

Shari'ah Supervision & Shari'ah Audit

Summary of a lecture by
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Shari'ah supervision and Shari'ah audit are new phenomenon which came out at the advent of Islamic banking a quarter-century ago.

1) What is Islamic banking:

- Banks (Islamic and otherwise) are financial intermediaries.
- The basic means for financial intermediation in conventional banking is interest based borrowing and lending.
- Interest is prohibited in Shari'ah because it is usurious.
- Islamic banks has to render financial intermediation interest free, which means that they have to develop substitutes based on other contractual relationships such as sale and partnership contracts (Murabaha, Mudarabah, Musharakah, Salam and Istisna'a).
 - Developing sale, lease and partnership contracts to become instruments of finance, requires not only financial engineering expertise, but also Shari'ah knowledge.
 - This is where Shari'ah scholars are involved in banking.

2) Shari'ah Supervision:

Shari'ah supervision is a process through which Shari'ah scholars provide guidance and give directions to the practitioners of Islamic banking in the following areas:

- a)- Development of new products and design of innovative procedures to render financial intermediation in an interest free fashion and within the Shari'ah permissibility, to meet the needs of their clients.
- b)- Training personnel of the bank.
- c)- Draft model contracts and master agreements for Islamic banking both in the investment and finance sections.

- d)- Answer questions and reply to inquires of the management and employees of the bank concerning Shari'ah aspects of banking. Some of these questions may be received from clients of the bank.
- e)- General advise and Hisbah, it is quite customary for Shari'ah board members to go out of their way to render guidance and give advise to the bank management on matters that deal with aspects other than just banking.

3) Genesis of Shari'ah boards:

Islamic banks came as an alternative to conventional banking. Mission of Islamic banks was (and still is) to establish a new system for financial intermediation. Such system was neither familiar to the general public nor fully known to the functionaries in Islamic banks. This meant that banks needed a vehicle to both assure legitimacy in the public eye, and to coach, accustom and inure the management of Islamic banks in the Shari'ah aspects relevant to banking. This is why Shari'ah boards were born.

4) Powers of Shari'ah boards:

Shari'ah boards are always autonomous and separate from the institution they serve. Hence, they have no executive power. However, their influence on the management depends on the nature of their relationship to the bank. There are many forms:

- a) One form is for the members of the board to be selected and appointed by the general assembly of the shareholders of the bank. In this case the Shari'ah board reports to that body. This is by far, the most powerful position for a Shari'ah board that is keen to influence the course of the bank and yet remain separate from it. Few banks are like this.
- b) The most common is for the members to be selected by the board of directors and reports to it. The Shari'ah board would still have “teeth” but it remains that the “buck” will stop before it reaches the shareholders. It is claimed that such arrangement is “frictionless” and beneficial.
- c) There are few cases in Muslim countries (namely Malaysia and Sudan) where appointment of a Shari'ah board is a legal

requirement for the conduct of Islamic banking and is part of the licensing process. In this case the selection is approved by a regulatory agency.

- d) In some cases outside independent advisors are resorted to, to furnish some of the normal functions of a Shari'ah boards. This is, obviously, the weakest situation.

In reality the strength of the Shari'ah board actually emanates from the stature of its members. Prominent Shari'ah scholars usually have greater effect regardless of their managerial status.

5) Extent of involvement:

Some regulators and central bankers were baffled about the nature of the job of Shari'ah boards in Islamic financial institution. They thought Shari'ah scholars, with little or no training in banking, “call the shots” in Islamic banks. Actually, Shari'ah boards have no executive power and they don't interfere in the day to day management of the bank nor take decisions on behalf of the management. They may express their views about the Shari'ah permissibility of a transaction, but they will never comment on the credit or risk aspects of it.

6) The transitional nature of Shari'ah boards:

The existence of Shari'ah boards are now an essential part of the working of Islamic banking. This is unique. It is not the “nature of things”. Islamic banking should be based on laws and regulations extracted from Shari'ah, or at least not contradictory to it. Once this is done, then only the function of audit and compliance is needed. Such job can be done by professionals not necessarily Shari'ah scholars.

Therefore, Shari'ah boards as they stand today are transitory. There are here no Islamic bank law is in existence and regulators are yet to come up with banking procedures that are in line with Shari'ah requirements. It is because of this many observers criticize the lack of standard Shari'ah products and forms of contract in Islamic banking.

There is an attempt now to initiate Shari'ah standards for the practice of Islamic banking as a foundation for future law.

7) Shari'ah compliance:

It is not sufficient that a bank has a Shari'ah board that meets every few months and drafts forms of contracts and approve new products. Just as

important is Shari'ah compliance making sure that Shari'ah requirements are adhered to by the functionaries. For this purpose, many Islamic banks appoint an internal Shari'ah officer in-charge of compliance. His job is mainly inspection, to ascertain the fact that set procedures are followed by the employees of the bank, and that decision of the Shari'ah board are implemented.

8) Shari'ah audit:

Part of the function of Shari'ah board's is to carry out its Shari'ah audit. Shari'ah audit is a duty in the process of formation. Shari'ah audit has similarities to financial auditing in the fact that both take place at the end of the financial year and result in the approval of these financials by the auditor. The concern of the Shari'ah board is clearly making sure that the sources of money and utilization of funds by the bank are both in line with Shari'ah. Some regulators are now encouraging such practice in earnest.

The function of Shari'ah audit requires a close co-operation with accounts auditors and in some Islamic banks auditors themselves are involved directly in the process.

Shari'ah boards do this audit through the inspection of sample of files in each product category i.e. Murabaha, Istisna'a,...etc. The purpose is to make sure that the set procedures have been followed and that approved forms of contracts are used.