Corporate Governance in the Islamic Banking System in Pakistan: The Role of the *Shari'ah* Supervisory Boards

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ABSTRACT:

Since it was launched commercially in the 1970‘s, Islamic finance has grown at a rapid rate. Today Islamic banks are operating in nearly all Muslim countries and many non-Muslim countries. To ensure that Islamic financial institutions comply with the religious requirements, banks are required to utilise the services of a *Shari’ah* Supervisory Board (SSB). These SSBs consist of a number of *Shari’ah* (Islamic law) scholars who conduct internal religious audit in Islamic financial institutions and are required to approve the *Shari’ah* compliance of new financial products before they are launched commercially. This study addresses the issues of accountability and governance in Islamic financial institutions in Pakistan, and investigates the roles and responsibilities of the SSBs and *Shari’ah* advisors. For the purpose of this study, the field-based case study method was applied and primary data was collected using semi-structured face-to-face interviews that were conducted over a period of five years with individuals from the Pakistani banking sector. Additional information was sourced from historical documents, State Bank of Pakistan directives and relevant court cases that involved the Pakistani Islamic Banking sector.

Thematic analysis of the data reveals that there is a worldwide shortage of competent *Shari’ah* advisors in the Islamic finance sector. The training of new *Shari’ah* advisors in Pakistan is affected by the lack of educational infrastructure and the lengthy time period required for training in Islamic jurisprudence. This has resulted in banks hiring individuals as *Shari’ah* scholars who are members of SSBs in more than one banking institution, thereby raising concerns about conflict of interest. The findings also detail the process by which SSBs and *Shari’ah* advisors ensure that Islamic financial institutions are accountable for their *Shari’ah* operations. The SSBs are required to verify that the operations of the banks are in conformity with religious law, and to impose the suggested penalties in case of non-compliance. Finally, in comparison with existing national *Shari’ah* governance models in the Middle East and South-East Asia, the study evaluates the new *Shari’ah* governance and application model for Islamic financial institutions that has been enforced by the State Bank of Pakistan. This model is seen as the first step towards the implementation in Pakistan of the *Shari’ah* governance requirements put forth by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), the global regulatory body for Islamic financial institutions.

DECLARATION:

This work contains no material that has been accepted for the award of any other degree or diploma in any university or other tertiary institution to Hussain Gulzar Rammal and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made in the text.

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CHAPTER 1

INTRODUCTION

This chapter provides an introduction to this study on the role of the *Shari'ah*[1] Supervisory Boards in the Islamic financing industry in Pakistan. The chapter begins with a brief background on Islamic financing and the importance of *Shari'ah* supervision in Islamic financial institutions[2]. It then describes the primary and secondary research questions, followed by a brief introduction to the methodology employed for this study. The chapter concludes with an overview of the structure the thesis.

1.1 THE ISLAMIC BANKING ENVIRONMENT

The interest-free Islamic financing system has established itself as a legitimate alternative to the conventional interest-based financing system. Islamic financing operates on the *Shari'ah* principle that prohibits *riba* (the use of interest) in financial transactions. Although the idea of Islamic finance is over 1400 years old, the commercialisation of the system only began in the 1950s (Gafoor 1996). Since then Islamic banking and finance has grown at a rapid pace and today Islamic financial products are available in both Muslim and non-Muslim countries. The assets of the Islamic finance sector are expected to reach the US$1 trillion mark by 2010 (Cihák and Hesse 2008). While Islam prohibits interest, it allows trade and earning of profit. The Islamic financial institutions have worked within this limitation and have introduced different financial products that fulfil the *Shari'ah* requirements and provide an alternative to the products offered by the conventional banks. These financial products include profit-and-

[1] *Shari'ah* refers to Islamic law. In Islamic States, *Shari'ah* governs both public and private lives of those living within the state. Please refer to Appendix 1 for the English translation of Arabic and Urdu words used in this study.

[2] For the purpose of this study ‗Islamic financial institutions' refers to banks (both conventional banks and pure Islamic banks) that offer Islamic financing products to customers.

loss sharing agreement, mark-up based financial products, and other non-interest bearing products (Choudhury and Harahap 2008).

Islamic financial institutions are guided by a control body known as the *Shari'ah* Supervisory Board (SSB), which consists of a number of *Shari'ah* advisors (Ghayad 2008). The purpose of the SSB is to ensure that Islamic financial institutions operate in conformity with *Shari'ah* and provide clarification in regards to any *Shari'ah* related questions that the financial institutions may have. The members of the SSBs are hired by Islamic financial institutions and act as an internal control body, therefore, enhancing the credibility of the financial institutions in the eyes of its customers, and bolstering its Islamic credentials. The role of the SSB is thus seen as being similar to that of company auditors (Karim 1990). Even though the Islamic financial institution compensates them, the SSB members are expected to retain their independence. In similar manner to auditors of traditional financial statements, SSBs certify at the end of the year whether the Islamic financial institutions operations were in conformity with *Shari'ah*. This task involves reviewing products and policies of the Islamic financial institution, and deciding on whether a new financial instrument introduced by the organisation is religiously acceptable (Warde 1998). The *Shari'ah* advisors therefore play a crucial role in ensuring that the Islamic credentials of the financing system remain intact and the Islamic financial institutions do not breach any *Shari'ah* laws.

While at first sight, the role of the SSB appears to be similar to an internal control body, the practice in Islamic financial institutions seems to vary. Theoretically if the SSB refuses to endorse a product, the financial institution should automatically remove that product from their portfolio. Also in theory, the SSB would perform a religious audit of all bank accounts

(Usmani 1998). The reality however is more complicated. Surveys conducted by researchers in Islamic financial institutions have revealed that in many cases the review is treated as a routine matter, with boards approving decisions already made by the bank‘s management (Warde 2000). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has tried to regulate the role of the *Shari'ah* advisors by setting standards for appointment and composition of SSBs. According to the standards, the authority to appoint SSB members should be vested in the annual general meeting of all shareholders of the Islamic financial institution. The justification for such action is that SSBs members will be free from any undue pressure from the management board if the latter does not have the power to appoint or dismiss them. The AAOIFI standards also specify the presence of at least three *Shari'ah* advisors as the minimum number required in a SSB (AAOIFI 1997; Bakar 2002). However the AAOIFI regulatory framework and guidelines are yet to be applied by all Islamic financial institutions worldwide and therefore variations in *Shari'ah* governance still exist.

Critics of the Islamic financial system point to the lack of consistency in the application and interpretation of *Shari'ah* in Islamic financial institutions (Abbas 2008; Karim 1990). Since the financial institutions employ their own *Shari'ah* advisors, there are fears that the SSB may approve products and transactions that may not fully comply with *Shari'ah* requirements. This has resulted in differences within the Islamic financing industry and among religious jurists in various Muslim countries in relation to which financial products are truly Islamic. Another difficulty faced by the Islamic financing industry relates to the lack of qualified and experienced *Shari'ah* advisors (Abbas 2008). The infancy of the industry and the rapid growth experienced by Islamic financial institutions has resulted in a shortage of

qualified *Shari'ah* jurists with a sound understanding of prudential requirements. To cover for this shortage, Islamic financial institutions are forced to employ *Shari'ah* advisors who are also providing services to other financial institutions. This practice has raised questions about transparency and conflict of interest as the *Shari'ah* advisors are employed by multiple organisations.

These concerns about *Shari'ah* governance and transparency are further exacerbated by the fact that extant literature on Islamic financing focuses on Islamic financial products and consumer behaviour. The governance of *Shari'ah* principles in Islamic financial institutions has remained largely unexplored by the research community and has resulted in a lack of information about the actual practice of *Shari'ah* application and monitoring in Islamic financial institutions. Also, due to the lack of consistency in the industry standards for *Shari'ah* supervision, Islamic financial institutions have traditionally been secretive about their *Shari'ah* practices due to fears of criticism from competitors and the wider religious bodies.

Further research in this area would help researchers and practitioners gain a better understanding of the functioning of SSBs. This study aims to address this gap by exploring the roles and responsibilities of SSBs and *Shari'ah* advisors in Islamic financial institutions. Using Pakistan as a case study, the study identifies the relationships between the SSB and the management of Islamic financial institutions, the role of the central bank and regulatory bodies in the application and governance of *Shari'ah* principles, the process of approval and audit of *Shari'ah* compliant financial transactions, and the selection and training of *Shari'ah* advisors. The next section discusses the research questions that this study aims to address.

1.2 RESEARCH QUESTIONS

The corporate and financial crises during the last two decades have brought corporate governance and accountability into the research spotlight. The collapse of corporations such as Enron and WorldCom and the Global Financial Crisis have all at least to some degree been attributed to the lack of accountability and transparency in the operations of corporate and financial institutions (Denis 2001; Falk 2008). Being a part of the global economy means that Islamic financial institutions are not immune to these governance issues and will be required to apply industry best practices and regulations such as the Basel II agreement. As discussed earlier, the focus on governance and control structures in Islamic financial institutions is a relatively recent phenomenon and remains largely unexplored by accounting, finance and management researchers. This lack of research has arguably contributed to inconsistencies in how the rules of *Shari'ah* can be applied and governed in Islamic financial institutions and has left the industry without any best practices for *Shari'ah* governance that could be used as benchmarks. This study addresses these inconsistencies in *Shari'ah* application in Islamic financial institutions in Pakistan and makes practical recommendations for improving the *Shari'ah* governance standards in Islamic financial institutions.

The Pakistani Islamic financing industry has been selected as the focus for this study for a number of reasons. Pakistan was the first nation in the world to declare itself an Islamic Republic and was the host of the Organization of Islamic Countries Conference in 1974 in Lahore. It was at this conference that the establishment of the Islamic Development Bank and commercialisation of Islamic financing was given a formal framework (Warde 2000). Seen as a pioneer in Islamic financing, Pakistan was the first country to attempt to convert its entire

financial system from conventional to Islamic financing. Pakistan officially launched the Islamic banking system in 1979. The initial approach taken was to gradually introduce Islamic finance on a dual-system approach where both conventional and Islamic financial products would be available. This was ultimately to be phased out by 1984, thus making Pakistan the first country in the world that would follow a pure Islamic financial system (Khan and Bhatti 2006). However due to uncertainty in the banking sector and repayment of interest on foreign loans, Pakistan could not completely eliminate interest from the economy and unofficially continued a dual banking system.

In 2002 the Supreme Court of Pakistan declared that Pakistan would follow a dual-financing system similar to the one implemented in Malaysia (Khan and Bhatti 2006). Islamic financing products are offered by Islamic banks (banks that only offer Islamic financial products) and Islamic windows (conventional banks that offer Islamic financial products through a dedicated Islamic financing branch). At present, the State Bank of Pakistan (the country‘s central bank) promotes Islamic banking through their Islamic Banking Department (IBD) and has issued a number of licences for the establishment of new Islamic banks (State Bank of Pakistan 2009). Thus, due to the pioneer status in the Islamic financing industry and the role of Islam in the business activities and daily lives of the people, Pakistan serves as an ideal case study to help identify the roles and responsibilities of SSBs and *Shari'ah* advisors.

Therefore the primary research question for this study is:

Primary Research Question:

What are the roles and responsibilities of Shari'ah Supervisory Boards and Shari'ah advisors in the operations of Islamic financial institutions in Pakistan?

As discussed earlier, the Islamic financing industry faces a number of challenges such as a shortage of qualified *Shari'ah* advisors and inconsistencies in the application of *Shari'ah* regulations in financial transactions. These inconsistencies have resulted in the introduction of new financial products which are considered Islamic in name but are criticised for being interest bearing products. It has been contended in the Islamic financing industry that the lack of educational infrastructure required to train the *Shari'ah* advisors is in part a contributing factor to this problem, and has forced Islamic financial institutions and central banks to lower the educational qualifications required for individuals to perform their duties as *Shari'ah* advisors. The AAOIFI, the Islamic Financial Services Board (IFSB) and the central banks of Muslim countries have tried to address these issues by issuing standards relating to responsibilities of the *Shari'ah* advisors and the minimum skill requirements for the selection of *Shari'ah* advisors (AAOIFI 2008; IFSB 2009; State Bank of Pakistan 2009). The application of these standards varies nationally depending on the individual country's prudential regulations, the Islamic school of thought the majority of the population follows, and level of Islamisation of the financial sector.

Other issues faced by the industry include a lack of agreed upon *Shari'ah* approval standards and practices for introduction of new products and the *Shari'ah* audit of Islamic financial institutions. The limited literature in the areas of *Shari'ah* approval tends to suggest that there is a difference between the expectation of *Shari'ah* application and actual practice (Warde 1998). While the SSBs are expected to evaluate each transaction for its *Shari'ah* compliance,

in reality many institutions make the decisions at the management level and expect the SSB's approval as a formality. The SSBs are also required to audit the financial records of the Islamic financial institutions and to take appropriate action if the audit reveals any transactions or business activities failed to comply with *Shari'ah*.

This study will aim to detail, analyse and explain the current practices of the above mentioned issues in Islamic financial institutions in Pakistan by addressing the following secondary questions:

Secondary Research Questions:

1. *What is the role of the State Bank of Pakistan and other regulatory bodies in the application and evaluation of Shari'ah principles in Islamic financial institutions?*

The commercialisation of the Islamic banking and finance sector was initiated by the governments of Islamic countries in the 1970s. To ensure that the Islamic financing system was implemented in Pakistan, the government of Pakistan directed the State Bank of Pakistan to implement changes to the prudential environment to accommodate the interest-free financing system. Since then, the State Bank of Pakistan has been given the responsibility for the promotion of Islamic banking in the country and regulating the sector. While the role of central banks in the application and governance of *Shari'ah* in Islamic financing in Muslim countries such as Bahrain, Indonesia and Malaysia has been briefly discussed in extant literature (Algaoud and Lewis 1997; Algaoud and Lewis 1999; Bakar 2002; Saeed 1996), the role of the State Bank of Pakistan has remained largely unexplored.

The other organisations that have an impact on the operations of the Islamic financial institutions are the regulatory bodies. In order to standardise the activities of Islamic financial

institutions globally, the central banks of Islamic countries formed two regulatory bodies: AAOIFI and IFSB (AAOIFI 2008; IFSB 2009). These regulatory bodies have introduced new governance standards with the aim of homogenising the auditing of *Shari'ah* governance in Islamic financial institutions. These standards are recent and their application in Islamic financial institutions is yet to be evaluated (Bakar 2002). This study aims to address this gap by analysing and detailing the role of the State Bank of Pakistan and other regulatory bodies in the application of *Shari'ah* in Islamic financial institutions.

2. *What are the minimum educational qualification and experience requirements for selection of Shari'ah advisors by Islamic financial institutions in Pakistan?*

Islamic financial institutions employ the services of *Shari'ah* advisors to ensure that their operations and financial products comply with *Shari'ah* principles. These advisors are Muslim jurists who are educated in Islamic jurisprudence and *Shari'ah* law. There is a lack of literature relating to the education qualification and experience required for *Shari'ah* advisors to perform their duties in the finance sector. Most studies addressing the *Shari'ah* advisors' presence in Islamic financial institutions have focussed on the role of the advisors in the implementation of *Shari'ah* in financial transactions rather than the practice of hiring *Shari'ah* advisors (see Banaga, Ray and Tomkins1994). This study therefore adds to the literature by detailing the process of hiring *Shari'ah* advisors and explaining the educational qualifications and experience required for these advisors to be employed by Islamic financial institutions.

3. *How do the SSBs and Shari'ah advisors form their legal opinion in response to enquiries by banks and interested parties?*

The *Shari'ah* advisors duties include forming legal opinion (relating to *Shari'ah*) in response to queries put forth by bank management and staff as well as other interested parties (Banaga et al 1994). The response of the *Shari'ah* advisors is made in the light of the teaching of the *Qur'an* and *Hadith* (the sayings and deeds of the Prophet Muhammad) (Usmani 1998). Despite general consensus on the process of forming religious opinion, there remains variation in the in application of *Shari'ah* in Islamic financial institutions. Karim (1990) states that the difference in opinions of the *Shari'ah* advisors is due to the individual's interpretation of religious text which has resulted in the lack of uniformity in the application of *Shari'ah* in Islamic financial institutions.

This study describes the reasons for variation in the opinion of *Shari'ah* advisors and explains how the advisors respond to queries put to them by banks and other interested parties.

4. *What is the process involved in carrying out technical Shari'ah reviews by banks offering Islamic financial products?*

To ensure that Islamic financial institutions comply with *Shari'ah* regulations, SSBs and *Shari'ah* advisors carry out internal *Shari'ah* audits. These audits verify that the institutions transactions are consistent with *Shari'ah* and that their financial products fulfil the requirements of being *halal* (products or actions that are acceptable under Islamic law). According to Banaga et al. (1994), *Shari'ah* advisors audit the day-to-day transactions of the Islamic financial institution to ensure that the activities are consistent with *Shari'ah*. In case

of any discrepancies, the *Shari'ah* advisors are required to take appropriate actions (these are discussed further in secondary question 5).

Due to the rapid growth of Islamic finance and the limited number of *Shari'ah* advisors, the *Shari'ah* audit and review process would need to be altered to accommodate for the vast number of bank branches offering Islamic financial products. This means that *Shari'ah* advisors may not be able to undertake *Shari'ah* audits physically in each branch of the Islamic financial institution's network. The findings of the study will describe the process by which *Shari'ah* advisors conduct *Shari'ah* audits in Islamic financial institutions in Pakistan.

5. *How do SSBs and Shari'ah advisors ensure that the banks implement Shari'ah controls?*

The *Shari'ah* advisors are employed by Islamic financial institutions to act as internal *Shari'ah* auditors but are expected to act independently and are expected to liaise with the central bank and regulatory bodies to ensure that the financial institutions remain *Shari'ah* compliant. To ensure that the Islamic financial institutions do not breach Islamic principles in their operations, *Shari'ah* advisors are expected to conduct *Shari'ah* audits of the financial institution's records. In the case where any breach is discovered, the *Shari'ah* advisor would judge the transaction as void and place a penalty on the Islamic financial institution (Lewis and Algaoud 2001). The amounts of the void transaction and the penalty would be put in a separate charity account which would be distributed to the nominated charities. This action is meant to deter the Islamic financial institutions from breaching *Shari'ah* principles in their transactions. This study addresses the role of the *Shari'ah* advisors in implementing *Shari'ah*

controls in Islamic financial institutions in Pakistan and the penalties the institutions face in case of any breaches of *Shari'ah* laws in their business transactions.

The practice of *Shari'ah* governance in Islamic financial institutions has previously been neglected in academic research. As the Islamic financing system continues to grow at a rapid pace there is a need to understand the practices of *Shari'ah* governance and the roles and responsibilities of *Shari'ah* advisors in Islamic financial institutions. A better understanding of the processes involved would help strengthen the implementation of *Shari'ah* in Islamic financial institutions and address the concerns expressed by critics of the system who have argued for more checks and balances in the application of *Shari'ah* in Islamic financing. This study is unique as it is the first study to focus on *Shari'ah* governance in Islamic financial Institutions in Pakistan. The primary and secondary questions identified for this study address the roles and responsibilities of the central bank, regulatory bodies and *Shari'ah* advisors in the application and supervision of *Shari'ah* in Islamic financial institutions and fill the gap relating to *Shari'ah* governance that exists in the current literature. The next section provides an overview of the methodology used to gather and analyse data for this study.

1.3 OVERVIEW OF METHODOLOGY

The methodology applied in this exploratory study is that of a field based case study employing an embedded case study design where the Pakistani Islamic financing industry is defined as one case study with different organisations embedded within it. Unlike holistic case studies, embedded case studies allow the examination of a specific phenomenon in operational detail, thus providing clearer measures and specific data (Creswell 1998). Embedded case studies can also help increase sensitivity to _slippage'. Using a longitudinal

approach, data was collected in Pakistan over a period of five years, 2002-2007. The rationale for the selection of Pakistan has been explained in the previous section. Data collection in Pakistan has also been assisted by the researcher‘s cultural background and personal contacts with members in the Pakistani banking industry.

In order to understand the differences in application of *Shari'ah* rules and the role of the SSBs in pure Islamic banks and conventional banks offering Islamic products (referred to as ‗Islamic windows‘), in-depth comparative research was conducted on individual organisations. These included two Islamic banks and four Islamic windows operating in Pakistan. In addition to analysing these organisations, individuals variously connected with the wider Pakistani banking sector were also interviewed. For the purpose of this study, primary data was collected via interviews with managers of Islamic financial institutions, *Shari'ah* advisors, and other individuals involved in the Islamic financing industry in Pakistan. A total of 30 individuals were interviewed across various cities in Pakistan. The semi-structured interview method was employed, utilising a combination of both open and closed ended questions, and relying on information provided by people who are considered experts in the field (Glesne 1999). This approach thus provides an opportunity to better understand the interviewees‘ views and interpretation of events. Since the area of study is relatively new, the information sought was primarily gathered from experts in the area of Islamic finance in Pakistan.

In addition to conducting interviews, the researcher also analysed memos and guidelines issued by the State Bank of Pakistan, as well as documents issued by the individual case study organisations providing background information about the topic area and assisting in

the construction of the interview questions. These documents included information on fit and proper criteria set by the State Bank of Pakistan for the selection of *Shari'ah* advisors and advisory boards. Other documents included the case study organisations' financial reports as well as *Shari'ah* audits.

Secondary data for this study was sourced from relevant journal articles, books, magazine articles, historical studies and newspaper articles. These sources provided the background information required to identify gaps in literature and develop interview questions for the collection of primary data.

Data analysis for this study focussed on the identification of themes and the development of associated categories that would help explain behaviours and relationships (see Shank 2002). Key themes and patterns emerging, continuing, discontinuing and re-emerging were identified across the whole period of the study through the processes of process noting, reflective noting and memo writing, and subsequent analysis, coding and memoing of both accumulated process and reflective notes (Hammersley and Atkinson 1995). The theme and pattern making were developed inductively from analysis of documentation and interviews, and the data was categorised (Scapens 1990; Pettigrew 1997; Ahrens and Dent 1998). This helped explain: the relationships between the concepts, and influences that impact the process and the apparent outcomes of the SSBs functioning. This study's methodology will be explained in greater detail in Chapter 3.

1.4 PLAN OF THE THESIS

The background and findings of this study are presented in seven chapters. The following provides an overview of the structure of the thesis in terms of the chapters that follow. Following this Introduction chapter, a comprehensive review and critique of the extant literature on Islamic financing, and the role of the SSBs are provided in Chapter 2. The chapter begins by addressing the area of corporate governance in banking and briefly covers the Basel II regulations and its implications for smaller banks. The chapter then covers the history of Islamic financing and describes the roles and responsibilities of the *Shari'ah* advisors. The methodology and method steps applied for this study are detailed in Chapter 3. The chapter begins by describing the use of the case study method employed for this study and details the method steps followed for the analysis of the primary and secondary data. The issues of reliability and validity are also detailed in the chapter.

Chapter 4 details the history of the banking sector in Pakistan. Providing a historical perspective on the development of, and challenges faced by, the Pakistani banking sector, the chapter details the impact of the nationalisation of the industry of the Pakistani government in the 1970s and its subsequent privatisation in the 1990s. The chapter also describes the events that led to the Islamisation of the banking sector in the 1970s and the related court decisions that have shaped the current practice of Islamic banking and finance in Pakistan. The chapter concludes with the profiles of the individual banks analysed for this study.

Chapters 5 and 6 present the findings of this study. These findings address the study's primary and secondary questions that deal with the training and selection of *Shari'ah* advisors by Islamic financial institutions in Pakistan; the potential for the *Shari'ah* advisors

facing a conflict of interest by offering their services to more than one organisation; the role of the government and the central bank in the enforcement and monitoring of *Shari'ah* principles in Islamic financial institutions; and the role of the *Shari'ah* boards and advisors in the approval and monitoring of financial transactions. The final chapter (7) evaluates the findings of this study with extant literature and details where the findings confirm or contradict the literature relating to the functioning of the SSBs in Islamic financial institutions. Based on the findings, the chapter concludes by making practical recommendations to help strengthen the *Shari'ah* governance in Islamic financial institutions in Pakistan and its implications for other institutions operating in this sector in other countries.

1.5 CONCLUSIONS

This chapter has introduced this study that seeks to explore the role of *Shari'ah* advisors and SSBs in the application and governance of *Shari'ah* in Islamic financial institutions in Pakistan. The background to the study was outlined and the importance of the study was identified by describing the primary and secondary research questions. The methodology and the method steps used for this study and the data analysis techniques were then briefly described. The final part of the chapter provides the outline of this study‘s structure. Following the introduction, Chapter 2 will now analyse the extant literature on Islamic finance and the role of the SSBs in Islamic financial institutions.

CHAPTER 2

LITERATURE REVIEW

This chapter provides a review of the literature in the area of Islamic finance including particular attention to current literature on the role of SSBs in Islamic financial institutions. The field of Islamic finance is in its infancy stage and therefore there are only a limited number of studies conducted in this area. The chapter begins with an introduction to corporate governance and agency theory. The chapter then reviews literature in the field of corporate governance in banks and the impact of the Basel II regulation. A brief profile of Islamic financing is then provided, followed by a discussion on the different modes of Islamic finance and a review of Islamic accounting. The chapter concludes with a discussion on the role of the SSBs in Islamic financial institutions.

2.1 CORPORATE GOVERNANCE

Corporate governance is considered to be a relatively new area of research even though the issues it addresses have been around since Adam Smith‘s time (Smith 1776). The interest in corporate governance has increased in the recent years due to the high-profile financial scandals and business failures such as Enron and WorldCom. There is no one single way of describing a firm and explaining the role of governance within it. According to Shleifer and Vishny (1997, p.737) corporate governance ―deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. A more comprehensive definition of corporate governance is provided by John and Senbet (1998) that deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected. They include as stakeholders not just shareholders, but also debt holders and even non-financial stakeholders

such as employees, suppliers, customers, and other interested parties. Hart (1995, p.687) closely shares this view and suggests that:

> *corporate governance issues arise in an organisation whenever two conditions are present. First, there is an agency problem, or potential conflict of interest, involving members of the organisation – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract*.

According to Zingales (1998) allocation of ownership, capital structure, managerial incentive schemes, takeovers, board of directors, pressure from institutional investors, and organisational structure, among other things, can all be thought of as institutions that affect the process through which quasi-rents are distributed. Garvey and Swan (1994) view the firm as a nexus of internal and external contracts and state that governance processes determine how the firm‘s executives administer such contracts.

These numerous definitions all refer to the existence of conflicts of interest between insiders and outsiders, with an emphasis on those arising from the separation of ownership and control (Jensen and Meckling 1976) over the partition of wealth generated by a company. There is also general agreement that governance issues cannot always be resolved due to significant uncertainty, information asymmetries and insider trading (Grossman and Hart 1986; Hart and Moore 1990; Hart 1995).

2.1.1 Agency Problem

The study of corporate governance in financial institutions focuses mainly on the issue of agency. Michael Jensen and William Meckling (1976) are credited with stimulating interest in corporate governance research by studying the agency problem inside the firm. According to Jensen and Meckling (1976) managers of a firm are the agents who make decisions on behalf of the shareholders (the principals) who supply the capital. Shareholders desire positive gains in their stock holdings. Managers work for the shareholders to achieve maximum shareholder value. Agency theory states that conflicts in a firm arise when agents' incentives are not aligned with those of the principals. Managers, who control the assets of the firm, may choose to satisfy their personal ambitions rather than those of shareholders; imposing costs on shareholders. These personal ambitions according to Denis (2001) include managers engaging in activities that directly benefit themselves such as managerial shirking and managerial consumption of perquisites. These actions may also benefit shareholders; but if they do not, the cost is borne by shareholders. Anticipating such problems, shareholders will discount the price of shares and therefore agency costs are borne by the original shareholders.

Extant literature on agency theory focuses on the issue of designing compensation plans so that managers have sufficient incentives to make decisions that maximise shareholder wealth, and thus reduce the manager-stakeholder agency problem. The study by Lewellen, Loderer and Martin (1987) found that compensation packages are usually designed by firms to ensure that agency costs are reduced.

The market‘s response to the adoption of compensation plan has also been the subject of many studies (see Brickley, Bhagat and Lease 1985; Gaver, Gaver and Battistel 1992; Kumar and Sopariwala 1992; Larker 1983; Tehranian and Waegelein 1985). Most of these studies propose that the adoption or change in a compensation plan is viewed as favourable by shareholders. Agarwal and Knoeber (1996), McConnell and Servaes (1990), and Morck, Shleifer and Vishny (1988) observe that managers‘ and shareholders‘ interests become more closely aligned as managerial ownership increases, resulting in improved firm performance. In addition, concentrated shareholdings by institutions can increase managerial monitoring and so improve firm performance, as can an outsider representation on corporate boards. However, as managers‘ equity stakes continue to increase, their interest begins to diverge from those of the shareholders, leading to greater agency problems and declining firm performances (DeAngelo and DeAngelo 2000; Himmelberg, Hubbard and Palia 1999; Karpoff, Malatesta and Walking 1996; Woidtke 2002; Zhou 2001).

Agency theory suggests that some monitoring and bonding mechanisms may develop to mitigate the agency problem and hence reducing the financing costs (Jensen and Meckling 1976). One such method is for the controlling owner of a firm to hire an independent external auditor to testify the accuracy of its financial statements. However this method has proven to be unsuccessful in some instances. A United Nations report by Rahman (1999) questioned the actions of the then Big Five auditors who gave a clean bill of health to large Asian companies and banks just prior to the Asian financial crisis. These institutions went bankrupt within a few months of the completion of the audit during the crisis. Weak corporate governance has been blamed as an important source of financing problems in East Asia that resulted in the

1997 Financial Crisis. Particularly since that time, promoting better governance of financial institutions has become the main concern of central banks in developing countries.

2.1.2 Sarbanes-Oxley Act

One major concern about promoting better corporate governance is the availability of appropriate control mechanisms that can reduce the existing agency conflicts of interest between controlling owners and minority shareholders. The extant literature on shareholder activism and institutional ownership has mostly focused on pension funds in the US and the UK, where conflicts of interest between controlling and minority shareholders were considered less likely to arise because ownership structure is diffuse and large owners are less likely to be involved in management (see Giannetti and Laeven 2007). The collapse of organisations like Enron, WorldCom and Barings Bank suggest that these steps have not been always successful in controlling agency issues. As a result of these collapses and in order to facilitate transparency and to help minimise financial crises, the United States introduced the Sarbanes-Oxley Act of 2002.

The Public Company Accounting Reform and Investor Protection Act of 2002 (commonly called the Sarbanes-Oxley Act or ‗Sarbox') is a United States federal law that was signed into law on July 30, 2002 (Zhang 2007). The Act came into force in response to a number of major corporate and accounting scandals including those affecting Enron and WorldCom. These scandals resulted in a decline of public trust in accounting and reporting practices.

The legislation is wide-ranging and established new or enhanced standards for all U.S. public company boards, management, and public accounting firms. The Act contains 11 titles, or sections, ranging from additional Corporate Board responsibilities to criminal penalties, and requires the Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the new law (Hamilton and Trautmann 2002).

The Act established a new quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, which is charged with overseeing, regulating, inspecting, and disciplining accounting firms in their roles as auditors of public companies (Li, Pinkus and Rego 2008). The Act also covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure.

A variety of complex factors created the conditions and culture in which a series of large corporate frauds occurred between the years 2000-2002. The highly-publicised frauds at Enron, WorldCom, and Tyco exposed significant problems with conflicts of interest and incentive compensation practices. These frauds and others resulted in over U.S. $500 billion in market value declines (Zhang 2007). The analysis of their complex and contentious root causes contributed to the passage of Sarbox in 2002. The two main contributing factors and events included:

- Failure of Board and Audit Independence: The corporate collapses in the United States exposed that in many instances Board members did not have the expertise to understand the complex business structures or failed to exercise their responsibilities. The scandals also disclosed in many instances the Audit Committee members of the

corporation were not truly independent of management and the decision-making process lacked transparency.

- Executive compensation: Fearing shareholder activism, corporations in the US tried to control the level of sending on executive compensation. Company stock options were not treated as compensation expense in company books thereby encouraging this form of compensation. To increase the value of the stocks and in turn their compensation, executives were making decisions that were highly risky and short-term in scope (Levitt 1998).

While the Act is aimed at US companies, its implications are far wider. US multinationals, regardless of the country in which they operate will have to be Sarbox compliant. This means that firms that deal with Sarbox compliant firms will also have to implement and incorporate the Sarbox regulations. In addition, any multinational that wishes to be listed on the US stock market will need to be Sarbox compliant. Thus, non-US firms that are considering expanding into the US market will need to bring their current business practices to be consistent with Sarbox (Ali and Gregoriou 2006).

New corporate governance regulations while effective at a broader level do not necessarily fulfil all the requirements of specific industries. The banking industry, due to its unique nature, requires governance regulations that cater for its demands. These regulations are covered in the next section.

2.2 CORPORATE GOVERNANCE IN BANKS AND BASEL II

Corporate governance in banks can be viewed in narrow and broad terms. The narrow approach to corporate governance views the subject as a process through which shareholders are assured that managers will act in their interests. However, Henderson (1986) argues that this view is flawed as it has been recognised as far back as Adam Smith‘s time that managers do not always act in the best interests of shareholders. The issue of manager‘s motivation has been on the rise due to the evolution of the modern firm, which is characterised by a large number of smaller shareholders, leading to a separation of ownership and control (Chew and Gillan 2005). As discussed earlier, the separation of ownership and control has given rise to agency problem whereby management operate the firm in their own interests and not those of shareholders (Jensen and Meckling 1976; Fama and Jensen 1983).

The broader view of corporate governance studies the method by which the suppliers of finance control the managers to ensure that their money is invested appropriately (see Shleifer and Vishny 1997; Vives 2000; Oman 2001). Arun and Turner (2004) and Macey and O‘Hara (2001) argue that since banking has a number of stakeholders, the broader view of corporate governance should be applied and should include the banks‘ depositors as well as shareholders.

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The agreed text for Basel II was published in June 2004 (Bank for International Settlements 2006) and describes the minimum standards for capital adequacy. The implementation of these standards is the responsible of national supervisory authorities that do so through domestic rule-making and

adoption procedures. The Basel II agreement was seen to improve on existing regulatory rules with the aim to align the capital requirements with the risk that the banks face. This move is seen to place more responsibility on the banks to identify the risks they may face and to concentrate on their ability to manage the risks (Bank for International Settlements 2006).

The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks they face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse (Daníelsson 2002). This can be accomplished by setting up regulatory standards which would require rigorous risk and capital management and would ensure that banks hold sufficient capital reserves that are enough to meet the risks that the bank exposes itself to. Thus the greater the risk, the greater the amount of capital that bank would need to hold.

The Basel II uses a three pillars approach – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline – to promote greater stability in the financial system. The need for Basel II stems from the inadequacies of the Basel I accord, which only dealt with parts of each of these pillars and was seen to be weak especially in the face of crisis faced by banks and financial institutions since mid-1990s (Bank for International Settlements 2006).

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: Credit Risk, Operational Risk and Market Risk. The second pillar deals with the regulatory response to the first pillar, and provides regulators

with a framework to deal with residual risk such as systemic risk, strategic risk, reputation risk, liquidity risk and legal risk. The third and final pillar deals with increased disclosures that banks must make. This is designed to allow the market to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately. These regulations are still in the consultative stage and have not been implemented.

There are many criticisms that are made of Basel II. These include that the more sophisticated risk measures unfairly advantage the larger banks that are able to implement them and, from the same perspective, since developing countries do not have such large multinational banks, Basel II could disadvantage them by restricting their access to credit or by making it more expensive. This may have direct implications on _pure' Islamic banks whose operations are relatively small and heavily reliant on limited *halal* credit. The implication of the Basel accord for Islamic banks is discussed later in this chapter.

As discussed in Chapter 1, the supervision of *Shari'ah* rules and procedures is mandatory in institutions engaged in Islamic finance. The following section provides an overview of the Islamic financing system and the role of the *Shari'ah* advisers and supervisors.

2.3 A PROFILE OF ISLAMIC FINANCING

The concept of Islamic Financing was introduced as early as the seventh century, but its commercial implementation only commenced in the 20th century (De Jonge 1996). The present-day revival of Islamic Finance began during the 1950s and 1960s as the colonial era came to an end and the newly independent Muslim states reassessed their economic policies

(Warde 2000). Preceding the formal commercial beginning of Islamic financing in 1970s, small scale limited scope interest-free institutions were unsuccessfully tried between the mid 1940s and 1960s in Malaysia and Pakistan (Gafoor 1996). In Pakistan one short-lived experiment took place in the late 1950s, where rural landlords created an interest-free credit network (Wilson 1983). According to Maali, Casson and Napier (2006) the philosophy of these institutions were based on social initiatives to achieve social goals. Similar moves were made by many Indian subcontinent loan cooperatives that were influenced by European mutual loan experiments, and religious ideals (Warde 2000). In Malaysia, the Muslim Pilgrims Savings Corporation was set up in 1963 to help pilgrims save for the expenses associated with performing *Haj* (religious pilgrimage). The Muslim Pilgrims Savings Corporation has since evolved into Tabung Haji – an Islamic savings bank which invests the savings of prospective *Hajis* (pilgrims) in accordance with Islamic religious rulings (Wilson 1995). The first commercial application of Islamic finance was undertaken in 1963 by Egypt‘s Mit Ghamr Savings Bank, which earned its income from engaging in trade and through profit-sharing investments (Lewis and Algaoud 2001; Warde 2000). While Mit Ghamr‘s charter made no reference to Islam or *Shari’ah*, the bank did not pay nor charge interest. The reasons for the bank‘s closure are unclear. Some believe the bank closed due to severe financial problems while others suggest that the bank, despite being commercially successful, was closed due to disagreements between the bank‘s founder and government officials (Warde 2000). By the 1970‘s, the push for Islamic finance had gained momentum. In 1973 the conference of foreign ministers of Muslim countries decided to establish the Islamic Development Bank with the aim of fostering economic development and social progress of Muslim countries in accordance with the principles of *Shari’ah* (Saeed 1996). Since then, the Islamic Banks have expanded worldwide and are expected to continue

growing at the rate of 15 per cent annually (Business Week 2005). Islamic financing products are offered by ‗pure' Islamic banks (banks that only deal with Islamic financing products) and via Islamic ‗windows' (in most instances this is a stand-alone branch of a conventional bank that offers Islamic financial products) (Hassan and Lewis 2007a; Warde 2000).

