

What is the Future Outlook of Shariah Harmonization?¹

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Abstract:

This paper at first looks into the needs for harmonization in this turbulence and uncertain markets and economic condition. Market changes are among the prominent factors that leads to harmonization; and it is also the leading issue that Islamic finance industry will have to deal with in the near future. Then this brief paper dwells with the direction of harmonization efforts in the Islamic finance industry. No doubt that harmonization is not a panacea for problems faced by Islamic finance, rather it is a journey that we must take to propel and advance this endeavour.

Keywords: Islamic Finance, Shariah Harmonization, IFSB, Islamic Fiqh Academy, AAOIFI

Introduction

The need for harmonizing shariah rulings and standardizing practices or products in Islamic finance industry is pressing and urgent. The industry, which has grown over the last 20 years at about 10-15% per annum, is now global in nature and serving financial needs of various types of customers and stakeholders. If in its early day Islamic finance only serve the needs of devout Muslims in the Middle East, South and South East Asia, today Islamic finance products are consumed by wide variety of customers all over the world, Muslims or otherwise.

This development calls for more advanced set of products and regulations; there is a need for variety of value added services, sophisticated regulatory framework, and also a 'similar regime' for shariah rulings. Shariah rulings, while it is naturally diverse, tend to impede Islamic finance industry in competing globally, even among Muslim countries. This is evident in the case of some early and country-specific Islamic banking products, like Bai Bithaman Ajil(BBA) in Malaysia or the recent case of Tawaruq in some of the

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Gulf Countries. These products largely confined to its country of origin. They are not popular, not to say unacceptable, in other markets.

Current Scenario

The very development of Islamic banking and finance in most Muslim countries, especially in the early days attributes for current divergence and sometimes conflicting views of shariah opinions and rulings on Islamic finance transactions. Each country started at somewhat different time period; Middle East started the first Islamic banking operations in late 1960s or early 1970s, Malaysia in the 1982, Indonesia in 1991, and the rest are sometimes during and beyond those periods. This caused some countries to experiment (early starters) while others are developing a new system based on other's experiences and mistakes.

Another reason is school of law and specific cultural background. The very nature of different *madzahib* as adopted by countries, restrict their universal or uniform application to rulings on commercial transactions. A more lenient Hanafi school, for instance, allows somewhat liberal rulings on what is permissible and what is not in banking/financial transaction. Governor of State Bank of Pakistan in 2006 rightly pointed out that "one of the issues faced by Islamic financial industry is lack of standardization of shariah rulings within the same jurisdictions and among various regions." Mr. Shamshad Akhtar further identified that "the diversity provided by different schools of thoughts on same issues at times creates confusion in the minds of the public, but if properly harmonized across the globe, (this diversity) can become a great strength for the Islamic financial services industry thereby providing different options suitable to the varying needs of customers".

Why Harmonization?

There are few explanations why the industry needs standardized or harmonized shariah rulings in the first place. *First*, standards make control and regulation easy and manageable. A central bank regulating different shariah regimes will be ineffective, cumbersome and costly. Likewise, banks and financial institutions will have a standard set of reporting guidelines and reporting systems, which enable them to focus more on business activities and make profits in the process. Compliance will be painless and supposedly more straightforward, than in a hypothetical different shariah rulings environment.

Second, global market place has forced markets appetite for most financial products to converge into several products. Similarly, the global nature of Islamic finance industry entails appetite of customers to become less fragmented and diverse. A recent report produced by the International Organization of Securities Commissions (IOSCO) in September 2008 suggests that “as the Islamic securities markets continue to expand both geographically and in terms of market size, the development of regulatory standards, standardization of documentation, practices and the ratings of products will be essential”.

Another notable factor for harmonization to contain a significant drawbacks from the previous strategy. In the case for Pakistan, for instance, in 1980’s it experienced a time when Islamic banking system was developed in “a rigid model...that resulted in a stalled process of product innovation and development”. Hence the strategy developed today is aimed “not to standardize each and every practice just for the sake of standardization only. Rather emphasis has been on a market based approach wherein the industry can on an ongoing basis provide shariah compliant banking services through a parallel and compatible system (SBP, 2008)”.

