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Regulatory Framework of Shari’ah Governance System in Malaysia, GCC Countries and the UK

Zulkifli Hasan*

I. Introduction

Shari’ah governance system as defined by The IFSB Guiding Principles on Shari’ah Governance System in Institutions Offering Islamic Financial Services (IFSB-10) refers to a set of institutional and organizational arrangements to oversee Shari’ah compliance aspects in Islamic Financial Institutions (IFIs). In this regard, majority of IFIs have established their own Shari’ah board and some of them even have set up a dedicated internal Shari’ah review unit or department to support Shari’ah board in performing its function. This indicates a positive development on the aspect of Shari’ah governance system in IFIs. Looking at the different framework and style of Shari’ah governance in various legal environment and diverse banking models, it is worth examining the regulatory framework of Shari’ah governance system in different jurisdictions.

Since the nature of this paper is explorative in character, the study chooses three different jurisdictions namely Malaysia, GCC countries and the UK as the case study. This paper focuses on the regulatory framework of the Shari’ah governance system of these three respective jurisdictions from three different regions as they provide three distinctive models. Uniquely, it is a sine qua non for the significant differences of Shari’ah governance system particularly from the regulatory overview as Malaysia represents model in mixed legal jurisdiction, GCC in Islamic and mixed legal environment and the UK in non-Islamic legal environment. This paper concludes with a brief review of the legal backgrounds and some observations on the Shari’ah governance frameworks of the case countries.

II. Shari’ah Governance Model from Regulatory Perspective

The existing framework of Islamic finance in various jurisdictions demonstrates diverse practices and models of Shari’ah governance system. Some jurisdictions prefer greater
involvement of regulatory authorities and some countries on the other hand favor otherwise. Until now, it is still debatable whether the former or the latter is more prevalent and appropriate for possible adoption. To illustrate these diverse approaches, this study identifies five Shari’ah governance models in the context of regulatory perspective.

2.1 Reactive Approach
This model is more prevalent in non-Islamic legal environment countries such as United Kingdom and Turkey. Although several Islamic banking licenses have been issued to IFIs, the regulatory authority is silent upon the Shari’ah governance framework. Like any other conventional banks, IFIs are required to comply with existing legislations and regulations. On top of that, IFIs have duty to make sure that all their business operation and products are Shari’ah compliant. There is no specific legislation governing IFIs as well as any directive specifying Shari’ah governance framework. At this point, the regulators will only react and intervene the Shari’ah governance matters if there is any significance issue involved which may affect the industry. For instance, the UK Financial Services Authority only concerns on the roles play by the Shari’ah board of IFIs to be advisory and supervisory and not executive in nature.

2.2 Passive Approach
This model is exclusive to Shari’ah governance model in Saudi Arabia. Saudi Authority Monetary Agency (SAMA) treats IFIs equal to their conventional counterparts. SAMA has yet to issue legislation pertaining to Islamic finance and guidelines on Shari’ah governance system. There is no national Shari’ah advisory board or any institutions to be the sole authoritative body in Islamic finance. The existing Shari’ah governance system as practiced by IFIs in the Kingdom is a product of self initiative rather than regulatory requirement or regulator’s direction.

2.3 Minimalist Approach
This model is mainly practiced by the GCC countries with the exception of Oman and Saudi Arabia. Unlike the reactive approach, the minimalist model allows slight intervention on the part of regulatory authorities. The regulatory authorities expect IFIs to have proper Shari’ah governance system without specifying the requirements in details. There is no restriction on multiple appointments of the Shari’ah board to seat in various institutions at one particular time. Some jurisdictions in the GCC countries such as Bahrain, Dubai and Qatar favor the adoption of the AAOIFI Governance Standards. The minimalist approach prefers the market to develop its own Shari’ah governance system rather than greater intervention on the part of regulators.
2.4 Pro-Active Approach
This model is favorable by Malaysian regulatory authority. The proponent of this model has strong faith in regulatory-based approach in strengthening Shari’ah governance framework. With this motivation, Malaysian regulator initiates comprehensive Shari’ah governance framework from regulatory and non-regulatory aspects. There are several laws were passed and amended by the parliament such as the Islamic Banking Act 1983, the Takaful Act 1984, the Banking and Financial Institutions Act 1984 and the Securities Commission Act 1993. The Central Bank of Malaysia Act 2009 confirms the status of National Shari’ah Advisory Council (SAC) to be the sole authoritative body in Islamic finance. Furthermore, the Bank Negara Malaysia (BNM) has issued the Guidelines on the Governance of Shari’ah Committee for the Islamic Financial Institutions known as the BNM/GPS1. To complement this, the Securities Commission of Malaysia issued the Registration of Shari’ah Advisers Guidelines 2009 which setting up the criteria for the registration of a Shari’ah adviser in the capital market sector.

2.5 Interventionist Approach.
While passive approach is exclusive to Saudi Arabia, interventionist model is unique to Shari’ah governance model in Pakistan. The interventionist model allows third party institution to make decision on Shari’ah matters pertaining to Islamic finance. In the case of Pakistan, the Shari’ah Federal Court is the highest authority in matters involving Islamic finance despite of the establishment of Shari’ah board at the State Bank of Pakistan level.

III. Shari’ah Governance System in Malaysia, GCC Countries and the UK

3.1 Malaysia
3.1.1 Regulatory Overview
Malaysia has a very unique legislative framework consisting of mixed jurisdictions and mixed legal systems namely common law and Shari’ah. The common law principles were applied in the civil court in almost matter of jurisdiction. Islamic law in contrast is practiced in Shari’ah court and only pertaining to the family matters and law of inheritance. The Federal Constitution puts Islamic banking matter under the jurisdiction of the civil court. This is due to the fact that Islamic banking is considered as under the item ‘finance’ in the Federal Constitution. As a matter of fact, Central Bank of Malaysia with a cooperation of judicial body has agreed to set up a special High Court in the Commercial Division known as the Muamalah bench. According to Practice Direction No.1/2003, paragraph 2, all cases under the code 22A filed in the High Court of Malaya will be registered and heard in the High Court Commercial Division 4 and this special high Court will only hear cases on Islamic banking.3

3 The implementation of this Muamalat bench shows a positive result on the increasing numbers of
The development of Islamic banking industry in Malaysia involved several phases whereby Phase 1 started in 1983 until 1993 and Second Phase began in 1994. Malaysia has liberalized its policy on the implementation of Islamic finance by allowing foreign entities to set up Islamic banks in the local market. These staggered developments are facilitated and supported by legal infrastructure through several legislations and directives namely the Islamic Banking Act 1983 (IBA), the Takaful Act 1984, the Banking and Financial Institutions Act 1989 (BAFIA), The Central Bank of Malaysia Act 2009 and the Securities Commission Act 1993.

The first Shari’ah board that has been set up was in 1983 by Bank Islam Malaysia Berhad. After 10 years, on 4 March 1993, BNM introduced an interest-free Banking Scheme in which conventional banks may offer Islamic banking products through its windows. With that policy, many conventional banks set up their Islamic windows and at the same time they appoint selected Muslim scholars to be members of the Shari’ah board. As part of the effort to streamline and harmonize the Shari’ah interpretations amongst banks and Takaful companies, the SAC was established on 1st May 1997 under the BAFIA where it is considered as the highest Shari’ah authority pertaining Islamic banking, finance and takaful in Malaysia.

The term Shari’ah committee or Shari’ah supervisory council or Shari’ah advisory council has been used interchangeably in Malaysia. The IBA refers the Shari’ah board as Shari’ah supervisory council and the BAFIA as Shari’ah advisory council. With the issuance of the BNM/GPS1, all Shari’ah board of IFIs and Takaful operators is recognized as Shari’ah Committee (SC) and the SAC is used as a reference to Shari’ah board of the BNM. The establishment of the SC is a statutory requirement to all banks which offer Islamic banking products pursuant to section 3 (5) (b) of the IBA for Islamic banks, section 124 (7) of the BAFIA for Islamic banking scheme bank. The main objective of the establishment of the SC is to advise the Islamic financial institutions on any Shari’ah matter and also to ensure compliance with the Shari’ah tenets and requirements. Section 3 (5)(b) of IBA provides that the BNM shall not recommend the grant of a license, and the Minister shall not grant a license, unless he is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of Shari’ah board.

The prime task of the SC is, in fact to further define, expand and in some cases to limit the scope of Section 2 of the IBA which is left opened for interpretation. In responding to the positive demands of the conventional banks to open Islamic counters, Section 124 (7) of the BAFIA was then introduced which provides for the establishment of the SC to advise the bank relating to Islamic banking business or Islamic financial business. As for Takaful, Section 8 of the Takaful Act 1984 provides that The Director General shall also refuse to register an settled cases. From the statistic, it shows that more than 75% out of 656 cases has been settled by the court from year 2003 to 2005 (Hasan, Z., 2007).
applicant unless he is satisfied (a) that the aims and operations of the Takaful business which it is desired to carry on will not involve any element which is not approved by the Shari‘ah; and (b) that there is in the Articles of Association of the Takaful operator concerned provision for the establishment of a Shari‘ah advisory body, as may be approved by the Director General, to advise an operator on the operations of its Takaful business in order to ensure that it does not involve in any element which is not approved by the Shari‘ah. Apart from institutions under the IBA, the BAFIA and Takaful Act 1984, SC also exists in institutions under the Development Financial Institutions Act 2002. Apart from those legislations, the Central Bank of Malaysia Act 2009 (CBA) plays a major role in term of supervising and monitoring the implementation of Islamic banking.

3.1.2 Shari‘ah Governance

The BNM has issued the BNM/GPS 1 that regulates the governance of SC of Islamic financial institution. Apart from that, the BNM has also issued the Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks known as BNM/GPS8-i. The BNM/GPS1 consists of 10 parts with 24 sections and one appendix. The contents include objectives, scope of application, establishment of the SC, membership, restrictions, duties and responsibilities of the SC and Islamic financial institutions, reporting structure, effective date and secretariat of the SAC. IFIs have to comply with the guideline by 1st April 2005 and the dateline has been extended to a development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) which carries on Islamic Banking Scheme to 1st September 2005.

