

**REGULATORY ARRANGEMENT FOR SHARIAH GOVERNANCE
PRACTICE OF ISLAMIC BANKING INSTITUTIONS IN PAKISTAN:
ISSUES AND CHALLENGES**

**Pakistan'daki İslâmî Bankacılık Kurumlarındaki Uygulamaların Şer'î
Uygunluğuna İlişkin Yasal Düzenlemeler: Sorunlar ve Zorluklar**

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Regulatory Arrangement for Shariah Governance Practice of Islamic Banking Institutions in Pakistan: Issues and Challenges

Abstract

Shariah governance practice is a vital component of the organizational arrangement of IBIs through which the business affairs of IBIs are examined, certified and monitored. It plays a crucial role to legitimize the business of IBIs. In Pakistan, SBP regulates the practice of Shariah governance through a dedicated department with the aid of its SAC and executes it through Shariah boards of IBIs. Applying descriptive analytical approach, the study has described the current state of Shariah governance practice of IBIs. It is the outcome of the regulatory arrangements in the form of regulatory guidelines, directives, standards and frameworks which have been issued during the last two decades by SBP to standardize the practice of Shariah governance for IBIs in Pakistan. The study highlights the formation of the regulatory arrangement which not only depicts the role of SBP, but it also illustrates the functions of SAC and the responsibilities of Shariah boards at IBIs. The study also attempts to confine the regulatory, advisory and supervisory roles of the SBP, the SAC and the Shariah board of IBIs respectively. An analytical review of the roles of these bodies which are defined through the regulatory arrangements facilitates to discover the loopholes in the current regulatory arrangement for Shariah governance of IBIs. Although, attempts have been made to address the issues in this regard by some writers but in case of Pakistan, the issues are yet to be identified. The study has found that the regulatory arrangement of Shariah governance practice has been constituted significantly by the SBP. However, composition, affiliation and independence of Shariah bodies at central bank and the institutional level are the aspects which pose regulatory issues in the current arrangement. Therefore, the study has discovered some possible solutions for these issues and proposes them for regulatory enhancements. It suggests that the SBP as central regulatory authority should specify regulations over the composition of SAC at SBP level to augment the regulatory and advisory process for Shariah governance practice of IBIs. It recommends that the number of the members at SAC as well as at the Shariah boards of IBIs should be maximized. The two bodies should have additional qualified members especially the number of Shariah qualified members need to be increased. It also proposes that the nomenclature of each body should be defined separately because referring with various names for each body

or using their names interchangeably could cause confusion. In addition, the members of SAC and the institutional Shariah boards should be barred from having multiple Shariah boards affiliations through specific regulations. It also recommends that the Shariah boards member must play their supervisory roles independently without any undue influence from the executives. So, a specific set of regulations is required which could guarantee the independence of Shariah boards of IBIs. The proposed recommendations of the study will not only facilitate the regulatory authority to revisit its arrangement and include conclusive measures, but they will also assist the industry to enhance the productivity of their Shariah board members. It will also assist the industry to establish an environment where contribution of the Shariah qualified members and their effective role would strengthen the marketability and credibility of the Shariah governance practice in the Islamic banking industry. Ultimately, a balanced, conclusive and enhanced regulatory arrangement for Shariah governance practice of IBIs would standardize the practice of Shariah governance at the domestic level as well as it could be harmonized with the international best practices of the Islamic banking industry.

Keywords: Islamic Law, Islamic banking, Regulations, Shariah governance, State Bank of Pakistan, Shariah Advisory Committee.

Pakistan'daki İslâmî Bankacılık Kurumlarındaki Uygulamaların Şer'î Uygunluğuna İlişkin Yasal Düzenlemeler: Sorunlar ve Zorluklar

Öz

Şeriat denetim uygulaması, İslami Bankacılık Kurumları'nın iş ilişkilerinin incelendiği, onaylandığı ve izlendiği IBK'ların organizasyonel düzenlemesinin hayati bir bileşenidir. IBK'ların işini meşrulaştırmak için çok önemli bir rol oynar. Pakistan'da Pakistan Devlet Bankası, Şeriat denetim uygulamasının Şeriat Danışma Komitesi'nin yardımıyla özel bir departman aracılığıyla düzenler ve bunu IBK'ların Şeriat kuralları aracılığıyla yürütür. Tanımlayıcı analitik yaklaşım uygulayan çalışma, IBK'ların Şeriat yönetim uygulamasının mevcut durumunu tanımlamıştır. Bu, Pakistan'daki IBK'larında Şeriat yönetiminin uygulamasını standartlaştırmak için SBP tarafından son yirmi yılda yayınlanan düzenleyici kılavuzlar, direktifler, standartlar ve çerçeveler şeklindeki düzenlemelerin sonucudur. Bu çalışma, Pakistan Devlet Bankası'nın rolünü göstermekle birlikte, aynı zamanda Şeriat Danışma Komitesi'nin işlevlerini ve IBK'lardaki Şeriat kurullarının sorumluluklarını da belirleyen düzenlemenin oluşumunu vurgulamaktadır. Çalışma ayrıca IBK'ların sırasıyla Pakistan Devlet Bankası, Şeriat Danışma Komitesi ve Şeriat kurulunun düzenleme, danışma ve denetleme rollerini sınırlandırmaya çalışmaktadır. Düzenleme planları ile tanımlanan bu organların rollerinin analitik bir incelemesi, IBK'ların Şeriat yönetimi için mevcut düzenleme planındaki boşlukları keşfetmeyi kolaylaştırır. Bu konudaki sorunları ele almak için bazı pazarlarca girişimlerde bulunulmuş olsada, Pakistan örneğinde sorunlar henüz tespit edilmemiştir. Bu çalışma, Şeriat denetim uygulamasının düzenleme planının önemli ölçüde Pakistan Devlet Bankası tarafından oluşturulduğunu ortaya çıkarmıştır. Ancak, şeriat organlarının merkez bankası ve kurumsal düzeydeki bileşimi, bağlılığı ve bağımsızlığı mevcut planda düzenleme sorunlarını ortaya çıkaran unsurlardır. Bu nedenle, çalışma bu sorunlar için bazı olası çözümler ortaya koymuş ve düzenlemenin geliştirilmesi için bu çözümlere dayalı öneriler sunmuştur. Bu çalışma, merkezi düzenleyici otorite olarak Pakistan Devlet Bankasının, IBK'ların Şeriat yönetim uygulamalarına yönelik düzenleme ve danışma sürecini artırmak için Pakistan Devlet Bankası düzeyinde Şeriat Danışma Komitesinin bileşimi üzerine düzenlemeler belirlemesi gerektiğini önermektedir. IBK'ların Şeriat kurullarının yanı sıra Şeriat Danışma Komitesindeki üye sayısının maksimize edilmesini tavsiye etmektedir. İki organın ek kalifiye üyeleri olmalıdır, özellikle Şeriat hususunda nitelikli üyelerin sayısı artırılmalıdır. Ayrıca, her bir

