

Scholastic congestion

The rapid growth of Islamic banking has strained the very heart of the system—the Shariah scholar. **Majid Dawood**, himself a Shariah scholar, discusses the issues affecting compliance in the long term

ISLAMIC BANKING AND FINANCE IS IN A revival, driven by a demand from Muslims for a faith-based alternative to conventional banking services, whose very *raison d'être* is *riba*, expressly proscribed in Islam.

Initially, conventional products were “Islamicised”, but there remains a shortage of Shariah-compliant financial products and suppliers. A core element of Islamic finance is Shariah-compliance certification—relating to

both the product structure and the ongoing review of its implementation and utilisation.

A major bottleneck in the Islamic banking and finance industry is the limited number of Shariah scholars conversant with international banking and finance, and are articulate in English.

Shariah scholars educated in the West and in disciplines such as economics have emerged as the prominent experts in Shariah compliance relating to *Fiqh al-Muamalat*.



More scholars are emerging due to the growth of the sector and increased demand for Shariah advisories.

The Islamic banking and finance sector is playing catch-up with the conventional sector. The development of products in conventional banking has led to a demand for the development of equivalent Shariah-compliant products. This in turn has spurred the scholars to facilitate the development of new generic Shariah-compliant products. As the impetus grows, so will the product range.

The growth of Islamic finance is now driving demand for Shariah-compliant “exotics”. Recently, sukuks and hedge-fund alternatives appeared on the market. The pace of product innovation is developing fast because the conventional financial institutions are entering the Islamic market. This growth is not as fast or as excessive as the dot com boom, but it is driven by a core bedrock of clientele and funds looking for a home over the longer term, and to be managed under Shariah precepts.

Greater demand for Islamic financial products in Muslim countries and the development of the sector in tandem with the conventional sector is encouraging growth in products and asset classes.

Most Islamic financial institutions outsourced the management of their Islamic funds to western fund managers. Now, the development approach is different. Islamic financial institutions are launching and managing their own products, and the conventional banking majors are launching their own Shariah-compliant products, primarily through dedicated Islamic banking windows or units. This has inevitably increased the demand for the services of Shariah scholars.

Criteria

The criteria for compliance is laid down by the Shariah supervisory board (SSB) appointed by the Islamic financial institution or other institutions offering Shariah-compliant products and services. Shariah compliance is reviewed regularly, either quarterly, bi-annually or annually, as required by the individual institutions.

As the market matures, the demand for the more ambitious and leading-edge products will increase. This innovative approach by institutions to differentiate their products requires Shariah scholars to spend more time researching the literature relating to *Fiqh al-*

Bottleneck To keep pace with the demands of the marketplace, Shariah scholars are spending more time researching the literature relating to *Fiqh al-Muamalat*

Muamalat so as to determine whether compliance is possible. The institutions first approach the international law firms, and after the substantial development of the product and documentation, the Shariah input is sought. This generally leads to substantial revision of the product and documentation.

If the scholars were engaged at the same time as the lawyers, the two could work together to arrive at a viable solution, saving both time and money. Institutions are not fully aware of the time constraints their requirements place on the scholars, whose decisions are based on knowledge, research and consultation. If the interaction between scholars and financial institutions is not timely, the required outcome may be delayed, creating unnecessary and avoidable obstacles.

The scholars appointed to the Shariah supervisory board instil confidence in the investors because of their reputation. Their reputation—based on a sound knowledge of Shariah, the Hadith, Sunnah and Fiqh al-Muamalat, and reliability of advisory service—are an excellent marketing tool.

Recommendations

Besides the Shariah compliance considerations, financial products must all satisfy local legal requirements and market acceptability if they are to be well received. Some products may be successful in one market, while in another the uptake may be slow. As such, it is imperative to develop products universally acceptable in the Islamic markets.

Many conventional bankers are under the notion that Shariah compliance merely involves scholars looking at removing only basic unacceptable terms from the structures and documentation. On the contrary, scholars have to consider the whole package—from the structure, to the documentation, marketing materials, press releases, application forms, and so on—to ensure that it is Shariah-compliant.

