



Shari'ah Governance of Islamic Banking Institutions in Pakistan: An Analytical Overview

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Abstract: Shari'ah governance is the arrangement that provides legitimacy to the business of Islamic Banking Institutions (IBIs) because the concept of Shari'ah governance requires that all business affairs of IBIs must be conducted according to Shari'ah rules and principles under the Shari'ah supervision. The research is formulated to overview the current and the previous regulatory arrangements of SBP for Shari'ah governance of IBIs and analyze the institutional arrangement for Shari'ah governance, which is a vital part of the Shari'ah governance practice of the Pakistani IBIs. Applying a descriptive methodology, the research has investigated the current practice of Shari'ah governance depending on the regulatory guidelines and standards issued by the SBP and the literature on the topic. The research has discovered that the Shari'ah governance of IBIs in Pakistan has been formulated and implemented significantly by SBP. At the industry level, the composition and functions of Shari'ah boards require some regulatory enhancements to safeguard the credibility and marketability of Shari'ah governance of IBIs. The research implies that Shari'ah boards must have additional members qualified for the position and their functions should be comprehensive, and their performance should be assessed so it could cater to the business needs of IBIs.

Keywords: *Shari'ah governance, Islamic banking, SBP, SAC, Shari'ah board*

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INTRODUCTION

The complexity of Islamic banking products and services nowadays requires a sound Shari'ah governance system. IBIs in Pakistan are required by the SBP to enhance their organizational structure with proper arrangements for Shari'ah governance practice. The Shari'ah governance practice which is formulated by number of organs is meant to regulate and systematize the Islamic banking operations. The organs which collectively formulate a Shari'ah governance practice are the board of directors, the management of the Islamic bank which includes other organs such as accounting and auditing departments and the most important and crucial organ which is the Shari'ah supervision (Minhas, 2012). The SBP as a regulator has been issuing guidelines and instructions since¹ the re-launching of Islamic banking industry in Pakistan, it aims to regulate and provide a smooth path for the operations of Islamic banking practice in the country (Khan, Tanveer, Shah, & Jamil, 2015; Homburg, Vomberg, & Muehlhaeuser, 2020).

The current Shari'ah Governance Framework (SGF) is a comprehensive guideline which confines the position of every organ that plays its due role to fulfil the requirements of the Shari'ah compliant mechanism. It was introduced in April 2014 and was enforced on 1st of January 2015 and the updated version of it was implemented in 2018. This

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¹Note: In this regard, the first regulatory required was the SBP's "Minimum Shariah Regulatory Standards (State Bank of Pakistan, 2004)" that required the IBIs to articulate Shari'ah advisory function in their organizational structure. See: (State Bank of Pakistan, 2004)

framework basically complements the previous instructions and guidelines issued by SBP in 2008 to regulate and supervise the Shari'ah compliant framework of the IBIs (Muhammad, 2019; Muliadi & Feriyanto, 2018). The Islamic banking industry is gaining great momentum globally whereas it is also becoming complex in Pakistan which triggered the authorities to formulate comprehensive SGF. The framework specifies the roles and responsibilities of the key organs of the Shari'ah governance practice. The research in hand intends to examine the previous and recent guidelines and instructions introduced by the SBP for the Shari'ah governance practice of IBIs (Husain, 2004; Razalli & Hasnan, 2017). These instructions and guidelines specify the composition of Shari'ah supervision in IBIs whereas the Fit and Proper Criteria of SBP facilitates IBIs to appoint appropriate Shari'ah board members and the SGF of SBP further outlines the roles and responsibilities of every organs and the business norms of IBI.

Therefore, the research is formulated to overview the current and the previous regulatory arrangements of SBP for Shari'ah governance of IBIs as well as to analyses the institutional arrangement for Shariah governance which is a vital part of the Shari'ah governance practice of the Pakistani IBIs. The discussion on these institutional arrangements can provide an analytical overview of the Shari'ah governance system introduced and practiced by Pakistans Islamic banking industry which also highlight the issues and challenges adhering with the Shari'ah governance practice in Pakistan.

RESEARCH METHODOLOGY

The research employs Qualitative methodology with adopting descriptive and analytical approach. It basically depends on reviewing the standards, guidelines, frameworks and regulatory directions issued by the SBP to regulate and supervise the Pakistan's Islamic banking industry. In addition, the research also includes the data collected from secondary sources e.g. books, journals, financial or banking reports issued by regulatory institutions of Pakistan for describing the nature and progress of Islamic banking industry in Pakistan and other jurisdictions. Based on the collected data, the research analyzes the current Shari'ah governance constituted for the IBIs in Pakistan and to produce and propose measures for the enhancement of Shari'ah governance of Pakistani Islamic banking industry.

REGULATIONS ON COMPOSITION OF SHARI'AH SUPERVISION

The composition of Shari'ah supervision is a very important aspect of the Shari'ah governance system. SBP has started developing its regulatory and Shari'ah compliant framework after re-launching Islamic banking industry. It was required to establish its own Shari'ah supervisory arrangement to have a sound Shari'ah supervisory and compliant mechanism for the Islamic banking industry. According to the organizational arrangement made by the SBP, an Islamic Banking Department (IBD) was established. The IBD is responsible for controlling the whole Islamic banking operations in the country. SBP regulates and supervises Islamic banking sector through its IBD. The department has established an interesting arrangement for the Shari'ah governance practice. In order to oversee the country's Islamic banking industry, the IBD of the SBP has established a central SAC which has seven board members consisting of three Shari'ah scholars, a member from the banking background, a chartered accountant, a legal expert and a representative of the SBP. The main function of the SAC is to advise and guide the SBP on Shari'ah related operations, procedures and regulations for Islamic banking and to ensure both Shari'ah compliance and the smooth operation of Islamic banks (Akhtar, 2007c).

