

SHARI'AH GOVERNANCE PRACTICES IN ISLAMIC FINANCIAL INSTITUTIONS: CHALLENGES IN SRI LANKA

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Abstract

Sri Lanka is a multi-religious country where the majority is governed by Sinhalese in which the legislation for Islamic banking and finance was adopted by the Central bank of Sri Lanka in the history of banking. To govern Shari'ah practices, the Shari'ah board was established in Sri Lanka to supervise the governance practices of Islamic financial institutions to assure the stakeholders on the shari'ah governance practices. The objective of this paper is to explore the internal and external challenges in practicing Shari'ah governance in Sri Lanka. A data source of this research is based on primary data i.e. structured interview from selected sharia'h supervisory board members, in-house shari'ah advisors, and shari'ah scholars in Sri Lanka. The results of the study reveals that the existence of many challenges on practicing shari'ah governance in Sri Lanka such as absence of comprehensive regulatory framework, lack of skilled shari'ah scholars, and qualification of members of shari'ah supervisory board. The implication of this research is to direct the practitioners and policy makers to formulate shari'ah governance framework and streamline the entire governance structure in future.

Keywords: Shari'ah Governance, Shari'ah Board, Islamic Financial Institutions, Challenges.

Introduction

Sharia'h governance can be defined as the overall system to assure the conformity of activities of Islamic banks and financial institutions to the precepts of Shari'ah Pertaining to transactions (Karim & Hamid, 2015). It is a system whereby an Islamic financial institutions attempts to comply with Sharia'h activities. To supervise the shari'ah practices, there was no specific body nominated globally at the beginning, and outsourced the consultation services to resolve the shari'ah related issues. These practices still the same until 1997. In 1999, the first shari'ah consultative committee was established by the Dubai Islamic bank to supervise the shari'ah activities (Kahf, 2004).

As far as shari'ah supervisory board concern, the first internal religious board was established in Egypt by Faisal Islamic Bank in 1976. The board was responsible to monitor the shari'ah governance practices of the bank (Malkawi, 2010). Following to Egypt, the in-house shari'ah supervisory board was established by Jordan Islamic bank and Faisal Islamic bank of Sudan in 1978, the Kuwait Finance House

in 1979, and the Bank Islam Malaysia Berhad in 1983 (Malkawi, 2010). In 1999, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has published and adopted the first Shari'ah governance standard for Islamic Financial Institutions globally. In 2006, the Islamic Financial Service Board (IFSB) has published the first corporate Governance standard for Islamic Financial Institutions. The standard was a Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds.

Islamic Finance was introduced in Sri Lanka in 1997 with the establishment of Amana investments. Following to amendment of banking Act No 30 of 1998 in March 2005, there were adequate facilities provided for conventional banks to establish Islamic Banking windows, Islamic insurance company and to launch Islamic finance companies. This legislation promote for established Islamic financial Institutions in Sri Lanka (CBSL, 2005). The Uniqueness of Islamic financial Institutions rests on Shari'ah rules and principles which are the foundation for the practice of Islamic Banking.

Practicing shari'ah governance in Islamic financial institutions in Sri Lanka is become debatable topic in the recent past (Nazhan, 2017) due to having improper shari'ah governance framework and strategies developed and/or formulated by Central bank of Sri Lanka. The Government and Central Bank of Sri Lanka have not been focusing on the improvement and the stability on Islamic financial systems in Sri Lanka to ensure the effective shari'ah governance practices. Having such practices, the Islamic financial institutions in Sri Lanka have been facing many challenges in practicing shari'ah governance in this context (Garasa, 2013). This study explores and investigates the internal and external challenges of practicing shari'ah governance in Islamic financial institutions in Sri Lanka. There are researches attempted to generate idea of shari'ah governance practices in Islamic financial institutions in global context, but little researches was focused on the challenges on practicing shari'ah governance globally, and no single research conducted in the un-stable economic and political environment like Sri Lanka. This research is based on the Islamic financial institutions in Sri Lanka.

Literature Review

Shari'ah Governance plays a vital role in the field of Islamic Banking and Finance Industry as it's considered to differentiate with conventional banking practices. The relationship between the bank and the investors-depositors is not only that of an agent and principal; it is also based on an implicit trust between the two that the agent will respect the desires of the principal to comply fully with Shari'ah. This relationship distinguishes Islamic banking from conventional banking and is the sole justification for the existence of Islamic banks. If the bank is unable to maintain this trust and the bank's actions lead to non-compliance with Shari'ah, the bank risks breaking the confidence of the investors-depositors.

