



The Role of Shariah Board in Islamic Banks: Pakistan's Perspective

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Abstract

The State Bank of Pakistan introduced diversion from the individual Shariah advisory system to the Shariah board mechanism by issuing the Shariah governance framework in 2016 by making it mandatory for the Islamic banks to have an independent Shariah board. In this paper, it is examined whether the Shariah boards have any effective role in the improvement of the Shariah compliance environment of the banks or not? And how to make it more effective for the betterment of the Islamic banking industry? A questionnaire has been developed to study and inspect these issues. The results indicate that even though the role of sharia board could not be denied in the improvement of Shariah compliance in IBI's, however, the mechanism may be further strengthened. The study also suggests that Shariah board members should be involved regularly by making it obligatory on the IBI's to arrange frequent meetings of the board.

Key Words: Shariah Board, Islamic Banks, Pakistan, Shariah Compliance

Introduction

Islamic banking is rapidly growing in Pakistan which is a good sign for the investor as well as the overall industry. As reported by the state bank of Pakistan, both the assets and liabilities of the Islamic banking industry witnessed growth in the last ten years. Similarly, the Market share of Islamic banking in overall banking industry has also reached almost 15 percent (SBP, 2017).

On the other hand, Shariah scholars emphasize that Islamic banks should not only focus on business expansion but Shariah compliance must be confirmed by adopting different tools (Usmani, 2009)

State bank of Pakistan being a regulator is also taking steps to ensure Shariah compliance in the industry to make it at par the guidelines of Shariah. For instance,

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it is mandatory for the Islamic Financial Institutions (IFIs) to form a Shariah compliance department or unit keeping in view the size of the institution. Further, it is also advised that the internal Shariah audit unit may also be established to conduct the Shariah audit of the bank. External Shariah audit has also become mandatory (Moini, 2015).

Regulatory Guidelines on Shariah Supervision

Monitoring and supervision of Shariah affairs, of Islamic Banking Institutions (IBIs), is a very important aspect. The bank shall need services of Shariah expert who will advise and supervise its transactions on daily basis to address different issues faced by the IBI, (Ismail, 2014) to cater the issue, the SBP while issuing circular No.1 of 2003 for setting up a schedule Islamic commercial bank in private sector, it is made compulsory on the scheduled bank to constitute Shariah board and brief resumes of Shariah board members shall be submitted to SBP along with other requirements for setting up as schedules Islamic commercial Bank (Shehzad, 2003).

Keeping in view the preliminary stage of the industry in the country, the Islamic Banking Department (IBD) of SBP issued circular no 2 on 29 April 2004 regarding minimum Shariah regulatory requirement in which the earlier guidelines have been modified.

It was the major milestone in the Islamic banking industry in Pakistan that for the first time in the history of the industry, The minimum Shariah regulatory standards and the "Fit and Proper Criteria" framed for selection of the Shariah Advisor have been incorporated in the guidelines by issuing the BPD Circular no 02 of 2004 IBD. (Said 2004) at this stage, the IBI's were given relaxation to appoint sharia committee on their own and not as part of the regulation of SBP.

On 29th April 2004, SBP issued further instructions regarding fit and proper criteria of Shariah advisor in which it is advised that Shariah advisor shall work only in one IBI, he shall not have any position in any other financial institution whether it is executive or non-executive, to address the issue of conflict of interest, the shall not approve any financial transaction acting as sharia advisor of both financial institution. (Said 2004)

To further strengthen the Shariah compliance practices of Islamic banking in Pakistan, SBP issued circular no 03 of 2014 regarding Shariah governance framework, The circular cover up roles and responsibilities of different stakeholders for Shariah compliance, however, the major decision which may be called a paradigm shift in the country, industry is moving away from individual Shariah advisory system to compulsory Shariah board system which shall consist of at least three Shariah scholar members. The Shariah advisors position has been removed and major responsibilities are assigned to resident Shariah board member

of the board. To implement the system, Islamic banking institutions have been given six months' time (Siad 2008).

On September 30th, State Bank of Pakistan further extended the timeline to January 01, 2015, for implementation of the Shariah governance framework through letter no 03 of 2014 (Muhammad 2014).

Finally, on April 07, 2015, circular no 01 of 2015 has issued in which the Shariah Governance Framework (SGF) has been issued for compliance. Further, it is advised that the framework shall come into force from 01 July 2015 (Muhammad 2015).

The framework stated that every IBI shall have a Shariah Board (SB) consist of at least three Shariah scholars members but prior written clearance shall be obtained before appointing a member of the Shariah board. These members shall be selected to serve the institution for three years initially, however, they will be eligible for reappointment. In the first phase, relaxation is given to Shariah board members for at least first-term appointment that they may serve in the Shariah boards of up to three IBIs, however, resident Shariah board members of IBI cannot serve in any other Shariah board (Moini 2015).

