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REPORTING ASSURANCE FOR RELIGIOUS COMPLIANCE IN ISLAMIC BANKS: ARE WE THERE YET?

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Abstract: *Shariah boards* (SBs*) play a unique role by providing assurance on religious compliance of Islamic banks. In fulfilling this governance responsibility,* SB *members must exercise diligence, independence and be transparent at all times. In this study, we examine the distinct governance structure of Malaysian Islamic banks as the country is perceived to have the most developed governance framework in the Islamic world. We critically evaluate the literature on the role and function of* SBs *and assess the existing support mechanisms available and identify challenges in providing effective religious compliance reviews. We highlight the inherent limitations of Malaysian* SBs *in performing the compliance review with studies reporting the independence of this authority being compromised with* SBs *appearing to rubber-stamp decisions already taken by top management. Finally, we highlight serious concern regarding the quality of the religious assurance provided in annual reports of Islamic banks and question as to who holds the ultimate right to provide the all-importantreligious assurance for the Islamic finance industry?*

Keywords*: Corporate Governance, Malaysia, Islamic Banking, Religious Compliance, Assurance, Shariah Board, Independence*

1. INTRODUCTION

Recent market surveys have indicated that Islamic banking assets account for USD$1.7t with an annual growth of 17.6%.[1] Empirical studies have also highlighted that the Islamic banking industry positively contributes to socio-economic growth. For example, Farag *et al.* (2014) reported that the Islamic banking industry has contributed in corporate social responsibility, while Gheeraert (2014) indicated

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that Islamic banking development has a positive role in economic growth. Arguably, the growth and confidence marked by the industry point to Islamic banks being distinct financial institutions that offer consumers with financial products that are consistent with their religious beliefs. Therefore, religious assurance is ultimate importance in determining the ethical legitimacy of Islamic banks. In these institutions, this task is undertaken by Shariah boards (*SBs*) whose responsibility is to ensure that the bank strictly complies with the tenets codified in the Islamic faith. The testament of such compliance in the annual reports of Islamic banks explicitly increases the confidence of various stakeholders which unequivocally enhances the integrity of Islamic banks. Indeed, the increase in the investments of various stakeholders and effective governance procedures in Islamic banks undoubtedly promotes the soundness of Islamic banks.

The ultimate responsibility of providing religious assurance rests on the shoulders of *SB*s members who serve in the capacity of religious auditors of Islamic financial institutions (IFIs) (see for example Bristion and El-Ashker, 1986). Their prominent role provides an additional governance mechanism over and above the governance system usually discussed for other conventional corporations. This paper is aimed at examining the literature on the role and function of *SB*s and the existing available mechanisms to support this role, and identifying the challenges that remain in performing the religious compliance review. The role and function of *SBs* are analysed in the context of the Malaysian regulatory setting as Malaysia is perceived to have the most advanced Islamic banking governance framework amongst the Islamic countries. Bank Negara Malaysia (BNM), as the Central Bank of Malaysia, has produced strict guidelines and a governance framework intended to promote a holistic Islamic finance infrastructure that upholds the compliance with Shariah principles.

In addition, we examine the issue of religious assurance in Islamic banks using both the stakeholder and legitimacy corporate governance theories. The underlying concern under the stakeholder theory are those groups or individuals directly or indirectly in the organisation that may affect or are affected by the actions, decisions, policies or goals of the organisation (Caroll, 1993). For the purpose of achieving good governancein banking operations, the stakeholder theory provides the exposition for management to perform its fiduciary duties by strategically looking into the interest of various stakeholders (see for example Berry and Rondinelli, 1998; Solomon, 2007; Collier, 2008). However, Gray *et al.* (1996) claimed that the legitimacy theory is a variant of the stakeholder theory which explains various aspects of corporate social behaviour. The legitimacy theory identifies the social perception on the organisational behaviour, performance, action and activities of the organisation to ensure that operations are conducted within the bounds and norms of their respective societies (O'Donovan, 2002; Deegan and Unerman, 2006). Arguments suggest that organisational failure in carrying out business activities within acceptable boundaries to the community may contribute to threats regarding the entity's legitimacy (Dowling and Pfeffer, 1975); hence, the management undertakes various strategies to ensure that organisations remain legitimate (Deegan *et al.,* 2000; Suchman, 1995; Patten, 1992; and Ashforthand Gibbs, 1990). Relating such reasoning to Islamic banks, the Shariah principles in fact extend the concept of stakeholder and legitimacy theories to include compliance to a value system in banking operations. This value system is elucidated in Shariah principles and has importance for Islamic banks so as to provide an ethical and socially-oriented method of financing (see for example Naqvi, 1994; Abdul Rahman, 1998; Iqbal and Mirakhor, 2004; Yusof and Amin, 2007).

