastern Studies, Harvard University, 2003), 152; El Hawary, Grais, and Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated," 20–21; AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Governance Standard for Islamic Financial Institutions No. 6, 52–56; IDB and IFSB, *Islamic Financial Services Industry Development: Ten-year Framework and Strategies*, 1; 9; 16; 22–23; Hylmun Izhar, "Identifying Operational Risk Exposures in Islamic Banking" (2010) 3(2) *Kyoto Bulletin of Islamic Area Studies* 21; Central Bank of Oman, Islamic Banking Regulatory Framework (Oman: Central Bank of Oman, 2012), Operational Risk, 4–5; IFSB, *Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services*, http://www.ifsb.org/standard/ifsb5.pdf (accessed January 20, 2014), 7.

[114] IDB and IFSB, Islamic Financial Services Industry Development: Ten-year Framework and Strategies, 22–23.

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2.17 *SHARĪ'AH* RISK – CAUSES AND EVENTS

After recognizing that *sharī'ah* risk exists, it is important to identify events that may cause this risk. According to the BCBS operational risk definition stated earlier, there are three internal causes of operational risk – people, internal processes, and systems – and one external cause – external events. Appendix 2.1 displays the BCBS's operational *risk loss* event types, and their corresponding definitions and activity examples. To maintain consistency, we have retained the four causes identified by the BCBS and grouped events that lead to *sharī'ah* risk under them.

2.17.1 Internal Causes

2.17.1.1 People

***Fatwa*[115] risk.** The SSB of an Islamic bank may expose it to *fatwa* risk or the possibility that a *fatwa* is incorrect, vague, or overly complicated.[116] There are numerous reasons for a *fatwa* to be incorrect. One example is an SSB that misreads a situation to mean something that it is not. This could be the result of an insufficiently detailed inquiry or negligence on the part of the SSB. For instance, an SSB that considers a product proposal put forth by the bank's product development team, yet fails to solicit legal counsel's observations on it, may get a misrepresentation of reality. Thus, coordinated meetings that bring together relevant department representatives to discuss a product or issue are essential for an SSB to build an accurate and comprehensive understanding of matters and issue correct *fatawa*.[117] Hammad argues that an SSB that negligently issues a *fatwa* without due consideration and is found to be mistaken should be held liable for bank losses that result from its negligence.[118] Another possible cause for having a distorted understanding of a situation is misrepresentation by senior executives or other employees that is meant to mislead the SSB into misunderstanding the situation or product. It is also possible for a *fatwa* to be incorrect if the SSB has inadequate experience. SSB members with academic backgrounds but little or no grasp of the disciplines of finance, economics, and banking may end up issuing incorrect *fatawa* due to their unfamiliarity with these fields and their improper understanding of them.

Additionally, a *fatwa* that is vague or does not have sufficient details could result in employees making assumptions that are incorrect and reading into such a *fatwa* what was not intended by those who issued it. Furthermore, such a *fatwa* may lack a clear procedure by which it could be implemented leading to unintended mistakes in implementation. On the other hand, an overly complicated *fatwa* communicated in sophisticated juristic jargon that cannot be deciphered by practitioners who are supposed to apply it may again lead to implementation mistakes.[119]

The internal *sharī'ah* audit function may also make the Islamic bank vulnerable to *fatwa* risk by issuing *fatawa* when it should not be doing so. This can happen when employees and senior executives misunderstand the role of this function and the difference between its role and the role of the SSB. Internal *sharī'ah* audit employees are in contact daily with their fellow coworkers who may informally inquire about the *sharī'ah* ruling of transactions, products,

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[115] *Fatwa* is an Islamic legal verdict or resolution. Here it relates to Islamic finance matters.
[116] DeLorenzo, "Shari'ah Compliance Risk," 400.
[117] *Fatawa* is the plural of *fatwa*.
[118] Nazih Hammad, *Fī fiqh Almu'amalāt Almālīyah Wa Almaīrafīyah Almu'aṣirah Qirā'ah Jadīdah* (Damascus: Dār Al-Qalam, 2007), 373–375.
[119] DeLorenzo, "Shari'ah Compliance Risk," 400.

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and the like. Internal *sharī'ah* audit employees are often revered by others in the bank due to the nature of their duty and the authority granted to them. Thus, they may be tempted to respond to questioners with verbal or written *fatawa* that have no precedent set by the bank's SSB. One possible reason that these employees may exceed the limits of their authority is their ego. It may be difficult for them to clarify to questioners that they are not authorized to issue *fatawa*, as doing so will decrease their perceived authority and power. Another reason for these employees to cross the limits of their authority is the perception of being entitled to issue *fatawa* because of their *sharī'ah* background and years of experience. Such dangerous thinking may prevail in certain circumstances more than others such as the case of an internal *sharī'ah* audit head who is arguably qualified to serve on the SSB but does not. New graduates with a bachelor's or master's in Islamic transactional law working as part of the internal *sharī'ah* audit team may also fall victim to this line of thought when trying to establish their authority within the organization. At other times, *fatawa* issuance by the internal *sharī'ah* audit team could be non-ego-related, but an avenue for relieving mounting pressure from other officers or senior executives who require quick *fatawa* for fluid situations. Getting access to SSB members to answer inquiries at short notice is not always easy as frequently they can be found traveling. After all, SSB members are not employees of the Islamic bank; their services are made available when they are called in for a meeting or they are asked to provide an opinion via communication technology. This may result in challenges, especially if the issue at hand is complex, and can translate into a longer-than-expected turnaround time in responding to inquiries. As time passes, pressure mounts on the internal *sharī'ah* audit team to respond until the burden is no longer bearable. While this is not a valid excuse for such an action, it demonstrates how business pressures can negatively affect the *sharī'ah* compliance of the organization. Applying this sort of pressure could also be a technique used by some senior executives in order for them to circumvent the SSB.