Future of Shariah Harmonization

There are at least three forces at the forefront and the driving force behind further harmonization and possibly standardization of Shariah in the coming future, one is market force of globalized markets and two, the emergence multilateral institutions like AAOIFI and IFSB and three, the ongoing Shariah forum such as Islamic Fiqh Academy of OIC, Dallah al- Barakah forum, Mudzakarah of shariah experts in Nusantara region (Malaysia, Indonesia, Thailand, Brunei, Singapore and The Philippine) and alike.

Globalized Market

As Islamic finance becoming more globalized in outreach and outlook, changes do occur. It is no longer serving traditional markets in the Middle East or South Asia, although these markets still constitute the largest, but the Islamic finance industry is now a popular alternative in the places like London, Geneva and Singapore. In fact, dominant players of Islamic finance in the Gulf Countries like the UAE and Bahrain are Western financiers and multinationals. The trend is not necessarily going to change in the future; the outlook may even becoming more globalized and diversified. The emergence of Sukuk is a clear example of how market forces of a globalized industry has changed the way the industry is governed.

Cross Border Transaction

A cross border organization play an important role in dealing with issues of supplementation, but should avoid duplicating or altering existing standards that can apply equally across both conventional and Islamic sectors. To do otherwise will add to industry's compliance burden, constrain cross border product flows, and hinder the acceptance of Islamic finance products as an integral part of the world's capital markets.

It follows that when considering how regulators might best facilitate cross border financial transactions we should start with the conventional market. If we identify the core issues in that market, we can then deal with any supplemental issues arising in the Islamic finance context. Facilitating international business flows by harmonizing regulation is not a new subject and remains a contentious one. International harmonization of regulation would undoubtedly facilitate cross-border business, and most business people support it in principle. But most of those people have their own idea of what the regulation should look like and will oppose the imposition of anything different.

Different Jurisdiction

Another serious question to be adhered to is about how the Shari'a components of Islamic finance transactions are dealt with in different jurisdictions. For example, there are differences between the method in which Dubai and Malaysia deal with Shari'a compliance. However, there are distinct advantages in Malaysia's approach of having a centralized Shari'a approval structure, as opposed to Dubai's, which is based on each issuer having its own Shari'a Board. There problem is that the number of differing Shari'a interpretations that prevail in the Middle East; the conviction with which they are held; and the fact that it is a cross border regional market: all place the prospect for conformity of interpretation and regulatory administration beyond reach –at least for the present.

A report by IOSCO found that different jurisdictions have adopted different models with respect to Shariah governance. Without making any judgement on the appropriateness of any given approach, these have been detailed below:

1. **Conventional approach:** Regulators do not possess the remit or may, as a matter of stated policy, not regulate Shariah compliance directly; however, the regulators may require disclosure of material information to investors, which includes details of Shariah compliance. For example, in France, the compliance of the issue with Shariah rules does not fall within the remit of the AMF (France Monetary Authority). It is the responsibility of the issuers, with assistance from

their advisers, to incorporate into the prospectus the relevant elements, including appropriate details of the Shariah board involved in the transaction, which provide the necessary information to enable investors to make an informed decision.

2. **Shariah systems approach:** Firms are required to have their own Shariah boards. The governance, function and operation of Shariah board decisions are regulated. For example, Dubai: see DFSA's Islamic Financial Business Module (ISF).
3. **Centralized approach:** There are firm based Shariah boards, and also a central Shariah board which assesses the compliance of financial products and institutions. The example of this method of supervision are Shariah Advisory Councils (SAC) in both of Securities Commission of Malaysia and Bank Negara Malaysia and National Shariah Board of Indonesia. (SAC) was established in May 1996 to advise the Commission on Shariah matters pertaining to the ICM.
4. **Other:** Approaches which have not been specifically identified in this report or hybrid versions of the previous models.