gövdenin isimlendirmesinin ayrı ayrı tanımlanması gerektiğini önermektedir, çünkü her gövde için çeşitli isimlerle atıfta bulunmak veya isimlerini birbirinin yerine kullanmak karışıklığa neden olabilir. Buna ek olarak, Şeriat Danışma Komitesi üyelerinin ve kurumsal Şeriat kurullarının, belirli düzenlemeler yoluyla birden fazla Şeriat kuruluna üyelikleri engellenmelidir. Ayrıca, Şeriat kurullarının üyelerinin kendi denetimlerini yöneticilerin herhangi bir usule aykırı etkisi olmaksızın bağımsız olarak yapmalarını tavsiye eder. Bu nedenle, IBK'ların Şeriat kurullarının bağımsızlığını garanti altına alabilecek belirli bir dizi düzenleme gereklidir. Çalışmanın teklif ettiği öneriler, düzenleyici otoritenin düzenlemesini yeniden gözden geçirmesini kolaylaştırmakla kalmayıp kesin önlemler içermektedir, aynı zamanda sektöre Şeriat kurul üyelerinin üretkenliğini artırma konusunda yardımcı olacaktır. Aynı zamanda Şeriat hususunda yetkili üyelerin katkısının ve etkin rollerinin İslami bankacılık endüstrisindeki Şeriat yönetim uygulamasının pazarlanabilirliğini ve güvenilirliğini güçlendireceği bir ortam oluşturmasıyla sektöre yardımcı olacaktır. Nihayetinde, IBK'ların Şeriat yönetim uygulaması için dengeli, kesin ve gelişmiş bir düzenleme planı, yerel düzeyde Şeriat yönetiminin uygulamasını standart hale getirecek ve aynı zamanda İslami bankacılık endüstrisinin en iyi uluslararası uygulamalarıyla uyumlu hale taşıyabilecektir.

Anahtar Kelimeler: İslam Hukuku, İslami bankacılık, Yönetmelikler, Şeriat denetimi, Pakistan Devlet Bankası, Şeriat Danışma Komitesi.

Introduction

The current financial system is based on a mechanism where the suppliers and utilizers interact through the intermediation of commercial banks, finance companies, saving and loan associations, insurance companies, investment companies such as mutual funds and fund managers. Following the same structure but with a modified version, the Islamic financial system comprising Islamic banks, Islamic investment banks, *takaful* companies, and Islamic mutual funds also evolves in this competing environment. Therefore, to stabilize and standardize the inter-sector or cross-sector operation of these financial institutions, i.e. various financial products, services, and transactions, the regulatory authorities play their role to regulate and supervise their business operations.¹ The tremendous expansion of the Islamic finance industry in the recent competitive financial market shows that it has the potential to become a

¹ Umer Chapra - Tariqullah Khan, *Regulation and Supervision of Islamic Banks*, (Jeddah: IRTI occasional Paper #3, IDB, 2000), 7, 8.

trillion-dollar industry at the global level.² To accomplish that level, it has to follow a specific market discipline. This market discipline is usually crafted through dedicated regulations³ which are issued by the regulatory authorities. In this regard, the regulations are formulated to standardize the conduct of IBIs. The system which is composed by the course of regulations to regulate and standardize the business affair of IBI is called Shariah governance practice. Shariah governance practice provides a legitimate foundation to the business of IBIs because it is the device that requires all business activities of IBI to be in compliance with Shariah rules and principles. To execute this concept, IBI requires a different kind of institutional arrangement where the operation, business, and affairs of IBI are conducted, controlled, and supervised through Shariah governance practice. The Shariah governance practice which is formulated by several organs is meant to regulate and systematize Islamic banking operations. The organs which collectively formulate a Shariah governance practice are the board of directors, the management of the Islamic bank which includes all of its departments such as accounting and auditing departments, and the crucial organ which is the Shariah supervision. The Shariah supervisory function of IBI is supported with Shariah review, Shariah audit, and compliance units in order to ensure that the business of IBIs complies with Shariah principles at every stage. Therefore, the regulations issued by the regulatory authorities ensure that Shariah governance practice is executed with its required spirit through various tools. For that purpose, all the regulations are supervised and monitored at the macro level when they are formulated under the supervision of central Shariah advisory whereas, at the micro level, they are executed through Shariah advisory function at an institutional level.

Based on the said premises, the State Bank of Pakistan (SBP) is entrusted with the statutory role to regulate and supervise the Islamic banking industry in Pakistan.⁴ Therefore, SBP has been performing its statutory role to establish a sound regulatory arrangement to regulate and supervise the practice of Shariah governance of IBIs under the advisory and supervisory function of its Shariah Advisory Committee (SAC). SBP has adopted an evolutionary approach to developing its regulatory arrangements for Shariah governance practice

² Zulkhibri – Ghazal, *Development of Islamic Banking Regulation in Selected Member Countries: A Comparative Analysis*, (Jeddah: IRTI Working Paper Series # 1436-12, IDB, 2015), 3.

³ Chapra – Khan, *Regulation and Supervision of Islamic Banks*, 1.

⁴ Section 54 (1) SBP Act 1956 States that “The Central Board may make regulations consistent with this Act to provide for all matters for which provision is necessary or convenient for the purpose of giving effect to the provision of this Act”.

which reveals that the efforts to enhance these arrangements are constantly being developed to meet the challenges of the dynamics of the Islamic banking industry domestically as well as internationally.⁵

The regulatory arrangement for Shariah governance practice consists of three elements. This arrangement is based on the multi-tiered Shariah compliant arrangements which are aimed to fulfill the clients' and investors' satisfaction. It has been designed to control three levels of the Shariah compliant process. The first stage is the SAC of the SBP which is responsible for approving the policies and regulations regarding Islamic banking and fitting and proper criteria for the Shariah advisors. The second layer is the Shariah board in all IBIs to facilitate the IBIs and to satisfy the customers regarding Islamic banking products and services. The third stage is the Shariah compliance inspection of SBP that examines the Islamic banking operations.⁶ The study in hand is aimed to describe the current state of Shariah governance practice and challenges that are affecting its regulatory and legal arrangements. Beginning with the introduction of the regulatory arrangement for Shariah governance practice in general, the first section of the study explains the origin and conceptual background of Shariah governance, the related literature review, the research problem, and its limitations. The second section describes the current state of the regulatory and supervisory mechanism established by SBP. The third section analyses and highlights the issues in this regard whereas the last section summarizes the discussion and concludes the study.

Origin of Shariah Governance of IBIs

Every financial or business entity needs an organizational arrangement that carries the whole operational system through its managerial tool in order to achieve the set goals for the betterment of any corporation.⁷ The modern corporate governance which is implemented in the Islamic banking institutions is originally derived from the conventional banking system

⁵ In 2008, SBP issued a circular defining the guidelines and instructions for Shariah Compliant business operation of the Islamic banking institutions and Fit & Proper criteria for Shariah advisors for appointment at the IBI. These efforts were primary which evolved and as a result SBP issued a consolidated complete Shariah Governance Framework, defining all the governance and institutional arrangements as well as guiding principles on Shariah compliant business.

