

Central Shari'ah Boards – the Future of Islamic Finance?

The establishment of Central Shari'ah Boards (CSB) in their contemporary shape and form is considered to be a turning point in the history of the industry and is expected to drive further valuable standardisation across the global industry.

However, with the gradual expansion of the scope of the CSBs, what will be the role of the institutional Sharia'ah Supervisory Boards in the future?

The one universal pillar that is not up for debate in this industry is Shari'ah Compliance and Governance, meaning abiding with Islamic Law in all dealings, transactions and activities in any institution claims to offer Islamic Financial Services.

To ensure seamless and appropriate compliance with the provisions of Islamic Law, a Shari'ah governance framework should be established across the core systems and functionalities of the institution with the ultimate responsibility remaining with the board of directors and the senior management.

The practical approach towards Shari'ah compliance and governance is steered by an independent advisory body appointed by the board of directors, called the Shari'ah Supervisory Board (SSB) or The Shari'ah Board. This independent body comprises of a group of individual scholars with recognised qualifications and credentials in Islamic Jurisprudence complemented by the necessary knowledge and understanding of financial services.

The SSB's key role is to issue a certifying opinion on the legitimacy of products, activities and controls in the context of compliance with the provisions of Shari'ah. A Shari'ah Board functionally operates as an independent advisor but with binding opinions.

Reliance on Shari'ah Supervisory Boards by the board of directors, regulators, shareholders and other stakeholders is an accepted practice in the market around the world. However, certain challenges have emerged due to conflicting opinions and rulings in the market which have led to creating discrepancies. Other challenges include the limited pool of scholars with recognised expertise in Islamic Jurisprudence in this relatively new industry.

To that effect, the need for an overarching regulatory and supervisory framework was recognised by many at an early stage in the industry's development, and was adopted in the statute in the UAE Federal Law No.6 of 1985 pertaining to Islamic Financial Institutions - which refers to an establishment of a national level Shari'ah Authority.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines the Central Shari’ah Board (CSB) within the AAOIFI Governance Standard No.8. as a

“broad-level board, or similar body of specialised jurists in Islamic commercial jurisprudence and experts in Islamic banking, finance, law and accounting etc. providing guidance and advice on Shari’ah matters, with limited supervision, that is established in a specific country or jurisdiction for providing uniformity and harmony in the products and practices with regard to Islamic finance through Fatawa (opinions), rulings and principles applicable on a broad base rather than a single institution”.

The two basic forms of Central Shari’ah Boards are further defined as:

National Shari’ah Boards:

Formed at a national level by a government authority having multiple regulatory regimes under its direct or indirect ambit.

Regulatory Shari’ah Boards:

Formed by a regulatory authority and specific to a jurisdiction having one or more industry segments under its ambit as defined by the regulator.

A variety of jurisdictions, particularly those where Islamic Finance is considered to be of systematic importance, have established Central Shari’ah Boards with varying roles and responsibilities.

While the UAE is considered to be one of the pioneers in this regard, especially with the issuance of Federal Law No.6 of 1985, the first Central Shari’ah Board to emerge globally was in the Republic of Sudan in 1992, as part of a national initiative to convert the financial system into becoming fully Shari’ah compliant.

This was then followed by the establishment of Central Shari’ah Boards in other countries such as Malaysia, Pakistan and a number of the GCC states. The table on the right lists the majority of jurisdictions with established Central Shari’ah Boards:

UAE	Oman
Morocco	Malaysia
Indonesia	Libya
Bahrain	Sudan
Algeria	Pakistan
Bangladesh	Tunisia
Kuwait	Nigeria
Palestine	

The role of Central Shari’ah Boards is dictated by the overarching policy environment of each jurisdiction. As stated in the definition, the relevant overall governing body determines the extent of advisory and supervisory activities of the CSB to ensure adequate governance and standardisation of the Shari’ah compliant financial activities.

The AAOIFI Governance Standard No. 8 carries an element of flexibility with respect to the operating module of CSBs, as the concept was not built on a “one size fits all” platform, similar to the Shari’ah Boards at individual financial institutions.