The Shari'ah governance system as a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shari'ah compliance over the issuance of relevant Shari'ah pronouncements, dissemination of information and an internal Shari'ah compliance review (IFSB, 2009). Shari'ah governance refers to a system conducted by Shari'ah principles and controlled by an effective religious board to insure that the activities of IFIs are in accordance with the Shari'ah principles and conducts (Grassa, 2013). Shari'ah governance is a governance system that ensures all activities and business transactions by Islamic Financial Institutions are free from non-permissible elements of Riba, Gharar and Maysir (Banking Insight, 2015).

In the beginning of the Islamic finance practice, there was no special body responsible to advise, supervise or monitor Islamic Financial Institutions on issues relating to Shari'ah matters. The establishment of the first modern Islamic banks (MitGhamr in 1963, the Nasser Social Bank in Egypt in 1972) was made without setting up any Shari'ah body as part of its internal corporate governance structure (Malkawi, 2010). Moreover, in the commencement of the Dubai Islamic Bank and the Islamic Development Bank in 1975, both of them did not have any permanent Shari'ah department in their banks. To resolve Shari'ah issue related to their activities, they have established a relationship with several scholars for consultation on their activities, transactions, products and services as well as asking fatwas for specific questions and transactions (Kahf, 2004). In general we can say that the activities of the banks did not diverge much from the Islamic Shari'ah, even if in 1985, when the Organization of the Islamic Conference (OIC) Fiqh Academy responded to a list of questions submitted two years earlier, the Islamic Development Bank had to revise some of its standing policies to make them Shari'ah-compliance (Kahf, 2004). These practices still the same until 1997 for Dubai Islamic Bank date of a major change in management that took place following of a financial scandal and which called for a restructuring of the bank. The new bank management established, for the first time, a Shari'ah consultative committee in 1999. However, the Islamic development bank has established a Shari'ah Supervisory Board only in 2003 (Kahf, 2004).

According to RihabGrassa, Islamic finance is based on Shari'ah law and all Islamic Financial Institutions' activities must be compliant with Islamic rules and principles. The risk of Shari'ah incompliance may have serious consequences on the continuity of the activities of the IFIs in particular and the development of the Islamic financial system in general. That is why, the need for an efficient Shari'ah supervisory system is considered as one of the vital element promoting the stability of the Islamic financial sector. With this aspiration, corporate governance in Islamic Financial Institutions has to set institutional arrangements to supervise ta

According to HMA, Hilmy & SMM, Mazahir, Today Islamic banks are operating in nearly all Muslim countries and many non-Muslim countries since 1970s. Unlike conventional banking industry, Islamic banking industry provides only the halal financial services for their customers because of its Shari'ah compliant system.

Therefore, the Shari'ah governance is the essence and vehicle for a comprehensive regulatory and supervisory infrastructure of Islamic banking system and it is the key feature of Islamic banking industry which distinguishes it from the conventional financial system. The overall compliance of Islamic banking and financial business is solely depending on the adequacy and efficiency of the Shari'ah governance.

S.M.M Nafees and all mentioned in their paper, In Sri Lanka there isn't proper sharia governance in all Islamic financial institutions. Amana is only the full fledged Islamic bank that is concerned about the good sharia governance. When a comparison is made among Malaysia, Bahrain and Sri Lanka one may find that there is a big gap with regard to Sharia governance.

Data Source and Methodology

Data Source

This research is qualitative, and based on survey research approach. This is the most suitable methods to explore the research questions and to reach the objectives which enables in-depth analysis of the challenges in practicing Shari'ah governance (Kate, Belinda, Brown & John, 2003). Primary sources mainly from semi structured interviews from selected Shari'ah Supervisory Board members, In-house Shari'ah Advisors and Shari'ah scholars in Sri Lanka. The data collected for this research is purely primary, namely face-to-face interviews. Face-to-face interviews involve the researcher approaching respondents personally, either in the street or by calling at people's homes (Kate, Belinda, Brown & John, 2003).

This study uses the Shari'ah Supervisory Board members, In-house Shari'ah Advisors and Shari'ah scholars in Sri Lanka, that had years of experience in the Islamic Banking and Finance Industry, as the sources of data. The sample institutions comprised of Full Fledged Islamic Banks (01 respondent), Islamic Banking Windows at Conventional Banks (04 respondents), Islamic Windows at Finance and Leasing Companies (04 respondents) and Takaful Company (01 respondent), Islamic microfinance service providers (02 respondents).

