

**THE ROLE OF *SHARIAH* 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 progress¹. 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 or fraud². 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

¹ A. R. Belkaoui, *Socio-Economic Accounting* (New York: Quorum Books, 1985) in Abdul Rahman (1998)

² M. Friedman, *The Social Responsibility of Business to Increase Profits*, *The Sunday Times Magazine*, (13 September 1970: 32-33) in Abdul Rahman (1998)

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

³ Briston, R. and El-Ashker, A. 1986. Religious Audit: Could It Happen Here?. The Accountancy (UK). October, pg. 120-121 in Abdel Karim, R.A. (1993)

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 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. Discouraging 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

⁴ Hafidhuddin, D. 2003. Islam Aplikatif. Jakarta: Gema Insani Press, pg.66, in Hafidhuddin and Tanjung (2006)

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'li (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

<i>Shariah</i> ruling	Accounting	Legal instrument	<i>Shariah</i> review	Rating agency	<i>Shariah</i> Governance	Screening process
Fatwa & resolution	Balance sheet	Terms and condition of the contract	Consideration of the process of review	Consideration of the element of <i>Shariah</i> compliance in the rating	Implementation of <i>Shariah</i> governance standards and guidelines	Consideration of the screening process cycle
		Combination of the contract				
	Accounting treatment	Terminology of the contract				

⁵ 'Abd al-Hamid al-Ba'li, "Taqnin A'mal al-Hai'ah al-Syar'iyyah: Mu'amalah wa Aliyatuh". Paper presented in al-Mu'tamar al-Thalith li al-Syar'iyyah li al-Mu'assasat al-Maliyah al-Islamiyyah, 5-6 October, 2003 in Bahrain, 63 in Triyanta (2010)

		act				
		The Sequencing of the contract				

Source: Lahsasna (2010b)

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.

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):

1. Guiding Principles of Risk Management, Dec. 2005
2. Guiding Principles on Corporate Governance, Dec. 2006

M. Fahim Khan⁷ 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)⁹, 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)¹⁰, 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.

⁸ Abu Moamer, F. M. 1989. An Analysis of the Role and Function of the Shariah control in Islamic Banks. Unpublished PhD Thesis: University of Wales in Syafei (2006)

⁹ Mautz, R. K. and Sharaf, H. A. 1961. The Philosophy of Auditing. American Accounting Association. In Syafei (2006)

¹⁰ Al-Qattan, M. 2003. Comparative System of Effective Shariah Supervisions of Banks. International Conference on Islamic Banking: Risk Management, Regulation, and Supervision. 30 September-2 October 2003. Jakarta: Islamic Banking Bureau-Bank Indonesia. In Syafei (2006)

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 activities¹¹.

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 repugnance¹².

¹¹ Bakar, M. D. (2002) The *Shariah* supervisory board and issues of *Shariah* rulings and their harmonisation in Islamic banking and finance. In: Simon, A., and Karim, R.A.A. (Eds). *Islamic finance: Innovation and growth*. Selected readings: 74-89. London Euromoney Books and AAOIFI. in Syafei (2006)

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 research¹³.

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 economy¹⁴. In some countries, such as Iran and Pakistan, Islamic banks are the only mainstream financial institutions¹⁵. 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 constitution¹⁶. 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

¹³ "Fiqh Academy must make thorough study of issues". The Malaysian Reserve on 3rd November 2009

¹⁴ ishrathusain.iba.edu.pk/speeches/WordDocs/PRUDENTIAL_ARRANGEMENTS.doc retrieved on 9th March 2010, 1:06 PM

¹⁵ Ilias (2009)

¹⁶ Kahf, M. (1999): Islamic Banks at the Threshold of the Third Millennium, in: Thunderbird International Business Review, vol. 41, nos. 4 and 5, 7-10/1999, pp. 445-460 and

Iqbal, Z. and Mirakhor, A. (1999): Progress and Challenges of Islamic Banking, in: Thunderbird

International Business Review, vol. 41, nos. 4 and 5, 7-10/1999, pp. 381-405 in Burghardt and Fuß (2004)

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 operations¹⁷.

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 bank¹⁸.

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* Supervisoy” 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

¹⁷ Strategic Plan for Islamic Banking Industry in Pakistan, *Shariah* Compliance, Appendix-C

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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