

## SHARIAH COMPLIANCE

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### **Practices in other countries.**

As mentioned in the main Strategy Paper four different approaches are being followed in case of Shariah rulings in different countries based on their regulatory approach.

In **Iran**, the products which can be offered by banks have been defined in Regulations issued by the Council of Ministers under the Usury Free Banking Act 1983 and the Council of Guardians performs the function of central Shariah board and provides guidelines to central bank and commercial banks. Commercial banks do not have a Shariah Board for guidance and/or supervision in day to day operations.

**Malaysia:** As part of the effort to streamline and harmonize the Shariah interpretations among banks and takaful companies, BNM established the National Shariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May 1997 as the highest Shariah authority on Islamic banking and takaful in Malaysia. Among NSAC's primary objectives are to:

- Act as the sole authoritative body to advise BNM on Islamic banking and takaful operations;
- Co-ordinate Shariah issues with respect to Islamic banking and finance (including takaful);
- Analyze and evaluate Shariah aspects of new products/schemes submitted by banking institutions and takaful companies

**Shariah Advisory Council (SAC):** The SAC of Bank Negara Malaysia (BNM) was established on 1st May 1997 as the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, takaful business, Islamic financial business, Islamic development financial business, or any other business, which is based on Shariah principles and is supervised and regulated by Bank Negara Malaysia. In Malaysia the Islamic banks are advised and provided guidelines by SAC. As the reference body and advisor to Bank Negara Malaysia on Shariah matters, the SAC is also responsible for validating all Islamic banking and takaful products to ensure their compatibility with the Shariah principles. In addition, it advises BNM on the Shariah aspects of the operations of these institutions, as well as on their products and services.

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The Malaysian Judiciary and the Regional Center for Arbitration Kuala Lumpur is using the SAC as the reference point in the event of a dispute that involves Shariah issues on Islamic banking and finance.

The Central Bank of Malaysia Act 1958 was amended in 2003 to enhance the role and functions of the SAC. The SAC was accorded the status of a sole authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. To preserve its independence, members of the SAC of Bank Negara Malaysia are not allowed to participate in any Shariah committee of financial institutions.

### **Shariah Committee for Islamic Banking Institutions:**

The Shariah Committee is made internally by the Islamic Banking Institutions. A Shariah Committee plays a complementary role to the SAC of Bank Negara Malaysia. Its duty is to advise the institutions on Shariah Compliance of banking operations; however the Shariah Advisory Council is the ultimate arbiter. The Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions were issued by BNM in December 2004. These aimed at achieving uniformity of Shariah decisions, in addition to creating and expanding the pool of competent Shariah personnel in Islamic banking and takaful.

The guidelines set out the rules, regulations and procedures in the establishment of a Shariah Committee (the Committee), the role, and scope of duties and responsibilities of a Committee as well as the relationship and working arrangement between the Committee and the SAC of Bank Negara Malaysia. The requirement to establish the Committee covers the Islamic banks, banking institutions that participate in the Islamic Banking Scheme, takaful operators and development financial institutions that provide Islamic banking facilities.

### **Duties and Responsibilities of Shariah Committee**

- To advise the Board on Shariah matters in its business operation
- To endorse Shariah Compliance Manuals.
- To assist related parties on Shariah matters for advice upon request.
- The Shariah Committee must advise the Islamic financial institution to consult the SAC on any Shariah matters which have not been resolved or endorsed by the SAC.
- The Shariah Committee is required to record any opinion given. In particular, the Committee prepares written Shariah opinions in the circumstances: i) where the Islamic financial institution makes reference to the SAC for advice; or ii) where the Islamic financial institution submits applications to Bank Negara Malaysia for new

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- product approval in accordance with guidelines on product approval issued by Bank Negara Malaysia.
- The Shariah Committee is also expected to assist the SAC on any matters referred by the Islamic financial institution. Upon obtaining any advice of the SAC, the Shariah Committee shall ensure that all SAC's decisions are properly implemented by the Islamic financial institution.
  - With regard to the reporting structure, the Shariah Committee reports functionally to the Board of Directors of the Islamic financial institution. This reporting structure reflects the status of the Shariah Committee as an independent body of the Islamic financial institution.

**Bahrain:** The CBB requires all banks to establish an independent Shariah Supervision Committee complying with AAOIFI's governance standards for Islamic Financial Institutions. All banks must comply with all AAOIFI issued accounting standards as well as the Shariah pronouncements issued by the Shariah Board of AAOIFI. National Shariah Board of the Central Bank of Bahrain serves and verifies the Shariah compliance of its own products only. No restriction for the member of National Shariah Board to serve any financial institution, also no limitation to serve only one institution. Each bank must have a separate function of Shariah review to verify compliance. The Shariah review function may be located in the Internal Audit function of the bank.