Falsification of information. This is another example of an event that could lead to *sharī'ah* risk. This is especially the case if the bank's information technology (IT) system does not have *sharī'ah* controls that restrict the user from performing transactions in the required *sharī'ah* sequence. For example, while the IFI may have a *murabaha*[120] module that has pre-set accounting entries for different parts of the *murabaha* transaction, it may lack a control function that restricts the user from inputting the sale of the good before inputting the purchase from the vendor. This opens the door for user errors and possible falsification of documentation. A financing officer who makes such a mistake may unfortunately choose to cover up the error by forging the date of the purchasing contract so that it precedes the date of the *murabaha* sale. Thus, *sharī'ah* auditors may have a difficult time catching this forgery. Had the bank had an IT system that controlled the sequence of the transaction then it would not have been as easy to forge the documents. If such forgery is caught then the sale contract would be null and void since the bank cannot sell before owning. The profits from such a transaction would be excluded. An event related to falsification is collusion between parties to conceal information from the SSB or *sharī'ah* auditors regarding transactions, products, or other matters. In particular, collusion may happen when a mistake occurs in a big transaction and employees fear that profits will be lost and they will be disciplined for their negligence or wrongdoing.

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[120] *Murabaha* is a cost-plus sale with particular guidelines.

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Guideline violations and unapproved products, transactions, legal documentation, or marketing. Violating procedures for transactions would constitute a breach, but launching a product without SSB approval would not only be worse, but might also lead to their resignation. In regard to legal documentation, neither the SSB nor legal counsel can do without the other party since each scrutinizes documentation from their own frame of reference. Coordinating matters between these two entities is important as certain legal clauses may contradict *sharī'ah* tenets, thereby impacting the validity of the contract. Another important dimension that requires attention is the guidelines that regulate the marketing of Islamic banking products and services. These have to be agreed with the SSB to prevent criticism and losses. Such guidelines include anything from the type of goods or services offered to customers for free in marketing campaigns to the type of images permitted in advertisements. Commonly practiced advertising techniques such as using images of alluring women would not be permitted by the SSB.

Insufficient resources, inadequate training, and negligence. Having insufficient human or financial resources for the internal *sharī'ah* audit function to diligently perform its tasks is another possible catalyst of *sharī'ah* risk. The reason for this is that it may lead to non-fulfillment or inadequate fulfillment of tasks, such as *sharī'ah* auditing of transactions, as duties may far exceed the capacity of employees.

The duties delegated to the internal *sharī'ah* audit function are large in number, yet limited human resources are dedicated to the function. A function of this importance cannot run on one or two employees, as is currently the case in many Islamic banks.

Several factors have led to this unfortunate situation. In spite of AAOIFI's efforts, *sharī'ah* auditing has not yet gained sufficient credibility as a profession and remains undervalued. Many regulatory bodies do not require Islamic banks to have internal *sharī'ah* auditors, thereby exacerbating the problem even further and giving management too much discretion in this respect. Second, clear qualifications for *sharī'ah* auditors are yet to emerge. In this regard, is it sufficient for a *sharī'ah* auditor to be fluent in Arabic but have little or no knowledge of English even though much of the contracts, communication, and transactions are conducted in English? Is it adequate for a *sharī'ah* auditor to have studied *sharī'ah* but not possess any background or training in accounting or banking? The consequence of hiring such individuals, especially if they do not undergo intensive training that brings their qualifications up to par, is that they will not be able to perform their functions adequately. While it may have been acceptable at the inception of Islamic banking to make an argument for hiring such persons due to the shortage of manpower and given their knowledge of *sharī'ah*, this is no longer the case as market conditions have changed and qualified candidates can be found. SSB members' qualifications are also a matter of concern. As previously stated, SSB members with academic backgrounds but little or no familiarity with finance, economics, and banking may unintentionally issue incorrect *fatawa.* Again, given the responsibility that is put on the shoulders of these jurists and the complexity of financial transactions and the effect that they have on the economy, it is necessary to have baseline qualifications against which jurists' credentials can be measured. Otherwise, the industry becomes even more susceptible to misinformed judgments that could negatively affect the direction of its development.

