

# DRAWING A SYNERGY BETWEEN THEORY AND PRACTICE - A MOVE TOWARDS A MORE STAKEHOLDER-ORIENTED REGULATORY FRAMEWORK FOR MODERN ISLAMIC FINANCE INSTITUTIONS: A COMPARATIVE ANALYSIS

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## Abstract:

This article argues that the Islamic finance (IF) industry, in its ideological foundations is very similar to the stakeholder and Business ethics theory in western thought. The paper further argues that the principles of *Maqasid al sharia* and *Maslaha* form the basis of the Islamic finance jurisprudence and need to be applied throughout the Industry via regulatory standards. However, industry practices of the IF industry do not always follow the *Maqasid* and *Maslaha* principles primarily because of the lack of regulation and standard setting at the international level. This article examines the different regulatory framework that are being utilised in different jurisdictions to regulate the Islamic finance Industry. This article takes the examples of Pakistan, Kuwait and the UK as representing three different regulatory frameworks in practice around the globe and then suggests the best possible method of incorporating the *Maqasid* and *Maslaha* into the regulation and practice of Islamic finance via a principle based Meta regulatory framework. We take an example from the Basel accord on banking best practices and argue that the Islamic finance industry also needs an International Meta regulatory framework like Basel, which can cater to the specific needs of the IF industry globally, even where jurisdictions do not accept Islamic law as a valid source of law so that the IF industry can incorporate the *Maqasid* of financial intermediation i.e. to ensure socio-economic justice in society.

**Keywords:** *Maqasid al Sharia*, *Maslaha*, Meta-regulation, Basel accord, Pakistan, UK, Kuwait.

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## 1. Introduction

The growing demand by Muslim investors and customers for a financial system which is in line with their religious beliefs has led to the Islamic finance industry emerging as the fastest growing segment of the global financial sector,<sup>1</sup> with Islamic Financial Institutions (IFIs) operating in more than 25 jurisdictions.<sup>2</sup> Such growth has, however, brought to light some of the shortcomings of the industry's practices and raised questions about how both the religious and the financial dimensions of the industry should be regulated. Given that IFIs operate in both Islamic and secular jurisdictions<sup>3</sup>, devising a universal regulatory framework is fraught with difficulty. This article will explore the challenges of regulating IFIs in different types of jurisdictions, and will then go on to advocate a meta-regulatory approach that could be applied by well-established supranational bodies.

The origins of the modern Islamic financial industry can be traced back to the 1960's, when the Mit Ghamar bank was started in Egypt,<sup>4</sup> though the underlying commercial practices and norms can be traced back to the time of the Prophet Muhammad (the Prophet of Islam) from the early 7th century. However, the modern day Islamic financial sector has come a long way from the basic trade contracts of medieval Arabia, catering to the financial needs of modern society with *Sharia*-compliant complex financial products such as *Sukuk* (bonds), *Musharakah* (partnerships), *Ijara* (leases), *Muadarabah* (agency contracts), *Muarabaha* (cost

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<sup>1</sup> See <<http://www.bbc.co.uk/news/business-28365639>>

<sup>2</sup> <<http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamic-banking-competitiveness-report-2014-15>>.

<sup>3</sup> Secular jurisdictions, for this paper are categorised as those Jurisdictions which do not accept Islamic law as a valid source of law e.g. England is considered a secular jurisdiction

<sup>4</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated" World Bank Policy Research Working Paper No. 3227 (February 25, 2004). SSRN: <<http://ssrn.com/abstract=610268>>.

plus transactions) *Salam* and *Istisna* (futures contracts).<sup>5</sup> What distinguishes these particular products and justifies the label 'Islamic' is their compliance with the *Sharia*,<sup>6</sup> primarily on account of the absence of *Riba* (usury) and *Gharrar* (speculation) in all financial transactions.<sup>7</sup> All IFIs, therefore must have a *Sharia* Supervisory Body (the SSB), to ensure that the principles of the *Sharia* are being followed.<sup>8</sup> The requirement for all IFIs to comply with the main principles of the *Sharia* and the resulting presence of the SSB raise two main issues regarding the regulatory aspects of the Islamic finance industry.

The first relates to the essential pre-requisites for compliance with the *Sharia* question. An initial problem is that the *Sharia* is not a single code of conduct but has a number of different connotations and interpretations.<sup>9</sup> Yet despite the differences of interpretation amongst different schools of thought<sup>10</sup>, it is possible to identify certain common features in all

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<sup>5</sup> Mohamad Taqi Usmani, *An Introduction to Islamic Finance* (Karachi, Pakistan, Idaratul Ma'aririf 2000).

<sup>6</sup> In this paper, the term Islamic law and Sharia are used interchangeably. However, in contemporary understanding 'Islamic law' is deemed to be an all-encompassing term used to denote concepts like '*fiqh*', '*usul*', '*qanun*', '*urf*', '*madhab*', '*fatwa*' and '*sharia*' itself. Jasser Auda, *MAQASID Al-Shariah as Philosophy of Islamic Law: a systems approach*. The International Institute of Islamic Thought, VA, USA, 2008.

<sup>7</sup> Ibid Usmani

<sup>8</sup> F E Vogel and S L Hayes *Islamic Law and Finance, Religion, Risk and Return* (The Hague: Kluwer Law International) 1998.

<sup>9</sup> *Sharia*, loosely defined means the principles of law that have been defined in the basic sources of Islam i.e. The *Quran* and the *Sunnah*. Sharia itself cannot be considered a system of laws, however a better definition of *sharia* is that it is a social system based on a loose set of principles derived from the Islamic faith and teaching. This can be differentiated from the concept of Islamic law, which is a much narrower definition and is reserved for those laws that have been promulgated by different jurisdictions based on the Sharia principles.

<sup>10</sup> School of thoughts refer to the different schools of Fiqh. *Fiqh*, as contrasted to Islamic law and Sharia, is the jurisprudence, which has been developed by the different recognised scholars belonging to one of the main schools of Jurisprudential thought i.e. *Shafi*, *Maliki*, *Hanbali* and *Hanafi* in the Sunni School and *Ja'fari* (*inc. Mustaali-Taiyabi Ismaili*) and *Zaidiyyah* schools of thought in the *Shia* school of thought.

Islamic financial rules and norms. These common features are in turn translated into common goals, practices and transactions that the IFI's undertake. These include, but are not limited to, the use of the basic financial intermediation model of the two-tiered *Mudarabah* and *Musharakah* for provision of banking facilities that mirror conventional banking model,<sup>11</sup> the presence of the SSB in ensuring the *Sharia* compliance and the role of the *fatwas* in deriving legitimacy for the financial products and services. There are numerous other commonalities between the Islamic financial intermediation model across the spectrum but these three features all differentiate Islamic financial institutions from their conventional counterparts and thus have a unique jurisprudential and legal position. So, the question can therefore be re-contextualised in the following manner: what is it that makes an Islamic financial institution 'Islamic' *per se* and different from a conventional financial institution? Is it the self-declaration of a financial institution that makes a financial institution 'Islamic' or is it the regulatory classification that determines whether an institution is Islamic or not? I argue in this article that determining whether a financial institution body is Islamic or not and therefore complies with the basic precepts of the *Sharia* is easier in those jurisdictions which recognise the *Sharia* as a source of law.<sup>12</sup> Therefore, the question then is: in a jurisdiction where the underlying principles of the *Sharia* are not recognised by regulators or the judiciary, and financial institutions self-declare their operations as 'Islamic', how can the supervisory and regulatory authorities best engage with the industry?

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<sup>11</sup> *Mudarabah* in simple terms can be defined as an investment partnership based on an agent/principal relationship, where the agent is called the Mudarib and the principal/investor is called the *Rab-ul-mal*. *Musharakah* in simple terms can be defined as simple equity participation partnership. For more details, see; Usmani, *An Introduction to Islamic Finance* (Karachi, Pakistan, Idaratul Ma'arif 2000).

<sup>12</sup> The range of recognition may vary amongst these jurisdictions from being purely sharia based eg Iran and Saudi Arabia, to having a parallel system of common/ civil law along with sharia eg Pakistan, Malaysia, down to those jurisdictions where sharia is recognised but is not the main governing source and is invoked in very exceptional circumstances e.g. Turkey.

This then brings us to the second issue: whether it is possible for the Islamic finance industry to have a universal legal doctrine or a set of universal common principles which are both acceptable at an international level (in both Islamic and non-Islamic jurisdictions), and can provide guidance to the supervisory and regulatory authorities on how best to engage with the industry? In this article, I argue that one such doctrine is the interpretive and jurisprudential doctrine from within the *Sharia* called the *Maqasid al Sharia*.<sup>13</sup> This can be translated as meaning the objectives of *Sharia*. In less simplistic terms, this means the normative outcomes that the *Sharia* aims to achieve in a social, religious and economic context. This concept of *Maqasid al Sharia* or intended outcome has a significant role to play in the current Islamic finance industry, since the industry claims to be adhering to the basic principles of the *Sharia* pertaining to finance such as providing services and financial instruments devoid of *Riba* and *Gharar* and upholding the basic tenets of Islamic commercial law (*Fiqh al muamlat*). The *Maqasid al Sharia* for Islamic finance can therefore have said to be: promoting social and economic welfare, equitable distribution of wealth, public welfare and act as a catalyst for development, abolition of usury and speculative trading. Therefore, as a common principle of operations all IFI's must be working towards the above-mentioned goals and aims and be ethical in their operations. The question that I explore in this article through a theoretical and comparative analysis is to see whether the regulatory regimes in different countries do justice to the aims set out by the IFI's as an industry within their respective regulatory models.