The guiding principle in Islamic finance is the prohibition of *riba* (Aggarwal and Yousef 2000; Choudhury and Hussain 2005). There are two predominant views concerning what *riba* means. One view is that *riba* translates to ‗interest': a moderate, economically justified remuneration of capital. The other view is that the prohibition of *riba* means prohibition of ‗usury': an excessive, sometimes extortionary rate of return (Warde 2000). The majority of scholars argue that there was no distinction between the terms ‗interest' and ‗usury' in Judaism or Christianity until the Reformation in Europe (Saeed 1999) and have adopted the stance that any form of interest constitutes *riba* (Gafoor 1996). There are some exceptions to this view. Egyptian scholars Hafni Nasif and Abdul Aziz Jawaish in the early part of the twentieth century stated that only interest which was equal to or more than the principal amount is illegal (Draz n.d. cited in Saeed 1996). Muhammad Asad (1984) in his study also used the term ‗usury' to explain *riba*. In 1986, the Jurisprudence Academy of the Islamic Conference issued a *fatwa*[3] condemning all interest bearing transactions as void (Al-Omar and Abdel-Haq 1996). This judgement was meant to eliminate any disagreements on the interpretation of *riba.* But in 1989, the *mufti*[4] of the Egyptian Republic, Muhammad Sayyed Atiyya Tantawi, issued a *fatwa* legitimising interest-bearing government bonds underwritten by Egyptian banks. To justify his position, he argued that since the certificates were issued to encourage the population to increase its level of savings, they resembled deposits and not

[3] *fatwa* is legal pronouncement in Islam, issued by a religious law specialist on a specific issue.
[4] A *mufti* is an Islamic scholar who is an interpreter or expounder of Islamic law, capable of issuing *Fatwa*.

loans and therefore the interest was legal (Mallat 1996). This interpretation failed to convince many leading scholars. In his ruling as the head of the Federal *Shari'ah* Court of Pakistan, Maulana Taqi Usmani (2001) dismissed Tantawi's *fatwa* as his solitary opinion. The Court stated that *riba* covers all forms of interest and not just usury. Hence, for the purpose of this study, *riba* will cover all interest bearing transactions.

Although Islam excludes interest from financial activities, it does not necessarily mean that the financier cannot earn a profit (Djojosugito 2008). In order to do so, the financier has to ensure that the gain made on the original amount is directly related to the risk undertaken on the investment (Siddiqui 1987). Under *Shari'ah* law, gains made on investment without risk is merely interest rather than profit. In order to understand how the Islamic system differentiates between profit and interest, one has to look at the differences between the Islamic and Capitalist economic ideologies. According to Capitalist theory, capital and entrepreneurs are treated as two separate factors of production where the former receives interest and the latter is entitled to profit. While interest is a fixed return for providing capital, profit can only be earned after distributing the fixed return to land, labour and capital (in the form of rent, wage and interest) (Usmani 1998). In comparison, the Islamic economic system does not consider capital and entrepreneur as separate factors of production. It believes that every person who contributes capital in the form of money to a business venture assumes the risk of loss and therefore is entitled to a proportional share of the actual profit (Siddiqui 1994). The system is protective of the entrepreneur, who in a capitalist economy would have to make fixed interest repayments even when the venture is making a loss (Usmani 2002). Capital has an intrinsic element of entrepreneurship, so far as the risk of the business is concerned and therefore, instead of a fixed return as interest, it derives profit. The more profit

the business makes, the higher is its return on capital. With no fixed interest repayments, the profit would be higher. In this way the profits generated by the commercial activities in the society are equally distributed amongst those who have contributed capital to the enterprise.

In economic terms, money has no intrinsic value; it is only a medium of exchange. But unlike the Capitalist system, earning interest on a medium of exchange without bearing any risks does not sit well in the Islamic system (Rahman 1994). Therefore the concept of Islamic financing is one of asset-backed financing. When a financier contributes money on the basis of the profit-and-loss sharing instruments, it is required to be converted into assets having intrinsic value (Usmani 2002).

2.4 MODES OF FINANCING

Due to the prohibition of *riba*, Islamic financial institutions are unable to offer conventional financial products. Instead the financial institutions have introduced financing options that are acceptable under Islamic law. In order to fulfil the needs of the Muslim consumers, Islamic financial institutions are constantly competing to introduce new products that can be comparable to conventional offerings. This represents a challenge, as the limitations placed by the religion does not allow for a great level of flexibility (Rosly 2005). Yet the new products that have been introduced, demonstrate the ability of these Islamic financial institutions to constantly innovate and market products that are both theoretically and practically sound (Iqbal and Mirakhor 2007). Some of the popular modes include profit and loss sharing, mark-up, leasing, insurance and bonds.

In a profit and loss sharing arrangement the financing institution forms a partnership with its clients and invests in a business venture. The profit and losses are shared between the parties at a pre-determined rate (Usmani 1998). Two commonly used profit and loss sharing products are *mudaraba* and *musharaka*. *Mudaraba* is an agreement between two parties, where one provides finance to another for utilisation in an agreed manner (Usmani 1998). The financier of the venture is known as the *rabb-ul-mal*, and the entrepreneur responsible for the management and execution of the project is referred to as the *mudarib*. The parties achieve their returns by sharing in the profits of the venture, which are divided on a proportional basis. Under a *mudaraba* agreement, returns cannot be provided as a lump sum, and cannot be guaranteed. To fulfil the requirements of this contract the parties must decide on a rate for sharing of the profits prior to the commencement of the business activity. After the business is completed the financier receives the principal and the pre-agreed share of the profit. The remainder of the profit is the entrepreneur‘s compensation for their ideas and services (Gafoor 1996). *Mudaraba* is an ancient form of financing practised by Arabs since long before the advent of Islam. Wealthy merchants financed the caravan trade and would share in the profits of a successful operation but could also lose all or part of their investment, if, for example, the merchandise was stolen, lost or sold for less than its cost (Gafoor 2001). After the introduction of Islam, this system was permitted to continue and was legitimatised as a finance instrument.

The other profit-and-loss sharing instrument is *musharaka.* The literal meaning of the word *musharaka* is sharing. Under Islamic law, *musharaka* refers to a joint partnership where two or more persons combine either their capital or labour together, formed for conducting business in which all partners share the profit according to a specific ratio while the loss is

shared according to the ratio of the contribution (Usmani 2002). It is based on a mutual contract, and therefore needs to have the following features to enable it to be valid:

- Parties should be capable of entering into a contract (that is, they should be of the legal age).
- The contract must take place with the free consent of the parties (without any duress).

In *musharaka*, every partner has a right to take part in the management, and to work for it (Gafoor 1996). The partners may however agree upon a condition where the management is carried out by one of them, and no other partner works for the *musharaka*. In such a case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment. However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business, and work done by any of them in the normal course of business shall be deemed as being authorised by all partners (Usmani 2002).

Musharaka can take the form of an unlimited, unrestricted and equal partnership in which the partners enjoy complete equality in the areas of capital, management and right of disposition. Each partner is both the agent and guarantor of the other. Another more limited investment partnership is also available. This type of partnership occurs when two or more parties contribute to a capital fund, either with money, contributions in kind or labour. Each partner is only the agent and not the guarantor of his partner. For both forms, the partners share profits in an agreed manner and bear losses in proportion to their capital contributions (Lewis and Algaoud 2001).

‗Interest' predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor. In contrast *musharaka* does not envisage a fixed rate of return. Rather, the return in *musharaka* is based on the actual profit earned by the joint venture. The presence of risk in *musharaka* makes it acceptable as an Islamic financing instrument. The financier in an interest-bearing loan cannot suffer loss but the financier in *musharaka* can suffer loss, if the joint venture fails to produce fruits (Haron, Ahmad and Planisek 1994; Lewis and Algaoud 2001; Rammal 2004; Usmani 2002; Usmani 1998).

The second mode of financing is based on the principle of cost plus mark-up (referred to as *murabaha*). In *murabaha* the financing institution purchases an asset on behalf of the customer and later sells it to the customer charging them the cost of the asset plus mark-up (Lewis and Algaoud 2001; Lewis 2007). This form of financing was meant to be used in foreign trade and working capital financing for circumstances in which the financial institution purchases raw materials and goods and sells them to a client at cost, plus a negotiated profit margin which would be paid normally within a fixed period of time or in instalments (Ahmed 1997). According to Usmani (1998) the profit and loss sharing instruments are the ideal mode of financing. However, *murabaha* should only be used in the interim as countries aim towards Islamisation of their economies, and its use should only be restricted to those cases where the use of profit and loss sharing instruments is not practicable (Usmani 1998). While it may appear that the mark-up is just another term for interest and thus used merely as a cover-up in Islamic banks, the legality of *murabaha* has not been questioned by any of the schools of Islamic law (Usmani 2002). The reason for this is that the financial institution first acquires the asset, and then resells it at a profit or mark-up rate. Thus

the operation is not just an exchange of money for money. The financial institution also assumes the risk where the client may later refuse to accept the goods (Wilson 1983). The presence of risk therefore makes the instrument *halal*. Usmani (1998) states that there are five steps that need to be followed to ensure a valid *murabaha* sale:

1. The client and Islamic financial institution sign an overall agreement whereby the financial institution promises to sell and the client promises to buy the commodities at a specified time on an agreed ratio of mark-up or profit added to the cost.
2. The Islamic financial institution then appoints the client as their agent for purchasing commodities when a specific commodity is required.
3. The client purchases the commodity on behalf of the Islamic financial institution and takes its possession.
4. The client informs the Islamic financial institution that the commodity has been purchased and passes the goods to the financial institution.
5. The client then purchases the commodities from the Islamic financial institution at the agreed upon time. The sale is concluded when the ownership and the risk of the commodity is transferred to the client.

The third popular form of financing is leasing (referred to as *ijarah*). Under *ijarah* the Islamic financial institution would buy a machinery or equipment and lease it out to their clients. The financial institution is thus transferring the usufruct of the property to the client in exchange for the rent claimed. In some instances the clients may opt to buy the items at the end of the lease period (a lease-purchase agreement) (Gafoor 1996). In such situations the monthly payments will consist of two components, that is, rental for the use of the equipment and instalments towards the purchase price. According to religious scholars, *ijarah* is an

acceptable financing mode because the financier converts financial capital into tangible assets and has thus assumed risks (Usmani 2002). In case of delay of payment of rent, the financier can impose a penalty. This penalty cannot be added to the income of the lessor, and should be paid to a charity (Usmani 1998).

For historical reasons, profit-and-loss sharing financial instruments are considered to be the most authentic and most promising form of Islamic contracts. Yet, partly due to the high risk involved with sharing in losses, profit-and-loss sharing constitutes only a small part (about five per cent) of their activities (Warde 2000). The most widely used financial mode is the cost plus mark-up because of its feature of agreed upon returns, which makes the transaction less ambiguous (Gafoor 2001).

According to some Islamic jurists commercial insurance can include *uncertainty*, *interest* and may be viewed as a way of *gambling*. All three of these components are strongly prohibited in Islam and questions are raised over its use by Muslims. As an alternative, the Islamic finance industry has introduced the concept of *takaful*, which is an Islamic insurance concept (Wahab, Lewis and Hassan 2007). Just like many Islamic financing products available today, *takaful* has been practised in various forms for over 1400 years. It originates from Arabic word *kafalah*, which means "guaranteeing each other" or "joint guarantee". The *takaful* system is a form of mutual insurance that is based on mutual co-operation, responsibility, assurance, protection and assistance between groups of participants (Thomas 2005).

In theory, *takaful* is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. Every policy holder pays their subscription to help those

who need assistance. The losses that are incurred are divided and liabilities are spread according to the community pooling system. The system overcomes the problems associated with traditional insurance as it eliminates uncertainty in respect to subscription and compensation, does not have any interest bearing payments, and does not derive advantage at the cost of others. The purpose of this system is not profits but to bear each others‘ burden (Thomas 2005).

The *takaful* concept is commonly used in *mudaraba.* In this system the entrepreneur accepts payment of the *takaful* contributions from investors. The contract specifies how the profits (surplus) from the operations of *takaful* are to be shared between the participants as the providers of capital and the entrepreneur. In order to eliminate the uncertainty in the *takaful* contract, the concept of donation and contribution is incorporated. In relation to this a participant shall agree to relinquish a certain proportion of their contribution as donation, thus enabling the contributor to fulfil their obligation of mutual help and joint guarantee should any of the fellow participants suffer a defined loss (Thomas 2005).

Sukuk can be described as Islamic investment certificates and are sometimes also referred to as Islamic bonds. Wilson (2004) states that *Sukuk* should not simply be viewed as a substitute for conventional interest-based securities. The distinction is that as compared to fixed-rate bills and floating-rate notes, *sukuk* is based on the principles of:

- Transparency and clarity of rights and obligations;
- Income from securities must be related to the purpose for which the funding is used, and not simply comprise interest; and

- Securities should be backed by real underlying assets, rather than simply paper derivates.

Sukuk is considered to be an authentic means of Islamic financing and is legitimised by the Fiqh (Islamic jurisprudence) Academy of the Organization of the Islamic Conference. According to the Fiqh Academy‘s ruling:

- Any collection of assets can be represented in a written note or bond; and
- This bond or note can be sold at a market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts.

Sukuk is normally issued in the case of *salam and istisna'a* contracts. *Salam* refers to a sale where the seller undertakes to supply a specific commodity to the buyer at a future date in return for an advanced price that is to be paid in full. The advantage of this is for both the seller and the buyer (Thomas 2005). For instance, a farmer who cannot afford to purchase fertilisers and other required equipment for farming would tend to use a *sukuk* agreement. This will allow the farmer to receive payment for crops in advance and thus capital that is required to purchase equipment and fertilisers. For the buyer the benefit is that the buyer pays for products at the current price. Had the buyer waited till the crops are ready, they may be required to pay more. Thus this system helps over the issue of uncertainty (referred to as *Gharar*).

Under the *istisna'a* system, a financing project is divided into smaller parts. These parts are then determined to have a completion time period and the project‘s cost is determined.

Subcontractors are invited to complete these parts at a price that includes the cost and a profit. At the completion of the project when the income is derived, the subcontractor is paid the agreed price in full. This form of *sukuk* is commonly used in the construction industry where buildings are sub-divided into smaller parts and contractors are invited to put in a tender for building these parts (Thomas 2005).

The next section review features of Islamic accounting and the workings of the SSBs in Islamic financial institutions.

2.5 ISLAMIC ACCOUNTING, AND *SHARI'AH* SUPERVISORY BOARDS

Extant literature on Islamic finance mainly focuses on the areas of new product development, ethical justification for Islamic finance, and customer satisfaction (see Ariff 2007; Dusuki and Abdullah 2007; Wilson 1997). In recent years there has been an increased interest in the governance of Islamic financial institutions, and adherence to international accounting and financial regulations (see for example Haniffa and Hudaib 2002; Jaffer 2005; Karim 2001; Simpson, Evans and Mahate 2003). This section looks at the areas of *Shari'ah* accounting and SSBs in the context of Islamic financial institutions' corporate governance.

2.5.1 Islamic Accounting

The prohibition of *riba* in the Islamic financial system means that in many instances conventional accounting practices may not be applicable in Islamic financial institutions. Some of these areas where differences exist include asset valuation under different Islamic financing contracts; recognition of income under the different financing modes; and treatment of prohibited income such as incidental interest earned by Islamic financial institutions on accounts held with corresponding banks and financial institutions (Ahmed 2002; Haniffa and Hudaib 2002). To address these issues the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991. The objective of the organisation is to set up *Shari'ah* acceptable accounting and auditing standards that would be used by Islamic financial institutions worldwide (AAOIFI 2006). This does not mean that all existing accounting concepts are ignored. The existing accounting concepts that are useful and do not conflict with *Shari'ah* rules are integrated into the AAOIFI standards without change (Lewis 2001). These include the concepts of reliability and timeliness of accounting information. The accounting concepts that are inconsistent with the *Shari'ah* rules are either rejected or modified to make them useful. For example, under Islamic financing, money has no intrinsic value and thus cannot be increased in value over time if it is not invested (Ahmed 2002; Khan 1991). This treatment of money has resulted in the modification of the generally accepted time value of money as a measurement attribute.

The body within AAOIFI responsible for setting the standards is the Accounting and Auditing Standards Board (AASB). The AASB consists of members from Islamic financial institutions, audit firms, *Shari'ah* scholars, regulatory bodies, academics, and users of financial statements. As the board consists of wider segments of interested parties taking part

in the preparation of the standards, it allows greater consensus and enhances the authoritativeness of the standards applicability (Karim 2001). To date AAOIFI has successfully issued financial accounting statements and standards, auditing standards, governance standards, and *Shari'ah* standards and rules (AAOIFI 2008). It has also promulgated a code of ethics for accountants and auditors in Islamic financial institutions, plus a statement on the purpose and calculation of the capital adequacy ratio for Islamic banks (Ahmed 2002; Al-Deehani, Karim and Murinde 1999; Karim and Archer 2006). However the AAOIFI lacks the power of enforcement, and relies on the voluntary adoption of the standards by regulators and Islamic financial institutions (Haniffa and Hudaib 2002). This has so far shown some positive results, with Bahrain making it an official requirement for all banks in its jurisdiction to adopt standards released by AAOIFI (Bakar 2002). Other countries including Saudi Arabia and Pakistan are also planning to adopt these standards in the future. Thus, the effectiveness of the AAOIFI's standards will become clearer as more countries integrate them into their existing accounting, auditing and governance requirements.

2.5.2 *Shari'ah* Supervisory Boards (SSBs)

The quality of the financial institution's governance and control is considered to be important for clients (Ahmed 2002; Haron et al 1994). Yet the topic of internal *Shari'ah* control in Islamic financial institutions is relatively unexplored with only a handful of studies addressing the issue. Some of these studies are summarised in this section.

Islamic financial institutions are guided by a legitimate control body known as the SSB, or by a *Shari'ah* advisor (Choudhury and Hoque 2006). The purpose of the SSBs is to ensure that

Islamic financial institutions operate in conformity with *Shari'ah* and are usually made up of a number of jurists who provide clarification in regards to any *Shari'ah* related questions that the financial institutions may have (Archer, Ahmed and Al-Deehani 1998; Ghayad 2008; Usmani 1998). These SSBs are hired by the financial institutions and act as an internal control body in the organisation, therefore enhancing the credibility of the bank in the eyes of its customers, and bolstering its Islamic credentials (Algaoud and Lewis 1997).

AAOIFI (cited in Bakar 2002, p.76) defines SSBs as:

> *A Shari'ah supervisory board is an independent body of specialised jurists in fiqh al-mu'amalat (Islamic commercial jurisprudence). However, the Shari'ah supervisory board may include a member other than those specialised in fiqh al-mu'amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh al-mu'amalat. The Shari'ah supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institutions to ensure that they are in compliance with Islamic Shari'ah rules and principles. The fatwas and rulings of the Board shall be binding on the Islamic financial institution.*

A *Shari'ah* board is a prerequisite for admission into the International Association of Islamic Banks (IAIB). The general characteristics of the *Shari'ah* Board were described as follows in an IAIB document (cited in El-Nagar 1980, p.20):

> *It is formed of a number of members chosen from among Jurists and men of Islamic jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into account: (a) they must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors. (b) They are appointed by the general assembly, as it is the case of the auditors of accounts. (c) The general assembly fixes their remuneration. (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts.*

The AAOIFI has set standards for appointment and composition of SSBs. According to the standards, the authority to appoint SSB members should be vested in the annual general

meeting of all shareholders of the Islamic financial institution. The justification for such action is that SSBs members will be free from any undue pressure exerted by the management or board who also should not have the power to appoint or dismiss them (AAOIFI 1997). The AAOIFI standard also specifies the minimum number of members required in a SSB. According to the standard a minimum of three members should be present in a SSB (Bakar 2002).

Banaga et al (1994) list the functions of the SSB as:

- Answering the enquiries that come from the community at large.
- Issuing formal legal opinions according to the Islamic law and enquiries submitted by bank management or any other interested party.
- Reviewing and revising all the dealings and transactions, which the bank enters into which clients so as to ensure that these agree with *Shari'ah*. If any deals or transactions contradict *Shari'ah* principles, such transactions would not be approved.
- Reviewing research on any particular relevant subject and issuing their opinion.
- Holding regular meetings to discuss all enquiries received. The minutes of these meetings are usually recorded.
- Receiving enquiries from the management or others and presenting them to the board of directors.
- Preparing draft opinions and delivering them to all those who are concerned.
- Issuing opinions in final form if the Board does not have any second opinion on the subject.
- Preparing contracts in collaboration with the legal advisor of the bank.

- Participating in the preparation of drafts of decrees, decisions and orders presented by the bank, and preparing explanatory notes thereto.
- Preparing the studies and research required to direct the *zakat*[5] resources towards the deserving parties and determining the rate or the percentage that in the light of the *Shari'ah* rules could be invested from the resources of the *zakat*.
- Carrying out the technical review and follow up to make sure that the *Shari'ah* controls are implemented by the bank, its branches and its affiliated companies.

These duties are seen to be broad and may not always be possible to be implemented due to the large volume of queries the SSBs may receive from the wider community. Thus ideally these duties would be performed by the SSBs but in practice only a select few activities from this list would be fulfilled by the SSBs. The regulatory role of the SSB is seen to be similar to that of an internal governance and control body. Even though the financial institution compensates them, the SSB members are expected to retain their independence (Algaoud and Lewis 1999; Karim 1990). Like company auditors, SSBs certify at the end of the year whether the financial institution's operations were in conformity with *Shari'ah* (Choudhury and Harahap 2008). This task includes reviewing products and policies of the financial institution, and deciding on whether a new financial instrument introduced by the organisation is religiously acceptable.

According to Lewis and Algaoud (2001, p.181), when the SSB feels that a transaction may not accord fully with, or be in breach of the principles of Islam, the following steps are taken:

[5] *Zakat* is the amount of money that every adult, mentally stable, free, and financially able Muslim, male and female, has to pay to support specific categories people. *Zakat* is obligatory after a time span of one lunar year passes with the money in the control of its owner. Then the owner needs to pay 2.5% (or 1/40) of the money as *zakat*. (A lunar year is approximately 355 days).

1. Finding alternative ways to make the transaction compatible with *Shari'ah*.
2. If no alternative suggestions can be made, the transaction is not processed.
3. If, however, the transaction has been executed and subsequently it is discovered that it has violated the approved Islamic business activities, the SSB would give its opinion to shareholders and the management to undertake steps to deduct the income generated by that transaction from the income account and have it distributed to a charity account. Thus, the financial institutions risks potential financial penalty as well as adverse publicity for non-compliance.

Saeed's (1996) study of SSBs in the Middle East found that in some Islamic financial institutions there was only one religious consultant, whereas in other financial institutions SSBs consisted of up to five members. The board members should be scholars of Islamic law and should believe in the idea of Islamic finance. According to the study, SSBs follow a number of methods to ensure the Islamic authenticity of the financial products being introduced by the Islamic financial institution. These methods include:

a. If the *Qur'an* has a text that is relevant to the problem at hand, the SSB will not go beyond the text in making their decision.

b. If the guidance in the *Qur'an* is open to interpretation; the SSB will take the view of the majority of the SSB members. In the event of difference in opinions between board members, the group will compromise and follow the opinion that is considered lenient and easy for the Muslim population as long as the decision does not deviate from the basic principles of Islamic financing.

c. If there is no guidance in the *Qur'an*, the board will examine the issue at hand using precedent.

Theoretically if the SSB refuses to endorse a product, the Islamic financial institution should automatically scrap that product. Also in theory, the SSB would perform a religious audit of all accounts (Karim 1990; Warde 2000). The reality however is more complicated. A survey conducted by Warde (1998) revealed that in many cases the review is treated as a routine matter, with boards approving decisions already made by the bank's management.

Although SSBs have similar supervisory procedures; there remain differences in interpretation (Hassan and Lewis 2007b). Karim (1990, p.39) points this out by stating that SSBs _are guided by their moral beliefs and obligations to religious peers and community', and therefore follow procedures that they believe fulfils *Shari'ah* requirements.

From the studies it can be deduced that the presence of SSBs in IFIs is seen to be sufficient to fulfil governance rules in relation to Islamic principles in the financial institutions. In reality this may be overstating the role of the SSBs. The presence of SSBs with few *Shari'ah* advisors may not be sufficient for the application and implementation of *Shari'ah* principles. There would need to be other checks and balances to ensure that the approved principles of Islamic finance are implemented within the financial institutions. The AAOIFI regulations in relation to the presence of SSBs should be seen as a minimum requirement rather than fulfilment of all governance responsibilities. IFIs would be best placed to increase the knowledge of bank staff and customers to ensure that there is a policy of constant checks and balance by all shareholders rather than merely relying on the SSB.

2.5.3 Issues Relating To SSBs Functioning:

A number of issues have been raised in connection with SSBs. One is about their independence. Since SSB members receive remuneration from the Islamic financial institution, there seems to be a potential for conflict of interest. Banaga et al's (1994) study found that one concern is that members of the SSB may legitimise dubious operations to ensure that they remain active on the board. The implications of such action is that certain financial products and procedures, which may be not be legitimate according to *Shari'ah*, may be approved, thereby creating a precedent for other Islamic financial institutions to follow.

There have also been questions asked about the need for SSBs. With bank employees able to access the latest research and training programmes related to Islamic finance from organisations such as the Institute of Islamic Banking and Insurance, the use of SSBs is viewed by some as fulfilment of a formality rather than an active control body (Nienhaus 2007; Warde 2000).

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In relation to the global growth and application of Islamic finance, the major criticism is that the practice of financial institutions having their own *Shari'ah* boards adds to the differences in application (Warde 2000). This makes it difficult to agree on globally acceptable products and procedures. Differences in application and procedures not only exist between nations but also within nations. In order to achieve uniformity in practice and interpretation at the national level, it has been argued that the central banks of the Muslim countries need to take a more proactive role in order to co-ordinate activities within the national boundaries (Gafoor

1996). There are already moves being made in this direction, with some central banks appointing their own *Shari'ah* advisors to oversee national operations. One significant attempt at national harmonisation occurred in Malaysia where a National Syariah (*Shari'ah*) Board was established in 1997 to harmonise financial practices and review the compatibility of new financial products with religion, as well as advise the Central Bank on religious matters (Bank Negara Malaysia 2006). The State Bank of Pakistan made a similar move in 2003 with the establishment of the Islamic Banking Department (State Bank of Pakistan 2006). Despite these efforts however, the two nations differ in their application of Islamic finance. While Malaysia is pursuing a dual finance system where both conventional and Islamic financing options will be available, Pakistan has previously attempted to enforce Islamic finance as the only available option. The presence of *Shari'ah* advisors is now compulsory in Islamic financial institutions operating in Pakistan, and this requirement was introduced to help overcome compliance and governance issues.

To streamline activities at the international level, the Islamic Financial Services Board (IFSB) was formed. The establishment of the IFSB in Malaysia in late 2002 was the result of a two-year consultative process initiated by a group of governors and senior officials of central banks of various countries, together with the support from the Islamic Development Bank, the International Monetary Fund, and AAOIFI. The IFSB serves as an international standard setting body of the regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry.

The IFSB is attempting to prepare a standard on Corporate Governance, and has also begun development of two prudential standards for the Islamic financial services industry, namely

Capital Adequacy and Risk Management standards (IFSB 2009). These standards are aimed at reducing the ambiguity in application of *Shari'ah* principles in different financial institutions and in different nations. The effectiveness of these standards will be clearer as nations work towards standardisation of supervision and governance rules in Islamic financial institutions.

2.5.4 Islamic Banking and the Basel Accord:

Karim (1996) argues that the way in which Islamic financial institutions collect investment capital is different from conventional financial institutions, therefore the application of the same rules (as was the case with the Basel accord) on all banks is not considered suitable. Islamic financial institutions tend to be relatively small and are often located in countries where Basel II is not the regulator‘s top priority (Caruana 2005). Thus the impact on Islamic financial institutions has not been felt as much as it has been on some small conventional banks that are situated in nations that have already adopted the directive (Caruana 2005).

Whilst Basel II applies equally across all banks, its impact is felt differently in the smaller banks than in the larger banks. The differences are not in the legislation itself but in the availability of associated models and historical data that a bank requires to complete its capital adequacy calculations (New Horizon 2008). Smaller banks, including the Islamic financial institutions, are likely to suffer from a lack of data and a smaller sample size which restricts them when attempting to build their own models, whereas the larger banks, including the Islamic windows, are able to develop customised risk models using their own historical experience.

The central banks of Malaysia and Pakistan have recently begun consultations with Islamic financial institutions for application of the Basel II accord in their respective markets. Since the features of the accord do not have a direct impact on the *Shari'ah* supervision in Islamic financial institutions, the impact of its future application will not be discussed further in this study.

2.6 A SUMMARY PERSPECTIVE

This chapter examines the current literature in the areas of corporate governance and Islamic financing. Corporate collapses in the United States and financial crisis in Asia in recent years have increased the need for transparent and efficient governance measures for corporations. The introduction of the Sarbanes-Oxley Act in the United States and the Basel II reforms has provided guidelines to help avoid the mistakes made by corporations in the past. The Basel II requirement is currently being considered by the central banks of Muslim countries like Malaysia and Pakistan, and will be implemented in the Islamic financing sector over the next few years. Because of their relatively smaller size, most Islamic financial institutions will be affected in the same way as small conventional banks do for the capital adequacy ratio requirement.

From its official launch in the 1970's Islamic financing has witnessed rapid growth worldwide. Facing competition from conventional banks, Islamic financial institutions have introduced financing options that allow clients to access products that avoid *riba* and are therefore acceptable under *Shari'ah* law. To ensure that financial institutions are able to report and govern the unique qualities of Islamic financing, a number of standard setting bodies have been established. These include AAOIFI and IFSB, who have introduced new

accounting and governance standards with the goal of standardising the application of Islamic finance. The presence of SSBs in Islamic financial institutions is compulsory and is aimed at ensuring that organisations do not merely meet the minimal standards of Islamic finance, but also fulfil the requirements in the spirit of Islam. There are questions raised concerning the functioning of the SSBs as there are concerns that the boards in some cases may not act independently. In an attempt to overcome this issue the central banks and regulatory agencies are working towards harmonising the roles and procedures of the SSBs.

Islamic finance is still in its infancy stage of development and therefore there is an extreme poverty of studies of this subject to date. The focus of extant literature in this area has been on the features of the Islamic financial products, and strategies to attract more customers towards this system. The areas of management practices, and the governance and implementation of *Shari'ah* laws in Islamic financial institutions remain largely unexplored with only a handful of studies focussing on the unique religious audits and supervisory requirements of such institutions. Yet, financial institutions operating under the Islamic system are witnessing rapid growth and are becoming a sector of the international banking community that is growing in significance. Thus there is an increasing need for knowledge concerning current corporate governance and supervisory practices employed in Islamic financial institutions, how and why these operate in the way they do, and strategic directions and policies that may assist their future development.

CHAPTER 3

METHODOLOGY

This chapter details the methodology used in this study. The chapter begins with a discussion on the use of case study in qualitative research, and the selection of cases. The method steps used in this study are then discussed, followed by an explanation of data analysis. The chapter concludes with a discussion on the reliability and validity of the method used.

3.1 FIELD BASED CASE METHODOLOGY

Extant research method literature discusses which methods or techniques are considered to be more suitable for business studies. It is sometimes stated that quantitative methods are more scientific than qualitative methods. But according to Ghauri and Grønhaug (2002) methods or techniques are not better simply because they are quantitative in nature. Jankowicz (1991) argues that the selection of the method and technique depends upon the research problem and its purpose. This study is qualitative in nature and attempts to answer the research question by understanding the process and working of the SSBs and the role of the *Shari'ah* advisors in Islamic financial institutions in Pakistan. Qualitative research is used for studies where the purpose is to understand a phenomenon in real world setting without any manipulation (Patton 2001). Strauss and Corbin (1990) define qualitative research as any kind of research that produces findings that are not arrived at with the aid of statistical procedures. According to Hoephl (1997), while quantitative researchers aim to achieve determination, prediction, and generalisation of their findings, qualitative researchers are more interested in understanding of a phenomenon and its application to similar situations. Qualitative research relies on the skills and experience of the researcher for analysis of the data. Undertaking such research requires the researcher to understand the rationale of the study, to work with the

explorative nature of the data and to able to utilise their intuition. According to Strauss and Corbin (1990) the skills required to do qualitative research include thinking abstractly, stepping back and critically analysing situations, recognising and avoiding biases, obtaining valid and reliable information, having theoretical and social sensitivity and having a shrewd sense of observation. Winter (2000) claims that in quantitative studies the researcher aims to disassociate themselves from the research process, whereas in qualitative studies the researcher immerses themselves in the project and records changes to the phenomenon as they occur (Patton 2002).

This study applies the field based case study methodology in the qualitative inductive theory generating tradition employing an embedded case study design. This is an exploratory and explanatory study that inductively identifies relationships between concepts from the field data. It explores and interprets the dimensions and characteristics of the emerging concepts that are a classification of the field activities, behaviours, practices and beliefs. In accordance with field based case study methodology, this study directly contributes to the foundation of theory development in a subject area where there has to date been little knowledge (Yin 1981; Torraco 2002). Bonoma (1985) explains this approach and states that when a phenomenon‘s requirement dictates theory building rather than verification or extension, the tasks of description, classification and comparison become relevant. Thus the description of the phenomenon is the first step and without it the adequate classification or the operational measures of the phenomenon cannot be achieved. The resulting research can then provide a deep understanding of the phenomenon under study and provide directions for theory building that often is missing from both simple descriptive work and most cause-and-effect research. This is what this thesis delivers

Eisenhardt (1989) explains that there are times when little is known about a phenomenon. In these situations, theory building from case study research is particularly appropriate because it does not rely on previous literature or prior empirical evidence (Amaratunga and Baldry 2001). Yin (2003) suggests that for case studies, theory development is an essential part of the design phase. Meredith (1998) describes the need for theory building by differentiating between the rationalist and interpretive methods. According to Meredith (1998), the rationalist methods are seen as being appropriate for testing or verifying existing theory, whereas the interpretive methods, such as case studies, are best for generating theory. In this sense, studies towards the analytical end of the continuum might be associated more frequently with theory building, whereas those near the cause-and-effect end are more frequently used for theory disconfirmation (Klein and Myers 1999).

Theory building case study research typically uses multiple methods for data collection such as observations, interviews and archival sources (see Eisenhardt 1989; Meredith 1998; Yin 2003). This use of multiple methods and sources of data are seen as supporting sources of evidence to assure that the facts being collected are indeed correct. Therefore the investigation of multiple settings via the embedded case study, as applied in this study, helps extend the generalisation of the results.

This study therefore identifies, explores and interprets what the presence of *Shari'ah* advisors in Islamic financial institutions and the governance of *Shari'ah* principles by the advisors means to the participants and their institution. In doing so, it contributes to the development of new theory on corporate governance in Islamic banking. In addition it offers field based

explanation of structures, processes and practices, and the forces that influence them and the potential implications using multiple methods and sources of data which makes the study both exploratory and explanatory.

In business studies, case studies are used to provide in depth insight into management situations and issues about which little is known, and to lay a foundation for developing new theory or revising previously held theories and understandings. A case study is a useful method when the area of research has been little studied and about which little is known or understood, and where the researcher is engaged in theory building types research (Ghauri 2004). It involves data collection through multiple sources such as verbal reports, personal interviews, researcher observations and documentary evidence. The main feature is therefore the depth of and specific focus on the research object, whether it is an individual, group, organisation, culture, incident or situation. In case studies, there needs to be sufficient information to characterise and explain the unique features and context of the case, as well as point out the characteristics that are common to several cases. Selltiz, Wrightsman, and Cook (1976) focus on the integrative powers of this method by stating that case studies have the ability to study an object with many dimensions and then to draw the various elements together to create a workable interpretation.

There are various types of case studies that researchers may select from. Scholz and Tietje (2002) state that case studies can be holistic or embedded in design. A holistic case study relies on narratives and phenomenological descriptions, making it qualitative in nature. According to Stake (1976), the understanding of the case is the primary objective in holistic case studies while themes and hypotheses become secondary in importance. Case studies that

involve more than one unit of analysis are referred to as embedded case studies (Yin 1989). Unlike holistic case studies, embedded case studies allow the examination of a specific phenomenon in operational detail, thus providing clearer measures and specific data. Embedded case studies can also help increase sensitivity to _slippage'. _Slippage' occurs when during the course of the study the entire nature of the case study may shift, resulting in the questions reflecting one orientation and the evidence reflecting another. By having a set of subunits as in embedded case studies, the research can proceed without starting over again to construct new questions (Miles and Huberman 1994). For the purpose of this study the Pakistani Islamic financing industry is defined as one case study with different Islamic financial institutions embedded within it.

3.1.1 Case Study Orientation

The use of case study for this research is appropriate to its overall purposes which are to explain how the SSBs operate and why the identified processes are followed. Yin (1994) states that case studies are a preferred option when the purpose is to answer _how' and _why' questions. Ghauri and Grønhaug (2002) explain this further by stating that when research questions are related to _how many?' or _how much?' survey or archival strategies are favoured. However, when the research question tries to answer _what', _how' and _why', a case study method is recommended. The latter is the approach adopted for this study.

Case studies have the potential to deepen our understanding of the research phenomenon, first because they allow us to take a longitudinal approach (Ghauri 2004), and second because of their contextuality (Yin 1994). This need for deep understanding is the motivation for a researcher to investigate a certain case (Gibbons, Limoges, Nowotny, Schwartzmann, Scott & Trow 1994). According to Scholz and Tietje (2002) a case study label is often associated with

the exploratory case study. Exploratory case studies can provide an insight into the way a phenomenon operates and helps develop models or theories (Boos 1992). The exploratory nature of the study means that the research design and data collection are not specified in advance.