The population consists of 25 Shari'ah Supervisory Board members and In-house Shari'ah Advisors. Non-probability sampling is a sampling where the samples are gathered in a process that does not give all the individuals in the population equal chances of being selected, so here researcher is selected Non-probability sampling technique

Table 2.1

Details of Interviews

Details of Interviewees	Duration of the Interview
Member of more than two SSB	1 Hour
Member of one SSB	45 Minutes
In-House Shari'ah Advisors	45 Minutes
Shari'ah Scholars in Sri Lanka	30 Minutes

Source: Author Compiled

Data Analysis

In this study examine the Shari'ah Governance practices in Islamic Financial Institutions and the Challenges in Sri Lanka; an Exploratory Data Analysis was conducted. Exploratory Data Analysis is an approach to analyzing data sets to summarize their main characteristics, often with visual methods. A statistical model can be used or not, but primarily Exploratory Data Analysis is for seeing what the data can tell us beyond the formal modeling or hypothesis testing task.

Data analysis provides information on how the data collected from the field was analyzed. Special focus was given to the thematic analysis of Braun and Clarke (2013) which was followed in the analysis of data. According to Denzin and Lincoln (2000) qualitative research does not have a distinct set of methods or practices that are entirely its own to analyze data. Thus it involves a process of summarization, classification and interpretation which is less structured (Lillis, 1999). All the field notes, transcripts of interviews accompanied by the documentary evidence (internally produced management reports) along with observations of my field visits were analyzed in isolation and taken together as a whole.

Ensuring Quality of Data

According to Ambert et al. (1995) qualitative research generally requires a great deal of time expenditure (Vaivio, 2008) on the part of the researcher but the significant amount of time spent in the

field should not be considered as a waste of time as it ensures the validity of data (Vaivio, 2008). Accordingly, 12-14 hours were allocated for conducting interviews and 2-3 hours were allocated for gathering data through documentary analysis. This prolonged time spent in the field helped to ensure quality of the research as it facilitated collecting rich data from the field.

Further, confidentiality of the interviewees was ensured while assurance was given not to divulge their names (Irvine & Gaffikin, 2006; Qu & Dumay, 2011). Through this, it was expected that the interviewees will express their ideas freely while giving rich in-depth ideas about the particular phenomena. In addition, all the interviews were tape recorded and detailed notes were taken down during the interviews along with the interviewees' expressions, feelings and reactions together with Researcher's personal reflections of the research context. Further, as illustrated in section 3.4 the data collection methods were spelt out in detail mentioning the people interviewed, why and how they were selected for interviewing, how much time was spent on interviewing, so the readers of the research could have a clear understanding on the process of data collection while facilitating the traceability of data. Accordingly, it is believed that this process facilitated data triangulation (Lillis, 1999) while ensuring quality of the research.

Findings and Discussion of Results

Descriptive Statistics

The job position, which was considered as the sample of this study, was categorized into three divisions. Out of 23 respondents, 52.2% were Member of SSB, 23.9% respondents were In-house Shari'ah Advisors and 23.9% were Shari'ah Scholars. As far as educational qualification of respondents is concerned, 16% percentages of them are with Bachelor Degree and Masters. 43% of them are Mufthees and other 25% are having professional qualification. In terms of their tenure in the field, 40% of in-house shari'ah advisors are having less than 1 year, and 60% of them are having more than 5 years' experience. 25% of members of the SSB are having 4-5 years' experience in the field and 75% of them are having more than 5 years. All shari'ah scholars are in the industry more than 5 years.

Findings and Discussion

An important feature of an Islamic Finance is ensuring Shari'ah compliance. Thus Islamic Financial Institutions have a complicated system of governance. Indeed, Islamic Financial Institutions are submitted to two internal structures of corporate governance: the Board of Directors and the Supervisory Shari'ah Board (Lewis, 2008). The first structure protects the shareholder's interest and focuses exclusively on the maximization of shareholder value. The second structure protects the Islamic community and customer and is concerned with conforming to Shari'ah and Islamic Law (Siagh, 2002) which are considered as external environment.

The researchers explore about the challenges of practicing Shari'ah Governance in Internal and external environment in which they investigate many challenges, such as Absence of comprehensive regulatory framework, repeat of names of SSB members, Absence of young Shari'ah Scholars and qualification of SSB and conflict of interest. Also the challenges of practicing Shari'ah Governance in External Environment are explored, such as Lack of Government and Central Bank' support, Misconception among public and Lack of awareness about the industry and products.