I argue that the *Maqasid* of financial intermediation under the *Sharia* can best be explained through an analogy and comparison with the stakeholder theory in western corporate

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<sup>13</sup> The closest idea to *Maqasid al sharia* can be the idea of 'raison d'être' or reason or justification for existence; M H Kamali, *Maqasid Al-Shari'ah: The Objectives of Islamic Law* (Islamabad: Islamic Research Institute, International Islamic University Islamabad) 1999

governance thought,<sup>14</sup> both having their roots in the wider ‘business ethics’ ideology and both focusing on the socio-economic betterment of society through financial intermediation.<sup>15</sup> However due to the dominance of the neo-liberal political and economic ideology that is not always the case, which is a problematic issue for the Islamic finance industry. Therefore, I

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<sup>14</sup> For a detailed explanation of stakeholder thought please see: Ackerman, B. A., Alstott, A ‘The Stakeholder Society,’ (1999). Yale University Press, New Haven, CT; Andriof, J. And Waddock, S. (2002). *Unfolding Stakeholder Engagement*. In: J.Andriof Et Al. (Eds. ). *Unfolding Stakeholder Thinking - Theory, Responsibility and Engagement*. Sheffield: Greenleaf Publishing; Argandona, A. (1998). *The Stakeholder Theory and The Common Good*. *Journal of Business Ethics*. 17, Pp. 1093-1102; Barnett, M. L. (2007). *Stakeholder Influence Capacity and The Variability of Financial Returns to Corporate Social Responsibility*. *Academy of Management Review*, 32(3): 794-816; Berman, S. L., Wicks, A. C., Kotha, S. And Jones, T. M. (1999). *Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Model and Firm Financial Performance*. *Academy of Management Journal*. 42 (5), Pp. 488-506; Boatright, J. R. (1993). *Ethics and The Conduct of Business*. New Jersey, Prentice Hall; Bradley R.Agle, Thomas Donaldson, R.Edward Freeman, Michael C.Jensen, Ronald K.Mitchell And Donna J. Wood, ‘Dialogue: Towards Superior Stakeholder Theory.’ *Business Ethics Quarterly*, Vol 18, Issue 2, Pp 153-190. 2008; Cadbury, A. (1992). *The Report of the Committee On Financial Aspects of Corporate Governance*. Gee and Co, London; Carroll, A. B, (1993), *Business and Society: Ethics and Stakeholder Management*, Cincinnati, Oh: South-Western; Carroll, A. B. (1991). *The Pyramid of Corporate Social Responsibility: Toward The Moral Management of Organizational Stakeholders*. *Business Horizons*, 34(4): 39-48; Carroll, A. B. (1999). *Corporate Social Responsibility: Evolution of A Definitional Construct*. *Business & Society*, 38(3): 268-295; Carroll, A. B. (2004). *Managing Ethically with Global Stakeholders: A Present and Future Challenge*. *Academy of Management Executive*, 18(2): 114-119; Collier, Jane and Roberts, ‘Introduction: An Ethic For Corporate Governance?’ *Business Ethics Quarterly* 11, 2001, 1:67-71; Donaldson, T., & Dunfee, T. W. (1994). *Toward A Unified Conception of Business Ethics: Integrative Social Contracts Theory*. *Academy of Management Review*, 19: 252-284; Donaldson, T., & Preston, L. E. (1995). *The Stakeholder Theory of The Corporation: Concepts, Evidence And Implications*. *Academy of Management Review*, 20: 65-91; Donaldson, T. (1999). *Making Stakeholder Theory Whole*. *Academy of Management Review*. 24 (2), Pp. 237-241; Jensen M C. (2000). *Value Maximization, Stakeholder Theory, And The Corporate Objective Function*. *Business Ethics Quarterly* 12(2)2: 35-256; Jensen, M. C. And Meckling, W. (1976). *Theory of The Firm: Managerial Behaviour, Agency Cost, And Capital Structure*, *Journal Of Financial Economics* 3: 305-360; Jawahar I M, McLaughlin, G L. ‘Toward A Descriptive Stakeholder Theory: An Organizational Life Cycle Approach.’ 2001 *Academy Of Management Review* 26(3): 397-414; Johnson, H.L , ‘Business In Contemporary Society: Framework And Issues.’ (1971)Routledge, London; Rossouw, G,J. *Business Ethics: Where Have All The Christians Gone?’* 1994, *Journal Of Business Ethics* 13, 557-570.

<sup>15</sup> G Rice ‘Islamic Ethics and The Implications For Business’ (Feb 1999) *Journal Of Business Ethics*, Vol. 18, No. 4, 345-358, Published By: Springer Stable URL: [Http://Www.Jstor.Org/Stable/25074059](http://www.jstor.org/stable/25074059) Accessed: 17/09/2010 08:36

argue that to devise an effective regulatory and governance framework for the Islamic finance industry (especially in a non-Islamic jurisdiction), the standard-setting bodies and regulatory authorities ought to utilize the fundamental ideology of the stakeholder theory, which reflects to a considerable extent the *Maqasid al Sharia* of the Islamic financial intermediation model. Borrowing practical guidelines from the stakeholder theory and practice will allow the Islamic finance industry to adapt and integrate with the norms and rules of secular jurisdictions without losing its own religious and ethical characteristics. At the same time, following the stakeholder principles will also allow secular regulators to better understand and assimilate the Islamic model of financial intermediation and thus cater for the unique religio-ethical nature of IFIs.<sup>16</sup>

Besides adapting the stakeholder model of governance, the appropriate regulatory framework for IFIs can be determined by focusing on the unique perspective of property rights as set out under the *Sharia* and the social, economic and legal needs of a whole range of stakeholders.<sup>17</sup> In other words, rather than the IFIs focusing simply on the shareholders and creditors as the main category of beneficiaries, as is the norm under the neo-liberal economic and legal principles, other stakeholders like the investment account holders (IAHs) and the *Sharia* supervisory bodies (SSB) in Islamic financial intermediation model must also be catered for.<sup>18</sup> Therefore the question that can be asked is: whether using the *Maqasid al Sharia* as the basis of the Islamic financial model, can we suggest an internationally recognised and acceptable framework for regulatory compliance for the Islamic finance industry? In the light

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<sup>16</sup> Z Iqbal and A Mirakhor 'Stakeholder Model of governance in Islamic Economic system' (2003) in the Fifth International Conference on Islamic Economics and Finance, IRTI Islamic Development Banks Bahrain.

<sup>17</sup> M A Afzalur-Rahman, *Islam Ideology and The Way of Life* (The Muslim School Trust, London 1980).

<sup>18</sup> MAA Sarker, 'Islamic Business Contracts, Agency Problem and the Theory of the Islamic Firm' (1999) *International Journal of Islamic Financial Services*, 1 (2): 12-28

of these issues of governance and regulation I will suggest practical solutions for some of the more systemic *Sharia* governance and regulatory issues of the global Islamic finance industry.

This article is divided into three sections; the first section examines the current regulatory framework, analysing the approaches taken at the supranational level and within three different types of jurisdictions to highlight the regulatory problems of trying to regulate the Islamic finance industry under a ‘common’ principled approach. The second section advances the view that we can use a Meta regulatory framework for the Islamic finance industry as this seems to be the most suitable for our current discussion and will set out the advantages of a meta-regulatory approach in this context. The third section of this article suggests a possible new framework for such an approach.

## ***2. The Current Regulatory Framework***

In this article I argue that, while uniform supervisory and regulatory standards have been set by the two main standard-setting bodies—the Audit and Accounting Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (ISFB)—their powers are limited. Although both the AAOIFI and the ISFB have published several regulatory standards addressing issues surrounding the internal corporate governance of IFIs and the *Sharia* compliance problems,<sup>19</sup> these standards are purely voluntary ones, and there is no supervisory mechanism in use to certify their enforcement. The effect of these standards will therefore depend on the extent to which they are recognized in national law of a particular jurisdiction and since IFIs operate in different jurisdictions (common law, civil laws and Islamic law), it gives rise to several corporate governance issues as well as cross jurisdiction

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<sup>19</sup> <<http://www.ifsfb.org/published.php> and <http://www.aaofii.com/en/standards-and-definitions/shari%e2%80%99a-standards/governance-standards.html>>.

regulatory issues. To understand the different regulatory approaches in practice across the broad spectrum of different jurisdictions we can identify three distinct groups for the purposes of this article:<sup>20</sup> The first group is made up of states that have a central regulatory regime for the IFIs. The second group consists of jurisdictions which don't have a central regulatory body for the Islamic finance industry yet have some legal mechanism in place for rule making and dispute settlement specifically catering the Islamic finance industry. The third group consists of such states which have no regulatory mechanism in place for Islamic finance industry yet allow individual IFIs to incorporate and operate. The detailed description of each group follows:

*i. The First Group*

The first group is formed of those jurisdictions which categorically recognise the *Sharia* as a valid source of law and allow legal rulings by the *Sharia* Boards (the SSB) and scholars involved in the legitimization of financial products and services in line with the *Sharia* precepts to be endorsed and accepted by the local judiciary and rule-making bodies. These jurisdictions also have in place a central the *Sharia* Regulatory Authority or a Central *Sharia* Supervisory Body, usually set up through a statutory enactment or via the central bank's by-laws, to specifically cater to the Islamic finance industry. These jurisdictions tend not to have any major problems in supervising and regulating the *Sharia* aspects of individual IFIs, either externally or internally. The distinctive feature of these jurisdictions is that they will have a Central Regulatory Authority that can give verdicts about the *Sharia* standing of a particular financial instrument, contracts, transactions and any internal supervisory regime in place. In summary,

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<sup>20</sup> This distinction is by no means water tight and non-exhaustive. The purpose of highlighting these three distinct regulatory approaches is to highlight the en-vogue regulatory approaches and their advantages and shortcomings

these jurisdictions regulate (any and) all aspects relating to the *Sharia* in context of the IFI's operation. This means that internal and external *Sharia* governance issues are dealt with by a Central Regulatory Body. In principle, these jurisdictions have a more 'top down' rule-based approach whereby the central bank (or the appropriate department of the government) continually regulates, monitors and licenses the IFIs. Countries which fall into this category are Pakistan, Sudan, Malaysia and Iran.