**Indonesia:**

### National Shariah Council (DSN)

In Indonesia, National Shariah Board formed by Indonesian Council of Ulemas in 1999, is an independent body duly recognized by Bank Indonesia and is responsible to issue Shariah rulings on products of Islamic banks. Bank Indonesia issues regulations for Islamic banking products based on Fatawa issued by National Shariah Board.

Fatwas concerning Modarabah Musyarakah contract, Modarabah Musyarakah in Islamic Insurance, Wakalah Bil Ujrah contract in Insurance (and Islamic Re-insurance) and fatwa concerning on Tabarru' contract in Insurance (and Islamic Re-insurance) were released by DSN in 2006. The fatwas released by DSN possess the power of positive law. In 2005, Bank Indonesia also issued a regulation on Standard of Contract that is periodically evaluated to keep its relevancy with the Islamic banking industry. So far, the regulations (released in 2006) are concerned with Ijarah, Istisna'a and Salam Contracts. Apart from coordinating with Bank Indonesia, DSN also takes a role in Shariah Supervisory Board selection process.

### Shariah Supervisory Board (DPS)

Every Islamic bank (or window) is obliged to have Shariah Supervisory Board (SSB). Shariah Supervisory Board (SSB) also plays critical role as partner of Bank Indonesia in Islamic banking supervision. Bank Indonesia has set up “fit and proper” criteria which include a test for new SSB members that cover understanding of Shariah principles and knowledge on Islamic banking and finance in general. Furthermore, to upgrade SSB’s roles, each Shariah supervisor is obligated to submit a report on the finding of Shariah supervision every six months to the Board of Directors, the Board of Commissioners, the National Shariah Council and Bank Indonesia.

Regulatory authorities of some countries like **Bahrain, Sudan, Syria, etc.** have adopted Shariah Standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), while some others use them as guideline.

In **Pakistan**, the banks are authorized to offer products based on Islamic modes under the Banking Companies Ordinance, 1962. The Shariah Board of State Bank of Pakistan has approved Essentials of Islamic modes of finance and Model Agreements, which previously issued as guideline to all Islamic banking institutions (IBI) have now been made part of recently issued Instructions for Shariah compliance in IBIs. Each IBI is required to appoint a Shariah Advisor who is responsible to give approval regarding Shariah compliance of all products of IBIs and issue Shariah rulings. The SBP Shariah Board advises State Bank in formulation of regulations on Islamic banking. In case of any difference of opinion between SBP Shariah Board and Shariah Advisor of an Islamic bank, the ruling of SBP Shariah Board is final.

In **other countries**, the rulings of Shariah Supervisory Board of Islamic financial institution are binding on the respective institution and regulatory authorities do not intervene in these affairs.

Islamic Financial institutions (IFIs) all over the world are generally using the similar modes of Islamic finance and products, with minor differences of nomenclature according to their regional, legal and other conditions. The commonly used modes are Murabaha, Ijara, Musharaka, Mudaraba, Diminishing Musharaka, Salam, Istisna, Wakalah and Kafalah etc. There is no difference of opinion among Shariah scholars of the world about permissibility of these modes. However, there are certain differences in application and modus-operandi of the transactions based on some of the above modes in different countries.

There is a difference of opinion among Shariah scholars on permissibility of certain modes/practices like Bai al Dain (Debt trading), Bai al Inah, Tawaruq, Hibah on current accounts, Commodity Murabaha, etc.

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There is also some variation in Shariah principles used by Islamic banks in deposit facilities. In the case of current accounts Bangladesh, Kuwait and Pakistan use the principle of Qard (loan) whereas other countries such as Malaysia, Indonesia, Brunei, Bahrain etc. use the principle of Wadiah (Guaranteed safe custody). In Iran the current accounts are accepted on the basis of Qard Hassan, on which a bonus is also paid to the depositors on discretionary basis by banks. This practice is not accepted in most of the other countries.

For savings accounts, Iran uses the principle of Qard Hassan whereas in Kuwait, both the principles of Qard Hassan and Mudaraba are applicable for these accounts. Most IBIs in Pakistan use the Mudaraba mode for saving accounts. In Malaysia, savings accounts are governed by the principle of al-Wadiah yad dhamanah or guaranteed custody. Islamic banks in some Muslim countries such as Bangladesh, Jordan, Kuwait and United Arab Emirates use the principle of Mudaraba for their savings accounts facility. As for the investment accounts facilities, Mudaraba is the only principle used by the Islamic banks in all countries.