In 2008, SBP issued detailed guidelines and instructions directing all full-fledged Islamic banks, Islamic banking subsidiaries and Islamic banking division of conventional banks to establish appropriate Shari'ah supervisory function in their respected IBIs (State Bank of Pakistan, 2008a). The instructions included the procedures for composition of Shari'ah supervision along with its functions while the current SGF of SBP which was initially introduced on April 2014 (State Bank of Pakistan, 2014a), provides comprehensive guidelines on the composition and function of the Shari'ah supervision. It has strengthened the Shari'ah compliance mechanism by providing a sound Shari'ah governance arrangement better than the previous instructions of the early 2008's. The composition of Shari'ah supervision recommended in the current SGF has been examined, comparing it with the previous arrangement set by SBP in the following:

- Every Islamic banking institution is required to constitute a Shari'ah board comprising no less than three Shari'ah scholars according to the "Fit and Proper Criteria" set by the SBP. The previous requirement was to appoint only one Shari'ah advisor in every IBI. Having only one Shari'ah advisor has always been questioned for a weak Shari'ah compliant product and lack of consistency.

- The appointment of the Shari'ah Board members and the chairman are required to be approved in advance by the SBP. In addition, IBIs are advised to enhance the function of SB by aiding of different expertise from law, banking, finance and accounting fields. However, the role of these experts is limited to be advisories.
- The terms of reference have been set three years for members of the SB with the flexibility of renewing if necessary. It is also clarified that the Shari'ah scholars working as single Shari'ah advisors in any Islamic bank can become part of the SB as a member or the chairman.
- The SB members are allowed to work with other Islamic banks as Shari'ah advisors, but this permissibility is limited to three Islamic banks. The banks are also advised to put some confidentiality clause in the contract to control the Shari'ah advisors on the secrecy and confidentiality of the institutions they work in.
- IBIs are required to report the SBP on the appointment, expiration and reappointment of the members or the chairmen of the Shari'ah board ahead of three months, citing the reasons for the arrangements of the IBIs' decision.
- IBIs are also bound to provide sufficient and reasonable report specifying the rationale for the dismissal of any Shari'ah board member and the SBP's approval on that action. Upon removal, resignation or termination of any Shari'ah board member, IBIs are required to fulfil the position within three months.
- Shari'ah Board's members are also required to submit their resignation to the BOD if they work for a domestic bank while working as Shari'ah advisors with a foreign Islamic bank. They must submit resignation to the country director and a copy of that has to be sent to the SBP as well.

Based on the above mentioned method of composition and the requirements of that aspect, the previous instructions in this regard were weak arrangement. On the other hand, the recent new SGF has put in place sound and comprehensive guidelines. The major differences that are observed are:

- According to the previous arrangement, only one Shari'ah advisor was required to assist IBI on its Shari'ah compliance function but the new arrangement requires a proper Shari'ah board comprising at least three scholars to support the Shari'ah compliant process in the IBIs.
- The early instructions were silent on the flexibility of the limitation of Shari'ah advisors' services to be hired by other IBIs so they were independent to provide their services to the multiple institutions. Thus, the recent framework restricts them to three IBIs only.
- There was no explanation on whether the SB can seek the assistance of any other relevant experts on Shari'ah compliant function or not, but the new arrangement encourages other relevant experts to take part in the Shari'ah compliant process.
- The limit of the term remains three years like the previous arrangement but there are many other restrictions put in place for the appointment, dismissal and resignations or reappointment which makes the new arrangement quite balanced and effective.

In spite of all these commendable improvements, the composition of the Shari'ah supervision for IBIs in Pakistan faces some issues which can be observed even in the current SGF of the SBP. Some of these issues are highlighted by many researchers in different governance frameworks as well, so similarly, these issues are adhering to the Pakistani Shari'ah supervisory practice which is identified as such;

- Composition of Shari'ah supervision by Islamic banks comprising only one Shari'ah advisor or a board with only three Shari'ah advisors create a weak Shari'ah compliant process.
- The board of directors of Islamic banks holds the ultimate power of decision making which raises questions about the independence of Shari'ah advisors.
- Allowing Shari'ah advisors to provide their services to more than one Islamic bank can cause conflict of interest and effect confidentiality issues.

Although the current SGF states that Shari'ah board must consist of at least three Shari'ah advisors as per the AAOIFI's standard requirements, the majority of Islamic banks are still following the early guidelines of the SBP which allows only one Shari'ah advisor (Rammal, 2006b). However, Rammal (2006b) indicates a review which analyzes the existing of Shari'ah supervision formulated by six banks. Among them only two Islamic banks have their Shari'ah supervisory boards comprising three to four Shari'ah advisors whereas four Islamic banking branches formed their Shari'ah supervision comprising only one person Shari'ah advisory (Rammal, 2006b).

The current SGF is gradually developing but this issue is causing serious problem in terms of weak Shari'ah compliant practice. If the new guidelines are followed accordingly and the Shari'ah supervision enhanced with no less

than five members from diversified backgrounds, and more focus on Shari'ah standard practice internationally, the IBIs will gain more confidence among the customers. This is the reason that some Islamic banking windows have established proper Shari'ah supervisory boards having more than one Shari'ah advisor to obtain more confidence and trust of the consumers who concern about Shari'ah compliant function and competition in the Islamic banking market (Rammal, 2006b).

The recent Shari'ah supervisory arrangement of Pakistani Islamic banking sector would become sounder and more robust if it follows the Shari'ah supervisory practice established by Malaysian regulatory authorities. According to Bank Negara Malaysia, IFIs must have the Shari'ah advisory board comprising no less than five members possessing strong knowledge in Shari'ah and finance (Bank Negara Malaysia, 2019). This increase in number will enhance the recent Shari'ah governance system and will bring more public and private confidence towards the products and services provided by the IBIs.