The advantage of this particular approach lays in the certainty for IFIs in knowing exactly what rules and procedures they need to follow. Secondly, the compliance with the regulatory standards set out by the central regulators are controlled by the regulatory bodies either themselves or through a recourse to the local judiciary and other national dispute settlement processes, therefore instilling confidence in the public regarding the *Sharia* compliance of the individual IFI and allowing IFIs to easily follow mandatory governance standards.

For example, in Pakistan the Islamic finance industry is regulated both by the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP).<sup>21</sup> The SBP handles all Islamic financial institutions such as Islamic banks,<sup>22</sup> whereas the SECP handles all *Sukuks*,<sup>23</sup> capital markets *musharakah* and *mudarabah* companies,<sup>24</sup> as well as other non-banking Islamic entities. Both regulatory bodies have set out detailed rules for all activities, ranging from traditional corporate governance standards such as the mandate rules for voting at the AGMs and the role of the BODs, to remuneration of the executives, the appointment of the *Sharia* Supervisory Board, the issuance of *fatwas*, the acceptability of new

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<sup>21</sup> <<http://www.secp.gov.pk/Org/ifd.asp>>.

<sup>22</sup> <<http://www.sbp.org.pk/departments/ibd.htm#h3>>.

<sup>23</sup> <[http://www.secp.gov.pk/notification/pdf/2015/SRO\\_112\\_SukukRegulations.pdf](http://www.secp.gov.pk/notification/pdf/2015/SRO_112_SukukRegulations.pdf)>.

<sup>24</sup> <[http://www.secp.gov.pk/circulars/pdf/Cir\\_2008/circular\\_10.pdf](http://www.secp.gov.pk/circulars/pdf/Cir_2008/circular_10.pdf)>.

financial instruments and the capital requirements.<sup>25</sup> In essence the central Islamic financial authority regulates all aspects pertaining to the working of the local Islamic finance industry. In addition, the SBP has adopted many of the regulatory standards set out by the IFSB and the AAOIFI via local statutory enactments and by-laws. As a result, the regulation of IFIs in Pakistan is in line with most of the IFSB and AAOIFI standards, bringing uniformity into the regulatory framework.

The other unique aspect of this group's regulatory model is that the local judiciary also takes a proactive role in dealing with the *Sharia*-related issues. The judgement of the Pakistan Supreme Court regarding the ban on *Riba* and Islamic banking in general is considered as a great judicial feat, laying down the ideological frontiers for modern day Islamic finance practices.<sup>26</sup> Like the Pakistani judiciary, the Malaysian judiciary has also been very proactive in dispute resolution and recognition of new products and services<sup>27</sup> and so has the Iranian and Sudanese judiciary.

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<sup>25</sup> <<http://www.sbp.org.pk/departments/Publications.htm>>.

<sup>26</sup> [http://www.supremecourt.gov.pk/web/user\\_files/file/jr\\_detailed\\_judgment\\_in\\_riba\\_case.pdf](http://www.supremecourt.gov.pk/web/user_files/file/jr_detailed_judgment_in_riba_case.pdf)> Mahmood-ur-Rehman *Faisal v Secretary, Ministry of Law* PLD 1992 FSC and subsequently in: *Federation of Pakistan v Mahmood-ur-Rehman Faisal* PLD 2000 SC 770. The arguments made by the parties involved were related to the actual understanding of the idea of *Riba* and its meaning. That decision opened up the debate surrounding the idea of a completely Islamic economic system which was to be devoid of any *Riba* based transactions and would follow the principles of *Sharia*. This decision was taken with a pinch of salt both in the practitioners' circle as well as the academics circles. The respondent in the case, which was the government of Pakistan, argued for a watered-down definition of *Riba* and argued based on certain Hadith that not all interest based transactions were to be deemed *Rabawi*. Even though the judgment was rendered against the government and the Government of Pakistan was given five years to implement the recommendation given by the Federal Shariat Court, the actual effect of the judgment was only partial, as this prompted the Islamic finance sector to mushroom, but only as a parallel financial system and not as the *only* legitimate financial system as had been originally envisaged by the Judgment itself.

<sup>27</sup> Bank Islam Malaysia Bhd v Adnan Omar [1994] 3 CLJ 735; Bank Kerjasama Rakyat Malaysia v Emcee Corporation [2003] 1 CLJ 625; Tahan Steel Corporation v Bank Islam Malaysia Bhd [2004] 6 CLJ 25; Malayan Banking Bhd v Ya'kup Oje & Anor. [2007] 5 CLJ 311 (HC (Kuching)); Bank Kerjasama Malaysia Rakyat Bhd v. PSC Naval Dockyard [2008] 1 CLJ 784 (HC(KL)).

Whilst this type of regulatory approach works well in jurisdictions such as Pakistan and Malaysia, Iran and Sudan, where the *Sharia* is recognised as a source of law, it cannot be implemented in jurisdictions where there is no central *Sharia* authority, nor in jurisdictions where the judicial system does not accept *fatwas* as having a legal standing. In such jurisdictions, where there is not Central *Sharia* Authority and the judiciary does not accept the *Sharia* as a valid source of law, the IFIs are not deemed as separate and distinct entities in the eyes of the law and are dealt with under the same regulatory regime as conventional financial institutions, which leads to several regulatory and governance issues. As a result, there is a definite need for a different regulatory approach to cater for the diverse types of jurisdictions in which IFIs are operating.

ii. *The Second Group*

This brings us to the second group of jurisdictions. These are those jurisdictions which do not have a separate Central *Sharia* Regulatory Authority to supervise and regulate IFIs, yet still recognise the *Sharia* as a valid source of law for IFIs. These jurisdictions instead accommodate the Islamic financial institutions within their existing regulatory and legal framework. Kuwait is a good example of such a jurisdiction. The legal code provides for the *Sharia* to be the main legal source for all aspects of life.<sup>28</sup> It also provides a definition of an IFI,<sup>29</sup> thereby acknowledging the existence of Islamic financial industry as a separate entity. However, paradoxically another legal decree explicitly states that the *Sharia* principles will not

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<sup>28</sup> Zulkifi Hasan, *Sharia Governance in Islamic Banks* (Edinburgh University Press Ltd, 2012)

<sup>29</sup> Central Bank of Kuwait law No 32, paper 86. (*Law No. 64/2007 (25 December 2007)*)  
<<http://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/chapter-three.jsp>>

be mandatory for commercial purposes.<sup>30</sup> The central banking law allows IFIs to operate under the *Sharia* principles and requires the bank's assembly to appoint a *Sharia* board in accordance with principles laid down by the AAOIFI.<sup>31</sup> Therefore, this regime recognises IFIs as being separate entities yet does not provide for a completely separate regulatory framework for them. This approach had been the dominant approach for many of the other Middle Eastern jurisdictions like UAE, Qatar and Bahrain. However, there is now a very strong move in many of these jurisdictions to move towards a more centralised regulatory framework, as is the case in Pakistan and Malaysia.

The other distinct feature of the regulatory approach in jurisdictions such as Kuwait is the issue of dispute settlement. Since, unlike the first group of jurisdictions, there is no central *Sharia* body to oversee the operations of individual IFIs, any dispute that does arise pertaining to the *Sharia* aspects is usually dealt with via one of the other existing legal/ religious bodies. So, for example, in Kuwait any such dispute is to be dealt with by the *fatwa* board in the Ministry of *Awqaf* and Islamic affairs rather than a specialised *Sharia* court.<sup>32</sup> In essence, in such jurisdictions there is no recourse to the mainstream judiciary for solving any disputes pertaining to the Islamic finance industry, which is in contrast to the approach in Pakistan and Malaysia. The responsibility of such a referral for disputes pertaining to the operational aspects of the IFI therefore falls on the Board of Directors (BOD) of the individual IFI. In doing so, such jurisdictions maintain the role of a traditional BOD, with the BOD being the main decision-making body of the IFI including those pertaining to sharia aspects of the IFI. Consequently, the corporate governance framework is essentially that of the traditional Anglo-

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<sup>30</sup> Kuwaiti Commercial Code of 1981 Paper 102, (amended by; Council of Ministers Law No. 15 of 2017 amending provisions of Law No. 1 of 2016 on the Promulgation of the Companies Law)

<sup>31</sup> Zulkifi Hasan (n 28)

<sup>32</sup> Zulkifi Hasan (n 28)

American corporation with central executive powers resting with the BOD and the SSB simply acting as an advisory body lacking any executive functions. This contrasts with the role of the SSB in IFIs in our first group (Pakistan, Malaysia and Sudan), where an SSB that is not convinced as to the whether a particular practice is compliant with the *Sharia* can challenge the ruling of the BOD and management on operational matters of IFI, and all such challenges are entertained through the local judiciary and the central *sharia* authority. However, in the second group the traditional corporate governance structure with the executive powers lying with the BOD are the norm, with limited recourse for the individual SSB to main stream dispute settlement processes.