Following this introduction, the next section presents a discussion on Islamic banking concepts and principles. This section also explains the regulatory bodies that are responsible for governing the Islamic finance industry. Section 3 then presents an extensive discussion of the Shariah governance framework of the Malaysian Islamic banking industry. Later, in Section 4, the essential elements on the governance function of *SB*s and othere stablished governance mechanisms in Islamic banks are then critically evaluated. Finally, section 5 concludes the discussion by highlighting the efficacy of the role of *SBs* in providing religious compliance assurance and draws some policy implications.

2. ISLAMIC BANKING AND FINANCE

The establishment of Islamic banks may be seen as a hallmark to the Islamic financial system since they are financial institutions that provide Muslims with financing facilities based on contracts derived from Shariah principles. Generally, the Islamic banking system refers to the banking system in which the principles underlying its operations and activities are founded on Shariah principles (Haron and Wan Azmi, 2009). As an alternative to the conventional financing system, Islamic banks aim to preserve social and economic institutions in Islamic banking operations. In addition, Shariah principles govern Islamic banks' transactions and operations including risk sharing, individual rights, property rights and the sanctity of contracts (Iqbal, 1997; Zaher and Hassan, 2001). Thus, it requires players to uphold justice and ethical rules that serve as principles which guide Islamic banks in managing their business activities (Dusuki and Abdullah, 2007b; Rosly, 2005a; Siddiqui, 2001; Haron, 1997 and 2000; Nawawi 1999).

The sanctity of contracts offered by Islamic banks is ensured from several different features. One of these is the seclusion of *riba* (interest) in financial contracts. The prohibition of *riba* in Islamic banking operations acts as the intrinsic principle that serves as the cornerstone and the nucleus of the Islamic economic system (Iqbal, 1997, pp. 42). For instance, the concept of *riba* violates the concept of justice in Islamic banks since the contract allows the lender to take advantage of lending money and the obligation of all the risks and losses are attached to the borrower(Mirza and Baydoun, 2000). However, Islamic banks promote the distribution of rights in generating the income from business operations by introducing the concept of profit and loss sharing. Besides *riba*, Muslims are also prohibited from taking any contract with the element of uncertainty (*gharar)*. The Shariah principles define *gharar* as trading with excessive risk from an unknown factor or unpredictable outcome (Al-Dareer, 1997; El-Gamal, 2000; Iqbal and Molyneux, 2005). For example, contracts or businesses involving *gharar,* include gambling and the sales of assets before possession. Hence, it can be understood that Islamic law encourages Muslims to deal with any business, trading and contracts in accordance with Shariah principles.

In addition, Muslims and Islamic organisations are also required to pay *zakat* (alms giving). *Zakat* purifies the wealth of the owner and acts as a mechanism for Muslims to distribute their wealth and income to ensure a fair standard of living for all. Meanwhile, IFIs generate their income based on Shariah-compliant products and services offered in Islamic banks such as *Mudharabah* (cost-plus), *Musyarakah* (partnership), *Bai' BithamanAjil* (deferred payment), *Wadiah* (saving account) and *Takaful* (insurance). However, the worldview underlying the operations of Islamic finance not only aims at financial aspects, but also at fulfilling social obligations that go beyond the aim of profit maximisation generally espoused by conventional banking.

2.2. Regulatory Framework for Islamic Banking Industry

Several international regulatory bodies provide guidelines and prudential standards that deal with the specificities of IFIs. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), for example, is an Islamic international autonomous non-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions in the industry. Various countries have adopted standards issued by AAOIFI including the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The work of AAOIFI continues to influence the governance practices of IFIs in other countries since the guidelines on Shariah governance in these countries are drawn up from the standards issued by AAOIFI, as in the case of Malaysia.