IFSB

An important step towards the harmonization of the Islamic finance industry was carried out on 3rd November, 2002, with the foundation of the Islamic Financial Services Board (IFSB) headquartered in Kuala Lumpur. The decision to establish such a body was taken by a group of governors, senior officials of central banks and monetary authorities of several Islamic countries, supported by the Islamic Development Bank, the AAOIFI and the International Monetary Fund. The general objective of the IFSB is 'promoting, spreading and harmonizing best practices in the regulation and supervision of the Islamic financial services industry'.

The IFSB serves as an international standard setting body of regulatory and supervisory agencies that have an interest in ensuring the reliability and stability of the Islamic financial services industry. It is specifically concerned with the standardization of Shariah committee rulings on Islamic banking practices. The IFSB also aims at standardizing the approach in Good Governance of Islamic financial institution and identifying risks in Shariah-compliant products and services and in assigning risk weights that meet internationally acceptable prudential standards.

AAOIFI

Among the most celebrated and outstanding efforts in harmonizing Shariah finance is the establishment of AAOIFI. AAOIFI or The Accounting and Auditing Organization for Islamic Financial Institutions is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry.

AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 1 Safar, 1410H corresponding to 26 February, 1990 in Algiers. Then, it was registered on 11 Ramadan 1411 corresponding to 27 March, 1991 in the State of Bahrain. As an independent international organization, AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide.

The objectives of **AAOIFI** are:

1. to develop accounting and auditing thoughts relevant to Islamic financial institutions;
2. to disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;
3. to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
4. to review and amend accounting and auditing standards for Islamic financial institutions.

AAOIFI carries out these objectives in accordance with the precepts of Islamic Shari'a which represents a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.

AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia,

Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.

Islamic Fiqh Academy, Nadawat and Mudzakarah

The Islamic Law of Contracts plays a pivotal role within the Islamic financial system. Islamic commercial jurisprudence consists of principles and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under Sharia.

While some of these principles and rules are based on clear and explicit rulings of Sharia, others are derived from Sharia scholars' interpretations and understanding of the law, known as Fiqh, as set out in the Qur'an. These interpretations can and do differ between Sharia scholars. Certain contractual terms deemed to be valid under Sharia by the scholars of one school of Fiqh may not be acceptable to scholars from another school. This has had significant implications for the development of Islamic finance.

To resolve these differences a series of creative efforts were conducted by Islamic Fiqh Academy of OIC and forums of dialog such as Multaqa Dallah al Barakah and ar-Rajhi and Kuwait Finance House and Faisal Finance group which discuss numerous aspect of Islamic finance on regular basis. More recently Bank Negara Malaysia also initiated Mudzakarah Ulama Shariah Nusantara, a special workshop to discuss issues on Shariah finance participated by leading Shariah experts from Malaysia, Indonesia, Thailand, Brunei, Singapore and The Philippine.

Malaysian and Indonesian Experiences

The Monetary authority in Malaysia believes that an effective Shariah framework would serve to ensure uniformity and harmonization of Shariah interpretation and hence will strengthen the regulatory framework and governance practices for the Islamic financial industry. Bank Negara Malaysia issued the Guidelines on the Governance of Shariah Committee for the Islamic Financial institutions in December 2004, aimed at achieving uniformity of Shariah decisions, in addition to creating and expanding the pool of competent Shariah personnel in Islamic banking and takaful.

Prior to the issuance of the guidelines, various Shariah bodies co-existed and were governed under separate legal framework. An Islamic bank was required under the

Islamic Banking Act 1983 to establish a 'Shariah Advisory Body', while a takaful operator needed to set up a 'Shariah Supervisory Council' stipulated under the Takaful Act 1984. These Shariah bodies were not adequately regulated, and were operating independently of one another, and were also independent of the Shariah Advisory Council (SAC) established at Bank Negara Malaysia. Therefore, these Shariah body needed to be regulated in order to avoid divergence of Shariah interpretations on similar matters and eliminate confusion among the public.