⁶ D. Akhtar, "Pakistan—Islamic Banking: Past, Present, and Future Outlook, SBP, Karachi, Pakistan". (2007), 3. Available at: <http://www.sbp.org.pk/about/speech/governors/dr.shams-had/2007/Islamic-Banking-11-Sept-07.pdf>.

⁷ Imran Hussain Minhas, "Shariah Governance Model (SGM) and its Four Basic Pillars", *Islamic Finance News Malaysia*, (Red Money Publication: April 18, 2012), 4. Available at SSRN: <http://ssrn.com/abstract=2153106> (Retrieved on April 6, 2014).

but the features which distinguish it are the conceptual and the operational natures of the Islamic banking business. However, some writer like Qattan elaborates Shariah governance by emphasizing and analyzing the role of Shariah supervisory board in the traditional corporate governance system.⁸ It indicates that he sought the function of Shariah supervision as an integral part of the traditional corporate governance structure. On the other hand, Ayeshat interprets the Shariah governance system with a different opinion. She expresses that corporate governance, which complies with Islamic law, is called Shariah corporate governance. She asserts using the term “Shariah Corporate Governance” justifying that majority of the researchers⁹ used to explain Shariah governance, referring to the role of Shariah supervisory board which was one of the components of the conventional corporate governance structure. Still, the existing Shariah corporate governance encompasses all other organs. It includes Shariah audit, Shariah review, Shariah research, Shariah compliance, and Shariah risk management.¹⁰ From her point of view, it can be understood that the additional organs of Shariah governance enhance its specific recognition and identity parallel to conventional corporate governance. Minhas considers Shariah governance as the alignment of corporate governance according to the Islamic principles, and it is a combination of the organizational arrangement, policies, procedures, rules, and regulations to facilitate the organization on Shariah compliance function which is the only reason for IFI to survive.¹¹ Zulkifli Hasan divides the available literature on corporate governance in Islamic finance into three main phases. The first phase which started from pre-1980s was silent on this topic but in the second phase (1980s-1990s), specific attention was given particularly in 1989 when a survey by Aboumouamer was conducted on Shariah control in Islamic banks and a book entitled “External Audit and Corporate Governance in Islamic Banks” by Banaga et al. was written about external audit and corporate governance of Islamic banks. The third phase (post-2000) witnessed the failure of some IFIs such as Ikhlas Finance House in Turkey, Islamic Bank of South Africa, Investment Companies of Egypt, etc. After these tragic incidents, significant attention had been given to this area and a good number of research were carried out by different individuals and

⁸ Muhammad A. Qattan, “Shariah Supervision: The Unique Building Block of Islamic Financial Architecture” *Islamic Financial Architecture: Risk Management and Financial Stability*, (Jeddah: IRTI, Islamic Development Bank, 2006), 273–287.

⁹ As Qattan explains in his research work, mentioned above his opinion.

¹⁰ Aishath Muneeza, “The Legal Evolution of Shariah Corporate Governance of Islamic Banks in Malaysia”, *Malayan Law Journal*, 2012.

¹¹ Minhas, “Shariah Governance Model (SGM) and Its Four Basic Pillars”, 1.

organizations such as the work by Chapra and Habeeb on corporate governance (2002) and the surveys of IFSB on Shariah boards, etc.¹² This significant consideration about corporate governance of Islamic banks is increasing and the need for academic research is required as the industry's rapid growth is facing new challenges and issues. The specific literature in the field of Shariah governance and its operational relevance can help these issues and challenges to be tackled accordingly.

Research Problem

In contemporary times, considerable attention has been given to the Shariah governance practice of IBIs and a significant number of researches published. Some highlight its theoretical aspects while others explored the operational issues. Much good work has been done regarding its regulatory framework while some researchers have focused on supervisory and operational aspects. Others have explored the Shariah governance system as a whole and discussed its function and how it can be or should be implemented. Some have elaborated on Shariah governance models such as Pakistani and other models which are practiced in different countries briefly and separately. However, no attempt has been made to produce an analytical study of Pakistan's current regulatory arrangement in this regard. Therefore, the research in hand has a specific focus to examine the current regulatory arrangement for Shariah governance practice which has been established by the SBP to cater to the regulatory needs of IBIs in Pakistan. The research also attempts to highlight the issues in the regulatory arrangement which are affecting the current practice of Shariah governance exercised by the IBIs. It will not only enhance the functions of regulatory and supervisory authorities at macro and micro levels, but it will also harmonize their efforts with international best practices.

Conceptual Background of Shariah Governance:

Basically, corporate governance in the Islamic banking system is the same institutional arrangement that is also implemented by conventional organizations but the only element which provides a specific identity to Islamic banking is the Shariah governance arrangement. Shariah governance is the specific institutional arrangement through which all Islamic banking operations are monitored and Shariah non-compliance risks are identified and rectified by Shariah experts. Zulkifli Hasan elaborates that, basically, the concept of corporate governance from an Islamic perspective does not

¹² Zulkifli Hasan, *Shari'ah Governance in Islamic Banks* (Edinburg: Edinburgh University Press, 2012), 21-22.

differ much from the conventional definition as it refers to a system by which companies are managed, directed, and controlled with the purpose of meeting the corporation's objectives mainly to protect all the stakeholders' interests and rights. But because of the different conceptual backgrounds, Islamic corporate governance requires additional distinctions and features compared to the western concept¹³. There is a special case of a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God¹⁴. This is the reason that many researchers have defined the term 'corporate governance in Islamic banking' rather than emphasizing the term 'Shariah governance' in the earlier available literature. It was the set of guidelines issued by the Islamic Financial Services Board (IFSB-10, 2009) on Shariah governance for Islamic banks that systematically defined the term 'Shariah governance framework' in the first place.¹⁵ Earlier than that IFSB guidelines (IFSB-3, 2006) had also used the term "corporate governance" for institutions offering only Islamic financial services while issuing these guidelines because there was no precedential example.

According to the IFSB-3 definition, corporate governance of Islamic financial institution is "a set of relationships between a company's management, its BOD, its shareholders, and other stakeholders which provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined"¹⁶. It further suggests that the corporate governance of IFI should encompass "a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders, provision of proper incentives for the organs of governance such as the Board of Directors, SSB, and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFs to use resources more efficiently and compliances with Islamic *Sharī'ah* rules and principles".¹⁷ The above definitions show that corporate governance of IFI is basically based on two main aspects and those are to protect the interests and rights of the

¹³ Hasan, *Shari'ah Governance in Islamic Banks*, 23.

¹⁴ Hussein Elasrag, *Corporate Governance in Islamic Finance: Basic Concepts and Issues*, (LAP LAMBERT Academic Publishing: 2014), 62.

¹⁵ Hasan, *Shariah Governance Islamic Banks*, 46.

¹⁶ IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services, (Excluding Islamic Insurance (Takâful) Institutions and Islamic Mutual Funds, 2006), 33.

¹⁷ IFSB-3, 33.

stakeholders through the set governance structure and to do so, Shariah compliance must be in place.