As it is identified that the board of directors which holds the decision-making power while the Shari'ah supervisory board members are appointed and can be dismissed by its approval, this ultimate power can affect the independence of the Shari'ah supervisory board. Although the appointment and removal of the Shari'ah advisors are to be reported to the SBP, this is seen as formality and the Shari'ah advisor who holds the responsibility to fulfil the Shari'ah requirements for the internal Shari'ah review and audits can possibly be dictated by the board of directors. (Chohan & Chohan, 2012) identify the two sides of this issue; on one hand, most banks in Pakistan are family owned which keeps the governance power in their charismatic directors' hands and allows them to have ultimate executive power to fulfil their maximizing financial needs. On the other hand, the Shari'ah supervisory board bears a different goal for safeguarding religious requirements of the Islamic banking operations. In that situation both boards having different targets and requirements can cause overlapping of power which will lead the industry into a great risk. Not only in the present but in the future, especially when the industry is still in its evolutionary stage, this issue will raise conflict of interest (Chohan & Chohan, 2012; Nawaz, Haniffa, & Hudaib, 2020; Tabash, Alam, & Rahman, 2020)

The overlapping and unbalance of powers between the two boards can produce an inappropriate decision which can affect the deposit, loan sanctioning policy or risk-taking operations for the IBIs. They suggest that the powers of the two boards must be confined and separated (Chohan & Chohan, 2012). In that case, the board of directors of Islamic banks is more responsible to safeguard the Islamic banking operations from all kinds of risk. (Akhtar, 2006) emphasizes on the role of BOD by suggesting that "commitment of dedicated, qualified directors who understand and can assess Shari'ah compliance would facilitate the effective oversight and protect the industry from overall reputation risks" (Akhtar, 2006) and that is a crucial need to be considered in the Islamic banking sector in Pakistan in the present time to save the industry from any possible danger.

Analyzing the previous instructions and guidelines and the recent SGF reveals that the Shari'ah advisors working with an Islamic bank are allowed to serve in multiple IBIs. However, according to the current SGF, Shari'ah advisors are allowed to provide their services to up to three IBIs. Although it requires the IBIs to bound their Shari'ah advisors to maintain secrecy and confidentiality of the institution and not to violate the secrecy red lines but working as a Shari'ah advisor in three IBIs, it will be a naturally unavoidable mistake. Bearing in mind that Shari'ah advisors have been given the right to have unhindered access to all records, documents and all kinds of information from all related sources including the professional advisors and the IBI staff in order to enable and form sound Shari'ah decisions or ruling for the products and services offered by the IBIs (State Bank of Pakistan, 2018b). This flexibility can create a serious problem regarding conflict of interest and confidentiality.

There is another aspect of this issue that has been highlighted by Rammal (2006a) as he argues that since the members of the Shari'ah board receive remuneration from the financial institution, that can create a potential conflict of interest which can force the members of the Shari'ah board to legitimize dubious operations to ensure that they could secure the position in the board (Rammal, 2006a). On the other hand, Zulkifli (2012) disagrees with Rammal's assumption by clarifying that the Shari'ah advisors are known as religious scholars; their decisions are driven by religious and moral values so it is not a solid reason for them to simply follow their greed, thus, this aspect should be regulated properly by the regulatory authorities (Zulkifli, 2012).

There are many countries where Shari'ah advisors are not restricted from working in multiple IBIs in the same time such as Saudi Arabia, Kuwait, Qatar, etc. Therefore, the issue of conflict of interest and the negative perception about Shari'ah advisors can emerge because if a Shari'ah advisor is working with the central Shari'ah board entrusted with the function to supervise the products and services of the IBIs of the country while at the same time he has to perform

the same role for any individual IBI, can naturally exist the conflict of interest. This issue can be rectified by enhancing the Shari'ah supervision with the necessary legal provisions as BNM's SGF restricts the Shari'ah advisors for being part of any Shari'ah advisory other than the one they represent (Zulkifli, 2012) but this restriction is limited to the Islamic banking. The same restriction can be observed in the current SGF of SBP, but it is a bit flexible by allowing them to in work up to three IBIs. However, this flexibility should be revoked and the Shari'ah advisors must be restricted to individual IBI so that the function of Shari'ah supervision could become more diversified and effective. This can be done only if the SGF of SBP is supported by the legal provisions and regulatory guidelines. The strict regulations and legal provisions are the only way which can improve the effectiveness of the Shari'ah governance system and the recent arrangement for the Shari'ah supervision for the IBIs in Pakistan.

FIT AND PROPER CRITERIA FOR SELECTION OF SHARI'AH BOARD MEMBERS

The SBP has established sound selection criteria for Shari'ah board members. The criteria which is officially known as "Fit and Proper Criteria" has been formulated after a course of directives and instructions issued by SBP from time to time for the Islamic banking industry. The SBP issued a circular on 29th April 2004 regarding the "minimum Shari'ah regulatory standards" comprising also the Fit and Proper Criteria for the selection of Shari'ah advisors. The banks were advised to follow the respected criteria by 30th June 2004. The criteria were revised in 2007 with certain amendments and details and all the IBIs were ordered to submit their Shari'ah advisors' information to the SBP in order to update their database. Along with that, the Shari'ah advisors who were holding executive or non-executive positions in more than one IBI were directed to leave either position and regularize their positions but later on in 2008, the SBP had given more flexibility to the Shari'ah advisors by making some amendments again in some parts of the Fit and Proper Criteria. The restriction to work with only one IBI in either executive or non-executive position remained but to work as a member of Shari'ah board or committee of any other institution was excluded from the restrictions. Regarding conflict of interest, the Shari'ah advisors were advised to avoid approving any transaction from two IBIs if they represent both of them (State Bank of Pakistan, 2008b). The Fit and Proper Criteria for the selection of Shari'ah advisors consists of eight essentials requirements for the appointment of Shari'ah advisor which are; educational qualifications of the Shari'ah advisor, his experience and exposure related to the field, his professional track record, solvency and financial integrity and integrity, honesty and reputation, conflict of interest, declaration of fidelity and secrecy as per section 33A of Banking Companies Ordinance (BCO), 1962. The criteria set by the SBP for the appointment of Shari'ah advisors in the IBIs is summarized next; (State Bank of Pakistan, 2007).