The Guidelines set out the rule, regulation and procedure in the establishment of a Shariah Committee as well as the relationship and working arrangement between the Committee and the SAC of Bank Negara Malaysia. Among the duties and responsibilities of the Committee are to advise the board of directors on Shariah matters on the bank's business operations to ensure that they comply with Shariah principle at all times, to endorse the Shariah compliance manuals, and to endorse and validate relevant documentations. To ensure the proper record for easy reference the committee is required to provide written Shariah opinions or decisions.

Almost similar to Malaysian approach of harmonizing Shariah finance, Indonesia also set out a Centralized Fatwa and decree on Islamic finance matters. Under this system Indonesian Council of Ulama (Majelis Ulama Indonesia-MUI) established an autonomous body to serve as National Sharia Board called Dewan Syariah Nasional or DSN. DSN consisted of eminent Islamic scholars and holds the ultimate authority to issue *fatwa* and approve every new Islamic finance products and practices. Banks, however, still have their own individual sharia committees, named DPS-Dewan Pengawas Syariah (Shariah Supervisory Board) whose role is to accommodate the need for product development from time to time and to ensure the application of DSN's *fatwa* and rulings.

Challenges Ahead

1. **Shari'ah 'arbitrage'** - Currently, there is a diversity of opinion regarding whether certain products or practices comply with Shari'ah law. While regulators will not be in a position to assess the compliance of products with Islamic principles, regulators will need to ensure that transparency of the Shari'ah compliance process is appropriately communicated to the financial consumer. The FSA of UK for instance noted that common Shari'ah standards would be beneficial, and it is currently supporting the development of such standards by various organizations,

which would make it easier for bankers and investors to assess, and access, the market.

2. **Shari'ah compliance throughout the product life cycle** - While a product may be deemed Shari'ah compliant prior to its launch, firms must also be cognizant of the need to maintain compliance after launch by monitoring their products and services. Compliance must be considered an ongoing obligation, as a breach of Shari'ah rules could undermine investor confidence in the products and threaten the firm's solvency.
3. **Shortage of competent Sharia scholars** One major issue related to Islamic financial regulation and supervision is the shortage of appropriately-qualified Sharia scholars in the Islamic financial industry. As a result it is common for individual scholars to hold positions on the SSBs of a number of Islamic firms. This raises concerns over the ability of SSBs to provide enough rigorous challenge and oversight of firms' products and services. Another issue is where the SSB of a firm is responsible for the yearly Sharia audit as well as approving products for Sharia compliance. As with conventional firms, some regulators like FSA would like to see these conflicts recognised and carefully managed.
4. **Potential conflict of interest** - As there is currently a shortage of Shari'ah scholars to certify that products conform to Islamic law, it is currently not uncommon for scholars to hold Shariah advisory positions within more than one financial firm. This raises concerns regarding the ability of scholars to apply a high level of oversight to the various products and services at different firms, as well as concerns of potential conflicts where scholars are both approving products and auditing existing products and processes within the same firm or at different firms.
5. **Lack of Uniformity.** A uniform regulatory and legal frame-work supportive of an Islamic financial system has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets.

6. **Slow Process.** If Islamic banks are to compete with conventional ones for customers willing to consider both options, innovation and speed are crucial. A sharia committee can slow down product development or halt it altogether: an Islamic bank in the Gulf region developed a new product in two months, for example, and then had to wait one or two months for the committee to approve it, in part because the committee will have a meeting on periodical bases.

Conclusion

The nature of Islam as rahmatan lil-‘alamin, which applies to Islamic finance as well, entails a strong case to make Islamic finance a blessing for all humanity. This, among others would become easier to attain through a harmonized shariah rulings. Harmonization is not about changing fundamental aspects of law, nor it is a compromise to market forces. Rather, as Islamic finance evolves, and our understanding of its nature and usefulness for our life, we must strive to find out a more sizeable common ground of understanding in terms of istinbath al ahkam, takyif al fiqhi, istidlal and implementation of maqashid al-shariah in commercial aspects.

The on going efforts by AAOIFI, Islamic Fiqh Academy and IFSB at global level and Shariah Advisory Council at national level and rigorous scientific dialogues allover the world on Islamic finance issues could accelerate the process of shariah harmonization. Insha Allah.

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