The Challenges of Practicing Shari'ah Governance in Internal Environment

- I. Absence of comprehensive regulatory framework governing Shari'ah Board attributes and Shari'ah practices.

While Southeast Asia countries have tried to develop a comprehensive regulatory framework governing SB compositions and practices, Sri Lanka has not made a lot of progress in the matter. However, in the both cases, many issues have not been solved yet.

Different frameworks in the different Islamic Financial Institutions stress that Shari'ah Board must consist on Shari'ah scholars specialized in Fiqh al Muamalat (Islamic Commercial Jurisprudence). However, today, the financial system becomes more and more complicated and sophisticated. That is why it is very important that Shari'ah Board must comprise professional bankers and accountants.

- II. Repeat of names of Shari'ah scholars in many SB.

They further raised issues such as multiple Shari'ah committee members on many IFIs in the same industry which add problems to the efficiency and effectiveness of the Shari'ah governance practices of the Shari'ah committee members. This practice is common in Middle-Eastern countries. The Shari'ah committee needs to maintain the confidentiality of the IFIs and if the interlock practice is allowed, there is possibility that confidentiality might be reduced among the competing institutions in the same industry.

Unlike Malaysia and Indonesia, Sri Lanka has limited the numbers of membership of scholar in Shari'ah Boards of Islamic Financial Institutions in the country. Regulatory and supervisory authorities in Sri Lanka have not made any restriction to limit the presence of scholars in the Shari'ah Boards of various Islamic Financial Institutions.

We cannot deny that the presence of some scholars in the SB of several Islamic Financial Institutions can have positive impacts on the performance and efficiency of the SB by gaining access to more operations and transactions which could in turn enhance the knowledge and the experience of scholars and permitting to develop new Islamic finance products and services.

Nevertheless, the excessive repeat of some names of scholars in many Shari'ah Boards over Islamic Financial Institutions can be explained in many times for commercial purposes to attract clients and to boost confidence on the respect of Shari'ah in all the activities of the Islamic Financial Institution. The Shari'ah committee needs to maintain the confidentiality of the IFIs and if the interlock practice is allowed, there is possibility that confidentiality might be reduced among the competing institutions in the same industry (Mazahiur, 2017&Nazhan, 2017).

III. Absence of external Shari'ah review.

Most of regulatory frameworks in IFIs in have not made any requirement about an external Shari'ah review (Aarif, 2017). Today, with the increasing development of Islamic finance worldwide and the sophistication of Islamic products and services, the need for an effective external Shari'ah audit seems to be very important at present more than before. The Shari'ah committee needs to maintain the confidentiality of the IFIs and if the interlock practice is allowed, there is possibility that confidentiality might be reduced among the competing institutions in the same industry.

IV. Absence of young Shari'ah scholars in the SB.

The majority of Shari'ah Boards are dominated by some names of Shari'ah scholars. The absence of young Shari'ah scholars can be a serious problem that may hinder the performance and the efficiency of futures Shari'ah Boards.

Young Shari'ah scholars must be present in every Shari'ah Board meeting to learn from the experience of knowledgeable scholars which can promote the efficiency of Shari'ah governance system in the future and in turn the growth and the stability of the Islamic finance industry (Mazahir, 2017).

V. Qualification of SSB members

In addition to the structural issue, AarifAbdeen, (2017) pointed out the important role of qualified personnel for better Shari'ah risk management. He stated that it is necessary for a person to know about risk management as well as Shari'ah. Moreover, my interview results highlight that a person who performs the Shari'ah risk management function should know the operations of the IFIs, Shari'ah requirements, and the contracts applied in IFIs.

In addition, there is a need for the experts from fiqh and usulfiqh in IFIs and the role of research in Islamic finance should be enhanced. I believe that there are limited experts who are well-versed in all aspects of IFIs such as operation, risk management, and Shari'ah and hence, in order to have an effective team, the team members should comprise experts from different backgrounds and continuous training should be required by the Shari'ah committee members to update their

knowledge. Also he stated that available scholars in SSB are qualified by their experiences more than paper qualifications.

VI. Conflict of Interest

The failure of the IFI management to understand, that the extent and seriousness of Shari'ah non-compliance risk. The current governance structure does not favor the Shari'ah scholars to promote Islamic values, especially when the IFIs management is more shareholder rather than stakeholder concentrated. Some of the Shari'ah committee members do not conduct Shari'ah review functions but focus on the ex-ante functions of Shari'ah governance. At the end of the financial year, they sign the declaration of Shari'ah compliance in the annual report without carrying out a proper Shari'ah review process. Even if they are conducting the Shari'ah review, they heavily rely on the internal audit department of IFIs and hence this practice is not healthy because Shari'ah compliance is not greatly determined by the internal audit department, but by the Shari'ah committee. Although Shari'ah advisors can assess the documents of IFIs, currently they refer to the documents presented to them only for the Shari'ah board meetings.