Inadequate training of employees is also problematic and may result in bank losses. To mitigate *sharī'ah* risks related to this, employees must be appropriately educated regarding the *sharī'ah* aspects of transactions to prevent mistakes. Such training is also important for

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employees to be able to respond to inquiries from customers about the rationale of conducting transactions in a particular sequence. *Sharī'ah* auditors and SSB members also require ongoing training. It is advisable for *sharī'ah* auditors hired for an entry level position to undergo rotations in different departments of the Islamic bank to familiarize themselves with the employees, operations, processes, and transactions. They should also be teamed up with more experienced *sharī'ah* auditors who would serve as their mentors. Experienced *sharī'ah* auditors also need continuous training but their needs must be assessed on an individual basis. As for SSB members, their training would be customized to meet their outstanding needs, such as accounting issues, and would be delivered via in-depth workshops or other suitable means. Finally, even with sufficient human resources and proper training, the bank may be exposed to unwanted *sharī'ah* risk if those performing their duties do so in a negligent manner.

Miscommunication. This is another possible trigger for *sharī'ah* risk especially when parties speak different languages. For example, if *sharī'ah* scholars can only speak Arabic, and lawyers can only speak English, and non-professional interpreters are used as a means of communication, then it is possible for the resulting interpretation to be inaccurate and the corresponding judgments to be incorrect. On the other hand, is it feasible to hire a professional interpreter for each meeting or translate every document? This can be very laborious, time consuming, and expensive, especially in the case of *sukuk* contracts, which can easily exceed 100 pages. This is a key reason why *sharī'ah* supervisory board members who are bilingual in Arabic and English are in heavy demand. In circumstances where such a jurist is the only person on the SSB with such linguistic capabilities, the jurist may summarize the densely worded contracts and broadly discuss them with fellow members. Should they agree, then the jurist may be tasked with addressing the contractual details on behalf of others. As far as employees of the internal *sharī'ah* audit function are concerned, they should be proficient in the language of discussion and writing of the SSB, if other than Arabic, as well as in English.

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Lack of segregation of duties. Conflicting duties, such as legalization and auditing, must not lie within the authority of the same entity, as this opens the door for such an entity to cover up its *sharī'ah* mistakes. An internal *sharī'ah* audit function that issues *fatawa* without SSB precedent can be tempted to cover up its mistakes if at any point it realizes that the SSB has a different juristic opinion on the issue. Such a cover-up would not be difficult to accomplish, given that the internal *sharī'ah* audit function is tasked with auditing and reporting on transactions. If these incorrect *fatawa* are discovered then profits from such transactions should be excluded, and those involved questioned and disciplined.

Loss of key player and disorganization. The loss of a key internal *sharī'ah* audit employee such as the head of the function may also result in *sharī'ah* risk. This can be the case if the department is dependent on this individual, knowledge has not been preserved, and matters are disorganized – for instance, *fatawa* have not been archived, *sharī'ah* aspects of processes have not been delineated, and knowledge in general has been left largely undocumented. In situations where a precedent *fatwa* has been issued by the SSB, the internal *sharī'ah* coordination department follows such precedent for similar scenarios. But what if the key player who has left the organization never documented *fatawa* in archives? While other employees may try to recall the *fatwa*, doing so opens the door for recollection mistakes to occur, and for *sharī'ah* risk to emerge. This example allows us to transition to the second cause of *sharī'ah* risk.

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2.17.1.2 Processes

The previous example leads us to the second cause of operational and sharīʻah risk which is "processes."

Unclear processes, policies, procedures, or responsibilities. Substandard practices may develop in the event of unclear processes, policies, procedures, or responsibilities, thereby opening the door for *sharīʻah* violations to occur. Inefficiencies can also develop due to the lack of standardization. The continuous cyclical examination and amendment of processes, policies, and procedures is also essential to keep abreast of legal, regulatory, and industry developments, which in most cases affect *sharīʻah* aspects of operations and transactions. Thus, the SSB may have to revisit some of its previously issued guidelines or *fatawa* in light of these developments and make any necessary modifications. Otherwise, transactions may not be in compliance with directives, making the Islamic bank vulnerable to fines. It is also important for this cyclical review to take place to ensure proper integration of newly issued SSB guidelines and *fatawa* into processes, policies, and procedures.

Inadequate internal *sharīʻah* governance arrangements or tools. Underestimating the importance of establishing prudent internal *sharīʻah* governance arrangements translates into inadequate *sharīʻah* compliance controls, and can have disastrous effects. Furthermore, establishing these structures but failing to ensure that the right tools are used to perform tasks can also lead to similar failure. Thus, the role of regulatory bodies here in ensuring that banks have established suitable arrangements and are appropriately equipped cannot be overestimated.[121]

Internal *sharīʻah* audit functions are, nonetheless, becoming more organized and attempting to standardize their processes, such as the method for soliciting and addressing *sharīʻah* inquiries, in an effort to become more effective and efficient. With respect to the inadequacy of certain tools, an example of this is inadequate *sharīʻah* audit checklists. Developing these checklists is especially challenging if *sharīʻah* controls have not been extracted from the guidelines and *fatawa* of the SSB and integrated into product manuals and policies and procedures. Nevertheless, they are essential for the proper standardized functioning of any internal *sharīʻah* audit function. Otherwise *sharīʻah* auditors will not have properly fulfilled their task as they may have mistakenly forgotten to consider some *sharīʻah* controls or added new ones that were not prescribed.