### **Composition, Role and Performance of SBP Shariah Board:**

In view of having a central body to guide SBP and the Islamic banking industry a Shariah Board was formed at the State Bank of Pakistan. Dr. Mahmood Ahmed Ghazi ex Federal Minister for Religious Affairs and a Shariah Scholar of world repute was appointed as its first Chairman.

### **Composition of the Shariah Board**

The Shariah Board comprises members drawn from fields such as Islamic Shariah, banking, accounting, law and other relevant fields. It has a minimum of five members. At least two members have to be Shariah scholars, one member to be a Chartered accountant, one a lawyer and one representing the bankers and the State Bank to be the Director of Islamic Banking Department of SBP, who also serves as the secretary of the Shariah Board. The Chairman of the Shariah Board has to be from among the Shariah scholars. The technical members, i.e. the lawyer, the accountant and the banker give their opinion in the relevant areas of their expertise to the Shariah scholars, who consider their views while giving a Shariah ruling on issues under review.

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### **Term of office**

- a) The initial term of office of all members of the Shariah Board is of two years. All members, excluding the ex-officio member, shall have a term of two years and shall be eligible for reappointment.
- b) The Chairman and members of the Shariah Board shall remain in office until their successors are appointed.
- c) The Governor of State Bank may fill any casual vacancy arising in the Shariah Board for the un-expired portion of the term of the member concerned.

### **Role and Responsibilities:**

The role and responsibilities of Shariah Board shall be as follows:

- a) Review and approve for Shariah compliance the products/instruments developed by State Bank of Pakistan for conducting its central banking and monetary management functions under the Islamic modes.
- b) Advise State Bank of Pakistan on Prudential regulations developed for Islamic banking sector.
- c) Approve the fit and proper criteria for appointment of Shariah advisors of institutions conducting Islamic banking activities.
- d) Advise State Bank on the Shariah ruling in case of a conflict arising from the Shariah audit of the Islamic banking activities of the banks under the supervisory control of State Bank.
- e) Advise State Bank on the Shariah rulings in case of a conflicting Shariah opinion on the Islamic banking products.
- f) Perform such other functions as may be assigned from time to time, by the State Bank for conducting of smooth functioning of Islamic financial system.

### **Performance of SBP Shariah Board:**

Role of SBP Shariah Board has been quite instrumental in the SBP's drive to promote Islamic Banking in Pakistan. Shariah Board has held 22 meetings so far. The performance of the Shariah Board has been quite satisfactory and despite the teething and bonding problems, which have been overcome quickly. Its advice and output have been very helpful in promoting the Islamic banking industry and building confidence among the stakeholders.

Till date the Shariah Board has contributed to the cause of Islamic banking in the following manner:

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- Recommendations for development of Islamic banking on sound footing.
- Approval of Essentials and Model Agreements for Islamic Modes of Financing after a due consultation process
- Approval and revision of Fit and Proper Criteria for Shariah Advisors of Islamic Banking institutions
- Approval of Term Sheet of Ijara Sukuk
- Approval of WAPDA, KSEW and PIA Sukuk as Shariah compliant security
- Guidance on Shariah Compliance Inspection of an Islamic bank
- Development of Essentials of Diminishing Musharaka
- Approval of Shariah Compliance Inspection Manual
- Review and approval of Instructions and Guidelines for Shariah compliance in Islamic Banking Institutions
- Review of AAOIFI Shariah Standards on Murabaha & Ijara for adoption/ adaptation in Pakistan's Islamic banking industry.

### Legal cover to the Decisions of the Board

In order to provide legal cover to the decisions of the Shariah Board, it has been prescribed in the recently issued instructions for Shariah compliance in Islamic banking institutions that the decision of the State Bank based on the rulings of Shariah Board will be binding on the institutions conducting Islamic banking business. At a later stage, when the banking law is revised, the constitution and powers of Shariah Board would be incorporated in that law in order to provide a legal cover to the Board.

**In Conclusion**, SBP's Shariah Board is an ideal Shariah supervisory body due to its unique composition. This distinctive composition of the board provides SBP with enormous benefits. While reviewing the Shariah compliance mechanisms in other countries we find that structures of national Shariah Boards comprises only of Shariah scholars. Complexity of issues faced by Islamic Financial Institutions requires that while giving a Shariah ruling the associated technical aspects such as those pertaining to legal, accounting and banking etc. also need to be considered on simultaneous basis. The composition of SBP's Shariah Board helps to cover and understand almost all aspects of any issue discussed in the meetings which gives comprehensiveness to its decisions. The rulings given by the Board are not only Shariah compliant but are also workable as they take into consideration the legal and financial infrastructure of the country and the business needs.

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