Another notable international standard-setting organisation that has contributed in shaping the governance landscape of IFIs is the Islamic Financial

Services Board (IFSB). The IFSB issues prudential standards and guiding principles for the effective supervision and regulation of the Islamic finance industry, which broadly includes the banking, capital market and insurance sectors. The IFSB has defined Shariah governance as "a set of organizational arrangements whereby the actions of the management in institutions offering Islamic financial services are aligned, as far as possible, with the interest of its stakeholder; provision of proper incentives for the organs of governance such as the *SB*s and the management to pursue objectives that are in the interest of stakeholders and to facilitate effective monitoring thereby encouraging IFIs to use resources more efficiently and comply with Islamic Shariah principles" (IFSB, 2006, pp. 33). Additionally, IFSB recommended the establishment of a sound governance mechanism for obtaining and applying rulings from Shariah scholars, as well as, monitoring religious compliance on aspects including the ex-ante and ex-post of financial transactions and the operations of Islamic Financial Services (IFSB, 2006, para. 47). The emphasis on the need for IFIs to ensure that all their activities do not contravene the Shariah principles has set the requirement for IFIs to establish an overarching Shariah governance mechanism, above the mechanisms that are usually discussed in regards to other corporations.

Another international regulatory body that has significantly influenced the commercial activities of financial institutions is the International Islamic Liquidity Management Corporation (IILM) established in late 2010. IILM is hosted by Malaysia, and the membership of IILM is open to central banks, monetary authorities and multilateral organisations. Currently, the members of IILM are from central banks and the monetary agency of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Turkey, the United Arab Emirates and the Islamic Development Bank. As an international institution, the objectives of the IILM include providing and issuing short-term Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management, international linkages and financial stability. Meanwhile, RAM Rating Service Berhad (RAM ratings) is a pioneer of credit-rating services for the Malaysian capital market that provides an in dependent credit opinion required by investors on the portfolios of corporations including Islamic banks. The credibility of Islamic banks in offering Islamic financial products and effective management may provide a good impact to the portfolio of Islamic banks and instil confidence among capital providers.

3. THE MALAYSIAN ISLAMIC BANKING ENVIRONMENT

The framework of the Shariah governance system for the Malaysian Islamic finance industry has been given high priority since the onset of the industry during the

1980s and 1990s. Since 1997, Malaysia has been instrumental in implementing a dual-layer Shariah governance system for its Islamic banking industry. Every bank offering Islamic banking products and services in Malaysia has an in-house, independent *SB*[2] with sole authority over Shariah matters. In 2005, Bank Negara introduced the 'Guidelines on the Governance of Shariah' or GPS-1. Following GPS-1, Bank Negara imposed the requirement for Islamic banks to have a minimum of three *SB* members who are responsible in ensuring that businesses and transactions are Shariah-compliant. GPS-1 further sets the limit on the membership of *SB*s to be no more than one bank, with the appointment of its members being subject to the approval of Bank Negara.

Shariah governance is commenced at the central bank level by an over-arching centralised *SB*, known as the Shariah Advisory Council (SAC). The SAC has been given the authority to undertake Shariah supervision at the macro level governing Islamic banking business, *takaful* (Islamic insurance) business and Islamic development financial business. To affirm its authority as the central Shariah body, the SAC was authorised with mandated power on its Shariah governance role in the recent amendment to the Central Bank of Malaysia Act 2009 in which the Shariah resolutions issued by the SAC are binding on all Malaysian IFIs (BNM, 2009). The governance procedures promulgated by this central governance system has been an important factor in standardising Malaysian Islamic banking practices; minimising inconsistencies in Islamic banking practices (Hassan, 2013).

