THE ROLE OF SHARI'AH SUPERVISORY BOARD
IN ISLAMIC FINANCIAL INDUSTRY
(CASE STUDY: IRAN, MALAYSIA, AND INDONESIA)

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Abstract

The obligatory of indoctrinating Muslim society with Islamic norm is unequivocally a need itself. Since the demand and the progress of Islamic financial industry has been growth immensely, an independent body auditing the operation becomes indispensable from day to day. It is not only auditing for the accountability of the Islamic financial institution (IFI)’s operation but also an auditing for the operation to be Shariah compliance. The Shariah supervisory board (SSB), comprises high caliber scholars, is formed in order to assess whether the operations and the products offered by IFIs are complying Shariah rules, in general. This paper elaborates their responsibilities and the manner of SSB in conducting their role in order to achieve the good corporate governance. Since the methodology used by scholars in their interpretation may differ and the circumstances faced when drawing conclusions and interpretation may also differ, different resolution may actually arise among them. Hence, it may difficult to achieve consensus in every issue, not only among scholars but also among Shariah forums. This paper also discusses and compares the different structure applied by Iran, Indonesia, and Malaysia financial systems.

Objectives of the research:

This paper tries to:
A. Elaborate the position of Shariah Supervisory Board (SSB) for Islamic financial institutions (IFI)
B. Discuss the corporate governance issues in the context of SSB
C. Analysis the structure and relationship among SSB and other Shariah forum
D. Explore and compare the SSB model applied by Indonesian, Iranian, and Malaysian

Key terms of the research
Shariah Supervisory Board, Corporate Governance, Iran, Indonesia, Malaysia

I. INTRODUCTION

A civilized society has its own built in system of indoctrination to ensure the people behave in socially acceptable manner. It is no exemption for Islamic society. As stated in the Qur’an, God obliges the Islamic governance to enforce proper behavior and to restrain
people from improper behavior. Thus, Islamic society is responsible for creating institutions that indoctrinate each citizen with Islamic norms. Society should also create a system of threats for those who try to violate the norms. Therefore, the Islamic society can perpetuate itself and be safe from external onslaught.

In the era of prevailing mainstream economic system, which is based on secularism, Islamic society is obliged to construct a system complies with Shariah as the solution. The classical economic view formulated in the nineteenth century expounded perfect market competition based on the premise that economic behavior is separate and distinct from other types of behavior, the objective function is to maximize profit and the criterion of business performance is economic efficiency and progress\(^1\). There is only one social responsibility, which is to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition without deception of fraud\(^2\). The known general view is an individual should be allowed to pursue his or her own interest. In contrast, a Moslem has the belief in the hereafter which should be embedded in the minds of all so that everyone abides by the rules of social conduct.

As the action, Islamic financial institutions (IFI) have been developed immensely and a large number of them have been established around the world for the last 25 years. This landscape is one of ways to create a system in Islamic society complies with Shariah. Thus, as Islamic business institutions, its performance is obliged to be Shariah compliance in all their activities and operations, to achieve *Maqasid al-Shariah* (the objectives of the Shariah) which is preservation of *masalih* where its essential is to protect religion (din), life (nafs), offspring (nasl), reason (*aql), and property (mal).

In accordance with that, every IFI must have its own board of advisor, its own guard, its supervisor to be available in consultation. Such board is highly important in regard to achieve *fallah* (the success in life and hereafter) as their objective. Abdul Rahman, *et al* (2004) emphasized that in order to ensure that the practices and activities of IFI do not contradict with the Islamic ethical standards, many authors argue that the IFI are expected to establish a *Shariah* Advisory Council (SAC) or *Shariah* Supervisory Board (SSB). Establishing *Shariah* Supervisory Board (SSB) is believed as one of ways to secure the *Shariah* compliance can be performed in their dealings. SSB is meant to abide strictly by Islamic principles. It is comprised of a number of scholars who are not only *Shariah* well acquaintance, but also familiar with Islamic financial matter. At the end, only the high quality scholars are appointed to such board.

Different answers might sometimes bring in the matter and thus it is a difficult one to entrust the SSB. However, after deliberation of those scholars', a collective *ijtihad* is brought up to, then, pass it and, again, deliberate it with other different SSB from various IFI to create a resolution regarding *Shariah* matter. The decision made by the Boards is called *fatwa*. Therefore, having strong internal and external relationship is important to build the whole system conform to *Shariah*. Detail about SSB will be deliberated in this paper.

II. DEFINITION

Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), an

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accounting standard setting body based in Bahrain, has issued the Governance Standard for IFI No.1 on the SSB (Appointment, Composition and Report) effective from 1 January 1999. This standard has been adopted and referred to only as guidance by some Muslim countries. AAOIFI defined SSB as an independent body of specialized jurist in fiqh al-muamalat (Islamic commercial jurisprudence) that is entrusted with the duty of directing, reviewing, and supervising the activities of the IFI in order to ensure that they are in compliance with Islamic Shariah rules and principles.