The structure of regulation and governance in the second group provides IFIs with a flexible environment to operate without there being a central rule-making body to make rules for them and oversee their operations. However, at the same time there is an acceptance of Islamic financial institutions as being separate and different from conventional financial institutions and thus a limited parallel legal and operational system for the IFI is provided. Where a financial institution is set up as an IFI, the law recognises it as such and provides for a partial separate regulatory regime under the Ministry of *Awqaf* and Islamic Affairs.<sup>33</sup> Therefore, IFIs are afforded some flexibility and are permitted to rely on the non-judicial administrative bodies and some legislative intervention as and when the need arises.

However, the shortcoming of this model is that it relies on the existence of a body such as the Ministry of *Awqaf* and Islamic Affairs in Kuwait (and other similar jurisdictions), as well as the recognition of *fatwas* regarding the *Sharia* acceptability (or otherwise) of operational issues, to ensure the recognition of IFIs as distinct and separate entities under local laws and regulation. This leads to a complex regulatory and governance framework for Islamic financial

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<sup>33</sup> Central Bank of Kuwait Law No. 32, Paper 86-100 (*Law No. 64/2007 (25 December 2007)*) <<http://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/chapter-three.jsp>>

industry, leading to a number of possible confusions. As a result, this regulatory approach may not be suitable as a blueprint for an international regulatory framework for IFIs in an international context due to the lack of recognition of the *Sharia* as a source of law in most jurisdictions.

*iii. The Third Group*

The third group of jurisdictions includes those states where there is no provision for recognition of the *Sharia* and therefore the regulation of IFIs is carried out under conventional regulations and laws, with some limited concessions given to IFIs (specifically for taxation purposes) to encourage the Islamic finance industry to keep operating in that jurisdiction. The best example of such an approach is the UK's outlook towards IFIs. The UK, like many other non-Islamic jurisdictions, adopts what can be called a self-regulation model for Islamic finance industry, allowing the local IFIs to structure their own rules and regulations (so long as these do not conflict with the local regulations and laws).

The UK, with its historically dominant position in world finance and an equally strong legal system, has grappled with the regulatory issues surrounding Islamic finance for some time now. The Financial Services Authority, the previous financial regulatory authority in the UK,<sup>34</sup> published some basic policy papers detailing the working of IFIs and made some regulatory inroads into recognising and allowing IFIs some laxity in very limited aspects like taxation and deposit protection.<sup>35</sup> However, since the FCA and its predecessors are all secular

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<sup>34</sup> This has now been replaced by the Financial Conduct Authority and the Prudential Regulation Authority. It is assumed for this paper's point of view that no significant policy changes have been made since the replacement of FSA and Islamic finance continues to have the same status as had been under FSA's regime.

<sup>35</sup> Deposit protection, which forms the backbone of consumer banking here in the UK, cannot be applied to IFIs since the operation of IFI's current accounts are structured as *mudarabah* contract

regulators with no knowledge and expertise of the *Sharia*, the regulatory regime has not been adapted to incorporate the unique religious nature of IFIs.

Nonetheless, several actions have been taken by HM Treasury and the FSA to allow for certain tax exemptions for Islamic house mortgages, for the waiver of stamp duties when dealing in *murabahah* home financing transactions, and for other such specific areas of Islamic finance.<sup>36</sup> These exemptions given by the legislature, though very encouraging, do not go far enough to streamline the regulation of IFIs as distinct entities from the conventional financial institutions. Given that IFIs will be competing internationally with conventional financial institutions, it is clear that they will have a competitive disadvantage and will face reputational and *Sharia* governance risk when operating in secular jurisdictions in which the legal system does not recognise the *Sharia* as a valid source of law. An example of this is the case of *Beximco Pharmaceutical vs Shamil Bank of Bahrain EC*,<sup>37</sup> in which the English courts refused to enforce a contract which had as a term that the governing law for the contract was to be the ‘principles of the glorious sharia’. The court took the view that the term ‘glorious sharia’ was too vague to be given any effect and did not deliberate any further, demonstrating the kind of legal and regulatory problems faced by IFIs in secular jurisdictions.

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between the bank and the customer/ depositor, which is based on a pure profit and loss sharing contract, with no possibility of allowing the IFI to guarantee any sort of return or protection of the capital invested. To overcome this aspect for investment contracts the FSA allowed IFIs to allow the customers to sign a document stating that they did not want to abide by the statutory deposit protection thus allowing for the contract to remain within the ambit of sharia principles regarding finance.

<sup>36</sup> Whereby there are two sales of the house, the first one by the bank and the second one from the bank to the customer at a mark-up, thereby originally it would have attracted two stamp duties, making it extremely expensive for the customer to buy an Islamic mortgage, thereby making it financial unviable for the Customer to buy from IFI and thus making IFI's unattractive and unable to compete with conventional mortgage lenders.

<sup>37</sup> [2004] EWCA Civ 19 pg. 11 para 40

A further *Sharia* compliance concern for IFIs operating in a jurisdiction like the UK is the issue of recognition of the religious pronouncements (*fatwas*) given by the *Sharia* Supervisory Bodies regarding the religious aspects of an IFI's operation.<sup>38</sup> In the other two models discussed above, the *fatwas* given by the SSB are the final say on all *Sharia* matters and can only be challenged in a court of law or a higher *Sharia* body such as the IBD in Pakistan<sup>39</sup> or the *Auqaf* council in Kuwait. However, in the case of SSBs of IFIs in the UK, their role has been restricted to being merely an advisory body, since identifying them as having an executive role would mean that the members of the SSB would come under the purview of the 'fit and proper criteria' of the FCA<sup>40</sup> and under the general duties owed by directors under sections 170-177 of the Companies Act 2006<sup>41</sup>. Being labelled as merely advisory therefore has very far-reaching effects for SSBs: the IFIs present in UK (and other similar jurisdictions) are basically operating without any effective external supervision of the internal *Sharia* compliance mechanism of the IFIs, which is a systemic reputational risk for the Islamic finance industry.

Other prominent issues arise in relation to the how the appointments of the internal *Sharia* Advisory Bodies (or Persons) are regulated, the terms of contracts for these *Sharia* Advisory Bodies, their remunerations and their qualifications.<sup>42</sup> All of these issues emanate from the fact that without a proper regulatory oversight of the IFIs in the UK, consumers and

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<sup>38</sup> A Qarni, 'Regulatory Controls of Islamic Banks by Central Bank and Islamic Banks' in The 6th Expert-Level Meeting On Islamic Banking (1990) (May 26-28, Bahrain), Under The Auspices of Bahrain Monetary Agency. The Organization of the Islamic Conference

<sup>39</sup> <<http://www.sbp.org.pk/Departments/Ibd.Htm#H1>>. (Departmental Objectives 5 And 6)

<sup>40</sup> <<https://www.handbook.fca.org.uk/handbook/FIT.pdf>>.

<sup>41</sup> Companies Act 2006 chapter 46

<sup>42</sup> Assem Safieddine 'Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory' (2009) *Corporate Governance: An International Review*, 17(2): 142–158.

other stakeholders of the industry will never be completely assured about the *Sharia* compliance of individual IFIs. The lack of confidence creates an environment of uncertainty and raises reputational and *Sharia* governance risks. Therefore, there is a need for a better supervisory framework for IFIs, specifically those IFIs which are operating on a self-regulatory basis in jurisdictions like the UK. These issues are dealt with in the following sections.

This study of the three most common regulatory models for IFIs has highlighted the shortcomings and risks that are present for the Islamic finance industry at an international level. It is therefore argued that there is a need to move away from national regulatory models (as instituted in Pakistan and Malaysia) and onto a more internationally applicable model of regulation for IFIs, so that IFIs operating in all jurisdictions are accommodated, which I argue in the next section can be done via a Meta-Regulatory Framework for IFI's.