Later on, the IFSB-10 guidelines entitled “Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services” define the ‘Shariah governance’ as “a set of institutional and organizational arrangements through which an IIFs ensures that there is effective independent oversight of Shari`ah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review”.¹⁸ This definition includes all key aspects of Shariah governance which are the Shariah board composition and its related operations. It illustrates the Shariah compliance objectives and the entire Shariah compliance process along with the transparency and the disclosure practice. Another bold initiative was taken by Bank Negara Malaysia when it rolled out its guidelines on Shariah governance in 2010 but the latest Shariah Governance Policy Document that was issued in 2019 is a comprehensive and advanced regulatory arrangement, however, it doesn’t provide a thorough definition on Shariah governance. The AAOIFI standards on Shariah governance have only encompassed the definition of the Shariah board and its function but do not provide a specific definition of Shariah governance. The later writings in this field have started explaining it specifically by using the term “Shariah governance”. Ahmad and Maksuda Khatun explain that the philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of Shariah compliance. With this aspiration, corporate governance in IFIs needs a set of institutional arrangements to oversee the Shariah compliance aspect of their business and operations. In the absence of a specific model of corporate governance in Islamic literature, the Shariah governance system was introduced to complement the existing corporate governance framework in IFIs. That is the main reason that a Shariah governance system is peculiarly exclusive and unique to the corporate governance framework in IFIs, unlike their conventional counterparts¹⁹. Minhas defines it in a general sense by stating that “governance is a method which an organization adopts to ensure that components of the organization follow the set rule, regulation, policies and processes. Governance is said to be good when it primarily ensures achievement of objectives with the existence

¹⁸ IFSB-10, Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services, (2009), 2.

¹⁹ Mahmood Ahmed – M. Khatun, “The Compliance with Shariah Governance System of AAOIFI: A Study on Islamic Banks Bangladesh”, *Journal of Islamic Economics Banking and Finance* 9/3 (July 2013), 2.

of effective risk management system, transparency, fairness, responsibility, accountability and independence. Good governance is termed as corporate governance when a business entity is operated, regulated and controlled by the well-designed risk management policies, processes, corporate regulations, rules and laws that lead the entity to achieve its ultimate goals²⁰. In addition, Minhas specifies that Shariah governance system is simply the alignment of corporate governance that operates according to the Islamic principles. Specifically, Shariah governance is “the set of institutional and organizational arrangements, policies, processes, procedures rules, regulations and laws which leads the organization towards Shariah compliance”²¹. Shariah governance applies to Islamic financial institutions (IFIs) as its compliance is the only reason for an IFI to exist. Shariah governance is based on four pillars which are (i) management and supervision (ii) Shariah advisory (iii) Shariah compliance and review and (iv) transparency and discloser. He adds that this process is monitored, either through the Shariah board or through a dedicated internal Shariah review department, working under the board of directors.²²

The definitions and explanations by different researchers clearly indicate that the recent practice of Shariah governance is basically the complement of the conventional corporate governance but the conceptual background and operational structure reflect its exclusive identity. That exclusive identity demands the Islamic banking institutions to articulate further organizational arrangements in its corporate structure for the purpose of Shariah compliant business operation. The first demand is that IBI has to establish a sound Shariah supervisory authority in the business association. Secondly, the Islamic banking institution has to ensure all of its financial activities comply with Shariah rules and principles. Thirdly, along with the protection of shareholder interests, Islamic banking institutions must consider their responsibility toward all stakeholders and the society to assure that neither the rights of individuals nor the collective social rights are violated. All these aspects of the Shariah governance system complete the true definition of Shariah governance.

²⁰ Minhas, “Shariah Governance Model (SGM) and Its Four Basic Pillars”, 1.

²¹ Minhas, “Shariah Governance Model (SGM) and Its Four Basic Pillars”, 1.

²² Minhas, “Shariah Governance Model (SGM) and Its Four Basic Pillars”, 1.

Limitation of Research

The above literature review offers insights into previous research on Shariah governance in the context of Islamic banking. Interestingly, a good volume of research is available on the Shariah governance practice in general. However, the research in hand is limited to explore the Pakistani model of Shariah governance and its related regulatory and supervisory arrangements. Although, there are various Shariah governance practices available in some leading Islamic countries such as Turkey, Malaysia, Indonesia but the proposed research has to examine specifically the regulatory arrangement of Shariah governance practice crafted by the State Bank of Pakistan. More specifically, the research analyses the composition and roles of the Shariah bodies at a regulatory level as well as at the institutional level. This will provide academic support to the Shariah governance practices in the Islamic banking industry of Pakistan.

Regulatory Arrangement of SBP for Shariah Governance Practice

Regulations are about changing the behavior of regulated institutions because undisciplined market behavior causes low standard social outcomes. Most importantly, regulation secures the banking system from disorder and failure and ensures financial stability. Regulatory roles of the SBP include the regulations implemented for monetary policy as well as prudential purposes.²³ To regulate the Islamic banking industry, SBP has established its three-tiered regulatory arrangement for Shariah governance practice of IBIs. Firstly, the Islamic Banking Department (IBD) of SBP and its associated SAC are entrusted to construct, introduce and issue regulatory guidelines and standards over Shariah governance practice of IBIs. Secondly, Shariah compliance inspection of SBP plays its role to monitor and examine the adoption and compliance behavior of IBIs towards the implemented regulations, guidelines, and standards. Thirdly, Shariah boards at IBIs are responsible to execute and supervise Shariah governance practices as required by SBP's regulatory guidelines²⁴ as well as to facilitate the IBIs and to satisfy the customers regarding Islamic banking products and services.²⁵ All these elements constitute Shariah governance practice for IBIs. The detail of each element is provided hereunder.

²³ Ishrat Husain, "Financial Sector Regulation in Pakistan: The Way Forward", *SBP Research Bulletin* 7/1 (2011), 31-44.

²⁴ Shamshad Akhtar, "Shariah Compliant Corporate Governance", *Annual Corporate Governance Conference Dubai on November 27, 2006*, 7. available at: <https://www.sbp.org.pk/ibd/speeches.htm>.

²⁵ Akhtar, "Pakistan—Islamic Banking: Past, Present, and Future Outlook", 3.

Central Shariah Advisory Committee of SBP

The re-launching of the Islamic banking industry in Pakistan required that there should be a religious authority at the national level to advise and supervise SBP on Shariah related affairs of the Islamic banking industry. For that purpose, on October 24th, 2003 the Central Shariah Board²⁶ was established under the organizational structure of the SBP.²⁷ The establishment of SAC of SBP was initially made under the Judgment of Sharia Appellate Bench of Supreme Court (1999) where the Supreme Court of Pakistan (SCP) advised in its Judgment in Para 7 titled “Establishment of special departments within the State Bank” as it states that: “Shariah Board of scrutiny and evaluation of Board’s procedures and products and for providing guidance for successfully managing the Islamic economics”.²⁸ It has seven members including a director of IBD as a non-member individual who acts as secretary to the committee. It comprises of three Shariah scholar members²⁹ and from the technical fields, it includes a member as a chartered accountant, a member as a lawyer, and a member as an expert of economics, finance, and banking whereas executive director of development finance group of SBP is also included as an ex-officio member. The Director of IBD of SBP acts as ex-officio secretary (non-member) to the SAC.³⁰ The composition of SAC is made of experts from different fields in order to produce sound and balanced Shariah resolution on the Islamic banking operations keeping in view the financial, legal, and business requirements of the country³¹.