Furthermore, Lahsasna (2010a) described the Shariah Board is a Legitimate Control Body consisting of a number of members chosen from among jurists of Islamic jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic finance. To ensure compliance to the Shariah, Islamic financial institutions use the services of Shariah boards comprised of Shariah scholars.

III. THE FUNCTION AND DUTIES OF SHARIAH SUPERVISORY BOARD

A. Functions of the Shariah Supervisory Board

Briston and El-Ashker (1986)\(^3\) stated that the functions of SSB lay in three main areas: ex ante auditing, ex post auditing, and the calculation and payment of Zakah. In line with AAOIFI Governance Standard, it is stated that the SSB is responsible to perform the ex ante and ex post audit which enables it to justify to what extent the IFI’s operation comply with Shariah principles. The concept of compliance from Shariah perspective is very much wider in scope since its conformity applies in all aspects of Muslims conducts including their financial transactions. An Islamic financial institution should avoid participating knowingly in transactions that transgressing or bypassing any Shariah regulatory requirements, in order not to be exposed to compliance risk (Muhamad, 2010).

Regarding the auditing process, in most IFI throughout the world, there are two auditors who have two different reports on the financial statements. One auditor is the external auditor as known traditionally and the other is Shariah advisor that also function as Islamic or religious auditor. However, both external auditor and Shariah advisor ideally should be from one organizational body since Islam does not recognize any separation between business and religion (Karim, 1993).

Abdallah (1994) divided the types of SSB into four types, namely:

1. Shariah consultant
2. Shariah Supervisory Board
3. Department of Fatwa and Research (DFR)
4. Central Higher Shariah Supervisory Board

Shariah consultant and Shariah Supervisory Board carry out their duties on a part-time basis. They usually convene weekly, fortnightly, or monthly meetings with the concerned departments and/or staff of the bank. Unlike those two models, DFR’s staffs are full-time and the department discharges its function on a daily basis and in collaboration with all organs of the bank. The DFR is an innovation of Sudanese. Meanwhile, the fourth type was established for the first time by International Association of Islamic Banks (IAIB) in 1983 to carry the higher ties of control and

supervision. Second development took place in Sudan for the establishment of the Higher Shariah Supervisory Board which is an independent body having its seat at the Central Bank.

In addition, Lahsasna (2010a) argued that every Islamic financial institution has a Council or Board called the Shariah Supervisory Board. This Supervisory Board functions as the supervisor of the Islamic banks activities is to ensure that all these activities operate in accordance with the Divine Principles. Since the boards have great responsibility, it is important that only high caliber scholars are appointed to such boards. The day-to-day application of Shariah by religious boards is two-fold. First, the religious board reviews the operations of the IFI to ensure that they comply with the Shariah. Second, An IFI is required to establish operating procedures to ensure that no form of investment or business activity is undertaken that has not been approved in advance by the Shariah board.

B. Duties and Responsibilities of Shariah Board

Abdul Rahman, et al's study (2004) indicated that the bank managers expect the Shariah advisors to be more legally, socially, and religiously responsible toward external stakeholders such as depositors, shareholders, regulatory agencies, customer and Muslim public. It also provided the evidence that the bank managers favor the Shariah advisors to be appointed by an and should report to the Central Bank. As implication, they suggested an immediate need for proper regulation on the role and function of the Shariah advisors in order to give more credibility to the Islamic financial industry practices.

Upon that, to achieve the effectiveness in Shariah supervision, it is considerably urgent for the Shariah board to examine the whole aspects related to the operation of the IFI, as the responsibility of the board is to ensure that the whole aspects are conducted on the basis of Shariah principles. As argued by Abdel Karim (1993), in performing their duties, the Shariah advisors must be guided by religious beliefs prescribed in the Qur’an, Sunnah, and Ijma’ (consensus among ‘Ulama) which would be more valued than any legal rules and professional codes of ethics. However, the Shariah supervision is not limited merely in giving Shariah opinions or issuing fatwas or advices before certain products are launched by the IFI, rather, reviewing and auditing exercises after the products or schemes are launched indeed compulsory (Triyanta, 2010).

Furthermore, AAOFI has come up with a set of legal framework to ascertain that the product and operations of IFI comply with Shariah principles. Shariah board members, as persons who are assigned to cater this ascertainment, have been associated with duties and responsibilities, which encompasses the following aspects:

1. Planning review procedures to be adopted by the Islamic banking and financial institutions.
2. Executing review procedures and preparation, and also review of working papers.
3. Documenting conclusions and reports after the review has been completed.

