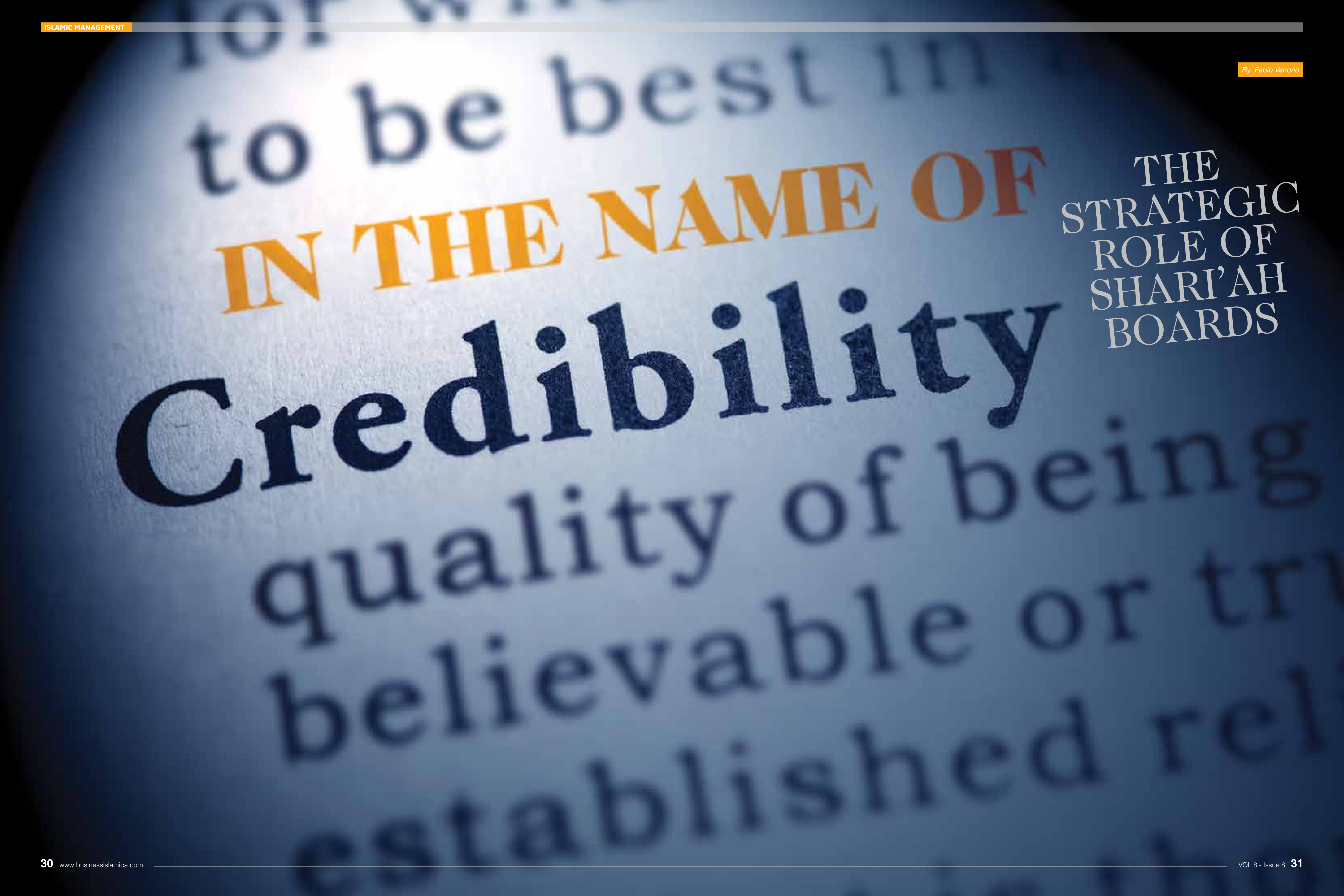

By: Fabio Vanorio

IN THE NAME OF Credibility

THE STRATEGIC ROLE OF SHARI'AH BOARDS

About Fabio Vanorio
Fabio Vanorio is an Executive Director at the Italian Ministry of Foreign Affairs. He lives in New York, currently on leave for a professional upgrade. His expertise in Islamic finance dates back to 2007; since then he carried out extensive academic research on Shari'ah-compliant finance, under the supervision of Prof. Paolo Savona.