The key functions Shariah Board is entrusted with are:³²

Review and approve Shariah compliance on the products/instruments developed by the SBP for conducting its central banking and monetary management functions under the Islamic modes.

²⁶ Initially it used to be called Shari’ah board but later it was renamed which is now called Shari’ah Advisory Committee. see: IBD Circular Letter No. 01 of 2018, Islamic Banking Department, SBP, April 11, 2018, see: www.sbp.org.pk. Visited on 6th March 2019.

²⁷ “Pakistan’s Islamic Banking Sector Review 2003 to 2007”, Islamic Banking Department, *State Bank of Pakistan*, 15.

²⁸ Judgment of Sharia Appellate Bench of Supreme Court of Pakistan, (1999), Para 7(a) at page 1013 of judgment dated the 23rd December, 1999, in civil Shariat Appeals No. 1 of 1992 etc.

²⁹ The criteria for the appointment of Shari’ah scholar members is set same as for the members of Islamic Ideology Council and members of Shariat Court in Pakistan.

³⁰ Shari’ah Advisory Committee of SBP, introduction see: www.sbp.org.pk, accessed on 7th March 2019.

³¹ “Pakistan’s Islamic Banking Sector Review 2003-2007”, 15-16.

³² “Pakistan’s Islamic Banking Sector Review”, 16.

Advise the SBP on prudential regulations developed for the Islamic banking sector.

Approve the fit and proper criteria for appointment of Shariah advisors in institutions conducting Islamic banking activities.

Advise the SBP on Shariah ruling in case of a conflict arising from the Shariah audit of Islamic banking activities under the supervisory control of the SBP.

Advise the SBP on the Shariah rulings in case of a conflicting Shariah opinion on the Islamic banking products.

The central SAC which was established by the IBD of the SBP is the highest authority for any conflict resolution in the Islamic banking product and service operations. Moreover, these are some other functions performed by SAC of the SBP which are:³³

The SAC is entrusted with the role to provide guidance regarding the rules and regulations on Shariah compliant procedures for Islamic banking operations, and the guidelines, instructions, and policies introduced by SBP related to the Islamic banking sector as approved by the SAC.

SAC has to harmonize the Shariah rulings of IBIs when the Shariah board or advisors in IBIs may produce some rulings which may contradict the rulings given by the SAC of the SBP or differ from other Shariah boards of different Islamic banking branches such issues are resolved and managed by the SAC of the SBP. The decision made by the SAC of SBP must be upheld. The SAC of the SBP, being the final authority on Islamic banking practice, is constituted and combined with multi-dimensional expertise.

Although the recent Shariah governance practice is a better arrangement, the composition of the SAC in the SBP is still required reforms. The SAC comprises seven members but only three Shariah scholars are required to be in the SAC. The SAC which has to oversee the overall Islamic banking operations in the country with only three Shariah scholars can cause weak supervision, less diversification of the products and services for the Islamic banking institutions, slow innovation, and introduction of the banking and financial services, etc. In this regard, the composition of SAC at SBP should comprise of more members especially Shariah scholars who have strong Shariah backgrounds along with sound awareness of the Islamic banking industry. This task can also be

³³ <http://www.sbp.org.pk/ibd/2007/Shariah-Practices-07-Aug-07.pdf>.

accomplished by providing academic support and technical training to the Shariah scholars under the supervision of senior experts in the field. Moreover, the members of SAC of SBP can serve in the Shariah boards of IBIs as well due to the absence of specific regulations in this regard. It is a clear sign of conflict of interest which should be managed through regulatory guidelines of SBP.

The regulatory authorities in Pakistan can also take into consideration the composition of the Shariah Advisory Council of Bank Negara Malaysia which comprises a total of nine members many of whom are Shariah scholars with diversified exposure. They are selected as members of the Shariah Advisory Council based on their adequate experience in Islamic banking and finance and appropriate ability to produce Shariah ruling. Besides, they are not allowed to be part of any Shariah committee of IBIs. A comprehensive and diversified SAC at the SBP can assure a sound and robust Shariah compliant resolution and diversified Islamic banking operations. This arrangement will not only harmonize Shariah compliance function in IBIs, but it will also protect the reputation of Islamic banks and enhance the public confidence towards the business of IBIs. This is something that the Pakistani Islamic banking system strongly needs because of its unpleasant experiences in the past.

Shariah Boards of IBIs

It is a requirement before obtaining the license for establishing an Islamic bank in Pakistan to have a Shariah supervisory arrangement in the Islamic bank's governance structure.³⁴ The guidelines issued by the SBP in 2008 required at least one Shariah advisor to be appointed in any Islamic banking institution but in spite of this, many Islamic banks, because of market competition and enhancing their Shariah compliant credibility, were forced to hire more than one Shariah advisor. Luckily, after the implementation of the Shariah governance framework of SBP, the requirements for the Shariah supervisory arrangement are augmented. Currently, every IBI must have a Shariah board that consists of at least three members.

The appointment of the Shariah board members must be according to the fit and proper criteria for the selection of Shariah board members issued by

³⁴ Criteria, licensing requirements and operational guidelines for setting up Islamic Banking through Stand-alone branches, can be seen here: <http://www.sbp.org.pk/bpd/2003/C1.htm>. . Accessed on 5th November 5, 2018. Detail Criteria for setting up schedule Islamic commercial bank based on principles of Shari'ah in the private sector and detailed criteria for setting up of Islamic banking subsidiaries by existing commercial banks is given in the circulars: <http://www.sbp.org.pk/ibd/2004/cir02.htm>. and <http://www.sbp.org.pk/bpd/2003/C1.htm>. . Accessed on 5th November 5, 2018.

the SBP.³⁵ The appointment of the members of Shariah board members must be approved by the SAC of SBP. The FAPC of the SBP provides the guidelines on the composition of the Shariah board within the IBIs. The Shariah boards of the IBIs in Pakistan represent the central SAC's role in the individual Islamic banks. Therefore, all IBIs are bound by the regulations and guidelines issued by SBP to operate under the supervision of their respected Shariah boards in order to fulfill the requirements for Shariah compliance while offering the products and services.³⁶ The duties and responsibilities of the SAC have been detailed out hereunder:³⁷

Shariah board of the IBIs are expected to ensure that a proper Shariah compliance function is in place by monitoring the products and services, policies, contracts, and agreements of the IBIs. Any product innovation, its launching, introduction, related terms, conditions, and agreements must be approved by the Shariah board. To fulfill this role, the management of the IBIs is required to facilitate the Shariah board by providing managerial assistance and access to all the necessary information. The Shariah board is also required to produce a Shariah report based on its Shariah reviews and endorsements of the different Shariah compliant products and services provided by IBIs. The report must be published along with IBI's annual progress report. The rulings and endorsements of the Shariah board are binding on the IBIs. Along with that, the Shariah board is also expected to guide the management, BOD, or banking staff on any issue or matter related to their duties.