Data and Methodology

The prime aim of the present study was to critically analyze and review the role of the Shariah board in Islamic banking institutions in Pakistan. For this purpose, a survey comprises of both closed and open-ended questions was prepared and distributed among 72 Islamic banking practitioners (respondents) of different Islamic banks in Pakistan filled the survey forms and returned to the authors. The data and information collected through this survey were then converted into percentages and averages and the result was drawn. Other related information and discussions were obtained from the published material of the State Bank of Pakistan and the Islamic Banking Division, Islamabad Pakistan.

Findings and Discussion

In order to ensure that all transactions and operations of Islamic Banking Institutions (IBI) in Pakistan are to be in conformity with the Shariah of Islam, SBP has devised a workable mechanism for all Islamic banks and their services and products. For this purpose, SBP has set up two most important supervisory/regulatory bodies to make sure that the services and products of IBI are in conformity with Shariah. This framework includes Shariah Board (SB) at the level of SBP, whose main functions comprises of reviewing and approving products developed by SBP, to advise SBP on prudential regulations, and also to approve the fit and proper criteria for the recruitment of Shariah advisors of IBI. Another regulatory body that SBP has made mandatory for all Islamic banks is

also known as Shariah Board (SB) but at the Islamic bank level.

According to SBP, every Islamic bank shall have a Shariah board consists of three Shariah scholars recruited by the respective board of directors (BoD) as per fit and proper criteria. The board has been empowered to decide, consider and supervise all Shariah related matters of the IBI in order to build the confidence of the general public. The present study is an attempt to evaluate the role of Shariah board in the improvement of the Shariah compliance environment of the IBIs by gathering information from the practitioners of the Islamic banking industry through a survey.

A question was asked in the questionnaire that whether the Shariah board has any impact on the Shariah compliance of Islamic banks, almost all the respondents are unanimous that yes the board has a significant impact on the Shariah compliance of IBI. The respondents are of the view that due to quarterly meetings of SB, reviewing operations of IBI, its regular and collective monitoring, submission of minutes to SBP, SB plays an important role in Shariah compliance of IBIs. However, one respondent has the observation that due to the duplication of the assignment of the Shariah advisor, the impact of SB on the Shariah compliance of IBI has reduced to a minimum level.

Most of the respondents are of the opinion that SB has many advantages. First, it ensures that all transactions, contracts and activities of IBI are in conformity with Shariah of Islam. It makes, verify, ratify and vet every transaction and operational issue according to Shariah. Another advantage of the SB is its monitory role to ensure the implementation of Shariah culture in IBI. Moreover, it has developed the confidence of the general masses on IBI. The SB also takes care off that the funding should be provided to Shariah compliant projects which have positive economic impact on the society. Last but not the least, it is the SB which has contributed significantly in the exponential growth of Islamic banking industry in Pakistan.

About the disadvantages (if any) of SB, eighty percent of the respondents say, there are no disadvantages of SB, while twenty percent of the practitioners enumerated a couple of disadvantages. For instance, some are of the opinion that lack of banking knowledge, busy and tight schedule of the SB members leads to delay in timely disposal of their assigned tasks. However, a couple of respondents also reported that additional resources are involved in reporting each and every activity of the Islamic bank to SB which increases the expenses of an IB compared to conventional bank.

Commenting on the question related to the gaps which SB needs to focus on, some respondents reported that SBs of IFIs should focus on the uniformity of the products and services which these IFIs offer. It has also been observed that some SBs have allowed products which others disallowed the same offered by other IBIs which undoubtedly create reputational risk and ambiguity in the mind of the general public regarding their integrity and compliance to Shariah. Twenty percent

of the respondents say that SB should arrange workshops, seminars, and conferences for general public as well as for banking staff to enhance their awareness about Islamic banking practices, besides focus on Shariah compliance of services and products. A quite sizeable number of respondents reported that SB should also focus on staff related issues and the members of SB should make their presence certain from 9.00 am to 5.00 pm in order to ensure timely execution of all the banking activities.

The board of directors (BoD) should involve members of SB in hiring the employees of the bank, some respondents suggested, which will definitely contribute to the efficiency of the bank. Moreover, majority of the respondents stated that SB has the potential and to impose their Shariah compliant decisions, however, sometimes fail to implement their decisions due to upper hand of the BoD and management in the process of decision making.

About the major contribution (if any) of the respective SBs, respondents reported some important contributions made by SBs in Pakistan. One of the most crucial contributions made by SBs is that this system has provided better alternative to conventional banking system and started *riba*-free Islamic banking system in Pakistan. It has contributed towards the standardization of policies, product structure, and governance structure of the IBs and provided solutions to different Shariah related banking issues. Due to the efforts of SBs, quite a sizeable number of wealthy people who were previously not interested in keeping their surplus wealth in interest-based banking system have been started depositing their money now in Shariah compliant banking system. The SB has discouraged unethical, unjust, unlawful and doubtful projects in the Islamic banking industry by introducing *riba*-free and Shariah compliant banking practices which undoubtedly improved the level of confidence of the general public including both depositors and investors.