Insufficient disclosure and transparency. *Sharīʻah* violations may not be recognized by stakeholders if there is inadequate disclosure or transparency. Hence, dormant *sharīʻah* risk may exist yet remain unidentified by stakeholders until it is too late. This kind of scenario sounds all too familiar in the wake of the financial crisis. Many annual reports issued to stakeholders by SSBs of Islamic banks often lack much-needed transparency on some of the most rudimentary facts, such as the number of meetings held, resolutions passed, products approved, and so on.[122] Haniffa and Hudaib found in their study of the annual reports of seven Islamic banks over the period 2002–2004 that only one had reported the remuneration paid to its SSB.[123]

[121] Zulkifli Hasan, *Shari'ah Governance in Islamic Banks* (Edinburgh: Edinburgh University Press, 2012), 226–227.
[122] Ibid., 183–228.
[123] Roszaini Haniffa and Mohammad Hudaib, "Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports" (2007) 76(1) *Journal of Business Ethics* 109.

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Additionally, more transparency needs to be introduced to allow stakeholders to inspect *fatawa* and the evidences used to derive them, as most SSB resolutions nowadays contain rulings without supporting proof.[124] To protect themselves against *sharīʻah* risk some counterparties are requesting SSB product and contract approvals before engaging in transactions. Until now, many Islamic banks have not posted such documents on their websites, nor have they posted their *fatawa*. This increases the opaqueness which surrounds *sharīʻah* aspects, and can give the impression that the bank is hiding something from the public.[125] Transparency is crucial for corporate governance to be effective.[126] It would allow stakeholders to hold the SSB, BOD, and senior management accountable for their mistakes,[127] and to compare the work of various SSBs against one another, inching closer towards market discipline.

Inappropriate use of charity account, profit distribution, and segregation of funds. Funds excluded due to *sharīʻah* contraventions are pooled in a charity account. Since this account can add up to millions of dollars, it is important for auditors to pay careful attention to movements on it, lest it be used by management to inflate profits which need to be reversed thereafter. Furthermore, assurances must be obtained that these monies were appropriated to credible charitable causes. Another issue related to accounts is the distribution of returns of investment accounts, which are operated on a profit and loss basis. Disguising these accounts under the profit and loss banner and choosing to operate them instead on a fixed-interest basis subjects the bank to serious *sharīʻah* risk. A final issue relating to financial records is the segregation of funds of a conventional bank from those of its Islamic window (that department of a conventional bank offering Islamic banking services). It is impermissible for an Islamic window to collect deposits, operate these funds within its conventional operations, and then distribute corresponding returns to Islamic investment account holders. This leads our discussion to the final internal cause of *sharīʻah* risk.

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2.17.1.3 Systems

Process and system accounting mismatches, inadequate product modules, poor reporting, and unapproved software. The bank's IT system's transaction processes and accounting entries should reflect those listed in product manuals, which are approved by the SSB. Otherwise, mismatches that point to inconsistencies can be conducive to *sharīʻah* risk. In checking for end-to-end uniformity, SSBs should not limit themselves to scrutinizing the legal documentation of products, but the should also inspect the IT system modules that account for and embody transactions, the reason being that accounting entries, system parameters, and other module aspects may be *sharīʻah* non-compliant. Hence, jurists should have some accounting background to be able to distinguish between permissible and impermissible entries. Such exposure will also prove helpful when SSB members are asked to pick the IT system option that matches their *fiqhi* perspective on a particular product issue.

A related matter is the manual inputting of accounting entries due to the inadequacy of the existing banking system. There are numerous reasons for this deficiency, including the small number of Islamic finance IT vendors, the costs involved in purchasing these modules, and

[124] Hasan, *Shari'ah Governance in Islamic Banks*, 216.
[125] Haniffa and Hudaib, "Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports," 111.
[126] BCBS, "Enhancing Corporate Governance for Banking Organizations," 15.
[127] Ibid.

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incompatibility issues of these modules with core banking IT systems. This practice is risky from both a *sharī'ah* and an accounting perspective as it opens doors for mistakes and forgery. It is also more time consuming, and can prove difficult when trying to generate reports. The lack of these system reports, their inaccuracy, or the inadequacy of information presented in them can lead to misinformed judgments that can create *sharī'ah* risk. Finally, under no circumstances should management proceed with business without the SSB's approval of its IT system.