About six years later, in 2011, Bank Negara introduced the Shariah Governance Framework (SGF) aimed at strengthening the governance of Islamic banking operations with an emphasis on four focal areas: Shariah compliance review; Shariah audit; Shariah risk and management; and Shariah research. Under the new SGF, the board of director (BOD) is required to appoint *SB*s of at least five members who have strong knowledge in Shariah background with appropriate qualifications in areas of accounting and auditing. The *SB* members are also required by SGF to be accountable and responsible for their decisions, views and opinions related to Shariah matters. The management of the Islamic bank is expected to provide accurate information regarding business transactions and operations to *SB*s. With the implementation of SGF in 2011 as the new governance framework for the Malaysian Islamic banking industry, the quality of religious assurance provided to the stakeholders is expected to be improved. This proposition is made on the basis that the new SGF grants emphasis on the accountability of key organs of an Islamic bank in undertaking their governance function.

More recently, additional legislation, i.e. Islamic Financial Service Act 2013 (IFSA), was enacted on March 2013 to solve issues concerning the integrity of *SB*s in providing views, opinions and assurances of religious compliance in the Shariah report of Islamic banks. Amongst issues highlighted in the IFSA were the appointment and qualifications of *SB* members and accountability of respected parties on the religious assurance of Islamic banking operations. For example, in pertaining to religious compliance, the failure of *SB*s and other internal governance of Islamic banks to comply with the IFSA 2013 provision shall make them liable to imprisonment for a term not exceeding eight years, or to a fine not exceeding twenty-five million ringgit or to both (BNM, 2013, para. 29). More recently, the Guidelines on Financial Reporting for Islamic Banking Institutions (GP8-i) have been revised and became effective on the 1st of January 2014 to better facilitate users of financial statements to evaluate and assess different risk profiles of various Shariah contracts.

4. RELIGIOUS ASSURANCE IN THE ISLAMIC BANKING INDUSTRY

4.1. The Governance of Shariah Boards

Central to the Shariah governance of IFIs is the role of an independent *SB* as the religious authority responsible for providing assurance on the bank's religious compliance; hence, instilling confidence in the shareholders and stakeholders (Briston and El-Ashker, 1986; Tomkins and Karim, 1987; Karim, 1990b; Karim, 1990a; Banaga et al., 1994; Rammal, 2006; Ghayad, 2008; Laldin, 2008a). Essentially, the competency and independence of *SBs* will ascertain the effectiveness of the *SBs'* role in handling religious issues surrounding Islamic banking business and operations. It is in this regard that various arguments had laid down the requirement for *SB* to comprise of members who possess expertise and qualification from various backgrounds such as Shariah, accounting, auditing, finance and law (see example AAOIFI, 1997, para. 7; Gambling *et al.,* 1993; Grais and Pellegrini, 2006; Ghayad, 2008; Laldin, 2008b).

In essence, the *SB*s have an important role in the area of ex-ante auditing and ex-post auditing. In the area of ex-ante auditing, the *SB*s have a religious advisory role to the BODs on various Islamic banking operational issues. This includes giving Shariah advice on the different stages of developing Islamic financing products; i.e. conceptual, legal documentation,implementation, reviewing and marketing of Islamic financing products (see for example Alhabshi and Bakar, 2008). In the area of ex-post auditing, the *SBs* are expected to conduct a review of Islamic banks compliance with the Shariah advice provided during the ex-ante stage. These religious compliance review functions are expected to be carried out on a continuous basis by evaluating religious compliance in banking operation, measuring remedial rectification to resolve non-compliance and establishing control mechanisms to avoid recurrence of non-Shariah compliance cases. The scope of the religious compliance reviews should cover overall Islamic banking operations, including the development of Islamic banking products, from the product structuring to product-offering stages. Ideally, the *SBs* should also evaluate whether Islamic financial products offered by Islamic banks meet the objectives of Shariah (*Maqasid al-Shariah*) (see example Kamali, 2000; Kahf, 2006; Siddiqi, 2006; Dusuki and Abozaid, 2007; Dusuki, 2010; Ahmed, 2011).

The key governance functions of *SBs* highlighted in the above maybe argued to be consistent with the current practices of external auditors in a corporation. For example, external auditors are required to have a high level of independence when discharging their audit functions as this will ensure the issuance of a quality audit report (Jamal and Sunder, 2011; Kueppers and Sullivan, 2010). The literature further documented that provision of reliable and transparent information by external auditors could enhance investors' understanding of financial reports (Graham *et al.,* 2005; Barth and Schipper, 2007; Billings and Capie, 2009). Despite these similarities, the accountability spectrum of *SBs* is broader since they are required to assess the ensured Shariah adherence in every aspect of Islamic banking operations. Hence, any instances of non-Shariah compliance in Islamic banks would undermine the credibility of *SBs* in providing religious assurance to the stakeholders.