Educational Qualification

The Educational qualification of the Shari'ah advisor must contain of Islamic classical study equal to Master of Arts in Pakistan, known as Shahadat ul Aalmia Degree from any recognized traditional Islamic Madrassa Board with not less than 70% marks (locally known as Darse-e-Nizami a, regional Islamic classical and traditional education system). It must be included with a second-class bachelor's degree along with enough understanding of banking and finance. As a second option, post graduate degree of Islamic Jurisprudence, L.L.M in Shari'ah with GPA of 3.0 or its equivalent marks from a recognized university added with good exposure of banking and finance.

The Shari'ah advisor must have approximately four years of experience in giving fatwa including the period of Ifta course or specialization. Alternatively, five-years' experience in teaching or research in the field of Islamic banking and finance and a good command of English and Arabic languages are also required. It states that priority will be given to those who have specialization in Islamic law or in Shari'ah rulings.

The FAPT also explains that SBP can grant concession to any candidate, in terms of educational qualification and experience, who holds sufficient knowledge in giving Shari'ah rulings related to Islamic banking and finance transactions, etc.

Track Record

Track record states that the Shari'ah advisor must have a faultless and clean professional career and have not been involved in any wrongful social, financial or economical activities. He must have good reputation meaning. He has never been dismissed nor terminated from any valuable position such as a director, chairman or an employee of a company he represented previously.

Solvency and Financial Integrity

It also required that the Shari'ah advisor must have flawless financial background in the sense that he has never been engaged in any illegal banking or financial activities. He must have never faced any default of payment of dues owed to any financial institution or defaulter of taxes or any proprietary dealings.

Integrity, Honesty and Reputation

Emphasizing on the Shari'ah advisor's personal transparency, as an individual he must have never committed any crime regarding improper financial dealings. He must not be involved in any offensive activities that were legally proven against him nor in any situation bearing settlements of civil or criminal legal procedures related to financial or investment frauds or disorders. He must have never violated any rules and regulations of the corporate, financial or banking regulatory system.

Conflict of Interest

For the precaution in facing any conflict of interest regarding any financial or banking decisions, Shari'ah advisors are barred from having multiple positions as a Shari'ah advisor in IBIs in the country ([State Bank of Pakistan, 2004](#)). It is also emphasized that Shari'ah advisors are not allowed to hold any executive or non-executive positions in any other financial institution except being Shari'ah advisor for the mutual funds of the same IBIs. It is also clarified that the Shari'ah advisors cannot have substantial interest which is 5% or above in the business of Exchange Company, as Member of Stock Exchange, part of Corporate Brokerage House nor is he allowed to be the employee of the abovementioned entities.

Declaration of Fidelity and Secrecy as per Section 33A of BCO, 1962

Before taking the position and responsibilities as Shari'ah advisor, he must sign a declaration of fidelity and secrecy as per provisions of Section 33A Sub-Section (2) of BCO, 1962.

The Shari'ah advisor is required to make a declaration with the statement that "I shall observe strict fidelity, secrecy and usage customary among bankers and all matters relating thereto and in particular shall not divulge or communicate any information relating to the affairs of its customers, which may come to my knowledge in discharging my duties directly or indirectly, except in circumstances in which it is in accordance with law, practice and usage customary among bankers" ([State Bank of Pakistan, 2018b](#)). IBIs are advised to keep the declaration in its safe custody.

These are very significant elements of the criteria encompassing almost every aspect of the requirements for the appointment of Shari'ah advisors in the IBIs of Pakistan. Although the criteria had been introduced in 2004, it was revised and amended in 2007 and its development still continues as the SBP always issues the IBD Circulars from time to time regarding Islamic banking operation to keep the system up to date. However, the criteria present some shortcomings as well, which most probably will affect the suitability and credibility of the growing Islamic banking industry. The first thing is that there is no obvious explanation as to what extent the exposure, awareness or knowledge of Islamic banking and finance is required for the Shari'ah advisor. Secondly, as it is notified by [Chohan and Chohan \(2012\)](#) being familiar with the Islamic banking and finance has not been made a compulsory requirement; it is kept only as an additional quality which will create an unhealthy gulf between the management of the IBIs and the Shari'ah advisors ([Chohan & Chohan, 2012](#)). This issue will cause a slow product development process. Thirdly, the involvement of SBP to relax the qualification and educational requirement will influence the individual IBIs' decision-making process which leads to lack of homogenous financial products due to less harmonized Shari'ah rulings on product development process. Fourthly, the part requiring the impeccable track record, integrity, honesty, solvency and reputation does not pinpoint the measures needed for that purpose. The last parts which are related to the conflict of interest and the declaration on fidelity and secrecy bound the Shari'ah advisors to stick with the single IBI but on the other hand, SBP allows its central SAC members to provide their services to other IBIs.

Moreover, the restriction of being the sole Shari'ah advisor with a single IBI is ignored and the Shari'ah advisors work in multiple IBIs which will surely highlight the issue of secrecy and confidentiality in a competing market environment (Chohan & Chohan, 2012). These issues must be rectified by SBP because the violation of its regulations can bring a certain reputational and credibility risk to the Islamic banking industry. Luckily, the Shari'ah governance arrangement is always being revised and amended by SBP from time to time through its IBD's Circulars, so it can be hoped that SBP will mitigate the issues adhering to the Fit and Proper Criteria for the appointment of Shari'ah advisors by making it more sound and convenient to the rapid growing Islamic banking industry of Pakistan.