Ferreira and Merchant (1992) in their study on field research in management accounting and control identify a number of advantages of using field based study over other forms of research. These include:

- Direct, in-depth contact with organisational participants through interviews.
- Focus on real tasks or processes, and
- Presentation of data that includes detailed description of context and practices.

The implementation of a field-based case study is justified by the nature of the research question that formed the basis of this study. The question was formulated after reviewing the literature in the area of corporate governance in the Islamic financial industry, which revealed a distinct lack of research into the workings of the SSBs, and the control methods utilised by financial institutions to ensure conformity to *Shari'ah*. As stated in the literature review chapter, the majority of extant studies on Islamic finance have focused on the features and application of *Shari'ah*-based financial products. Only a limited number of studies have focussed on the workings and structure of governance in Islamic financial institutions. This study aims to cover this gap and therefore the primary research question focuses on investigating, understanding, and explaining the processes involved in the workings of the SSBs in the creation, approval, and control of new Islamic financial products offered by financial institutions in Pakistan. This will form the basis for inductive theory building from the findings of the study. This process of theory building using inductive case studies is an

accepted practice in qualitative research (Ghauri 2004). Eisenhardt (1989, pp.548-549) for example states that case studies are:

> *"Particularly well suited to new research areas or research areas for which existing theory seems inadequate. This type of work is highly complementary to incremental theory building from normal science research. The former is useful in early stages of research on a topic or when a fresh perspective is needed, while the latter is useful in later stages of knowledge development."*

Eisenhardt (1989) further states that creative insights often arise from paradoxical evidence, and attempting to reconcile evidence across cases, types of data, and different investigators, and between cases and literature increases the likelihood of creative reframing into a new theoretical vision.

3.1.2 Selecting Cases

As in other methods of data collection, it is important in case studies to decide the target population that is to be used for the investigation. According to Ghauri (2004), the population consists of firms, individuals, groups or elements that will be represented in the study. Once a decision on the target population is made, the next stage is to assess the accessible population (Cooper 1984). Out of this accessible population one or a few cases, objects or firms have to be selected for study. This selection should be based on criteria that are consistent with the research problem (Ghauri and Grønhaug 2002).

The time available for the study, financial resources for travelling, personal contacts and other practical issues are of great importance. For the purpose of this study, a longitudinal approach was taken where data was collected using multiple interviews and observations over a period of five years, 2003-2007. In total the researcher visited Pakistan on five occasions

with each visit lasting between 30 to 45 days and included travel to Karachi, Lahore and Islamabad. This length of exposure to the research sites facilitated interpretation and understanding of the social, political, economic and institutional context and their evolution over the period studied. The longitudinal period allowed observation of emerging and developing practices and attitudes in Islamic banking governance. The Pakistani Islamic banking industry was selected for this study as the one embedded case study. The selection of Pakistan was based upon the following reasons:

1. The researcher‘s cultural background and personal contacts with members in the Pakistani banking industry.
2. The uniqueness of the Islamic banking industry in Pakistan.[6]

It is difficult to determine how many cases should be included in a study. In many instances only one case is enough. Mintzberg (1979, p.583) supports the use of this approach and states:

> *“What, for example, is wrong with a sample size of one? Why should researchers have to apologize for them? Should Piaget apologize for studying his own children, a physicist for splitting only one atom?”*

Ghauri (2004) states that the research problem and the research objectives should influence the number and choices of cases to be studied. A single-case study is appropriate when a case is exploratory and revelatory. This allows the researcher to observe and study the phenomenon which was previously not accessible and which can provide useful insights, and serves as a first step to a later, more comprehensive study (Ghauri and Grønhaug 2002; Yin 1994).

[6] Pakistan has previously attempted to transform the entire banking industry to Islamic banking, whereas most other Muslim nations have advocated the use of both conventional and Islamic banking. Please refer to Chapter 4 for the history of the Pakistani banking sector.

In order to understand the differences in application of *Shari'ah* rules and the role of the SSBs in pure Islamic banks and Islamic windows, in-depth comparative research was conducted on individual Islamic financial institutions. According to Yin (2003), a case study may involve more than one unit of analysis. This usually occurs when within a single case study, attention is given to units and subunits and is referred to as embedded case study. By treating individual Islamic financial institutions as subunits in the Pakistani banking industry, the author was able to overcome the potential risk of slippage faced in holistic case studies, where the entire nature of the study may shift due to the change in one subunit (Yin 2003). These individual Islamic financial institutions included Islamic banks and Islamic windows offering Islamic financial products in Pakistan. Profiles of these financial institutions are provided in Chapter 4.

3.2 METHOD STEPS

The information related to the workings of the SSBs was gathered by utilising both primary and secondary data. Primary data was collected through interviews, while secondary data was collected through relevant literature history and policy documents. This section provides information on the method steps used to gather data.

3.2.1 Secondary Data Collection

Secondary sources of information are often ignored by researchers even though these can be relevant to the research topic. Researchers should therefore look at several sources for data availability on the topic/area of study in question before commencing primary data collection

(Miles and Huberman 1994). According to Ghauri and Grønhaug (2002) secondary data can help researchers in the following manner:

- Answering research questions or solving some of the research problems.
- Helping in problem formulation and/or making more concrete and focussed research questions.
- Deciding about the appropriateness of a certain research method or even suggesting better research methods for a particular problem.
- Providing benchmarking measures and other findings that can be compared later on with the results of the study at hand.

Some of the secondary sources that can be important for research purposes include:

- Internet sites and web pages of different companies and organisations.
- Central and local government studies and reports, state budgets, rules on international trade regarding imports and exports, and the policies on foreign direct investment.
- Academic journals and organisational newsletters relevant to the problem area.
- Historical studies regarding the development of a particular discipline or problem area.
- Textbooks and other published material directly or indirectly related to the problem area.

For the purpose of this study secondary data was sourced from relevant journal articles, books, magazine articles, historical studies and newspaper articles. These sources provided the background information required to identify gaps in literature and develop interview

questions for the collection of primary data. A list of secondary data used for this study is produced in Table 3.1.

Table 3.1: List of Secondary Data sources

Secondary Data	Details
Journal Articles	These included journal articles dealing with Islamic finance, corporate governance, accounting, auditing and control.
Books	These included books on Islamic finance and corporate governance
Newspaper Articles	Articles on Islamic banking and auditing written by journalists and practitioners in English and Urdu language newspapers published in Australia, Malaysia, Pakistan, UAE, UK and USA.
Magazine Articles	Articles on Islamic banking and auditing published by professional magazines in Australia, India, Malaysia, Pakistan and the UK
Historical Studies	Studies conducted in the late 1970s and 1980s by researchers in Pakistan on the introduction of Islamic banking in Pakistan. These were in addition to studies that were published and counted under the books section above.

In order to understand the current operations of the SSBs and *Shari'ah* advisors in the Pakistani Islamic banking industry, it is important to analyse the history of the industry in the country. Historical data and information help identify what has worked and what hasn't worked in a particular context (Parker 1994). Using historical research method for this study allowed the researcher to discover the unique features and impact of the Pakistani cultural context within which the Islamic financial institutions and SSBs operate. Pakistan was one of the few countries that took a proactive step towards elimination of *riba* from the economy. In order to achieve this, the Pakistani government took certain steps in the late 1970s and early 1980s to achieve this goal. Research articles and government orders relating to the government's steps were also analysed for this study.

Historical review provides a number of benefits in a qualitative study. According to Ghauri and Grønhaug (2002), in historical review one aims to describe the past so that the present situation can be understood or the future can be planned for. Using historical documents and analysis allows a variety of potential uses. For example, according to Parker (1997), business history offers the following opportunities:

- It can be used to build a view of the past from which professional consciousness and cohesion can be manufactured.
- It can reveal practices and outcomes, which may normally be ignored.

It can challenge beliefs or offer some indicators of previous experience that may have an impact on future policies. To this end, historical review requires the researcher to examine existing records and reports and talk to different people to obtain as a clear picture as possible of the events that have influenced the evolution of the phenomenon. Keeping the research question in mind, the researcher reviewed the archives in an interrogative manner by questioning the possible motives behind the government‘s moves to make the Pakistani financial system *Shari’ah* compliant and identifying the limitations of the research articles, and other publications on this subject.

The use of secondary data provides a number of advantages. The foremost advantage of using secondary data is the saving in time and money. Using existing data means that the researcher does not have to spend time in the field collecting data for their study. Using secondary data is also a cheaper alternative as the researcher does not need to spend money travelling to the field. This can be particularly expensive when the organisation being studied is in a far geographic location. Miles and Huberman (1994) state that while secondary data has advantages, it also has some disadvantages. The greatest drawback of using secondary data is

that the data is not focussed to the study and may be too broad in nature. Ghauri and Grønhaug (2002) suggest that the best way to overcome this problem is to take the research problem as the starting point for secondary data needed, and not the other way round. If the secondary data does not fit with the specific research problem they should not be used. Although secondary data is usually seen as being inexpensive, sometimes data provided by specialist organisations can be quite expensive. These databases can usually provide more accurate information which may be more useful than information sourced from public domains. Finally, secondary data may not always be accurate. It can be difficult to test for authenticity and accuracy when it comes to secondary data. Therefore researchers need to be extremely careful in the selection and use of secondary data as any inaccuracy in the data is the responsibility of the researcher.

3.2.2 Primary Data Collection

Primary data collection is suggested when secondary data is not available or unable to help answer the research questions. What a researcher gathers as their primary data depends upon the research problem and research design. There are various options available as far as primary data collection is concerned. Some of the more widely used options include observations, experiments, surveys and interviews.

As compared to secondary data, primary data provides the benefit of being purposeful and focussed to the project in hand. The data is therefore consistent with the research questions and purpose. While often seen as an advantage of using secondary data, primary data collection can in some cases be a cheaper alternative (Ghauri and Grønhaug 2002). For

example, conducting telephone surveys may be cheaper than purchasing data from a specialised database company.

Primary data collection does have some disadvantages as well. The amount of time required to collect data primary can be a major disadvantage for a researcher. This is especially true in instances when the researcher is undertaking a longitudinal study where the researcher collects data over a number of years (Silverman 2005). The cost of collecting the data is another hurdle a researcher can face with the cost of travel (in some cases to another country), accommodation and other related expenses can increase the cost of undertaking the research. Finally, where the researcher is attempting to undertake a field study, getting access to an organisation may be difficult. Organisations may not be open to the idea of an _outsider' gaining access to the company's operations and may not collaborate as much as the researcher would have hoped for (Stake 1995).

For the purpose of this study, primary data was collected via interviews with managers of financial institutions, *Shari'ah* advisors, and other individuals involved in the Islamic banking industry in Pakistan. A total of 30 individuals were interviewed over a period of five years across various cities in Pakistan. Table 3.2 provides a list of the interviewees.

Table 3.2: List of individuals interviewed

Role	Individuals interviewed	Total interviews including repeats
Executives from the Islamic Banking Department of the State Bank of Pakistan	3	5
Managers of Islamic banks	4	9
Managers of Islamic windows	6	13
Managers of banks offering conventional banking products	5	12
Shari'ah advisors	4	6
Executives from advertising companies working with Islamic financial institutions	2	3
Executives of companies using Islamic banking products	4	9
Chief researchers of international Islamic banking regulatory bodies	2	4
TOTAL	**30**	**61**

These interviewees were identified by employing both purposive and snowball sampling. In a purposive sample the researcher tries to get all possible cases that fit particular criteria, and in a snowball sample the researcher gets cases using referrals from one or a few cases, and subsequent referrals (Neuman, 2003). For the purpose of this study the selection of the interviewees was based on meeting one or more of the following criteria: experience in the banking and finance industry in Pakistan and experience in the Islamic banking and finance industry in Pakistan. This allowed the researcher to not only obtain information from bankers and *Shari'ah* supervisors, but also from regulators, researchers and users of banking products. Such a strategy for this type of study has been advocated by Bernard (1988), Creswell (1998),

Flick (2002), Glesne (1999), Hammersley and Atkinson (2000), Miles and Huberman (1994) and Silverman (2000).

According to Silverman (2005), the majority of published qualitative research articles use interviews. Interview-based research is considered optimal for research involving a small population of possible interviewees. Using this option requires the researcher to focus on the depth of the collected data rather than the breadth (Daniels & Cannice 2004). Bailey (1982) states that the advantages of using interview studies include:

- Flexibility in relation to information sought.
- Better response rate than mailed questionnaires.
- Opportunity to observe nonverbal behaviour.
- Control over the environment in which the interview is conducted.
- Control over the order of the questions asked.
- Opportunity to record spontaneous answers.
- Assurance that the responses are provided solely by the interviewee.
- Opportunity to ensure that all questions are answered.
- Can identify the precise time of the interview, providing opportunity to compare change in responses over time.
- Opportunity to use a more complex questionnaire.

However there are also disadvantages of using the interview method. Bailey (1982) identifies these as follows:

- The high costs of conducting interviews.

- The time required to: arrange an interview, travel to meet the interviewee, conduct the interview.
- The bias created by any interviewer‘s misunderstanding of the interviewee‘s answer.
- As compared to survey studies, interviewees are not given the opportunity to conduct research, to check records, to consult about facts, or to ponder their reply.
- Interviews can be viewed as an inconvenient exercise in contrast to survey, where the interviewee can take their time and can complete the questionnaire in parts if convenient.
- Interviewees cannot enjoy the same level of anonymity that they receive if responding to survey questionnaires.
- To ensure that they get in-depth information from the interviewees, interviewers may change the wording of the questions. This can make it difficult to compare the answers of different interviewees as the questions are not standardised.
- The physical distance between the interviewer ad the interviewee may be too great or the interviewees may be scattered around a country or the world. This can make it difficult to gain accessibility to potential interviewees.

There are four interview strategies used in qualitative research: structured interviews; semi-structured interviews; open-ended interviews and focus group (Silverman 2006). The selection of the appropriate interview strategy depends on the type of information being sought and requires the interviewer to demonstrate certain skills. According to Noaks and Wincup (2004), structured interviews require the interviewer to demonstrate neutrality and consistency in the way interviews are conducted, while semi-structured interviews require the interviewer to create a rapport with the interviewee and probe for further details when

required. Open-ended interviews require the interviewer to remain flexible and demonstrate active listening, and in a focus group the interviewer requires facilitation skills and the ability to back away from discussions so the group dynamics can emerge (Noaks and Wincup 2004). For the purpose of this study, the semi-structured interview method was employed. As discussed earlier, the author has personal contacts with members of the Pakistani banking industry and was therefore able to create rapport with the interviewees. Since the area of study is relatively new, the information sought was gathered from experts in the area of Islamic finance in Pakistan. Semi-structured interviews utilise a combination of both open and closed ended questions, and rely on information provided by people who are considered experts in the field (Glesne 1999). This approach thus provides an opportunity to better understand the interviewee's views and interpretation of events. Byrne (2004, p.182) explains the benefits of open-ended interview questions over closed-ended survey questions and states that:

> *"Qualitative interviewing is particularly useful as a research method for accessing individuals' attitudes and values – things that cannot necessarily be observed or accommodated in a formal questionnaire. Open-ended and flexible questions are likely to get more considered response than closed questions and therefore provide better access to interviewees' views, interpretation of events, understandings, experiences and opinions…[qualitative interviewing] when done well is able to achieve a level of depth and complexity that is not available to other, particularly survey-based, approaches."*

To gain insight into the working of the SSBs, interviewees were asked a number of questions which are detailed in Appendix 2. The interviews were conducted in Urdu and English. The researcher's ability to communicate in both the languages eliminated the need for translation services. Over the five year period follow-up face-to-face interviews were conducted with 25 of the interviewees to ensure that the views expressed by the interviewees during the

interviews were correctly translated and transcribed. This was done by asking some of the questions asked in the previous interview. The same response given by the interviewee meant that the researcher has successfully transcribed the information. The interviews also provided the researcher the opportunity to ask follow-up questions in the light of new secondary data and the information provided by other interviewees. Each interview lasted between 30 minutes to two hours.

The selection of the interviewees, who were treated as experts in the field, was based upon their experience and knowledge of the subject areas. According to Meuser and Nigel (1991 cited in Flick 2002), in expert interviews the interviewee is of less interest as a person than is their capacity of being an expert for a certain field of activity. These experts are integrated into the study, and are not seen as a single case study but as representing a group. The range of potentially relevant information provided by the interviewee is restricted much more than in other forms of interview. Therefore, the interview guide here has a much stronger directive function with regard to excluding unproductive topics. Meuser and Nagel (1991 cited in Flick 2002) discuss a series of problems and sources of failing in expert interviews. The main question is whether or not the interviewer manages to restrict and determine the interview and the interviewee to the expertise of interest. Some of the common problems include:

- The expert blocks the interview in its course, because he or she proves to be not an expert for this topic as previously assumed.
- The expert tries to involve the interviewer in ongoing conflicts in the field and talks about internal matters and intrigues in his or her work field instead of talking about the topic of the interview.

- He or she often changes the role between an expert and a private person, so that more information results about him or her as a person rather than his or her expert knowledge.
- As an intermediate form between success and failure, the ‗rhetoric interview' is mentioned. In this, the expert gives a lecture on his or her knowledge instead of joining the question-answer game of the interview.

The researcher overcame these potential issues by employing a number of strategies. The interviewees were selected using snowballing methods and through referrals from contacts in the industry. Thus, the individuals identified for the interviews were experienced and did not block the interview it its course. Having communicated with the individuals via email and phone prior to the interview and having sent them a brief of the study, the agenda of the meeting was ‗telegraphed' in advance. This ensured that during the interview the expert was less likely to talk about irrelevant issues. Also, not knowing the interviewees personally and conducting the interviews during business hours in the interviewees offices resulted in the interviews being focussed on the topic. Based on the researcher's past experience in the field in Pakistan, the interviews were not audio recorded. Past experience in Pakistan has shown that interviewees are not comfortable if interviews are audio recorded, which makes it difficult for the interviewer to engage the interviewee. Instead notes were made during the interview allowing the interviewers to feel more comfortable during the interviews.

After returning from each interview a set of fieldnotes were written that described the people, places, activities and conversations. Fieldnotes are the written account of what a researcher hears, sees, experiences, and thinks in the course of collecting and reflecting on the data in a

qualitative study. When conducting interviews, a researcher can be more successful in capturing the meaning and context of the interview if fieldnotes are written out. Relying solely on the content of the interview may result in missing the sights, smells, impressions, and extra remarks said before and after the interview. Fieldnotes can provide the context when the interviews are transcribed and also allow a researcher to record ideas, strategies and reflections and note patterns as they emerge rather than waiting till the data analysis stage (Bogdan and Bilken 1998).

In addition to conducting interviews, the researcher also accessed important legal, technical, and banking documents that also constituted primary data for this study. This included analysis of memos and guidelines issued by the State Bank of Pakistan, and of documents issued by the individual case study organisations. Such documentation provided background information about the requirements and functionality of SSBs and assisted in the construction of the interview questions. These documents included information on fit and proper criteria set by the State Bank of Pakistan for the selection of *Shari'ah* advisors. Other documents included the Islamic financial institutions' annual reports as well as *Shari'ah* audits. Table 3.3 provides a list of documents that were used for the purpose of this study.

Table 3.3: List of documents analysed

Islamic Banks	**Commercial Banks**
Research publications and standards produced by AAOIFI and IFSB.	General documents concerning the Basel Accord.
Documents detailing the general terms and conditions of Islamic Development Bank‘s Islamic Banking Portfolio.	Prudential Regulations for Commercial Banking issued by the State Bank of Pakistan.
Fit and Proper Criteria for Appointment of *Shari’ah* advisors. Published by the State Bank of Pakistan.	Fit and Proper Criteria for Appointment of *Shari’ah* Advisors. Published by the State Bank of Pakistan.
Detailed Criteria for Setting up of Scheduled Islamic Commercial Bank Based on Principles of *Shari’ah* In The Private Sector.	Detailed Criteria for Setting up of Islamic Banking Subsidiaries by Existing Commercial Banks.
Reports on technical *Shari’ah* review conducted by *Shari’ah* Supervisory Boards.	Reports on technical *Shari’ah* review conducted by *Shari’ah* advisors.
Bank‘s annual financial reports.	Bank‘s annual financial reports.

3.3 DATA ANALYSIS

Data analysis is the process whereby the researcher brings structure and meaning to the mass of collected data (Ghauri and Grønhaug 2002). Winter (2000) state that qualitative and quantitative data have different characteristics and therefore require different methods of analysis. Qualitative data is based on meaning expressed where the data collected is usually non-standardised requiring classification into categories and analysis is conducted through the use of conceptualisation. Quantitative data on the other hand is based on meanings derived where the data collected is numerical and standardised and analysis is conducted through the use of diagrams and statistics.

Analytical techniques for qualitative research are both varied and reasonably well-formulated (see Miles and Huberman 1994; Pettigrew 1990; Strauss and Corbin 1990; Yin 1989). Silverman (2000) states that data analysis should not wait till all the data is gathered. Even if only one interview has been conducted, the researcher should start transcribing, and analysing the data in the light of the research questions. This was the approach taken by the researcher in this study.

Stake (1995) advocates four forms of data analysis and interpretation in case study research. In categorical aggregation, the researcher seeks a collection of instances from the data hoping that issue-relevant meanings will emerge. In direct interpretation, the researcher looks at a single instance and draws meaning from it without looking for multiple instances. The researcher can also establish patterns and look for correspondence between two or more categories. And finally, the researcher can develop natural generalisations from analysing the data. These are generalisations that people can learn from the case either for themselves or for applying it to a population of cases.

For the purpose of this study, data analysis focussed on the identification of themes and the development of associated categories that would help explain behaviours and relationships. Thematic analysis involves searching for patterns in the data. Once a pattern is found, then there is good reason to suppose that something systematic is creating that pattern. This pattern is referred to as a theme (Shank 2002). Key themes and patterns emerging, continuing, discontinuing and re-emerging were identified across the whole period of the study through the processes of process noting, reflective noting and memo writing, and subsequent analysis, coding and memoing of both accumulated process and reflective notes

(Hammersley and Atkinson 1995). The theme and pattern making developed inductively from analysis of documentation and interviews, and the data was categorised (Scapens 1990; Pettigrew 1997; Ahrens and Dent 1998). This helped explain: the relationships between the concepts, and influences that impact the process and the apparent outcomes of the SSBs functioning. Potential relationships between the concepts were developed through memo writing, which portrayed and analysed each event, incident, discussion or behaviour identified and categorised from the source data. Memos from data analysed were accumulated under categories with a view to saturating the category‘s dimensions, associated contexts and meanings. This was done to the point where categories stabilised and subsequent memos merely reinforced previously accumulated memos without providing significant new explanations of categories (Glaser and Strauss 1967; Fox-Wolfgramm 1997; Ahrens and Dent 1998; Silverman 2000). The analysis of data for coding was done manually at the end of each interview. The more interviews were conducted, the more codes were added and unrelated codes gradually removed. This method was seen to be more thorough than waiting to analyse data once all the interviews were completed (Miles and Hubermann 1994). The categories were then developed and refined through a process of comparison, where data coded under a particular category were compared for similarities with and differences from data previously coded under the same category. This allowed the consolidation of a category, and the identification of new categories or subcategories (Glaser and Strauss 1967; Strauss and Corbin 1990; Miles and Huberman 1994; Hammersley and Atkinson 1995; Silverman 2000).

3.4 VALIDITY AND RELIABILITY

The criteria of validity and reliability are commonly alluded to in quantitative research and now it is reconsidered in the qualitative research paradigm (Golafshani 2003). According to Patton (2002) qualitative researchers should be concerned with validity and reliability when designing a study and analysing results. Some authors have developed their own concepts of validity and reliability and have generated what they consider to be more appropriate terms, such as, rigour, reliability and trustworthiness (Lincoln and Guba 1985; Seale 1999; Mishler 1990; Healy and Perry 2000; Stenbacka 2001; Davies and Dodd 2002). While the reliability and validity are essential criteria for quality in quantitative studies, in qualitative studies dependability, applicability and transferability are seen as essential criteria for quality (Lincoln & Guba, 1985; Mathison 1988). These terms are used to describe the accuracy and applicability of the methodology used and the outcomes of the research carried out by the researcher. This section looks at the use of validity and reliability in qualitative research and how these were met by the researcher.

Broadly defined, **validity** is concerned with the question of whether the researcher is studying the phenomenon they claim to be studying. The term validity is usually associated with quantitative research and is used to determine whether the research has truly measured what it was intended to do (Glesne and Peshkin 1992; Hoepf 1997; Wainer and Braun 1998; Seale 1999). In qualitative research the term validity is described in a number of different ways. Due to the richness of qualitative methods, it is difficult to have a single concept of validity (Winter 2000). Creswell and Miller‘s (2000) description of validity in qualitative research shows the importance of the researcher‘s behaviour during the research. According to the

authors validity in a qualitative study is affected by the researcher‘s perception of validity and their choice of paradigm assumption (Creswell and Miller 2000).

Reliability is concerned with the question of whether the researcher is obtaining reliable data (McKinnon 1988). Similar to validity, reliability is often associated with testing or evaluating quantitative research. In qualitative research the reliability is judged on the basis of quality of the research. A good quality study aims to provide clarification and generate understanding (Kirk and Miller 1986; Eisner 1991; Stenbacka 2001). The use of reliability in qualitative research is questioned by authors such as Stenbacka (2001) who claims that the concept does not truly reflect the quality aspect of the study. As Stenbacka (2001, p.552) argues:

> *“The concept of reliability is even misleading in qualitative research. If a qualitative study is discussed with reliability as a criterion, the consequence is rather that the study is no good.”*

Some researchers argue that the demonstration of validity should be sufficient in a study as without validity there cannot be reliability (see Lincoln and Guba 1985; Patton 2002).

Dependability is sometimes used in qualitative research to describe reliability. Dependability is measured by analysing the processes or steps followed by the researcher and the outcomes of the study. This in turn can be seen as enhancing the reliability of the study (Lincoln and Guba 1985; Hoepfl 1997). To ensure dependability the researcher is expected to verify the research steps through examination of raw data, data reduction products, and process notes (Clont 1992; Campbell 1996; Seale 1999).

Another term used to express validity and reliability is **'trustworthiness'** (Lincoln and Guba 1985). Mishler (1990) argues that trustworthiness has replaced validity and reliability as it is seen as a defensible idea and can help establish confidence in the study (Lincoln and Guba 1985; Johnson 1997; Seale 1999).

Davies and Dodd (2002) argue that the notion of **rigour** in qualitative research should differ from those in quantitative research. According to the authors the concept of rigour is biased towards quantitative research and needs to be reconceptualised by exploring subjectivity, reflexivity, and the social interaction of interviewing to make it relevant to qualitative research (Davies and Dodd 2002).

In order to establish reliability and validity in the study, the researcher took a number of steps. These included:

- undertaking a longitudinal study over a period of five years
- using multiple sources of information like interviews and document analysis
- by behaving in a positive manner which resulted in repeat visits and access to other potential interviewees.

These steps are further detailed in the next section that deals with threats to validity and reliability.

3.4.1 Threats To Validity And Reliability

In qualitative research the use of validity, as described in quantitative research, has often been questioned (Smith 1984). Stenbacka (2001) believes that validity as defined in quantitative research cannot be used for qualitative research. She argues that the term validity should be redefined for qualitative research. Validity concerns are challenging to handle and emphasis is usually placed on the following types: descriptive, interpretative, theoretical, and generalisability (Ghauri and Grønhaug 2002).

Descriptive: Descriptive validity refers to the degree to which the actual description given by the researcher holds true. Descriptive validity is concerned with the initial stage of data gathering. In this phase the emphasis is on accuracy in the statements that describe what was observed and experienced (Runciman 1983). Inaccuracies may occur if the relevant data was not gathered during the data collection stage, or if the language chosen does not best describe the observations and experiences (Maxwell 1992). By cross-checking the descriptions used for the study with multiple sources such as literature, documentation and multiple interviews, the researcher was able to obtain descriptive validity.

Interpretive: Interpretive validity is achieved by the qualitative researcher when they understand and report the participants' viewpoints, thoughts, intentions, and experiences (Johnson 1997). Interpretation is essentially related to the expressions used by the researcher to describe a situation and is mutually constructed between researchers and subjects. In qualitative research interpretation is seen as an unavoidable element of data collection (Winter 2000) and was applied in this study where the responses of the informants were reported in the findings.

Theoretical: Theoretical validity refers to the adequacy of the researcher‘s suggested theory for explaining the study‘s findings. According to Maxwell (1992) theoretical validity is a more abstract form of analysis than the descriptive and interpretive validities. Winter (2000) counters this by stating that this form of validity is applicable not only to the research, but also to the mental and emotional constructs of the researcher. Thus regardless of the metatheoretical constructions the researcher defines the recording and interpretation of the data at the initial stage of research (Winter 2000). The case study method used in this study does not attempt to test existing theory but aims to develop and elaborate theory on *Shari'ah* supervision.

Generalisability: Generalisability refers to the extent to which the findings from a study can be generalised to other settings. If the validity can be maximised or tested then the results can be viewed as credible and defensible (Johnson 1997). This may lead to generalisability of the results (Stenbacka 2001) which according to Patton (2002) is one of the criteria for quality case studies. The study aims to provide insights into the *Shari'ah* supervision process in the Islamic banking sector. These findings may lead to appropriate practices which could be generally applied through the industry.

The threats to reliability and validity in field studies differ from threats faced in other methods such as experimental studies. McCall and Simmons (1969), and Simon and Burstein (1985) identify four different types of threats in field studies:

- Observer-caused effects.
- Observer bias.
- Data access limitations.

- Complexities and limitations of the human mind.

Observer-caused effects are reactive effects of the observer‘s presence on the phenomenon under study. This threat is a result of participants changing their behaviour and conversations due to the presence of the observer. The observer may be viewed as a management spy, which would cause the participant to alter their natural behaviour.

In observer bias, the researcher‘s selective perception and interpretation can distort the true observation. The problem of observer bias cannot be eliminated, rather effort should be made to recognise the problem and manage it. This means that the researcher should accept the existence of the bias and make efforts to ensure that the data being analysed does not become contaminated.

Data access limitations occur due to a number of reasons. First, researchers may only be on site for a limited period of time and cannot observe what happened before their arrival and after their departure. Unknown to the researcher, the observation may take place during a period when the organisation or participant may be in the middle of an abnormal occurrence. Thus, the observation may be of an atypical situation rather than a typical one (Simon and Burstein 1985). Additionally, the research host may also place restrictions on mobility and access to certain individuals and/or documentation.

The complexities and limitations of the human mind mean that the statements made by the participants may not be clear and may not be taken on face value. The subject may consciously try to deceive the researcher by responding in a manner that is consistent with the

company or observer beliefs but may not be the truth. Another problem occurs due to human error. While the participant may not be deliberately trying to mislead the researcher, the incorrect information may be a result of natural human tendencies, such as forgetting to mention a certain piece of information (McCall and Simmons 1969).

The researcher potentially faced these reliability and validity issues while conducting interviews in Pakistan. Acknowledging these issues beforehand meant that certain strategies were employed to minimise the impact of these threats (McKinnon 1988). These strategies included:

- The amount of time the researcher spent in the research setting.
- The use of multiple data collection methods and multiple observations.
- The researcher‘s social behaviour while in the setting.

Spending a substantial amount of time in the research setting is considered as one of the requirements of good field research. Doing so can reduce the potential threat of observer bias. By not allowing themselves enough time, researchers take the risk of trying to seek interpretations and meaning of actions immediately, without understanding the context and reasoning behind it. The longer the researcher spends time at the research setting, the more the opportunity to confront events and statements that may be contrary to the researcher‘s expectations. For the purpose of this study, the researcher travelled to Pakistan annually for five years to visit the selected individual organisations, and to interview people connected with the Pakistani banking industry. This allowed the researcher to manage observer bias and understand the context prior to interpreting the actions and statements of the participants.

The second strategy relates to the use of multiple methods and observations. According to Black and Champion (1976), in field studies the occurrence is studied in its natural location and time and is present in multiple manifestations. This means that the researcher is faced by multiple indicators of the occurrence and needs to draw on multiple methods, such as observation, interviewing and document analysis. By doing so, the researcher can validate their findings using different methods. This strategy was used in this study. As mentioned earlier in the method steps, the researcher used a mixed method by conducting interviews, analysing relevant documents, and studying the historical context to understand the introduction and growth of the Islamic banking and finance industry.

Finally, the researcher‘s behaviour in the fields can also help overcome the threats associated with reliability and validity in field studies. The researcher made all attempts to ensure that the participants and the research organisations felt comfortable with the researcher‘s presence. This strategy not only helped in overcoming observer-caused effects but also helped in getting access to more participants via snowballing. Most of the interviewees were happy to discuss not only issues relating to the Islamic banking industry and their organisation, but when prompted were also willing to recommend other participants who were familiar with the industry. Thus, by being aware of personal behaviour, the researcher was able to access a wider pool of data sources.

By undertaking a longitudinal study over a period of five years, accessing multiple sources of information, and by behaving in a positive manner which resulted in repeat visits and access to other potential interviewees, the researcher has attempted to address the concerns of reliability and validity in this study.

These steps were taken to ensure that the study met the triangulation requirement. In quantitative studies the test for validity is very specific whereas in qualitative research, triangulation methods are generally applied. Triangulation can be described as the means for improving the validity and reliability of research. In qualitative study there is no one _œorrect' way of undertaking triangulation and the researcher can select from multiple methods of data collection and data analysis. The methods chosen in triangulation to test the validity and reliability of a study depend on the criterion of the research (Golafshani 2003). Triangulation is seen as a way of establishing valid proposition in qualitative studies where traditional scientific techniques cannot be applied. The use of triangulation strengthens a study as different methods of testing for accuracy are applied (Healy and Perry 2000).

3.5 CONCLUSIONS

This chapter has explained the methodology used for this study. Using the Pakistani Islamic banking industry as the embedded case study and selecting individual cases for comparison, the researcher undertook field research over a prolonged period in Pakistan. The data for this longitudinal study was gathered using primary and secondary sources. Primary data collection methods involved analysing documentation issued by the State Bank of Pakistan and the individual organisations and conducting interviews with *Shari'ah* supervisors and other individuals who had knowledge of the Pakistani banking industry. These experts were interviewed using semi-structured interview method. Secondary data was collected by analysing journal articles, books, magazine and newspaper articles, and historical studies conducted on the introduction of Islamic financing in Pakistan. To understand the present working of SSBs, a historical analysis of the Pakistani Islamic banking industry was also undertaken. This allowed the researcher to understand the context of the operations and to

understand why certain procedures were followed and whether they were successful or not. The data was analysed by identifying key themes. The identification of themes allowed the researcher to identify and explain the relationships between the concepts, and influences that impact the process and the apparent outcomes of the SSBs functioning. Potential relationships between the concepts were developed through memo writing, which portrayed and analysed each event, incident, discussion or behaviour identified and categorised from the source data. Finally, the issues of reliability and validity were addressed. The threats of observer-caused effects, observer bias, data access limitations and complexities and limitations of the human mind were faced by the researcher. These threats to the reliability and validity in field study were overcome by the researcher undertaking a longitudinal study over a period of five years, using multiple sources of information like interviews and document analysis, and by behaving in a positive manner which resulted in repeat visits and access to other potential interviewees.

CHAPTER 4

PROFILE OF PAKISTANI BANKING SECTOR AND INDIVIDUAL CASES

This chapter profiles the Pakistani banking sector and attempts made to Islamise the economy and the banking and finance sectors. In 1947 Pakistan came into existence as an independent homeland for the Muslims of South Asia. Thus the Islamic faith is central to Pakistan‘s identity and influences the way the country‘s political affairs and the economy are managed. The chapter provides an overview of the recent history of the banking sector in Pakistan. This background helps explain the contextual factors that led to the introduction of Islamic banking and finance in Pakistan, and the characteristics of the governance system followed by Pakistani banks in the Islamic banking area which are detailed in the results chapters. The chapter begins with an overview of Pakistan. The history of the Pakistani banking sector is then discussed, followed by details of the steps taken by the government to convert the economy to an interest-free system. The chapter concludes with the profiles of the individual banks analysed in this study.

4.1 PROFILE OF PAKISTAN

With a population of more than 172 million people (2008 estimate), Pakistan is the sixth most populated country in the world (Population Reference Bureau 2008). Situated in South Asia, Pakistan borders the Middle East via Iran, Central Asia via Afghanistan and Tajikistan, East Asia via China and other South Asian countries via its Eastern border with India (Dunung 1999).

The demand for a new country in South Asia called Pakistan was first put forth in a resolution in Lahore by the All India Muslim League on 23 March 1940 (Ahmad 1997). This new proposed country would be the homeland for the Muslims of South Asia and on 14 August 1947 Pakistan was created. Pakistan‘s population consists of people from different ethnic backgrounds such as Punjabis, Sindhis, Balochs, Pathans, Bengalis and Mohajirs (those who migrated to the newly independent state of Pakistan after the partition) who came together as a nation on the basis of the common religious belief of Islam (Khan 2007). The differences in the ethnic background were exposed in 1970-1971, when the then Eastern part of Pakistan broke away from the Western part to form the independent nation of Bangladesh (Memon 1996; Ziring 1971).

Pakistan was the first country in the world to declare herself an Islamic Republic on 23 March 1956 (Constitution of Pakistan 2008). More than 97 per cent of Pakistan‘s population belongs to the Islamic faith, making it the second most populated nation in the Muslim world after Indonesia. As such, religious beliefs heavily influence the national and business culture of Pakistan (Karim 2008). For the majority of Pakistan‘s existence, the military has ruled the country and many of the state owned enterprises, and a few financial institutions, are managed by active and retired military personnel (Dunung 1999).

4.2 THE BANKING SECTOR (PRE-PARTITION – 1974)

Prior to the partition of India, the financial sector was in the hands of foreign banks, some of which were British by origin. The oldest banks operating in India were the Chartered Bank and the Grindlays Banks, both of which commenced their operations in 1883 (Baig 1999; Baig 2000; Khalid and Hanif 2005). Among the local banks, the Imperial Bank of India was

the largest Indian Bank. Founded in 1919, the Imperial Bank performed the dual roles of a commercial bank as well as the central bank for India. In 1935 an independent central bank called the Reserve Bank of India was established. However, due to its large network, the Imperial Bank continued to play the role of a subsidiary of the Reserve Bank of India (Khalid and Hanif 2005).