Inexperienced vendor, non-timely support, non-user-friendly system, and system mistakes. With the Islamic finance industry growing as rapidly as it is, conventional banking IT system vendors are finding before them an opportunity to tap into a new market segment by introducing Islamic finance modules. However, if vendors have inadequate experience and do not receive sufficient expert support when developing their modules, then this may lead them to develop impermissible system options that can contribute to *sharī'ah* risk. Additionally, untimely vendor support and the non-user-friendliness of a system module can exacerbate the problem. A system that cannot be relied upon due to mistakes also presents *sharī'ah* challenges.

2.17.2 External Causes

External causes are those that are external to the Islamic bank and can lead to *sharī'ah* risk. Below are some of the most frequent external events.

***Fatwa* risk.** This may also be listed here if we consider the situation where an Islamic bank chooses not to establish its own SSB, but rather procures the services of a *sharī'ah* advisory consulting firm. In such a case, the same aforementioned *fatwa* risk issues would remain, and additional ones might arise. For example, a possible risk that could emerge is when a jurist is both a partner in the *sharī'ah* advisory firm as well as a scholar who sits on the firm's SSB. Will the jurist be more lenient in *fatawa* due to the fact that he is also a partner in the *sharī'ah* advisory firm? The same question could also be posed with respect to jurists who sit on SSBs of Islamic banks, and whose services are solicited directly, rather than through a firm, in return for compensation. This situation is similar to that of external audit firms, which are paid remuneration for the services they provide. Does such monetary compensation affect the results of their audits?

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Inexperienced *sharī'ah* advisory firm and conflicts of interest between auditing, consulting, and legalizing duties. Related to the same topic of *sharī'ah* advisory firms are two external events, which may also pose *sharī'ah* risk. The first is hiring an inexperienced *sharī'ah* advisory firm that does not have a well-established track record in providing these services. Such a firm may not be qualified to provide the necessary expertise and could introduce preventable *sharī'ah* mistakes. The second is the possible conflict of interest that emerges as a result of providing several different services to the same Islamic bank, such as furnishing *fatawa*, auditing, and consulting. The financial auditing industry learned the dangers that could emerge from offering conflicting services, such as auditing and consulting, after several painful corporate fiascos. These lessons are also applicable to *sharī'ah* advisory firms, especially given that they offer a further conflicting service, legalizing via the issuance of *fatawa*. From this perspective, it is problematic for these firms to be engaged in legalizing the same products that they end up auditing because this opens the door for mistakes to be covered up.

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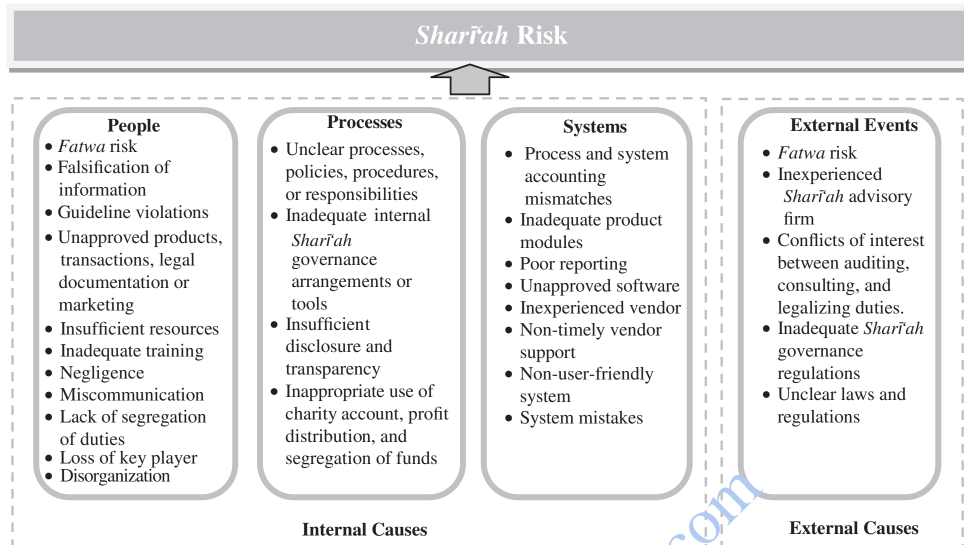

FIGURE 2.5 *Sharīʻah* risk events grouped under the four BCBS operational risk causes
Source: Karim Ginena, "Sharīʻah Risk and Corporate Governance of Islamic Banks," *Corporate Governance* 14, No. 1, (2014): 96.

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Inadequate *sharīʻah* governance regulations and unclear laws and regulations. Regulators have an important role to play in *sharīʻah* governance given the instability that may result.[128] While the extent of involvement of regulators will differ from one jurisdiction to another, regulators are advised, at the very least, to require banks to demonstrate that they have adequate internal *sharīʻah* governance arrangements that are capable of addressing *sharīʻah* risks.[129] As we have seen, inadequate *sharīʻah* governance regulations or the complete lack thereof may lead banks to be negligent towards *sharīʻah* governance issues, resulting in unrestrained *sharīʻah* risk. Unclear laws and regulations could lead to the same result.