The Challenges of Practicing Shari'ah Governance in External Environment

I. Lack of Government and Central Bank' Support

In countries like Sri Lanka, the Islamic finance industry has become too big to be ignored. While awareness has increased since 2005, the industry in Sri Lanka still faces several regulatory hurdles. Amendments to the Banking Act to allow banks to engage in other types of Islamic financial instruments, demystifying Islamic finance concepts among regulators and developing Islamic finance professionals are a few issues that need to be addressed for the progression of the industry.

Central Bank of Sri Lanka as a sole regulator of the country not consist separate division for Shari'ah governance. It may affect the following instances:

- While providing the license for the new Islamic financial institutions they may consider only on the areas of country's rules and regulations without Shari'ah matters.
- The internal Shari'ah boards of the institutions haven't any body to overrule their decisions when different interpretations between the Shari'ah committee members occur.

II. Misconception among public

A study by Hasan (2012) on Shari'ah governance system in Malaysia, GCC and the UK concluded by classifying Shari'ah governance system into two types namely: Regulated and Self-regulated Shari'ah governance systems.

- I. Regulated-there is an adamant interest from the regulatory authority such as the central bank or financial service authorities to ensure products and operations of IFIs comply with Shari'ah rules and principles. E.g. Malaysia, Bahrain, Kuwait, UAE, Indonesia, Sudan, Pakistan, Nigeria, Uganda, Oman and Qatar among others.
- II. Self-Regulated- no specific law or any requirement from regulatory authority specifying Shari'ah governance. IFIs establish their own policies and guidelines to deal with Shari'ah issues. E.g. United Kingdom, Saudi Arabia, Kenya, Tanzania, Egypt, Turkey.

Mazahir stated that (2017), According to the above classification, Sri Lanka is coming under the Self-Regulated category. Therefore the functioning of SSB particularly under self-regulated Shari'ah governance system has been widely criticized from corporate governance and risk management perspectives.

On governance perspective, it is argued that the system raises concerns on SSB independence, confidentiality, competence, consistency, accountability, transparency and disclosure (Grais; Pellegrini, 2006b; Van Greuning; Iqbal, 2008). From risk management perspective, it is argued that the system poses Shari'ah, reputational and legal risks which can adversely affect the stability and growth of the Islamic finance industry.

III. Lack of awareness about the industry and product

Sri Lanka's experience with Islamic finance so far suggests that banks are merely trying to attract the highly- productive Muslim population, many of whom have stayed clear of conventional banks because of religious beliefs. But the industry wants to unleash the full potential of Islamic finance here. There are compelling reasons why Islamic banking should be taken more seriously.

"Interest in Islamic finance is growing partly because the market is liquid and global investors are looking for opportunities outside the Middle East," says Mubarak. However, attracting investors for capital is also challenging given the need to compete with the conventional banking sector and regulations. Islamic banking is a small market here and returns are low compared with other Islamic finance markets in the region, so it is difficult to attract global Islamic finance investors as well.

Conclusion

As we may already be aware the global Islamic Banking and Finance (IBF) sector has been growing steadily, As for Sri Lanka, the penetration of Islamic Banking and Finance is very low, Of Sri Lanka's total banking and finance sector assets, less than one percent only belongs to Islamic banking and finance. Effective Shari'ah Governance frame work will enhance the confident on Shari'ah compliance of the industry among the stakeholders who are believe with Islamic values. The objective of this study is to explore the internal and external challenges of practicing Shari'ah governance in Islamic Financial Institutions in Sri Lanka. The result of this study suggest that, there are some internal and external

challenges of practicing Shari'ah Governance in Islamic Financial Institutions in Sri Lanka and its impact on growing of the industry. The internal challenges are such as absence of comprehensive regulatory framework, repeat of names of SSB members, absence of young Shari'ah Scholars and qualification of SSB and conflict of interest. The external challenges are reported as lack of support from government and Central Bank, Misconception among public and Lack of awareness about the industry and products. In the above research analysis, Most of these external challenges are binding on inadequate of government rules and regulatory system which can be accomplished needs of Islamic Finance Industry.

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