The management is required to periodically report and certify to the Shariah board that the actual investments and business activities undertaken by the institution conform to forms previously approved by the Shariah board.
In addition, Hafidhuddin (2003)\(^4\) distinguished the Islamic bank with conventional bank since Islamic bank has the SSB which has the following duties and obligations:

1. Controlling and supervising the operation of the bank along with its products so as to make it is accordance with Shariah.
2. Making socialization to the society of Islamic bank particularly and about Islamic economics generally.
3. Discoursing and developing Islamic values in Islamic bank or other IFI.

The details described by Lahsasna (2010a) of the main duties and responsibilities of the Shariah Committee (as in Malaysia) are as follows:

1. To advise the Board on Shariah matters in its business operation.
   
   The Shariah Committee shall advise the Board on Shariah matters in order to ensure that the business operations of the IFI comply with Shariah principles at all times.
2. To endorse Shariah Compliance Manuals.
   
   The IFI shall have a Shariah Compliance Manual. The Manual must specify the manner in which a submission or request for advice be made to the Shariah Committee, the conduct of the Shariah Committee’s meeting and the manner of compliance with any Shariah decision. The Manual shall be endorsed by the Shariah Committee.
3. To endorse and validate relevant documentation
   a. To ensure the products of the IFI comply with Shariah principles in all aspects. The Shariah Committee must endorse the following:
      b. the terms and conditions contained in the proposal form, contract, agreement or other legal documentation used in executing the transactions; and
      c. the product manual, marketing advertisements, sales illustrations and brochures used to describe the product.
4. To assist related parties on Shariah matters upon request
   
   The related parties of the IFI such as its legal counsel, auditor or consultant may seek advice on Shariah matters from the Shariah Committee. The Shariah Committee is expected to provide assistance to them so that compliance with Shariah principles can be assured completely.
5. To advise on matters to be referred to the Shariah Advisory Council (SAC-in Malaysia) or other similar authorized council
   
   The Shariah Committee must advise the IFI to consult the SAC on any Shariah matters which have not been resolved or endorsed by the SAC.
6. To provide written Shariah opinion
   a. The Shariah Committee is required to record any opinion given. In particular, the Committee shall prepare written Shariah opinions in the following circumstances:
      b. where the IFI makes reference to the SAC or other similar authorized council for

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advice, or

c. where the IFI submits applications to the Central Bank for new product approval in accordance with guidelines on product approval issued by the Central Bank.

7. To assist the SAC or other similar authorized council on reference for advice

The Shariah Committee must explain the Shariah issues involved and the recommendations for a decision. It must be supported by relevant Shariah jurisprudential literature from the established sources. The Shariah Committee is also expected to assist the SAC or other similar authorized council on any matters referred by the IFI. Upon obtaining any advice of the SAC or other similar authorized council, the Shariah Committee shall ensure that all SAC’s decisions are properly implemented by the IFI.

C. Duties and Responsibilities of IFI Regarding the Supervision

To ensure the smooth running of the Shariah Committee (SC), an IFI is responsible:

1. To refer all Shariah issues to the SC

The IFI must refer all Shariah issues in its business operations to the SC for advice. The submission for advice or a decision must be made in a comprehensive manner for an effective deliberation by the SC. This will include explaining the process involved, documents to be used and other necessary information.

2. To adopt the SC’s advice

The IFI is required to adopt and take necessary measures for the implementation of SC’s advice.

3. To ensure that product documents be validated

The IFI shall obtain validation of the SC relating to Shariah issues in all product documentation.

4. To have a Shariah Compliance Manual

The IFI shall ensure that the Shariah Compliance Manual is endorsed by the SC.

5. To provide access to relevant documents

The IFI must provide necessary assistance to the SC. The SC must be given access to relevant records, transactions, manuals or other relevant information, as required by them to perform their duties.

6. To provide sufficient resources

The IFI must provide the SC with sufficient resources, such as budget allocation, independent expert consultation, reference materials and training. It is also the duty of the Islamic financial institution to familiarize the SC on its operation and business.

7. To remunerate the members of the SC accordingly

The Board shall determine the remuneration of the SC members (through its Remuneration Committee). The remuneration shall commensurate and reflect the roles and functions of the SC.
IV. Importance of Shariah Supervisory Board

The Shariah Supervisory Board (SSB) is important to ensure that the current operations of the IFI conform to Shariah principles. Therefore, the following indicators could enhance the integrity of the SSB so as to increase the level of confidence among the Muslim community towards Islamic financial institutions.

A. Include someone with expertise in accounting.

This criterion is important so that the board has robust understanding in what is happening in the day-to-day operations of the entities. Knowledge in Shariah principle, coupled with knowledge in business, accounting or finance will help the board to be of high independence while making decision.

B. SSB meets with audit committee and/or external auditor to review the financial statements.

The SSB should actually check and balance with the external auditor. They have to meet with audit committee and/or external auditor not only to review the financial statement, but also to review the whole operation of the business.