The objective of BNM/GPS 1 is to set out the rules, regulations and procedures in the establishment of the SC, to define the role, scope of duties and responsibilities of the SC and to define relationship and working arrangement between the SC and the SAC (Section 5). The BNM/GPS1 shall only be applicable to an Islamic bank licensed under the IBA, a financial institution licensed under the BAFIA which participates in the Islamic Banking Scheme, a development financial institution prescribed under the DFIA which carries on Islamic Banking Scheme; and a takaful operator registered under the Takaful Act 1984 (Section 6).

The Bord of Directors (BOD) shall appoint the members of the SC and the tenure shall be valid for a renewable term of two years but subject to the approval of the BNM (Section 8). The member of the SC shall at least either have qualification or possess necessary knowledge, expertise or experience in Islamic jurisprudence or Islamic law of transaction (Section 11). With purpose of mitigating the risk of potential of conflict of interest and confidentiality issues, IFIs are not allowed to appoint any member of the SC in another IFI of the same industry (Section 19).
To ensure that the SC would be able to function effectively, the SC shall at least consisting of a minimum three members in which will be coordination by the Shari’ah secretariat of the respective IFIs (Section 15). The SC members may be disqualified if he fails to meet the requirements or breach of corporate governance such as he has acted in a manner which may cast doubt on his fitness to hold the position, has been failed to attend 75 percent of meetings in a year without reasonable excuse, has been declared a bankrupt, or a petition under bankruptcy laws is filed against him, was found guilty for any serious criminal offence, or any other offence punishable with imprisonment of one year or more, or subject to any order of detention, supervision, restricted residence or banishment (Section 16).

As regard to roles and responsibilities, section 20 provides clear duties and responsibilities of the SC and it includes inter alia to advise the BOD on Shari’ah matters in its business operation, to endorse Shari’ah Compliance Manuals, to endorse and validate relevant documentations, to assist related parties on Shari’ah matters for advice upon request, to advise on matters to be referred to the SAC, to provide written Shari’ah opinion and to assist the SAC on reference for advice. Besides, the IFIs must assist the SC as well as possible in providing sufficient relevant information and these include referring all Shari’ah issues to the SC, to adopt the SC’s advice, to ensure that product documents be validated, to have a Shari’ah Compliance Manual, to provide access to relevant documents, to provide sufficient resources and to remunerate the members of the SC accordingly (Section 21).

The SC is legally required to produce a Shari’ah report expressing their observation on IFIs’ compliance with Shari’ah principles. In this aspect, the Guidelines on Financial Reporting for Licensed Islamic Banks (BNM/GP8-i) specifies minimum requirement of the Shari’ah report. The BNM/GP8-i requires content of the Shari’ah report to be at least declaration of Shari’ah compliance endorsed by the Shari’ah committee members. In term of the reporting structure, the SC will report functionally to the BOD as this reflects the status of the SC as an independent body of the IFIs. The BOD is bound by any decision of the SC and they have to consider the SC’s views on certain issue related with operational matters, policy or business transactions.

The amendment to the Central Bank of Malaysia Act 1958 in 2003 enhances the role of the SAC. Now, the SAC is accorded to be the sole authoritative body on Shari’ah matters pertaining to Islamic finance. The amendment provides that the BNM may establish an advisory council which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, Takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on principles and is

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4 The BNM/GP8-i Shari’ah report’s format is lacking of several important information as compared to the format of the AAOIFI Governance Standard No.1. The AAOIFI requires additional information on the Shari’ah report which contains necessary information on Shari’ah compliance matters such as activities, operations and transactions carried out by IFIs (AAOIFI, 1997).
supervised and regulated by the BNM. The decision made by the SAC nevertheless is only binding upon the arbitration and not the court.

Due to several controversial court cases involving IFIs, with the initiative of the BNM, the CBA was passed in July 2009. Chapter VII section 51-58 specifies the Shari’ah governance framework of the SAC. This new Act confirms the status of the SAC as the highest authority in matters pertaining to Islamic banking, finance and Takaful. In addition, it clarifies the position of Shari’ah pronouncement and the SAC’s deliberation to be binding upon the court as well as arbitration. To demonstrate the significance of the SAC’s authority, the appointment of the SAC members then will be made by the Yang Di Pertuan Agong or the King of Malaysia with the advice of finance minister. This important amendment finally clarifies the status of the Shari’ah ruling to have binding force upon Islamic banking, finance and Takaful matters.

Despite of the recent legal development, it is worth noting that the CBA has jurisdiction to only in matters fall under the auspices of the BNM, so as to exclude the Shari’ah board in the Securities Commission. In August 2009, the Securities Commission of Malaysia issued the Registration of Shari’ah Advisers Guidelines under section 377 of the Capital Markets and Services Act 2007. This Guideline specifically provides rules and procedures for registration of Shari’ah advisers in matters regulated and supervised by the Securities Commission (SC, 2009).

3.2 GCC Countries
The establishment of the GCC countries was done in 26 May 1981, in Abu Dhabi with aims at fostering and furthering cooperation amongst the member states (“The European Community and the Gulf Co-Operation Council,” Arab Law Quarterly, Vol. 2, No. 3, pp. 323–327). The IFIs in GCC region, namely countries in the Arabian Peninsula which are consisting of Saudi Arabia, Kuwait, Bahrain, Qatar and the United Arab Emirates except the Sultanate of Oman have their own framework of Shari’ah governance system. The monetary agencies or financial authorities are responsible for the regulation and supervision of the IFIs including in the matter of Shari’ah governance.

It is relatively imperative to understand the legal background of the GCC countries particularly to the application of Islamic law or Shari’ah in their judicial system before

5 Previously, the establishment of IFIs in the Gulf States is done by Decree from the Ruler. For instance the Dubai Islamic Bank by the Decree from the Ruler of Dubai in 1975, the Kuwait Finance House by the Decree No. 72/1977 from the Emir of Kuwait, the Bahrain Islamic Bank by the Decree No. 2/1979 from the Emir of Bahrain, the Masraf Qatar al-Islami by the Decree No. 45/1982 and the Qatar International Islamic Bank by the Decree No. 52/1990 from the Emir of Qatar. The UAE was the first Gulf State that introduced specific law to govern the establishment of IFIs in its Law No. 6 of 1985 (Al-Suwaidi, 1993: 300).

6 There are few corporate governance codes or regulations have already been in place such as the Corporate Governance Regulations (2006) of Saudi Arabia, the ADM Corporate Governance Code (2006), ESCA Corporate Governance Regulation (2007), ADSM Corporate Governance Listing Rules (2006) of the UAE, the Corporate Governance Code for Listed Companies of Bahrain. These codes however do not specifically tackle the issue of Shari’ah governance in IFIs.
discussing their Shari’ah governance framework.7 With the fact that not all GCC countries’ constitution prescribed that Shari’ah as the source of legislation, there is issue as to what extent Shari’ah applies or could apply particularly in relation to Islamic finance.8 At this point, this subsection is not only discussed laws and regulation pertaining to Shari’ah governance in the GCC but also to provide some basic information on their legal backgrounds. The study explores the application of Shari’ah and tries to relate it with the implementation of Islamic finance in the GCC jurisdictions.

Generally, the Shari’ah governance approach in the GCC can be classified into two i.e. either it is regulated via legal and supervisory requirements as in the case of Bahrain, Kuwait, UAE and Qatar or through self regulation such as in the case of Saudi Arabia. This study excludes Oman as one of the case countries in the GCC region since the government of Oman has resisted implementing the Shari’ah-compliant banking for political reasons.9 The Central Bank of Oman has reiterated its rejection of Shari’ah-compliant banking due to its policy of allowing only universal bank and less demand as compared to its conventional counterpart (MEED, 2007).10 This section 5.2.2 presents the diverse Shari’ah governance system amongst the GCC countries and therefore enables the study to highlight and identify essential issues that would be useful for further analysis.

3.2.1 Bahrain

3.2.1.1 Regulatory Overview

Bahrain was exposed to the English system more as compared to other GCC countries (Al-Suwaidi, 1993: 292–293). However, after independence in 1971, Bahrain has developed several substantive and procedural laws and at the same time put Shari’ah as a main source of legislation as stated in the Article 2 of the Constitution of Bahrain. This position creates difficulties for commercial sectors particularly financial institutions because the interest-based

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7 Prior to 1961, majority of the Gulf States except Saudi Arabia were put under the extra-territorial jurisdiction of British Crown. After independence, Kuwait in 1961, Oman in 1971, Bahrain, the UAE and Qatar in 1971, all of them have developed their own codified legal system (Al-Suwaidi, 1993: 289-301). On the other hand, Saudi Arabia has never fallen under the extra-territorial jurisdiction of British and therefore less influence by the common law.

8 The Constitution of Kuwait, Bahrain and the United Arab Emirates clearly states that Shari’ah is a source of legislation, Qatar’s constitution is silent on this position and Saudi Arabia has no written constitution but vividly adhere to al-Quran and al-Sunnah as its only constitution.

9 Perhaps, the situation will be different in the future as the first company in Oman namely Sohar Alumunium has raised USD260 million for the first Greenfield aluminium smelter project via Citi Islamic Investment Bank in Dubai. This indicates positive interest in Oman on Islamic finance (Alam, 2006).