Despite efforts to curb *sharīʻah* risk, violations may still occur. This may be the result of the Islamic bank outgrowing its existing internal *sharīʻah* governance framework, or gaps that appear in areas that have not been addressed. Nonetheless, continuous improvement measures should ensure that such contraventions are rapidly addressed and kept to a minimum. Figure 2.5 illustrates events that may lead to *sharīʻah* risk and groups them under the four BCBS operational risk causes. Additionally, *sharīʻah* risk violations could also be mapped to different units and lines of business of the Islamic bank. Table 2.2 presents the sample classification of business units and lines provided by the BCBS.

[128] Habib Ahmed, "Shari'ah Governance Regimes for Islamic Finance: Types and Appraisal" (2011) 44(4) *Journal of Institute of International Economics* 393–396.

[129] IDB and IFSB, *Islamic Financial Services Industry Development: Ten-year Framework and Strategies,* 23; *IFSB, Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services*, 1; 5.

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Business Unit	Business Lines	
	Level 1	**Level 2**
INVESTMENT BANKING	Corporate Finance	Corporate Finance
		Municipal/Government Finance
		Merchant Banking
		Advisory Services
	Trading & Sales	Sales
		Market Making
		Proprietary Positions
		Treasury
BANKING	Retail Banking	Retail Banking
		Private Banking
		Card Services
	Commercial Banking	Commercial Banking
	Payment & Settlement	External Clients
	Agency Services	Custody
		Corporate Agency
		Corporate Trust
OTHERS	Asset Management	Discretionary Fund Management
		Non-Discretionary Fund Management
	Retail Brokerage	Retail Brokerage

TABLE 2.2 BCBS sample mapping of business units and lines
Source: BCBS, Operational Risk Data Collection Exercise - 2002 (Basel: BCBS, 2002), Annex 1.

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2.18 *SHARĪʻAH* RISK MANAGEMENT

As we have seen, *sharīʻah* risk can emanate from internal or external causes; however, the internal causes are more often the reason behind this risk. At the bank level, the internal *sharīʻah* control system is vital for managing and minimizing *sharīʻah* risk through the identification, measurement, evaluation, monitoring, reporting, and controlling of the risk. In this regard, responsibility is to be delegated to qualified persons with clear roles and lines of authority and who are to be held accountable for their actions. This is in line with the BCBS's general guidance on managing operational risk through appropriate infrastructure, internal controls, systems and mechanisms, and trained, competent individuals. Comprehensive *sharīʻah* risk management requires different stakeholders identified earlier to play an active role in pursuit of this objective.

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2.19 *SHARĪʻAH* COMPLIANCE RESPONSIBILITY OF BOD AND SENIOR MANAGEMENT

As part of its duty to oversee risk management, the BOD is responsible for monitoring *sharīʻah* risk and having a precise and comprehensive understanding of it, its impact on the bank, and its objectives and stakeholders. Moreover, the BOD is accountable for establishing an efficient and effective organizational structure for *sharīʻah* governance that adequately assesses and manages the Islamic bank's exposure to *sharīʻah* risk, and ensures compliance of activities with *sharīʻah* precepts.[130]

AAOIFI recommends for Islamic banks what it calls the audit and governance committee to assist the BOD in supervising financial reporting, overseeing and monitoring *sharīʻah* compliance, and other essential functions.[131] Elaborating on the role of this committee, AAOIFI says that it should, "among other matters include, the process for financial reporting, internal controls, internal audit oversight, external audit oversight and Shari'a compliance."[132] The committee should periodically review the efficiency and effectiveness of the internal *sharīʻah* control system and audit function, as well as assess the adequacy of *sharīʻah* controls. *Sharīʻah*-related responsibilities of the committee could be classified under four main domains: *sharīʻah* reporting, internal *sharīʻah* control, internal *sharīʻah* audit function, and external *sharīʻah* audit. Table 2.3 displays a more detailed account of the activities of the committee.

The BOD must also ensure that a competent SSB is appointed, and recognize the independence of the SSB in making its own decisions and not try to wrongly influence its resolutions, thereby compromising the SSB's independence and objectivity. On an annual basis, the BOD should assess the performance of SSB members using the IFSB's suggested performance measures, and resolve any issues involving conflicts of interest. However, the BOD may not dismiss any SSB member without the approval of shareholders and possibly even the regulator. This measure is meant to protect SSB members from improper BOD influence. In consultation with the SSB, the BOD should approve all *sharīʻah*-related policies and ensure their implementation. It must also guarantee that proper mechanisms are in place to escalate objective *sharīʻah*-related reports to it in a timely fashion, and that employees not only understand their duty towards *sharīʻah* compliance, but can also communicate their *sharīʻah* concerns without fear of losing their jobs.[133]

Senior management are also responsible for robust internal *sharīʻah* governance, as they implement policies and strategies and perform functions mandated by the BOD.[134] They are also liable for ensuring that the Islamic bank's internal *sharīʻah* governance arrangements instituted by the BOD are implemented through processes and systems, proper delegation of

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[130] AAOIFI, Governance Standard for Islamic Financial Institutions No. 6, 51–62; Central Bank of Oman, "Islamic Banking Regulatory Framework," General Obligations of Governance, 7; Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions," http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf (accessed January 21, 2014). 10.

