

# Shari`ah Supervision in Modern Islamic Finance

by Yusuf Talal DeLorenzo

**S**hari`ah supervision may be thought of as the single most important distinction between a conventional and a truly Islamic financial venture. For, while a business may attempt to represent itself as “Islamic,” unless it has qualified Shari`ah supervision, it has no way of certifying that its services, products, and operations are actually Shari`ah-compliant. In the emerging Islamic financial sector, therefore, Shari`ah supervision is not a matter to be taken lightly. Public confidence, in any sector, is always an important consideration; and in the financial sector its importance is paramount. Shari`ah supervision signifies a real commitment on the part of management to the principles of transparency and accountability in the matter of Shari`ah compliance.

## ***What is Shari`ah Supervision?***

While it may be convenient to explain Shari`ah supervision as a religious audit (especially to Western observers and regulators), its scope is far more comprehensive. In essence, Shari`ah supervision is the process of ensuring that a financial product or service complies with Islamic legal precepts and principles, either by its conforming (to one degree or another) to a recognized Islamic legal norm or by its not violating the same. Ideally, Shari`ah

supervision will be a part of an Islamic product or service from the time of its development, to its launch, and throughout the period it is offered. At the stage of research and development, or of drafting contracts or offering memorandums, Shari`ah supervision, in one form or another, should be an active participant. By including Shari`ah supervision and advice at the earliest stages, management may save costly legal fees that may be required at a later stage if elements of the proposed business/contracts need to be modified to comply with Shari`ah principles and precepts. Generally speaking, if Shari`ah supervisors are to certify a venture, they will insist on being a part of its development; or at least to having access to the details of whatever went into the development or structuring of the product, instrument, service, or enterprise. Moreover, once a product is launched, Shari`ah supervision may take the form of ongoing monitoring through periodic audits. Such audits may be undertaken by means of site visits, document reviews, or consultation with management at regular intervals.

## ***Purpose***

The most obvious and immediate purpose of Shari`ah supervision is to certify for practicing Muslim consumers and clients that the financial product or service being offered to them is acceptable from an

Islamic legal perspective and is therefore lawful to them.<sup>1</sup> Such certification, generally documented in a formal fatwa (Shari`ah position paper), may be thought of as a form of due diligence. In effect, the Shari`ah supervisor, or supervisory board, performs this due diligence on behalf of consumers who are without access to the details of what is offered to them and, likewise, without the experience or qualifications to evaluate those details in light of Shari`ah teachings. By assuming responsibility for the Shari`ah compliance of an Islamic financial institution, including its policies and practices, Shari`ah supervision places itself in a position of directly representing the religious interests of the Muslim investor or consumer; and by making every possible effort to ensure that an Islamic financial product is halal, the services performed by Shari`ah supervisors are directed toward the investor, or the consumer. Undoubtedly, as a result of these efforts, Islamic financial institutions and their management will also benefit. But certainly the primary beneficiary is the Muslim consumer who can rest assured that his/her money is being put to use in ways that accord with the teachings of Islam. It is for this reason that Shari`ah supervision may also be characterized as consumer advocacy.

### **Background**

Since many if not most of the dealings or operations of Islamic banks may be considered novel, in the sense that these were unknown in the times of the classical jurists, there is a very real need for reliable opinions on these dealings; legal and academic opinions derived from authentic Shari`ah sources by the means and methodologies established by generations of Muslim jurists. Then, while it may indeed be possible for an individual to come up with authoritative opinions on these issues, it soon became clear to the newly established Islamic banks that it would be better to have the collective opinions of a group of scholars. Moreover, the banks soon learned that it was best to appoint scholars with specializations in the field of fiqh al mu`amalat, and who also had working knowledge of modern financial markets and practices. Then, by means of qualified Shari`ah supervision, Islamic banks may assure their clients and investors that the operations they undertake are reviewed in all of their details for compliance with the principles and precepts of the Shari`ah. By means of such a review, by such a group of experts, the banks and financial institutions may clearly demonstrate that their transactions and dealings conform to Islamic legal norms.

### **Elements of Shari`ah**

#### **Supervision:**

#### **Numbers**

Shari`ah supervision may be performed by an individual supervisor/advisor, or by a board of supervisors/advisors, commonly known as a Shari`ah Supervisory Board.<sup>2</sup> Whether an institution has a board or a single supervisor is its own choice. Generally speaking, however, such a choice is informed by several considerations.