A review of a selected number of charters of established CSBs in leading industry jurisdictions reveals the following key areas of roles and responsibilities of the Central Shari’ah Boards around the world:



1

Ascertaining of Laws, Regulations and Judicial matters at a national level in the context of Shari’ah compliance in Islamic Finance transactions

3

Dispute resolution in cases of conflicts between Shari’ah Supervisory Boards at individual financial institutions with powers to act as the final approving party with binding decision-making powers in respect to Shari’ah related matters

5

Issuance of relevant prudential guidelines and regulatory frameworks, e.g. Shari’ah Governance Frameworks

7

Any other matters deemed necessary by the relevant governing body

2

Reviewing and issuing approvals of Shari’ah structures that are related to products offered by regulatory and supervisory authorities to support the wider monetary system or national debt instruments, e.g. the Central Bank’s liquidity facilities

4

Acting as a standard-setting body through the issuance of minimum product, structure and operating requirements to the wider financial market

6

Reviewing and issuing approvals of fit and proper criteria of Shari’ah Supervisory Board members in individual financial institutions

While the roles do not deviate drastically from one country to the other, the approach of each Central Shari’ah Board varies with respect to the implementation and execution of its mandates. It is important to note that the interpretation of mandate is subject to the overarching regulatory and policy environment in each jurisdiction. This then organically drives the nature of operations by the respective Central Shari’ah Board. For example, while the Malaysian and the UAE Central Shari’ah Boards may be viewed in the context of a regulatory body, the approach

followed by countries such as Pakistan and Bahrain is more similar to that of an industry-wide advisor.

Comparative Analysis

The table below sets-out a comparison of the published terms of reference of a number of leading Islamic Finance jurisdictions where a Central Shari’ah Board exists at a regulatory level for Islamic Banking, Takaful and/or Capital Markets.

	UAE	Malaysia	Pakistan	Bahrain	Sudan
Number of Scholars	Five	Nine	Five	Three	Seven
Appointment of the CSB	Appointed by the UAE Cabinet of Ministers	Appointed by Malaysia’s Head of State, in consultation with the Minister of Finance	<i>No specific reference made public</i>	Appointed by the Board of Directors and Governor of the Central Bank of Bahrain	Appointed by the President of the Republic, in consultation with Minister of Economy
Accountability	Central Bank of UAE	Bank Negara Malaysia	State Bank of Pakistan	Central Bank of Bahrain	Ministry of Economy and Financial Planning
Rotation / Reappointment	Three years, renewable	No reference	Two years, renewable	Three years, renewable	Five years, renewable
Shari’ah Compliance Supervision	Core part of overall banking supervision	Core part of overall banking supervision	Only at dispute level	Only at dispute level	Core part of overall banking supervision
Involvement in the legal system	Advisory to the legal system, informally the highest decision maker in Shari’ah related matters	Binding decisions in the laws of courts as commissioned by the Malaysian Supreme Court	Advisory to the legal system	Advisory to the legal system	Decisions by the CSB inforceable by the laws of court
Product Standards / Shari’ah compliant structures guidelines	Mandated full suite of AAOIFI Shari’ah Standards in addition to guidance on structures and product development	Issuance of product standards and Shari’ah structural guidance through enforceable regulations by Bank Negara Malaysia	Partial adoption of AAOIFI Shari’ah Standards. Standards are amended based on interpretation of SBP/SAC and issued for mandated use	Mandated full suite of AAOIFI Shari’ah Standards	Mandated full suite of AAOIFI Shari’ah Standards and mandated additional standards issued through CBoS

This benchmarking demonstrates the variations between the global Central Shari'ah Boards in terms of applications and practices, as well as the common ground around the ultimate purpose behind the module.

As stated within the AAOIFI's GSIFI 8, this standard is meant to establish an advanced degree of harmonisation and convergence in the work of Shari'ah Supervisory Boards (SSBs) of Islamic financial institutions in order to iron out those instances where contradiction and differences arise between the Fatwas, rulings, decisions, and applications by such entity-level boards.

This will result in ensuring consistency in products and services offered by the Islamic Financial Institutions (IFIs) as well as the promotion of standardised practices, which will, in turn, increase the credibility of the Islamic finance industry and boost the confidence of its clients and investors in IFIs and their offerings.

There are 2 different approaches a CSB may take based on the above benchmarking practice which is to act in the capacity of an overarching advisor, where supervision and oversight remain in the hands of SSBs in the individual institutions, subject to the examination of the supervisory authority as seen in Pakistan and Bahrain.

However, the other approach as seen in Malaysia, the UAE and Sudan is expanded into a regulatory / supervisory position, where the Central Shari'ah Board's involvement extends to examination and providing reasonable assurance on Shari'ah compliance in individual institutions – this takes place through the integrating the objectives within the overall supervisory review process.

It is not uncommon for a new regulatory approach to bring forward an element of a market shock. Regulation is a natural instigator of reaction by financial institutions in principle. For the Islamic Finance industry, where the element of specific supervision is relatively new at a global scale, the inception of the CSB module is expected to drive similar instigator results - a crucially needed proposition with its own set of challenges, such as:

1. The impact of Central Shari'ah Boards on the need of Shari'ah Supervisory Boards in individual financial institutions:

As of date, all jurisdictions with functioning CSB still maintain the requirements of Shari'ah Supervisory Boards in individual financial institutions. In addition, AAOIFI's standards remain to acknowledge the role of the SSBs in conjunction with the overarching central boards.