### ***3. Meta-Regulations: A New Avenue for Islamic Finance?***

Meta-Regulation can be defined as 'the proliferation of different forms of regulation (whether tools of state law or non-law mechanisms), each regulating one another' and it is 'a key feature of contemporary governance'.<sup>43</sup> The concept behind Meta-regulation for financial institutions, posits that law is not the appropriate method to regulate stakeholder rights, since law will remove the flexibility needed for regulating financial institutions for the benefit of a large number of stakeholders.<sup>44</sup> Since the use of black-letter laws and rules for regulating IFIs

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<sup>43</sup> C Hood, O James and C Scott 'Regulation in government: has it increased, is it increasing, should it be diminished?' *Public Administration* 78, 2, 283–304

<sup>44</sup> C Coglianese and Evan Mendelson 'Meta-Regulation and Self-Regulation,' University of Pennsylvania, Penn Law School Public Law and Legal Theory, Research Paper No. 12-11.

is made all the more difficult for the Islamic finance industry across the jurisdictional spectrum due to the lack of the *Sharia* enforcement mechanism in many jurisdictions, the only practical venue left open for Islamic finance industry is a meta-regulatory enforcement framework.

In other words, for Islamic finance,

[m]eta-regulation (would) entail any form of regulation (whether by tools of state law or other mechanisms) that regulates any other form of regulation. Therefore, it might include legal regulation of self-regulation (e.g., putting an oversight board above a self-regulatory professional association), non-legal methods of ‘regulating’ internal corporate self-regulation or management (e.g., voluntary accreditation to codes of good conduct, etc.), the regulation of national law-making by transnational bodies (such as the EU), and so on.<sup>45</sup>

This holds true for an industry like Islamic finance for two reasons, the first being that there is no single authoritative body that can uniformly regulate all IFIs in different jurisdictions and the second being that the focus of the Islamic finance industry on the stakeholder nature of financial intermediation needs a flexible approach to regulation. As argued before, the stakeholder nature of Islamic finance is derived from the *Maqasid al Sharia* of financial intermediation under Islamic law and therefore we can make the argument that meta regulation is the best way to regulate the industry at an international level whereby the private sector, the government sector and the international supranational regulatory and standard setting bodies (IFSB/AAOIFI) are involved in devising a regulatory framework based on the principles espoused by the *Maqasid al Sharia* of financial intermediation.

I therefore argue that applying a Meta-Regulatory Framework to the Islamic finance industry in this context is not trying to give a ‘one-size-fits-all’ solution, but rather to elaborate

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<sup>45</sup> Levi-Faur, D. and J. Jordana. (2004) (Eds.) *The Politics of Regulation, Institutions and Regulatory Reforms for the Age of Governance*, Cheltenham: Edward Elgar

on the fact that the regulatory approach for the Islamic finance industry ‘points to the need for social controls to encourage the beneficial effects of the institutional behaviours and to regulate or prevent the harmful effects.’<sup>46</sup> For an industry like the Islamic finance industry, regulation via an international meta-regulatory framework is possibly the best way to balance out the competing interests of the free market mechanism with the need of financial stability for society in general, because meta regulation in this context is to encourage ‘those ways that outside regulators seek to induce regulated entities to develop their own self-regulatory responses.’<sup>47</sup>

Thus, by using Meta-Regulatory Mechanisms, an international regulatory framework can be shaped which will fulfil the basic requirements for individual IFIs, namely *Sharia*-compliance in IFIs operating in jurisdictions that do not accept Islamic law, as well in those IFIs operating in jurisdictions that follow Islamic law. The logical conclusion that follows from these arguments is that the stakeholder ethos, being the most likely to achieve the *Maqasid al Sharia* of financial intermediation, is the most appropriate philosophical basis for justifying the regulation and supervision of Islamic financial industry at both a macro (industry) level and a micro (institution) level and provides the necessary uniformity of rules, regulations and enforcement mechanisms that has been missing in the industry to date.

Furthermore, the ethical foundations of the stakeholder point of view is in line with the Islamic financial ethos of equity, distributive justice, inclusive financial intermediation and the

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<sup>46</sup> Bradley R. Agle, Thomas Donaldson, R. Edward Freeman, Michael C. Jensen, Ronald K. Mitchell and Donna J. Wood, ‘Dialogue: Toward Superior Stakeholder Theory’ *Business Ethics Quarterly* / Volume 18 / Issue 02 / April 2008, pp 153-190. DOI: <http://dx.doi.org/10.5840/beq200818214> (About DOI), Published online: 23 January 2015

<sup>47</sup> Coglianese, Cary and Mendelson, Evan, *Meta-Regulation and Self-Regulation* (2010). *THE OXFORD HANDBOOK ON REGULATION*, Martin Cave, Robert Baldwin, Martin Lodge, eds., 2010; U of Penn Law School, Public Law Research Paper No. 12-11; U of Penn, Inst for Law & Econ Research Paper No. 12-06. Available at SSRN: <http://ssrn.com/abstract=2002755>

welfare of a wider class of stakeholders.<sup>48</sup> It can therefore be argued that the stakeholder point of view is in line with the wider *Maqasid al Sharia* of Islamic finance, and therefore the stakeholder governance and regulatory structure can be incorporated in the Meta-Regulatory framework being suggested by this article.

Another reason why Meta-Regulation is particularly well suited for IFIs is because of the lack of a single international institution to oversee the operations and enforcement of regulatory standards of IFIs as an industry. The result is that a principle-based approach with an emphasis on ‘substance’ rather than ‘form’ (in ideological and practical terms) can be best achieved through Meta-Regulation.<sup>49</sup> Consequently, the international standard-setting and regulatory bodies like the IFSB and the AAOIFI, being major stakeholders for the industry, need to ensure that their regulatory framework for Islamic financial institutions is in line with the stakeholder approach so that the essence (the *Maqasid*) of the Islamic teachings is comfortably amalgamated with the conventional corporate governance and regulatory practices. Finally, the strongest case for Meta Regulation of the Islamic finance industry may be made on the basis of the following assertion that ‘meta regulation may be most appropriate when the government lacks ready access to information about regulatory problems and their possible solutions, precisely the kinds of complex circumstances where more conventional forms of regulation face their greatest challenges’.<sup>50</sup> So what should this Meta Regulatory framework look like?

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<sup>48</sup> R I Beekun, *Islamic Business Ethics*. Herndon, USA, 2002, The International Institute Of Islamic Thought.

<sup>49</sup> The form versus substance debate has been at the centre of modern day Islamic financial literature. These arguments have been made by the author in an upcoming (unpublished) paper; S S Hamid, ‘A rereading of the fundamentals of Islamic finance: principles of Contract law, *Riba* and *Gharrar* in light of the *Maqasid Al Sharia* and *Maslaha* principle’ (forthcoming in JISPIL December 2015).

<sup>50</sup> Cary Coglianese and Evan Mendelson, ‘Meta-Regulation and Self-Regulation’ (2010) U of Penn Law School Public Law Research Paper No. 12-11; U of Penn, Inst for Law & Econ Research Paper No. 12-06. <<http://ssrn.com/abstract=2002755>>.

#### 4. *The ‘Framework’*

The proposed framework is intended to cater to the unique stakeholder nature of the Islamic finance industry, incorporating the religious/ethical character into the supervisory and regulatory framework. The biggest challenge for the Islamic finance industry in general is to instil confidence in the public that the IFI is ‘Islamic’ in ‘substance’ and not just in name or ‘form’. Therefore, it is imperative that a regulatory regime is put in place which can provide the necessary supervisory and regulatory support for the Islamic finance industry working in all jurisdictions. Moreover, this must be a regime which is principle-based and goal-oriented so that rather than relying on strict rules, the local regulators can easily and flexibly apply such principles to facilitate the working of the IFIs in an environment where there is transparency and accountability in their operations. This would entail the regulatory framework having clearly defined the *Sharia* principles so that along with making the public and stakeholders aware and well-informed of the *Sharia* compliance of each individual IFI’s operations, the regulatory regime is able to ensure prudent risk management, proper appointments to the SSB and that proper dispute settlement mechanisms pertaining to the *Sharia* disputes are in place. It should also allow for religious pronouncements by the *Sharia* scholars (the *fatwas*) to be incorporated into the overall framework of the IFI’s operational ambit. These aims, it is argued, can be achieved through a goal-based and/or performance-based Meta-Regulatory framework for IFIs.

##### *a. A Goal and Principles Based Meta-Regulatory Framework for Islamic Finance.*

The terms ‘goal-based’ and ‘performance-based’ regulation tend to be used interchangeably. In both goal-based and performance-based regulation, the regulation does not specify the

means of achieving compliance, but rather sets out goals that allow alternative ways to achieve regulatory compliance.<sup>51</sup> Sometimes, these regulations promote or encourage the use of management systems with a continuous improvement cycle to move a corporate entity beyond simple compliance with a regulatory goal. The other major characteristic of a performance-based regulatory framework is that it places more importance on reviews, inspections, audits and their control, frequency and timing. The latter are underpinned by a determination of where the board's resources should best be focused. Tied to this regulatory approach is the use of performance indicators to assess relative levels of regulatory compliance by the regulated entities.

It is thus argued that a Meta-Regulatory Framework which is 'smart',<sup>52</sup> proactive, flexible and responsive needs to be instituted for the Islamic finance industry to supervise and regulate the industry at an international level.<sup>53</sup> It is clear that the international standard-setting agencies like the IFSB and the AAOIFI, which regularly publish best practices and guidelines, would need to be fully involved in the establishment of this new international regulatory framework.