SHARI'AH GOVERNANCE MECHANISM OF SBP

The arrangement which has been formulated by the SBP for effective Shari'ah governance has different dimensions. On one hand, it creates a Shari'ah compliant mechanism at the central level; on the other hand, it forms this function of Shari'ah supervision at the individual IBI level and keeps a close check and balance on the Islamic banking operations of the IBIs. An additional Islamic banking inspection practice is introduced as well by SBP.

Akhtar (2007b) explains the recent arrangement of the Shari'ah governance mechanism which has been arranged by the SBP. This arrangement is based on the multi-tiered Shari'ah compliant arrangements which is aimed to fulfil the clients' and investors' satisfaction. It has been designed to control three levels of the Shari'ah compliant process. The first stage is the SAC of the SBP which is responsible for approving the policies and regulations regarding Islamic banking and fit and proper criteria for the Shari'ah advisors. The second layer is the Shari'ah advisors in all IBIs to facilitate the IBIs and to satisfy the customers regarding Islamic banking products and services. The third stage is the Shari'ah audit system that controls the Islamic banking operations (Akhtar, 2007b). Each of these levels of Shari'ah compliant mechanism is detailed in the following section:

Central SAC of SBP

The re-launching of Islamic banking industry in Pakistan requires that there should be a religious authority at the national level to control and guide the SBP on the Islamic banking operations in the country and to comply with Shari'ah rules and principles. That was the reason why on October 24th, 2003 the Central Shari'ah Board was established within the organizational structure of the SBP (Ghazali, 2018).

The Central Shari'ah Board comprises of seven members; a lawyer, a banker, a chartered accountant and three Shari'ah scholars and an officer of SBP. The Board chairman is selected amongst the Shari'ah scholars. Moreover, the director of the IBD of SBP acts as the secretary to the SAC as well as coordinates between SBP and the SAC. The composition of the Board is made of experts from different fields in order to produce a sound and balanced Shari'ah resolution on the Islamic banking operations keeping in view the financial, legal and business requirements of the country (Akhtar, 2007c).

The key functions of the SAC of SBP are summarized hereunder (Akhtar, 2007b):

- Reviewing and approving Shari'ah compliance on the products/instruments developed by the SBP for conducting its central banking and monetary management functions for the Islamic banking industry.
- Advising and guiding the SBP on prudential regulations developed for Islamic banking sector.
- Approving the Fit and Proper Criteria for the appointment of Shari'ah advisors in institutions conducting Islamic banking activities.
- Facilitating the SBP on Shari'ah ruling in case of a conflict arising from the Shari'ah audit of Islamic banking activities under the supervisory control of the State Bank.
- Assisting the SBP on the Shari'ah rulings in case of conflicting Shari'ah opinions produced by SBs of IBIs on the Islamic banking products.

The Central SAC which was established by the IBD of the SBP is the highest authority for any conflict resolution in the Islamic banking product and service operations. Moreover, these are other functions performed by SAC of the SBP which are: (State Bank of Pakistan, 2008c)

- The SAC of SBP is entrusted with the role to provide guidance regarding the rules and regulations on Shari'ah compliant procedures for Islamic banking operations, and the guidelines, instructions and policies introduced by SBP related to Islamic banking sector as approved by its SAC.
- Shari'ah board or advisors in IBIs may produce some rulings which go against the rulings given by the SAC of the SBP or differ from other Shari'ah boards of different Islamic banking branches which are resolved and managed

by the SAC of the SBP. The decision made by the SAC of SBP must be upheld. Being the final authority on Islamic banking practice, the SAC is constituted and combined with multi-dimensional expertise. The members of the SAC are highly qualified with Shari'ah and Islamic banking and finance experiences and with a wide exposure to local and international practices so that their guidance to SBP is expected to be sound and effective.

Although the recent Shari'ah governance mechanism is a better regulatory arrangement, the formation of the SAC in the SBP is still requires some improvements. The board which comprises only seven members has only three Shari'ah scholars. The board which has to oversee the overall Islamic banking operations in the country with only three Shari'ah scholars can cause weak supervision, less diversification of the products and services for the IBIs, slow innovation and introduction of the banking and financial services, etc. For that purpose, the composition of current SAC of the SBP should comprise of more members especially Shari'ah scholars whom have strong Shari'ah background along with sound awareness of Islamic financial and banking industry. This task can be accomplished by providing academic support and technical training to the Shari'ah supervisors under the supervision of senior experts in the field.

The regulatory authorities in Pakistan can also take into consideration the composition of Malaysian Shari'ah Advisory Council which comprises members who are Shari'ah scholars and experts of the industry and constitutes with a balanced number of its members. They are selected as members of Shari'ah Advisory Council based of their dedicated and sound experience in Islamic banking and finance and conclusive skill in producing ruling (Dusuki & Abdullah, 2011). A solid and balanced Shari'ah supervisory board at the SBP can assure a sound and robust Shari'ah compliant resolution and diversified Islamic banking operations. It will not only protect the banking services from Shari'ah non-compliant activities, but the reputation of the Islamic banks and their services could be improved. It will also eventually enhance the Shari'ah governance mechanism of SBP towards the Islamic banking industry of Pakistan. This is something that the Pakistani Islamic banking system strongly needs because of its unpleasant experiences in the past.

Shari'ah Governance Arrangement of IBIs

It is a regulatory requirement before obtaining the license for establishing an Islamic bank in Pakistan to have a Shari'ah supervisory arrangement in the Islamic bank's governance structure (State Bank of Pakistan, 2003). The guidelines issued by the SBP in 2008 required at least one Shari'ah advisor to be appointed in any Islamic banking institution but in spite of this, many Islamic banks, because of market competition and enhancing their Shari'ah compliant credibility, were forced to hire more than one Shari'ah advisor. Luckily, after the implementation of the SGF of SBP, the requirements for the Shari'ah supervisory arrangement is that the Shari'ah board of the IBI must consist of at least three members in all IBIs.