C. Details of the activities of SSB

The number of board meetings held in a year and details of attendance of each individual member in respect of meetings are disclosed. Such information needs to be disclosed in the annual report so that shareholders will be more confident in having transactions with Islamic banks. By disclosing the number of meetings held annually will assure the shareholders that the board has been doing their job in ensuring the activities of the organization are in line with the Shariah requirements.

D. SSB committee members attend at least 75 per cent of meetings on average.

Each member of the SSB is expected to attend at least 75% of the meetings held per year. It is important in their report they should disclose how many meetings have been conducted throughout the year, the attendance of each member as well as the description of their duties

E. SSB is independent body.

One of the two problems faced by the financial reporting system of IFI is the independence of the SSB. In-house SSB (appointed by the company), may not be independent of the IFI's management even though it may try hard to be independent. Proposed the necessity to create a centralized Shariah Board (for each country) to clear the Shariah compatibility of various modes and instruments of finance used by banks. The existence of decentralized SSB leads to conflicting opinions which creates inconsistency and uncertainty. Thus, if the SSB is appointed and remunerated by the company, it is considered to be dependent. This issue will be discussed under subtopic of corporate governance.

V. The Legal Shariah Position of SSB

Errico and Farahbaksh (1998) stated that laws should state clearly that the central bank (or a separate supervisory authority) has the authority and all necessary powers to supervise Islamic banks and conventional banks, if applicable.

Lahsasna (2010a) described the legal position of the Shariah board is to
endorse whether the financial product or service being offered is acceptable from an Islamic legal perspective. Such certification generally is documented in a formal fatwa (Shariah position paper). The Shariah supervisor performs this due diligence on behalf of consumers who are without access to the details of what is offered to them. Shariah supervision places itself in a position of directly representing the religious interests of the Muslim investor or consumer. Their position is to ensure that every that an Islamic financial product is halal. The services performed by Shariah supervisors are directed towards the investor, or the consumer.

There is a very real need for reliable opinions on these dealings. Legal and academic opinions derived from authentic Shariah sources by the means and methodologies established by generations of Muslim jurists. The IFIs appoint scholars with specializations in the field of fiqh al muamalat, and who also had working knowledge of modern financial markets and practices. By means of qualified Shariah supervision, IFIs may assure their clients and investors that the operations they undertake are reviewed in all of their details for compliance with the principles and precepts of the Shariah. Therefore the banks and financial institutions may clearly demonstrate that their transactions conform to Islamic legal norms.

The purpose of having the Shariah Advisory Council or similar authorized council is to ensure that the business of IFIs carrying on IFI business do not involve any element which is not approved by the Religion of Islam. The term ‘the Religion of Islam’ is not, explained anywhere in any statute. The meaning of ‘the Religion of Islam’ in this context would clearly be left to the interpretation of the courts whenever there is a dispute on any principle of the Shariah. In many cases on IFI decided by civil courts, hardly any reference was made to any principle of the Shariah. The new amendment of the law give more power to SAC or similar authorized council when it comes to dispute, whereby the court is bound to refer to their advice and their resolution will be binding.

VI. Qualification

Lahsasna (2010a) elaborated the qualification of SSB are as follow:

1. A member of a Shariah Committee shall be an individual. A company, institution or body shall not constitute a Shariah Committee member.

2. The proposed member of the Shariah Committee shall at least either have qualification or possess necessary knowledge, expertise or experience in the following areas:
   a) Islamic jurisprudence (Usul al-Fiqh) ; or
   b) Islamic transaction/commercial law (Fiqh al- Mu’amalat).

   It should be noted that paper qualification on the above subjects will not be mandatory as long as the candidate has the necessary expertise or experience in the above areas.

DeLorenzo (2010a) argued that IFIs must adhere to the best practices of corporate governance plus they have one extra layer of supervision in the form of religious boards. The religious boards have both supervisory and consultative functions. Since the Shariah scholars on the religious boards carry great responsibility, it is important that only high caliber scholars are appointed to the religious boards.
He also argued that IFIs which offer products and services conforming to Islamic principles must, therefore, be governed by a religious board that acts as an independent Shariah Supervisory Board comprising of at least three Shariah scholars with specialized knowledge of the Islamic laws for transacting, fiqh al mu’amalat, in addition to knowledge of modern business, finance and economics.

A Shariah supervisor, thus, will be someone with a background in the classical Shariah sciences. Therefore, supervisors need to have studied the fiqh al mu'amalat. Supervisors also need to have studied the Usul fiqh. It also a plus point when Shariah supervisors have produced academic work or studies on one aspect or another of these rules.

DeLorenzo (2010b) elaborated beside those qualifications, regarding the capability of linguistic, the classical Arabic language and the ability to deal directly with legal texts, glosses, and commentaries in that language are needed. Along with that, understanding of modern finance, markets, and economics is also clearly required. An effective Shariah supervisor must be familiar with international business practices (urf) and have an appreciation for regulatory environments. Therefore, English language is especially important. The supervisor should have the ability to work with a team.