It is also pertinent to reiterate that the gap between the set standards and their actual application in practice lies at the enforcement end, since currently there is no effective body to enforce the standards set out by both the IFSB and the AAOIFI at the international level. The best method of enforcement is of course to incorporate these standards into the national regulatory framework of individual countries as is the case in Pakistan and Malaysia. However,

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<sup>51</sup> Cary Coglianese and Evan Mendelson, 'Meta-Regulation and Self-Regulation' (2010) U of Penn Law School Public Law Research Paper No. 12-11; U of Penn, Inst for Law & Econ Research Paper No. 12-06. <<http://ssrn.com/abstract=2002755>>.

<sup>52</sup> Cary Coglianese and Evan Mendelson (n 51)

<sup>53</sup> Al-Jassar, J., 'Regulatory Environment and Strategic Directions in Islamic Finance' (Proceedings of the Fifth Harvard University Forum on Islamic Finance, Centre for Middle Eastern Studies, 2000)

as we have already seen, such an approach is impractical for countries like the UK and other EU countries that do not accept the *Sharia* as a valid and separate source of law and leaves many of the IFIs unregulated and unsupervised, increasing the risk of a systemic reputational failure of the industry.

*b. A memorandum of understanding with the IFSB and AAOIFI*

For this aim of an effective enforcement mechanism to be attained, the state(s) that allow IFIs to operate within their jurisdiction(s) need to agree on common enforcement standards as well as developing guidelines in their frameworks so that a heightened sense of importance is placed on licensing, reviews, inspections and audits. To achieve this purpose, the major task of the international standard-setting bodies (the IFSB and AAOIFI) should be to expand and to develop performance indicators to assess relative levels of regulatory compliance in such a way that is principle- and outcome-focused and takes into account the basic principles of sharia (the *Maqasid al Sharia*).<sup>54</sup>

It is therefore argued that a way forward for incorporate this Principle based framework into local regulatory standards is for the Jurisdictions that allow and encourage Islamic finance industry to set up shop in their jurisdiction to sign a Memorandum Of Understanding (MOU) with the international standard setting bodies like the IFSB/ AAOIFI. The MOU to allow for the internationally published regulatory standards to be applied to the Islamic finance industry in that particular jurisdiction. This practice would fill in the regulatory gap in countries that fall in the third category as classified in this paper e.g. England and other secular jurisdictions. This recommendation of an MOU between the host country and the regulatory body is in line with

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<sup>54</sup> Some rudimentary work has been done on these aspects, for example:  
<<http://www.irti.org/English/Research/Documents/WP-1435-18.pdf>>.

other international banking supervisory/ regulatory regimes like the Basel accord<sup>55</sup> pertaining to regulatory and supervisory standards. The Basel charter takes a similar approach to enforcement and implementation, it provides the following regarding the Legal status; ‘The BCBS does not possess any formal supranational authority. Its decisions do not have legal force. Rather, the BCBS relies on its members' commitments, as described in Section 5, to achieve its mandate.’<sup>56</sup>

The Basel Charter then goes on to describe in Section 12 (which deals with its published standards);

‘The BCBS sets standards for the prudential regulation and supervision of banks. The BCBS expects full implementation of its standards by BCBS members and their internationally active banks. However, BCBS standards constitute minimum requirements and BCBS members may decide to go beyond them. The Committee expects standards to be incorporated into local legal frameworks through each jurisdiction's rule-making process<sup>5</sup> within the pre-defined time frame established by the Committee. If deviation from literal transposition into local legal frameworks is unavoidable, members should seek the greatest possible equivalence of standards and their outcome.’<sup>57</sup>

These examples from the Basel accord charter show that a very similar framework for supervision and regulation can be instituted for the Islamic finance industry. As a matter of fact, the IFSB already has as its members the central banks/ regulators of almost all of the countries that have the presence of the Islamic finance industry. Therefore, the suggestions made in this chapter are furthering the ideals of an international regulatory/ standard setting regime by giving a practical blue print of the enforcement mechanism for the Industry.

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<sup>55</sup> < <https://www.bis.org/bcbs/charter.htm> >

<sup>56</sup> <https://www.bis.org/bcbs/charter.htm>

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The implementation of the suggested Principle based framework in this chapter can be done on a country specific basis, with each jurisdiction agreeing to certain minimum principle standards (as suggested in this chapter) and then customising the rest of the regulatory regime as per their own national standards.

So, one way of practically implementing these standards is based on instituting performance indicators that are *Sharia*-based alongside conventional financial indicators. This will tailor the governance structures to the needs of the IFI.<sup>58</sup> The aim of this principles-based framework would be to provide supplementary standards specifically for the sake of internal and external *Sharia* governance in a particular jurisdiction (and not in lieu of existing national regulations). In the case of a conflict between conventional governance and regulatory standards, the individual IFI should have the freedom to decide which standards they intend to apply; if the local conventional regulatory standards are in line with the standards proposed by the IFSB or the AAOIFI then the local standards may be applied (as is the case in Pakistan and Malaysia). However, where it is deemed that the national regulatory standards do not allow for a proper *sharia*-compliant framework to be instituted and are laxer than those set out by the IFSB and AAOIFI, the IFI must opt for the *Sharia*-compliant option, whilst maintaining compliance with the national laws and regulation as far as possible.

It is unlikely that there would be any major conflict between the national regulatory standards and the standards set out by the IFSB or AAOIFI, since most of the governance and regulatory standards issued by these bodies follow the best practices as already suggested by the IMF, Basel accords and the World Bank.<sup>59</sup> Secondly, the IFSB's standard setting body is

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<sup>58</sup> Most governance and regulatory standards set out by the IFSB and the AAOIFI already have considered the standards set by other international bodies like the OECD, WB and IMF and tailored them to IFI's.

<sup>59</sup> Luca Errico and Mira Farhbaksh 'Islamic Banking: Issues In Prudential Regulation And Supervision' (1998) IMF Money And Exchange Department, Wp/98/30, Working Paper

made up of representatives from almost all those jurisdictions where IFIs are operating, which means that the regulatory and governance standards that are issued by the IFSB have already taken into account most national regulatory requirements.

*c. Certificates of Compliance: A Move Towards a Principle-Based Regulatory Framework*

In light of the arguments made in the previous sections I argue that the best *Sharia* enforcement mechanism for IFIs would be to institute a system of ‘certification’ by the two main regulatory standard setting bodies, the IFSB and the AAOIFI, for any financial institutions that wish to operate as IFIs. In this regard, these two bodies should be given the mandate to issue ‘certificates of compliance’ for all financial institutions desirous of operating as *sharia*-compliant institutions. These certificates would be issued to confirm that the financial institution in question is indeed operating as an IFI and has complied with all the *sharia* and governance standards laid down by either the IFSB or AAOIFI (whichever standard is chosen by the jurisdiction). These certificates would give validity to the *Sharia* compliance aspects of the IFI and would be aimed at instilling confidence in the stakeholders that they are indeed dealing with a *Sharia* compliant financial institution. This system of certification is in line with the Meta-Regulatory approach best suited to the Islamic finance industry, whereby the self-regulatory nature of IFIs working in secular jurisdictions can be catered for whilst maintaining an international harmonised supra regulatory framework.

It is for this reason that no particular national regulatory and enforcement approach can be deemed entirely appropriate to cater for the differences in regulatory practices for Islamic

finance institutions at an international level.<sup>60</sup> The best way to ensure compliance with the regulatory and supervisory standards of the AAOIFI and the IFSB is to give these standards making bodies the power not only to issue but also to revoke ‘certificates of compliance’. This would allow all IFIs’ stakeholders to deal with any given IFI with confidence, knowing undoubtedly whether a particular IFI is actually *Sharia*-compliant or not and whether it is indeed following good corporate governance practices as set out by the IFSB and AAOIFI.

These certificates of compliance follow the practice in the Islamic Halal food industry, reflecting the simple idea that the best mechanism for ensuring *Sharia* compliance in a jurisdiction where the *Sharia* is not a recognised source of law is to ensure that only those financial institutions can label themselves as ‘Islamic’ financial institutions which follow established *Sharia* standards. By doing so, and keeping true to its religious and stakeholder norms, the industry will benefit immensely. The use of this certification process will also allow for Islamic finance as an industry to be truly stakeholder-oriented because establishing such a certification process ensures that the stakeholders dealing with the industry (as well as the individual institutions) are made aware of the ‘Islamic’ status of the IFI, thereby allowing customers, lenders, investors, employees, suppliers and regulators to make informed decisions regarding the *Sharia* compliance of services and financial products on offer by individual IFIs. In essence, by following the stakeholder principled framework and instituting a certification process, the industry’s processes and procedures will become more transparent thereby decreasing the reputational and systemic risks as well as enhancing the corporate governance of IFIs. This would be a truly ‘Meta Regulatory’ Framework, where the individual IFIs operating in non-Islamic jurisdiction can self-regulate themselves to a reasonable level, but

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<sup>60</sup> Surprising the FSA (FCA) talks about the fact that they would not be adopting any one approach to regulation.

with that self-regulation overseen by the process of certification by the supranational standard-setting bodies, thereby ensuring at least a minimal level of *Sharia* compliance.

It is accepted that for such a Meta-Regulatory Framework to be successful, national regulators need to be willing to accept these standards as decisive on all aspects relating to the *Sharia* in an IFI, especially in such jurisdictions where the *Sharia* is not accepted as a valid source of law. They will need to encourage and facilitate such IFIs in obtaining these ‘certificates’, as these will give a boost to the local IFIs in terms of stakeholder confidence in their operations, as well as encouraging more competition amongst the local IFIs. This endeavour, it is believed will translate into tangible financial results in the long term for the country’s financial system by eliminating systemic and institutional financial risks for the Islamic finance industry.