Notwithstanding, the composition of Shariah board in the IBIs is significantly arranged but there are some issues which raise confusion over the identity and the composition of the Shariah boards at the IBIs. Although, the nomenclature for the central Shariah body has been modified³⁸ but due to the absence of specific regulations for specifying the nomenclature for the institutional

³⁵ In 2008, SBP issued a circular defining the guidelines and instructions for Shari'ah Compliant business operation of the Islamic banking institutions and Fit & Proper criteria for Shari'ah advisors for appointment at the IBI. These efforts were primary which evolved and as a result SBP issued a consolidated complete Shari'ah Governance Framework, defining all the governance and institutional arrangements as well as guiding principles on Shari'ah compliant business.

³⁶ "Pakistan's Islamic Banking Sector Review 2003-2007", 17-18.

³⁷ "Pakistan's Islamic Banking Sector Review 2003-2007", 17-18.

³⁸ IBD has issued a Circular Letter No. 01 on April 11th which made Change in nomenclature of 'SBP Shariah Board' to 'Shariah Advisory Committee. All the Islamic banking institutions, IB subsidiaries and conventional banks with Islamic banking branches are advised to use the new title for the regulatory and supervisory purposes. See: <http://www.sbp.org.pk/ibd/2018/CL1.htm>. Accessed on 29th October, 2018.

Shariah boards, the term “Shariah board” is interchangeably used for Shariah bodies whether it works in the SBP or at IBI. The similarity of the names creates confusion for the researchers and the viewers of the reports published by the institutions in Pakistan. When the “Shariah board” is used, it is always asked which Shariah board, the one of the SBP or the one of the IBI! This confusion can be erased by simply giving each body different regulated nomenclature which can be recognized easily. The BNM has regulated the nomenclature for the two bodies where the national Shariah board is named “Shariah Advisory Council” whereas the Shariah boards of the individual Islamic banks are called “Shariah Committees”. The reference can be easily made by simply giving them different names. The second issue is related to the composition of the Shariah board of IBIs. The SBP regulations require that the Shariah board of the IBI must consist of at least three members³⁹. However, the Shariah board of the IBI should have more than three or at least five members because the additional combination of different expertise would ensure a diversified and sound Shariah ruling. It will be based on considering legal, financial, and banking requirements of the operations which will bring more harmony and credibility to the products and services of the IBIs. The third issue is the affiliation of the Shariah board’s members with multiple Shariah boards of different IBIs which has been allowed by the arrangement of SBP for Shariah governance practice.⁴⁰ Affiliation with multiple IBIs with the same capacity would cause a conflict of interest which is considered a serious operational risk. That is why they must be restricted to serve within single IBIs.

Shariah Compliance Inspections by SBP’s Supervisory Authorities

The SBP has put in place a unique Shariah compliant mechanism. According to that mechanism, there is a Shariah compliant inspection (SCI) practice introduced by SBP. The major task of this inspection is to ensure Shariah compliance in the IBIs. Shariah inspection arrangement is made by the SBP to enhance the credibility of the Shariah compliant function within the IBIs. This kind of arrangement is exclusive to Pakistan where SBP as a regulator sets the Shariah compliant inspection process as a regulatory obligation for all Islamic commercial banks.

To conduct the function of Shariah compliance inspection, SBP has arranged a collaboration of two famous firms. One is a leading international firm

³⁹ “Shari’ah Governance Framework”, IBD, SBP (2018), 3. An updated version of Shari’ah Governance Framework can be seen here: <http://www.sbp.org.pk/ibd/2018/C1-Annex-A.pdf>. Accessed on 6th November 2018.

⁴⁰ FAPC, Annexure- A, SGF, 2018, SBP, 13.

Ernst & Young and the second is locally based and internationally acclaimed consultancy firm Ford Rhodes Sidat Hyder & Co. affiliated with the former. These two firms have compiled the Shariah Inspection Manual, prepared the parameters and procedures for conducting the Shariah compliance inspection process. Through the Shariah Compliance Inspection SBP determines the variety of procedures adopted by the different IBIs and accumulates findings. Based on the findings of SCI, SBP set its strategies to enhance standardized practices of Islamic banking institutions.⁴¹ In addition to SCI, an Enforcement Framework for Shariah compliance also in place which operates under the IBD to monitor the IBI's compliance practice.⁴²

The major function of the Shariah Compliance Inspection is to review the arrangements made by IBIs, their general banking services and operations, financial statements, and accounting records. This inspection aims to ensure that all the operations, transactions, and practices are being conducted according to the Shariah injunctions with letter and spirit.⁴³ It also aims to ensure that the rulings, transactions, *fatwa*, the terms of Islamic contracts, and the sequence for execution of the contracts are duly Shariah compliant. SBP has managed to adopt the AAOIFI's accounting standards so the implementation of these standards has been planned to be conducted through this inspection. All IBIs are bound to undergo the Shariah Compliance Inspection.⁴⁴ In the existence of two other Shariah supervisory authorities i.e. Shariah Compliance Inspection and the Shariah boards at IBIs, it is natural to have a difference of opinions, to rectify the conflict of opinion among them, the issue is referred to the SBP and the decision of SAC of the SBP is considered final.

However, the Shariah Compliance Inspection is an admirable arrangement in caring out effective auditing practice but in the presence of Shariah compliant mechanism of SBP for approving the product development process, the Shariah Compliance Inspection may cause a delay in the operation. If SBP enhances the function of its SAC by adding more knowledgeable and experienced experts from different and relevant fields, the Shariah compliant mechanism would become more effective and sounder. In that case, there will be no need to create additional measures to examine the level of Shariah compliance. And that will

⁴¹ "Process for Standardization of Shariah Practices" <http://www.sbp.org.pk/ibd/2007/Shariah-Practices-07-Aug-07.pdf>. Accessed on November 8, 2018.

⁴² "Pakistan's Islamic Banking Sector Review 2003-2007", 10

⁴³ "Pakistan's Islamic Banking Sector Review 2003-2007", 21.

⁴⁴ Akhtar, "Shariah Compliant Corporate Governance", 4.

allow the IBIs to operate without any regulatory hinder or procrastination in the business.