However, in the long term future, the requirement for individual boards may become obsolete subject to a gradual expansion of CSBs to cover a wider scope, where the need at an individual institutions level will only be required for executional, i.e Internal Shari'ah Supervision Departments / Personnel.

In a way, this could reform to be more similar to broader regulatory compliance by financial institutions where an in-house compliance team manages all aspects and corresponds directly with the Regulatory Authority.

2. Possible conflict between CSB rulings and the overarching prudential regulatory framework:

This challenge is not of unique nature to the CSB module per say. Historically, since the inception of the industry, various incidents have brought forward challenges where prudential regulations may conflict with the provisions of Shari'ah.

Compliance with Shari'ah is inevitable for Islamic Financial Institutions and prudential regulations apply similarly by supervisory authority to all FIs. Hence, the challenge can only be addressed at the top level, where regulators and standard-setting bodies (i.e. AAOIFI and IFSB) find the middle ground to ensure overall accomplishment.

It is crucial for the CSB's operations to be integrated within the regulator's infrastructure and have a consistent dialogue with the relevant standard setting bodies.

3. Limited pool of global scholars and conflicts of interest:

Shari'ah Scholars with deep and adequate understanding of banking and financial services remain to be a rare breed of professionals at a global scale. While various names are on the rise and future looks bright, the deep knowledge held by the pioneers remains to be predominant.

With the existence of SSBs at individual institutions and the rising number of global CSBs, the scarcity of Shari'ah Scholars will remain a challenge at the wider industry scale, especially with conflict of interest being addressed across regulators and standard-setting bodies.

Meaning, the duplication of Scholars is generally phasing out, resulting in an even smaller population. The extensive efforts in the development of well-known names is the key viable solution till date.

Conclusion

The introduction of Central Shari'ah Boards in its contemporary shape and form is considered a turning point of seamless value to the industry. Standardisation is a definite success factor in the Islamic Finance storyline, and nothing brings standardisation forward better than a regulator.

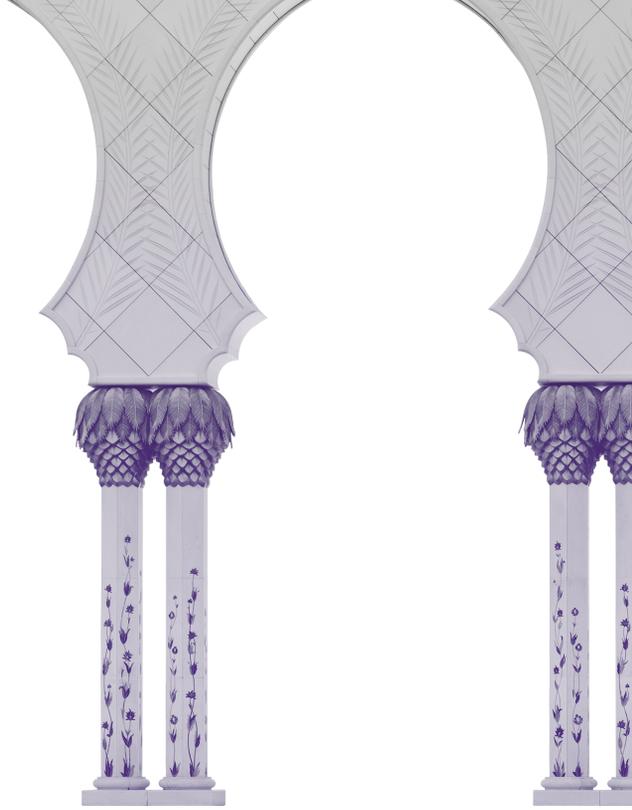
It is also important to recognise the original mandate of Central Shari'ah Boards, similar to Shari'ah Supervisory Boards historically, where the standard, guidance, and advise is set forward for the purpose of ensuring compliance with the provisions of Islamic Law, while facilitating an open platform for institutions to comply in a reasonable manner.

Based on the benchmarking and comparison between the different approaches by the stated jurisdictions, we can conclude that there is no "ideal" operating module for a Central Shari'ah Board, as it all depends and falls on the overarching regulatory environment in the jurisdiction.

One can debate that a Central Shari'ah Board must include an element of direct examination and that is to regulate the existing infrastructure, where "independent" members in the SSB are effectively recognized as the highest power in Shari'ah Governance and Compliance. However, the extent of regulation and oversight must be defined clearly to avoid potential market shocks in order to achieve a balanced goal.

The lessons learned so far are to bring further enhancement to the operating module of Central Shari'ah Boards and a wider value add to the Islamic Finance industry.

The Islamic Finance space develops at a rapid space and is definitely a topic to watch out for rapid updates.



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