10 These two set of justifications of not having Islamic finance indicate the failure of the Oman authority to appreciate the very reason for the existence of Islamic finance. The Islamic finance is not only concern with the market demand or material in nature but it concerns more on the fundamental aspect of Shari’ah. Unfortunately, as of to-date, Oman is the only state in the GCC countries that does not permit Shari’ah-compliant banking activities.
transactions would have been declared illegal. In view of this, Bahrain developed its own laws such as the Law of Civil and Commercial Procedure of 1971, the Law on the Establishment of the Bahrain Monetary Agency of 1973, the Companies Registration Act of 1983 and the Commercial Law of 1987 which are based mainly on the Egyptian code. Article 76 of the Commercial Law of 1987 clearly allows interest charges in commercial loan but subject to the rate determined by the Bahrain Monetary Agency (Al-Suwaidi, 1993: 292). As such, the Civil Court of Bahrain has comprehensive jurisdiction over civil and commercial matters except those relating to *Shari‘ah* disputes.\(^\text{11}\)

With reference to Islamic finance industry, Bahrain is known as one of the leading players of Islamic finance. Besides initiating the establishment of Bahrain-based Liquidity Management Centre, Bahrain also hosts two international institutions for Islamic finance namely the AAOIFI and the International Islamic Financial Market (IIFM). The Central Bank of Bahrain (CBB) is the sole regulator of financial sector. The CBB is responsible for regulating and supervising all financial institutions, insurance sector as well as capital markets. There are five main legislations which governed the financial system of Bahrain namely the Central Bank of Bahrain and Financial Institutions Law 2006, the Bahrain Stock Exchange Law 1987, the Commercial Companies Law 2001, The Anti Money Laundering Law 2001 and the Financial Trust Law 2006. The legal provision for the implementation of Islamic finance in Bahrain is provided in the CBB Rule Book Volume 2, Islamic Banks.

3.2.1.2 *Shari‘ah* Governance

The CBB Rule Book Volume 2, Islamic Banks, Part A, High Level Control, section 1.3.15 provides that the CBB requires all banks to establish an independent *Shari‘ah* board complying with AAOIFI’s governance standards for IFIs No. 1 and No.2. This section provides a clear legal requirement for the establishment of the *Shari‘ah* board in IFIs in Bahrain in which failure to do that will constitute non-compliance with the CBB’s directive.

Unlike the other GCC countries, Bahrain has established National *Shari‘ah* Advisory Board of the CBB with purpose to serve and to verify the *Shari‘ah* compliance (Hasan, A., 2007). *Shari‘ah* board of the CBB nevertheless is different with the other national *Shari‘ah* board as in the case of Malaysia, Sudan, Indonesia, Pakistan and Brunei as it does not have authority upon the other IFIs. As regard to the *Shari‘ah* governance system, Bahrain follows the AAOIFI governance standards where it requires all IFIs to establish *Shari‘ah* Supervisory board. Section 1.3.16 of the CBB Rule Book requires IFIs to adopt the standards as well as having a separate function of *Shari‘ah* review for a purpose of ensuring *Shari‘ah* compliance.
as stipulated in the standards No.3. To address this issue, the practice of the IFIs shows that the Shari’ah review or audit is carried out by the existing internal audit personnel. This legal requirement for the adoption of the standards reflects the role of Bahrain as the host of the AAOIFI since its establishment in 2001.

3.2.2 United Arab Emirates

3.2.2.1 Regulatory Overview

On 2nd December 1970 seven Emirates decided to forms a federal union consisting of Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al-Quwain, Al Fujairah and Ras Al-Khaima known as United Arab Emirates (UAE). After independent in 1971, the government passed the UAE Provisional Constitution of 1971 with aim at preserving the internal autonomy of the seven emirates (Al-Muhairi, 1996). In the meantime, article 7 of the UAE Constitution recognized Shari’ah as a main source of legislation and the religion of the state is Islam.\(^\text{12}\) In addition article 75 of the Federal Law No. 10/1973 provides that the Supreme Court of the UAE shall apply the provision of Islamic law.\(^\text{13}\) In term of banking and finance sectors, the Union Law No. (10) Of 1980 Concerning the Central Bank, the Monetary System and Organization of Banking is the main governing law for the financial sector in the UAE. This legislation grants power to the Central Bank of the UAE to regulate and supervise the financial institutions.

At the beginning of financial regulation development of the UAE, any kinds of interest in respect of civil transactions are prohibited by virtue of article 714 of Federal Law No. 5 of 1985. This provision implicates the interest-based transaction to be void and unenforceable. Only in 1987, the Civil Transactions Law was amended by Federal Law No. 1 which excluded commercial transactions from being governed by the civil transactions law and finally, the Federal Law No. 11 of 1992 invalidated all previous laws with respect to the interest prohibition. As a result, the charging of interest in commercial transaction is then permissible in the UAE.\(^\text{14}\) The Federal Law No. 18 of 1993 grants the bank’s right to charge interest in respect of a commercial loan as per the agreed rate in the contract (Tamimi, 2002: 51).\(^\text{15}\)

\(^{12}\) There are two views on the interpretation of the article 7 of the UAE Constitution. The Islamist tends to interpret that Shari’ah shall be the supreme law and above all of other laws while the Liberalist places Shari’ah on an equal footing with other laws. The practice however shows different situation where Shari’ah rules are made obligatory in criminal cases and not strictly applicable in commercial matters especially in relation to banking and finance disputes (Al-Muhairi, 1996: 219–244).

\(^{13}\) Article 75 of the Federal Law No. 10/1973 provides that “the Supreme Court shall apply the provisions of the Shari’ah, Federal Laws and other laws in force in the member Emirates of the Union, conforming to the Islamic Shari’ah. Likewise it shall apply those rules of custom and those principles of natural and comparative laws which do not conflict with the principle of the Shari’ah”.

\(^{14}\) This was affirmed by the Constitutional Division Bench of the Supreme Court in the case of No. 14, Year 9 (June 1981). The Supreme Court held that articles 61 and 62 of the Civil Procedure Law of Abu Dhabi No. 3/1970 concerning interest charges were unaffected by the article 7 of the Constitution since they were in existence before the application of the Constitution dated 2 December 1971 (Al-Suwaidi, 1993: 293).

\(^{15}\) See Article 61 and 62 of the Civil Court Procedures Law of Abu Dhabi as amended by Law No. 3 and
position was taken in view of the necessity or Dharuriyah for the economic stability and the needs of the people. Moreover, during this time, the implementation of Islamic finance in the UAE is still at its infancy stage and could not meet the needs of the market.\(^\text{16}\) The Civil Court has jurisdictions in banking matters and any financial transactions in which a bank is involved so that any consideration of the legality of interest would fall under its jurisdiction (Ballantyne, 1985: 14).

Despite of the above, the UAE at the same time makes numerous efforts to promote the Islamic finance where Dubai is leading the way as a centre for its Islamic finance. In 1985, the UAE government has passed specific law in relation to Islamic finance in the name of the Federal Law No. 6 of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies. Article 1 of this Federal Law requires the IFIs to conduct business in accordance with Shari’ah which shall be stated in the articles and memorandum of associations.

Dubai presents a unique position in comparison with other parts of the UAE. The UAE authority has passed separate law with the Federal Law No. 6 of 1985 known as the Dubai International Financial Centre Law No. 13 of 2004 and the Islamic Financial Business Module of the Dubai Financial Services Authority which provide legal framework for law regulating Islamic financial business as well as regulation on the Shari’ah board. The DIFC Law No 13 leads to the establishment of the DIFC which enjoys certain privilege and economic incentive from the government.\(^\text{17}\) All institutions and corporate entities under the jurisdiction of the DIFC are governed by the DIFC Law and subjected to the DIFC Court and the DIFC Arbitration Centre.

3.2.2.2 Shari’ah Governance

The Shari’ah governance system in the UAE except Dubai is governed by the Federal Law No. 6 of 1985. Article 5 of the Federal Law No. 6 of 1985 requires the establishment of “Higher Shari’ah Authority” under the Ministry of Justice and Islamic Affairs to supervise Islamic banks, financial institutions and investment companies and to provide Shari’ah opinion on matters pertaining to Islamic banking and finance. This article 5 clearly states the position

\(^\text{16}\) This was confirmed by the Constitutional Department of the Federal Supreme Court of Dhabi in its interpretation Decision No. 14/9 issues on 28 June 1981 (Tamimi, 2002: 50-51).

\(^\text{17}\) DIFC is a financial free zone established in the UAE by Federal Decree Number 35 for the year 2004. IFIs registered under the DIFC enjoys privilege of 100 percent foreign ownership (normal companies in the UAE must have at least 51 percent of the company’s shares owned by UAE national), zero percent tax rate on income and profits, the freedom to repatriate capital and profits without restrictions, internationally accepted laws and regulatory processes and so on and so forth (Al Tamimy & Co., 2008: 6–7). Article 3 (3) provides the establishment of three centers under the DIFC namely the DIFC Authority, the DIFC Services Authority and the DIFC Judicial Authority.
of the Higher Shari‘ah Authority to be binding. Besides Higher Shari‘ah Authority which is government established body, it is worth mentioning here that Shari‘ah scholars in the UAE have voluntarily initiated the establishment of a central committee of the Shari‘ah supervisory board for purpose of harmonization and standardization of Shari‘ah practice (Humayon, 2009). This voluntary arrangement at least would be able to assure consistency of Shari‘ah rulings.

In term of composition of the Shari‘ah board, article 6 requires all IFIs to clearly stipulate the establishment of the Shari‘ah board in the articles and memorandum of association. This provision further puts a condition of a minimum of three members. The articles and memorandum of association must contain manner and governance of the Shari‘ah board such as its duties, responsibilities, functions and appointment. In the aspect of appointment, the Shari‘ah advisors of the Higher Shari‘ah Authority are appointed by the government and at the individual IFI level by the BOD or the AGM. The IFIs cannot simply appoint their Shari‘ah board members but they are required to submit the proposed names of the Shari‘ah advisors to the Higher Shari‘ah Authority for approval.

With respect to IFIs that registered under the DIFC, they have to comply with the DIFC law and regulations particularly the Law Regulating Islamic Financial Business DIFC Law No.13 of 2004 and the DIFC Services Authority (DFSA) Rulebook on Islamic Financial Business Module (ISF). As a general requirement, the DFSA requires IFIs to adopt the AAOIFI Governance Standards to ensure consistency and compliance with the Shari‘ah (Praesidium and DIFC, 2007: 40–44). In the aspect of Shari‘ah governance, section 13 of the law requires IFIs to establish Shari‘ah board and the DFSA has the power to make rules prescribing its appointment, formation, conduct and operation. In this instance the ISF specify the requirements of Shari‘ah governance system of DIFC.