[131] AAOIFI, Governance Standard for Islamic Financial Institutions No. 4, 32–35.

[132] Ibid., Governance Standard for Islamic Financial Institutions No. 6, 59.

[133] Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions," 7.

[134] AAOIFI, Governance Standard for Islamic Financial Institutions No. 1, 6.

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responsibilities to qualified individuals, sufficient allocation of financial and human resources to *sharī'ah* compliance, and the establishment of an organizational structure that determines lines of authority and accountability. Besides ensuring that these arrangements operate efficiently and effectively, senior management are responsible for cultivating a *sharī'ah*-compliant culture within the organization, setting such compliance as an overarching requisite for all policies, procedures, and activities, ensuring that employees are familiar with *sharī'ah* requirements, and providing key stakeholders with ongoing *sharī'ah* risk training.[135] Management must verify that *sharī'ah* policies and procedures are accessible, updated, and implemented. It is also their duty to provide accurate, detailed, and timely disclosure to the SSB and *sharī'ah* auditors, refer *sharī'ah* inquiries and issues to the SSB, verify that SSB directives are carried out, and follow protocol if non-compliant activity is discovered.[136] In the event that they spot *sharī'ah* non-compliant activity, management is to notify the internal *sharī'ah* auditor, stop conducting such activity, remedy the situation by following the instructions of the internal *sharī'ah* auditor and/or the SSB, and ensure that appropriate measures are taken for the mistake not to be repeated.[137] Finally, management is responsible for following up on concerns and recommendations expressed by supervisory authorities, the SSB, internal, external, and *sharī'ah* auditors.

***Sharī'ah* Reporting**	**Internal *Sharī'ah* Audit Function**	**External *Sharī'ah* Audit**	**Internal *Sharī'ah* Control**
Monitoring the *sharī'ah* reporting process and determining its adequacy	Overseeing the effectiveness and efficiency of the internal *sharī'ah* audit function	Endorsing criteria for the appointment of an external *sharī'ah* audit firm	Understanding *sharī'ah* risks that the bank is currently or may be exposed to and the implications of these risks for the institution and the industry in the short and long term
Verifying the objectivity and integrity of *sharī'ah* reports	Approving the function's line of reporting, ensuring that it is not undermined, and establishing that conflicts of interests are resolved	Recommending to the BOD the appointment of an external *sharī'ah* audit firm, as well as costs involved	Overseeing the development, by management, of an effective and efficient internal *sharī'ah* control system, *sharī'ah* risk management processes, and *sharī'ah* governance policies and measures that are commensurate with the needs of the bank and in line with laws, regulations, and best practices

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[135] Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions," 12–14.
[136] Ibid.
[137] Central Bank of Oman, "Islamic Banking Regulatory Framework," General Obligations of Governance, 18–19.

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***Sharīʿah* Reporting**	**Internal *Sharīʿah* Audit Function**	**External *Sharīʿah* Audit**	**Internal *Sharīʿah* Control**
Periodically reporting progress and findings to the BOD	Approving the function's charter and code of ethics, which at a minimum should include *sharīʿah* foundations, principles (faith-driven conduct, professional competence and diligence, trustworthiness, religious legitimacy, objectivity, and professional conduct and technical standards) and rules outlined in AAOIFI's code of ethics for accountants and auditors of Islamic Financial Institutions	Approving the external *sharīʿah* audit firm's engagement letter, scope of work, and fees involved	Challenging management on proposed policies, procedures, and controls
Overseeing the development of *sharīʿah*-compliant accounting policies and practices by management in line with laws, regulations, and best practices, and ensuring that new standards and policies receive appropriate deliberation from a *sharīʿah* perspective	Approving the function's strategic and annual plan including its scope, budget, etc.	Ensuring that a direct channel of communication exists between the firm and the BOD	Discussing the internal *sharīʿah* control system with management on an ongoing basis
Inspecting adequacy of internal channels for (a) reporting *sharīʿah* concerns and violations to the internal *sharīʿah* audit function or the audit and governance committee or the SSB or banking supervisors, (b) responding to customers' *sharīʿah* inquiries and complaints	Reviewing *sharīʿah* reports submitted by the internal *sharīʿah* audit function as well as those furnished by banking supervisors and management's responses and discussing their findings with relevant parties	Ensuring that the external *sharīʿah* audit firm's independence is not in any way compromised and that appropriate measures are in place to protect it	