Majority of the respondents (80 %) are of the opinion that public confidence has increased since the adoption of Shariah board system in IBIs by the SBP. The general public is now more aware compared to past that the prime responsibility of the SB is to make sure that all the operations of IB will be in conformity with Shariah of Islam and no transaction will be allowed if it is in some way or another repugnant to the tenants of Islam. Even the mere existence of the SB in the IBs gives a sense of satisfaction and confidence among the customers of IBs. This sense of satisfaction and confidence in turn increases the credibility level and hence contribute to their financial performance.

However, twenty percent (20%) of the respondents are not agree that public confidence has increased due to SB system by SBP. They are of the opinion that general public is not aware of the basic role of the SB in IBs because there is no mechanism of direct interaction between public and SB members. Moreover, according to them, people generally compare benefit cost analysis (BC ratio) and conclude that Islamic and conventional banking system is the same as both charge

extra amount, so, SB has not made any contribution to this perception from the mind of the general public. Therefore, they suggested that public confidence can be further increased through the establishment of direct contact between customers and SB members and secondly, the SB should arrange public awareness programs on mass scale level.

The adoption of SB system in IBs has impacted positively or negatively the overall environment of bank, eighty five (85%) percent of the respondents reported in affirmative. According to them, monitoring and Shariah compliance mechanism has been improved compared to past and that all transactions are now in line with Sharia of Islam. Due to adoption of SB system, management of the banks now give more weight to the decisions of SB in Shariah related matters. They suggested that at-least Shariah scholars should be members of the BoD if we want to bring more positive change in the overall environment of IBs. Moreover, fifteen percent of the respondents reported that there is no major change in the overall environment of the banks. They say that SB has totally ignored the internal staff of the bank and their genuine issues and so all is similar as of previous structure of Shariah advisors.

Regarding the weaker aspect of the present structure related to SB, three percent of the respondents reported that there is no weaker aspect while twenty five percent of the respondents say that most of the SB members are affiliated with many other banks at a time resultantly important Shariah related issues and matters are being delayed while sometimes relaxations are given by SB due to management pressure or market practices which should not be allowed. Twenty percent of the respondents are of the opinion that one weaker aspect of the present structure of SB is less interaction of SB members with the banking staff as well as public. This gap between SB members, staff and general public negatively affect the level of satisfaction and confidence of the people.

Some of the respondents are of the opinion that SB or advisor merely works as an advisor having no full authority and command over the transactions and operations of the bank. Therefore, SB should be given space in the BoD to have their full say in all decision making processes and practical involvement in banking activities. Moreover, ten percent of the respondents reported that parallel system of conventional and Islamic banking system is by itself the weaker aspect of the present banking structure which should be eliminated in a country like Pakistan.

How to enhance more the effectiveness of the SB, majority of the respondents suggested that SBP should increase the power and authority of the SB in all types of Shariah related matters. Some are of the opinion that SBP should make BoD and SB parallel in authority and decision making in order to make all transactions fully Shariah compliant. Another suggestion forwarded for the effectiveness is that SB members should give more time to their own banks and the number of SB meetings should be increased. The role of SB of SBP should be strengthened through reporting of the Shariah advisor of IBs to SB of SBP. Product concept

rules should be approved by SB of SBP for uniformity of practices in the IBI along with the supervision of the same through Shariah advisors of the banks instead of the current structure of SBs, they commented. Moreover, the SBs should start trainings, workshops, and seminars for both staff and public and give enough time to the problems and genuine issues of the banking staff.

Conclusion

Islamic banking system is based on basically the prohibition of riba in all its shapes and forms, therefore, in order to make it sure that all the operations and transactions of Islamic banks (IBs) in Pakistan are to be consonance with the Shariah of Islam, SBP, the regulator, has issued Shariah governance framework in 2016 making it compulsory for all IBs to have Shariah boards (SBs) whose main function is to supervise the activities of the bank from Shariah perspective. In this paper, it has been tried through a survey to critically evaluate the role of SB that whether it has played an effective role in the improvement of the Shariah compliance environment of the bank, has it contributed towards confidence building, governance structure and in bringing positive changes in the overall environment of the bank.

The majority of the respondents reported that it is the SB that has been empowered by SBP to decide, consider and supervise all Shariah related issues of the IBI, build the confidence of the general masses and which has contributed significantly to the exponential growth of IBI in Pakistan. The respondents are unanimous that SB has a significant impact on the Shariah compliance of IBI. The SB has also contributed to the governance structure of Islamic banks, enhanced public confidence and brought positive changes in the overall environment of the bank, respondents reported.

About the weaker aspect of SB, respondents stated that most of the SB members are affiliated with many other banks resultantly Shariah issues are delayed and further it is also some-how create the issue of conflict of interest and against the spirit of good corporate governance as described by SBP in its circular no 03 of 2008 which states that sharia advisor shall not approve a transaction acting as sharia advisor of two different financial institutions by representing both sides (Said 2008). It has also been observed that less interaction of the SB members with the staff and customers adversely affected the performance of the bank and SB. The respondents suggested that SBP should increase the power and authority of SB in all types of Shariah related matters in order to make it more effective than before. Some respondents argued that SBP should make both SB and BoD parallel in power and authority. By and large, SB plays an important and significant role in the overall performance of IBI, according to the majority of the respondents.

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