There are several regulatory issues that would be key to the effectiveness of the ‘certificates of compliance’ in reflecting the ‘Islamic’ nature of the industry, it is those that we turn to:

*i. The Criterion for Issuance of the Certificates of Compliance: A Sharia Principle Based Criteria*

Certificates of compliance should be based on a number of key operational aspects of the financial institutions. These would comprise the *Sharia* compatibility of the IFI’s operation, its governance framework (including the appointments of SSB and the apportionment of the powers and duties of the board of directors and the SSB), dispute resolution mechanisms, the decision-making process of the SSB and their *fatwa* pronouncements, information disclosures, adherence to good corporate governance practices as laid down by the IFSB and the AAOIFI, and *sharia*-compliance audit processes. The idea behind these certificates is to ensure that both

*sharia* governance and conventional corporate issues are catered for. The details of how the compatibility criteria will be set up may be left up to the two standard-setting bodies.

ii. *Agency Costs and Revocation of Certificates of Compliance: The Process of Sharia Audits*

To further facilitate a proper enforcement framework for IFIs at an international level, the international standard-setting bodies should be given the authority to carry out *sharia* and performance audits biannually (or annually). Carrying out such audits would ensure that individual IFIs maintain their compliance with established standards and can therefore be issued the ‘certificates of compliance’. These certificates of compliance would be one way for the local regulators to recognise the IFI as a separate and distinct entity from the local banks, therefore accepting that the *sharia* aspects of the IFI have been complied with and would therefore form a secondary licensing regime. This certification process will take the regulatory burden off the local regulators and they would be able to focus simply on the issue of compliance with the local regulation. By doing so, both the IF industry as well as the local regulators benefit greatly and complement each other.

Instituting such a regulatory framework would mean increasing compliance costs for individual IFIs, especially those IFIs which are working in countries like the UK and other non-Islamic jurisdictions without the requisite state-level recognition of their special religious nature. To add to this problem, there may also be a shortage of suitably qualified *sharia* scholars in such jurisdictions which would also add to the costs of compliance. In the long term, however, the initial costs of obtaining the compliance certificates would eventually be balanced out by an increased level of confidence by stakeholders and by local regulators. In turn, this would mean increased financial stability and consequently less chance of bank defaults and

bank runs for the Islamic finance industry as a whole. The alternative - allowing an IFI to operate without proper *Sharia* compliance - is likely to lead to a loss of confidence by the consumers, customers, regulators and creditors, and may lead to a systemic reputation and strategic failure of the whole Islamic financial industry in that region.

In this process of the *Sharia* certification, the role of the IFSB and the AAOIFI should also include the powers to revoke the ‘certificates’ in the case of an IFI failing to follow the established the *Sharia* governance standards. This process would be an integral part of the process of annual audits detailed in the previous paragraph. By exercising this power of revocation, the IFSB and AAOIFI would supervise and ensure that only those IFIs which are truly *sharia* compliant in form and substance are certified. Whilst the ‘certificate of compliance’ may be withdrawn by the IFSB and AAOIFI based on the *Sharia* non-compliance, the national regulator would still be able to decide according to its own regulatory standards and laws whether the financial institution qualifies to function as a conventional *financial* institution or not. This way, both aspects of prudential regulation can be achieved without compromising the integrity of either system and at the same time strengthening the market for the operations of IFIs.

It is also recommended here that in case of the local regulator wanting to devise a separate regulatory framework (on the same lines as has been done in Pakistan, Malaysia and Iran) for the local Islamic finance industry, they may be allowed to do so on the basis of the *sharia* compliance standards issued by the IFSB or the AAOIFI.

### *iii. The SSB and Fatwas: The Form versus Substance Debate*

Another regulatory aspect that has caused some concern for the Islamic finance industry is the regulation and harmonisation of internal *Sharia* governance mechanisms, specifically

related to the role of the SSB and their religious pronouncements (*fatwas*). I would suggest that aspects relating to the *fatwas* and their admissibility should be brought under the exclusive purview of the IFSB and the AAOIFI via the certification process mentioned earlier, specifically if the local legislature is not willing to make any amendments in its regulatory framework to accommodate the *fatwas*. Even where these legislative amendments have been made (as is the case in jurisdictions like Pakistan, Malaysia and Iran), they should be made in consultation with the IFSB and AAOIFI, either by selecting such regulatory standards that have already been published by the two standard setting bodies or selecting those which are in line with the national regulatory framework and supplementing the national regulatory standards with those published by the IFSB and AAOIFI.

So, for example in Pakistan the SSB's of the IFIs have the power to issue a religious pronouncement (*fatwa*) regarding the suitability of financial products/services being utilised by the IFI, and the *fatwa* forms an integral part of the operation of the IFI. However, if the BOD or the management of the IFI does not obtain the *fatwa* before launching a product, that whole process can be made *void ab initio* on the basis of it not having complied with the internal *sharia* approval process as the regulations/ laws deem the *fatwas* as an integral part of the whole process.<sup>61</sup> Secondly for countries like Pakistan and Malaysia, the SSBs of individual IFIs can challenge the BOD and the management on aspects related to *sharia* compliance, as the SSB have legal standing as an integral part of the IFI. However, this is not the case in UK and other non-Islamic jurisdictions, where the final arbiter and decision-makers are the BOD/ Executive management whose decisions can only be challenged by the AGM in very limited circumstances.

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<sup>61</sup> <<http://www.sbp.org.pk/ibd/2004/Setting-up%20of%20IB%20Annex%20I.pdf>> and <http://www.sbp.org.pk/ibd/2004/CIR03-Annexure-IV.pdf>

Without making the requisite regulatory and legal changes in the framework for IFIs, it looks increasingly difficult to argue that the SSB's religious pronouncements will ever have legally binding statuses in the eyes of the local regulators in non-Islamic jurisdiction. This brings into question the whole practice of allowing the SSBs a role in the decision-making process in IFIs operating in non-Islamic jurisdictions. Without formal legal standing the SSB is nothing more than an advisory body in the IFI, and their *fatwas*, which ought to have legal standing, are nothing more than advisory opinions, which can be ignored and overlooked by the management of the IFI. This highlights the reputational risks for the IFIs operating outside of the Islamic jurisdictions, which may lead to a systemic failure for the industry without proper sharia compliance mechanism in place and needs to be addressed at an international level via meta-regulatory mechanisms.

*iv. Enhancing the Effectiveness of the SSB: Reconfiguring the Articles of Association.*

Building up on the previous point on the lack of legal standing of the SSB, I argue that in order to enhance the powers of the SSB and mitigate the possible concerns caused by the imbalance of power between the SSB and the executive board, there should be a mandatory requirement in the audit process instituted by the IFSB/AAOIFI to ensure that the IFIs have amended their articles of association (the constitutional document of the IFI) to incorporate the SSB as an integral part of the decision-making process. By amending the articles of association (constitution) of the IFI, the exact ambit of powers for the SSB can be specifically laid down, which would allow the SSBs to enforce their opinions (*fatwas*) via local corporate laws and get the needed legal validation.

In doing so, each IFI's constitution can specify the recourse to a dispute resolution method (both internal and external) in case of a conflict of opinion between the SSB and the BOD. For example, in case of a conflict of opinion and a deadlock between the SSB and the BOD/ management regarding a matter of *Sharia* compliance, the Articles (constitution) of the IFI could specify recourse to a local or international specialist arbitration body which specialises in Islamic finance, rather than the local judiciary. This would be a preferable solution because the local judiciary of a secular jurisdiction would not usually be well-versed in the legal aspects of Islamic finance and would thus be ill-suited to give an opinion on such matters. It follows that if the powers of both the BOD and the SSB are clearly set out in the constitution of an IFI, the chances of conflict per se are reduced. However, the issue of enforcement and validity of religious pronouncements (*fatwas*) by the SSB will remain contentious in a non-Islamic jurisdiction.

There must therefore be better cooperation and coordination, particularly between and within governments, the financial and security regulatory authorities and the IFSB and the AAOIFI, to try to achieve some uniformity in the regulatory environment in the jurisdictions in which IFIs are currently operating.

It is also argued that a failure to develop this coordination at the jurisdiction level will lead to *Sharia* arbitrage and forum shopping by the individual IFIs and may give way to a 'race to the bottom', causing the IFIs to move between jurisdictions looking for the most relaxed regulatory environment. This could risk IFIs abandoning (deliberately or accidentally) the basic tenets of *Sharia*, which could turn out to be a systemic issue and may lead to the loss in confidence across the globe in Islamic finance industry. This means that the industry must focus on the international regulatory and supervisory aspects of IFIs and concentrate all its energy in devising a framework that not only stabilises but also encourages public and stakeholder confidence in the industry at an international forum. The suggestion regarding the

changes to be brought in the articles of association (constitutional document) of the individual IFI will help in making the internal sharia compliance mechanisms (like the SSB's *fatwas*) more effective, thereby making the industry less open to reputational risks and at the same time more *Sharia* compliant, even in those jurisdictions where the *Sharia* is not accepted as a main source of law. It is reiterated here that a 'Basel' type of supervisory framework will be the best possible solution.

v. *Dispute Resolution*

Keeping in view the previous discussion regarding the issues surrounding the possible conflicts of interest between the SSB and the BOD, this article also argues that any disputes that may arise regarding *Sharia* compliance in IFI's operating in non-Islamic jurisdictions should be handled by any such organisation which has expertise in the resolution of disputes related to *Sharia*.<sup>62</sup> It is therefore asserted that the IFSB/AAOIFI should recommend and institute such dispute resolution methods in consultation with national regulators which would be deemed appropriate to the Islamic finance industry, especially where the local courts are not well-versed in *Sharia*.