The appointment of the Shari'ah board members must be according to the fit and proper criteria for the selection of Shari'ah board members issued by the SBP. The appointment of the members of Shari'ah board members must be approved by the Central SAC of SBP. The FAPC of the SBP provides the guidelines on the composition of the Shari'ah board within the IBIs. The Shari'ah boards of the IBIs in Pakistan represent the role of SAC in the individual Islamic banks. Therefore, all IBIs have been obligated through a course of regulations and guidelines issued by SBP to operate under the supervision of their respected Shari'ah boards to meet the Shari'ah compliant requirements of their products and services (Akhtar, 2007c).

Roles and Responsibilities of SB

Shari'ah advisors of the IBIs are expected to ensure that a proper Shari'ah compliance function is in place by monitoring the products and services, policies, contracts and agreements of the IBIs. Any product innovation, its launching, introduction, related terms, conditions and agreements must be approved by the Shari'ah board. To fulfil this role, the management of the IBIs is required to facilitate the Shari'ah board by providing managerial assistance and access to all the necessary information. The Shari'ah board is also required to produce a Shari'ah report based on its Shari'ah reviews and endorsements of the different Shari'ah compliant products and services provided by IBIs. The report must be published along with IBI's annual progress report. The rulings, fatwe and endorsements of the Shari'ah board are binding on the IBIs. Along with that the Shari'ah board is also expected to guide the management, BOD or banking staff on any issue or matter related to their duties (State Bank of Pakistan, 2018b).

Notwithstanding, the composition of the Shari'ah board in the IBIs is a significant arrangement but there are some issues which confuses the identity and the composition of the Shari'ah boards at the IBIs. To begin with, the term

Shari'ah board used to be used for both Shari'ah boards whether it works in the SBP or the one at the individual Islamic bank. The similarity of the names was creating confusion for the researchers and the viewers of the reports published by the institutions in Pakistan. When the Shari'ah board is used, it used to be always asked which Shari'ah board, the one of the SBP or the one of the IBI! This confusion was eliminated by the SBPs circular which specified SAC as the nomenclature for the SBP's Shari'ah Committee (State Bank of Pakistan, 2018a). However, the same way the nomenclature for the institutional Shariah board is also needed to be regulated to avoid any possible confusion in the future. The Malaysian Shariah governance model has an admirable arrangement in this regard. There are two different titles are used; the national Shariah board is named Shariah Advisory Council whereas the Shariah boards of the individual Islamic banks are called Shariah Committees. The reference can be easily made by simply giving them different names. The second issue is related to the composition of the Shariah board of the IBIs. The SBP regulations require that Shariah board of the IBI must consist of at least three members (State Bank of Pakistan, 2018b). It is the similar weakness of Shariah supervision as the one at the central level. The Shariah board of the IBI should have more than three or at least five members because the rationale behind the composition of the Shariah Board is combining different expertise is the need for a diversified and balanced Shariah ruling when considering legal, financial and banking requirements of the operations. So, the same expertise and needs should also be observed during the composition of the Shariah board at the individual banking level which will bring more harmony and credibility to the products and services of the IBIs.

SGF depends on the two most important organs which are the Board of Directors and the management of the Islamic banks. They are considered the main players of the field to run the overall institutional organization towards the set goals in accomplishing and implementing the policies for achieving the set objectives (Minhas, 2012). The present arrangement of the SGF introduced by SBP confines the role of board of directors and the management of the IBIs in the following (State Bank of Pakistan, 2018b):

The Board of Directors and its Role

- The board of director has been granted with an ultimate responsibility to ensure that the operations of the Islamic banking institution comply with the rules and principles of Shariah. In offering its managerial role, the BOD is expected to possess full awareness of Shariah non-compliant risk as he must be aware of other risks adhering to IBIs in order to preserve the reputational and financial reputation of the IBI. That is why BOD must keep its effective oversight to bring along the functions of all organs according to Shariah rulings and guidance provided by the Shariah board.
- The board of directors is also responsible for the protection of the Investment Account Holders or (IAHs) Profit and Loss Sharing Depositors (PLS) and their rights toward IBI. IAHs or PLS depositors accept the risk equally like shareholders but do not enjoy the right to vote or join any shareholder meetings to express their points of view on the IBIs performance. The IAHs or PLS depositors expect IBI regarding their deposits to be utilized in Shariah permissible instruments for permissible gains, so the BOD is responsible to put in place a sound risk management system in order to fulfil the expectations of the IAHs or PLS depositors and safeguard the credibility of IBIs.
- The BOD is also responsible for constituting a Shariah board to guide it on Shariah related matters as well as to provide assistance on introduction and implementation of Shariah compliance mechanism. The appointment of Shariah board members, their terms of reference and their remuneration must be approved by the BOD but these tasks can be done by the country manager or the CEO in case foreign banks have Islamic banking branches.
- The BOD is also made responsible to manage meetings with Shariah board at least twice a year to discuss the Shariah compliance environment, the issues and obstacles and recommendations on the enhancement of Shariah compliance mechanism. The BOD will also examine the performance of IBIs on the enforcement of the decisions, observations and recommendations provided by the Shariah board of the IBI.