Chief among these considerations is the product or operation itself. An Islamic home financing alternative, for example, is a complex affair and will undoubtedly benefit from the collective opinions of a diversified Shari`ah Board. The same will be true of a commercial or investment banking operation. An Islamic mutual fund, on the other hand, may require a single supervisor, especially if it has licensed itself to an index provider like the Dow Jones Islamic Market Indexes, and is set up to do no more than track the index. An actively managed fund, however, even if it is licensed to an index, may require more than one supervisor. These are considerations that have to do with the nature and requirements of the supervision itself. At the same time, marketing considerations may also be of importance to management. If a product or service is to be marketed internationally, for example, or in a market in which Muslims from different parts of the world are found (like the US and UK), then it may be in the interest of management to engage several scholars, each from a different part of the Muslim world. Whatever the case, prudence dictates that there be at least three supervisors for any Islamic financial undertaking. Moreover, experience has shown that at least one of the members needs to reside in the same country or region as the operation, so as to be readily available for consultation, even on short notice. In some cases, too, a Shari`ah supervisor will maintain an office and keep regular hours at the bank or financial institution.

#### **Elements of Shari`ah**

#### **Supervision:**

#### **Qualifications**

Obviously, a Shari`ah supervisor will be someone with a background in the classical Shari`ah sciences. In particular, however, supervisors need to have studied the fiqh al mu`amalat or rules concerning transactions developed by the classical jurists and expanded upon by later generations of Shari`ah scholars. Most Shari`ah supervisors have produced academic work or studies on one aspect or another of these rules. In addition, such a background presupposes facility in the classical Arabic language and the ability to deal directly with legal texts, glosses, and commentaries in that language. In addition to all this, an understanding of modern finance, markets, and economics is also clearly required. Finally, an effective Shari`ah supervisor must be familiar with international business practices (urf) and have an appreciation for regulatory environments. For these reasons, the English language is especially important. One more point that should be kept in mind is the supervisor's ability to work with a team, oftentimes in a cross-disciplinary and cross-cultural environment. Generally speaking, today's Shari`ah supervisors possess the qualifications and characteristics discussed above. In addition, many Shari`ah supervisors have benefited from the exposure afforded by multiple board membership. Then, while at the present time there are no standard qualifications for Shari`ah supervisors, it is to be hoped that, in the future, and as the Islamic financial sector grows, graduate level programs will be developed for the specific purpose of preparing new generations of scholars with all of the requisite skills. At present, however, the number of people

qualified to serve as Shari`ah supervisors is limited. My own suggestion in regard to preparing scholars for a future in Shari`ah supervision is twofold.<sup>3</sup> Firstly, Islamic financial operations may appoint, in addition to its full Shari`ah Board members, junior members who will participate in discussions, prepare memos and briefs, take notes, and perform research and other tasks for the Shari`ah Board, but who will not have full status as voting Shari`ah Board members. Secondly, junior members may be appointed on a rotating basis, such that each will serve, much like a law clerk for a serving judge in the United States, for a period of one year. By means of this rotating arrangement, many scholars will have an opportunity to learn first hand about the workings of Shari`ah supervision. Moreover, as junior members become increasingly more familiar with modern business norms and practices, it will become easier for them to analyze situations and think through options, with the result that their contributions to the work of the Shari`ah Supervisory Boards will become increasingly valuable. Obviously, such junior members will be compensated for their efforts, though not at the same level as the full board members.

***Elements of Shari`ah Supervision:***

***Independence***

In order to be effective, Shari`ah supervision must be independent. In addition, the decisions of the supervisor/s must be binding on management. If these steps are not taken, the credibility of the supervision, and the company, will be in question. The recommendation of AAOIFI is that Shari`ah supervision must serve

at the pleasure of the company's Board of Directors, and not be subject to management. Under such an arrangement, the Board will be free to approve or disapprove of what management does, or proposes to do, solely on the basis of Shari`ah/legal considerations. Of course, this is not to say that a Shari`ah Board will automatically become a thorn in the side of management. On the contrary, most Shari`ah Boards operate in the spirit of cooperation and accommodation.

***Elements of Shari`ah Supervision: Communication***

An essential element in the success of any undertaking is communication. This is equally true in regard to Shari`ah supervision. To begin with, there must be clearly delineated lines of communication between management and Shari`ah supervision. Oftentimes, an Islamic financial institution will appoint one of its executives, whether from business operations, finance, or legal, to act as liaison with the supervision. This person will be responsible for coordinating and documenting regular meetings, arranging for the requirements of Shari`ah supervision, following up on decisions and suggestions, and processing and channeling communications to and from supervision. When board members live on different continents and work in different time zones, the work of such a coordinator can be challenging.