Section 5.1.1 of the ISF requires the composition of Shari‘ah board to be at least of three members who are competent to perform their functions. The ISF does not specify the appropriate body for the appointment of Shari‘ah board, it only states that appointment shall be made by the governing body of the IFIs. The practice indicates that some of the appointments are made by the AGM and some of them by the BOD. The ISF restricts the Shari‘ah board members to be director or controller of IFIs that they serve for purpose of avoiding conflict of interest.

While section 5.1.1 deals the issue of appointment, composition and restriction pertaining to the Shari‘ah board, section 5.1.2 addresses the issue of transparency and disclosures where it requires the IFIs to document its policy in relation to appointments, dismissals or changes, the process and qualification and the remuneration of the members of the Shari‘ah board. In this aspect, the IFIs are required to maintain 6 years record of its assessment of the competency of Shari‘ah board members and the agreed term of
reference for each of them. In dealing with the issue of conflict of interest, the IFIs must have mechanism in the form of policy and procedures to manage any potential conflict of interest of the Shari‘ah board. Besides, the IFIs shall also provide reasonable assistance to the Shari‘ah board in the aspect of right of access to relevant records and information and shall not at all times to provide misleading information and to interfere with the Shari‘ah board’s ability to perform its duties.

Section 5.2 and 5.3 of the ISF clearly stipulate the requirement to adopt the AAOIFI Governance Standards where the IFIs are obliged to produce Shari‘ah annual report which must be submitted to the DFSA. Section 5.3 further requires the IFIs to conduct internal Shari‘ah review in accordance with the AAOIFI Governance Standards No. 3. In this aspect, the IFIs must ensure that the internal Shari‘ah review is performed by the internal audit function or the compliance function either part of the existing internal audit or compliance department or independent internal Shari‘ah audit department of the IFIs. The IFIs must also ensure that the internal Shari‘ah review is conducted by competent and sufficiently independent body to assess compliance with Shari‘ah.

3.2.3 Kuwait
3.2.3.1 Regulatory Overview
The legal system of Kuwait is based on French and Egyptian models particularly to its commercial code such as the Commercial Companies Law of 1980 and the Commercial Code of 1981 (Gerald, 1991: 322). Article 2 of the constitution of Kuwait vividly put Shari‘ah as a main source of legislation and Islam as the official religion. This can be evidenced in article 547 of the Civil Law Code of Kuwait of 1981 where this code prohibited the practice of charging interest on loans and article 305 which declares such transaction to be void. Nevertheless, within the same year the Kuwait Authority issued a specific legislation to exclude the commercial transaction from the application of the code (Ballantyne, 1985: 5). As a result of the issuance of the Commercial Code of 1981, interest charge on loans by financial institutions is expressly permissible (Ballantyne, 1987: 12–28).

The principal ministerial authority for enforcement of commercial laws is the Ministry of Commerce and Industry and the Central Bank is the sole regulator for monetary financial system in the State of Kuwait. The Central Bank of Kuwait Law No. 32 of 1968 (CBK Law)

18 The original Commercial Code of Kuwait 1961 was drafted by Al-Sanhouri, an Egyptian jurist which was contained more principle of western secular law than of the Shari‘ah (Ballantyne, 1988: 317–328).
19 Al-Moqatei (1989: 138–148) views that Kuwait is considered as the leader among the Gulf state in returning to Islam through the adoption of some Islamic laws in the form of legislations since 1980s.
20 Article 102 of the Commercial Code provides that the creditor has the right to interest in accordance with the terms of contract and if in the absence of specified contract, the interest shall not exceed 7 percent and if the debtor delays in payment the interest then shall be calculated on the agreed basis rate. In addition, article 115 further states that interest shall not be paid for a frozen interest.
amended by Law 130/1977 is the governing legislation that provide regulatory framework for currency, grant authority to the Central Bank of Kuwait to supervise the financial institutions and matters on the organization of banking business. This requires the financial institutions to strictly comply with Commercial Code and Commercial Companies law (Al-Suwaidi, 1993: 291–292). The judicial system of Kuwait puts the civil court to have jurisdiction over commercial matters and this includes banking and finance disputes.

As regard to Islamic finance, section 10 of the CBK Law (Article 86–100) addresses the legal provision pertaining to the rules and controls of IFIs. Article 86 states that the CBK is responsible to regulate and control the activities of IFIs. The definition of Islamic bank in general can be found in article 86 of the CBK Law which considers Islamic bank as a business entity that exercises the activities pertaining to banking business which should be complied with the Shari’ah principles. This general and wide provision on the activities of Islamic banks without defining every single contract in Islamic law of transactions creates flexibility to IFIs in relation with the Islamic financial services and products in Kuwait.

3.2.3.2 Shari’ah Governance
The Shari’ah governance practice in Kuwait is regulated by virtue of article 93 of the CBK Law which provides a legal basis for the regulations of the Shari’ah board. Article 93 requires all IFIs to establish an independent Shari’ah board which shall be appointed by the bank’s General Assembly. Unlike the other Shari’ah governance approaches which allow the appointment of Shari’ah board by the BOD, this article 93 specifically requires the appointment to be made only by the General Assembly. In term of the composition, the CBL Law puts a condition of a minimum of three members and this requirement is similar with the AAOIFI governance standard as well as Shari’ah governance system in Bahrain and the UAE. The IFIs are also required to mention the establishment of the Shari’ah board in their articles and memorandum of association and both documents must specify the powers, workings and governance of the Shari’ah board.

There is no Shari’ah board in the CBK to act as the highest Shari’ah authority in Islamic banking and finance. This may raise an issue of dispute settlement in case of conflict of opinions amongst members of the Shari’ah board. To address this issue the CBK Law recognizes the Fatwa Board in the Ministry of Awqaf and Islamic Affairs as the final authority for any Shari’ah dispute involving Islamic banking and business. The BOD of the IFIs has responsibility to refer the dispute to the Fatwa Board. The CBK Law nevertheless is silent about the status of decision of the Fatwa Board in which it should be made binding to all IFIs. Interestingly, article 100 of the CBK Law clearly provides the supremacy of Islamic law where it states that IFIs shall be subject to the provision of the CBK Law but subject to the Islamic Shari’ah principles. This is a strong legal proviso which placed Shari’ah as the
supreme law in relation with Islamic banking and finance in Kuwait.

As regard to the reporting structure, the Shari’ah board has duty to submit a Shari’ah report to the bank’s General Assembly since they are also appointed by the AGM. The CBK Law specifies the content of Shari’ah report to contain the Shari’ah opinion on the bank’s operation in term of Shari’ah compliance including comments and views upon the Shari’ah issues. This Shari’ah report must be included in the IFIs’ annual report.

3.2.4 Saudi Arabia
3.2.4.1 Regulatory Overview
The history of banking systems in Saudi Arabia began since in the 20th century with the first commercial bank under the name of Dutch Commercial Company which was established in 1926 (Hamed, 1979: 167). As a general overview, Banking and Finance in Saudi Arabia is controlled by the Saudi Arab Monetary Agency (SAMA) established by Royal Decree M/23 of 23.05.1377 on 15 December 1957 which functions under the Banking Control Law 1966 as amended by Decree 2/ 1391 (Pepper, 1992). Shari’ah is a main source legislation of Saudi Arabia where the Shari’ah court is the highest body in the judicial system.21 Commercial matters however are put under the jurisdiction of commercial court which is more like a commercial council set up by Order 32/1350 1931 (Pepper, 1992). Only until 1970s, the emergence of IFIs began when the Islamic Development Bank was established in Jeddah in 1974 followed by the Islamic Dar al-Mal al-Islami Company, the Faisal Islamic Bank and the Al Baraka Banking group. It is important to note that all of IFIs in Saudi Arabia are not supervised by the Saudi Arab Monetary Agency (SAMA) but they are monitored and organized as commercial companies by the Saudi Ministry of Commerce (Al Sayed, 2005: 302).

The development of Islamic finance in Saudi Arabia is considered as unique and distinctive.22 The legal framework of financial system is governed by the Banks Control System by virtue of royal decree No. 5 on 12th June 1966 and this law is silent on the issue of usury or interest.23 As a result, majority of the financial institutions have been conducting business in the conventional banking manner.24 For instance article 8 and 9 considers money

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21 Although Shari’ah is considered as the main source of legislation, the other source of law such as customary law, world case law and doctrine and jurisprudence are also acceptable (Ballantyne, 1986: 13–14). In the case of Aramco Arbitration, Saudi Arabia v Arabian American Oil Company [1958] 27 ILR 117, the arbitrator affirms that the proper law of the Concession Agreement was Islamic law but it is necessary to refer to other laws in order to fill lacunae in the existing legal frameworks.

22 Unlike the other GCC Countries, Saudi Arabia does not have written constitution since al-Quran and al-Sunnah are considered as its constitution. The administrative structure of Saudi Arabia was established by the Organic Instructions of the Hijazi Kingdom 1926 which is supplemented by the Statute of the Council of Deputies of 1932 and the Constitution of the Council of Ministers 1958 (Pepper, 1992).

23 See (Sfeir, 1988: 729–759).

24 Despite there is no specific regulation to penalize the financial institution that involves in interest-
lending as perfectly legitimate. Despite the Banks Control System 1966, the legal system of Saudi Arabia is actually based on Islamic law. This position puts the IFIs in Saudi Arabia to operate under strange legal framework since the existing law of the Bank Control System 1966 still applicable and it has not been repealed or amended to regulate the establishment and the existence of the IFIs. This is supported by a statement made by Al Sayari (2004) where he mentions that as of 2004 there is no law has been passed by the Saudi authority and not even a single Islamic banking license was granted from the SAMA to any companies in Saudi Arabia. Despite of the Capital Market Laws of 2003, 15 Sukuk issuances in 2000–2008 and huge Islamic mutual funds in the Kingdom, there is no single legislation specifically regulating the implementation of Islamic finance (Wilson, 2009).