In addition to his academic qualifications in International quantitative economics and finance, he hold a Post-Graduate Diploma in Islamic Banking and Insurance at the Institute of Islamic Banking and Insurance (IIBI) of London (UK). Recently, he began an in-depth analysis concerning the existing links between the expansion and evolution of Shari'ah-compliant finance and the asset allocation of Islamic Sovereign Wealth Funds.

Oman, the last of the GCC countries to bring in Islamic finance, set up a Central Shari'ah Board, directly dependent on the Central Bank, which will have direct oversight of Islamic banking institutions. The Monetary Authority took on the religious supervisory function, appointing a five-member board. According to Reuters, the choice of a centralized model could now speed up product development, limit costs for Islamic banks and facilitate issues of Sukuk. In this regard, in early 2015, Oman's finance Ministry has planned the first sovereign Sukuk issuance of 200 million Rials ($519.5 million).

Shari'ah advisers play a crucial role in the development of Islamic finance because none of the Islamic financial products can be recognized as "Islamic" without their endorsement. Unlike any corporate body, the Shari'ah board, by its nature, does not receive any task mandate. Its work is oriented to enforce the laws of God.

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It could then be argued that the only reference is Divine Guidance. In this sense, the Agency theory for modeling the possible behaviors of actors and optimizing the results with appropriate policies, is not relevant. It becomes possible, then, to introduce control and incentive mechanisms in order to avoid distortions in behaviors.

Currently, two are the Shari'ah Board models differently schemed by two major centers of Islamic finance - the Persian Gulf and Malaysia.

Malaysia has opted for a centralized Government Shari'ah Board – guided by the Central Bank – responsible for the religious compliance of the financial products. Each financial entity may have its own decentralized Shari'ah Board but every interpretation must be conformed to the rules laid down by the Central Shari'ah Board. Pakistan, Morocco, Nigeria and recently Indonesia have also established a uniform Shari'ah Board within their central banks. Indonesia's Financial Services Authority (Otoritas Jasa Keuangan), has signed an agreement with the country's national Shari'ah board to strengthen oversight of the Islamic finance industry, supporting a centralized approach.

In the Gulf States, conversely, each financial entity has its own Shari'ah Board, which decides on the religious conformity of Islamic products available. A homogeneity is ensured (sometimes in a questionable way) by the simultaneous presence of the few Shari'ah scholars in the many Shari'ah Boards. The shortage of Shari'ah scholars sufficiently trained and ready to sit in a Shari'ah Board allow the overlapping of their mandates, sitting them in many Shari'ah Board, both providing greater uniformity in the Islamic decision-making process, and also creates conflicts of interest. They could be compelled to legitimize shady operations to ensure their business. Besides, with a Shari'ah Board, the external auditors are not qualified to carry out supervision on religious rules.

For this reason, the United Arab Emirates Federal National Council, a half-elected advisory council with some parliamentary powers, plans to push for a Central Shari'ah Board are getting stronger.

Unifying standards with a centralized model is hard to manage yet because of the vested interests that exist in the Islamic industry. Resistance to unification of Shari'ah boards comes from the regulators, to whom any new structure could reduce their power, and from the Islamic financial scholar's community, who depend on the current system of issuing Fatawa.

According to the Islamic Financial Services Board (IFSB), differences in Shari'ah governance standards among legal systems reflect diversity in the development levels of the Islamic financial institutions. There cannot be a "one-size-fits-all" approach, in IFSB's view, since standardization tends to flatten innovation, not desirable for an evolving area like Islamic finance. The IFSB main concern is about the strength and the independence of the Shari'ah governance process, namely how the rules of Islamic law are interpreted. It is not the substance of the Fatawa to be considered from IFSB, but rather the conditions under which the Shari'ah Boards work.