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Sharī'ah Reporting	Internal *Sharī'ah* Audit Function	External *Sharī'ah* Audit	Internal *Sharī'ah* Control
	Examining and discussing actions included in the remedial plan proposed by management to address internal *sharī'ah* audit findings as well as banking supervisors' concerns and approving or recommending them to the BOD	Evaluating the performance of the external *sharī'ah* audit firm and recommending to the BOD re-appointment or removal in light of findings	
	Verifying that actions set out in the remedial plan are implemented within the scheduled time frame	Establishing a policy for engaging the external *sharī'ah* audit firm in non-audit responsibilities and ensuring that it is observed	
	Ensuring that healthy lines of communication exist between the function and senior management, the SSB, external *sharī'ah* auditors, banking supervisors, and the BOD	Considering written representations required by the external *sharī'ah* audit firm from management indicating that the latter fulfilled their responsibilities in ensuring *sharī'ah* compliance; put in place necessary *sharī'ah* controls; complied with supervisory *sharī'ah* guidelines, AAOIFI *sharī'ah* standards, *sharī'ah* supervisory board *fatawa*, and any other guidelines; disclosed to auditors deficiencies in the internal *sharī'ah* control system and all *sharī'ah* non-compliance instances; and provided relevant and complete *sharī'ah* information and unrestricted access to personnel for obtaining audit evidence	

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***Sharīʻah* Reporting**	**Internal *Sharīʻah* Audit Function**	**External *Sharīʻah* Audit**	**Internal *Sharīʻah* Control**
	Conducting or approving specific *sharīʻah* investigations	Reviewing and discussing with relevant parties weaknesses and concerns arising from findings of the external *sharīʻah* audit firm and the *sharīʻah* supervisory board	
	Suggesting to the BOD the qualifications of the Head and staff of the internal *sharīʻah* audit function as well as the remuneration scheme	Evaluating management's responses to address external *sharīʻah* audit findings and examining, discussing, and approving or recommending to the BOD remedial plans proposed	
	Nominating a Head for the internal *sharīʻah* audit function, appraising the individual's performance on a yearly basis, and recommending re-appointment or replacement	Establishing that actions set out in the remedial plan are implemented within the scheduled time frame and periodically reporting progress to supervisory authorities	
	Examining *sharīʻah* supervisory board-related matters including nomination, appointment, resignation, dismissal, re-appointment, performance evaluation, and compensation, and making recommendations in light of findings to the BOD		
	Ensuring that staff advance their *sharīʻah* and technical expertise via training programs		
	Establishing compliance with AAOIFI's Governance Standard for Islamic Financial Institutions No. 3		

TABLE 2.3 *Sharīʻah* responsibilities of the audit and governance committee

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Appendix 2.1: Operational Risk – Loss Event Types

- **Internal fraud:** Losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/discrimination events, which involve at least one internal party. Examples include: Transactions not reported (intentional), Transaction type unauthorised (w/monetary loss), Mismarking of position (intentional), Fraud/credit fraud/worthless deposits, Theft /extortion/embezzlement/robbery, Misappropriation of assets, Malicious destruction of assets, Forgery, Check kiting, Smuggling, Account take-over/impersonation, Tax non-compliance/evasion (willful), Bribes / kickbacks, Insider trading (not on firm's account).
- **External fraud:** Losses due to acts of a type intended to defraud, misappropriate property or circumvent the laws, by a third party. Examples include: Theft/Robbery, Forgery, Check kiting, Hacking damage, Theft of information (w/monetary loss).
- **Employment practices and workplace safety:** Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination events. Examples include: Compensation, benefit, termination issues, Organised labour activity, General liability (slip and fall), Employee health & safety rules events, Workers' compensation, All discrimination types.
- **Clients, products, and business practices:** Losses arising from an unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product. Examples include: Fiduciary breaches/guideline violations, Suitability/disclosure issues (KYC, etc.), Retail consumer disclosure violations, Breach of privacy, Aggressive sales, Account churning, Misuse of confidential information, Lender Liability, Antitrust, Improper trade/market practices, Market manipulation, Insider trading (on firm's account), Unlicensed activity, Money laundering, Product defects (unauthorised), Model errors, Failure to investigate client per guidelines, Exceeding client exposure limits, Disputes over performance of advisory activities.
- **Damage to physical assets:** Losses arising from loss or damage to physical assets from natural disaster or other events. Examples include: Natural disaster losses, Human losses from external sources (terrorism, vandalism).
- **Business disruption and system failures:** Losses arising from disruption of business or system failures. Examples include: Hardware, Software, Telecommunications, Utility outage/disruptions.
- **Execution, delivery, and process management:** Losses from failed transaction processing or process management, from relations with trade counterparties and vendors. Examples include: Miscommunication, Data entry, maintenance or loading error, Missed deadline or responsibility, Model/system misoperation, Accounting error/entity attribution error, Other task misperformance, Delivery failure, Collateral management failure, Reference Data Maintenance, Failed mandatory reporting obligation, Inaccurate external report (loss incurred), Client permissions/disclaimers missing, Legal documents missing/incomplete, Unapproved access given to accounts, Incorrect client records (loss incurred), Negligent loss or damage of client assets, Non-client counterparty misperformance, Miscellaneous non-client counterparty disputes, Outsourcing, Vendor disputes.

Source: BCBS, "Working Paper on the Regulatory Treatment of Operational Risk," (Basel: Bank for International Settlements, 2001), 21–23.

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