Empirical studies were also conducted to analyse the role of *SB*s. For instance, a survey was conducted by Alhabshi and Bakar (2008) to ascertain the prevalence of *SBs* of institutions offering Islamic financial services (IIFS) across jurisdictions. The study highlighted the concern in the decrease of *SBs'* role when performing religious compliance reviews on Islamic financial product development. Hasan (2011) conducted a survey on the current Shariah governance practices of IFIs in Malaysia, UK and GCC countries. He asserted that about 58% of *SBs* delegate their religious compliance review function to the compliance unit. Additionally, Rammal (2010) conducted in-depth interviews to investigate the role of *SBs* in IFIs in Pakistan and his study showed that some of the conventional banks offering Islamic banking windows tend to perceive the role of *SBs* in a negative fashion due to differing philosophies between *SBs* and the management on the purpose of Islamic banking transactions. In contrast, the study found that Islamic banks perceived an active role of *SBs* to ensure that all the Islamic banking systems and operations are religiously compliant. Rammal (2010) further indicated that the level of acceptance on the role of *SBs* may affect the need of religious compliance in the Islamic banking sector. More recently, Hassan (2012) made an in-depth investigation on the role, independency and religious compliance review effectiveness of *SBs* in the Malaysian Islamic banking industry. Drawn from his in-depth interviews with 46 key leaders in the Malaysian Islamic banking industry, the study revealed a grave concern on the independence of *SBs* and the quality of religious assurance provided by *SB*. It was highlighted that the religious compliance review function of the *SB* was mainly undertaken by the compliance officers and the results were then presented to the *SB* for approval. Hassan (2012) also presented evidence of instances where the religious compliance review was undertaken by the *SB* with no due diligence. Meanwhile, AAOIFI and IFSB have issued guidelines that clearly spell out the role of *SBs* in Islamic banks. For example, AAOIFI clearly explained the role of *SBs* as "the governance authority who are entrusted with the duty of directing, reviewing and supervising the activities of the IFIs in order to ensure that they are in compliance with Islamic Shariah principles" (AAOIFI, 1997, para. 2). In the same wavelength, IFSB outlined that Islamic financial services are required to develop a mechanism for obtaining rulings from Shariah scholars, applying fatwas and monitoring religious compliance on aspects including the ex-ante and ex-post of financial transactions and operations of Islamic Financial Services (IFSB, 2006, para. 47). In addition, AAOIFI set out the requirement for *SBs* to issue a report on the level of religious compliance in the operations of Islamic banks (AAOIFI, 1998, para. 10-25). This report, which is included in the annual report of Islamic banks, was also recommended to include all the fatwas (Shariah decisions and rulings) issued by *SBs* (AAOIFI, 1998, para. 25-26; IFSB, 2006, para. 49).

4.2. Internal Governance Mechanism in Islamic Financial Institutions (IFIs)

In ensuring religious compliance, several parties within Islamic banks hold key responsibilities in the Shariah governance of these banks. For instance, the BODs are responsible in implementing advice provided by *SBs* and to monitor, as well as, supervise management to ensure that all business activities do not only meet the expectations of shareholders and other stakeholders, but more importantly, those activities are in accordance with Shariah principles. Additionally, the BODs may require the management to provide them with reports on the activities of Islamic banks, including all matters related to religious compliance. Another important Shariah governance mechanism is the role of compliance officers. These officers play a significant role in assisting the *SB* in the area of ex-post religious compliance tasks. Amongst the crucial roles of these compliance officers are monitoring the internal Shariah control system of Islamic banks by verifying that all transactions and operations are performed in accordance to the Shariah advice provided by *SBs*. Essentially, the compliance officers carry the same requirements as the *SBs* in that they should have a background in Shariah qualification. Besides competency in educational qualifications, the compliance officers are expected to demonstrate high integrity and neutrality when undertaking their role and function.