The role of Muslims in the banking sector prior to the independence of Pakistan was limited. The only bank in pre-partition India that was owned by the Muslims of the sub-continent was Habib Bank which was established in 1941 (Khalid and Hanif 2005). To improve and strengthen the banking sector for the future Muslim State of Pakistan, the leader of the Muslim League, Muhammad Ali Jinnah, expressed his desire that another Muslim bank be established before partition. In 1947, a few months before the creation of Pakistan, the Muslim Commercial Bank was established (Baig 1999). After the creation of Pakistan, both Habib Bank and Muslim Commercial Bank shifted their headquarters to Karachi, the then capital city of Pakistan. Pakistan did not have its own central bank until 1948, a year after independence (Khalid and Hanif 2005). In May 1948, the founder of Pakistan, Muhammad Ali Jinnah, took steps for the immediate establishment of a central bank. These steps were implemented in June 1948, and the State Bank of Pakistan commenced operation on 1 July 1948. Under the ‗State Bank of Pakistan Order 1948', the bank was required to regulate the issuing of bank notes and keeping of reserves with a view to securing monetary stability in Pakistan (International Monetary Fund 2005).

From 1947 to 1974, the Pakistani banking sector grew rapidly. The private sector invested in the establishment of commercial banks with a network of branches across the country. At the same time, the State Bank of Pakistan granted licenses to certain foreign banks to operate in Pakistan. But in 1974, the banking industry fell into chaos when the government decided to nationalise the banking sector (Husain 2004).

4.3 THE BANKS (NATIONALIZATION) ORDINANCE, 1974

The Pakistani economy experienced rapid growth during the 1960s and in 1969 the exports of Pakistan were higher than the combined exports of Indonesia, Malaysia, Philippines and Thailand combined (Husain 2004). But popular perception had developed in Pakistan that income and regional disparities had widened resulting in concentration of wealth in a few hands. In 1971, the elected Government led by Zulfiqar Ali Bhutto came to power on a platform of promoting a socialist economy in the country (Karim 2008). The role of the government increased sharply, exercising both direct as well as indirect controls over the economy. The direct controls included restrictions on the entry and exit of new companies in the business sector; allocation of resources, and regulation of monopolies. Indirectly, the Government of Pakistan intervened in the economy through taxation, provision of subsidies and incentives in the form of tariff protection, tax exemptions, infrastructure and social services (Baig 1999). The Bhutto-led government decided that the best way for achieving equitable growth in Pakistan was to nationalise the industry, banks, insurance, educational institutions, utilities and other industries. Thus the public sector was responsible for the provision of all infrastructures including energy and communications and financial services but it also participated in the manufacturing activities as well.

The action to nationalise the banking sector was first promulgated as an Ordinance on 1 January 1974 by the President of Pakistan as _The Banks (Nationalization) Ordinance, 1974‘. The Bill of the Act was introduced in the National Assembly on 23 January 1974 with the following statement of objects and reasons:

> *"In order to provide the directing banking activities towards national socio-economic objectives, co-ordinating banking policy and co-operation in various areas of feasible joint activity without eliminating healthy competition in various fields of operation, and ensuring complete security of depositors' funds, the Banks (Nationalization) Ordinance, 1974 (I of 1974), was promulgated on the 1 January, 1974. This Bill, which contains certain additional provisions relating to the management and administration of the banks, seeks to replace the said Ordinance by an Act of Parliament".* (State Bank of Pakistan 1974, p.2)

Pursuant to the Rules of Procedure and conduct of business in the National Assembly, 1973, the Bill was referred to the Standing Committee on Finance, Planning and Development, Economic Affairs and Statistics. The Committee considered the Bill at its meeting held on the 28th January, 1974 and unanimously recommended introduction of the Bill in the National Assembly. On 29 January 1974 the Bill was introduced in the National Assembly and received the assent of the President of Pakistan on 7 March 1974 (State Bank of Pakistan 1974).

Though foreign banks were not affected under the policy of nationalisation, all life insurance companies, both Pakistani and foreign, were taken over by the government under its policy of nationalisation. The business operations, assets and properties of the sequestered insurance companies were merged under the patronage of State Life Insurance Corporation. In the banking sector, the government decided to retain only five major banks and the remaining banks were merged into them. As a result of this policy, Habib (overseas) Bank and Standard

Bank were merged into Habib Bank Limited, while Bank of Bahawalpur, Eastern Mercantile Bank and Eastern Bank Corporation were handed over to the National Bank of Pakistan. The Commerce Bank and Union Banks were amalgamated with the United Bank Ltd and the Premier Bank was merged into the Muslim Commercial Bank. Over half a dozen small banks operating in Punjab and NWFP were merged with Australasia Bank under a new title of Allied Bank of Pakistan. A new institution called the Pakistan Banking Council was also established. The Pakistan Banking Council was set up to act as a holding company of nationalised commercial banks and to exercise supervisory control over them. It therefore played the role of a coordinator between the nationalised banks and the government (Baig 1999; Khalid and Hanif 2005).

The deposits in the nationalised commercial banks were fully insured by the government. But despite this assurance, the high and increasing rate of inflation resulted in reduced deposits by 20 per cent and in real terms, deposits were reduced by about 23 per cent. At the same time there was rapid expansion in staffing, which grew by 55 per cent, and number of branches, which grew by 82 per cent in a period of five years (Khalid and Hanif 2005). Subsequent to the process of amalgamation, serious problems developed in the personnel adjustments in different banks. Before the merger of banks, the smaller banks were run by comparatively low paid and less qualified staff but with high ranks and designations. Their adjustment with the high cadre staff of larger banks created problems for the banks in the early days of nationalisation. In order to solve this problem, identical new grades, pay scales and positions across all banks were introduced by the finance minister (Baig 1999).

The operations of the nationalised banks were gradually becoming focussed on satisfying the requirements of the Banking Council which defeated the main principle of the Nationalization Act: serving the people. The appointment of Presidents and Senior Executives of the nationalised banks was made by the government while finance minister or senior bureaucrats in the finance ministry had the powers for transfers and postings of the bank staff. The Pakistan Banking Council became a strong body and was accused by many of nepotism when it came to promotions. In order to gain promotions or postings at desirable locations bankers had to win favour with the Banking Council by appeasing them through different ways[7]. On average, the chief executives or presidents of the banks were allowed to remain in a position not for more than two and half years (Husain 2004). As these chiefs of the banks were unsure of their likely term of service, their efforts were directed towards ensuring that they maintained a healthy working relationship with the Banking Council.

4.4 PRIVATISATION OF THE PAKISTANI BANKING SECTOR

By the end of the 1980s, the economy of Pakistan was facing challenges such as financial inefficiency, a crowding out of the private sector, and the deterioration of the quality of outputs and services, in addition to the rising vulnerability of financial institutions (Zahid 2000). Thus it was clear that the nationalisation process had been unable to meet the national socio-economic objectives. The role of the State Bank of Pakistan as the central bank had also been considerably weakened due to the presence of the Pakistan Banking Council, which also exercised supervisory control over banks. The duplication of the supervisory role was

[7] Such actions by bank managers included providing unsecured loans to friends and family members of staff of the Banking Council of Pakistan; and internal promotion of junior staff who were acquaintances of staff of the Banking Council of Pakistan.

diluting the State Bank of Pakistan‘s enforcement of its regulations over the nationalised commercial banks.

In April 1989, the Pakistani government appointed a British firm M/s N.M. Rothschild as consultants to undertake a study of the privatisation strategy the government should pursue. In May 1989, the consultants submitted their ―Privatisation and Public Participation in Pakistan” report which recommended privatisation on a widespread ownership basis as an appropriate strategy for Pakistan (Husain 2004; International Monetary Fund 2005; Zahid 2000). Through "Widespread Ownership" the consultants intended to bring thousands of small investors into share ownership which would help the development of Pakistan's capital markets. However, the report did warn that in case the participation strategy is not carefully structured to ensure that appropriate regulation is in place and the workers

The consultants were also of the view that a new department should be established that would deal with the privatisation of the various sectors. This department was expected to work under the instructions of the Ministry of Finance. The report also indicated that to increase the attractiveness of the units that were identified for privatisation should undergo financial restructuring (Zahid 2000).

In 1990, a Committee on Disinvestment and De-regulation was formed. The Committee in its preliminary report, submitted to the government in January 1991, recommended the disinvestment of 118 industrial units, which included 45 nationalised units taken over during the period 1972-74 (Husain 2004). The government approved this disinvestment plan and announced the creation of a Privatisation Commission to implement the disinvestment

programme within the shortest possible time. At the same time, a Cabinet Committee on Privatisation, with the Minister for Finance and Economic Affairs as its Chairman, was constituted to approve the recommendations of Privatisation Commission.

The dominance of public sector banks at the beginning of the 1990s was apparent with a share of 92.2 per cent of the total assets of the banking sector. The remainder belonged to foreign banks, as domestic private banks did not exist at that time. As of 30 June 1990, a total of 24 commercial banks (7 domestic and 17 foreign) were operating in Pakistan. Domestic banks, with absolute public sector ownership and a broad branch network, were catering to most of the commercial banking needs of the economy (Zahid 2000). But despite their dominance, the nationalised commercial banks were characterised by high intermediation costs[8]; over-staffing and over-branching; huge portfolio of non-performing loans, poor customer services; under-capitalisation; poor management; narrow product range; aversion to lending to SMEs/housing and other segments; undue interference in lending from agencies such as the Pakistan Banking Council, loan recovery and personnel issues (Baig 2000).

To prepare the public sector banks for privatisation, the government took a number of steps. The government made amendments in the Banks (Nationalization) act of 1974, paving the way for privatisation of the nationalised commercial banks and allowing entry of foreign banks in the country. The Pakistan Banking Council was abolished in January 1997, handing over supervisory powers to the State Bank of Pakistan. Other steps included equity injection of Rs46 billion in some of the public sector banks and write offs equivalent to Rs51 billion, layoffs of close to 35,000 employees in two phases from public sector banks and the closing

[8] Intermediation costs: the cost involved in the placement of money with a financial intermediary.

of over 2000 unbanked branches[9] (Husain 2004). To reduce the level of non-performing loans, the Pakistani government and the State Bank of Pakistan coordinated to establish the ‗Committee for Revival of Sick Industrial Units' and the ‗Corporate and Industrial Restructuring Corporation' which enabled debt recovery of over Rs15 billion.

The then Governor of State Bank Dr. Ishrat Husain (Husain 2004) underlined the uniqueness of Pakistan's political influence in economic matters. The implementation of the privatisation was undertaken during the regime of General Musharraf, who took over control of the government in 1999 in a military coup and subsequently was elected as the President of Pakistan. Husain (2004, pp.9-10) states:

> *"It is illustrative to understand the political economy considerations also. All of the above tough measures were taken during the military regime headed by General Musharraf. It must be recognized that these were not easy decisions that could be carried out under an elected representative government and a well functioning parliament. There would be all kinds of pressures on the elected leaders not to close the branches or shed off the redundant workers or to transfer the NPLs at a discount or issue the tax refund bonds. These were the tough measures that the President was convinced were necessary to prepare the banks for privatization and secure a decent buyer at a reasonable price. It is not therefore obvious that this experience would be amenable to replication under a different set of political regime".*

By March 2004, the share of the assets owned by nationalised commercial banks had declined to 18.6 per cent while those of the private sector banks jumped to 76 per cent. This included the share of foreign banks, which increased, from 7.8 per cent in 1990, to 10 per cent in 2004 (Husain 2004).

[9] Unbanked branches: refers to those branches that do not have enough customers to justify continued operation.

4.5 ISLAM, PAKISTAN AND THE ECONOMY

The move to bring in Islamic principles into the economy began with the passing of the constitution in 1956. The new constitution not only proposed that Pakistan be renamed as the Islamic Republic of Pakistan but also proposed that certain steps be undertaken to ensure that Muslims in Pakistan are permitted to live in a truly Islamic society. These proposals included specifically banning the sale and consumption of alcohol and broadly suggested that the government should take steps to bring the country to be compliant with *Shari'ah* principles. The impact of Islam on the country's philosophy was challenged in June 1962, when the second constitution under the leadership of the first Martial Law ruler President General Ayub Khan was introduced (Ziring 1971). The new constitution proposed removing the term "Islamic" from the official name and renaming the country "Republic of Pakistan". This lead to an immediate backlash from legislators and by December 1962 the first amendment to the constitution was made and the country was once again called the "Islamic Republic of Pakistan" (Blood 1995).

In 1962, the government of Pakistan established the Council of Islamic Ideology (CII). CII was given the task to advise the on how existing laws and provisions could be brought into conformity with the injunctions of Islam (Hassan 2007). Some of CII's functions included:

- To recommend laws conforming to the teachings of the *Qur'an* to the federal and provincial assemblies.
- To advise the parliament, the government or the president on any question referred to the council as to whether a proposed law is or is not repugnant to the injunctions of Islam.

- To make recommendations for bringing the existing laws into conformity with Islamic injunctions.
- To compile guidance for parliament and provincial assemblies.

During the 1960‘s CII made numerous recommendations to the Pakistani government on the elimination of interest from the economy as dictated by *Shari’ah* (Ahmad 1995: Ahmed, Iqbal and Khan 1996). These recommendations were largely ignored by the government.

The late 1960‘s saw Pakistan‘s identity as an Islamic state being challenged once again. The idea that Pakistan would serve as a homeland for Muslims in South Asia was threatened when ethnic identity became the central issue. This ultimately led to the break-up of the eastern part of Pakistan from the western part and the creation of a new independent Bangladesh in December 1971 (Blood 1995). During this upheaval, the CII‘s report of 1971 which recommended the elimination of interest from the economy went unnoticed (Ahmad 1995). The new leader of Pakistan, Zulfiqar Ali Bhutto, was elected to the office on the platform of social reform and secularism but soon turned his attention towards making Pakistan an important nation in the Muslim world. On 14 August 1973, on the occasion of the 26th anniversary of Pakistan‘s creation, the third constitution of Pakistan came into force and carried on the principles of Islamisation of the nation (Constitution of Pakistan 2008). Pakistan hosted the second Islamic Summit of Muslim Nations (also known as Organization of Islamic Countries) in Lahore during February 22-24, 1974 (Ali 2005). It was during this event that Islamic banking and finance received the official support of the Muslim nations with the summit members agreeing to the establishment of the Islamic Development Bank.

In 1976, CII amended its previous questionnaire of 1966, regarding the dilemma of interest, and mailed it to well-known Islamic jurists, Islamic laureates, economists and researchers of the State Bank of Pakistan, and to economic organisations in other Muslim countries (Ahmed et al 1996). The results of the questionnaire were analysed by CII and a set of recommendations were sent to the government. These recommendations were generally ignored and failed to attract any formal public debate in parliament.

Political uncertainty has been a major weakness of governance in Pakistan and this trend continued in the 1970s. The election in early 1977, which the incumbent government of Zulfiqar Ali Bhutto won, was tainted with claims of election rigging. The religio-political and other opposition political parties joined forces and campaigned against the government's alleged rigging of the election and lack of Islamic principles in the governance system (Burki and Baxter 1991). To please the religious parties, Bhutto declared that the weekly holiday would be moved from Sunday to Friday to help Muslim citizens observe the Friday prayers (Karim 2008). On 5 July 1977, Prime Minister Zulfiqar Ali Bhutto was arrested on charges of conspiracy to murder a political opponent and General Muhammad Zia-ul-Haq took over the reins of the country and declared martial law rule (Memon 1996).

One of the first steps taken by General Zia was to address the issue of Islamisation of the Pakistani economy (Ahmad 1995). A self-proclaimed devout Muslim, General Zia asked CII to prepare a blueprint of an interest-free economic system in September 1977 (Khan 2008). This move was seen as a step forward in fulfilling the requirements of Article 227 of the Pakistani constitution which states that all existing laws should be brought into conformity with the injunctions of Islam as laid down in the *Qur'an*. The CII viewed the President's

decision as an opportunity to enforce Article 31 of the Pakistani constitution which states that steps should be taken to enable the Muslims of Pakistan, individually and collectively, to order their lives in accordance with the fundamental principles and basic concepts of Islam (Ahmed et al 1996; Constitution of Pakistan 2008). The issue of interest free financing was seen as addressing Article 37 of the constitution which focuses on the promotion of social justice and eradication of social evils. For CII Article 37 placed responsibility on the State to eliminate *riba* as early as possible (Council of Islamic Ideology 1980).

To assist in the task, CII set up a panel consisting of 15 economists, central and commercial bankers, and financial experts. In view of the complexity of the task of eliminating interest from a system in which it was deeply embedded, the panel advocated a gradual approach. It submitted an interim report in November 1978 which recommended immediate removal of interest from financial institutions whose transactions are relatively less complex and from where interest could be removed with greatest ease (Ahmad 1995). While CII and their expert panel deliberated on the course of action towards an interest-free economy, General Zia made an announcement regarding an interest-free economy. On February 10, 1979, on the date of Prophet Muhammad‘s birth anniversary, General Zia announced that within a period of three years the Pakistani economy would be interest-free and that a decision had been taken to make an immediate start in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan (Khan 2008). Within a few months of this announcement, these specialised financial institutions took the necessary steps to re-orientate their activities on a non-interest basis. The conversion of operations of commercial banks to non-interest basis was a much more complex task and had therefore to be spread over a

longer time period. This decision was made without the final report from CII and was seen as an attempt to further strengthen the General's religious credentials before the execution of Zulfiqar Bhutto, which was carried out on 4 April 1979 (Ali 2005; Burki and Baxter 1991; Haqqani 2005).

The government introduced a scheme in July 1979 under which the nationalised banks were required to provide interest-free loans to farmers. From 1 July 1980, the coverage of the scheme was enlarged to include loans to small fishermen and cooperative societies for water course improvement (International Monetary Fund 2005).

The CII appointed panel produced its final report in June 1980 which contained recommendations for eliminating interest from all domestic financial transactions. The panel recognised the difficulty in eliminating interest from foreign transactions immediately and advised a gradual reduction in dependence on interest-bearing foreign loans. The reports by the panel were scrutinised by CII which made changes to the report to ensure conformity with Islamic law before submitting it to the government (Ahmad 1995).

The final report of CII provided a detailed framework for reorganisation of banking practices and procedures on the basis of profit and loss sharing instruments of *mudaraba* and *musharaka*. The CII report emphasised that the ideal Islamic techniques to replace interest in the banking and financial fields are profit and loss sharing instruments and *qarz-e-hasna*[10].

[10] *Qarz-e-hasna*: Literal meaning "godly loans" which is given in the name of Allah. These loans are usually given to the poor and destitute. Other use of this loan includes providing scholarship to deserving students. These loans are not compulsory and do not need to be repaid although receivers of the loan may wish to repay at a later date without any increase in the loan amount.

However, the report recognised that it may be difficult to change the entire system to profit and loss sharing (Council of Islamic Ideology 1980) and approved the use of other financial instruments such as leasing, hire-purchase, investment auctioning and financing on the basis of normal rate of return. The report however cautioned that the use of these methods should be kept to a minimum or there was a risk that these would open a back door for interest bearing products.

The CII report also warned that the adoption of profit and loss sharing system could be slow due to the low levels of literacy in Pakistan. The report suggested that the Government of Pakistan should also invest in educating the wider population and reform the tax system and accounting environment to aid the growth of the profit and loss system. No change was contemplated in the CII report with respect to the functions and responsibilities of the central bank (the State Bank of Pakistan). However, it recognised that the operating procedures and the contents and substance of its monetary policy instruments would undergo significant changes consequent to the elimination of interest (Khan 2008). These were discussed in detail in the CII report.

In view of the complexity of the task, the CII report suggested that elimination of interest could be made gradually under a phased programme. It laid down a plan of action with an order of priority for the elimination of interest from different sectors. According to the report, the process should commence with eliminating interest from government transactions, followed by eliminating interest from the operations of the commercial banks and other financial institutions, culminating finally in deposits of the banks becoming interest-free in the true sense of the term (Hassan 2007). The report argued strongly against starting the

experimentation with model banks or opening interest-free counters in existing commercial banks, side by side with interest-based operations.

In the meantime, the State Bank of Pakistan also prepared a report on the elimination of interest. The report was prepared by a committee headed by the Governor of the State Bank of Pakistan and did not differ substantially from the CII report in as far as the measures to eliminate interest were concerned. However, the CII report was a more comprehensive document and its special importance lay in the fact that it was prepared by a constitutional body which is especially charged with advising government on matters relating to *Shari'ah* (Hassan 2007).

The State Bank of Pakistan undertook the formidable task of overhauling the then existing bank legislation to meet the requirements of an interest-free system. The State Bank of Pakistan Act and Banking Companies Ordinance underwent substantive and far-reaching changes. Amendments were made in a number of other laws having a bearing on banking transactions (Khan 2008). Subsequently, as the new system got under way, further appropriate legislation was undertaken.

As part of the Islamisation of the country, the Government of Pakistan in 1979 decided to establish the Federal *Shari'ah* Court (FSC) of Pakistan (Federal *Shari'ah* Court 1991). The court consists of eight Muslim judges including the Chief Justice who are appointed by the President of Pakistan. These judges are selected from serving or retired judges of the Supreme Court of Pakistan or a High Court or from individuals who possess the qualifications of the judges of a High Court. Of the eight judges, three are required to be

Ulemas[11]. The FSC was given the power to examine and determine as to whether or not a certain provision of law is repugnant to the injunctions of Islam. Any appeals against the FSCs decisions would be made to the *Shari'ah* Appellate Bench of the Supreme Court, consisting of three Muslim judges of the Supreme Court and two *Ulemas* appointed by the President of Pakistan. If a certain provision of law was to be declared to be repugnant to the injunctions of Islam, the government was required to take necessary steps to amend the law so as to bring it in conformity with the injunctions of Islam.

A major step in the progressive elimination of interest from the operations of commercial banks was taken in January 1981 when, in accordance with the government decision, separate counters were set up for accepting deposits on profit and loss sharing basis in all of the five nationalised commercial banks (Hassan 2007). It was announced that the deposits received on profit and loss sharing basis will not be used by the banks in interest-bearing operations and that these accounts will be maintained quite separately.

The Government of Pakistan had intentions to eliminate interest from the economy within a period of three years but the parallel system of banking continued to operate in the country, giving customers the option of depositing their money in interest-bearing bank accounts. In June 1984, the government announced that the parallel system would end during the course of 1984-85 (Khan 2008). Accordingly, all commercial operations of the banks were transformed into non-interest based modes of financing except for past commitments which were allowed to run to maturity according to the original terms of the contract. The other exception related to on-lending of foreign loans which continued to be governed by the terms

[11] *Ulemas* are Muslim legal scholars who are known as arbiters of *Shari'ah* law.

of the loan. From 1 July 1985, banks were prohibited from accepting any interest-bearing deposits except foreign currency deposits which continued to earn fixed interest rate (Khan 2008). Barring the deposits received in the current accounts, all deposits accepted by banks shared in the profits and losses of the banking company. The current accounts were exempt as the capital sum was guaranteed and no interest was traditionally paid on these accounts.

The modes of financing specified in a State Bank circular permitted the use of mark-up technique (*murabaha*) for financing a wide variety of activities in the private sector. However, in view of the widespread criticism that charging a mark-up over mark-up in case of default was not compatible with Islamic teaching, banks were instructed to discontinue the practice of charging an amount on default (Ahmed et al 1996). Other modes of financing specified in the State Bank circular were as follows: loans free of interest but carrying a service charge; *qarz-e-hasna*; purchase of trade bills on the basis of mark-down or mark-up in price; purchase of movable or immovable property by the banks from their clients with buy-back agreement or otherwise; leasing; hire-purchase; financing for development of property on the basis of a development charge; *musharaka*; equity participation and purchase of participation term certificates and *mudaraba* certificates; and rent-sharing in the case of house financing (Ahmad 1995).

The *mudaraba* technique of financing was first introduced in June 1980 when a law called the –Mudaraba Companies and Mudaraba (Flotation and Control) Ordinance" was promulgated and followed up by issuance of enabling regulations in January 1981 (Khan 2008). Under this law companies, banks and other financial institutions could register themselves as *mudaraba* companies and issue *mudaraba* certificates to mobilise funds. The

use of these funds was limited to fund only those business activities that were permitted under *Shari'ah* and required prior clearance from a religious board established by the government specifically for the purpose. The law contains a number of provisions to safeguard the interest of *mudaraba* certificate holders. These include quicker and simpler adjudication of disputed manners by a tribunal specially set up for this purpose and a condition imposed on the auditors to certify that the business conducted by the *mudaraba* company is in accordance with the objects, terms and conditions of the *mudaraba*. The promulgation of the *mudaraba* law opened the way for the issuance of a new type of financial instrument in the form of *mudaraba* certificates and helped in broadening the dimensions of the newly-emerging Islamic financial market. Investment through the medium of *mudaraba* companies gained a good deal popularity and by the end of 1991 over 30 *mudaraba* companies had been listed on the stock exchange.

The capital market in Pakistan also witnessed a rapid growth in leasing business in the context of Islamisation of the financial system. With certain conditions, leasing was deemed as an approved mode of Islamic financing and some firms were registered specifically as leasing companies. The concept of *musharaka* was used in developing another new financial instrument known as Participation Term Certificates (PTCs) (Hassan 2007). These PTC were intended to replace the interest-bearing debentures for financing long-and-medium-term requirements of business and industry and were designed to be a variable dividend security with the return on it linked to actual profit made within a specific maturity period.

The Pakistan Banking Council described other approved modes in broad general terms and provided banks with the flexibility to develop their own model agreements and documents for

practising them. In response, banks dropped their plans to finance on the basis of profit and loss sharing, leasing and hire-purchase and started to rely heavily on mark-up mode of financing (*murabaha*). By 1984, the mark-up financing option made up 86.7 per cent of the total banking operations of the commercial banks. The profit-and-loss sharing system amounted to only 3.1 per cent of total financing operations of Pakistani banks (Khan 2008). The State Bank of Pakistan‘s profit-and-loss sharing schemes like *mudaraba* companies and PTC financing were abandoned after some time because of accounting, tax, legal and other structural constraints. Banks invested a large portion of profit-and-loss sharing deposits in interest-based venues and other fixed mark-up investments and paid almost risk-free and predetermined rates of return to profit-and-loss sharing depositors (Hassan 2007). In 1985, the SBP permitted banks to invest their profit-and-loss sharing funds in interest-based government securities further complicating the Islamisation of the banking sector in Pakistan (Zaidi 1987).

The banking sector faced further challenges in regards to implementation of the government‘s interest-free economic vision. The State Bank of Pakistan lacked in the research and development advisory facilities that might assist in the Islamisation process. There was a lack of proper Islamic *Shari'ah* training for bankers. No efforts were made to bring rigorous reforms in accounting, tax, legal and other state institutions so as to create conducive socio-economic environments for the interest-free banking practice. According to Khan (2008), a number of Islamic jurists had reservations over the practice of mark-up financing in Pakistan (see Lashkar 1991; Kadri 1996). In 1985 the President of Pakistan, General Muhammad Zia-ul-Haq, admitted before the National Assembly of Pakistan that he had been unsuccessful in eliminating interest from the economy and financial sector of Pakistan (Nienhaus, 1988).

Though the financial system of the country underwent significant changes since then, the process of Islamisation was challenged by critics who questioned whether the new system was truly Islamic. This challenge took on a legal form when petitions were taken up by the FSC which declared a number of existing financial laws and practices as repugnant to the injunctions of Islam and called upon the Pakistani government and other concerned agencies to take necessary action to bring them in conformity with the Islamic tenets by the end of June 1992. The following section details the FSC judgement of 1991.

4.6 FEDERAL *SHARI'AH* COURT JUDGEMENT IN 1991

The FSC of Pakistan announced a judgement in December 1991 on the legality of interest on financial transactions. The court, presided over by Justice Tanzilur Rahman, decreed that the provisions of interest in a number of fiscal laws came under the definition of *riba* and thus these legal provisions were repugnant to *Shari'ah*. The court fixed 30 June 1992 as the day when this decision would come into effect and these legal provisions would be null and void after that date (State Bank of Pakistan 2003).

The FSC got the mandate to admit petitions challenging fiscal laws on 25 June 1990. Prior to this, the Government of Pakistan had made successive amendments in the constitution to keep fiscal laws out of the jurisdiction of the FSC. The FSC admitted the first petition challenging ~~"in~~terest" on 11 December 1990, after which a number of other petitions were filed. The hearing concluded on 24 October 1991 and the judgement announced on 7 December 1991 (Ahmed et al 1996). The ruling covered the following areas: definition of

riba, Indexation of loans, Legality of mark-up and leasing transactions, and Interest in international transactions.

The FSC based its judgement on various verses from the *Qur'an*, the sayings of Prophet Muhammad (*Hadith)*, and extracts from CII the report of 1980. The ruling also referred to the replies of the questionnaires issued by the FSC to 12 distinguished scholars, economist, bankers and jurists from within Pakistan and abroad (Federal *Shari'ah* Court 1991). In its judgement, the FSC stated that:

> *"a transaction which contains excess or addition over and above the principal amount of loan, which is predetermined in relation to time or period to be conditional to the payment of predetermined excess or addition, payable to the creditor (such a transaction containing the said elements) constitutes riba and any sale, transaction or credit facility, in money or in kind, has been considered to be a transaction of riba, which is unlawful (haram) in the territory of Islam and in Muslim society. There is a consensus (ijma) of the Muslim jurists on it"* (Federal *Shari'ah* Court 1991, p.104).

Thus, according to the ruling, any stipulated increase on capital will be considered *riba* and therefore illegal. This ruling applied regardless of whether the increase on capital was high or low, simple or compound, taken for any reason (personal or productive), and for whatever length of time. The FSC also ruled that the indexation of loans would not be permitted. There was an argument put forward to the court that in a period of inflation the purchasing power of the money erodes over time and thus the creditor should be compensated for this erosion in the real value of money. The court discussed this issue at great lengths quoting from the contemporary economics texts and classical Islamic legal sources to show that in case of price increase, the principal sum lent will have to be returned in the same quantity and in the same currency in which the loan was taken in the first instance. The court gave various

reasons for this. First, the increase in value is so similar to interest that it would be impossible to differentiate one from the other. Second, the erosion in value due to inflation has not been caused by the debtor or by their use of the money; therefore it seems inequitable to ask the debtor to compensate for it. Third, demanding indexation of loans gives a privileged position to capital as compared to other factors of production which is also affected by inflation in one way or the other. Fourth, it is difficult to agree on one such basket of commodities which affects all types of creditors uniformly. Fifth, indexation would tend to induce the savers to shy away from risk capital which has been emphasised in the Islamic value system. Sixth, the supporters of indexation do not recommend a reduction in the debt during times of deflation which is inequitable (Federal *Shari'ah* Court 1991).

The court was unable to provide an alternative and acknowledged the challenge by stating that:

> *"there should be a means of redressing these evils (of inflation), and indexation is claimed to be one such technique. But an evil, as already discussed above, should not be redressed by a similar or a bigger evil. Muslim economists should try to explore the ways of fighting inflation within the sanctions provided by the Shari'ah"* (Federal *Shari'ah* Court 1991, p.177).

On the issue of the mark-up based financing system (*murabaha*) introduced by Pakistani banks in the 1980's in the wake of Islamisation of the economy, the court ruled it to be illegal. The court quoted extensively from Justice Maulana Taqi Usmani's research and concluded that the mark-up charged is the price of time allowed on a debt is interest and therefore forbidden (Ahmad 1995). The court acknowledged that there was a difference of opinion among the jurists regarding the issue of increase in the price of a commodity due to the deferred payment, but did not deliberate any further. This ruling was a major blow for

the Islamic banking and financing system in Pakistan as majority of the Islamic financial transactions were based upon the *murabaha* option. In relation to the leasing and lease-purchase options of financing used by Pakistani financial institutions, the FSC ruled that these were acceptable forms of financing and fulfilled the requirements of being *Shari'ah* compatible (State Bank of Pakistan 2003).

The FSC also ruled that the Government of Pakistan could no longer argue that international transactions be exempt from *Shari'ah* requirement prohibiting interest. The court recommended that in the future the Pakistani government should undertake all financing on the basis of equity while foreign exchange markets could continue to operate as usual (Ahmad 1995).

The FSC judgement invoked a mixed reaction in the wider community. The financial institutions in Pakistan and their depositors opposed the FSC judgement on the grounds that it harmed their earnings. On the other hand the borrowers supported the FSC judgement as its implementation would result in an automatic cancellation of accrued interest on their liabilities towards banks. Foreign investors were nervous about the uncertainty that the FSC judgement had created and in response a sharp decline in foreign investments, aids and loans was observed (Hassan 2007). The religio-political parties demanded immediate enforcement of the FSC judgement in the country whereas others called for challenging the FSC judgement in the Supreme Court of Pakistan (Khan 2008). To allay the fears of the depositors and foreign investors, the Government of Pakistan and the financial institutions lodged appeals against the FSC judgement in the Supreme Court of Pakistan.

4.7 THE COMMISSION FOR ISLAMIZATION OF THE ECONOMY REPORTS: 1992 AND 1997

In response to the criticism levelled against the interest-free financial system operating in the Pakistani economy, the Government of Pakistan constituted a new committee called the Commission for Islamization of the Economy (CIE). The Commission was formed in 1991 and was given the task of making recommendations for improving the credibility of the interest-free banking practice in Pakistan (International Institute of Islamic Economics 1998; Khan 2008). In June 1992, the CIE submitted its first report which is commonly referred to as the Hanfi Commission Report (headed by the then Governor of the State Bank of Pakistan, Mr. I.A. Hanfi). The report observed that the Islamic banking system in Pakistan was using non-Islamic financial options and needed to be rectified. The commission recommended that the profit and loss sharing instruments such as *mudaraba* and *musharaka* be used as the basic forms of Islamic financing options and that steps should be taken to remove obstacles in the application of these modes (State Bank of Pakistan 2003). The CIE also ruled that the mark-up system used by the *murabaha* option was interest based. The recommendations made to the government included:

- Introduction of a law to prohibit interest
- Taking steps to create a mass awareness of the new system
- Providing adequate training to the bank‘s staff to apply these modes of financing in their operations
- Reinforcing the system of corporate audit
- A thorough re-appraisal of the tax system and treating dividend paid on equity as at par, for tax purposes, with profit paid on other interest-free finance
- Recovery laws to be made more effective and stringent, and

- Establishment of a permanent committee consisting of *Shari'ah* experts and bankers to advise the government on various aspects of Islamisation of banking and financial system.

The CIE report was criticised by many observers as an attempt to satisfy the government's coalition partners who consisted of religio-political parties (Khan 2008). There was only one occasion where all 12 members of the commission were available and it took only seven meetings for the commission to conclude its findings (Khan 2008). The CIE's report therefore had no impact and the government did not take any action on it (Hassan 2007).

During the period of 1992-1997 there were no significant attempts made to progress the issue of interest elimination from the economy. The Government of Pakistan and many commercial financial institutions appealed the decisions of the FSC to the *Shari'ah* Appellate Bench of the Supreme Court of Pakistan. These appeals delayed the enforcement of the FSC's deadline of July 1992. In May 1997, the CIE published its second report called the Raja Zafarul Haq Commission Report (headed by Raja Zafarul Haq, the Federal Minister for Religious and Minorities Affairs) (Mehmood 2002, State Bank of Pakistan 2003). The report recommended that a phased approach to transition to an Islamic economy should be undertaken. The transition should first see changes made to the private domestic transactions and then to government and foreign transactions. This recommendation was made without providing a specific date for implementation. The commission proposed that an act of parliament be introduced which after consultation would provide the ancillary details toward the adjustment and smooth transition to the new system; specifically it would provide for the manner in which the existing arrangements will be converted to the new system, suggested alternative

modes of financing, method of settlement of Government liabilities (including mobilisation of resources for retiring government‘s debt) and constraints on its future fiscal operations (Khan and Bhatti 2006). The report recommended that the State Bank of Pakistan be given a more involved role to ensure the smooth implementation of the new proposed changes.

The CIE also invited the International Institute of Islamic Economics (IIIE) to offer its recommendations to revamp the financial sector of Pakistan along Islamic lines. In July 1998, the IIIE submitted its findings to the CIE, titled, ‗International Institute of Islamic Economics (IIIE)‘s Blueprint of Islamic Financial System, Including Strategy for Elimination of Riba‘‘ (Khan 2008). The IIIE report suggested a number of permissible financing options including *mudaraba*, *musharaka* and *ijarah*. The IIIE concluded that Islamic banks were not charity houses and thus were not required to provide *qarz-e-hasna* loans to the destitute members of the society (International Institute of Islamic Economics 1998). The report like the CIE‘s second report recommended a more involved role for the State Bank of Pakistan where the State Bank would regulate the Islamic financial market.

The IIIE was criticised for preparing its report without consulting bankers or experts in the Islamic *Shari'ah* and other related disciplines. The IIIE‘s approach for eliminating interest from the financial system of Pakistan was seen as being quite narrow with the focus being on replacing interest-based financing options with ones that were interest-free without making changes to the existing banking environment (Khan and Bhatti 2006; Khan 2008).

4.8 JUDGEMENT OF THE *SHARI'AH* APPELLATE BENCH OF THE SUPREME COURT OF PAKISTAN 1999

The Federal Government of Pakistan as well as different banks and financial institutions of the country filed 67 appeals in the *Shari'ah* Appellate Bench of the Supreme Court of Pakistan against the judgement of the FSC. Under pressure from the coalition religio-political parties, the government of Prime Minister Nawaz Sharif on 2 July 1997 tried to withdraw its appeal filed with the *Shari'ah* Appellate Bench (Hasan 2007). The request to withdraw the appeal was rejected by the Supreme Court and in 1999 the Appellate bench commenced its hearing. The *Shari'ah* Appellate Bench was comprised of Justice Khalilur-Rahman, Justice Munir A. Shaikh, Justice Wajeehuddin Ahmad and Justice Maulana Taqi Usmani. The bench started hearing the appeals in March 1999 and invited more than 20 scholars from within the country and from abroad to assist the court in resolving the issues involved. The experts who addressed the court included *Shari'ah* scholars, bankers, lawyers, economists, businessmen and chartered accountants. The hearing of the case continued till the end of July 1999 on day-to-day basis after which the judgement was reserved (Supreme Court of Pakistan 1999).