The Executive Management and its Role

The executive management is one of the main organs of the SGF. It has the vital role of running the business of the IBIs according to the guidelines, policies, instructions and directions. IBIs cannot fulfil the expectations of various stakeholders and shareholders without a well-trained and committed management. According to the arrangement of SGF, the executive management is entrusted with the following responsibilities (State Bank of Pakistan, 2018b):

- The due role of the executive management is to implement the SGF. It must assure that products programmers, procedure manuals, checklists and transactions meet the approvals of the Shariah board. The management must make available all the resolutions of the Shariah board for all the banking staff and make sure that these approvals are clearly understood by them as well as every executive of the management is responsible in participating in training sessions managed by the training department and Shariah compliant department along with their group members to enhance their skills.
- The executive management has been made responsible and accountable to enforce the Shariah boards resolutions within all executive sections and not to compromise strictly on any Shariah non-compliance. The management must prosecute whoever fails in offering his or her responsibilities in this regard and based on their impressive performance they must be rewarded and promoted as well.
- The management is also responsible in providing all the necessary information to the Shariah board, enabling it to produce its Shariah ruling on any product or proposal based on solid information and understanding.
- The Shariah boards resolution is binding on the IBIs but in case of any conflict between the management and Shariah board, the situation must be resolved according to the conflict resolution process introduced by SBP.
- The management of the IBI is also required to arrange Islamic banking and finance training programmes to improve the awareness and ability of the BOD members and all parts of the management about Islamic finance.
- The management has to maintain the environment of IBI with productive functionality, Shariah compliance mechanism and the exclusive characteristics of Islamic banking and finance by creating awareness among all organs of the IBIs.

The SGF has granted an exclusive role to the BOD and the executive management that is why they are ultimately responsible and accountable for the smooth and sound function of all organs of the IBIs. The regulatory authorities also put in place some prosecuting and appreciating methods to stimulate the management for a better and efficient performance. Moreover, SBP in its IBD Circular issued on December 6, 2010, has directed the IBIs on the Shariah compliance report. The Shariah advisor has the responsibility of preparing and submitting the Shariah compliance report to the BOD, so, for the better and convenient preparation of the Shariah compliance report, the BOD, and the management of the IBIs are advised to invite their respected Shariah advisors to the BODs annual meeting to discuss simultaneously the annual audited accounts and the Shariah compliance report ([State Bank of Pakistan, 2010](#)).

Although the SGF has made an interesting arrangement for confining the role of BOD and the executive management in the IBIs, there are some shortcomings that are affecting their function of this arrangement. First of all, it does not provide any guidance on the BODs composition. The framework is silent on what are the suitable and proper criteria for being a member of BOD. The BOD which has been granted the ultimate and decisive role in the IBIs should possess a certain level of Shariah compliant awareness. It cannot just ignore Shariah related matters by putting all the responsibilities on the Shariah boards shoulders. A Shariah literate and knowledgeable BOD along with the skillful and knowledge Shariah advisors can assure a strong and robust Shariah compliant function. That is why, commitment of dedicated, highly qualified and Shariah literate board of directors can effectively oversee the IBI governance system and keep the credibility of IBI safe from any reputational risk. They would prefer to safeguard the Shariah compliant function rather than be influenced by financial and profit motive incentives, so there should be some requirements set by the regulatory bodies at the licensing stage demanding IBIs to demonstrate the sponsors identification and the level of their commitment to Islamic banking ([Akhtar, 2006](#)).

In addition, the management of the IBIs in Pakistan is mostly conventional banking oriented and lacking knowledge of Islamic principles related to commercial and financial transactions; on the other hand, the Shariah advisors are hired based on their pure religious qualifications (Madrasa oriented). They face the challenge to get along with the modern banking environment coming from pure religious institutions. This gap of the two mentalities can bring a serious disruption to the IBIs operations ([Chohan & Chohan, 2012](#)). Both sides should enhance their capabilities prior to starting their professions. For that purpose, the government of Pakistan with the assistance of SBP should establish academic training institutions and practical avenues with the sole task of preparing and producing graduates specially to fulfil the needs and requirements of the Islamic banking and finance industry. This arrangement would bring harmony, credibility and sustenance to the IBIs, to its business and reputation.

Shariah Compliance Inspections by SBPs Supervisory Authorities

The SBP has put in place a strong Shariah compliant mechanism. According to that mechanism, there is a Shariah compliant inspection practice introduced by SBP. The major task of this inspection is to ensure Shariah compliance in the IBIs. Shariah inspection arrangement is made by the SBP to enhance the credibility of the Shariah compliant function within the IBIs. This kind of arrangement is exclusive to Pakistan where SBP as a regulator sets the Shariah compliant inspection process as a regulatory obligation for all Islamic commercial banks (Akhtar, 2006)

To conduct the function of Shariah compliance inspection, SBP has arranged a collaboration of two famous firms. One is a leading international firm Ernst & Young and the second is locally based and internationally acclaimed consultancy firm Ford Rhodes Sidat Hyder & Co. affiliated with the former. Both of them had been given the task to compile the Shariah Inspection Manual, preparing the parameters and procedures for conducting the Shariah compliance inspection process. SBP had carried out the Shariah Audit Inspection of an Islamic bank on test bases in order to get the observations of the auditors and the Shariah Board of the SBP. These observations were taken into account during the formulation of the Shariah compliance inspection process (Akhtar, 2006).

The major function of the Shariah Compliance Inspection is to review the arrangements made by IBIs, their general banking services and operations, financial statements and accounting records. The aim of this inspection is to ensure that all the operations, transactions and practices are being conducted according to the Shariah injunctions to the letter and spirit (Akhtar, 2007c). It is also aimed to ensure that the religious rulings, transactions, fatwe, the terms of Islamic contracts and specifically, the sequence of execution of the different contracts are duly Shariah compliant. SBP has managed to adopt the AAOIFIs accounting standards so the implementation of these standards has been planned to be conducted through this inspection. All IBIs are bound to undergo the Shariah Compliance Inspection (Akhtar, 2006).

Hence, the Shariah Compliance Inspection is an admirable arrangement in caring out an effective auditing practice but in the presence of Shariah compliant mechanism of SBP for approving the product development process, the Shariah Compliance Inspection may cause delay in the operation. If SBP enhances the function of its SAC by adding more knowledgeable and experienced experts from different and relevant fields, the Shariah compliant mechanism would become more effective and sounder. In that case there will be no need to create more institutional arrangements or the SBPs involvement in this process and bound all the IBIs to conduct an external audit from any independent bodies recognized by SBP so the IBIs progress more in a liberty environment.