Equity funds raise specific Shariah compliance issues. Apart from the financial ratios and the screens of prohibited activities, there is an urgent need to have common criteria relating to stock universe selection and dividend purification. Considerable time and effort, backed by intellectual property, is made available to clients. When the more exotic financial products are being considered, much more research is required to determine whether the structures can be made Shariah-compliant.

Innovative means of addressing the myriad of financial products being considered is keeping the Shariah scholars busy and creative. These are exciting times, indeed.

The current generation of scholars advising Islamic financial institutions are naturally experts in Fiqh al-Muamalat. They have studied either under Shariah experts or at universities in the Muslim countries, or at Western universities with specialist Islamic law departments. One of the crucial elements of this expertise is knowledge of classical Arabic, the language of the original texts relating to Fiqh al-Muamalat. Those scholars with additional qualifications in economics and finance, or with an understanding of financial systems and banking, are obviously at an advantage. These scholars have gained invaluable experience by working on Shariah supervisory boards of financial institutions and through interaction with lawyers.

A development in Shariah compliance over the past two years is the establishment of Islamic legal compliance firms, similar to international law firms. These firms have eminent Shariah scholars specialising in Fiqh al-Muamalat as partners. One of the first such firms to be incorporated is Yasaar Ltd in the UK through the initiative of Sheikh Dr MA Zaki Badawi of the Muslim College in London, and Sheikh Dr MA Elgari of the King Abdul Aziz University in Jeddah, Saudi Arabia—both prominent and experienced Islamic scholars.

They were later joined by Sheikh Yusuf DeLorenzo of the USA, and Dr. Mohd Daud Bakar, vice chancellor of the International Islamic University of Malaysia, based in Kuala Lumpur. Since then several other Shariah-compliance firms have been established in Malaysia, Dubai, Bahrain, Kuwait and Pakistan.

Some of the challenges faced by the Shariah scholars and the Islamic banking and finance sector arise from there being four schools of Islamic law. Scholars sometimes differ in their interpretations of some aspects of Fiqh al-Muamalat; these interpretations are accepted by some Muslim countries and rejected by others.

Organisations have been established to develop a common code of practice and to make recommendations. The International Islamic Financial Market in Bahrain, for instance, endorses Shariah compliance for all Islamic capital markets products. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), also based in Bahrain, was similarly set up to develop and issue uniform accounting standards for Islamic financial institutions, and

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later to standardise Shariah opinions for the more common Islamic contracts.

The Islamic Financial Services Board (IFSB) was set up in Kuala Lumpur, Malaysia in November 2002 under the aegis of the Islamic Development Bank, AAOIFI, and regulatory authorities from Muslim countries. The mandate of the IFSB is to set the prudential and supervisory standards for the global Islamic banking sector. The Bahrain-based Liquidity Management Centre is facilitating the development of a secondary market for Islamic securities by lead-arranging sukuks, which are rated, listed and open to trading.

Documentation

Many law firms and financial institutions crave standard universally acceptable documentation for Islamic contracts. Law firms and Shariah scholars under the guidance and support of the regulatory authorities are trying to establish common structures, legal agreements and documentation for some of the tried and tested contracts. With minor changes, these contracts can be adapted for a particular jurisdiction.

There is a definite need to train Shariah scholars for the future. Scholars studying for a career as Shariah-compliance advisors should be given the opportunity to work with the experienced scholars. This form of apprenticeship honours the status quo while being a building block for the future.

Shariah compliance is an important growth area within the global Islamic finance industry. The establishment of companies offering Shariah-compliance advisory services over the past three years underlines this growth. These companies will inevitably streamline themselves into Islamic legal compliance firms and will ultimately be beneficial to the development of the sector in the long-term. ■

Majid Dawood is CEO of Yasaar Ltd, 1 Liverpool Street, London EC2M 7QD. Tel: +44 (0)20-7956-2014; fax: +44 (0)20-7956-2001; mobile: +44 (0)7747-004411.