Today’s Shariah supervisors possess the qualifications and characteristics discussed above. Many Shariah supervisors have benefited from the exposure afforded by multiple board membership. At the present time, there are no standard qualifications for Shariah supervisors. In the future, and as the Islamic financial sector grows, graduate level programs will be developed for the specific purpose of preparing new generations of scholars with all of the requisite skills. At present, the number of people qualified to serve as Shariah supervisors is limited.

Furthermore, DeLorenzo (2010b) suggested two points with regard to scholars for a future in Shariah supervision. Firstly, Islamic financial operations may appoint, in addition to its full Shariah Board members, junior members who will participate in discussions, prepare memos and briefs, take notes, and perform research and other tasks for the Shariah Board, but who will not have full status as voting Shariah Board members. Secondly, junior members may be appointed on a rotating basis, such that each will serve. By means of this rotating arrangement, many scholars will have an opportunity to learn first hand about the workings of Shariah supervision. As junior members become increasingly more familiar with modern business norms and practices, it will become easier for them to analyze situations and think through options, with the result that their contributions to the work of the SSB will become increasingly valuable. Such junior members will be compensated for their efforts, though not at the same level as the full board members.

Shariah supervision may be performed by an individual supervisor/advisor, or by a board of supervisors/advisors, commonly known as a Shariah Supervisory Board. In Malaysia Shariah board consists of 3 members. IFI should have at least three supervisors for any Islamic financial undertaking. Experience has shown that at least one of the members needs to reside in the same country or region as the operation, so as to be readily available for consultation, even on short notice. In some cases, a Shariah supervisor will maintain an office and keep regular hours at the bank or financial institution.

VII. Methodology of Resolutions Exercised by SSB
Apart from various models of the Shariah board in various countries, there are some methods and procedures of the process which Shariah board members undertake to examine and ascertain Shariah compliance of the product and operation of Islamic financial institutions. These methods and procedures are called by instrument for supervision, which according to 'Abd al-Hamid al-Ba’ili (2003)\(^5\), there are three instruments for supervisory activities:

1. Researching and evaluating the operation of the bank
2. Issuing decisions relating to the product and operation which may be periodically, daily, weekly, monthly, annually, etc
3. Withdrawing or cancelling decisions and operations which are not in line with Shariah principles

The non-compliance towards issued fatwas is perceived as ignorance and infringement towards Islamic tenets. It is reasonable therefore, specific actions are to be taken on the relevant institutions which do not comply with the fatwas. In this regard, respective bodies which have the authority, namely the National Shariah supervisory body and the Central Bank, shall ensure the enforcement of the fatwas.

In regard of identifying incongruence in Shariah compliance, Lahsasna (2010b) depicted some tools and instruments that can be used. The tools play a crucial role in identifying incongruence in Shariah compliance, and help the IFI to carry out their banking business in accordance with Shariah.

**Islamic tools and instruments for identifying incongruence in Shariah compliance**

<table>
<thead>
<tr>
<th>Shariah ruling</th>
<th>Accounting</th>
<th>Legal instrument</th>
<th>Shariah review</th>
<th>Rating agency</th>
<th>Shariah Governance</th>
<th>Screening process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fatwa &amp; resolution</td>
<td>Balance sheet</td>
<td>Terms and condition of the contract</td>
<td>Consideration of the process of review</td>
<td>Consideration of the element of Shariah compliance in the rating</td>
<td>Implementation of Shariah governance standards and guidelines</td>
<td>Consideration of the screening process cycle</td>
</tr>
<tr>
<td></td>
<td>Accounting treatment</td>
<td>Terminology of the contract</td>
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However, when the act of non-compliance continues, the Shariah Supervisory Board has to send a report on the pertaining case to the Central Bank and the National Shariah supervisory body. The action taken by this supervisory board is based on the provision that the task to ascertain Shariah compliance lies in their hands and the board of directors.

VIII. The Issue of Diversity of Opinions and Their Implication in the Industry

In examining the IFI’s activities the authorized council used fiqh as their reference. Fiqh is an intellectual and technical effort to provide a sound understanding of the Qur’an and the Sunnah and derive laws from them. Diversity in fiqh began with the start of Ijtihad, on issues where direct ruling was not mentioned from the Qur’an and Sunnah. Other reasons that led to that difference were due to the methodology used by scholars in their interpretation. Other than that, it also due to the difference circumstances when drawing conclusions and interpretation.

Triyanta (2010) argued that for the purpose of introducing fatwas which are acceptable globally, various legal opinions from some major madhhab in the Muslim society need to be considered. Fatwas issued by the AAOIFI, IFSB, Majma al-Fiqh and other International standards body for Islamic financial business are to be considered as reference for the SSB in issuing resolution. As in Malaysia, IFI may adopt another opinion that is different from Malaysian standard with the approval of SAC within the Central Bank.