***Elements of Shari`ah Supervision: Education***

The correlate of consumer advocacy is consumer education. In making this observation I mean to refer to the world of

possibilities for enhancing Muslim consumer awareness of, and appreciation for, Islamic financial services and products. For example, the Dow Jones Market Indexes developed and supported a course on the Principles of Islamic Investing that was offered to students of the Dow Jones University on the internet. Unfortunately, the course is no longer available, though efforts are underway for its revival at another venue. Likewise, several Islamic financial institutions supported the effort to produce the *Guide to Islamic Investing* in cooperation with the Lightbulb Press; and others are supporting the *Guide to Islamic Home Acquisition*. In short, every institution offering Islamic financial services needs to concern itself, to one degree or another, with issues of consumer education. Obviously, the chief concern will be to provide information about their own products. But, generally speaking, Muslim consumers need to know that Islamic financial alternatives exist. They need to know that these alternatives are viable, from both a religious viewpoint and a practical one. And they need to know that these are competitive and worthy of their trust. These are the basics of such an education. Obviously, there is much more that can be done. In a service-oriented market that is driven by competition, the firms with the better services will have the most success. Shari`ah supervision that engages in consumer education enhances service, not to mention consumer confidence.

***Shari`ah Supervision Then and Now***

As the sector goes, so goes its Shari`ah supervision. Perhaps

nothing could be more obvious. In the days when Islamic banking was in its infancy, Shari`ah supervision, too, was feeling its way. With little or no exposure to modern finance, Shari`ah supervisors faced a very steep learning curve. To begin with, in the fifties and sixties, there was very little in terms of literature on the subject. The State Banks of a handful of Muslim countries sponsored conferences on "Islamic Economics" and Shari`ah scholars were invited to contribute. These early papers and presentations led to more concerted efforts and scholarship. With the advent of Islamic banking in the seventies, and a real demand for Shari`ah supervision, there was more incentive for such academic efforts. Indeed, the development of the sector, and the development of the various sets of expertise required to give it momentum went hand in hand. Today, after the passing of over thirty years since the first Islamic banks opened their doors for business, Shari`ah supervision continues to improve and evolve. Globally, a number of different efforts to increase our understanding of Islamic finance are underway. Universities offer courses on various subjects in Islamic Finance today, not only Economics; and several important graduate dissertations have been published in English and Arabic. Journals on the subject of Islamic finance are published regularly. Websites devoted to the subject are available on the internet. Learned academic bodies like the OIC Fiqh Academy in Jeddah, AAOIFI in Bahrain, the IIBI in London, the IIT in Cairo, and the Fiqh Academy in India have produced volumes of literature on the subject; and everywhere scholars are at work. Recently, at a conference on Islamic Finance in Dubai, a

welcome step was taken to promote the efforts of individual scholars. This was the "New Voices" competition, sponsored by the US-based Guidance Financial Group, in which scholars were invited to submit their original work to a jury of experts; and the best paper was awarded a substantial dollar prize. My own experience has led me to a view of the future of Shari`ah supervision that includes increasingly informed discourse by enlightened Shari`ah scholarship. It may be difficult to achieve consensus on every issue, but the important thing is that our Shari`ah scholars are now able to speak with authority on these issues. Moreover, cross-disciplinary collaboration on projects in which there is active participation by lawyers, Shari`ah scholars, and business professionals will bring more innovation to the industry and further enrich the emerging academic discourse. Innovation and creative thinking have always been a part of development; and it is clear that the Islamic financial industry is developing in ways, and on a scale, that were unimaginable only a few decades ago.

and Auditing Organization of Islamic Financial Institutions (AAOIFI) in Bahrain held that it was sufficient to call such a body a "Shariah Board." In order to be more readily understandable to regulators in Muslim-minority countries, such as the US and Europe, there is nothing wrong in using another name, like Ethical Advisory Board.  
<sup>3</sup> I am pleased to report that one of these suggestions has been implemented by one of the groups with which I work; and that the other will be implemented in the coming year by another.

---

**Footnotes**

- <sup>1</sup> The operative religious/legal principle in this matter is one regarding collective and individual responsibility. In cases where expertise is required for the good of the community, such as expertise in medical, or political, or military affairs, the principle is that as long as the community produces individuals capable of dealing with such matters, the community will have performed its duty, or fard kifayah.  
<sup>2</sup> The First Annual Conference on Shari`ah Supervision held last year by the Accounting