As regard to banking disputes, the SAMA has set up specific institution in October 1987 to hear cases pertaining to banking matters including Islamic finance known as the Banking Disputes Committee (BDC). The establishment of the BDC is governed by the BDC Regulations. With purpose to give exclusive jurisdiction to the BDC, another Resolution of the Council of Ministers No. 732/8 of 10.07.1407 (10 March 1987) have been issued via Circular of the Minister of Justice No. 12/138T of 28.07.1407 (28 March 1987) which specifically instructed the Shari’ah court to not to hear any more banking disputes (Reumann, 1995: 230–237). Until to-date, the banking disputes in Saudi Arabia are heard in the BDC and not in the Shari’ah court as practiced in pre-1987.

3.2.4.2 Shari’ah Governance

Since there is lacuna in the regulatory framework pertaining to Islamic finance in Saudi Arabia, the nature of Shari’ah governance system is different with other jurisdictions. The notion of having Shari’ah governance system within the IFIs is not due to any legal and supervisory requirements but rather as a voluntary initiative and indirect influence from the market. In other words, the Shari’ah governance model in Saudi Arabia is much more based on self-regulated approach. As an illustration to the Shari’ah governance system in Saudi based transaction, any claims for interest however are not enforceable. Interestingly in Saudi, the religious sentiment is so strong in which it is reported that deposit attracting interest in 1988 only reached at 49 percent. As compared to Bahrain it reached 80 percent and Kuwait 85 percent in the same year respectively. This illustrates a natural antipathy and awareness on the prohibition of interest is significantly strong amongst Saudi people (Reumann, 1995: 218–219). More recent study by Ernst and Young in 2008 reported that between 70–90 percent of Saudi Arabian mass affluent investors prefer Shari’ah investment products over conventional products (Hamedanchi and Altenbach, 2009: 58–61).

25 The situation is expected to be different as the SAMA has consulted a group of consultants, legal and banking specialist or steering committee to study the feasibility of Islamic finance in Saudi Arabia and hence to provide the required legal framework (Al Sayari, 2004).

26 It is worth noting that the Shari’ah governance system in Saudi Arabia must take into consideration of the influence of other Shari’ah scholars who are even not sitting in any Shari’ah board of the IFIs. For instance if a negative Fatwa is issued by Sheikh Al-Mani’a on certain Islamic banking product, it would be very difficult to sell the products in the market (Selvam, 2008: 12–14).
Arabia, it would be beneficial to refer to Al-Rajhi model. The 11th General Assembly of the Al-Rajhi has established *Shari’ah* board and its charter. The provision of the establishment of the *Shari’ah* board was clearly stipulated in the articles of association as well as Al-Rajhi internal rules and guidelines. The *Shari’ah* board of Al-Rajhi is deemed to be independent of all organ of governance such as the management and BOD since the appointment is made by the AGM.

Al-Rajhi *Shari’ah* board plays four major roles to ensure and promote the *Shari’ah* compliance. Firstly, the *Shari’ah* board shall monitor the activities and the implementation of *Shari’ah* rulings with the assistance of the *Shari’ah* Control Department. Secondly, the *Shari’ah* board also has to assist the bank to develop product by applying any *Shari’ah* contract instrument that would be acceptable to local and international markets. Thirdly, the *Shari’ah* board shall promote and create an awareness of Islamic finance both to the internal and external parties. At this point, the *Shari’ah* board is required to develop the necessary information and communications for implementing the roles of the *Shari’ah* board. Finally and the most interesting job description of the Al-Rajhi *Shari’ah* board is to ensure the proper selection of the employees particularly at the top management level. Unlike the other *Shari’ah* boards, the Al-Rajhi has granted authority to the *Shari’ah* board to assist in the process of selecting employees who have capacity and well qualified to implement the Islamic banking practice (Al-Rajhi, 2009).

There are three main specific organs that support the function of *Shari’ah* board namely its secretariat, *Shari’ah* Control Department and Control and Information Unit.27 The secretariat deals with the *Shari’ah* board meeting and its operative procedures. The *Shari’ah* control department assists the *Shari’ah* board in performing the *Shari’ah* review functions while the Control and Information unit specifically provides information and creates awareness to promote *Shari’ah* compliance (Al-Rajhi, 2009). Besides that, the Al-Rajhi has even gone further to develop its own *Shari’ah* governance arrangement by setting up an Executive Committee to oversee the functions of the *Shari’ah* Control Department, to appoint *Shari’ah* controllers and to study issues submitted to the *Shari’ah* board. The committee consists of three members, two of them are the *Shari’ah* board members (one of them is a committee chairman) and the third is the General Secretary of the *Shari’ah* board. This Executive Committee will then have to submit its reports to the *Shari’ah* board.

Since there is no standard guideline of *Shari’ah* governance issued by the regulatory

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27 Another Saudi Bank namely Bank Al Bilad has established *Shari’ah* board, Preparatory Committee and *Shari’ah* Group as its institutional arrangement for *Shari’ah* compliance purpose. *Shari’ah* board plays a role as fatwa issuing body while Preparatory Committee acts as research unit that studying *Shari’ah*-related issues and inquiries before it could be forwarded to the *Shari’ah* board for deliberation. Another functions emanates from the *Shari’ah* board is the *Shari’ah* Group that consisting of *Shari’ah* Secretariat and *Shari’ah* Audit Department. The *Shari’ah* secretariat coordinates all matters concerning *Shari’ah* while *Shari’ah* audit conducts periodic *Shari’ah* review (Al Bilad, 2009: 13–14).
authority, the Al-Rajhi has passed its own *Shari’ah* guidelines and procedures known as the *Shari’ah* Monitoring Guide and *Shari’ah* Control Guidelines with a purpose to ensure the proper monitoring and implementation system of *Shari’ah* rulings. The *Shari’ah* guideline of Al-Rajhi makes it very clear that the *Shari’ah* board’s rulings are considered binding. Therefore, all products or services must be approved by the *Shari’ah* board before it could be offered into the market.

### 3.2.5 Qatar

#### 3.2.5.1 Regulatory Overview

Qatar celebrated its independent in 1971 with its first Provisional Constitution on 2 April 1970 and was replaced by the Amended Provisional Constitution of 19 April 1972. Article 1 of the 1972 Constitution clearly states that the Islamic law is a main source of legislation and Islam is the religion of the state (Hamzah, 1993: 83). Although, the constitution of Qatar specifically puts *Shari’ah* as a main source of legislation, in the aspect of commercial transaction, *Shari’ah* nevertheless is acceptable as one of the main sources of legislation but not as a primary consideration.\(^{28}\) Moreover, there is contradiction between the Qatar civil and commercial codes and its Constitution.\(^{29}\) This can be evidenced by referring to article 4 of the Civil and Commercial Code which states that *Shari’ah* shall apply in the absence of express legislation provision or custom.

This position puts *Shari’ah* as a secondary source of legislation in the aspect of commercial transaction in which contradicting to the article 7 of the Constitution. In view of the similar situation that happened in Kuwait, UAE, Bahrain, it is presumed that the Qatar Civil and Commercial Code is excluded from the application of article 7 and hence permits the interest-based transaction in Bahrain financial sector. In fact, the Law No 7 of 1973 amended by Law No. 7 of 1975 granted power to the Qatar Monetary Agency to determine the interest rates on deposits and loans. The government of Qatar then established the Qatar Central Bank (QCB) that inherited all functions of the Qatar monetary agency. The QCB is the regulatory body which supervises and manages the financial sector in Qatar while the Doha Securities Market serves as the securities market regulator. The judicial system of Qatar places the civil court to hear cases pertaining to commercial, banking and finance disputes.

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\(^{28}\) In the case of *Ruler of Qatar v International Marine Oil Company Limited* [1953] 20 ILR 534, the arbitrator rejected the application of Islamic law as the proper law of the Concession Agreement despite its acknowledgment of Islamic law as a source of legislation. It is decided that Islamic law is inappropriate to govern modern oil concession. Ballantyne (1987: 16–17) views that the true reason behind this case was not because of Islamic law was inappropriate but the concession agreement was full of irregularities which would make it invalid.

\(^{29}\) It is reported that since 1960s, the application of Islamic law in Qatar has been confined to family and personal matters such as marriage, divorce and inheritance (Amin, 1983: 302). See also Hamzah (1994: 79–90) for further understanding on the historical background of Qatar legal system. Qatar legal system has emerged into three stages namely tribal law, Islamic law and modern law.
In early 2005, the government of Qatar established the Qatar Financial Centre (QFC) with purpose to create an independent regulatory body for financial sector and the Qatar Financial Markets Authority (QFMA) to manage the securities market. The establishment of the QFC was regulated by the QFC Law (Law No. 7 of 2005) and the QFMA by the Law No. 33 where both laws are regarded as the main legislation governing the basic construction of the QFC. The QFC Law establishes four different independent bodies namely the QFC Authority, the QFC Regulatory Authority, the Appeals Body and the QFC Tribunal. The QFC has power to regulate the financial sector including the Islamic financial business. As the QFC is inspired by the DIFC model that has separate judicial system with the federal, the QFC also has its own civil and commercial court and the regulatory tribunal as part of its legal infrastructure.

In parallel with the expansion and Islamic banking growth in Qatar financial market, the QFC Regulatory Authority has issued the Islamic Finance Rule Book 2007 (ISFI) in July 2007. The ISFI provides rules and regulations pertaining to Islamic financial business such the endorsement of IFIs and Islamic windows, disclosure requirements, constitutional documents, systems and control, conduct of business standard and Shari‘ah board. With the issuance of the ISFI, all IFIs and Islamic windows shall comply with the ISFI and they are subjected to the supervision of the QFC Regulatory Authority.

3.2.5.2 Shari‘ah Governance
There are two regulatory frameworks of Shari‘ah governance system in Qatar namely for the IFIs under the auspices of QCB and the QFC. The QCB has issued the prudential regulation for banking supervision known as Instructions to Banks (the Instructions) in March 2008 and Part Seven of the Banking Supervision Instructions provides the guidelines for IFIs. Meanwhile, the QFC has its own rules and regulation pertaining to Shari‘ah governance system as stipulated in the ISFI.