Studies have claimed that Islamic banks face major challenges in the area of ex-post religious compliance processes where the internal governance mechanism of Islamic banks are made accountable. One of the empirical researches in this field of study is by Hassan (2012) where he noted the deficiencies in the implementation of religious compliance review involving various parties within Malaysian Islamic banks. This study also revealed that *SB* were suspicious on the authenticity of the religious compliance review undertaken by various parties within the management of Islamic banks. Other reported instances include the top management of Islamic banks dictating operational issues although the *SB* argued otherwise.

Arguably, effective Shariah auditing of Islamic banking operations is paramount to the provision of religious assurance. Such a proposition was given in consideration that, in addition to assurance on the credibility of financial statements, the shareholders and other stakeholders are also deemed to place high emphasis on aspects of auditing and the religious compliance review confirming that Islamic banking operations are indeed religiously compliant**.** Studies have argued that the establishment of a Shariah audit framework and an effective Shariah audit program in Islamic banks may be able to reduce the religious non-compliance risk and assist the harmonisation of Shariah practices across Islamic banks (see for example Shahwan *et al.,* 2010; Abdul Rahman, 2008). Basically, the Shariah audit function refers to the periodical assessment conducted by an independent internal auditor aiming at enhancing the soundness and effectiveness of the internal control system for religious compliance. The scope of Shariah audit may cover all aspects of Islamic banking operations including the auditing of financial statements; compliance auditing on organisation structures, people, processes and application system; and reviewing the adequacy of the Shariah governance process. Finally, the results of the Shariah audit will be reported to *SBs* at least on an annual basis.

The significance of internal Shariah governance mechanisms have also been addressed in the standards and guidelines issued by regulators. For instance, the IFSB deployed requirements for Islamic banks to appoint compliance officers to assist *SBs* in conducting the religious compliance review function (IFSB, 2006, pp. 23). The IFSB also outlined that the compliance officer must be a person who is adequately trained and has the required competency to ensure that religious compliance review functions are conducted in an appropriate manner (IFSB, 2006, pp. 23). In addition, the regulatory body stressed that the compliance officers may require the management to rectify any matters related to religious compliance (IFSB, 2009, pp. 3).

5. CONCLUSION

The legitimacy of Islamic banks is dependent on the provision of operations and activities that are Shariah compliant. The *SB*s of Islamic banks have authority to provide religious assurance on bank operations, but their effectiveness is dependent on several factors. The *SB*s should have the required competency with relevant knowledge and skills to manoeuvre this fast growing industry to greater heights. Therefore, issues on the independence of *SB*s in performing their task are of significant concern. In particular, there has to be effective communication and engagement between *SB* members and the relevant parties within Islamic banks as this is paramount in providing quality religious assurance issued by *SB*s in their Shariah report. That said, it is clear that the failure of *SBs* in performing their 'religious duties' will substantially affect the credibility of Islamic banks as financial institutions that uphold principles of social justice.

Our critical review also highlights pertinent challenges relating to the role of *SB*s. Foremost, the industry is facing a shortage of individuals who are well versed in both Shariah and finance disciplines. Another intriguing factor is the manner in which *SBs* actually operate within the governance framework of Islamic banks. We, therefore, believe it imperative for *SB* members to be independent in discharging their duties and transparent in issuing their religious assurance. There also remains a serious concern over the quality of religious assurance currently provided by *SB*s since there is evidence on the failure of *SBs* to perform their religious compliance task with the required level of diligence. After all, previous evidence has shown that *SB*s delegated their religious compliance review function to bank compliance officers and the results then submitted to the *SB* for mere approval. This current trend in providing assurance is somewhat worrying and will obviously not be acceptable under the assurance framework supplied by external auditors. In this light, we believe this study touches upon some important policy considerations that could assist regulators both in Malaysia and elsewhere to find effective mechanisms to strengthen the governance role of *SBs*. Finally, it is also plausible to suggest that regulators should consider allowing *SBs* to focus solely on their religious advisory role and transferring this important responsibility of conducting religious compliance reviews and issuance of religious assurance to external Shariah auditors. Perhaps this is the best conceivable way forward.

Notes

1. World Islamic Banking Competitiveness Report 2013-14.
2. The Shariah board of Malaysian Islamic banks is also known as the Shariah Committee.

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