IX. The Issue of Standardization of SSB Opinions

Lahsasna (2010a) elaborated that attempts to uniform various interpretations were made as earlier as the second century of Hijrah. One of the Caliphates of the second Hijrah appointed Imam Malik (a renowned Islamic jurist of the time) to unify fiqh. The attempt, however, failed, as it was not feasible to compel people to accept one opinion or one single school of thought. The diversity, therefore, continued to prevail.

The best experience in the history of Islamic law was the introduction of Majallah al-Ahkam al-Adliyyah (translated into English as The Mejelle (2001))6 by the Ottoman Caliphate towards the end of 19th century of A.D (1877-1926). This Mejelle was meant to be the civil code of the caliphate dealing with commercial transactions.

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6 Translated by C.R. Tyser, B.A.L. (President of District Court of Kyrenia), D.G. Demetriades (Registrar of District Court of Kyrenia), and Ismail Haqqi Effendi (Turkish Clerk of District Court of Kyrenia), Kuala Lumpur: The Other Press.
This was the most comprehensive ‘code’ of Islamic commercial law in the entire history of Islamic law. It was decided that all countries under the Ottoman rule should comply with the provisions of the Mejelle. However, this decision did not address the issue of diversity of Shariah opinions on different matters in different schools of thought.

Few other similar codes were later attempted by al-Azhar University Research Academy in accordance of major schools of thought. The job, however, was not completed. More recently, the General Secretariat of the Arab League countries tried to codify laws in accordance with Islamic Shariah. It did compile a codified document relating to financial transactions (containing 1,316 articles). This job too, however, could not be completed to the extent to enable it to be used as standards for Shariah opinions on various issues related to contemporary finance industry.

The highest reference with regard to any issue on Islamic law which is inclusive of Islamic commercial law was the decisions and resolutions of International Islamic Academy of Fiqh, an organ of the Organization of Islamic Conference (OIC) which is based in Jeddah. Resolutions which are endorsed by this Academy are accorded with great respect and adherence by the member countries. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is based in Bahrain, to prepare as many Shariah Standards as possible is the best achievement for Islamic finance industry. These Shariah standards are aimed at achieving harmonization and convergence in the concepts and applications among the Shariah supervisory boards of Islamic financial institutions and to avoid contradictions or inconsistencies between the fatwas and applications of these institutions.

Other attempt was made by the Islamic Financial Services Board (IFSB) which is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry. Refer to (IFSB):

2. Guiding Principles on Corporate Governance, Dec. 2006

M. Fahim Khan argued that “the unification or harmonization or codification alone, if achieved, may not solve all of the problems. The immediate challenge involves more than harmonizing fiqh opinions and codifying them. It relates to standardizing the entire process of how to advise, supervise, and monitor Shariah compatibility of an institution or any of its operations/products, and includes how a verdict should be arrived at and how a certificate should be formulated when validating the Shariah compatibility of a financial activity to ensure transparency and good governance.

X. The Corporate Governance Issues in the Context of SSB

The concept of independence is considered as the fundamental principle of audit to maintain the auditor’s credibility in performing their role (Abdel Karim, 1993). Independence also refers to the relationship between an auditor and management (DeLorenzo, 2010b). For the auditor to be independent, he/she should have an incentive(s) to withstand any management attempts to influence his/her not to report

7 In Lahsasna (2010a)
any discovered breaches. Being independent is not applicable only to the external auditors but to internal auditors as well (Abu Moamer, 1989).\(^8\)

There are a number of similarities between the nature and the role of SSB and the external auditor. Both parties publish report to the owner of the business and verify that the financial statements fairly represent the results of the organization's operations. While the SSB certifies whether the activities comply with the Shariah, the external auditor confirms whether the financial statements presented a fair view of the bank's financial position and of the result of its activities.

The AAOIFI Governance Standard (2002a) dictates that the SSB members must be appointed by the shareholders in the annual general meeting. Thus, the SSB members will be able to perform their role well since they are given a legitimate right by the shareholders to supervise the institution's activities and transactions in relation to adherence to Shariah principles. However, Bank Indonesia states that the SSB members should appointed by the Central Bank, thus, the members will be enables to be above all the institution's stakeholders' interests. Hence, the SSB members may be enabled to be really representing the interest of all of the Islamic financial institution's stakeholders, particularly in ensuring that the Islamic financial institution's operations are in accordance with Shariah principles.

According to Mautz and Sharf (1961), in general, types of independence divided by two, (1) practitioner independence and (2) professional independence. Practitioner independence means that the auditors need to maintain the proper attitude of their planning, performance, and report in conducting an audit. Furthermore, this particular independence demonstrates the ability of auditors to make objective and unbiased audit decisions. Meanwhile, professional independence means that the auditors need to avoid any appearances which reduce the independence of auditors. Hence, the auditors must consider the publics’ and other's perceptions of their independence. However, the auditor should demonstrate that there is no threat to his or her independence such that an outsider would not doubt the auditor's objectivity.