Chapter 1 of Banking Risk, Credit and Financing Risk of the Instructions requires IFIs to establish the Shari‘ah board. The Shari‘ah board must consist of not less than two qualified Muslim members appointed by BOD and approved by the general assembly. This chapter further states that the Shari‘ah board has duty to oversight and approve all Islamic activities of the IFIs in compliance with the Shari‘ah. As such, contracts and documentations of the IFIs’ transactions must be ratified by the Shari‘ah board. In carrying out this duty Shari‘ah board shall be assisted by the internal auditor and the audit report shall be submitted to the Shari‘ah board. The Instruction requires the IFIs to implement the AAOIFI governance standards.

The Instruction contains two unique features which differentiate its position with other Shari‘ah governance frameworks. Firstly, the Instruction restricts the Shari‘ah board members to receive credit facilities for commercial purpose. This position raises an issue as to the
reasonability of such restriction. If the purpose of such restriction is to ensure independence of Shari‘ah board and to avoid conflict of interest, the prohibition shall include receiving credit facilities for both personal and commercial purpose. Secondly, the IFIs are required to appoint their directors and senior management who are highly-qualified, experienced and trained in the field of Islamic financial services. This is a unique provision where it cannot be found in any rules and regulations of other jurisdictions.

The ISFI specifies Shari‘ah governance framework to IFIs registered with the QFC. Section 5 of the ISFI requires IFIs to establish and maintain systems and controls to ensure Shari‘ah compliance of all their Islamic financial business. Section 5.2.1 (1) details out this requirement by including the Shari‘ah compliance aspect, the Shari‘ah board and internal Shari‘ah review matters. It also requires IFIs to have a system by which disputes, conflict of interest and potential conflict of interest can be identified and managed. In the aspect of Shari‘ah governance, section 6 of the ISFI provides a comprehensive provision pertaining to the Shari‘ah board matters. Section 6.1.1 requires that all IFIs to establish their own Shari‘ah board. Although there is no Shari‘ah board at the QCB or the QFC, the government of Qatar has established the Supreme Shari‘ah Council attached to its Ministry of Awqaf as the highest Shari‘ah authority that responsible to deal with the Shari‘ah matter. The Supreme Shari‘ah Council shall be the final authority in case of Shari‘ah disputes pertaining Islamic finance.

As regard to the composition of the Shari‘ah board, the ISFI puts a condition of a minimum of three members which is appointed by the governing body of the institution. Section 3 of the Interpretation and Application Rulebook 2008 defines the governing body as the BOD, the management or other governing body of an authorized firm. In this context, the appointment as well as the dismissal and changes of the Shari‘ah board members will be made by the BOD.

In term of qualification of the Shari‘ah board, the ISFI does not specify the exact conditions of the Shari‘ah board members. Section 6.1.1 (B) (ii) just mentions that the members appointed must be competent to perform their functions as Shari‘ah board by considering their qualifications and previous experience. In addition, the ISFI restricts the Shari‘ah board members to be appointed as a director or controller of IFIs. This restriction is perhaps intended to clarify that the role of the Shari‘ah board members which is supervisory and advisory in nature and they do not have executive power. Section 6.1.2 requires the policy documentation of the Shari‘ah board as to how appointments, dismissals or changes will be made, the process through which the suitability of Shari‘ah board members will be considered and the remuneration. The ISFI also makes it compulsory to IFIs to establish and retain records of its assessment of the competence of the Shari‘ah board members and the agreed terms of engagement of each member of the Shari‘ah board for at least six years from the date
on which the individual ceased to be a member of the Shari’ah board.30

A unique position of the ISFI is the IFIs have legal responsibilities to take reasonable steps to ensure that the members of the Shari’ah board are independent and not subject to any conflict of interest. They are required to provide the QFC Regulatory Authority any information with regard to the qualifications, skills, experience and independence of the Shari’ah board. Furthermore, they shall take reasonable measures to ensure that their employees to provide assistance to the Shari’ah board, to give right of access to relevant records and information, do not interfere and do not provide false or misleading information to the Shari’ah board for purpose of Shari’ah compliance.

The ISFI clearly mentions the requirement for the adoption the AAOIFI Governance Standards particularly in the aspect of Shari’ah review. Section 6.2 requires IFIs to ensure that all Shari’ah reviews are undertaken in accordance with the AAOIFI Standards on Governance No. 2 and to submit Shari’ah report as stipulated in the AAOIFI Standards on Governance No. 1. The Shari’ah report shall then be submitted within four months after the financial year end. To complement the process of Shari’ah review in accordance with the AAOIFI Governance standard No. 3, the IFIs must perform an internal Shari’ah review to audit the extent to which the IFIs comply with Fatwas, rulings and guidelines issued by the Shari’ah board. The internal Shari’ah review shall be conducted by the internal audit and the individuals or departments involved in performing the review are competent and sufficiently independent to assess compliance with Shari’ah.

3.3 United Kingdom

3.3.1 Regulatory Overview

Attempt to introduce Islamic financial services in the UK began in 1980s when Al Barakah Bank endeavored to form a full-fledged Islamic bank in 1982. This attempt was unsuccessful as Al Barakah Bank was forced to close in June 1993 by the Bank of England after failing to satisfy certain requirements of the regulators (Housby, 2005). This is one the main reasons of why the UK authorities are very careful and vigilant in the implementation of Islamic finance in the UK. Despite of that, Islamic retail products already appeared in the UK market since 1990s (HM Treasury, 2008a: 12).

In 2000, the Bank of England with the cooperation of HM Treasury set up a working group to study the feasibility of Islamic finance in the UK. This working group was set up

30 Section 6.1.4 of the ISFI requires that the records of the assessment of competence of Shari’ah Supervisory Board members to include at a minimum: (A) the factors that have been taken into account when making the assessment of competence; (B) the qualifications and experience of the Shari’ah Supervisory Board members; (C) the basis upon which the Authorized Firm has deemed that the proposed Shari’ah Supervisory Board member is suitable; and (D) details of any other Shari’ah supervisory boards of which the proposed Shari’ah Supervisory Board member is, or has been, a member.
by the Sir Edward George, the then Governor of the Bank of England and the members comprised of the representatives from the Treasury, the Financial Services Authority, the Council Mortgage Lenders, banks and Muslim organizations including the Muslim Council of Britain (Briault, 2007). Since then several legislative measures were introduced by HM Treasury in relation to the tax and regulatory systems to enable the development of Islamic finance in the UK and in August 2004, the first full Shari’ah-compliant retail Islamic bank, the Islamic Bank of Britain was authorized.

According to a report produced by International Financial Services London, at the beginning of 2008 the UK hosted five Islamic banks, more than twenty Islamic windows, one Takaful operator; nine fund managers and one Shari’ah compliant hedge fund manager (HM, Treasury, 2008a). In the meantime, the UK authorities continue to develop the Islamic finance in the UK by establishing the Islamic Finance Council based in Scotland in 2005 and a special sub group in early 2007 to produce a strategy for the promotion of the UK as a centre of Islamic financial services and in April 2007, the HM Treasury and the UK Debt Management Office undertook the feasibility study for sovereign Sukuk issuance. This positive development further enhances the growth of Islamic finance industry in the UK and may stimulate the expansion into other European countries.

3.3.2 Shari’ah Governance

Although Islamic banking is consider new to the UK, they have already well-developed Islamic financial structure and governance framework. The UK authority applies equal legal treatment for conventional and Islamic finance. As regard to the Shari’ah governance, there is no legal requirement for the IFIs to establish the Shari’ah board either at the individual banks or national levels. The UK authorities nevertheless do concern on the issue of Shari’ah governance as Clive Briault, the Managing Director, Retail Markets, The Financial Services Authority (FSA) mentions that the FSA needs to clarify from a financial and operational aspects upon the role of Shari’ah board in the IFIs (Briault, 2007).

The major concern of the FSA is whether the Shari’ah board has an executive or directorial role in the IFIs. As long as it does not have such executive role, there will be no significant issue from the FSA’s perspective. The practices of the existing five Islamic banks in the UK show that the Shari’ah governance is managed by the individual IFIs and they are free to adopt their own Shari’ah governance without being adhered on any national or other higher level of Shari’ah board. The HM Treasury clearly mentions that the UK government does not intend to follow the Shari’ah governance approach of other jurisdictions since the

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31 This sub group was set up by UK Trade & Investment (UKTI), through their Financial Services Advisory Board and consisted of 15 practitioners and representatives from UKTI and HM Treasury and four private sector working groups were set up into another four specific sub groups of Banking & Insurance, Legal, Accountancy and Education, Training and Qualifications (ETQ) (HM Treasury, 2008a: 14).
UK authorities are secular bodies and not religious regulators. In the aspect of composition of the *Shari’ah* board, the current practice shows that the Islamic Bank of Britain and the European Finance House consist of three *Shari’ah* advisors, the Bank of London and the Middle East and the European Islamic Bank with four *Shari’ah* advisors and the Gate House Capital with one *Shari’ah* advisor. A variety of *Shari’ah* board composition amongst the IFIs indicates that there are no legal or policy requirements of the FSA or other UK authorities which creates flexibility to the IFIs in the UK to organize and manage their own *Shari’ah* governance.

The FSA also concerns on the aspect of confidentiality and shortage of *Shari’ah* scholars. Some of the *Shari’ah* advisors are sitting in more than three different *Shari’ah* boards at one particular time and this position may raise potential issues of confidentiality and conflict of interest. At the moment, the individual IFIs tackle this issue internally as there is no specific guideline of the *Shari’ah* board. The HM Treasury however has highlighted its concern on these aspects by recommending standardization of products and practices of Islamic finance services. In this aspect, the UK government supports the roles play by the international standard setters such as the AAOIFI, the IFSB and the IIFM (HM Treasury 2008a: 19–25). The standardization of products and practices guarantees further growth of Islamic finance industry as it may reduce cost and time, to improve documentation and confidence; to lessen the burden of *Shari’ah* scholars (HM Treasury, 2008a: 23) as well as to mitigate the potential of *Shari’ah* risk. In order to address the problem of shortage of *Shari’ah* scholars in the UK, the Islamic Finance Council in collaboration with the Securities and Investment Institute (SII) offer the Scholar Development Programme specifically for *Shari’ah* advisors or potential *Shari’ah* scholars. This programme provides a wide range of subjects with the knowledge of the conventional system that the *Shari’ah* scholars need to be able to practice in the UK or elsewhere (SII, 2008).