On 23 December 1999, the Appellate Bench announced the decision to uphold the Federal *Shari'ah* Court's ruling and declaring interest as unlawful (BBC News 1999). The court ruled that existing laws relating to banking and finance would need to be removed by 30 June 2001 (Supreme Court of Pakistan 1999). The bench resolved that the prevalent mark-up practice used in *murabaha* was an interest-based activity, because it involves pure lending on the basis of mark-up or fixed rent on the loaned capital (Supreme Court of Pakistan 1999). The court also ruled that the existing profit-and-loss sharing financing arrangements in the financial system of Pakistan are based on interest and confirmed the FSC's verdict that bills,

debentures, bonds and other commercial instruments should be banned under Islamic *Shari'ah* (Supreme Court of Pakistan 1999).

The full judgement of the court consisted of 1100 pages, making it the most voluminous judgement ever delivered by a superior court. The order of the Supreme Court was 106 pages long (Supreme Court of Pakistan 1999). The court directed the government to undertake a number of steps. Some of these steps included:

1. The federal government shall, within one month from the announcement of the judgement, constitute a high-level commission in the State Bank of Pakistan. This commission would be fully empowered to carry out, control and supervise the process of transformation of the existing financial system to the one conforming to *Shari'ah*. It membership shall comprise of *Shari'ah* jurists, committed economists, bankers and chartered accountants.
2. Within two months of its creation, the commission shall elucidate the strategy to evaluate and implement the reports of the Commission for Islamization of the Economy as well as the report of Raja Zafarul Haq Commission. This task should be carried out after circulating the reports among the leading banks, religious scholars, economists and the State Bank and Finance Division, inviting their comments. The feedback and final recommendation of the commission shall be sent to the Ministries of Law, Finance and Commerce, all the banks and financial institutions to take steps to implement it.
3. The court also directed the Ministry of Law and Parliamentary Affairs to form a task-force within one month from the announcement of the judgement. The task force would comprise of officials from the Ministry and two *Shari'ah* scholars from the

Council of Islamic Ideology or Economy. The task force would be expected to draft a new law for the prohibition of *riba* and to review the existing financial and other laws to bring them into conformity with the requirements of the new financial system.

4. All banks and financial institutions shall arrange for training programmes and seminars to educate the staff and the clients about the new arrangements of financing, their necessary requirements and their effects.
5. Serious efforts shall be made by the Government of Pakistan to relieve the nation from the burden of foreign debts as soon as possible, and to renegotiate the existing loans. Serious efforts shall also be made to structure the future borrowings, if necessary, on the basis of Islamic modes of financing.
6. The following laws being repugnant to the injunctions of Islam would cease to have effect from 31st March 2000:-
    - The Interest Act, 1839.
    - The West Pakistan Money-Lenders Ordinance, 1960.
    - The West Pakistan Money-Lenders Rules, 1965.
    - The Punjab Money Lenders Ordinance, 1960.
    - The Sindh Money Lenders Ordinance, 1960.
    - The N.W.F.P. Money Lenders Ordinance, 1960.
    - The Balochistan Money Lenders Ordinance, 1960.
    - Section 9 of Banking Companies Ordinance, 1962.
7. The other laws or the provisions of the laws to the extent that those had been declared to be repugnant to the injunctions of Islam would cease to have effect from 30th June, 2001.

Following the Appellate Bench decision, the government set up a ‗‗Commission for Transformation of Financial System (CTFS)'' in the State Bank of Pakistan to devise measures for ensuring the compliance of the financial sector with *Shari'ah*. As per the *Shari'ah* Appellate Bench's ruling, the CTFS was constituted in January 2000 under the Chairmanship of Mr. I.A. Hanfi, a former governor of the State Bank of Pakistan (Mehmood 2002; State Bank of Pakistan 2003). The Ministry of Law and Parliamentary Affairs of Pakistan formulated a task force which would be responsible for devising legal and regulatory frameworks for the Islamic economy. Another task force was established in the Ministry of Finance of Pakistan with the expectation that it would direct and facilitate the transformation of extant interest-based government securities into Islamic modes of financing (Khan 2008; State Bank of Pakistan 2008).

The CTFS submitted two interim reports to the Government: the first in October 2000 and the second in May 2001 (State Bank of Pakistan 2008). The first interim report provided key features of the Islamic financial system and recommended some actions to be taken for preparation of introduction of a *Shari'ah* compliant financial system. These suggested actions included changes to the legal environment to allow the working of the Islamic financial system; training of bank staff and the wider community. The second interim report provided details on *Shari'ah* compliant modes of financing and proposed a legal framework for its implementation. The final report submitted in August 2001 and was an amalgamated version of the previous two interim reports and dealt with financial products, documentation issues (for example, letter of credit), credit cards and various kinds of bank accounts (Hassan 2007; Khan 2008). The CTFS stated that except for the current accounts, all other deposits would be accepted on the basis of the *mudaraba* principle. In the case of current accounts, the banks

were not required to provide any return on the deposits and were permitted to charge accounting keeping fees. The CTFS also suggested that its recommendations should be circulated among financial institutions t aid the awareness and expectation of the Islamic financial system (Hassan 2007).

4.9 APPEAL AND SUBSEQUENT RULING OF THE SUPREME COURT 2002

In the year 2000, United Bank Limited filed a Civil *Shari'ah* Review Petition seeking review of the *Shari'ah* Appellate Bench's judgment of 23rd December, 1999 (Supreme Court of Pakistan 2002). Despite the formation of the CTFS at the State Bank of Pakistan, the Government of Pakistan was running out of time to carry out the transformation of the economy by the deadline imposed by the *Shari'ah* Appellate Bench. In the year 2001 an application was filed with the *Shari'ah* Appellate Bench requesting suspension of the operation of the judgment and extension of time for its implementation (Khan 2008). In view of the evidence put forth by the federal government, the *Shari'ah* Appellate Bench provided an extension for implementation of the judgment till 30 June 2002 (Khan and Bhatti 2006).

Prior to the appeal, the Government of Pakistan imposed a premature retirement on Justice Maulana Taqi Usmani who was one of the judges of the *Shari'ah* Appellate Bench that ruled against the government's appeal in 1999 (Khan 2008). The Appellate Bench now consisted of the following judges: Justice Sh. Riaz Ahmed, C.J., Justice Munir A. Sheikh, Justice Qazi Muhammad Farooq, Justice Dr. Allama Khalid Mahmood, and Justice Dr. Rashid Ahmed Jullundhari. Two of these judges were appointed by the Government of Pakistan specifically for the hearing of the United Bank Limited's petition. These judges were known for holding a

personal opinion that bank interest does not fall under the definition of *riba* that is prohibited by the *Qur'an* (Khan 2008).

At the commencement of hearing of these review petitions, objection to the constitutionality of the appointment of the two judges (Dr. Allama Khalid Mahmood and Dr. Rashid Ahmed Jullundhri, *ad hoc* members of the *Shari'ah* Appellate Bench) was raised. It was urged that their inclusion in the *Shari'ah* Appellate Bench was unconstitutional and illegal. The court observed that the question of appointment of *ad hoc* members of the Bench could not be raised (Supreme Court of Pakistan 2002). Furthermore, it was observed that both the learned *ad hoc* members were recognised scholars, were on the panel of *Ulema* and their appointment had met the requirements of the Constitution of Pakistan and the FSC. With the military once again controlling the government agencies, the religio-political parties had less political influence. Two major religious parties, namely the ‗Jamaat-e-Islami'' and ‗Jamiat-e-Ulema-e-Pakistan'' opposed the review of the case and pleaded with the Appellate Bench to reject the appeal made by the bank (Khan 2008).

The counsel for the Government of Pakistan argued that according to the constitution of Pakistan, the FSC had no jurisdiction to embark upon declaring *riba* as illegal. The constitution placed a duty upon the federal government and not the FSC to eliminate *riba* as early as possible and therefore the FSC as well as the *Shari'ah* Appellate Bench of this Court had no jurisdiction to set deadlines for elimination of *riba* (Supreme Court of Pakistan 2002).

The counsel for the government and the United Bank Limited also contended that the rulings by the FSC and that of the *Shari'ah* Appellate Bench had serious weaknesses, where the most important and delicate questions having material bearing on the issues involved in these cases have not been dealt with. The Government counsel stated that in the course of the hearing he had raised at least 33 propositions which were not attended to by the *Shari'ah* Appellate Bench. He argued that the judgment of the FSC in 1991 was biased as Justice Dr. Tanzilur Rahman, (the then Chief Justice of the FSC who had since retired) had predetermined the judgment. It was explained that during the judgment, Justice Rahman had failed to acknowledge his conflict of interest as he had heavily relied on the report of the Council of Islamic Ideology which was authored when he was the Chairman of the Council (Supreme Court of Pakistan 2002).

It was also argued that the *Shari'ah* Appellate Bench, also ignored the opinions of other respected Islamic jurists, whose views on interest did not match those of the learned judges. Thus the decision relied much upon the writings of Dr. Tanzilur Rahman and Justice Maulana Taqi Usmani (Supreme Court of Pakistan 2002). The government also claimed that the alternative banking and financial system proposed in the judgment under review was not at all workable and despite attempts the government had been unable to implement it.

On 24 June 2002, the *Shari'ah* Appellate Bench ruled that the previous decision by the bench in 1999 as well as the FSC ruling required further clarification and therefore the case should be sent back to the FSC for further review. In making the decision the court stated:

> *"In the light of the foregoing discussion, we are of the considered view that the issues involved in these cases require to be re-determined after thorough and*

elaborate research and comparative study of the financial systems which are prevalent in the contemporary Muslim countries of the world. Since the Federal Shari'ah Court did not give a definite finding on all the issues involved the determination whereof was essential to the resolution of the controversy involved in these cases, it would be in the fitness of things if the matter is remanded to the Federal Shari'ah Court which under the Constitution is enjoined upon to give a definite finding on all the issues falling within its jurisdiction.

Resultantly, Civil Shari'ah Review Petition No. 1 of 2000 filed by the United Bank Ltd is allowed, the judgment dated 23rd December, 1999 passed by the Shari'ah Appellate Bench of this Court in Shari'ah Appeals No. 11 to 19 of 1992 and the judgment dated 14th November, 1991 of the Federal Shari'ah Court passed in Shari'ah Petitions No. 42-I + 45-I of 1991 etc. are set aside and the cases are remitted to the Federal Shari'ah Court for determination afresh in the light of the contentions of the parties noted above and the observations made which are germane to the controversy. Besides the points raised before this Court, the parties would be at liberty to raise any other issue relevant to these cases and the Federal Shari'ah Court may also, on its own motion, take into consideration any other aspect which may arise or may be found relevant for determination of the issues involved herein". (Supreme Court of Pakistan 2002, pp. 23-24)

This decision was seen as a major blow to the Islamisation process and since then the FSC has made no further ruling on the interest-free economic model.

4.10 THE CURRENT SCENARIO OF THE PAKISTANI BANKING SECTOR

In the aftermath of the decision of the *Shari'ah* Appellate Bench of the Supreme Court, Pakistan embarked on a policy of dual system (of conventional and Islamic finance), similar to the one followed in Malaysia. In September 2001, the government announced that the goal of an interest-free economy would be gradually achieved in a phased manner to avoid causing

any disruptions to the existing financial system (State Bank of Pakistan 2008). On December 1, 2001 the State Bank of Pakistan issued detailed criteria for setting up an Islamic commercial bank in the private sector of Pakistan. The first Islamic commercial banking license was issued in January 2002 and the first Islamic bank (pure Islamic bank that only offers Islamic financial products) in the country commenced full-fledged commercial banking operation from March 2002 (State Bank of Pakistan 2008). In January 2003, the State Bank issued a circular detailing instructions on setting up of subsidiaries and stand-alone branches for Islamic banking by existing commercial banks. The criteria laid out in the circular for setting up subsidiaries were almost similar to those issued for setting up a scheduled Islamic commercial bank. To ensure that income from the interest-based activities of the banks did not enter the Islamic financial system, the State Bank‘s circular emphasised the complete segregation of the accounts of the Islamic banking subsidiaries and the parent banks undertaking conventional banking (State Bank of Pakistan 2008).

On September 15, 2003, the State Bank of Pakistan established the Islamic Banking Department (State Bank of Pakistan 2008). The department was given the task of promoting and developing the *Shari'ah* compliant Islamic banking as a parallel and compatible banking system in the country. The Islamic Banking Department at the State Bank of Pakistan established a *Shari'ah* Board comprising two *Shari'ah* scholars and three experts in the areas of banking, accounting and law to advise it on modes, procedures and regulations for Islamic banking (Qureshi 2007). Since its inception, the Islamic Banking Department of the State Bank has introduced a number of regulations relating to the operations of the Islamic financial institutions. These include the fit and proper criteria for the selection of *Shari'ah*

advisors and the *Shari'ah* supervision and governance model which was introduced in 2008. These regulations and the *Shari'ah* governance model are detailed in Chapters 5 and 6.

As of October 2008, there were five licensed full-fledged Islamic Banks with branches all over Pakistan (Pakistan and Gulf Economist 2008). Table 4.1 lists the banks operating in the Pakistani banking sector. Some of these banks that were analysed for the purpose of this study are profiled in the following section.

Table 4.1 List of Banks Operating In Pakistan

NOTE:
This table is included on page 132 of the print copy of the thesis held in the University of Adelaide Library.

Source: Pakistan and Gulf Economist (2008)

4.11 PROFILE OF INDIVIDUAL CASES

Since the introduction of the first Islamic bank in Pakistan in 2002, the number of institutions offering Islamic banking products has rapidly grown. As of October 2008, there were five Islamic banks and 12 Islamic windows (State Bank of Pakistan 2008). A big reason for the growth of Islamic financial institutions has been the reluctance of the State Bank of Pakistan to issue licences for the establishment of new commercial banks in Pakistan. For a period of three years from 2004, only licences for the establishment of Islamic banks were approved (Qureshi 2007). Banks offering conventional products could only enter the Pakistani markets through acquisition of an existing bank or by applying for an Islamic banking licence, which would exclude their conventional financing operations in the country.

The findings of this study are based on the analysis of the individual banks in the Pakistani banking sector. For the purpose of this study both Islamic banks and Islamic windows were analysed. In total two Islamic banks and four Islamic windows were analysed, and as detailed in the Methodology Chapter 3, the interviews were conducted between 2002 and 2007. As of January 2007 (when the last set of interviews were conducted), there were three Islamic banks and eight Islamic windows operating in Pakistan. The profiles of the banks analysed are provided below:

Bank #1:

Established in 2002, Bank # 1 is a pure Islamic bank. It has more than 100 branches throughout Pakistan, making it the largest Islamic bank in Pakistan in terms of a branch network. The Bank is a publicly listed company and was established with support from the State Bank of Pakistan and the Government of Pakistan. The Bank‘s main shareholders are

financial institutions from Pakistan and the Middle East. The Bank‘s SSB consists of four *Shari’ah* advisors.

Bank #2:

Bank # 2 is a pure Islamic bank that commenced its operations in Pakistan in November 2005. The Bank is one of the oldest Islamic banks in the world. It is registered in Pakistan as a Public Limited Company and its 100 per cent owned by its parent company in the Middle East, where it is a listed company. It has a network of 17 branches in the country. The Bank is the first to launch an Islamic Visa Debit Card in Pakistan. The Bank‘s SSB consists of three *Shari’ah* advisors.

Bank #3:

Bank # 3 is a commercial bank which provides Islamic financial options through a dedicated Islamic branch (Islamic windows). It was incorporated as a public listed company in 1967 in Europe and has operations in Europe, North America, Asia and Africa. It commenced its operations in Pakistan in 1991. Its operations were merged with another commercial Pakistani bank in 2006 and it remains the principal shareholder of the merged entity. The new Bank has over 50 branches spread across the country. It was granted an Islamic banking licence in 2004 and started its operations later that year. At present it has 4 Islamic banking branches in Pakistan. The Bank relies on the advice of its resident *Shari’ah* advisor on matter related to conformity of operations to Islamic law.

Bank #4:

Bank #4 is one of the oldest commercial banks in Pakistan. It is the largest private sector bank with over 1,450 branches across the country. It has international branches spread over Asia, UK and Africa. It was one of the big five banks that were nationalised in the 1970s and was privatised in 2004. The Bank commenced its Islamic banking operations in 2005. The bank has one dedicated Islamic banking branch in Karachi. The bank uses the services of a resident *Shari'ah* advisor for its Islamic financing operations.

Bank #5:

Bank #5 was established in 1959 in Pakistan as a commercial bank. It has over 1000 branches in Pakistan and 16 branches overseas (mainly Asia). It is one of the big five banks that were nationalised in the 1970s and subsequently privatised in 2002. It was awarded an Islamic banking licence in 2006 and commenced its operations later that year. It has one Islamic banking branch and like other commercial banks relies on the advice of its resident *Shari'ah* advisor.

Bank #6:

Bank #6 is a Pakistani commercial bank that began its operations in 1992. Since then the bank has grown and now has close to 100 branches spread over Pakistan. The bank's main consumer base is the small & medium sized entrepreneurs. Nearly forty percent of the bank's credit portfolio is related to export financing. It began its Islamic banking operations in 2005 and has two Islamic window licences but so far has only opened one Islamic banking branch. Its *Shari'ah* advice is sought from its resident *Shari'ah* advisor.

Table 4.2 provides a summary of the profile of the banks analysed in this study.

Table 4.2 Individuals Banks Analysed

BANK	DETAILS
Bank #1	Pure Islamic bank established in 2002. Largest Islamic bank with more than 100 branches across Pakistan. The Bank's SSB consists of four *Shari'ah* advisors.
Bank #2	Pure Islamic bank that commenced its operations in Pakistan in November 2005. It has a network of 17 branches in the country. The Bank's SSB consists of three *Shari'ah* advisors.
Bank #3	A commercial bank which provides Islamic financial options through dedicated Islamic branches (Islamic windows). It was granted an Islamic banking licence in 2004 and has 4 Islamic banking branches in Pakistan. The Bank relies on the advice of one resident *Shari'ah.*
Bank #4	The largest private sector bank with over 1,450 branches across the country. The Bank commenced its Islamic banking operations (Islamic window) in 2005 and has one dedicated Islamic banking branch. The bank has one resident *Shari'ah* advisor.
Bank #5	Established in 1959, the bank is a commercial bank which commenced its Islamic banking branch (Islamic window) in 2006. It has one Islamic banking branch and relies on the advice of its resident *Shari'ah* advisor.
Bank #6	A commercial bank that began its operations in 1992. It began its Islamic banking operations in 2005 and has two Islamic window licences but so far has only opened one Islamic banking branch. Its *Shari'ah* advice is sought from its resident *Shari'ah* advisor.

4.12 CONCLUSIONS

This chapter has provided a profile of the Pakistani banking sector and the individual banks analysed for the purpose of this study. Pakistan was created as a homeland for the Muslims of South Asia. Thus, religion plays a significant part in the governance and functioning of the economy. Pakistan was the first country in the world to declare herself as an ―Islamic Republic" and the constitutions have placed responsibility on the government to ensure that the nation follows the Islamic way of life. In the 1960s the Government of Pakistan formed special committees that would provide advice to the government on how to Islamise the country. The Pakistani banking sector operated successfully till the 1970s when the Government of Pakistan in 1974 decided to nationalise the banking sector. The move to make

the Pakistani economy an interest-free one began in 1977 after the takeover of the government by the military ruler General Zia-ul-Haq. The decision to move to an interest-free economy was quick and politically motivated. With limited time and limited consultation, the banks were forced to introduce Islamic financing options that would help transform an economy that used conventional financial products to one that would use *Shari'ah* compatible products. These products included the mark-up system which was heavily criticised by religious scholars who claimed that the option was interest based. In 1991, the FSC ruled that the Pakistani economy was not *Shari'ah* compliant and the banking products used by banks were religiously illegal. The Court gave a deadline for the transformation of the economy on *Shari'ah* lines which the government appealed. In the meantime the privatisation of the banking sector was set in motion. After further appeals the *Shari'ah* Appellate Bench of the Supreme Court of Pakistan upheld the appeals filed by the Government of Pakistan and commercial banks against the judgement of the FSC. Since then the banking sector in Pakistan has been privatised and a dual system is in place where both conventional and Islamic financing operate.

The historical events that led to the nationalisation of the banking sector and the subsequent attempts to Islamise the economy help explain the current situation in the Pakistani banking sector. The political decisions made by the government as a result of pressure from the religio-political forces, forced the hurried introduction of Islamic banking and finance in Pakistan. The lack of involvement of the business community in the decision making led to the application of an Islamic financing system that was not understood by many in the banking sector. These historical events also shaped the introduction of new Islamic banking products in Pakistan and the approval of these products by *Shari'ah* advisors.

To gain an insight into the functioning of SSBs and the role of the *Shari'ah* advisors, six individual banks were analysed. Out of these six banks, two were full-fledged Islamic banks and four were Islamic windows. The profiles of the Islamic financial institutions reflect the recent establishment of these organisations which reflects the infancy stage of Islamic banking in Pakistan. The findings of the research are provided in the next chapter.

CHAPTER 5

FINDINGS: MEMBERSHIP AND SELECTION OF *SHARI'AH* ADVISORS

The findings of this study are presented in two chapters. Chapter 5 discusses the findings in relation to the membership of SSBs and selection of *Shari'ah* advisors. Chapter 6 details the findings related to the role of the *Shari'ah* advisors in Islamic financial institutions and the application of *Shari'ah* supervision in these institutions in Pakistan. The next section provides a brief discussion in relation to the future of Islamic financing in Pakistan, followed by detailed discussion on the findings.

The first finding relates to the membership of SSBs in institutions in Pakistan. The findings compare the requirements set up by the State Bank of Pakistan and the international regulatory bodies and compares it to the operations of the banks analysed for this study. The second finding relates to the selection of *Shari'ah* advisors in Pakistan. The results from the banks are analysed against the selection criteria set up by the State Bank of Pakistan. These criteria include training requirements and the issue of conflict of interest.

5.1 VIABILITY OF ISLAMIC BANKING IN PAKISTAN

The Islamic finance industry worldwide is in its infancy and constitutes a small percentage of the overall financing projects in the global economy. In Pakistan, Islamic financing constitutes less than three per cent of all transactions (State Bank of Pakistan 2007). The findings of the study reveal varying opinions in relation to the projected growth and future of the Islamic banking and finance in Pakistan. While interviewees from the Islamic banks see a

strong future for the industry, the response of majority of the individuals from the conventional banks, and minority from the Islamic windows, was far less optimistic.

The State Bank of Pakistan and the Pakistani government has set an ambitious target of 10 per cent for all financing to be undertaken under the Islamic financing system within the next decade (State Bank of Pakistan 2007). According to interviewees from the Islamic banks and Islamic windows, the Islamic banking sector was growing rapidly worldwide and as more Muslims become aware of the system and prohibition of *riba* in Islam, the industry is likely to attract more customers. A reason for the small market share held by Islamic financial institutions in Pakistan is the relative short period of time these financial institutions have operated in Pakistan:

> *"Islamic banking is still new but has a bright future. You can tell from the rapid rate of growth of the industry that more and more Muslims are turning to the system. If we continue to perform well and compete at the same level as non-Islamic banks then we will grow even faster. Pakistan is the ideal country for the industry to grow. We are a Muslim country and unlike countries like Malaysia, we have an overwhelming Muslim majority. This means that our products are relevant to the entire population. As long as there is government support, you will see more Islamic banks opening up in Pakistan"* – Manager of Islamic window.

But most of the interviewees from conventional banks that had no Islamic products seemed sceptical of the government's set targets and the potential of the Islamic financing industry. According to these interviewees, the haste in which the system was introduced in Pakistan without proper industry feedback and training had left the banking fraternity unsure about the features and application of the Islamic financial system. The lack of clarity led to the functioning of an Islamic financial system in the 1980s which was criticised by religious scholars as being un-Islamic:

> *"…in the early 1980s we were given orders by head office that due to the government action we had to convert our accounts to profit-and-loss sharing. None of us understood what it meant or how it could be applied…..Well we went ahead and followed the head office orders only to find that the mullahs (religious leaders) were not pleased and that apparently we were following an un-Islamic system….. In any case Islamic financing will never take over from conventional financing as the main source of funding in this country. Pretty soon we will see a stagnation of the growth in Islamic financing and we will end up with too many Islamic banks fighting for a small market share"* – Manager of conventional bank.

Interviewees from the conventional banks were also critical of the Islamic financial system's global appeal. The interviewees were of the view that Islamic financing would be limited to certain projects only, as it does not have the global appeal to become the main financial system for countries:

> *"Islamic banking has managed to get some customers but how big is the whole industry in Pakistan? Would companies that have for decades dealt with interest based instruments suddenly move to Islamic system because some religious leaders believe that's the right path? And what about dealing in international transactions? Businesses find it difficult enough to get international sales deals because of the political uncertainty in Pakistan. Imagine a trader demanding that the foreign company agree to interest-free financing agreements. We need to be realistic and practical about Islamic banking. Yes there are people who want to use it and its fine to provide an option for them. But majority of the population has rejected the system and trying to force it on people will be a useless exercise"* – Manager of conventional bank.

One of the issues that have impacted the growth of the industry is the area of *Shari'ah* governance. The lack of consistency in the application of *Shari'ah* principles in Islamic financial institutions is seen as an area of concern. The Islamic finance sector is addressing this issue by making it mandatory for financial institutions to have *Shari'ah* advisors as

internal auditors of *Shari'ah* application. The following section details the finding relating to *Shari'ah* supervision in Islamic financial institutions in Pakistan.

5.2 MEMBERSHIP OF *SHARI'AH* BOARDS

The results of the study reveal that the requirements of *Shari'ah* supervision are not completely understood by individuals in the Pakistani banking sector. The regulatory body for Islamic financial institution, AAOIFI has specified a number of requirements for *Shari'ah* supervision and SSB membership. According to AAOIFI, it is recommended that every Islamic financial institution should employ SSBs that ensure that the bank's operations comply with the *Shari'ah* requirements (Bakar 2002). These SSBs, according to AAOIFI, should consist of a minimum of three *Shari'ah* advisors (Bakar 2002).

In Pakistan, the AAOIFI requirements seem to be largely ignored. The State Bank of Pakistan's requirements on *Shari'ah* advisory only requires the presence of one *Shari'ah* advisor. The State Bank of Pakistan's circular detailing the criteria for setting up a scheduled Islamic bank in Pakistan (State Bank of Pakistan 2004a) states that a bank applying for an Islamic licence should provide a certificate that confirms that:

> *~~a~~ Shari'ah Advisor has been appointed in the light of State Bank of Pakistan's Shari'ah Board's "Fit and Proper Criteria" and the approval of State Bank of Pakistan. However, Islamic Banks are free to appoint a Shari'ah Committee at their own discretion and not as part of State Bank of Pakistan's regulation*".

This regulation applies to all Islamic financial institutions in Pakistan, regardless of whether they are Islamic banks or Islamic windows (State Bank of Pakistan 2004b; State Bank of

Pakistan 2004c). A review of the six banks in Pakistan analysed for the study revealed wide variation in the *Shari'ah* advisory membership of Islamic banks and Islamic windows. The Islamic Banks in Pakistan tend to utilise the services of SSBs, which include three to four *Shari'ah* advisors, whereas the Islamic windows rely on the services of a single *Shari'ah* advisor. The two Islamic banks analysed in this study, both utilise the services of SSBs. The first bank has a *Shari'ah* board consisting of four *Shari'ah* advisors and the second bank has a board membership made up of three advisors. The four Islamic windows analysed for this study all have one resident *Shari'ah* advisor each whose services the banks utilise.

The findings of the study also indicate that the Islamic financial institutions in Pakistan are not following the trend found in Islamic financial institutions globally. When compared to the findings of an international survey of more than 60 Islamic financial institutions worldwide conducted by the International Institute of Islamic Thought in 1996, it is found that the number of *Shari'ah* advisor used by Islamic financial institutions in Pakistan is lower than those in other Islamic financial institutions. The findings of the 1996 survey revealed that 71.6 per cent of Islamic financial institutions had SSBs consisting of three or more *Shari'ah* advisors, and only 20 per cent of the financial institutions had one *Shari'ah* advisor (International Institute of Islamic Thought 1996). In comparison, majority of the Islamic financial institutions in Pakistan utilised the services of only one *Shari'ah* advisor.

The interviewees of this study gave various reasons for the difference in membership numbers between Islamic banks and Islamic windows. The majority of the interviewees believed that the difference in membership was due to the regulations of the State Bank of Pakistan:

> *"The number of Shari'ah advisors that a bank needs is a State Bank regulatory issue. The State Bank requires that only pure Islamic banks should have Shari'ah boards that consist of a few advisors. Islamic windows only need one Shari'ah advisor. Islamic banks also have to inform the State Bank before they introduce new products. We [Islamic windows] don't have to follow that requirement"* – Manager of Islamic window.

These responses further strengthen the notion that the requirements for internal *Shari'ah* audit and membership are not completely understood since the State Bank makes no distinction between Islamic banks and Islamic windows in relation to the number of *Shari'ah* advisors employed. The responses also demonstrate a lack of clarity in the industry regarding reporting issues. The State Bank of Pakistan (2007) specifies that all Islamic financial institutions, regardless of whether they are Islamic banks or Islamic windows, have to inform and seek clearance from the State Bank of Pakistan before launching a new Islamic financial product.

The interviewees from the Islamic banks referred to the AAOIFI requirement as reason for the difference in *Shari'ah* membership but could not recall the minimum number of members required by AAOIFI. The interviewees from Islamic windows on the other hand were less aware of the AAOIFI regulation. Barring two interviewees from the Islamic windows, who mentioned the AAOIFI regulation, the rest of the interviewees were unaware of the AAOIFI regulations and referred only to the State Bank of Pakistan's expectations and requirements. A possible explanation for the unawareness of AAOFI regulation could be that the State Bank of Pakistan has only recently started making efforts to include AAOIFI regulation into the Pakistani Islamic banking sector (State Bank of Pakistan 2007). In August 2007, the State Bank of Pakistan released a circular stating that the Pakistani Islamic banking sector would

gradually incorporate some of the AAOIFI regulations and therefore many of the managers from the banking sector (especially form Islamic windows) seemed unaware of the regulations during the interviews.

A review of the AAOIFI website shows that the two Islamic banks analysed in this study are both members of AAOIFI, whereas none of the Islamic windows that were analysed hold membership of AAOIFI (AAOIFI 2008). The membership of AAOIFI may explain the presence of SSBs in the Islamic banks rather than just an advisor, and the degree of knowledge exhibited by interviewees from Islamic banks regarding AAOIFI regulations.

Another reason provided by some interviewees for the variation in number of *Shari'ah* advisors in Islamic financial institutions was that Islamic banks were the ones that were developing new products and demonstrating innovation in the banking sector. Therefore, the Islamic banks required the services of SSBs to ensure compliance with the *Shari'ah* principles. The Islamic windows on the other hand were seen as only offering Islamic financial products that had been approved by the State Bank of Pakistan's Islamic Banking Department. Thus a single advisor in the Islamic windows was seen as being sufficient. This explanation seemed to be one that interviewees from Islamic banks believed made their organisations' operations more religiously compliant than their Islamic window counterparts, and assisted in the growth of the industry. Barring one interviewee from an Islamic window, who agreed with this statement, all other interviewees from Islamic windows, conventional banks and the State Bank of Pakistan disagreed with this reasoning.

While the reasons for membership may not be clearly understood, the interviewees provided various arguments on the benefits of using a board or an advisor. The interviewees from

Islamic banks claimed that the presence of SSBs meant that the *Shari'ah* decisions of the bank were based on the consensus of a number of *Shari'ah* scholars rather than the interpretation of a single advisor. On the other hand the interviewees from the Islamic windows claimed that since there was usually only one dedicated branch offering Islamic products, a resident *Shari'ah* advisor provided more benefits than having one centrally located SSB which is expected to cover a large network of branches.

Since Islamic finance in theory deals with profits and losses rather than interest, the approval of applications by customers for Islamic products usually take a longer time period than the products of conventional financing. The *Shari'ah* approval process is one of those steps that add to the overall time taken for the approval of financing agreements. According to the interviewees from Islamic windows, having a *Shari'ah* advisor present in the branch on a regular basis meant that approval of financing from Islamic windows was faster than approval from an Islamic bank. Also, the approval of only one advisor meant that there were no issues with disagreements or difference in opinions that may occur in the functioning of SSBs, and this too helped reduce the time required for approval.

While the SSBs in Islamic banks may have more than one *Shari'ah* advisor upon whom the bank staff can rely, the findings reveal that not all the *Shari'ah* advisors of the Islamic banks are based in Pakistan. The SSB of the Bank#1 consists of four *Shari'ah* advisors, two of whom are based in the Middle East. Bank #2's SSB consists of three advisors, only one of whom is based in Pakistan. Thus, even though the bank may have the services of multiple advisors for internal *Shari'ah* audit and *Shari'ah* support, physically the Islamic banks may

only have available the services of one advisor for assistance in matters requiring urgent attention.

The interviewees further revealed that the number of advisors in a bank can also have an impact on customer confidence. The executives of the advertising companies that are hired by Islamic financial institutions were of the opinion that the presence of SSBs in banks, as opposed to a single advisor, seemed to evoke more confidence amongst consumers. According to the interviewees the use of SSBs meant that the consumers would be more comfortable with the *Shari'ah* compliance of the bank:

> *"The way Islamic banking has been introduced in Pakistan, people are still quite cautious. The uncertainty regarding whether banking products are Shari'ah compliant or not because of all the court decisions, has people worried that banks are just claiming that their products are Shari'ah approved. Having a Shari'ah board with a few scholars means that consumers believe that there is more discussion amongst scholars and more chances of the product being Shari'ah compliant, both on paper and in spirit"*- Executive of advertising company.

The responses revealed that due to the consumer confidence issue some Islamic windows in Pakistan have started to utilise the services of SSBs rather than just an advisor. These Islamic windows are not members of the AAOIFI and do not have to demonstrate the existence of SSBs. But according to the interviewees, the presence of the board would help the Islamic windows improve their *Shari'ah* credibility in the eyes of the consumers and help them compete more effectively with Islamic banks.

5.3 *SHARI'AH* ADVISORS AS BRAND MANAGERS

The Pakistani Islamic banking industry also seems to provide a unique view on the perceived role of *Shari'ah* advisors. The responses revealed that not only do the numbers of *Shari'ah* advisors in the bank have an impact on the way consumers rate the banks, but the reputation of the *Shari'ah* advisors also plays an important role for consumers when selecting an Islamic financial institution. According to the interviewees from the advertising companies, Islamic financial institutions make it a point to highlight to the consumers the experience and reputation of their *Shari'ah* advisors. This, according to the interviewees, gives the individual Islamic financial institution a competitive advantage over other financial institutions offering similar products:

> *"The way banks can differentiate themselves from others is through their existing brand name and brand recognition. For consumers, the reputation of the banks is extremely important: at the end of the day it is a commercial operation so consumers will not take risk with unknown banks. The Islamic windows can use their existing brand name and brand loyalty to attract consumers. The Islamic banks on the other hand are new and don't have the level of brand recognition as the conventional banks. The Islamic banks therefore need to use the goodwill of its staff to shore up support for their brand. There are two strategies Islamic banks are following. First, they are recruiting experienced branch managers who have well-built reputation in the industry and this is a way to attract corporate clients who have worked with these managers previously. Second, these banks hire well-known Shari'ah advisors and promote their profiles and use them as brand ambassadors to attract the consumers."* – Executive of advertising company.

Reports in Pakistani newspapers confirm the role of *Shari'ah* advisors as brand ambassadors. The news reports show that *Shari'ah* advisors from Islamic banks tend to represent the bank at the signing of new agreements with other financial and educational institutions. Some of the Islamic windows do not have to face the same brand issues since their conventional

operations have a well-established brand name and this brand equity seems to be transferred to their Islamic window operations as well. This would in part explain why conventional banks with Islamic windows are the market leader in the global Islamic banking sector. The interviewees from Islamic banks and the Islamic windows gave a similar view regarding the reputation of the *Shari'ah* advisors. One interviewee from the Islamic bank when asked about the SSB members detailed the experience and profile of all of the *Shari'ah* advisors. The interviewees also explained that the SSB had a chief or lead advisor who was responsible for signing off on documents on behalf of the board. The chief advisor's experience and achievements were part of the detailed responses that was provided:

> *"There is a small number of Shari'ah advisors globally that have an international profile. Pakistan is a leader in the industry having produced Shari'ah scholars who are globally acknowledged as being experts in Shari'ah interpretation. These scholars are also members of AAOIFI and other regulatory bodies, including the State Bank's Shari'ah board. These scholars bring with them years of experience and knowledge and ensure that our products are Shari'ah compliant and innovative. We can therefore be sure that our products are comparable to the products of any other Islamic bank and we can compete with any of them. Plus, our customers can be confident that our products are all completely halal as they have been approved by these scholars"* – Manager of Islamic bank.

The interviewees from conventional banks when asked their opinion about *Shari'ah* advisors and their reputation also stated that there were only a handful of well-known scholars and were able to recall their individual names. Although not personally known to them, they were aware of these scholars from reports they had read in the newspapers and professional banking magazines.