The concept of professional independence means that the SSB members need to be independent in appearance. Hence, the SSB members have to avoid any actions which may reduce the perceptions of the IFI's stakeholders of their independence, although, the SSB members are guided by their moral beliefs and obligations to their religious peers and the community (Abdel Karim, 1993). The SSB members must maintain their position neutral from any of the IFI's stakeholders. According to al-Qattan (2003), to be perceived independent, the SSB members must avoid any influence or pressure from any of the IFI's stakeholders in performing their role. Hence, the members of SSB are prohibited to be either the employer or on the board of directors of IFI. Similarly, the AAOIFI Governance Standard (2002b) states that the members of SSB should not be as directors or significant shareholders of the IFI. Abdel Karim (1993) also suggested that to perceive independence of the SSB is very much influenced by moral values.


Triyanta (2010) added that to ensure freedom of presentation of opinion by the Shariah Board, the following are taken into consideration:

1. They must not be working as personnel in the bank. That means they are not subject to the authority of the board of directors.
2. They are appointed by the general assembly.
3. The general assembly fixes their remuneration.
4. The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.

According to the AAOIFI Governance Standard (2002b), SSB must perform Shariah review in order to examine the extent to which the IFI's activities comply with Shariah rules and principles as reflected in the fatwa(s), rulings and guidelines issued by the SSB. SSB has successfully innovated and developed various new products of financial institution which do not only fully comply with Islamic principles but which also suit with the modern and prudent banking activities.¹¹

For the purpose of the annual report the National Shariah supervisory body’s members must conduct a comprehensive audit for a period of one year, and issue the Shariah opinion with regards to the compliance of the products and operations of the institutions according Shariah principles. In annual report, the statement of Shariah opinion must be included (Triyanta, 2010). Based on the above process and procedures, the issuance of Shariah opinions in the annual report is the last stage of the whole process conducted in ascertaining Shariah compliance of IFI.

XI. The Relationship between the SSB and other Shariah Forum such International Fiqh Academy

The International Council of Fiqh Academy is an initiative and constituted under the auspices of the Organization of the Islamic Conference (OIC) represented by all its member countries. Its resolutions were not much debated or argued by Shariah scholars. For example in its Second Session which was held at Jeddah during December 22-28, 1985 adopted a resolution which, inter alia, provided:

1. Any excess or profit on a loan for a deferred payment when the borrower is unable to repay it after the fixed period and similarly any excess or profit on a loan at the time of contract are both forbidden as riba in the Shari’ah.
2. Alternative banks should be established according to the injunctions of Islam to provide economic facilities.
3. The Academy resolves to request all Islamic countries to establish banks on Shariah principles to fulfill all the requirements of a Muslim according to his beliefs so that he may not face any repugnance.¹²

¹² http://www.islamic-banking.com/shariah_ruling.aspx retrieved on 9th March 2010, 1:02 PM
However, its 19th session which was held in Sharjah, United Arab Emirates, during 26 – 30 April 2009 when it is decided that it is not permissible to execute both tawarruq (organized and reversed) because simultaneous transactions occurs between the financier and the mustawriq, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation, has been attracting many debates, arguments and discussions. For example, Bahrain-born Shariah scholar Sheikh Nizam Yaquby said that the academy has to retain its past practice of a thorough and meticulous decision making process. He, who sits on Shariah boards of more than 40 banks globally, was present at the Sharjah meeting, when was asked about AAOIFI, said its standards go through a rigorous research\textsuperscript{13}.

Globally, academic bodies like the OIC Fiqh Academy in Jedda, AAOIFI in Bahrain, the IIBI in London, the IIIT in Cairo, an the Fiqh Academy in India have produced volumes of the supervisory literatures which can be accessed trough internet. Although, it may be difficult to achieve consensus in every issue, the important thing is our Shariah scholars are able to speak with authority on the issue.

XII. Discussion on the Iranian, Indonesian, and Malaysian Model of Shariah Supervisory Board

A. Iranian Model

In Iran, the law for Usury (Interest) Free Banking enacted in 1984 mandates compliance of the entire banking system with Islamic Law. The implementation of this law and Islamic banking as an integral part of economic system started in 1986 and countries to shape the structure of Iranian economy\textsuperscript{14}. In some countries, such as Iran and Pakistan, Islamic banks are the only mainstream financial institutions\textsuperscript{15}. Besides the foundation of a variety of individual banks, the countries of Pakistan, Iran and Sudan have changed their financial systems entirely to a banking system running on an Islamic basis, which is fixed in these countries' respective constitution\textsuperscript{16}. As the countries of Iran, Pakistan and Sudan have chosen Islamic Banking as their constitutionally legal banking system, these countries tried to completely ban the existence of riba. However, this prohibition can only be realized on a national level, whereas external debt of these countries is serviced by interest payments like in a conventional banking system, in order to remain in the International Monetary Fund (IMF). In other Muslim countries, where conventional and Islamic Banking coexist, interest is legally allowed, but special riba-free products are structured for Muslim investors.