Even though the UK authority is silent on many aspects of *Shari’ah* governance, the situation is different in the case of *Sukuk*. HM Treasury (2008b: 39) did highlight the need for the appointment of internationally recognized *Shari’ah* scholars for ensuring *Shari’ah* compliance of the Government Sterling *Sukuk* Issuance. Furthermore, there was suggestion to incorporate British *Shari’ah* scholars onto the board to approve the *Sukuk* issuance (HM Treasury, 2008b: 24). This position indicates indirectly that the UK authority has started to look into possible framework of *Shari’ah* governance. It is expected that the growth of Islamic finance industry in parallel with the sophistication of its products may force the UK authority to consider to introducing a comprehensive *Shari’ah* governance framework in the future which can be a good model for the countries with non-Islamic legal environment.32

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32 A study conducted by Ahmad and Hassan (2006: 41–57) on the potential for the adoption of the UK regulatory framework for Islamic finance in Australia revealed that the Australian authority may follow the...
IV. Regulatory Issues

Regardless of positive development on the Shari’ah governance framework in the case countries, it is observed that there are few significant regulatory issues which are inherently essential to Shari’ah governance system such as legal status of the Shari’ah pronouncement, conflict of laws, court’s jurisdiction, addressing issues on differences of Shari’ah rulings, and the Shari’ah board’s advisory and executive roles. This section attempts to highlight these regulatory issues in order to enlighten further discussion on the actual Shari’ah governance legal framework. With diversity in the implementation of Shari’ah governance in IFIs, a high standard of Shari’ah governance practice should be promoted to ensure that the institution of Shari’ah board could play its role effectively.

4.1 Legal Status of the Shari’ah Pronouncement

One of the debatable issues on Shari’ah governance is the status of Shari’ah rulings. The issue refers to whether the Shari’ah rulings are binding on IFIs, court or any other related institutions? To illustrate this important issue, we may refer to a survey conducted on the perception of Shari’ah rulings where one of the findings shows that only 56.6 percent of the IFIs consider the Shari’ah rulings to be binding, 20 percent as merely advisory and 22.4 percent gave no response (Dawud, 1996: 43). The result of this survey indicates that there are loopholes and shortcomings on the Shari’ah governance framework particularly in positioning Shari’ah board decision as binding and mandatory. Ironically, the IFSB survey on Shari’ah board across jurisdictions demonstrates that even 60 percent of the respondents agreed that the national Shari’ah authority should be the highest authority in Islamic finance, only a few jurisdictions has affirmed the practice (IFSB, 2008b: 18).

With reference to the existing Shari’ah governance framework in some countries, they have already provided clear legal provision on the superiority of Shari’ah board decision. This is in parallel with the AAOIFI governance standard where it stresses that fatwa issued by the Shari’ah board shall be binding and fully enforceable (AAOIFI, 2005: 4). Similar situation in the case of the IAIB Shari’ah board as all the board’s decisions for Shari’ah supervision are binding on the banks which are members of the institute (Wilson, 1997: 83–93).

In Malaysia, section 16B (8) of the Central Bank of Malaysia Act 1958 provides two different positions of the Shari’ah board rulings where they are binding upon the IFIs and the arbitrator and merely persuasive to the court. One matter which deserves special note here is that the advice given by the Shari’ah board would not be taken as binding to the court. This position nevertheless has been resolved with The Central Bank of Malaysia Act 2009 where UK model by passing legislation to strengthen Islamic financial market in which will enable the Muslim as well as non-Muslim community to find a viable Islamic financial services.
the *Shari’ah* rulings are binding to both court and arbitration. Similarly, in the case of the UAE where article 5 of the Federal Law No. (6) 1985 provides the establishment of “Higher *Shari’ah* Authority” (HSA) and the HSA shall be accorded the final authority in *Shari’ah* matters in Islamic banking and finance. All determination and decision made by the HSA shall be binding and mandatory to all IFIs in the UAE. While legal framework of Malaysia and the UAE has provided clear position of rulings made by the *Shari’ah* board, the situation is different in other jurisdictions as in the UK, Saudi Arabia, Kuwait, Qatar and Bahrain as the status of *Shari’ah* pronouncements is still ambiguous.

In the light of the above discussion, laws and legal arrangement in certain jurisdictions such as the UAE and Malaysia seem capable to provide clear position on the status of the *Shari’ah* board decision to be binding and mandatory whereas in many other countries experience the otherwise. With this respect, there must be a practical solution to resolve the issue by examining and studying the respective countries legal environment and structure and pro-active efforts and continuous endeavors should be carried out in placing the *Shari’ah* as the supreme law by ensuring the *Shari’ah* board determination is binding and mandatory upon the IFIs, the arbitrator and the court of justice.

### 4.2 Conflict of Laws

Most of IFIs operate in the environment where the legislative framework consisting of mixed jurisdictions and mixed legal systems. As such, every transaction, products, documents and operation must comply with the *Shari’ah* principles as well as other laws which may lead to the issue of conflict of laws. In the case where the *Shari’ah* law is the ultimate legal authority such as in some of the GCC Countries, such conflict may not be a big problem whereas in the countries of mixed legal systems as in Malaysia or in a non-Islamic legal environment

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33 It is worth noting the recommendations of the Council of Islamic *Fiqh* Academy for the purpose of *Shari’ah* enforcement in its Fifth Meeting in Kuwait in 1988. The Council provides five recommendations to solve the problem of enforcing the *Shari’ah* rules namely to continuously conduct thorough and comprehensive research relating to the issue of *Shari’ah* enforcement, to ensure coordination between the council and other scientific institution entrusted with the enforcement of *Shari’ah* rules, to collect bills relating to Islamic law from Islamic countries and to benefit from them, to urge for the reform of education programs and various means of communication in order to mobilize them towards the enforcement of *Shari’ah* and to widen the training ground of research in order to prepare human resources for the application of *Shari’ah* (The Council of Islamic *Fiqh* Academy, 2000: 96–97).

such as in the UK, the issue of conflict of laws is very significant. This raises the question of how Shari’ah principles apply in the event of conflict of laws either with the laws of the jurisdiction or other statutory legislations and how it will be adjudicated in a court.

In the case of Malaysia, section 55 of the IBA attempts to solve the problems of conflict of laws in which it mentions that the IBA will prevail over the Companies Act 1960. Nevertheless, this provision is silent about the prevailing laws in the event of the IBA is contravened with other statutory legislation. Although, there is principle of construction expression of unius est exclusion alterus (the express mention of one thing implies the exclusion of another) in common law, the court is not bound to apply that principle and may decide based on other statutory laws which sometimes contravene to the Shari’ah. This section 55 does not solve entirely the issue of conflict of laws and therefore its scope should be extended to cover not only the Companies Act but any other law so as to ensure that Shari’ah is always be the prevailing laws.

In a non-Islamic legal environment and international commercial practice, the problem is far more complicated. Since there is no legal provision to give assurance on the superiority of Islamic law, some of IFIs incorporate a specific proviso stating that the respective agreements of Islamic financial products shall be governed by Islamic law. Although this choice of law clause indicates the intention of the parties to be governed by the Shari’ah, it is still questionable whether this is enforceable in a court. In the case of Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd [2004] 1 Lloyd’s Rep 1, the learned judge clearly states that reference to the Shari’ah in the agreement did not automatically displace the choice of governing law based on two grounds i.e. article 3.1 of the Rome Convention contemplates that a contract shall be governed by the law chosen by the parties and article 1.1 refers the law as the law of a country. In this circumstance, the court held that the English law is the governing law of the contract and not the Shari’ah.


36 It is worth mentioning that the conflict of laws may happen only in certain areas of laws as a study performed by Sayyid Ab Allah Aki Husayn, a Pakistani scholar who reveals that only a small portion of Pakistani civil law (which is quite similar with the Malaysian law) is considered to be against the Islamic law (Mohamed, 2003: 2).


38 In this case the defendant failed to repay amounts due under bay al-Murabaha financing agreements. Clause on choice of law in the agreements provided that subject to the principles of the Shari’ah, the agreements were to be governed by English law. The Court refused to allow the defendants to challenge the transactions on the grounds that they were not in fact in accordance with the Islamic law. In the case of Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. & Ors, the London High Court resolves the dispute by applying the pragmatic approach of English commercial law rather than Islamic law.
In the light of the above, it is necessity for the Shari’ah governance system to have sound legal framework to resolve the issue of conflict of laws. In parallel with rapid development of Islamic finance industry and the exposure to a non-Islamic legal environment and international commercial practice, the authority shall examine and study the existing legal framework so as to take into consideration the Shari’ah elements within the legal context of international finance and commercial law. Such framework shall place Shari’ah as the prevailing laws in the event of conflict of laws and any Shari’ah issues arise shall be referred solely to the Shari’ah board for determination. Another possible way of addressing the issue of conflict of laws is by mean of arbitration. It is strongly encouraged for IFIs to incorporate in the respective agreements a clause on preferment for arbitration in the event of default or dispute. At this point, the establishment of International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA) on 19 April 2005 in Dubai is a very good effort in providing alternative dispute settlement for Islamic finance industry (Iqbal, 2007: 361–383). The IFIs from different legal jurisdictions may refer the IICRCA for determining and resolving the issues of conflict of laws.

4.3 Court Jurisdiction

Based on brief description of regulatory framework of Shari’ah governance in the case countries, Islamic finance cases fall under jurisdiction of non-Shari’ah court as in the case of Malaysia, Kuwait, Qatar, UAE, Bahrain and the UK while in the case of Saudi Arabia, it refers to Banking Dispute Settlement. Basically, this is not appropriate since Islamic finance is part of Islamic law and ideally it should be the jurisdiction of Shari’ah court in which it will not be happened in some jurisdictions particularly the United Kingdom. In this instance, two issues might be significant in respect to the Shari’ah governance system particularly judges ability to decide Islamic finance cases and to what extent the judges keenness to refer Islamic finance disputes to the Shari’ah board for deliberation.