A review of the websites of the six banks analysed was undertaken. Barring two Islamic windows, which did not state the name and other details of their *Shari'ah* advisor, all the other institutions had a webpage detailing the name, qualification and experience of their *Shari'ah* advisors. The role of *Shari'ah* advisors as representative of the bank seems to contradict the expectation that the *Shari'ah* advisors would act as independent religious auditors even though they are employed by the banks. When asked about this apparent contradiction, the interviewees from the banks explained that this was a reaction to consumer expectations rather than an active strategy by the bank. According to the interviewees, the consumer confidence seemed to be higher when well-known *Shari'ah* advisors were used by Islamic financial institutions. Therefore, banks had no option but to promote the membership of the SSBs and the profile of their advisors. One manager from the Islamic window recalled the experience of their institution:

> *"Our IPO received a very weak response from the public. Our research indicated that one reason for it was that the potential investors were not familiar with the profile of our Shari'ah advisor. As a result we had to make in changes and had to temporarily bring in a high-profile Shari'ah advisor. This seemed to change the investor perception and we received a far better response from the investors. So at the end of the day it is the public that forces us to use the Shari'ah advisors to market our products".*

The use of *Shari'ah* advisors as the bank's brand ambassadors seems to be unique to the Pakistani banking sector. The roles specified and expected from the central bank and other regulatory bodies focuses on the *Shari'ah* compliance and supervision. But the Pakistani Islamic banking sector seems to utilise the goodwill of *Shari'ah* advisor to aid in improving its image in the eyes of the consumers. This according to the findings can be traced back to

the unplanned introduction of the interest-free system in Pakistan in the late 1970s which lead to consumers becoming sceptical of the Islamic credentials of the banks.

5.4 SELECTION AND TRAINING OF *SHARI'AH* ADVISORS

The Islamic financial institutions in Pakistan are required to follow the guidelines laid out by the State Bank of Pakistan in relation to the selection of *Shari'ah* advisor. This section details the requirements set up by the State Bank and analyses the practice of hiring of *Shari'ah* advisors in Islamic financial institutions.

5.4.1 The State Bank of Pakistan's Requirements

As highlighted in Chapter 2, the issue of *Shari'ah* supervision in Islamic financial institutions has only recently become the subject of research. The State Bank of Pakistan had no regulation for *Shari'ah* supervision up until a few years ago. In 2004, the State Bank of Pakistan released standards detailing the criteria for appointment of *Shari'ah* advisors in Islamic financial institutions. Prior to this the State Bank of Pakistan only required the use a *Shari'ah* advisor but did not provide detailed criteria in relation to their qualification or selection. These new criteria were compiled in a circular titled "Fit & Proper Criteria For Appointment of *Shari'ah* Advisors" (State Bank of Pakistan 2004d). The circular covers five areas:

1. Minimum qualification and experience.
2. Track record.
3. Solvency and financial integrity.
4. Integrity, honesty and reputation, and
5. Conflict of interest.

The minimum qualification and experience requirement states that the *Shari'ah* advisor must have at least five years of experience in giving religious rulings, and should have knowledge of or ‗at-least be familiar with' the banking industry. The number of years of experience can be relaxed if the advisor can demonstrate experience of no less than three years in teaching Islamic *fiqh* in a reputable institution (non-financial) with a proven track record. The minimum educational qualification specified by the State Bank of Pakistan is *Dars-e-Nizami*[12]. Other education qualifications such as Masters of Arts in Islamic studies, banking, economics and finance may be viewed as added qualification but are not seen as compulsory for the appointment of a *Shari'ah* advisor (State Bank of Pakistan 2004d).

In relation to the advisor's track record, the circular states that the candidate must not have been previously dismissed as an employee or director/chairperson of a company. The candidate must also demonstrate an impeccable track record in the company(ies) they have previously served, either in the capacity of an employee or director/chief executive, or as chairperson. The circular also requires that the advisor should not been associated with any illegal activity (especially relating to banking business), has not been in default of payment of dues owed to any financial institution and/or default in payment of any taxes individual capacity or as proprietary concern or any partnership firm or in any private unlisted and listed company, and has sufficient means to discharge his/her financial obligations (State Bank of Pakistan 2004d).

[12] *Dars-e-Nizami* refers to the basic syllabus that is followed by the majority of *Madrassas* (religious Islamic schools) in South Asia. It was framed by Maulana Nizamuddin Firanghi Mahali, and teaches the students about Islamic interpretation of the *Qur'an*.

The State Bank of Pakistan also requires that the *Shari'ah* advisor should not have any convictions in any criminal offence or involved in any fraud or financial crime. The advisor should also not subject to any adverse findings or any settlement in civil/criminal proceedings particularly with regard to investments, financial/business, misconduct, fraud, formation or management of a corporate body. Other requirements state that the advisor would not have been involved with a company/firm whose registration/license has been revoked or cancelled or gone into liquidation. Finally, in relation to integrity, the advisor should also demonstrate that they have not been debarred for giving religious rulings by any religious institution/body (State Bank of Pakistan 2004d).

The final area covered by the State Bank of Pakistan's regulation relates to the area of conflict of interest. The requirement states that the *Shari'ah* advisor in one financial institution cannot act as a *Shari'ah* advisor in any other financial institution. The term financial institution includes any bank, investment finance company, non-banking finance company, venture capital company, housing finance company, leasing company or *mudaraba* company. This conflict of interest does not apply if the *Shari'ah* advisor is nominated by the State Bank of Pakistan in its own *Shari'ah* board (State Bank of Pakistan 2004d).

5.4.2 Training of *Shari'ah* Advisors

Reviewing the State Bank circular shows that the educational requirement for *Shari'ah* advisors is focussed on training in principles of Islam with some familiarity with the banking sector. This requirement can mean that if the *Shari'ah* advisor has met only the minimum standards specified, then their knowledge of banking and finance may be significantly lower than other staff working in the Islamic financial institutions. This may lead to potential

disagreements when bank staff is trying to introduce new Islamic products. Part of the approval process requires clearance from *Shari'ah* advisors. The lack of knowledge about *Shari'ah* principles by the bank staff and the lack of knowledge about banking and finance by *Shari'ah* advisors can delay the approval process and lead to disagreements between bank staff and *Shari'ah* advisors. Thus the proper training of both *Shari'ah* advisors and bank staff is important for the smooth functioning of the bank.

Due to the fact that the industry is relatively new, there are not many institutions in Pakistan that provide training for Islamic banking. The *Shari'ah* advisors as well as managers and relevant staff from Islamic financial institutions are required to receive some level of training to be able to apply religious education into the commercial world. With *Madrassas*[13] only providing training in religious interpretation of the *Qur'an*, *Shari'ah* supervisors are required to attend other institutions that would provide training in the commercial aspects. In Pakistan, most of the *Shari'ah* advisors are trained at one educational institution[14] in Karachi. Established in the early 1950s, the Training Institute is one of the oldest centres for Islamic education in Pakistan. Since it commenced its operations, the Training Institute has attracted students from Burma, Indonesia, India, Malaysia, Afghanistan, Iran, Turkey and other Muslim countries. The Training Institute provides education from basic level to post-graduate degrees and a student who intends to undertake their entire schooling and education in the Training Institute would spend 16 years in the Training Institute. In Islamic financing education and interpretation, the Training Institute is served by religious scholars who are

[13] *Madrassas*: Islamic religious schools.

[14] For the purpose of this study, the identity of the educational institution is not revealed and is instead referred to as the ‗Training Institute'. All information relating to the operations of the institution was sourced from their website.

Shari'ah advisors to Islamic financial institutions. The graduates from this Training Institute also serve on *Shari'ah* boards of many Islamic financial institutions. The Pakistani industry therefore relies quite heavily on the services of this Training Institute for the skill development of *Shari'ah* advisors. The Training Institute is also involved in the research of Islamic finance and has published a number of research books on the topic.

The interviewees from the Islamic banks confirmed that the Training Institute was used for training not just the *Shari'ah* advisors but also other staff in the bank who had to carry out their functions in Islamic products. This was done to ensure that staff working in Islamic banks were aware of the *Shari'ah* rulings and justification for the religious principles when introducing Islamic products. This step according to the interviewees had a number of benefits. Having some basic knowledge about *Shari'ah* meant that staff was able to better inform clients about the products, and would have fewer issues when preparing documents for the review of *Shari'ah* scholars:

> *"The training of Shari'ah advisors is an issue for the entire industry…. the problem is that in the past there were no dedicated training centres for Islamic finance. A few have opened up now but they are mainly focussing on educating the general bank staff rather than Shari'ah scholars. The only thing potential Shari'ah advisors can do is to try and learn from experienced Shari'ah scholars. Our Shari'ah advisors have been trained by* Maulana ***** ***** *at the* ***** (name of local training institution). *The institute is recognised worldwide as a leader in the training of fiqh and Sunnah. We even send our general staff to get training there to help them understand the features of the products and the system"* – Manager of Islamic bank.

When asked whether there were other educational institutions that could provide similar training, the interviewees claimed that while there were other educational institutions established in other cities of Pakistan and overseas, the local Training Institute has a well-

established reputation and more cost effective. And since Karachi is the business capital of Pakistan, most financial institutions have established their head office and country office in that city:

> *"There are other institutions as well. No doubt….. But they are not really for training Shari'ah advisors and the overseas institutions are very expensive for us to send staff to train at. So why shouldn't we just use a local institution and get training from some of the best scholars in the world?"* – Manager of Islamic bank.

The training of staff in Islamic windows seemed to be less organised when compared with staff from Islamic banks. The Islamic windows tend to focus on the training of the *Shari'ah* advisor only and not on the training of the other staff. These Islamic windows are dedicated branches with only a small number of staff. In the majority of the cases analysed, these Islamic windows were managed by staff that has previously only had experience in conventional bank branches or conventional banks. Barring one Islamic window, where the manager had taken individual initiative to get training in Islamic finance, the remainder of the managers of Islamic windows received no structured training. When asked about the training programme in place, the interviewees referred to the training for the *Shari'ah* advisor at the local Training Institute. The interviewees also mentioned that the *Shari'ah* advisor helped explain details of the *Shari'ah* requirement to the staff from time to time. As for training of the staff, one manager produced a set of training presentation handouts produced and provided by the State Bank of Pakistan Other managers from Islamic windows revealed how the banks provided no training and the bank staff was forced to self-train by reading through books on Islamic finance. According to the interviewees, they had faced issues with changing from conventional financing options to Islamic financial options and therefore the *Shari'ah* advisor's role was crucial in the bank's functioning:

> *"I had no training in Islamic finance. It was the same with most of the staff in the bank. We were not expected to know much about the products but the understanding was that as long as we knew how the PLS [profit and loss sharing] savings system worked and understood other products like leasing then we would be able to operate without too many issues….Over time we have made efforts to learn by discussing Shari'ah related issues with our* [*Shari'ah*] *advisor when possible and by attending training seminars organised by the State Bank."* – Manager of Islamic window.

The results reveal two trends in the area of training in the Pakistani Islamic banking sector. First, the training of general bank staff appears to be poorly organised and has resulted in a lack of understanding about the system. The *Shari'ah* advisors on the other hand are familiar with the Islamic principles but not well-versed in banking and finance requirements. Second, the *Shari'ah* supervisors in Islamic windows also act as educators of the general staff in *Shari'ah* interpretation.

Another organisation that is involved in the training is Pakistan's central bank. The State Bank of Pakistan is not only involved in conducting *Shari'ah* audits on Islamic financial institutions, it has also taken on responsibility in providing training and research to staff in Islamic financial institutions. This is in reaction to the existing lack of *Shari'ah* training in the Pakistani Islamic banking industry. Staff that have previously been employed in conventional financing face the problem of not being adequately trained before being employed by Islamic financial institutions. While these individuals are skilled in dealing with the banking industry's requirements and customer service, they are not familiar enough with the finer details of the products and the reasoning for its use. Even though the *Shari'ah* advisors of the Islamic financial institutions can help assist in the training, it is not physically possible for the

advisors to train all the bank staff as the operations of the banks are spread across several locations and the advisors are not available on a daily basis.

The State Bank‘s training and research documents relate to the products approved by the State Bank‘s *Shari’ah* Board and the particular of the products as detailed by them. In relation to *Shari’ah* supervision and role of the *Shari’ah* advisor, the State Bank does not provide much training apart from documentation advice which details the role of the *Shari’ah* advisors.

Thus there is a significant gap in the training of bank staff regarding the role of the SSBs and *Shari’ah* advisors. This lack of training can explain the lack of understanding regarding the requirements of SSBs. This finding is further detailed in the next chapter.

5.4.3 Variation in Application

While the training provided to *Shari’ah* advisors in Pakistan may be standardised in academic content, the findings reveal that the application of *Shari’ah* varies across Islamic financial institutions. As discussed earlier all *Shari’ah* advisors have to fulfil the requirement of gaining knowledge in *Dars-e-Nizami*. This educational qualification provides knowledge about Islamic *fiqh*. Further studies undertaken by the *Shari’ah* advisors gives them the ability to be able to interpret religious text. But the interpretation is not consistent over the industry. Some *Shari’ah* advisors believe that products like *murabaha* are un-Islamic and only profit-and-loss sharing instruments should be used by Islamic financial institutions. One explanation for the differences that occur is the variation that is found in interpretation of religious text

based on the different schools of thought. There are four main Islamic schools of thoughts: Hanafi, Hanbali, Maliki and Shafi'i.

Hanafi ***School***

The Hanafi school is named after the Muslim jurist Imam Abu Hanifa. The Hanafi school of thought is based on the verdicts, legal thought and analysis of Imam Hanifa and two of his followers. It is believed to be the most liberal school of thought in its interpretation of the *Qur'an* and *Sunnah*[15]. One of Abu Hanifa's verdicts regarding commercial interest is that a Muslim in a non-Muslim country may engage in the un-Islamic transactions of the indigenous people if, i) they have a valid need and reason to do so, ii) they have no intention of any deception and fraud, and iii) they have no other course of action open to them. The Hanafi school of thought caters for diverse cultures, norms and circumstances, and for that reason it has been adopted primarily by non-Arabs such as the Iranians, Afghanis, Turks, Muslims in Russia and the Indian sub-continent (Pakistan, India and Bangladesh), and also in Syria (Islamic Finance 2008).

Hanbali ***School***

The Hanbali school of thought is based around the philosophy of Imam Ahmed ibn Hanbal. The Hanbali school of thought is said to be the most literal of all the schools, taking almost every text of the *Qur'an* by its words only. Although there is a methodology that the Hanbali scholars claim and maintain, the emphasis is to keep consistency in interpretation of the text. A substantial number of people in Saudi Arabia follow this school of thought in the present day (Islamic Finance 2008). *Shari'ah* supervisors following the Hanbali school of thought

[15] *Sunnah*: refers to the traditions, practices and actions of Prophet Muhammad.

have a strict interpretation of the *Qur'an* and are more cautious when approving new Islamic banking products.

Maliki ***School***

The approach taken by the Maliki school is to follow the practice of the people of Madinah (a holy city in Arabia), who are thought to be the closest to the original *Sunnah* of the Prophet. The followers of the school argue that if the community of Madinah agreed or sanctioned a certain act, then their view should be given priority over any other since Madinah was the hub of Islamic knowledge and practice. Most of Imam Malik's students travelled to North Africa and Spain and hence almost all of North Africa (excluding Egypt), Spain and Sudan follow the Maliki school of thought (Islamic Finance 2008). In case of disagreement over the Islamic credentials of financial products, the followers of the Maliki school would tend to follow the guidance from the community of Madinah.

Shafi'i ***School***

Named after the jurist Mohammed ibn Idris as-Shafi, the Shafi'i school's interpretation is based on giving priority to any sound *Hadith* over analogy. Followers of the Shafi'i school do not accept the authority of the companions of Prophet Muhammad, arguing that they had a right to their opinions as much as others have a right to their own. The rest of the Muslim world (Egypt, Malaysia, Indonesia Iraq and some of the African countries) follow this school of thought (Islamic Finance 2008). *Shari'ah* advisors following the Shafi'i school would look exclusively at the *Qur'an* and *Hadith* and ignore any interpretation made by the Prophet's companions. If these texts do not provide a clear guide on a certain Islamic financial product, then the advisor would tend to reject the product's Islamic credentials.

The impact of the various schools seems to have an impact at the national level rather than in-country differences. Muslim countries tend to differ in their interpretation of Islam based on the school of thought followed by the leading scholars of the country. This variation of application of Islam in Muslim countries can lead to variation in the application of Islamic finance as well:

> *"The interpretation of the religious text can depend on the Islamic school of thought you have studied under. The Pakistani Islamic education system is based mainly on the* Hanafi *school of thought. This means that all of us have a similar level of training. But this doesn't mean that all of us will have the same interpretation….Personally, I have seen more variation from country to country rather than within country. Some countries have scholars who follow a very strict interpretation of Qur'an and tend not to back it up with Hadith" – Shari'ah* scholar.

Another explanation for the variation is due to the uncertainty that the industry in Pakistan faced during the 1980s and 1990s. As discussed in Chapter 4, the introduction of new Islamic financing products in the 1980s focussed on the profit-and-loss sharing instruments. Over time new mark-up based agreements such as *murabaha* were introduced, which created uncertainty in the industry. The subsequent court cases in 1991, 1999 and 2002 further complicated this issue. Some *Shari'ah* scholars therefore believe that *murabaha* is not a proper Islamic financing option even though the product is declared by the State Bank as an accepted financing instrument:

> *"I have read the case of Egypt where till today some maulanas believe that interest is acceptable in Islam and only sood* [usury] *is prohibited. In Pakistan we don't see these arguments as we have clear understanding that all interest is haram* (prohibited by Islam). *There is more clarity as the State Bank itself has provided the industry with a detailed list of financing options that are permitted. When I attend conferences on Islamic finance there is discussion amongst Shari'ah scholars on the authenticity of murabaha and takaful but most Shari'ah advisors won't*

> *risk their reputation by going against the State Bank specified models so you will see far more consistency in financing instruments in Pakistan" –* Manager of Islamic window.

The steps taken by the State Bank of Pakistan in releasing documentation regarding approved financial instruments for use in Pakistan seems to have brought about some consistency in the working and *Shari'ah* requirement of Islamic financial products in the sector even though globally the consistency has not yet been achieved. But with SSBs consisting of advisors from different parts of the world, there is a risk that advisors may disagree on the particulars of certain products and this could result in delays in approvals and affect the functioning of the SSBs.

Another area covered by the State Bank's circular relates to the *Shari'ah* advisor's conflict of interest. The next section details the conflict of interest issue in Pakistani Islamic financial institutions.

5.4.4 Conflict of Interest

The State Bank of Pakistan's document titled _Fit and Proper Criteria for *Shari'ah* Advisors' (State Bank of Pakistan 2004d) specifies that *Shari'ah* advisors can only act as advisor for one Islamic financial institution. Acting as a *Shari'ah* advisor or being a member of SSB in another Islamic financial institution is seen as a conflict of interest and is not permitted by the State Bank of Pakistan. Despite this prohibition, many of the *Shari'ah* advisors in both Islamic banks and Islamic windows are either members of SSBs or are the resident *Shari'ah* advisors for more than one Islamic financial institution. This breach is well-known amongst members of the banking fraternity. As discussed in Chapter 2, *Shari'ah* advisors are

employed by Islamic financial institutions but are meant to act as unbiased and independent auditors. The employment is meant to ensure that the *Shari'ah* advisors do not work for other organisations. Therefore their intended role is that of an internal auditor rather than an external auditor.

A look at the global situation reveals a similar problem. In Britain, the most active European market in the Islamic banking sector, the Financial Services Authority watchdog in November 2007 highlighted possible "significant" conflicts of interest in that concentration of expertise (Ainley, Mashayekhi, Hicks, Rahman and Ravalia 2007). The agency reported that the shortage of appropriately qualified scholars ~~r~~aises concerns over the ability of *Shari'ah* supervisory boards to provide enough rigorous challenge and oversight" (cited in Abbas 2008).

An explanation for this conflict of interest is that there are only a handful of Islamic scholars globally who are specialists in *Shari'ah* and hold sway over Islamic finance. One of the world's most respected scholars, Sheikh Nizam Yaquby, in a recent interview described the challenge of having a very limited pool of *Shari'ah* advisors. According to Sheikh Yaquby there are about 60 scholars in the world qualified to advise banks involved in Islamic finance (Abbas 2008). This number is not even sufficient to fill the demand in the Middle East.
As explained earlier, the training of *Shari'ah* advisors can take as long as a decade. Thus the shortage will continue to affect the growth of the industry. One way Islamic financial institutions are overcoming this shortage is by hiring scholars and advisors who are already performing their duties in other Islamic financial institutions.

The employment of *Shari'ah* scholars as *Shari'ah* advisor by multiple Islamic financial institutions presents a dilemma for the industry as it brings into question the conflict of interest of these advisors and raises the issue of effective *Shari'ah* governance in Islamic financial institutions. When asked about this conflict of interest, the interviewees acknowledged this problem and explained that the limited pool of qualified *Shari'ah* advisors was the main reason for the use of scholars in multiple Islamic financial institutions:

> *"Training in Islamic jurisprudence requires a longer time investment than normal finance training. You are talking about people who spend 10-16 years training in fiqh and then go on to undertake further studies like an M.A. in Islamic studies or a related PhD degree. I think there are about 50 advisors or so worldwide that are qualified enough and have the experience to be Shari'ah advisors in banks. [Thus] it makes sense to have the advisors provide their service to more than one organisation. If the industry stops experienced advisors from being on multiple boards, then you will end up with serious problems where unqualified and inexperienced scholars will be on bank boards and you can imagine the inconsistencies that would come out of it" – Shari'ah* scholar.

This shortage provides serious challenges for Pakistani Islamic financial institutions. If the State Bank implements its laws then there is a risk of brain drain as the advisors may choose to be employed by those Islamic financial institutions that may provide the highest compensation or join financial institutions that do not have operations in Pakistan and therefore do not breach the regulations. The issue also highlights the need for establishment of specialised training institutions that would help prepare future *Shari'ah* advisors and auditors. The AAOIFI has introduced new course in this area and leaves the scope for more indigenous based programmes to be introduced in Pakistan (AAOIFI 2008).

The State Bank of Pakistan has recognised this reality and in September 2008 made the following change to the criteria set up for *Shari'ah* advisors:

> *"With a view to facilitate the Islamic Financial Industry, it has been decided to revise Para 7 (a) & (b) of Annexure to IBD Circular No.2 of 2007, regarding "Conflict of Interest" as follows:*
>
> *a) The Shari'ah Advisor of an Islamic Banking Institution (IBI) shall not work in any other IBI in any capacity whatsoever. Additionally, in the spirit of good corporate governance, no Shari'ah Advisor shall approve a transaction from both sides representing two financial institutions.*
>
> *b) Shari'ah Advisor of an IBI shall not hold any executive/non-executive position in any other financial institution, except working as member Shari'ah Board/Committee of other financial institution(s)"* (State Bank of Pakistan 2008a).

This amendment demonstrates an acceptance by the State Bank of Pakistan of the reality of shortage of *Shari'ah* advisors. It also points towards a trend where State Bank's regulation is regularly changed to respond to the industry's requirements. This indicates that the State Bank is yet to set up long term objectives and aims for *Shari'ah* supervision in Pakistan. The Bank also needs to be more proactive in training and documentation regarding procedures of *Shari'ah* supervision and audit.

5.5 CONCLUSIONS

This chapter has presented the first set of findings of this study. The Pakistani Islamic banking sector is in its infancy stage where only a small percentage of the total economy utilises products from Islamic financial institutions. While interviewees from the Islamic banks and Islamic windows believe that the system will continue to grow in Pakistan, the interviewees from conventional banks believed that the system will be unable to sustain its growth in the long run.

The findings of the study reveal variations in the number of *Shari'ah* advisors used by Islamic financial institutions in Pakistan. The Islamic banks utilise the services of SSBs which consist of three or more advisors whereas the Islamic windows only employed one *Shari'ah* advisor. This finding in Pakistan shows that the country is not following AAOIFI requirements which states that all Islamic financial institutions should have a SSB consisting of at least three advisors. Yet, the State Bank of Pakistan has specified that institutions offering Islamic banking products only need to have one advisor. This difference in the recommended number of *Shari'ah* advisors employed is being used by Islamic financial institutions to promote their *Shari'ah* credentials. Islamic banks claim that the use of SSBs results in the bank following decisions that are made by a panel of jurists rather than one advisor. The Islamic windows claim that having one advisor fastens up the process. The responses from individuals from the marketing industry shows that *Shari'ah* advisors are not merely employed for their *Shari'ah* supervisory skills; they are also used as brand ambassadors by banks. This has resulted in a competition within the industry where Islamic financial institutions are trying to get the services of well-known advisors to enhance their Islamic credentials with consumers.

In relation to training of *Shari'ah* advisors, the study compares the requirements set up by the State Bank of Pakistan with the reality on the ground. The findings reveal that most of the *Shari'ah* advisors have trained at one educational institution (Training Institute) in Karachi. Some banks also make the effort to send their staff to train at the Training Institute. But there are issues in the industry as far as training is concerned. The educational requirement for *Shari'ah* advisors set up by the State Bank, and the time required to train as a *Shari'ah* advisor means that advisors are not familiar with issues related to banking and finance. The

general bank staff on the other hand are not well-versed in the *Shari'ah* requirements and this has the potential to create conflict in the organisation.

Even though majority of the *Shari'ah* advisors seem to be trained at the same Training Institute, the *Shari'ah* application in the organisation was varied. During the decade of 1990s and early 2000s the Islamic financial institutions in Pakistan varied in their opinions on which products were *Shari'ah* compliant. This variation was due to the interpretation of the *Qur'an*, *Hadith* and *Sunnah* by *Shari'ah* scholars. This variation in interpretation was due to the different Islamic schools of thoughts that exist. The attempts by the State Bank of Pakistan to present the industry with approved financing modes seem to have helped bring consistency within the Pakistani Islamic banking sector. The variation though continues to be an issue at the global level.

Finally, the requirements for *Shari'ah* advisors provided by the State Bank of Pakistan specify that *Shari'ah* advisors may not act as an advisor to more than one Islamic financial institution. Since *Shari'ah* advisors are employed by banks, providing their services to another organisation would be viewed as a conflict of interest. But this prohibition is discarded by Islamic financial institutions and *Shari'ah* scholars are often found to be performing their duties for multiple organisations. The findings of this study reveal that due to a limited pool of *Shari'ah* advisors worldwide, the Islamic financial institutions have no alternative but to use the experienced *Shari'ah* advisors. This issue is related directly to the amount of time that is required to train *Shari'ah* advisors and indications are that this shortage will be felt for some years to come. The State Bank of Pakistan as a result of this

reality has altered its requirement and now allows the membership of *Shari'ah* advisors on multiple SSBs.

The next chapter details the findings in relation to the role of *Shari'ah* advisors in Islamic financial institutions in Pakistan and compares Pakistan's *Shari'ah* supervision model with other well known *Shari'ah* supervision models.

CHAPTER 6

FINDINGS: DUTIES OF *SHARI'AH* ADVISORS AND THE PAKISTANI *SHARI'AH* GOVERNANCE MODEL

This chapter details the findings related to the role of the *Shari'ah* advisors in Islamic financial institutions, and the application of *Shari'ah* supervision and governance in financial institutions in Pakistan. The first finding relates to the duties and responsibilities of the *Shari'ah* advisors and their perceived role in Islamic financial institutions in Pakistan. The findings compare the directive issued by the State Bank of Pakistan pertaining to the *Shari'ah* application and governance in Islamic financial institutions, to the operations of the banks analysed for this study. The second finding relates to the *Shari'ah* governance model developed for Islamic financial institutions in Pakistan. The Pakistani *Shari'ah* governance model is analysed against other national models used by Bahrain, Indonesia, Iran and Malaysia. The model is further evaluated for its suitability to be applied by Islamic financial institutions in other countries.

6.1 DUTIES AND RESPONSIBILITIES OF *SHARI'AH* ADVISORS

One of the issues faced by the Islamic finance sector globally is the lack of consensus in relation to the role of *Shari'ah* advisors and SSBs in Islamic financial institutions. As discussed in Chapter 2, there have been a limited number of studies dealing with *Shari'ah* governance in Islamic financial institutions. Using these few extant studies, the researcher investigated the role of *Shari'ah* advisors in Islamic financial institutions in Pakistan.

The State Bank of Pakistan has recently attempted to clarify the role of the *Shari'ah* advisor by issuing a directive titled ~~I~~nstruction for *Shari'ah* Compliance in Islamic financial

institutions" (State Bank of Pakistan 2008bc). According to the document, it is the *Shari'ah* advisors' responsibility to ensure that all products and services and related policies and agreements of Islamic financial institutions are in compliance with *Shari'ah* rules and principles. The document relates to a number of requirements that an Islamic financial institution should follow. The requirements related to *Shari'ah* advisors are detailed below and compared with this study's empirical evidence. The topics relate to:

- Answering *Shari'ah* queries from the community.
- New product introduction.
- *Shari'ah* review and audit.
- Use of a charity fund, and
- The State Bank of Pakistan's *Shari'ah* audit.

Answering *Shari'ah* Queries from the Community

One of the duties of the *Shari'ah* advisor or SSBs is to answer queries that come from the community at large. A review of the websites of the banks analysed for this study shows that not all banks provide the names and details of the *Shari'ah* advisors, and only a small number have the contact details available for the general public to ask questions. Out of the six organisations analysed, only one of the Islamic banks and one Islamic window had provided options on their company website for members of the community to seek the opinion of *Shari'ah* advisors.

The interviewees explained that due to Pakistan's large population it was not possible for *Shari'ah* advisors to answer all queries raised by the community. The interviewees further cited other additional factors which they argued to be impediments to implementing this

requirement. Due to the government's determination to increase the amount of business conducted under Islamic banking, many business students in Pakistan are keen to learn about the system. As described in Chapter 5, there is a shortage of educational institutions that teach Islamic financing courses. This shortage has led to students turning to *Shari'ah* advisors for guidance and knowledge about the system. This also adds to the number of queries the *Shari'ah* advisor already receives from staff of the Islamic financial institutions. The *Shari'ah* advisors explained that being on the board of different banks, the number of queries received from the general public can be too numerous for practical response:

> *"We try our best to help the community in learning more about the system. We present our views in seminars and conferences and try and answers as many emails as we can. Unfortunately, it is not possible for us to answer all the queries. We have a duty to the banks that employ us and we have to make sure that the banks' operations remain halal. We also get queries from bank staff and that means we can't answer the public's queries" – Shari'ah* advisor of Islamic window.

New product introduction

As discussed in Chapter 5, the State Bank of Pakistan's Islamic Banking Department has published a document titled "The Essentials of Islamic modes of financing", which details the *Shari'ah* approved Islamic financial products and the minimum criteria used to establish the products' *Shari'ah* compliance (State Bank of Pakistan 2008b). According to the State Bank, these essentials should be considered minimum requirements for *Shari'ah* compliance and Islamic financial institutions may include additional conditions and controls in their procedures for the sake of more effective *Shari'ah* compliance and prudence. If an Islamic financial institution wants to introduce a new Islamic banking product in Pakistan for which essentials have not been prescribed by the State Bank, then the Islamic financial institution is expected to consult with their resident *Shari'ah* advisor and follow AAOIFI's *Shari'ah*

standards as a guideline (State Bank of Pakistan 2008bc). To obtain approval for the product, the Islamic financial institution is required to prepare a full set of documents including details of the financial agreements, process flows, checklists and manuals pertaining to the product. These documents are to be vetted and certified by the *Shari'ah* advisor and the salient features of the products are to be submitted to the Director of the Islamic Banking Department of the State Bank of Pakistan.

As discussed in Chapter 5, the introduction of new Islamic products in the past required the Islamic financial institution to inform the State Bank of Pakistan, but not seek their permission. This led to a situation in the 1980s when banking institutions introduced Islamic financing products which guaranteed returns, and there was no central governing and controlling body responsible for checking the *Shari'ah* credentials of the products. This new process of seeking the State Bank's approval is seen as a way of standardising the introduction process for Islamic financial products. The role of the *Shari'ah* advisor in the introduction of Islamic financial products is further discussed later in this chapter.

***Shari'ah* review and audit**

The directive further states that *Shari'ah* advisors of Islamic financial institutions shall have access to all records, documents and information from all sources including professional advisors such as lawyers. It is the responsibility of the Islamic financial institution's management to furbish the *Shari'ah* advisor or SSB with all relevant documents. The State Bank requires all Islamic financial institutions to introduce *Shari'ah* compliance mechanisms as part of their control structure (State Bank of Pakistan 2008bc). These *Shari'ah* control mechanisms should ensure that the transactions and processes followed by the financial

institutions are *Shari'ah* compliant, and all related conditions approved by the resident *Shari'ah* advisor are being met. The State Bank directive also recommends that proper training should be provided to the relevant staff in the area of *Shari'ah* Compliance.

In addition to the introduction of the *Shari'ah* control mechanisms, all Islamic financial institutions operating in Pakistan are now required to undertake an internal *Shari'ah* audit to ensure that the goals and objectives of *Shari'ah* compliance are achieved. The *Shari'ah* audit can be carried out as part of the regular internal audit or as a separate process. The purpose of the internal *Shari'ah* audit is to ensure that the system of internal control system is conceptually sound and effective in implementation (State Bank of Pakistan 2008bc).

The State Bank also requires that *Shari'ah* advisors/SSBs should prepare a report verifying that the Islamic financial institution's annual financial statements have been examined and whether the operations of the financial institution have been carried out in accordance with the *Shari'ah* requirements. The report of the *Shari'ah* advisor should also confirm that the allocation of funds and profit and loss sharing ratios conform to the basis vetted by the *Shari'ah* advisor in accordance with *Shari'ah* rules and principles (State Bank of Pakistan 2008bc). If the *Shari'ah* advisor finds that any of the Islamic financial institution's earnings have been realised from sources or by means prohibited by *Shari'ah* rules and principles, then that amount must be credited to a charity account and declared in the *Shari'ah* advisor's report. Therefore, the *Shari'ah* advisor is not only responsible for the identification of non-*Shari'ah* activities, but is also expected to take action against the Islamic financial institution by specifying the amount that the financial institution would need to pay into the charity account. If the *Shari'ah* advisor feels that the Islamic financial institution has deliberately

breached the *Shari'ah* regulation and misled either the *Shari'ah* advisor or external *Shari'ah* auditors, then they are bound to inform the State Bank of Pakistan's Islamic Banking Department.

The Islamic financial institution's resident *Shari'ah* advisor or the chief advisor leading the *Shari'ah* board is required to certify and sign-off on a document that verifies that the Islamic financial institution's operations are consistent with *Shari'ah* requirements. The report is therefore similar in nature to an auditor's report (State Bank of Pakistan 2008bc). The *Shari'ah* advisor's report forms part of the financial Islamic financial institution's annual financial report.

The findings of the study reveal that before the State Bank's directive was released, Islamic financial institutions did not include a detailed report from the *Shari'ah* advisor in the annual financial report. A review of the annual reports of the six institutions selected for this study shows that only in the last two years have the Islamic financial institutions detailed information relating to the amount deposited into the charity account (State Bank of Pakistan 2008bc). As the directive has only come into effect in the financial year 2007-08, some of the Islamic windows are yet to comply with this requirement.

The internal *Shari'ah* audit of the Islamic financial institutions in Pakistan has in the past been the sole responsibility of the *Shari'ah* advisor. With the increase in the branch network of the Islamic financial institutions, conducting on-site *Shari'ah* audits for each branch has become difficult. The new directive recognises this limitation and does not expect the

Shari'ah advisors or the SSBs to undertake *Shari'ah* audits of all transactions or all branches as has been previously claimed by some authors (see Banaga et al 1994). The advisors therefore carry out this task at a central location:

> *"It is not possible for the Shari'ah advisors to visit each branch and conduct a Shari'ah audit. It is possible for Islamic windows, as they usually only have one branch. Our branch network is spread throughout Pakistan so we send our details to the head office for the Shari'ah board to assess our transactions*" – Manager of Islamic bank.

As discussed in Chapter 5, the Islamic finance industry worldwide is faced with the difficulty of selecting *Shari'ah* advisors from a limited pool of qualified individuals. This has led to a situation where *Shari'ah* advisors are providing their services to more than one Islamic financial institution. For *Shari'ah* advisors this means that they are expected to carry out internal *Shari'ah* audits across the branch network of two or more Islamic financial institutions. This can be a very costly and time-consuming exercise. Therefore, carrying out the *Shari'ah* audit of the Islamic financial institution at one central location is seen as a feasible option.

Use of a charity fund

Unlike conventional banks, Islamic financial institutions are not permitted to use the money they receive from their clients' late payment fees. Any such amount received should be used for charitable purposes. The State Bank of Pakistan's directive requires that every Islamic financial institution in Pakistan create a charity fund in which income of the financial institution from non-*Shari'ah* compliant sources or penalties and late payment charges received from clients in default or overdue cases will be credited (State Bank of Pakistan 2008bc). The amount in this fund must be utilised for charitable and social welfare purposes

in accordance with the policy vetted by *Shari'ah* advisor and approved by the management. The financial institution is required to submit a copy of the institution's charity policy to the Islamic Banking Department of the State Bank of Pakistan within a period of seven days of its approval by the board. Any modification in this policy should also be communicated to State Bank within a period of seven days of the change. *Shari'ah* advisors are required to certify that the amount to the charitable fund has been credited. This certification is part of the *Shari'ah* advisor report that accompanies the institution's annual financial report (State Bank of Pakistan 2008bc).

The use of charity accounts by Islamic financial institutions in Pakistan has previously been criticised due to the lack of transparency and disclosure. In the past, Islamic financial institutions did not reveal the amount that was transferred to the charity account. This led to many questioning the transparency of Islamic financial institutions. A review of the annual reports of the case studies analysed reveals that the Islamic banks have taken a lead in this area and have been revealing the amount of money that is credited to the charity accounts. This information is provided in the *Shari'ah* advisors report, but does not break down the amount that is received from late fees or from activities that were considered non-*Shari'ah* compliant. The *Shari'ah* advisor's report also fails to identify how much money was given to individual charities.

State Bank of Pakistan's *Shari'ah* Audit

To ensure consistent application of *Shari'ah* rules, the State Bank of Pakistan is authorised to carry out independent *Shari'ah* audits to verify that the Islamic financial institutions are adhering to the "Instruction for *Shari'ah* Compliance in Islamic financial institutions" and

other related *Shari'ah* requirements (State Bank of Pakistan 2008bc). The audit also verifies that the rulings of the Islamic financial institutions' *Shari'ah* advisors comply with instructions, guidelines and directives issued by the State Bank of Pakistan's *Shari'ah* Board from time to time.