Issues and Challenges in the Current Arrangement of Shariah Governance Practice

The initial specific regulatory guidelines which governed the Shariah governance practice in IBIs were the minimum Shariah Regulatory Standards⁴⁵ which required the IBIs to establish institutional Shariah supervision according to the SBP's "Fit and Proper Criteria" for the selection of Shariah Advisor.⁴⁶ In 2008, SBP issued detailed guidelines and instructions directing all full-fledged Islamic banks, Islamic banking subsidiaries, and Islamic banking division of conventional banks to arrange a proper Shariah supervisory function in their respected IBIs.⁴⁷ The instructions included the procedures of the composition of Shariah supervision along with its functions. Moreover, the current Shariah governance framework of SBP which was issued in April 2014, provided comprehensive guidelines on the composition and function of the Shariah supervision. It has strengthened the Shariah compliance mechanism by providing a sound Shariah governance arrangement far better than the previous instructions or regulatory arrangements. The arrangement of Shariah supervision as recommended in the current Shariah Governance Framework has been examined and compared with the previous arrangement set by SBP in the following:

Firstly, every Islamic banking institution is required to constitute a Shariah board comprising no less than three Shariah scholars. The previous requirement was to appoint only one Shariah advisor in every IBI. Having a single Shariah advisor has always been questioned as a weak Shariah compliance and a lack of consistency. Secondly, the appointment of the Shariah Board members and the chairman must be approved in advance by the SBP. In addition, IBIs are advised to enhance the function of the Shariah board by aiding different expertise from law, banking, finance, and accounting fields. However, the role of these experts is limited to be advisory. The terms of reference were set

⁴⁵ This policy document contains the requirements which are obligatory to fulfill for obtain the license for the commencement of Islamic banking operation. See; <http://www.sbp.org.pk/ibd/2004/cir02.htm>.

⁴⁶ Islamic Banking Department, IBD Circular No. 2, April 29, 2004, retrieved from; <http://www.sbp.org.pk/ibd/2004/cir02.htm>, accessed on 23th October 2019.

⁴⁷ These regulatory arrangements known as "Guidelines and Instructions for Islamic Banking Institutions" were issued by SBP as a follow up for the earliest regulatory guidelines known as "minimum Shari'ah Standards for Islamic Banking Institutions" which was issued by SBP in 2004 with the primary objective to promote Islamic banking industry in Pakistan.

three years for members of the Shariah board with the flexibility of renewing if necessary. Thirdly, the Shariah board members can work with other Islamic banks as Shariah advisors, but this permissibility is limited to three Islamic banks. The banks are also advised to put some confidentiality clause in the contract to control the Shariah advisors on the secrecy and confidentiality of the institutions they are associated with. Fourthly, IBIs are required to report the SBP on the appointment, expiration, and reappointment of the members or the chairmen of the Shariah board ahead of a certain time, citing the reasons for the arrangements of the IBIs' decision. Fifthly, IBIs are also bound to provide enough and reasonable reports specifying the rationale for the dismissal of any Shariah board member and the SBP's approval on that action. Upon removal, resignation, or termination of any Shariah board member, IBIs are required to fulfill the position within three months. Finally, Shariah Board's members are also required to submit their resignation to the BOD if they work for a domestic bank. In case of working as Shariah advisors with a foreign Islamic bank, they must submit resignation to the country director and a copy of that must be sent to the SBP as well.

These aspects of the regulatory arrangement reveal that the previous instructions in this regard were not rigorous. However, the existing Shariah Governance Framework has put in place sound and comprehensive standards which magnifies the regulatory arrangement for Shariah governance. The major differences of the previous and current regulatory arrangement have been identified in the following:

According to the previous arrangement, only one Shariah advisor was required to assist IBI on its Shariah compliance function but the latest arrangement requires a proper Shariah board comprising at least three scholars to support the Shariah compliance process in the IBIs. Thus, the early instructions were silent on the Shariah advisors' affiliation with multiple IBIs, so they were independent to provide their services to the multiple institutions. Thus, the current regulations restrict them to be part of three IBIs at maximum. In addition, there was no explanation on whether the Shariah advisors can seek the assistance of any other relevant experts on Shariah compliant function or not, but the new arrangement encourages the Shariah board to seek professional support from other relevant experts in the Shariah compliant process. However, the limit of the term remains three years like the previous arrangement but there are many other restrictions put in place for the appointment, dismissal, and resignations or reappointment as mentioned above which make the latest arrangement quite balanced and effective.

Despite all these commendable improvements, the composition of the Shariah supervision for IBIs in Pakistan faces some issues which can be observed even in the existing Shariah Governance Framework. Some of these issues are highlighted by researchers in different governance frameworks as well. Similarly, these issues are adhering to the Pakistani Shariah governance practice which as identified hereunder.

Composition of Institutional Shariah Board

Although the current Shariah governance framework states that Shariah supervision must consist of at least three Shariah advisors as per the AAOIFI's standard requirements, the majority of Islamic banks are still following the early guidelines of the SBP which allows only one Shariah advisor.⁴⁸ Rammal indicates a review that analyzes the existence of Shariah supervision formulated by six banks. Among them, only two Islamic banks have their Shariah supervisory boards comprising three to four Shariah advisors whereas four Islamic banking branches formulated their Shariah supervision comprising a single Shariah advisor.⁴⁹ The current Shariah governance framework has been implemented in a gradual manner but this issue may cause weak Shariah compliant practice. If the new guidelines are followed accordingly and the composition of the Shariah board is enhanced with no less than three members following the international practice, the IBIs will gain more confidence among the customers. This is the reason that some Islamic banking windows have established proper Shariah supervisory boards having more than one Shariah advisor to obtain more confidence and trust of the consumers who concern about Shariah compliant business and competition in the Islamic banking market.⁵⁰

The current Shariah governance practice of Pakistani IBIs would become sounder through SBP's rigorous regulations over the composition of the Shariah board. In this regard, getting insights from the Shariah governance practice established by Malaysian regulatory authorities where BNM requires IBIs to compose Shariah committee comprising at least five members who possess a strong knowledge in Shariah and finance. The increase in number will enhance the Shariah governance practice and will strengthen the credibility and marketability of the business of IBIs.

⁴⁸ G. H. Rammal, *Corporate Governance in the Islamic Banking System in Pakistan: The Role of the Shariah Supervisory Boards*. (Australia: University of Adelaide, Faculty of Professions, Doctoral Thesis, 2010), 147.

⁴⁹ Rammal, *Corporate Governance in the Islamic Banking System in Pakistan*, 143.

⁵⁰ Rammal, *Corporate Governance in the Islamic Banking System in Pakistan*, 147.

Independence of Shariah Board

Productive and professional Shariah rulings can be produced through an independent Shariah board. As it is identified that the board of directors holds the decision-making power while the Shariah board members are appointed and can be dismissed by its approval, this ultimate power can affect the independence of the Shariah supervisory board. Although the appointment and removal of the Shariah advisors are to be reported to the SBP, but it seems to be a formality, and the Shariah advisor who holds the responsibility to supervise the Shariah requirements for the internal Shariah review and audits can possibly be dictated by the board of directors. Chohan and Chohan identify the two sides of this issue; on one hand, most banks in Pakistan are family owned which keeps the governance power in their charismatic directors' hands and allows them to have ultimate executive power to fulfill their maximizing financial needs. On the other hand, the Shariah board bears a different goal which is to safeguard the religious requirements of the Islamic banking operations. In that situation, the two boards may contradict each other's targets and interests. This conflicting situation may cause overlapping in the power which may end up with catastrophic results for the IBI.⁵¹ The overlapping and unbalance of powers between the two boards can produce an inappropriate decision that can affect the deposit, loan sanctioning policy, or risk-taking operations for the IBIs. They suggest that the powers of the two boards must be confined and regulated. In that case, the BOD has to act more responsibly to safeguard the Islamic banking operations from all kinds of risk. Shamshad Akhtar emphasizes the role of BOD by suggesting that the "commitment of dedicated, qualified directors who understand and can assess Shariah compliance would facilitate the effective oversight and protect the industry from overall reputation risks."⁵² This situation can be rectified by the SBP's regulatory specifications to confined the jurisdictions of the two boards and restricting them to coordinate and maintain consistency towards the marketability of the business and Shariah credibility in the operation. As well as regulatory guidelines should also specify criteria for qualified BOD of IBIs. This issue is required to be addressed preferably in the present time to save the industry from any possible danger.