The significance of the former issue can be illustrated in the case of Arab Finance Malaysia Berhad v Taman Ihsan Jaya and Ors [2008] 5 MLJ where the High Court ruled that the profit derived from Bay Bithaman Ajil (BBA) facility is unlawful and illegitimate as it involves element of interest and therefore IFIs may only claim the principal amount of financing. This judgment will seriously affect the Islamic finance industry in Malaysia as the BBA represents more than 80 percent of total financing in Malaysia. By referring to the inadequate arguments of the learned judge particularly in explaining Riba and elaborating BBA from Shari’ah point of view, it indicates that the court may need expert’s deliberation who is specialized in Shari’ah particularly Fiqh Muamalat. In this context the Shari’ah board is the ideal institution to be referred to by the court. After more than a decade of the implementation of Islamic finance with numerous cases report, there is no single case the
court has referred to the Shari’ah board. This indicates the passive court’s attitude towards having the Shari’ah board’s deliberation pertaining to Shari’ah matters involving Islamic finance cases in spite of its limited ability on the subject. The Shari’ah governance approach with strong and effective Shari’ah coordination facilitated by comprehensive regulatory framework would be able to resolve this issue.

4.4 Addressing Issue on Differences of Shari’ah Resolution

The absence of a comprehensive set of regulatory framework on the Shari’ah governance may cause problems to the development of Islamic finance. The issue on the differences of various fatwa rulings amongst the Shari’ah boards may affect the Islamic finance image especially when international entities established their Islamic banks in different jurisdiction. The IFSB survey indicates low percentage of reconciled Shari’ah issues pertaining to different of Shari’ah resolutions. Bahrain, Bangladesh, Indonesia, Sudan indicate less than 20 percent, UAE slightly more than 20 percent and Malaysia 40 (IFSB, 2008b: 42). This crucial finding denotes that most of the Shari’ah issues related with resolution of Shari’ah differences are not reconciled in many countries.

The diversity of interpretation of Shari’ah may affect the determination of certain rulings on particular issue where one IFI would accept a new product as being Shari’ah compliant while others would decide to be non-compliant (Mcmillen, 2006: 139–140). To tackle this issue, there are a few approaches would be possible to be implemented and these include by establishing the Shari’ah board at national level, providing legal provision on the final authority of the Shari’ah board’s rulings, allowing interdisciplinary experts to be appointed as the Shari’ah board members and issuing universal Shari’ah prudential standards.

In the case of conflict of opinions amongst members of the Shari’ah boards in Kuwait, the BOD of the designated IFIs may transfer the matter to the “Fatwa Board” in the Ministry of Awqaf and Islamic Affairs and the Fatwa Board shall be the final authority on the matter (Article 93 of the CBK Law 32/1968). Similarly in Malaysia, The Central Bank of Malaysia Act 2009 grants the power to the SAC as the sole Shari’ah authority and will be referred to by the court or arbitrator in disputes involving Shari’ah issues in Islamic banking, finance and takaful cases.

Another possible approach to address the issue of various legal opinions is by allowing interdisciplinary experts or professionals to be appointed as the Shari’ah board members. A combination of interdisciplinary experts in the composition of Shari’ah board may enable the board to come out with solid and concrete Shari’ah rulings. For instance, the composition of

39 Sheikh Mohammed Taqi Usmani views that there has been nearly consensus amongst the Shari’ah scholars on Shari’ah related issues in Islamic banking and finance and only about 10 per cent disputed-opinions which are still need to be resolved. (New Horizon, November 2004: 15). According to the GCIBFI sampled about 6000 Fatwas, it is found that 90 per cent were consistent across the IFIs (Grais and Pellegrini, 2006).
the Shari’ah board members of the BNM consists of Shari’ah scholars, chartered accountant, lawyer, judge\(^{40}\) and central banker. This approach is preferable because any issues discussed in the Shari’ah board deal not only pertaining to Shari’ah matter but also legal and financial aspects.\(^{41}\) The Shari’ah board members must possess necessary knowledge and training to enable them to scrutinise the business operations and management policies adequately.

It is also crucial to see some uniformity and standards are set to ensure that the differences of legal opinion are addressed effectively. In this aspect, the issuance of Shari’ah prudential standards is really necessary. The AAOIFI has developed over 20 basic Shari’ah standards with purpose of bringing diverse Shari’ah opinions to universally acceptable standards (New Horizon, 2004: 15). The AAOIFI Shari’ah standards however have been adopted only by a few countries since the standards are not made obligatory except Bahrain, Jordan, Sudan, Qatar, and Dubai. The standards are used as guidelines in Saudi Arabia, Kuwait, Malaysia, Lebanon, and Indonesia. It is expected that many countries will implement the AAOIFI Shari’ah standards in parallel with the rapid growth of Islamic finance and the need to address various legal opinions amongst the Shari’ah board.

4.5 Executive, Advisory and Supervisory Roles of Shari’ah Board

Shari’ah board plays significant roles in ensuring Shari’ah compliance in all products, transactions and operations of IFIs. The issue here is whether Shari’ah board has an executive role in exercising his power or it just has an advisory authority? This issue is very significant especially in the non-Islamic legal environment such as in the UK where FSA puts a standard requirement to authorize person to be a director who has an executive role in the company. There are two main consequences if Shari’ah board members are seem to have executive power or directorship role in IFIs in the UK i.e. it is possible that many of Shari’ah scholars may not meet the competency and capability criteria as required by the FSA and the existing practice of multiple membership of Shari’ah board in various IFIs may be considered as contrary to the rule of conflict of interest (Ainley, et al, 2007: 13). At the moment, there is no controversial issue on this matter since the FSA’s perspective upon the role of Shari’ah board is advisory and the board does not interfere in the management of the IFIs.\(^{42}\) It is assumed that potential conflict is likely to exist due to the increasing in numbers of Shari’ah board of IFIs and rapid growth of Islamic finance industry in the UK and the Europe.

\(^{40}\) The BNM has appointed Tun Abdul Hamid Haji Mohamad, the then Chief Justice of Malaysia on 1st November 2004 as a member of the National Shari’ah Advisory Council for Islamic Banking and Takaful (New Horizon, 2005: 5).

\(^{41}\) The IFSB Guiding Principles however limits the power of those non-Shari’ah experts or professionals by preferring to not to grant voting right to them (IFSB, 2008a: 4).

\(^{42}\) The FSA considers the Shari’ah board has an advisory roles based on the existing governance structure, reporting lines, fee structure and the terms and conditions of the Shari’ah board of IFIs in the UK (Ainley, et al, 2007: 13–14).
On the other hand, if the role and responsibilities of Shari’ah board are considered neither executive nor supervisory but merely advisory, it raises another significant issue as to the actual function of Shari’ah board and to what extent its deliberation binds the IFIs? If it is merely advisory, the IFIs may ignore the decision made by Shari’ah board since it does not have an authority to enforce its deliberation. It gives an impact that the decision made by Shari’ah board is not binding upon the court but also to the respective IFIs and even in alternative dispute resolution such as the arbitration. In fact, the absence of supervisory roles of the Shari’ah board if it is merely advisory may negate the efficiency of ex-post monitoring of Shari’ah compliance aspects. This issue hence needs proper deliberation and it is submitted that the Shari’ah board must be given full authority to have supervisory and advisory roles that address the Shari’ah compliance aspect of IFIs. In addition, it is also a good board practice if any members of the Shari’ah board be appointed as one of the members of board of directors. This provides an opportunity for the Shari’ah scholars to voice out their concerns on any aspects of Shari’ah and at the same time to educate the other board members the true spirit of Islamic principles.

V. Conclusion

The Shari’ah governance system in Malaysia, GCC Countries and the UK can be classified into two namely regulated via legal and supervisory requirements as in the case of Malaysia, Bahrain, Kuwait, UAE and Qatar or through self regulation such as in the case of Saudi Arabia and the UK. In term of classification from regulatory perspective, Malaysia is identified as a strong proponent of regulation-based approach, Bahrain, Kuwait, UAE and Qatar as minimalists approach, Saudi Arabia as passive approach and the UK as reactive approach. In view of numerous legal issues involved in the existing Shari’ah governance framework, the need to have a comprehensive legal framework and effective Shari’ah governance system is really crucial. A failure to provide efficient Shari’ah governance either through law or legislation on the part of regulators and the banking sector would inevitably lead to serious disruptions in Islamic finance industry.

In this aspect, the AAOIFI Shari’ah and governance standards are important efforts for bringing the standardization of Shari’ah practices while the IFSB prudential standards on governance would be able to guide and promote for the best practice of Shari’ah governance system. Referring to the diverse perception and acceptability on the AAOIFI standards and IFSB guidelines, there must be strong mechanisms to guarantee their universal adaptation.

43 Interestingly, Inovest, an Investment Company in Bahrain has appointed Dr. Fareed Mohammed Hadi, a member of its Shari’ah board as the BOD member. This is a very rare practice where a Shari’ah scholar has been acknowledged to seat as the BOD member who has executive power (Inovest, 2009).
and one of them is through having a proper legal framework. For this purpose, thoroughly and intensively studies need to be conducted to examine, analyze and scrutinize for the possible adaptation of the AAOIFI standards and the IFSB guidelines in various markets and environments.

The foregoing discussion seems to suggest that the existing regulatory framework of Shari’ah governance system needs further enhancement and improvement in order to reinforce the development and growing of Islamic finance industry. This brings into focus the measures and efforts that need to be taken to strengthen the IFIs through enhancing the Shari’ah governance framework. It is a strong belief that some common legal elements that underlying and promoting good governance and best practices are fundamentally to be drawn to facilitate the creation and optimize a healthy and viable environment for Shari’ah governance system without impeding further growth of the industry.

Bibliography


Regulatory Framework of Shari‘ah Governance System