Shariah Advisory Board in Securities and Exchange Commission of Pakistan

The Islamic Capital market, Takaful services and other financial services provided in Pakistan are regulated and supervised by the SECP. The Islamic modes of finance, capital market and Takaful operations are supervised by the Shariah advisory board of the SECP.

The Shariah Advisory Board of the SECP was established by the government on 8th March under Section 9 of the Security and Exchange Commission of Pakistan Act 1997 (XLII of 1997). The Board which comprises nine members is headed by an insurance Commissioner to oversee the efficiency of the Board. The Board consists of a Chairman along with eight other members from different backgrounds such as Shariah scholars and legal, accountancy and financial experts added with two members as Joint Director and Director to represent the SECP in the Board. The secretary to the Commission has been appointed to act as the secretary to the SAB as well (Securities & Exchange Commission of Pakistan, 2013).

According to a Religious Board, constituted by the government, is responsible for approving the prospectus of each Modaraba containing the types of business to be conducted, management, etc. While the Religious Board has a significant role, there is no requirement for Modarabas or their management companies to appoint Shariah advisers at the individual fund level. Islamic mutual funds and Takaful operators, on the other hand, are required to appoint Shariah Council/Boards but no explicit fit and proper criteria have been laid down by SECP in this regard. SECP is also authorized to appoint a Central Shariah Board under the Takaful Rules, 2005, which has not been established yet (Akhtar, 2007a).

The SAB of the SECP has been granted with the authority to be the reference body and the advisory to the SECP regarding Shariah matters. Apart from that, the SAB of the SECP has to perform the duties for the Shariah interpretations, clarifications, promotion and development of the Islamic financial transactions of the IFIs such as Islamic Mutual Funds, Islamic Pension Funds, Takaful Operators and other IFIs that come under the SECPs regulatory and supervisory jurisdiction. The specific key functions of the SAB of the SECP are to approve the products of IFIs and

their Shariah conformity, to recommend permissible parameters for the Islamic capital markets operations as well as to provide guidance on the standards used for the reporting and the auditing and to bring innovation and harmonization in the financial products and services of the IFIs.

Even though, the SAB of the SECP has its specific role to perform and the IFIs and their operation fall under its supervisory scope, an issue arises which results in overlapping of the supervisory and regulatory system. Akhtar (2007c) has clarified this issue with an example whereby the BCO allows banks to operate as Mudaraba management companies for flotation of Mudaraba whereas the terms Mudaraba Companies Ordinance states that Mudaraba can be formulated to direct any form of Shariah compliant business e.g. trading, manufacturing, airline, financing, leasing, services and so on but these are regulated by SECP. Because of the overlapping regulatory jurisdictions, the banks have to float their Mudaraba through their separate subsidiaries which causes higher administrative, regulatory and set up costs. For years, these Mudaraba used to be under the SBPs regulatory jurisdiction but the authority regarding the licensing and winding up are taken by SECP so the regulatory and supervisory authorities have also been shifted to SECP. She suggests that this issue needs to be resolved by formulating cross sector regulatory arrangements of IFIs (Akhtar, 2007a). According to the recent governance arrangement made by the authorities, a collaboration of SBP, the Institute of Chartered Accountants of Pakistan and the SECP has been formed to manage the introduction adoption and regulatory process of the standards of the Islamic financial institutions in Pakistan which is a pleasant hope for the future development of this particular sector (State Bank of Pakistan, 2014b). Other than the above mentioned Shariah supervisions, there are other institutions in Pakistan which keep a close eye on the laws, regulations and legislations regarding the Islamic banking and financial operations in the country. These institutions are the Council of Islamic Ideology and the Federal Shariah Court of Pakistan. The role which is played by the Council of Islamic Ideology is considered as advisory and supervisory and their recommendations are not binding. On the other hand, the role of the Federal Shariah Court of Pakistan is more to settle the issues and cases related to any Shariah and religious matters. The authority of the Federal Shariat Court is far decisive and binding, but the parties have given the right to appeal in the Shariah Appellate Bench of the Supreme Court of Pakistan. Therefore, the above mentioned institutions and their functions do not directly affect the Shariah governance arrangement in Pakistan, but their involvement is seemed to be more cause affective when there is any matter that relates to their jurisdiction. Thus, it is very obvious from the above mentioned discussion that Islamic banking industry is majorly supervised and regulated by the SBP which directs the IBIs and their operations through its IBD and with the help of its Shariah Board, the Shariah governance function is performed. The functions and its scope of responsibilities have been discussed in the subsequent chapter respectively.

CONCLUSION

The current Shari'ah governance implemented by the SBP provides a good arrangement for the IBIs. The Shari'ah composition process has been specifically explained which encompasses the overall mechanism of Shariah compliance such as appointment of the Shari'ah board members and the criteria for their selections. It confines all the key organs of the IBI and their respected roles. It also demonstrates the Shariah governance mechanism set by the SBP, according to which, the Central SAC has the role to control and monitor the overall country's Islamic banking industry and its operations. The function of Shariah board has been introduced in all IBIs to support the Central SAC and act to safeguard the Shariah compliance function and represent the central SAC role in the IBIs. The arrangement of the SGF has also highlighted the due roles of the BOD and the executive management which are considered the key players of the game.

Despite all this tremendous arrangement provided by the new SGF, there are still issues within this structure of arrangement which questions the future of the Islamic banking industry in Pakistan. The composition of the SAC of the SBP itself needs further enhancement whereas the composition of the Shari'ah board in IBIs also requires many reforms which can strengthen their role and abilities for a sound Shari'ah compliance function. The BOD and the management are considered highly responsible and accountable for the smooth and sound operation of IBIs not only to enhance the profitability but to consider the credibility of the IBIs as well. This objective can be achieved if a dedicated and determined BOD and management be part of the governance structure of the IBIs which run the institutions according to Shariah rules and principles and save the industry from all kinds of risks which adhere to the business of Islamic banking.

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