Chapter 15
A Proposed Model for Efficient Shariah Governance of Islamic Financial Institutions

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ABSTRACT

The Islamic banking and finance sector has predominantly relied on self-regulation for Shariah governance. Despite existing regulatory bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB), Islamic financial institutions largely remain self-regulated, as resolutions from these bodies are generally non-binding unless voluntarily adopted. Some countries have implemented Shariah-governance-related regulations, but these regulations often do not extend beyond the requirement to establish Shariah-compliance oversight bodies, which are typically controlled by the same operating banks. Conflicts between these regulatory authorities and Fiqh academies further complicate matters. This study addresses these challenges by identifying the deficiencies in the current system and then proposing necessary reforms to establish an effective Shariah governance framework. Such reforms are crucial for safeguarding the industry's integrity from within and facilitating its pursuit of its objectives.

1. INTRODUCTION[1]

Islamic banks are subject to the provisions set by the Islamic Shariah to be rightly called as 'Islamic'; the factor that distinguishes them from their conventional counterparts (Ahmad, 2000). Islamic banks avoid usury transactions and adhere to a few restrictions to align with the legal requirements of banking and finance set by Shariah. In addition to avoiding usury, uncertainty and gambling in their financial

DOI: 10.4018/979-8-3693-2683-1.ch015

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activities, Islamic financial institutions (IFIs) are also necessitated to observe some Islamic business ethics and norms including principle of justice, fulfilling covenants, and removal of hardship etc. (Ayub, 2007). These restrictions are in place to guard the Islamic banking business and motivate the institutions to make legitimate profit only through real economic activities that are inherently inseparable from risks, unlike the conventional banking business, which is based on usury and guaranteed quick profits. Islamic banks should thus embrace governance, especially Shariah governance, to avert Shariah risk that is specific to Islamic banking system.

While corporate governance, in general, serves as a comprehensive framework enabling companies to establish the modus operandi, management, monitoring, and overall performance evaluation, in the context of Islamic banking corporate governance is supplemented by an additional dimension known as Shariah governance. This supplementary component aims to safeguard that the financial institutions, purporting to abide by religious principles, uphold these principles consistently across their management practices, product offerings, service provisions, internal operations, accounting procedures, and customer interactions.

Shariah governance is an essential aspect of Islamic financial institutions as it serves to verify their commitment to the provisions of Islamic Shariah. Compliance with these provisions distinguishes Islamic financial institutions from their conventional counterparts. These distinguishing factors brings additional risks and challenges that are unique to IFIs. IFI's exposure to default risk, market risk, credit risk, liquidity risk, and Shariah non-compliance risk (International Monetary Fund, 2018) adds to the complexities of Islamic financial services and hence the difficulty in enforcing Islamic financial instruments in certain legal environments (Karim & Archer, 2011).

The Islamic Financial Services Board (IFSB) defines the Shariah governance system as "a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review" (IFSB, 2009).

Hence, Shariah governance is a complete system that outlines how IFIs follow the Shariah principles in conducting their business functions (Ginena & Hamid, 2015), and failure to adhere to Shariah governance exposes Islamic financial institutions to the risk of Shariah non-compliance. This risk not only jeopardizes the reputation of the Islamic financial institution but also undermines the confidence customers have placed in them. Consequently, the institutions lose the competitive edge provided by their Islamic identity, which enables them to attract customers. Additionally, non-compliance with Shariah can result in financial losses for the institution. If a transaction is found to be non-compliant, the Shariah controllers may decide to withhold the profits derived from it as a means to remove any impermissible elements. Furthermore, the lack of Shariah compliance may lead customers to initiate legal proceedings against the offending institution, resulting in procedural expenses or fines.

Bhatti and Bhatti (2009) assert that there is a need to shape the structure of the existing Shariah governance system that can confirm the compatibility of IFIs with the Shariah law, and hence to safeguard the rights of the stakeholders. The current Shariah governance has gaps that prevent it from achieving Shariah compliance. According to Haqqi (2014), a comprehensive Shariah governance system rests on four fundamental pillars: (i) management and oversight, (ii) the Shariah Advisory Board, (iii) Shariah adherence and evaluation, and (iv) transparency and disclosure. While Haqqi (2014) covers the broader framework for a comprehensive governance system, it leaves ground for further detailed discussion of the internal and external Shariah Supervisory Boards and their purposes. In order to collectively establish an effective framework for assessing and supervising Shariah compliance, Grais and Pellegrini (2006a)

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