In case any difference of opinion arises between the *Shari'ah* advisor of the Islamic financial institution and the State Bank's inspection staff regarding Islamic banking practices, the case would be referred to the State Bank's *Shari'ah* Board. The *Shari'ah* Board will deliberate over the details of the case and will make a decision which will be final and binding.

As discussed in Chapter 5, differences in *Shari'ah* interpretation meant that previously *Shari'ah* advisors in Islamic financial institutions were able to take decisions that did not necessarily match the view of the majority of religious scholars. By centralising the approval of new product introduction and specifying *Shari'ah* duties, the State Bank of Pakistan has attempted to address this concern. The role of the *Shari'ah* Board of the State Bank of Pakistan's Islamic Banking Department is further analysed as part of the Pakistani model for *Shari'ah* governance.

Thus, the analysis of the *Shari'ah* advisors' role in Pakistani Islamic financial institutions reveals that while the *Shari'ah* advisors are performing most of the roles expected of them, they are unable to perform all. These unfulfilled roles include the expectation that the *Shari'ah* advisors will be able to answer all queries put forward to the *Shari'ah* scholar by the general public and the expectation that the *Shari'ah* advisor will undertake an internal audit of every branch of the Islamic financial institution. The limited pool of qualified *Shari'ah*

advisors combined with a lack of educational and training infrastructure means that the advisors are unable to meet these expectations. On the other hand, the *Shari'ah* advisors play an active role in the Islamic financial institutions use of a charity account and internal audit at a central location. To ensure that the financial institutions are following the *Shari'ah* principles, external *Shari'ah* audits are conducted by the Islamic Banking Department of the State Bank of Pakistan.

The next section details the role of the *Shari'ah* advisor as viewed by staff of the Islamic financial institutions.

6.2 PERCEIVED ROLE OF *SHARI'AH* ADVISORS

The interviewees for the study were asked about the role of *Shari'ah* advisors in Islamic financial institutions. The findings revealed divergent views on the need for *Shari'ah* advisors and SSBs in Islamic financial institutions. Some of the interviewees saw the role of the *Shari'ah* advisor as nothing more than that of ~~"r~~ubber stamping" documents. According to some of the interviewees from the Islamic windows and conventional banks, the presence of *Shari'ah* advisors was to merely fulfil the requirements of the State Bank of Pakistan. Some interviewees were of the view that since Islamic finance is growing and training is becoming compulsory for staff, there should not be a need for SSBs. The interviewees claimed that the important decisions were already made by the bank staff and approved by management and it was a mere formality that the *Shari'ah* advisor approves the steps. When asked about the possibility that the *Shari'ah* advisors may rule against the Islamic financial institution, the interviewees stated that since the *Shari'ah* advisors are compensated by the financial institutions, it was unlikely that the advisors would rule against their employers.

The findings also revealed conflict between *Shari'ah* advisors and other staff members. The conflict was seen as result of the differences in qualifications and business philosophy. The *Shari'ah* advisors were seen as individuals who were well-versed with Islamic law but were not aware of the pressures and requirements of the global financial regulations and competition. This difference in approach to banking meant that the *Shari'ah* advisor and bank staff were at times unable to successfully communicate their views to each other:

> *"once in a while we invite the Shari'ah members to attend our monthly meeting to discuss any issues that either side may have. These meetings become a farce. We try to explain our stance to them keeping in view the world's economic system. The advisors tend not to have much knowledge of business in general and thus start to give their views on Islam using Arabic words that we can't make sense of. This usually ends up frustrating both sides"* – Chief Investment Officer of Islamic window.

The interviewees from the Islamic banks were more supportive of the *Shari'ah* advisors' role than their counterparts in the Islamic windows. The interviewees explained that the bank staff were not sufficiently knowledgeable to make a judgement on a product's *Shari'ah* credentials and conformity. While the bank staff had some training in the basic principles of Islamic products, the interviewees were of the view that this was not sufficient to carry out the duties that a *Shari'ah* advisor undertakes. The Islamic bank interviewees also pointed out that the *Shari'ah* advisors were going beyond their normal duties by assisting in training of the bank staff:

> *"our staff are knowledgeable about the Islamic products but many are keen to learn more about the background of the Shari'ah laws. The Shari'ah advisors are kind enough to address seminars for our staff where there is a healthy exchange of views and opinions"* – Manager of Islamic window.

The *Shari'ah* advisors saw their role to be multifaceted. The *Shari'ah* advisors in both Islamic banks and Islamic windows stated that their role included being an employee of the bank, a representative of the State Bank and a *Shari'ah* auditor and regulator. The most important of these roles was that of a *Shari'ah* regulator because ensuring the long-term viability of the Islamic financing system was the most important duty a *Shari'ah* scholar had to fulfil. When asked about the potential for conflict in Islamic financial institutions between staff and *Shari'ah* advisors, the interviewees explained that most of the bank staff were keen to understand and learn about the system. Where there was a disagreement with staff, the *Shari'ah* advisors put it down to a difference of opinion in relation to what business transactions are permitted in Islam:

> *"it is every Shari'ah scholar's duty to ensure that the Islamic financing system remains "pure" and Shari'ah compliant. In doing so, there can be disagreements with bank managers but that is expected. Bank managers are responsible for maximising profits, while we are entrusted with ensuring the bank complies with Shari'ah principles" – Shari'ah* advisor of Islamic window.

The findings thus reveal that Islamic banks tend to work more effectively with *Shari'ah* advisors where the management is aware of the advisor's role and responsibilities. The managers of the Islamic windows tend to see the *Shari'ah* advisor's role in a negative fashion and there is more chance of a conflict in Islamic windows between advisors and managers due to divergent philosophies regarding the purpose of Islamic business transactions. A possible explanation for this variance in attitude can be linked to the profile of the staff. In conversations with the interviewees and observations of the staff during the field study, it was evident that the staff of the Islamic banks tend to have a strong belief in the ~~"r~~eligious righteousness" of the Islamic financing system and are more aware of the *Shari'ah* requirements and the role of the *Shari'ah* advisors. The majority of the staff of the Islamic

windows are trained in the conventional banking practices and are less accepting of the role of the *Shari'ah* advisors. As the level of awareness of the Islamic financial system grows, these variances may gradually disappear.

The findings therefore reveal that the perceived role of the *Shari'ah* advisor varies across the industry and depends on whether the advisor is employed by an Islamic bank or an Islamic window. This variation can be related to the level of training the bank staff have regarding the role of the *Shari'ah* advisors and the need for *Shari'ah* compliance within the Islamic finance sector.

The next section details the Pakistani model for *Shari'ah* governance and compares it with other existing national *Shari'ah* governance models.

6.3 NATIONAL MODELS OF *SHARI'AH* GOVERNANCE

The final finding of the study reveals that Pakistan has recently implemented a new *Shari'ah* Governance system in the Islamic banking sector aiming to regulate the implementation of *Shari'ah* rules. This move comes at the time when the AAOIFI and IFSB are working towards regulatory consistency in relation to *Shari'ah* supervision in Islamic financial institutions. Pakistan is not alone in attempting to implement a national governance model. There are different models of *Shari'ah* supervision that have been put proposed and applied by countries to ensure compliance to *Shari'ah* law in Islamic financial institutions in their country. The Pakistani model is in addition to four other well-established models that are in use in Iran, Malaysia, Bahrain and Indonesia. The following section summarises the four models, followed by a detailed analysis of the new Pakistani model:

The Iranian Model

Iran, (along with Sudan and previously Pakistan), is one of two countries in the world that only permits the use of Islamic finance for all transactions. In Iran, only those Islamic financial products can be offered by banks that have been defined in regulations issued by the Council of Ministers under the Usury Free Banking Act of 1983 (State Bank of Pakistan 2008d). The Council of Guardians performs the function of a central *Shari'ah* board and provides guidelines to the central bank and commercial banks. Contrary to AAOIFI regulations, and unlike the Pakistani system, the commercial banks in Iran do not need to have a *Shari'ah* board for guidance and/or supervision in day to day operations. The Council of Guardians is entrusted with ensuring that the principles of *Shari'ah* are applied consistently across all Islamic financial institutions in Iran (State Bank of Pakistan 2008d). The drawback of the system is that the banks do not have access to a resident *Shari'ah* advisor or board that would carry out an internal *Shari'ah* audits.

The Malaysian Model

The Malaysian model of *Shari'ah* governance in Islamic financial institutions is considered the most comprehensive among all national models. In 1997 Bank Negara Malaysia (the Central Bank of Malaysia) established the National Shari'ah Advisory Council on Islamic Banking and Takaful (NSAC) as the highest *Shari'ah* authority on Islamic finance in Malaysia (State Bank of Pakistan 2008d). In Malaysia the Islamic banks are advised and provided guidelines by NSAC. As the reference body and advisor to Bank Negara Malaysia on *Shari'ah* matters, the NSAC is also responsible for validating all Islamic banking and *takaful* products to ensure their compatibility with the *Shari'ah* principles (Bakar 2002). In 2003, The Central Bank of Malaysia Act 1958 was amended to enhance the role and

functions of the NSAC, and accorded the council the status of a sole authoritative body on *Shari'ah* matters pertaining to Islamic banking, *takaful* and Islamic finance (State Bank of Pakistan 2008d). To preserve its independence, members of the NSAC of Bank Negara Malaysia are not allowed to participate in any *Shari'ah* committee of financial institutions.

The Malaysian model allows for variation in the number of *Shari'ah* advisors employed by Islamic financial institutions. The Islamic Banks utilise the services of SSBs (also referred to as ~~–~~*Shari'ah* Committee" in Malaysia) consisting of at least three *Shari'ah* advisors, whereas Islamic windows employ only one *Shari'ah* advisor. The SSBs and advisors play a complementary role to the NSAC of Bank Negara Malaysia, and their duty is to advise the institutions on *Shari'ah* compliance of banking operations; however the NSAC is the ultimate arbiter. The Guidelines on the Governance of *Shari'ah* Committee for the Islamic Financial Institutions were issued by Bank Negara Malaysia in December 2004 (State Bank of Pakistan 2008d).

The Bahrain Model

The central bank of Bahrain requires all banks to establish an independent *Shari'ah* Supervision Committee complying with AAOIFI's governance standards for Islamic Financial Institutions. All banks must comply with all AAOIFI issued accounting standards as well as the *Shari'ah* pronouncements issued by the *Shari'ah* Board of AAOIFI (State Bank of Pakistan 2008d). The National *Shari'ah* Board of the central bank of Bahrain serves and verifies the *Shari'ah* compliance of its own products only. There is no restriction on the members of National *Shari'ah* Board serving on boards of any financial institution, nor is there a limitation restricting *Shari'ah* advisors to serving only one institution (Bakar 2002).

Each bank must have a separate function of *Shari'ah* review to verify compliance, which may be located in the internal audit function of the bank (State Bank of Pakistan 2008d). The Bahraini system is considered to be the most closely aligned to the AAOIFI regulations.

The Indonesian Model

In Indonesia, the National *Shari'ah* Board formed by the Indonesian Council of *Ulemas* (religious scholars) is responsible for issuing rulings on products in Islamic Banks. The Board was formed in 1999 and is seen as an independent body which is recognised by Bank Indonesia, the central bank of Indonesia (State Bank of Pakistan 2008d). In addition to coordinating with Bank Indonesia, the National *Shari'ah* Board also takes a role in the selection process of SSBs.

Islamic financial institutions in Indonesia is obliged to have SSBs (consisting of three *Shari'ah* advisors) which are seen as partners of Bank Indonesia in Islamic banking supervision. Bank Indonesia has set up "fit and proper" criteria which include a test for new SSB members that cover understanding of *Shari'ah* principles and knowledge on Islamic banking and finance in general (State Bank of Pakistan 2008d).

The Pakistani Model

As described in Chapter 4, *Shari'ah* supervision and control requirements in the Islamic banking sector in Pakistan have evolved since its launch in the late 1970s. In 2003 the State Bank of Pakistan established the Islamic Banking Department with the hope of bringing consistency in the regulation of *Shari'ah* in the Islamic banking sector. In 2008, the State Bank of Pakistan proposed a model for the application of *Shari'ah* rules in Islamic financial

institutions in Pakistan (State Bank of Pakistan 2008d). The Pakistani *Shari'ah* model was introduced to rectify inconsistencies found in the application of *Shari'ah* principles across the banking sector in Pakistan. The new model gives the *Shari'ah* Board of the State Bank of Pakistan the overall responsibility for regulating the Islamic financial institutions in Pakistan.

The *Shari'ah* Board is responsible for reviewing and approving the *Shari'ah* compliance of products and instruments developed by the State Bank of Pakistan for conducting its central banking and monetary management functions under the Islamic modes. In the year 2007, the *Shari'ah* Board approved and published a document listing the particulars of financial products that are considered to be *Shari'ah* compliant and are permitted for use by Islamic financial institutions in Pakistan (State Bank of Pakistan 2008bc). Islamic financial institutions are permitted to introduce new products but these need to be first approved by the State Bank's *Shari'ah* Board.

The *Shari'ah* Board of the State Bank consists of five members: two *Shari'ah* advisors, one Chartered Accountant, one lawyer and the Director of the Islamic Banking Department of the State Bank of Pakistan. The Director of the Islamic Banking Department acts as a representative for all banks and the State Bank of Pakistan (State Bank of Pakistan 2008d). The Director also acts as the secretary of the *Shari'ah* Board while the chairman of the *Shari'ah* Board is selected from among the *Shari'ah* scholars. The lawyer, accountant and the Director of the Islamic Banking Department give opinions in the relevant areas of their expertise to the *Shari'ah* scholars, who consider their views while giving a *Shari'ah* ruling on issues under review. The State Bank in conjunction with the *Shari'ah* Board has also developed a list of criteria for the appointment of *Shari'ah* advisors in Islamic financial

institutions. Not only do financial institutions have to select advisors based on these criteria, but the appointment of the advisor has to be approved by the State Bank (State Bank of Pakistan 2008d).

As described earlier in the chapter, the State Bank‘s Islamic Banking Department is responsible for conducting external *Shari’ah* audits in Islamic financial institutions in Pakistan. If the audit reveals that the Islamic financial institution has failed in its *Shari’ah* duties, the State Bank would refer the matter to the *Shari’ah* Board. The *Shari’ah* Board would then make a ruling on whether the *Shari’ah* failures identified by the State Bank breach the operational activities expected of Islamic financial institutions in Pakistan (State Bank of Pakistan 2008d).

The Pakistani *Shari’ah* governance model has a number of strengths. According to the State Bank of Pakistan, the establishment of the Islamic Banking Department and the introduction of the new governance model are part of the re-launch of Islamic banking in the country (State Bank of Pakistan 2008e). The initial launch of Islamic financing in Pakistan was in part unsuccessful due to uncertainty about the system‘s application and a lack of research into the impact of Islamic banking on the conventional banking sector. This new model is seen as an attempt to bring consistency in the application of *Shari’ah* principles and to gradually move the Pakistani sector to be consistent with the AAOIFI regulations (State Bank of Pakistan 2007).

The weakness of the Pakistani model is that the State Bank intends to carry out the task of external audit of *Shari’ah* implementation in all Islamic financial institutions. With the

growing number of Islamic financial institutions offering Islamic financial products in Pakistan, the task of carrying out audits in all of them will be a time-consuming exercise, and will be a difficult task considering the staff resource limitations of the State Bank. Another potential issue relates to the conflict of interest of the *Shari'ah* Board members. Unlike the Malaysian model, Pakistan allows *Shari'ah* advisors from the State Bank's *Shari'ah* Board to perform *Shari'ah* advisory duties for other Islamic financial institutions (State Bank of Pakistan 2008d). This dual responsibility of the *Shari'ah* advisors can raise concerns when the *Shari'ah* Board is assessing the religious compliance of banks for which the *Shari'ah* advisors also work. This may raise questions about the advisor's independence and can influence the banks to select those individuals as *Shari'ah* advisors who are also on the State Bank's *Shari'ah* Board.

The Pakistani *Shari'ah* governance model when compared with other national models has a number of strengths and weaknesses. The Pakistani model is the newest of all national models and has many similarities with the other national models. There are some differences though which reflect the historical events that shaped the Pakistani banking sector[16]. The findings reveal that the Pakistani *Shari'ah* governance model is similar to Malaysia in requiring the presence of at least one *Shari'ah* advisor in Islamic financial institutions. In contrast, the Bahraini and Indonesian models require the presence of SSBs and reflect the membership requirements laid out by AAOIFI. The Iranian model does not require the financial institutions to have a local *Shari'ah* advisor. This means that unlike the other national models, the Iran model is the weakest when it comes to conducting internal *Shari'ah* audits in Islamic financial institutions.

[16] For the history of the Pakistani banking sector, please refer to Chapter 4.

All the national models emphasise on the role of a centralised regulatory body (in most cases a centralised *Shari'ah* board). This board ensures standardisation within the country's Islamic financial sector and creates consistency in *Shari'ah* application. Previously, this standardised approach was lacking in Pakistan, but the new *Shari'ah* governance model provides a regulatory role for the *Shari'ah* Board of the Islamic Banking Department of the State Bank of Pakistan. The weakness of the Pakistani model is that it permits the State Bank's *Shari'ah* Board members to also act as *Shari'ah* advisors in other Islamic financial institutions. This creates a potential conflict of interest as the *Shari'ah* Board members of the State Bank are expected to provide judgements in case of conflict between the State Bank's *Shari'ah* audit team and the Islamic financial institution's interpretation and application of *Shari'ah* rules. This dual role of the *Shari'ah* advisors is similar to the Bahraini model but in contrast to the Malaysian and Indonesian models, where the members of the central governing body are not allowed to work for other financial institutions. The Pakistani model therefore seems to have elements of most of the existing national models of *Shari'ah* governance. The only exception to this is the Iranian model, which seems to be the least aligned with other national models.

The next section further discusses the Pakistani *Shari'ah* governance model and analyses the potential for the model's adaptability in other countries.

6.4 EVALUATION OF THE PAKISTANI *SHARI'AH* GOVERNANCE MODEL

The findings of the study reveal that members of the Islamic banking sector view the Pakistani *Shari'ah* governance model as a positive step but one which has some challenges.

While the *Shari'ah* Board of the State Bank of Pakistan has approved a number of Islamic financial products that can be used by Islamic financial institutions, Pakistan has lagged behind countries like Malaysia when it comes to product innovation. The interviewees referred to the fact that the State Bank of Pakistan is yet to make a judgement on whether the use of credit cards in Islamic banking is appropriate. According to the State Bank's documentation, the review of credit cards in Islamic financial institutions would be undertaken in 2010 (State Bank of Pakistan 2008e). Till then there is no restriction on the introduction of credit cards. But the past experience of banks in Pakistan is forcing many institutions to remain conservative and ignore the use of credit cards, which some Islamic scholars have labelled as un-Islamic due to the credit lending option. As discussed in Chapter 4, the Pakistani banking sector introduced a number of innovative Islamic products and instruments in the 1980s which was later declared un-Islamic by the courts in Pakistan. To avoid a repeat of the claims and counter claims made by jurists in relation to the Islamic credentials of financial products, Islamic financial institutions are awaiting the State Bank's review on certain products before they introduce them. While some Islamic financial institutions have introduced what is referred to as Islamic credit cards, most financial institutions in Pakistan have refrained from introducing them. The interviewees explained that Islamic financial institutions are unlikely to risk their reputation by introducing new products such as credit cards unless they are entirely sure that the State Bank will not make a ruling against the product in the future.

This cautious approach has resulted in Pakistan failing to launch any new innovative Islamic financial products since the 1980s. While Malaysian Islamic financial institutions and some financial institutions in the Middle East have introduced credit cards which have been duly approved by their central banks, Pakistani Islamic financial institutions are lagging behind

their international counterparts and risk losing their market share. Other innovations made by Malaysian Islamic financial institutions include the use of Real Estate Investment Trusts (REITs) (Y-Sing 2009). This new product launch is seen as an opportunity for Islamic financial institution to convert their extra liquidity into real estate property such as shopping centres and earning a profit by letting out the shops for rental income. Following the lead of Malaysia is Qatar which is planning to introduce this option into their existing product range. Pakistani Islamic financial institutions have not yet considered introducing REITs due to similar reservations as those expressed in relation to credit cards.

The interviewees were asked why Pakistan had taken such a cautious path with respect to new product development and *Shari'ah* governance model. The main reason provided by managers of Islamic banks and Islamic windows for the cautious approach was the strict interpretation of the *Qur'an* and *Sunnah* put forth by *Shari'ah* advisors. The interviewees explained that the Pakistani *Shari'ah* advisors had a reputation of being strict in their interpretation of the *Qur'an* as compared to *Shari'ah* advisors from Malaysia and Indonesia. Therefore, introducing new products is seen as a risky proposition as *Shari'ah* advisors may in the future reject the authenticity of new products, just as was the case with *murabaha* in the early 1990s. The *Shari'ah* scholars interviewed for the study claimed that the introduction of new products needed to be carefully managed. The interviewees claimed that investment options like REITs present the problem that the entity renting the property could use the premises to undertake business activities that are not compliant with Islamic principles.

Therefore it was not sufficient to merely confirm whether the product is authentic, but how it may be applied and used in the future is also an important consideration:

> *"Islamic banks have to be responsible not just for their activities but also the activities of the customers. REITs need to be look carefully before it is introduced in Pakistan. It is not the Shari'ah side of it that's an issue; it's the contractual side that needs to be strengthened to ensure continued compliance under Shari'ah" – Shari'ah* scholar.

Regarding the use of a new *Shari'ah* governance model in Pakistan, the interviewees from Islamic windows stated that Pakistan is unique in its interpretation of Islam and this is being transferred to the banking sector as well. The interviewees described how Pakistan was the first Islamic Republic in the world and the first country to implement Islamic banking. Therefore, Islamic values were central to Pakistan's identity and religion influenced all aspects of daily life. This, according to the interviewees, meant that when it came to interpretation and application of Islamic text, Pakistan had more religious institutions and religious scholars than other Muslim countries and therefore Pakistan had managed to apply a more balanced form of Islam. This ~~"b~~balanced" form of Islam, according to the interviewees, was evident in the new *Shari'ah* governance model introduced by the State Bank of Pakistan.

6.5 SCOPE FOR THE PAKISTANI *SHARI'AH* MODEL'S GLOBAL EXPANSION

As described in the previous section, the Pakistani model of *Shari'ah* governance devised by the *Shari'ah* Board of the State Bank came into effect in 2008. Unofficially, the State Bank and the Islamic financial institutions in Pakistan have been following a similar *Shari'ah* governance models since the opening of the first Islamic bank in Pakistan in 2001. This unofficial system has evolved over time and is the basis of the new *Shari'ah* governance

model approved by the State Bank. The Pakistani model is thus viewed by many as a system that has been tested by Islamic financial institutions over time, and can be adapted by other Islamic financial institutions around the world.

The individuals interviewed for this study indicated that the Pakistani *Shari'ah* governance model was flexible and easier to apply than other national models and Islamic financial institutions in Pakistan are considering using the model for their future operations overseas. There are a number of reasons provided for why the model would be considered suitable for other countries. Interviewees suggested that the presence of Pakistani trained *Shari'ah* advisors in Islamic financial institutions worldwide meant that the Pakistani *Shari'ah* governance model could be applied in institutions operating outside of Pakistan without too many hurdles. This approach would only work in countries that have not yet approved the use of a particular *Shari'ah* governance model or formalised their own alternative. As an example, many interviewees referred to the Islamic Bank of Britain following a *Shari'ah* governance model that is similar to the Pakistani *Shari'ah* governance model. The Islamic Bank of Britain commenced its operations in 2004 and is aiming to attract the local British Muslim clients, especially those who migrated from India and Pakistan during the 1940s and 1950s. The scope for using the Pakistani model is also there for Pakistani Islamic banks financial institutions that are planning to expand operations overseas, especially in market that have a large population of Pakistani and Bangladeshi expatriates and migrants:

> *"the manner in which we have introduced our products and conducted our business in Pakistan has been quite successful. We are hoping to further refine our operations based on what we have learned and will be using the same system when we commence our Islamic banking operations overseas*" – Manager of Islamic window.

As the Pakistani Islamic financial institutions expand into the global markets in the next few years, the viability of the Pakistani governance model in foreign countries will become much clearer.

6.6 CONCLUSIONS

This chapter has presented the final set of findings of this study. A lack of research on governance and role of *Shari'ah* scholars in the Islamic banking sector has resulted in a lack of agreement over the specific roles of *Shari'ah* scholars and SSBs. The Pakistani Islamic banking sector is in the process of regulation and standardisation where the State Bank of Pakistan's Islamic Banking Department is setting up rules on *Shari'ah* application and governance in Islamic financial institutions. The State Bank's *Shari'ah* Board has recently issued a directive that details rules and processes that Islamic financial institutions and *Shari'ah* advisors are required to follow. The findings of the study compare these directives against organisational realities.

The findings of the study reveal that while some studies suggest that *Shari'ah* advisors should be available to respond to queries from the community regarding Islamic finance issues, it is not practical to expect them to do so. Pakistan's large population combined with a lack of educational institutions that teach Islamic finance has resulted in *Shari'ah* scholars receiving more queries from the community than they can answer. The expectation that *Shari'ah* advisors will be informally training bank staff in *Shari'ah* requirements and the allowance given by State Bank for advisors to be employed by more than one Islamic financial institution makes it difficult for the advisors to fulfil the expectation of answering queries that the community has of them.

The *Shari'ah* advisors are expected to play a central role in the introduction of new Islamic financing products. Prior to the State Bank's directive that lists the approved Islamic financial products that Islamic financial institutions are permitted to offer, the *Shari'ah* advisors would work with the financial institutions' management to introduce new products. Once the products were approved, the State Bank of Pakistan required notification of the product launch. Since the new requirements have been implemented, Islamic financial institutions need the *Shari'ah* advisor or SSBs to verify the *Shari'ah* compliance for Islamic products that have been approved by the State Bank. In case Islamic financial institutions wish to introduce a new product that is not listed on the State Bank's approved Islamic financial products document, then the *Shari'ah* advisors would need to work with the Islamic financial institutions' management and demonstrate that the new product matches AAOIFI regulations. The new product would also require the approval of the *Shari'ah* Board of the State Bank prior to its commercial launch.

The *Shari'ah* advisor/SSBs are also required to act as auditors of *Shari'ah* regulations in Islamic financial institutions. *Shari'ah* advisors are required to verify that the activities of the Islamic financial institutions are consistent with the State Bank's expectation and *Shari'ah* requirements. If the *Shari'ah* advisor finds that the Islamic financial institution has failed in its duty then the advisor is bound to allocate the money earned from un-Islamic transactions to be transferred to a special charity account. If the advisor feels that the financial institution has deliberately failed in its duty to follow the Islamic rules in business transactions, then the advisor is required to inform the State Bank of Pakistan's Islamic Banking Department. Thus, the *Shari'ah* advisor plays the role of a *Shari'ah* auditor.

The State Bank‘s directive further requires that all Islamic financial institutions establish a charity account. This charity account would be used to deposit any late fees or penalties received from clients, and other amounts that the *Shari’ah* advisor has identified as having earned from non-*Shari’ah* sources. The amount deposited in the charity account would need to be certified by the *Shari’ah* advisor and declared in the advisor‘s report which accompanies the Islamic financial institution‘s annual financial report. The findings reveal that *Shari’ah* advisors and SSBs are unable to undertake audits of every branch and therefore carry out the audit of the books at a central location.

The external *Shari’ah* audit of the Islamic financial institution is carried out by the State Bank of Pakistan. If the auditors find a variance in interpretation and application of *Shari’ah* rules by the Islamic financial institution‘s *Shari’ah* advisor and the State Bank‘s rules, then the issue would be sent to the *Shari’ah* Board of the State Bank along with the details of the issue. The *Shari’ah* Board would make a decision on the issue which would be binding on all.

The findings also reveal variations in the way the role of the *Shari’ah* advisor is perceived by staff in Islamic banks and Islamic windows. Some bank staff in Islamic windows view the role of the *Shari’ah* advisor to be that of a mere formality to fulfil the requirements of the State Bank and refer to the potential conflict between the management and *Shari’ah* advisors that exists within the organisation. The staff from the Islamic banks tend to view the role of the *Shari’ah* advisor in a positive light, where the advisor not only has the ability to ensure that the institution‘s transactions remain *Shari’ah* compliant, but also assist in training the bank staff. The *Shari’ah* advisors themselves view their role as regulators of *Shari’ah* and see

themselves as responsible for keeping the Islamic finance sector free of any non-*Shari'ah* influence.

Finally, the chapter looks at the Pakistani model of *Shari'ah* governance introduced by the State Bank of Pakistan. This model is the first formal model established in Pakistan. Comparing the model with other national models from Bahrain, Indonesia, Iran and Malaysia shows that the Pakistani model is more liberal than the Iranian model but not as well-established as the model applied by Bahrain and Malaysia. The Pakistani model has centralised the *Shari'ah* requirements by placing it under the control of the *Shari'ah* Board of the State Bank of Pakistan but has weaknesses in the membership of the *Shari'ah* Board. *Shari'ah* advisors who are serving Islamic financial institutions in Pakistan are permitted to serve for the State Bank. This creates a potential for conflict of interest when the State Bank is reviewing the activities of one of the Islamic financial institutions in which the *Shari'ah* advisor of the State Bank's *Shari'ah* Board may also be employed.

The interviewees from the Islamic financial institutions view the Pakistani model to be flexible enough to be applied in foreign countries where the financial institutions intend to expand. However some of the interviewees believe that the Pakistani Islamic banking and finance sector is more cautious in the introduction of new products than countries such as Malaysia. This cautious approach has discouraged innovation in the Pakistani Islamic banking and finance industry, and products such as *Shari'ah* compliant credit cards and REITs are still to be officially launched by the State Bank of Pakistan. The *Shari'ah* advisors believe that introduction of new Islamic financing products should be undertaken with

caution, ensuring that Islamic financial institutions do not introduce products which may affect the authenticity of the system in the future, such as the mark-up based agreements.

The next chapter concludes this study by summarising the major findings of the study and demonstrating where the extant literature on *Shari'ah* governance in Islamic financial institutions is confirmed, contradicted or gaps identified. Using the findings of the study, the chapter will identify implications, and make recommendations for: policy makers; for the individuals and organisations involved in the Islamic finance practice; and for regulators of the Islamic banking sector. Areas for further research will also be identified.

CHAPTER 7

CONCLUDING CHAPTER

This study concludes with this final chapter that details how the research questions for this study were answered, establishes this study's contribution to the research literature, and based on the findings makes recommendations for the Islamic banking and finance sector in Pakistan. The chapter begins by summarising the key findings of the study. It then details how the research questions for the study were addressed, followed by a comparison of the findings with extant literature on *Shari'ah* governance in Islamic financial institutions. Practical recommendations for the Islamic banking and finance sector in Pakistan are then provided and the chapter concludes with suggestions for future research in the area of *Shari'ah* application and governance.

7.1 SUMMARY OF FINDINGS

The findings of this study are unique and significant for the industry. As discussed in Chapter 2, the field of Islamic finance has experienced rapid growth over the last three decades. But despite this growth the areas of *Shari'ah* governance and the roles and responsibilities of *Shari'ah* advisors are largely unexplored and to date little has been known and understood about these issues. This study is the first of its kind to explore the roles of *Shari'ah* advisors in Pakistan, and the findings of the study have implications for policy makers, financial institutions and regulatory bodies. As discussed in Chapter 3, the exploratory nature of the study meant that the qualitative approach to gathering data and related information was most appropriate for addressing the research questions posed in this study. The gathering of data using an on-site field study approach is unique in this subject area. This approach required collecting data via semi-structured interviews on-site in Pakistan over a period of five years.

The findings of the study are significant for stakeholders in the Islamic finance sector. The findings have revealed gaps in the currently available literature and identify *Shari'ah* governance issues in Islamic financial institutions that have previously not been addressed in academic publications. These findings include: variation in the number of advisors in the Islamic financial institutions, the training of *Shari'ah* advisors, the shortage of qualified *Shari'ah* advisors in the industry, the role of the *Shari'ah* advisor in Islamic financial institutions and the particular Pakistani model of *Shari'ah* governance.

Variation in the Number of Advisors:

The findings of the study reveal variations in the number of *Shari'ah* advisors employed by Islamic financial institutions in Pakistan. The Islamic banks utilise the services of SSBs which consist of three or more advisors whereas the Islamic windows only employ one *Shari'ah* advisor. This finding in Pakistan shows that the country is not following AAOIFI requirements which state that every institution should have a *Shari'ah* Supervisory Board (SSB) consisting of at least three advisors. In contrast to the AAOIFI requirements, the State Bank of Pakistan has specified that Islamic financial institutions operating in Pakistan only need to have one advisor. Despite this requirement, Islamic banks tend to employ a SSB with three *Shari'ah* advisors whereas Islamic windows tend to employ one resident *Shari'ah* advisor. By employing SSBs Islamic banks fulfil the AAOIFI requirements and are therefore eligible for institutional membership of the AAOIFI.

Training of *Shari'ah* Advisors:

In relation to the training of *Shari'ah* advisors, the findings reveal that most of the *Shari'ah* advisors have been trained at the same single educational institution in Karachi. While there are some other institutions in Pakistan (in Islamabad and Lahore) that also provide similar training courses, the ‗Training Institute'[17] in Karachi dominates the market based on its professional links with organisations in the Islamic banking sector in Pakistan. The institute is owned and managed by individuals who have previously served as a judge in the Federal *Shari'ah* Court of Pakistan and are serving as *Shari'ah* advisors in Islamic financial institutions and are members of the *Shari'ah* Board of the State Bank of Pakistan. Due to this existing relationship the State Bank of Pakistan and some banks also send some of their staff to train at this institute. The interviewees in this study saw the reliance on one institute for training as a positive, as this would lead to consistency in application. The findings of this reveal that this is not necessarily the case when it comes to application of *Shari'ah* principles in Islamic financial institutions. The variation in the application is further discussed later in this chapter.

The educational and experiential requirements for *Shari'ah* advisors set up by the State Bank of Pakistan, and the time required to train as a *Shari'ah* advisor means that some advisors are not familiar with issues related to banking and finance. The general bank staff on the other hand are not well-versed in the *Shari'ah* requirements in business operations. These differences in education and training of *Shari'ah* advisors and bank staff means that they do

[17] The ‗Training Institute' is the dominant educational institution that provides training for *Shari'ah* advisors and general bank staff in the area of Islamic banking and finance. Please refer to Chapter 5 for a complete profile of the ‗Training Institute'.

not share a professional culture and this has the potential to create communication errors as both sides are unable to understand the technical terminology used by the other side.

Shortage of Qualified *Shari'ah* Advisors in the Industry:

In relation to the independence of *Shari'ah* advisors, the findings reveal that the State Bank of Pakistan has changed its requirements as a response to the shortage of qualified *Shari'ah* advisors. The requirements for *Shari'ah* advisors provided by the State Bank of Pakistan in the past specified that *Shari'ah* advisors may not act as an advisor to more than one Islamic financial institution. But this prohibition was ignored by Islamic financial institutions and *Shari'ah* scholars were often performing their duties for multiple financial institutions. The findings of this study reveal that due to a limited pool of *Shari'ah* advisors, the institutions have no alternative but to use the experienced *Shari'ah* advisors. According to industry experts there are about 60 scholars in the world qualified to advise banks involved in Islamic finance (Abbas 2008). This number is not even seen as sufficient to meet the demand in the Middle East. In response to this shortfall, the State Bank of Pakistan has altered its previous requirement that *Shari'ah* advisors only perform their duties in one Islamic financial institution and now allows the employment of *Shari'ah* advisors in multiple financial institutions.

Role of the *Shari'ah* Advisor in Islamic Financial Institutions:

The findings of the study reveal that *Shari'ah* advisors carry out a number of duties both formally and informally. Formally the *Shari'ah* advisors conduct internal *Shari'ah* audits on the business transactions of Islamic financial institution. Theoretically the *Shari'ah* advisors are employed by the financial institution's shareholders, but in practice they are selected by

the management of the Islamic financial institution and their selection needs to be approved by the State Bank of Pakistan. The advisors are expected to provide an annual *Shari'ah* report to the shareholders of the Islamic financial institutions and to the State Bank of Pakistan. This report details the Islamic financial institutions' compliance with *Shari'ah* and any breaches of Islamic law discovered during the audit. The advisors are also expected to routinely answer *Shari'ah* related queries put to them throughout the financial year by staff and management of the Islamic financial institution. The *Shari'ah* advisors in the past were expected to play a central role in the introduction of new products. Informally there is an expectation within Islamic financial institutions that *Shari'ah* advisors should train bank staff in *Shari'ah* related issues. These practices and expectations in Pakistan extend beyond Islamic financial governance research policy literature which has to date advocated that *Shari'ah* advisors should answer queries from bank staff and management but which has remained silent about *Shari'ah* advisors' provision of training to bank staff. This informal role of the *Shari'ah* advisor in training bank staff can be attributed to the lack of educational institutions in Pakistan that provide courses in Islamic banking and finance.

Perception of Roles:

The findings also reveal that there are differences in the way the role of the *Shari'ah* advisor is perceived in the Pakistani Islamic banking sector. These variations can in part be explained by whether the bank staff are employees of Islamic banks or Islamic windows. The staff of Islamic windows tend to have basic knowledge about *Shari'ah* requirements and their application in Islamic financial institutions. Therefore they tend to view the role of the *Shari'ah* advisors in a positive light. The Islamic bank staff believe that the *Shari'ah* advisors not only ensure that the Islamic financial institution's transactions remain *Shari'ah*

compliant, they also assist in training the bank staff in *Shari'ah* principles and their relevance to the finance sector.

The staff of Islamic windows on the other hand view the presence of *Shari'ah* advisors in financial institutions as a mere formality in order to fulfil the requirements of the State Bank of Pakistan. According to the staff, the decisions in Islamic windows are made by the management team and the *Shari'ah* advisors merely "rubber stamp" the decision to satisfy the requirements of the State Bank of Pakistan. Since the advisors are employed by the Islamic financial institution, the staff believe that the advisors would not reject the decisions made by the financial institution's management team.