⁵¹ Muhammad Naveed Chohan & Muhammad Waheed Chohan, "Corporate Governance in the Islamic Banking Institutions of Pakistan: Waking Legal and Regulatory Challenges", <http://saicon2011.ciitlahore.edu.pk/Business%20Ethics/11-1039%20m.%20naveed.pdf>, (Retrieved on April 6, 2014), 8.

⁵² Akhtar, "Shariah Compliant Corporate Governance", 2.

Multiple Boards' Memberships

Analyzing the previous instructions and guidelines and the recent Shariah governance framework reveals that the Shariah advisors working with an IBI are allowed to serve in multiple Islamic banking institutions. However, according to the current Shariah Governance Framework, Shariah advisors can provide their services to up to three IBIs. Although it requires IBIs to ensure that Shariah advisors abide by the secrecy and confidentiality of the institution but working in a competing environment, conflict of interest would be an undeniable fact. Bearing in mind that Shariah advisors have been given the right to have unhindered access to all records, documents, and all kinds of information from all related sources including the professional advisors. Additionally, the management of IBI is responsible to enable the Shariah board to form sound Shariah decisions or rulings for the products and services offered by the IBIs. Therefore, permitting the Shariah boards' members to associate with multiple IBIs can create a serious problem regarding conflict of interest and confidentiality. However, a precise set of regulations from SBP can resolve this issue adequately.

Another aspect of the same issue has been highlighted by Rammal as he argues that since the members of the Shariah board receive remuneration from the financial institution, that can create a potential conflict of interest which can force the members of the Shariah board to legitimize dubious operations to ensure that they could secure their position in the board.⁵³ On the other hand, Zulkifli Hasan disagrees with Rammal's assumption, clarifying that the Shariah advisors are known as religious scholars; their decisions are driven by religious and moral values so it is not a solid reason for them to simply follow their greed.⁵⁴ Thus, this aspect should be regulated properly by the regulatory authorities.

Furthermore, there are many countries where Shariah advisors are not restricted from working in multiple IBIs at the same time such as Saudi Arabia, Kuwait, Qatar, etc. Therefore, the issue of conflict of interest and the negative perception about Shariah advisors may emerge. The reason is, if a Shariah advisor is working with the central Shariah board entrusted with the role to supervise the products and services of the IBIs of the country while at the same time he has to perform the same role for any individual IBI, this can naturally cause a conflict of interest. This issue can be rectified by enhancing the

⁵³ H. G. Rammal, "The importance of Shari'ah Supervision in Islamic Financial Institutions". *Corporate Ownership and Control* 3/3 (2006), 204-208.

⁵⁴ Zulkifli, *Shariah Governance in Islamic Banks*, 86.

regulatory arrangement over Shariah governance practice with the support of legal provisions. It can be observed in the BNM's regulatory arrangement where it restricts the Shariah advisors from being part of any Shariah advisory other than the one they represent.⁵⁵ This kind of restriction can be observed in the current Shariah Governance Framework of SBP but it still allows them to serve in up to three IBIs. However, this flexibility should be revoked by adequate regulations. It should specify that Shariah advisors must refrain from being part of multiple Shariah boards of different IBIs and associate to a single IBI in order to enhance the productivity, effectiveness, and credibility of Shariah board. Supporting these regulatory arrangements with adequate legal provisions would augment the practice of Shariah governance of IBIs. The sound regulations and adequate legal provisions are the only guarantees that can improve the effectiveness of the Shariah governance practice of IBIs in Pakistan.

Findings:

Based on the examination of the literature and the regulatory guidelines issued by the SBP, the research has found some key aspects which are needed to be considered in order to enhance the current regulatory arrangement of Shariah governance practice in Pakistani IBIs. They are:

- The number of Shariah qualified members in the central Shariah Advisory Committee are inefficient which needs to be maximized in order to fulfill the regulatory needs of the IBIs.
- The regulatory policy is unclear and unrevealed regarding the qualification, criteria, and scope of the central SAC.
- The nomenclature of the two Shariah bodies is yet to be specified. Although at a macro level it has been specified by SBP but using the same titles for the institutional level usually creates confusion while referring. Therefore, setting regulated two different nomenclature for both bodies will rectify the issue.
- Due to unspecified regulations on the restriction of multiple board memberships, the members of central SAC participate in the Shariah boards of IBIs. The members of central SAC must refrain from holding positions at the institutional level Shariah boards in order to avoid conflict of interest.

⁵⁵ Zulkifli, *Shariah Governance in Islamic Banks*, 88-89.

- The regulatory requirement for the number of institutional Shariah board members is not enough which should be at least five in order to maintain productivity and efficiency for Shariah compliance in business operation.
- There are no specific regulations that guarantee the independence of the institutional Shariah board. Appointments of the Shariah board members at IBIs are made by the board of directors which compromises the independence of the members. Therefore, the appointment must be made by the SBP.

Future Research:

Although, the study provides thorough insights over the regulatory arrangement for Shariah governance practice of the Pakistani IBIs. However, it recommends statistical and empirical field research in order to investigate the effectiveness and performance of the central SAC as well as the institutional Shariah boards.

Conclusion

The regulatory arrangement for Shariah governance practice of IBIs in Pakistan has been constituted significantly by the SBP through various regulatory guidelines, instructions, policies, and frameworks with the advisory aid of its central SAC. However, the critical part of this arrangement is its execution in IBIs through Shariah boards of IBIs. Despite all these regulatory arrangements, there are still some issues adhering with the current regulatory arrangement which questions the future of Shariah governance practice of the Islamic banking industry in Pakistan. Among them is the composition of the SAC of the SBP which itself needs further enhancement whereas the composition of the Shariah board in IBIs also requires reforms. In addition, the independence of Shariah board in IBI and the affiliation of Shariah advisors with multiple IBIs with the same capacity are the issues that need precise regulations to be specified in order to strengthen their role and abilities for a sound Shariah compliance function. In this regard, the BOD should also be held responsible and accountable for the smooth and sound operation of IBIs not only to enhance the profitability but to consider the credibility of the business of IBIs as well. This objective can be achieved if a dedicated and determined BOD becomes part of the governance structure of the IBIs. This kind of regulatory arrangement will ensure that the business operation of IBI runs according to Shariah rules and principles and save the industry from all kinds of risks which adhere to the business of Islamic banking.

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