The core business of Shari'ah Boards is to not only make religious observations, but financial ones as well. It will set religious compliance parameters before a fund's asset are allocated. The parameters are documented and available to the fund's shareholders or investors. It must be remembered that it is the fund's Board of Directors that has the legal responsibility for the affairs of the Fund and not the Shari'ah Board.

Musharakah and Mudarabah contracts, for example, can meet with the equity risk due to the Profit-and-Loss Sharing (PLS) principle among financial institutions and investors. Talking about financial investments, even considering putting in place the Regulators' risk mitigation requirements, in Permanent Musharakah contracts any change in stock prices can alter the sharing balance among the parties, with additional gains or losses for the financial institution with respect of the pre-defined ratio in the Musharakah agreement. In Diminishing Musharakah contracts, likewise, each change in the balance between stock and market prices may modify the convenience in shares repurchase if compared to the pre-established price. In Mudarabah, a lower-than-nominal stock price can generate inability in continuing the business.

In a Shari'ah-compliant risk evaluation, the contribution of the Shari'ah Board is therefore crucial. Compared to ethical funds, where the evaluation of ethics in the investment is internal to the corporate governance, i.e. taken by the fund management also with information from external professional bodies, for Islamic investment funds, the evaluation of religious compliance is external to the corporate governance because, whatever the asset class of the fund, the Shari'ah Board has no direct control over the Fund's portfolio management. Hence the strategic importance of the Shari'ah Board, particularly in its relationship with the Fund management involving it in the preparation and review of all legal and financial documentation of each transaction. The Shari'ah Board supervisory function is of paramount importance for protecting the (Islamic or not) investor, ensuring the "purity" of the monies used.

Shari'ah financial governance has gained more and more respect and recognition and the IFSB Guidelines should prove helpful in increasing its credibility. Numerous issues remain to be resolved in order to fully exploit the potential of the strategic role of Shari'ah supervisory boards, but the incentive to continue on the current path is strong and supported by market forces, the drivers of the promotion of Islamic finance industry.

IN THE DECISION-MAKING PROCESS, THE SHARI'AH BOARDS RECKON WITH THREE ASPECTS:

(1) The Shari'ah-compliance of the terms of contracts

(2) The best investment for the company

(3) The value creation, through the investment, for their company and the Islamic community. This is particularly important when comparing Shari'ah-compliant and Ethics-compliant investment funds. While ethical funds find their "wild cards" in the market risk, Islamic funds have a typical risk, i.e. the Shari'ah-compliant risk.

Once a financially structured product has been launched, Directors of the Fund, Shari'ah Board members and fund management meet on a regular basis, or as otherwise agreed, to discuss issues relevant to the ongoing Shari'ah endorsement of the fund.

The Shari'ah-compliant risk is linked to any reported breaches of Shari'ah stipulation. This risk, then, is when securities - firstly considered as Shari'ah-compliant, and whose presence in an Islamic AUM (Assets Under Management) is, therefore, permitted - have to be reclassified, due to sudden circumstances, as non Shari'ah-compliant after a review carried out by the Shari'ah Board. In this case, the changes requested by the Board (or the delay in the adoption thereof) may negatively affect the overall value of the fund.

	FINANCIAL EVALUATION	ETHICAL EVALUATION	INVESTMENT TARGET	TYPICAL RISK
ETHICS - COMPLIANT FINANCE	Ethical investment requires a double evaluation: budgetary and behavioral	Ethical evaluation of investment is internal to the governance	Profits maximization, constrained by an obligation of social responsibility	Ethics - compliant risk (linked to the investment's social impact)
SHARI'AH COMPLIANT FINANCE	Shari'ah - compliant investment put the religious compliance before the financial evaluation	Religious evaluation of investment is external to the governance	Profits maximization, according to the Islamic Law contracts	Shari'ah - compliant risk (linked to the investment's religious impact)