The findings of the study reveal that *Shari'ah* advisors view their role in the Islamic financial institution to be that of regulators of *Shari'ah* and believe that they are responsible for ensuring that the Islamic financial system remains free from any business dealings and wealth that may breach *Shari'ah* principles. Therefore *Shari'ah* advisors tend to make their decisions independently from the influence of the management team even though the advisors are employed y the financial institution.

However the findings of the study also reveal that the perception of the role of the *Shari'ah* advisors by staff of the Islamic windows can lead to disagreements between management and *Shari'ah* advisors in advisor's role and responsibilities. The management team expects the advisors, who they view as bank employees, to approve managers' decisions without any resistance. The *Shari'ah* advisors on the other hand see themselves as independent from the Islamic financial institution and prefer to make their decision after being assured that all the

decisions made are consistent with *Shari'ah*. These variations in perception of roles can lead to frustration among bank staff and *Shari'ah* advisors and can create a hostile working relationship between the two sides.

Pakistani Model of *Shari'ah* Governance:

Finally, the study details the Pakistani model of *Shari'ah* governance introduced by the State Bank of Pakistan in 2008. The Pakistani model follows the introduction of similar national models by Bahrain, Indonesia, Iran and Malaysia. The Bahrain model is considered to be most closely aligned to the AAOIFI's suggested model for *Shari'ah* governance in Islamic financial institutions. According to the Bahrain model, all Islamic financial institutions should employ an SSB consisting of at least three *Shari'ah* advisors. The central bank of Bahrain also has its own *Shari'ah* board that looks after the *Shari'ah* compliance of the central bank's business activities. The *Shari'ah* advisors serving the central bank are permitted to provide their services to other Islamic financial institutions.

The Indonesian national model of *Shari'ah* governance follows the Bahrain models in requiring all Islamic financial institutions to employ an SSB consisting of three *Shari'ah* advisors. The role of the SSB is to ensure that the Islamic financial institutions' activities are consistent with the rulings of the National *Shari'ah* Board. This Board is seen as an independent body formed by the Indonesian Council of *Ulemas* and is recognised by the central bank of Indonesia.

Iran (along with Sudan) does not permit conventional financing and the economy is reliant on Islamic financing. The Iranian national model is considered unique as it does not require

Islamic financial institutions to employ *Shari'ah* advisors. Instead the power to supervise, govern and implement *Shari'ah* principles is held by the central bank of Iran.

The Malaysian model of *Shari'ah* governance is considered to be the most comprehensive among all national models. In Malaysia the National *Shari'ah* Advisory Council on Islamic Banking and Takaful (NSAC) is the highest authority on Islamic finance and was established by the central bank of Malaysia. Members of NSAC are not permitted to work for Islamic financial institutions. The Malaysian model permits variation in the number of *Shari'ah* advisors employed by Islamic financial institutions. Islamic banks in Malaysia are required to employ an SSB consisting of three *Shari'ah* advisors whereas Islamic windows are only expected to employ one *Shari'ah* advisor.

The State Bank of Pakistan‘s introduction of the new national governance model has given it control over the introduction of new Islamic financing instruments in Pakistan. The State Bank‘s Islamic Banking Department established a *Shari'ah* Board that advises the State Bank on *Shari'ah* requirements and has established minimum standards for *Shari'ah* governance that Islamic financial institutions are required to meet. These standards include minimum educational and experiential requirements for selection of *Shari'ah* advisors. The *Shari'ah* advisors who perform their duties as members of the State Bank‘s *Shari'ah* Board are permitted to be employed by Islamic financial institutions. The Islamic Banking Department also conducts external *Shari'ah* audit of the Islamic financial institutions‘ business activities and transactions.

Comparing the Pakistani model with the other national *Shari'ah* governance model reveals a number of similarities among the models. The exception to this is Iran which does not require Islamic financial institutions to employ *Shari'ah* advisors. The Bahrain, Indonesian and the Malaysian models require Islamic financial institutions to employ an SSB with three *Shari'ah* advisors (Malaysia only requires SSBs for Islamic banks) but the Pakistani model states that the Islamic financial institutions only need to employ one advisor. The Malaysian model does not permit members of the central bank's *Shari'ah* board to work for other financial institutions. But the Pakistani model follows the Bahrain model in allowing members of the State Bank's *Shari'ah* Board to be employed as *Shari'ah* advisors in financial institutions.

The findings of this study reveal that the Pakistani model is the State Bank's first step towards implementing a *Shari'ah* governance system. This has taken the form of attempting to standardise the *Shari'ah* application of Islamic financial institutions operating in Pakistan. In the longer term the State Bank shows signs of attempting to alter the Pakistan *Shari'ah* governance requirements to comply with the governance requirements that have been laid out by AAOIFI (State Bank of Pakistan 2007).

7.2 ADDRESSING THE RESEARCH QUESTIONS

The findings of this study helped address the primary and secondary research questions identified in Chapter 1. In answering these questions, the findings of this exploratory study provide insights into the workings of SSBs and *Shari'ah* advisors and the role of the State Bank of Pakistan and other regulatory bodies.

Primary Research Question:

What are the roles and responsibilities of Shari'ah Supervisory Boards and Shari'ah advisors in the operations of Islamic financial institutions in Pakistan?

The findings of the study show that the role of the SSB and *Shari'ah* advisors has evolved since the establishment of the State Bank of Pakistan's Islamic Banking Department (IBD) in 2003. Previously the State Bank of Pakistan played a more decentralised role where the application of *Shari'ah* in Islamic financial institutions was the financial institutions' responsibility. The supervision and governance of *Shari'ah* was undertaken by the *Shari'ah* advisors employed by the Islamic financial institutions. These duties included assisting in the development and approval of new Islamic financial products, auditing the Islamic financial institutions' transaction records to ensure compliance with *Shari'ah* and taking appropriate action in case of non-compliance, answering *Shari'ah* related queries put forth by the Islamic financial institution's management, and training bank staff in *Shari'ah* related aspects of banking and finance. Since the new *Shari'ah* governance model was introduced by the State Bank of Pakistan in 2008, the SSBs and *Shari'ah* advisors have continued to carry out all their previous roles except that of approving the introduction of new Islamic financial products. The process of approving new Islamic financial instruments and products is now carried out by the *Shari'ah* Board of the State Bank's IBD.

Thus, the role of the SBBS and *Shari'ah* advisors in Pakistan can be described as being that of an internal auditor. The advisors ensure that the State Bank's regulations regarding *Shari'ah* compliance and governance are applied in the Islamic financial institutions. This includes checking transactions for *Shari'ah* compliance and ensuring that *Zakat* is directed

according to Islamic requirements. Informally, the advisors also provide training to staff of the Islamic financial institutions in relation to religious law and the implications for business.

Secondary Research Questions:

1. *What is the role of the State Bank of Pakistan and other regulatory bodies in the application and evaluation of Shari'ah principles in Islamic financial institutions?*

As explained earlier, the State Bank of Pakistan has introduced a new *Shari'ah* governance model in 2008. According to the new model, the State Bank of Pakistan's IBD has overall supervisory control over the *Shari'ah* activities of all Islamic financial institution. The IBD has introduced "Fit & Proper Criteria for Appointment of *Shari'ah* Advisors" which all Islamic financial institutions have to follow. In addition to this the IBD has approved a list of financial products that comply with *Shari'ah*. The Islamic financial institutions are only allowed to offer Islamic products that have been approved by the IBD. To ensure that Islamic financial institutions comply with the *Shari'ah* requirements laid out by the State Bank of Pakistan, the IBD carries out external *Shari'ah* audits of the Islamic financial institutions' commercial transactions.

The other regulatory agency that has a direct impact on *Shari'ah* governance in Islamic financial institution is the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). The AAOIFI has attempted to standardise the *Shari'ah* governance practice of Islamic financial institutions worldwide by setting relevant standards. According to the AAOIFI regulations, all Islamic financial institutions should have an SSB consisting of at least three *Shari'ah* advisors. This requirement has not yet been implemented in Pakistan due to the shortage of qualified *Shari'ah* advisors. Pakistan's regulations have historically

stated that Islamic financial institutions can operate with the services of one *Shari'ah* advisor. The AAOIFI regulations are effectively guidelines since they are voluntary for member countries and institutions cannot be enforced. However, the State Bank of Pakistan intends to follow the AAOIFI requirements and has stated that over time it aims to integrate the AAOIFI *Shari'ah* regulations into the Pakistani *Shari'ah* governance model.

2. *What are the minimum educational qualification and experience requirements for selection of Shari'ah advisors by Islamic financial institutions in Pakistan?*

The State Bank of Pakistan's circular titled "Fit & Proper Criteria for Appointment of *Shari'ah* Advisors" states that the *Shari'ah* advisor must have at least five years of experience in giving religious rulings, and should have knowledge of or at least be familiar with the banking industry. The circular further states that the number of years of experience can be relaxed if the advisor can demonstrate experience of no less than three years in teaching Islamic *fiqh* in a reputable institution (non-financial) with a proven track record. In relation to the advisor's track record, the circular states that the candidate must not have been previously dismissed as an employee or director/chairperson of a company. The candidate must also demonstrate an impeccable record of activity in the company(ies) they have previously served, either in the capacity of an employee or director/chief executive, or as chairperson. The circular also requires that the advisor should not been associated with any illegal activity (especially relating to banking business), has not been in default of payment of dues owed to any financial institution and/or default in payment of any taxes individual capacity or as proprietary concern or any partnership firm or in any private unlisted and listed company, and has sufficient means to discharge their financial obligations (State Bank of Pakistan 2004d).

The minimum educational qualification specified by the State Bank of Pakistan is *Dars-e-Nizami* which is the basic syllabus that is followed by the majority of *Madrassas* (religious Islamic schools) in South Asia. It was framed by Maulana Nizamuddin Firanghi Mahali, and teaches the students about Islamic interpretation of the *Qur'an*. Other education qualifications such as Masters of Arts in Islamic studies, banking, economics and finance may be viewed as added qualification but are not seen as compulsory for the appointment of a *Shari'ah* advisor (State Bank of Pakistan 2004d). The findings of the study show that while some of the smaller Islamic windows hire *Shari'ah* advisors with minimum knowledge of the prudential requirements, most *Shari'ah* advisors have supplemented their religious education with professional courses in banking and finance or a post-graduate degree in Arts and Economics.

3. *How do the SSBs and Shari'ah advisors form their legal opinion in response to enquiries by banks and interested parties?*

The findings of the study reveal that Pakistani *Shari'ah* advisors form their legal opinion based on their interpretation of the *Qur'an* and *Hadith* (oral traditions relating to the words and deeds of Prophet Muhammad). The interpretation depends on which school of thought the individual *Shari'ah* advisor follows. In the past this has resulted in the introduction of new Islamic financial products (like the mark-up based *murabaha*) that were deemed to be *Shari'ah* compliant by some advisors but this variation by school of thought was later questioned by the *Shari'ah* Court of Pakistan for its authenticity. To overcome these variations in interpretation and to bring consistency in *Shari'ah* application, the State Bank of Pakistan has released a list of approved financial products that Islamic financial institutions can use. If the *Shari'ah* advisors of the Islamic financial institution believe that a new Islamic

financial product fulfils the *Shari'ah* compliance criteria and should be introduced, then the advisor is required to work with the State Bank's IBD to obtain approval.

The findings also show that while the *Shari'ah* advisors were expected to be available for answering *Shari'ah* related queries from staff and management of the Islamic financial institutions, the advisors were not expected to answer all queries put forward by the wider community.

4. *What is the process involved in carrying out technical Shari'ah reviews by banks offering Islamic financial products?*

The *Shari'ah* review of the financial transactions of Islamic financial institution is undertaken both internally and externally. Internally the *Shari'ah* audit is conducted by the SSB or by the resident *Shari'ah* advisor. In the case of Islamic banks, the SSBs conduct the *Shari'ah* audit of the Islamic bank's financial transactions at one central location (usually the head office). As Islamic banks usually have a large network of branches, it is not feasible for SSBs to conduct *Shari'ah* audits in each branch. The Islamic windows in Pakistan tend to operate a stand-alone branch. Thus the *Shari'ah* advisors of Islamic windows do not face the challenge of auditing a large number of branches and carry out the audit of all the transactions on the branch premises.

The external *Shari'ah* audit is carried by the State Bank of Pakistan's IBD. The external audit ensures that the Islamic financial institutions are following the guidelines provided by the IBD and the business practices and transactions fulfil the *Shari'ah* requirements. In the event that the audit reveals that the Islamic financial institution deliberately breached the *Shari'ah*

regulations, the IBD would enforce a financial penalty on the financial institution and can bar the Islamic financial institution‘s *Shari’ah* advisors from operating in the banking and finance sector. As the IBD is a small department with limited human resources, conducting external *Shari’ah* audits of all the Islamic financial institutions in Pakistan can put an enormous burden on the department‘s resources.

5. *How do SSBs and Shari’ah advisors ensure that the banks implement Shari’ah controls?*

While the *Shari’ah* advisors are employees of the Islamic financial institutions, they are expected to act independently. The advisors are required to audit the financial transactions of the Islamic financial institution to check for any breaches of *Shari’ah* law. If the audit reveals that certain transactions breached *Shari’ah* compliance, the *Shari’ah* advisors are expected to take appropriate action. In case of a deliberate attempt by the financial institution to breach *Shari’ah* regulations, the advisors are expected to inform the State Bank of Pakistan. In any case where the institution has unintentionally breached the *Shari’ah* requirement, the advisors are expected to inform the financial institution‘s management committee of the breach and transfer the amount of the transaction to the financial institution‘s charity account. The SSB and advisors are also expected to produce an annual report which certifies that the financial institution‘s transactions fulfil *Shari’ah* requirements and any breaches of *Shari’ah* have been identified and dealt with.

To ensure that the Islamic financial institutions do not undertake any financial transactions that contradict *Shari’ah* laws, the *Shari’ah* advisors make themselves available to answer any queries from bank staff that relate to interpretation and application of *Shari’ah* laws. The

advisors are also involved in training bank staff in the essential requirements of Islamic law in business thus ensuring that the Islamic financial institutions‘ activities remain *Shari'ah* compliant.

7.3 ADVANCING THE LITERATURE

This section compares the findings of the study to the extant literature in the area of *Shari'ah* governance in Islamic financial institutions. As discussed in Chapter 2, extant literature is limited in research on the application of *Shari'ah* in Islamic finance. Thus, this study offers a number of significant additions to our knowledge of this subject area.

Internal *Shari'ah* Audit:

The findings of the study confirm the role of the *Shari'ah* advisors in conducting internal *Shari'ah* audits in Islamic financial institutions. The shareholders and the management of the Islamic financial institution along with the State Bank of Pakistan expect the *Shari'ah* advisors to carry out periodic checks to ensure that the institutions‘ business practices are compliant with *Shari'ah*. The advisors attest to the *Shari'ah* compliance of the Islamic financial institution and prepare an annual *Shari'ah* audit report which is presented as part of the financial institution‘s annual report. This finding in Pakistan confirms Banaga et al‘s (1994) expectation of *Shari'ah* advisors‘ duty of conducting internal *Shari'ah* audits.

Penalty for Non-Compliance:

In a case where the *Shari'ah* audit reveals that the Islamic financial institution has undertaken financial transactions that breach *Shari'ah* law, the *Shari'ah* advisors are expected to take action against the Islamic financial institution. If the breach is judged to have been deliberate,

the *Shari'ah* advisors are expected to immediately inform the State Bank of Pakistan. Failure to do so could result in the State Bank of Pakistan barring the *Shari'ah* advisor from performing their duties in any Islamic financial institution.

In the event that the breach is deemed to be unintentional, the *Shari'ah* advisor is expected to inform the Islamic financial institutions' management and is required to transfer all sums of money earned from the transaction to a charity account. The findings of this study confirm Lewis and Algaoud's (2001) claim that the *Shari'ah* advisors in Pakistan carry out this responsibility and certify in the annual *Shari'ah* report the amount that was transferred into the charity account.

Variation in Interpretation and Application of *Shari'ah*:

The study reveals that the Pakistani Islamic finance sector had in the past faced uncertainty and lacked consensus over which products were essentially *halal*. The lack of uniformity in application led to the introduction of new mark-up based products (like *murabaha*) which were rejected by the Federal Shari'at Court of Pakistan, only to be later accepted by the *Shari'ah* Appellate Bench of the Supreme Court of Pakistan. The findings of the study reveal that this variation is due to whichever Islamic school of thought followed by the *Shari'ah* advisors. Depending on the school of thought, an individual can either follow a strict literal interpretation of *Qur'anic* verses or follow a more liberal interpretation. This variation confirms Karim's (1990) view that *Shari'ah* advisors are guided by their obligations to religious peers and community, and follow procedures that they believe fulfils *Shari'ah* requirements. In confirming Karim's (1990) view, this study also however, reveals resultant difficulties in trying to achieve uniformity in *Shari'ah* application. To help overcome these

issues of variation and interpretation, the State Bank of Pakistan has taken over the responsibility of approving new Islamic financial instruments.

Approval of New Islamic Financial Instruments:

According to Banaga et al (1994), part of the SSBs duty is to approve new Islamic financial instruments and products that are proposed by the Islamic financial institutions. The *Shari'ah* auditors are expected to assess the *Shari'ah* compatibility of the financial instrument. If the product fails the assessment, the Islamic financial institution would be prohibited from using the instrument. In the past this was true in the case of Pakistan where *Shari'ah* advisors were expected to approve new products. But the new *Shari'ah* governance model introduced by the State Bank of Pakistan has given the Islamic Banking Department (IBD) the responsibility to approve new Islamic financial instruments in Pakistan. The IBD has issues a list of approved Islamic financial instruments that Islamic financial institutions can use to offer products to their clients. But if an Islamic financial institution wants to introduce a new instrument that is not on the IBD's list, then the institution would need to seek formal approval from the State Bank of Pakistan.

This new approval process is in response to criticism that *Shari'ah* advisors were merely "rubber stamping" their approval for the introduction of new products that had been proposed by the Islamic financial institutions' management. The findings of the study therefore reveal that while the process of introducing new products in the past matched the expectations in the literature, the new model in Pakistan is unique and has previously not been explored.

Number of *Shari'ah* Advisors Employed:

Extant literature on the role of *Shari'ah* advisors focuses on the AAOIFI regulations for the number of *Shari'ah* advisors that are employed by the Islamic financial institutions. The presence of a *Shari'ah* Supervisory Board (SSB) is considered mandatory for the functioning of Islamic financial institutions (Bakar 2002; El-Nagar 1980). As discussed earlier in the chapter, the AAOIFI regulations require all Islamic financial institutions (Islamic banks and Islamic windows) to employ an SSB consisting of at least three *Shari'ah* advisors.

The findings of this study and comparison of different national *Shari'ah* governance models reveal that Bahrain and Indonesia follow the expectation of employing an SSB while Iran, Malaysia and Pakistan do not have such requirements for Islamic financial institutions operating in those countries. In Iran, Islamic financial institutions are not required to have an SSB or even a resident *Shari'ah* advisor, since the central bank carries out the duties of *Shari'ah* governance in the banking sector. Malaysia does require the use of SSBs but this is only expected of Islamic banks. The Islamic windows in Malaysia are required to only employ one *Shari'ah* advisor.

The Pakistani governance model specifies that all Islamic financial institutions have to employ one *Shari'ah* advisor but there is no expectation for an SSB to be employed. The findings of the study reveal that while the Islamic financial institutions are not required to employ an SSB, the Islamic banks operating in Pakistan tend to utilise the services of an SSB with a minimum of three advisors. Doing so allows the banks to become eligible for membership of AAOIFI. The Islamic windows on the other hand generally tend to use only one *Shari'ah* advisor but there some Islamic windows in Pakistan that also tend to employ an

SSB. According to the interviewees from Islamic banks, using SSBs allows the financial institution to make decisions based on the views of different jurists rather than just one person. The respondents from the Islamic windows believe that having just one *Shari'ah* advisor in one branch means that the Islamic financial institution can make quick decisions as there issues related to disagreements between the advisors is overcome. The findings of this study therefore contradict the general expectation in the existing literature that all Islamic financial institution employ SSBs.

Training and Hiring of *Shari'ah* Advisors:

As discussed in Chapter 2, there is limited research undertaken in the area of *Shari'ah* governance in Islamic finance. The areas of training *Shari'ah* advisors and their hiring by Islamic financial institutions have remained largely unexplored. The findings of this study provide an insight into these issues in Pakistan, and a first offering of research data on this subject in the Islamic finance literature generally.

The State Bank of Pakistan has published the ‗Fit and Proper Criteria' for the selection and hiring of *Shari'ah* advisors by Islamic financial institutions. The document provides minimum selection criteria for *Shari'ah* advisors and focuses on their educational and experiential requirements. These requirements state that *Shari'ah* advisors must be educated in the Islamic religious law but are not required to be well-versed in finance and business education. The findings of the study show that Pakistan has a shortage of educational institutions that can provide training in both religious and business education. The State Bank's educational requirements for *Shari'ah* advisors reflect this shortage.

The results of this study reveal that the *Shari'ah* advisors meet the State Bank's educational requirement and are educated under the *Dars-e-Nizami* syllabus. Most of the advisors tend to further their education in application of *Shari'ah* in business by undertaking training courses offered by one institution in Karachi, Pakistan. This Training Institute has strong links with the State Bank of Pakistan and financial institutions in Pakistan.

The shortage of training institutions and the rapid growth of the Islamic finance sector have resulted in a shortage of qualified and experienced *Shari'ah* advisors in Pakistan. To overcome this shortage some *Shari'ah* advisors in Pakistan are employed by multiple Islamic financial institutions. These findings related to selection and training of *Shari'ah* advisors in Pakistan offers a significant addition to the current literature in Islamic finance which to date has been silent on these issues.

Conflict of Interest:

Another area of *Shari'ah* governance not covered by extant literature relates to the independence of *Shari'ah* advisors. As discussed in the previous section, some *Shari'ah* advisors in Pakistan are employed by multiple Islamic financial institutions to perform duties as *Shari'ah* advisors in each financial institution. This brings into question their independence and the potential for conflict of interest. The other potential for conflict of interest in Pakistan occurs in the State Bank's Islamic Banking Department (IBD). The introduction in 2008 of the new *Shari'ah* governance model in Pakistan resulted in the creation of the new *Shari'ah* Board' in the State Bank of Pakistan's IBD. The *Shari'ah* Board consists of a number of individuals such as *Shari'ah* advisors, a lawyer, an accountant and the director of the IBD. This Board is responsible for the formulation and implementation

of *Shari'ah* governance in the Islamic finance sector in Pakistan and resolves any issues relating to disagreements between the State Bank's *Shari'ah* auditors and the Islamic financial institution's *Shari'ah* advisors over interpretation and application of *Shari'ah*.

The governance model in Pakistan allows the *Shari'ah* advisors who are serving on the *Shari'ah* Board of the IBD to also serve as *Shari'ah* advisors for Islamic financial institutions. This raises concerns over the independence of the external *Shari'ah* audit undertaken by the State Bank of Pakistan, as the audits may require assessing the performance of *Shari'ah* advisors of Islamic financial institutions that are also members of the State Bank's *Shari'ah* Board. This finding of *Shari'ah* advisors operating for multiple Islamic financial institutions has previously not been exposed and explored in the literature.

7.4 IMPLICATIONS AND RECOMMENDATIONS

As discussed earlier, the findings of the study show that the issues of education and training of *Shari'ah* advisors, shortage of qualified *Shari'ah* advisors and potential for conflict between *Shari'ah* advisors and bank staff are some of the *Shari'ah* governance issues facing the Pakistani Islamic finance sector. These issues threaten to negatively impact the future growth opportunities of Islamic finance and thus have implications for policy makers, financial institutions and regulators. Based on the findings, the study recommends some practical solutions to help address these issues and strengthen *Shari'ah* application and governance in Islamic financial institutions. These recommendations include: investment in educational infrastructure, and outsourcing of *Shari'ah* audit to accounting and auditing firms.

Investment in Educational Infrastructure

The shortage of training institutions in Pakistan dedicated to Islamic financing has been identified as the main reason for the limited pool of qualified *Shari'ah* advisors. To overcome this issue, there is an evident need for the Government of Pakistan in conjunction with the State Bank of Pakistan to invest in the educational infrastructure. While Pakistan has a few training institutions that do provide courses in Islamic education, the available evidence suggests that a case can be made for establishing educational institutions that offer specific courses and degrees in Islamic financing.

Taking such a step would ensure that Pakistan follows the lead of countries like Malaysia that have established higher education institutions offering Islamic finance courses. Such institutions could provide courses in Islamic finance that would conform to the syllabus followed by AAOIFI training courses and other Islamic financing educational institutions around the world. This would also facilitate Pakistan *Shari'ah* advisors and bank managers to not only operate within the Pakistan Islamic finance sector but also in the Islamic finance sector worldwide.

However merely increasing the number of training facilities may not be sufficient. At the policy level, the State Bank of Pakistan's IBD may need to re-consider the criteria established for the hiring of *Shari'ah* advisors. The requirement that the potential advisor be trained in *Dars-e-Nizami* (the education provided by religious seminaries in Pakistan) means that those individuals who are schooled in non-religious schools would be excluded from performing the duties of a *Shari'ah* advisor.

As revealed in the findings, the training of *Shari'ah* advisors in *Dars-e-Nizami* has resulted in a gap where some advisors have found it difficult to transfer their knowledge to the finance industry. Changing the requirement to accommodate both financial and religious education would arguably not only help overcome the shortage of qualified *Shari'ah* advisors but could also help reduce miscommunication between bank staff and *Shari'ah* advisors as they would be able to communicate using technical terms that are part of the banking industry. In addition, the AAOIFI's course for qualifying as a "Certified *Shari'ah* Advisor and Auditor" does not specify knowledge of religious education as prerequisite for the qualification (AAOIFI 2008). By removing the requirement of *Dars-e-Nizami*, the State Bank would also bring their requirement closer to compliance with the AAOIFI.

Outsourcing *Shari'ah* Audits

The findings of this study reveal that the shortage of qualified *Shari'ah* advisors is a worldwide problem affecting the Islamic finance industry. This shortage of advisors has led to the practice of multiple Islamic financial institutions employing the same individual as their *Shari'ah* advisor. This has raised questions about the potential for conflict of interest in Islamic financial institutions. As the industry experiences rapid growth this issue will continue to persist.

Pakistan has tried to address this problem by reducing the number of *Shari'ah* advisors each Islamic financial institution is required to hire. But the Pakistani model has also established a *Shari'ah* Board in the State Bank of Pakistan's IBD. *Shari'ah* advisors on IBD's *Shari'ah* Board are also employed by Islamic financial institutions. As the State Bank of Pakistan conducts external *Shari'ah* audit of the commercial banks, the presence of these advisors on

the *Shari'ah* Board of the IBD and in Islamic financial institutions raises concerns over the conflict of interest that these advisors may have when serving two organisations.

As the findings reveal, the Bahrain governance model also allows *Shari'ah* advisors of the central bank to be employed by other commercial institutions. Therefore, this conflict of interest is not just limited to Pakistan or countries that follow the Pakistani model of governance. The external audit of Islamic financial institutions by the State Bank of Pakistan also has resource implications. As the IBD has limited human resources, the task of conducting *Shari'ah* audits of Islamic financial institutions can place immense pressure on the resources of the department.

To overcome these issues, the State Bank of Pakistan could consider removing the external *Shari'ah* audit of Islamic financial institutions from its portfolio. Like the conventional banking system, independent accounting and auditing firms could conduct the external *Shari'ah* audit of the Islamic financial institution's business transactions. With AAOIFI offering certification courses for *Shari'ah* auditing, accounting and auditing firms in North America, Europe and the Middle East are hiring individuals with knowledge of *Shari'ah* principles that need to be applied in financial institutions. Since the State Bank of Pakistan has centralised the *Shari'ah* governance application process with the IBD, the audit by accounting firms would require them to follow the State Bank's directives and requirements when conducting the *Shari'ah* audits of Islamic financial institutions. Such a step would reduce the pressure on the State Bank's resources and would help address the concerns raised by critics in relation to the potential conflict of interest of *Shari'ah* advisors.

7.5 SUGGESTIONS FOR FUTURE RESEARCH

The study has detailed the roles and responsibilities of *Shari'ah* advisors in Islamic financial institutions in Pakistan. The study has also revealed the role the State Bank of Pakistan plays in the application and governance of *Shari'ah* regulations in Islamic financial institutions. The findings of this study have identified areas for further research in *Shari'ah* governance in Islamic financial institutions.

Further development of our knowledge of *Shari'ah* governance implementation in Islamic financial institutions also requires research that will compare and evaluate the *Shari'ah* governance practices of Islamic financial institutions in non-Muslim majority countries. This would facilitate evaluation of the role local regulatory bodies' play in the application and governance of *Shari'ah* in the finance sector which is traditionally dominated by conventional financing options. As the central bank in those countries would not have a central *Shari'ah* governance control body like Pakistan, the variation in the practices of Islamic financial institutions in those countries and the response to the variations from the regulatory bodies would add to the literature on *Shari'ah* governance.

The practice of *Shari'ah* governance in the Pakistani Islamic banking sector merits further examination over time. As discussed earlier, the new Pakistani *Shari'ah* governance model was introduced in 2008. The impact of the new model is yet to be completely felt in the Pakistani Islamic finance sector. Future studies could not only look at how the Pakistani Islamic financial institutions have responded to the introduction of the new *Shari'ah* model, but could also research any regulatory changes the State Bank may make to achieve their goal of future compliance with AAOIFI regulations.

7.6 SIGNIFICANCE OF THE STUDY

This study researches the area of *Shari'ah* governance in Islamic financial institutions and the role of the *Shari'ah* advisors in these institutions in Pakistan. The literature review for this study revealed that there was a shortage of literature available on the subject of *Shari'ah* governance in Islamic finance and the role of the *Shari'ah* advisors. To address this gap the role of the *Shari'ah* advisors in Islamic financial institutions in Pakistan was explored. As detailed in Chapter 4, the Pakistani banking sector has experienced numerous changes and the Government of Pakistan's decision to introduce the Islamic banking system resulted in the development of new Islamic financial instruments and policies for application of *Shari'ah*. For these reasons Pakistan was selected as the country for study.

The findings of the study have identified a number of gaps in the literature on *Shari'ah* application and governance in Islamic financial institutions. These findings are significant for the global Islamic banking and finance sector in general and the Pakistani market in particular. The findings reveal that the perception of roles of the *Shari'ah* advisors in Islamic financial institutions may not match the expectation identified in the literature. This expectation relates mainly to the independence of the advisors who are employees of the financial institution but supposedly operate as unbiased independent *Shari'ah* auditors. The worldwide shortage of qualified *Shari'ah* advisors and the resulting practice of advisors being employed by multiple Islamic financial institutions have previously not been addressed by academic research. The findings of this study show that the shortage is directly affecting the ability of countries like Pakistan to implement the suggested governance structure proposed by the AAOIFI which requires financial institutions to employ an SSB.

These findings have implications for the Islamic financing sector as regulators (especially in non-Muslim countries) are expressing their concerns over the *Shari'ah* governance quality in the Islamic finance sector (Ainley et al 2007). In addition to confirming and discounting some of the *Shari'ah* advisor roles that have been described in current literature, the findings of this study have also identified roles and practices of the *Shari'ah* advisors and the role of the central bank that have previously not been discussed in academic literature. These include the informal training *Shari'ah* advisors provide to bank staff and the employment of *Shari'ah* advisors in more than one financial institution. The role of the central banks in the Islamic financing sector has also remained largely unaddressed. The findings of the study reveal that over the last few years the State Bank of Pakistan has taken a proactive role in the enforcement of *Shari'ah* principles in Islamic financial institutions and the development of new Islamic financial instruments. These responsibilities include conducting external *Shari'ah* audits of Islamic financial institution‘ records, approving the introduction of new Islamic financial products, and issuing detailed requirements for the education and selection of *Shari'ah* advisors in Islamic financial institutions in Pakistan. The findings of this study have also revealed that nations vary in their application of *Shari'ah* in Islamic financial institutions and follow their own national model of *Shari'ah* governance. Thus this study has significant implications for the Islamic financing sector in Pakistan and worldwide. By addressing these issues through academic research and undertaking steps to address challenges such as shortage of *Shari'ah* advisors, the Islamic financing sector globally would not only improve the *Shari'ah* governance quality but will also be in a better position to improve their market potential.

APPENDIX 1: TRANSLATION OF ARABIC & URDU WORDS USED IN THE STUDY

Dars-e-Nizami: the basic syllabus that is followed by the majority of Islamic religious schools in South Asia.

fatwa: legal pronouncement in Islam, issued by a religious law specialist on a specific issue.

fiqh: Islamic jurisprudence that complements Islamic law with evolving rulings/interpretations of Islamic jurists.

gharar: risky or hazardous sale, where details concerning the sale item are unknown or uncertain.

Hadith: oral traditions relating to the words and deeds of Prophet Muhammad

Haj: the pilgrimage to the Islamic holy city of Mecca undertaken by Muslims.

Hajis: the pilgrims who undertake the pilgrimage to Mecca.

halal: products or actions that are permitted under Islamic law.

haram: products or actions that are prohibited under Islamic law.

ijarah: a lease based Islamic financing agreement.

istisna'a: contract of exchange with deferred delivery, applied to specified made-to-order items.

kafalah: to guarantee each other. The term *kafalah* is the basis of the *takaful* financing agreement.

madrassa: an Islamic religious school that provides education in Islamic law.

maulana: a religious scholar. Also referred to as *maulvi* or *mullah*.

mudaraba: a profit-and-loss sharing Islamic financing agreement.

mudarib:	the entrepreneur responsible for the management and execution of a project under the *mudaraba* contract.
mufti:	an Islamic scholar who is an interpreter or expounder of Islamic law, capable of issuing *fatwa*
mullah:	a religious scholar. Also referred to as *maulvi* or *maulana*.
murabaha:	a mark-up based Islamic financing agreement.
musharaka:	a profit-and-loss sharing partnership based Islamic financing agreement.
qarz-e-hasna:	a loan which is given in the name of Allah. These loans are usually given to the poor and destitute.
Qur'an:	the holy book of followers of Islam.
rabb-ul-mal:	the financier of the project under a *mudaraba* contract.
riba:	refers to interest charged on the lending and borrowing of money.
salam:	a form of forward contract when the price for an asset is paid upfront at the time of the contract for an asset or commodity to be delivered later.
Shari'ah:	Islamic law based on the teachings of the *Qur'an*.
sood:	refers to usury. A term used commonly in the Indian sub-continent. Also used to describe the rate of interest charged on money borrowed.
sukuk:	Islamic investment certificates and are sometimes also referred to as Islamic bonds
Sunnah:	the traditions, practices and actions of Prophet Muhammad.
takaful:	referred to as Islamic insurance.
ulema:	Muslim legal scholar who is known as arbiter of *Shari'ah* law.
zakat:	the amount of money that every adult Muslim is obliged to pay to support specific categories people.

APPENDIX 2: SAMPLE OF QUESTIONS ASKED DURING INTERVIEWS:

EXECUTIVES FROM THE ISLAMIC BANKING DIVISION OF THE STATE BANK OF PAKISTAN:

- What role does the State Bank play when new Islamic products are introduced by banks?
- What are the criteria set by the State Bank for qualification of *Shari'ah* advisors?
- What is the requirement placed on banks in relation to the operations of *Shari'ah* advisors?
- What are the responsibilities of *Shari'ah* advisors in banks?
- What do you think are some of the issues facing the Islamic banking sector in Pakistan?
- How does the State Bank monitor the working of *Shari'ah* advisors?

MANAGERS OF ISLAMIC BANKS AND BANKS OFFERING PRODUCTS VIA ISLAMIC WINDOWS:

- What is the process for introducing new Islamic products by your organisation?
- What is the make-up of your *Shari'ah* department?
- Describe the process through which *Shari'ah* approval is sought?
- What are your views about the Islamic banking sector in Pakistan?
- What role do regulatory bodies play in the operations of the Islamic banks?
- Is staff required to obtain training in Islamic financing?

MANAGERS OF BANKS OFFERING CONVENTIONAL BANKING PRODUCTS:

- What potential and challenges do you believe the Islamic banking sector in Pakistan faces?
- What level of competition do banks offering Islamic products pose for your organisation?
- Is your organisation planning to introduce Islamic banking products?
- What role do you think *Shari'ah* advisors play in the Islamic banking sector?

- What is the role of the regulatory bodies in the promotion and monitoring of Islamic finance?

***SHARI'AH* ADVISORS:**

- What potential and challenges do you believe the Islamic banking sector in Pakistan faces?
- Why are there differences in the application of *Shari'ah* for financial products (for example prohibition of *murabaha* in some institutions but acceptance in others)?
- What are the responsibilities of the *Shari'ah* advisor in your organisation?
- What is the process to which new Islamic financing products are introduced by your organisation?
- What is the role of the regulatory bodies in the monitoring of Islamic banks and the *Shari'ah* advisors?
- What training (financial or *Shari'ah* related) have you undertaken since joining the organisation?

EXECUTIVES OF COMPANIES AND MARKETING AGENCIES DEALING WITH ISLAMIC BANKING PRODUCTS:

- What potential and challenges do you believe the Islamic banking sector in Pakistan faces?
- Why is the growth of Islamic financing still slow?
- Why does your organisation choose Islamic products over conventional financial products?
- What makes products offered by Islamic banks and Islamic windows *Shari'ah* compatible?
- What role do you think *Shari'ah* advisors play in the Islamic banking system?
- Does the reputation of the *Shari'ah* advisor play a part in consumer's decision to select Islamic products from a particular bank?

CHIEF RESEARCHERS OF INTERNATIONAL ISLAMIC BANKING REGULATORY BODIES:

- Why are there differences in the application of *Shari'ah* for financial products (for example prohibition of *murabaha* in some institutions but acceptance in others)?
- What are the advantages and challenges of having *Shari'ah* advisors in each institution?
- What role can regulatory bodies play in standardising the Islamic financial system?
- What minimum level training and qualifications should *Shari'ah* advisors posses?

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