In regard with Shariah supervisory board, while the Council of Ministers have defined the products which can be offered by banks under the Usury Free Banking

\textsuperscript{13} “Fiqh Academy must make thorough study of issues”. The Malaysian Reserve on 3rd November 2009
\textsuperscript{14} ishrathusain.iba.edu.pk/speeches/WordDocs/PRUDENTIAL\_ARRANGEMENTS.doc retrieved on 9th March 2010, 1:06 PM
\textsuperscript{15} Ilias (2009)

Act and the Council of Guardians performs the function of central Shariah board and provides guidelines to central bank and commercial banks. Commercial banks do not have a Shariah Board for guidance and/or supervision in day to day operations\textsuperscript{17}.

In all Islamic countries, each institution offering Islamic financial services has in-house religious advisers, who are collectively known as the Shariah Supervisory Board (SSB), except in Iran, where compliance of the whole banking system with Shariah is guaranteed and monitored by the central bank\textsuperscript{18}.

### B. Indonesian and Malaysian Model

The IFIs in Indonesia and Malaysia are in-house religious advisers. Meanwhile, Triyanta (2010) elaborated that there are some slight differences between Indonesia and Malaysia apparent due to the fact that the Shariah board in IFI in Indonesia, as the term “Shariah Supervisory” board implies, is designated for supervisory tasks, instead of advisory. Meanwhile the standing regulation in Malaysia requires the term “advisory” board.

National Shariah Council (NSC) in Indonesia is an element of the National Ulama Council which has been recognized as an authoritative council for issuing fatwas in various matters, the body has a moral obligation to issue fatwas as the guidance for the Muslims in the country. While in Malaysia, SAC is part of the Central Bank. This is due to the fact that conventional banks conducting Islamic banking business are under supervision of the Central Bank of Malaysia, and thus they are also subject to the same advisory body. It is the Supervision Department in the Central Bank of Malaysia which is responsible for any compliance and ignorance.

In contrast to Malaysia in which a nationally recognized SAC deals solely in Banking and Takaful minus Islamic Securities (since the Securities Commission of Malaysia (under Securities Commission Act 1993) has its own Shariah Committee with its resolution), the NSC of Indonesia deals with all aspects of Islamic financial business, which encompasses Islamic banking, Islamic insurance, Islamic mutual fund, and some other Islamic financial businesses. Hence, the fatwas compilation also comprises these various aspects.

The problems faced by SAC in Malaysia are more on pursuing the rapid development of the product and the conflict of law (ikhtilaf). While in Indonesia, the issue is more on lack of an integrated expertise as the National Shariah Council (NSC) are more knowledgeable on Shariah rather the practical experience. Also, there is no constraint from legal perspective to handle various positioned at any one time, therefore, it has lack regarding the regulation terms of creating independence of the SSB members.

### XIII. Conclusion and Finding

The Shariah supervisory board (SSB), comprises high caliber scholars, is formed in order to assess whether the operations and the products offered by IFIs are complying Shariah rules, in general. However, the legal position, its structure, specific functions, duties and responsibilities may differ among them as there are many types of SSB and various SSB models applied by Muslim countries where the IFIs have been

\textsuperscript{17} Strategic Plan for Islamic Banking Industry in Pakistan, Shariah Compliance, Appendix-C

\textsuperscript{18} Wafik Grais and Matteo Pellegrini (2006)
developed. They must be independence and achieve the good governance as those are the fundamental principles of auditing to maintain their credibility in performing their role. Different resolution may actually arise among them. The difference may due to the methodology used by scholars in their interpretation or the difference circumstances they faced when drawing conclusions and interpretation. Hence, it may difficult to achieve consensus in every issue, not only among scholars but also among Shariah forums.

As in Iran, the banking system has been changed entirely to be running on an Islamic basis, which is fixed in this country’s respective constitution. Therefore, there is no such in-house religious advisor in the commercial banks, indeed, the whole banking system is guaranteed and monitored by the central bank and the Council of Guardians performs the function of the central of Shariah board.

Unlike in Iran, each IFI in Indonesia and Malaysia has their own SSB. However, there are slight differences regarding the functions and the structure nationally. In Indonesia, the SSB is more on “supervisory” performance, while in Malaysia, the term “advisory” is stand on the regulation. Moreover, the National Shariah Council (NSC) in Indonesia is an element of the National Ulama Council which has been recognized as an authoritative council for issuing fatwas in various matters, while in Malaysia the Shariah Advisory Council is part of the Central Bank.

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