A possible option for integrating such a dispute resolution mechanism is to have a mandatory arbitration clause (an ADR clause) in the constitution documents of all IFIs operating in secular jurisdictions. By doing so the IFIs will have access to specialised dispute resolution bodies, who in turn would have access to *sharia* experts and would therefore be in a much better position than a secular judiciary to give decisions on internal and external *Sharia* compliance matters. An example of such a body already operating in the UK is the Muslim

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<sup>62</sup> Zulkifi Hasan (n 28).

Arbitration Tribunal<sup>63</sup>, which primarily deals with Family law issues in the UK. A similar (or perhaps the same) body could be set up with expertise in Islamic finance and help the local Muslim communities in handling disputes pertaining to financial matters in line with Islamic injunctions.

vi. *SSB Qualifications: The Regulatory Response*

This brings us to the critical issue of the selection of the *Sharia* qualified persons suitable for modern day IFIs, especially in the secular jurisdictions like the UK. There is currently no requirement for any formal licensing and qualification for an individual to become a SSB member, which means that there is no oversight of the appointment process. This is more of an issue for those jurisdictions where the *Sharia* is not accepted as a source of law and where there is no Central *Sharia* Supervisory Authority. This raises a number of concerns for the operations of IFIs and their ability to comply with the *Sharia* norms. There is clearly a need to have a proper system of recognition, licensing and qualifications for the members of SSBs. Considering the key role that the SSB plays, the selection criterion should be on the same lines as the FCA's criteria for a 'fit and proper' person.<sup>64</sup> A similar criteria for a 'fit and proper' person does exist for an IFI operating in Pakistan,<sup>65</sup> but as has been mentioned no such criteria exists in most other jurisdiction. One of the major reasons for such a lack is rooted in the basic non-recognition of '*fatwas*' as a valid source of law in many of the jurisdictions like UK and other EU countries.

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<sup>63</sup> <<http://matribunal.com/application-form.php>>

<sup>64</sup> <<https://www.handbook.fca.org.uk/handbook/FIT.pdf>>.

<sup>65</sup> <<http://www.sbp.org.pk/ibd/2004/CIR03-Annexure-IV.pdf>>

The suggestion here is that the individual members of each SSB ought to be approved or acknowledged as *Sharia*-qualified by the IFSB or the AAOIFI (or any other recognised standard's body) before being allowed to undertake the task of issuing *fatwas* and sitting on the SSB. This will require the industry to move towards a standardised testing and qualification process for *Sharia*-qualified persons. In the Meta-Regulatory Framework that is being recommended here, the supranational bodies (IFSB and the AAOIFI) need to institute a standardised 'fit and proper sharia qualified person test' which should allow individuals desirous of the role to meet certain minimum standards before being appointed as a *Sharia*-qualified person. As *Sharia* compliance forms the major part of the operation of the Islamic finance industry it has to be streamlined at an international Meta-Regulatory level. These *Sharia* qualification statuses can either be granted on the basis of sitting a qualification exam or on the basis of the previous experience of the individuals already undertaking these roles in the Islamic finance industry. The more effective and efficient approach would be to institute a standardised international test on the same lines as qualifying exams for accounting and finance professionals,<sup>66</sup> hence bringing in much-needed uniformity to this important regulatory aspect.

It should be acknowledged that a considerable amount of work has already been undertaken in issuing *Sharia*-qualified scholar statuses across the globe: Malaysia, the UK, Bahrain, Saudi Arabia, Egypt and Pakistan have all set examples of the kind of qualifications that are appropriate for the *Sharia* scholars working in the Islamic finance industry, as scholars qualified from these jurisdictions have gone on to sit on a number of different SSBs across the globe. With many different bodies already issuing such a qualification,<sup>67</sup> one option would be

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<sup>66</sup> <http://www.financialskillspartnership.org.uk/professional-qualifications-explained/#Banking>.

<sup>67</sup> <http://www.ibfim.com/>,  
[http://www.mifc.com/index.php?ch=ch\\_directory\\_talent&pg=pg\\_directory\\_talent\\_human&ac=107](http://www.mifc.com/index.php?ch=ch_directory_talent&pg=pg_directory_talent_human&ac=107) ,  
<http://www.cimaglobal.com/Study-with-us/Islamic-finance-qualifications/> ,  
<http://www.nottingham.edu.my/Study/Postgraduate-courses/Business/Investment-and-Islamic->

for the IFSB and the AAOFI to allow these local academic and licensing bodies to issue these qualifications by simply listing on their own websites which qualifications would be deemed acceptable for which roles. This way all the different stakeholders and IFIs alike will have the confidence that the *Sharia* qualified person (or body) is indeed qualified to decide on the *Sharia* aspects.

vii. *Achieving the 'Public Good' through the Meta-Regulatory Framework and the Normative Mission Statement of the IFIs*

The Islamic finance industry has come a long way in modern times and has made strides in almost all aspects of its operation. However, the regulatory pressure to abide by conventional governance and regulatory practices seems to be leading the industry to lose focus on the fundamental reason for its existence i.e. to facilitate and promote socio-economic justice in society and all its stakeholders. The industry has had to adapt neo-liberal governance and regulatory norms, mimicking the profit-making ethos of conventional financial institutions. This regulatory dilemma surrounding the Islamic finance industry has been debated under the rubric of the 'form' versus 'substance' debate by practitioners and academics, highlighting the dichotomy between the ideological essence (the *Maqasid al Sharia*) and practice of financial intermediation in Islamic financial laws.

This mounting regulatory pressure generates a need for an internationally acceptable stakeholder-based meta-regulatory framework that balances out the diverse aspects of IFIs, i.e. their religious origins and the modern application of those religious principles. This article has made the case for a Meta-Regulatory Framework that achieves some uniformity between the

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[Finance-MSc.aspx](http://www.inceif.org/academic-programmes/chartered-Islamic-finance-professional/) , <http://www.inceif.org/academic-programmes/chartered-Islamic-finance-professional/> , <http://www.amanaglobal.com/training/> , <https://www.dur.ac.uk/dcief/> , <http://www.Islamic-banking.com/Default.aspx> , [http://www.nibaf.gov.pk/Pages/Islamic .htm](http://www.nibaf.gov.pk/Pages/Islamic.htm)

regulatory practices amongst all the different jurisdictions where IFIs are operating, both Islamic and secular. The self-regulation of IFIs in secular jurisdictions would thereby have a certain amount of international supervisory oversight via a system of licensing and certification by the international standard setting bodies i.e. IFSB and the AAOIFI. For the proposed framework to be effective, it needs to concentrate on the ‘substance’ of the Islamic financial intermediation model by incorporating the *Maqasid al Sharia* doctrine into its standards.

## 5. Conclusion

Taking into account all the suggestions made in this article, it can be argued that a ‘smart’, reflexive and principle-based Meta-Regulatory Framework is the optimal way of achieving the ‘common good’ as a regulatory aim for Islamic finance as an industry. The requirement to achieve the ‘common good’ can be deemed a sub-set of the normative ‘public good’ (*Maslaha*) in Islamic jurisprudence and thus conforms to the ideological basis of the larger *Maqasid al Sharia* of financial intermediation by the banks and other institutions under Islamic law. With the special emphasis of Islamic finance on achieving welfare for the whole of society, it has been argued that in normative as well as practical terms, the purpose of the Islamic economic system is the achievement of the public good (*Maslaha*) by ensuring a just and equitable distribution of wealth amongst the members of society. Further to this aim, the presence of a carefully devised meta-regulatory framework for IFIs which focuses on stakeholder practices and embodies business ethics is not only a requirement but also has clear advantages for the practice and the theory of IFIs at the level of the individual, industry and the society.

It is therefore argued here, that since the *Maqasid al Sharia* of IFIs is to facilitate and act as intermediaries to ensure a just and equitable distribution of wealth in society, the regulatory framework should put a special emphasis on the internal corporate governance

framework modelled on the stakeholder corporate governance norms. The stakeholder theory with its focus on the principles of honesty, integrity, ethical trading, societal responsibility, stakeholder justice, employee participation, investor protection and transparency is in line with the true *maqasid al sharia* of financial intermediation and thus must be made as the practical guideline for the meta-regulatory standards being argued for in this paper. This can be achieved by instituting a framework of licensing, certification and supervisory oversight by the two-main standard setting bodies on the same footing as the Basel accord.

In summary, the aim of a regulatory framework for IFIs therefore ought to be:

*to support social, ethical and economic development - providing the citizens, the depositors, the investors and other stakeholders who are directly and indirectly involved, with the protection and confidence they need to feel confident when dealing with the Islamic finance industry that the Industry is well-structured, safe, secure, Sharia compliant, well governed and risk averse.*