Shariah Boards and the Corporate Governance of Islamic Banks in the United Kingdom

Scott Morrison, Ph.D.*

Abstract

In the last decade Islamic banks (or banks with Islamic windows) that can compete with conventional (i.e. non-Islamic banks) have begun to emerge in Britain. A governmental policy of neither prejudice nor favour, coupled with legislative reforms evince the UK government’s increasing interest in encouraging and even actively promoting Islamic banking and finance, and London as its European capital. At the same time, codes and guidance concerning corporate governance have gained stringency in the UK, following on the financial crisis that began in 2007. Structurally similar to conventional banks in most legal respects, the Shariah Board of Islamic banks and financial institutions poses a variety of unique challenges to UK corporate governance. This article explores those challenges and outlines how they might begin to be met; it does so with reference to corporate governance measures implemented in Malaysia and by its central bank, the Bank Negara Malaysia.

1. Introduction

A. Islamic banking in Britain

The introduction and operation of Islamic banking and finance in the United Kingdom over the last decade, and its future success or failure, rest upon the interpretation and application of shariah in a novel legal, policy, and regulatory environment. As a highly regulated sector in the UK (as it is in most countries) the hurdles that any bank must surmount in order to pass regulatory muster are high. Islamic banking has faced some additional hurdles due to its relative novelty and unfamiliarity in this western country where Muslims comprise a minority, and not necessarily a minority well-acquainted with shariah, or its implications for banking and finance.

Among those additional hurdles -- some of which have already been overcome -- this article will consider those relating to the corporate governance of Islamic banks. This article extends the literature on corporate governance in Britain and its enforcement vis-à-vis banks1 onto terrain that has been little explored,2 even though the problems of managing the adjudication of shariah in the context of Islamic banks and banks with

* Associate Professor, Akita University, Tegata Gakuen-cho 1-1, Akita City, Akita 010-8502 JAPAN, Tel. +81 (0) 18-889-3252, Mobile: +81 (0) 80-3045-6789, Email: smsmorrison@gmail.com, morrison@gipc.akita-u.ac.jp
Islamic windows operating in the UK3 is at least as challenging and (sometimes qualitatively different to) those issues that presently face conventional (i.e. non-Islamic) banks and financial institutions.

**B. Shariah and the share-holder**

The shareholders and depositors of Islamic financial institutions expect that certain transactions will be excluded or refused by the institution in which they are invested. Paradigmatically, these include those transactions trafficking in interest or in forbidden goods (such as pornography or pork; alcohol, or other intoxicants). The institutional mechanism with enforcing this limitation on transactions is the Shariah Board. The mandate of the Shariah Board is to: evaluate, and to approve or reject, contractual documents and transactions, and to oversee all operations of the bank, ensuring that the bank conforms to the principles of Islamic law.

The legal, regulatory and policy regimes that apply to Islamic banks in Britain contain a tension, one that may even rise to the level of a contradiction in the absence of necessary adjustments. The two propositions that yield the tension or contradiction are: (1) Islamic banking and finance should be encouraged and put on par with conventional banks, and (2) companies (including banks) should observe standards of governance under which their boards are accountable to the shareholders, or to a larger universe of stake-holders.

The possible contradiction arises because the norms, codes and legislation of corporate governance to which Islamic banks operating in the UK are subject require these banks, along with their non-Islamic counterparts, to consider the interests of the shareholders and other stakeholders when making decisions about operation and management – including decisions about whether to allow or to refuse a particular transaction, contract, or product. However, in the case of Islamic banks, when there is a putative conflict between the demands of religious duties towards God (Allah), and those towards the shareholders or other stakeholders, the former as a matter of principle must trump the latter.

Furthermore, even supposing the utmost good faith on the part of Shariah Boards, and supposing that its decisions and rationales for those decisions are made known, there is no means of appeal. A result of these two features of the Shariah Board -- its divine loyalty and its privileged position as final arbiter – is that it is ultimately unaccountable to shareholders or to any larger set of notional stakeholders.

**C. Shariah Boards and Islamic jurisprudence**

The Shariah Board is the sole and exclusive interpreter of Islamic law within an Islamic bank. It alone has the power to allow or to stop a transaction or the introduction of a new type of financial product on the grounds of religious permissibility or impermissibility. The Shariah Board is essentially autonomous and
unsupervised. The absence of an avenue of appeal is a function of the essential character of the Islamic legal tradition. There is no code or agreed body of written (or unwritten) law, although there may be an informal consensus (‘ijma) on many matters. Shariah is based both on Qur’an and the Sunna (the sayings and deeds of the Prophet Muhammad). While the Qur’anic text has been essentially settled since the eighth century CE, the boundaries of the Sunnah and the authenticity of particular aphorisms is contestable, and, in fact, contested. The legal pluralism of Islam, with its four legal schools in the largest sect of the faith (the Sunni),8 and the factual differences in the content, customs, and culture of shariah from school to school or country to country makes durable agreement, much less unanimity, unattainable. While the power of independent legal reasoning (ijtihad) in Islamic history may be seen as a virtue (in the context of modernisation, for example), ijtihad reinforces still further the autonomy, and the opacity of the operation of, the Shariah Board.

It is evident from the small number of cases that have accumulated in the English courts that the UK judiciary will only apply English law and offers no relief for the problem of the variability of shariah interpretations.9 Fissiparous tendencies are compounded by the fact that precedent is not binding, even within one legal school, in Islamic law.

As a result of the features of Islamic jurisprudence set out in this section, the determinations of shariah scholars and the Boards upon which they serve may legitimately differ, undermining legal certainty. A critical mass of Islamic banks departing from a consensus could introduce systemic instability and -- potentially -- failure.10 Incoherent decisions by Shariah Boards individually or collectively could damage consumers’ confidence and belief in the authentic Islamic character of the sector. The membership and personnel of Shariah Boards also raises both regulatory and practical issues. Any director must be registered under FSA Approved Persons rules; they must satisfy the ‘Fit and Proper test for Approved Persons,’ which implies that the FSA must assess their ‘competence and capability’.11 In the absence of recognised programmes of education and certification, the decentralised nature of education in Islamic law complicates this task.12 There is a widely documented shortage of scholars to occupy seats on Shariah Boards. The shortage produces a further issue which is conflicts of interest, as scholars may sit on a variety of Shariah Boards at different, and potentially competing, Islamic banks.

2. Company law, the Financial Services Authority (‘FSA’), and modern corporate governance

A. Company law: the legal formation of Islamic banks

The Islamic banks in Britain are public companies limited by shares. They have a two-tier board structure consisting in a management board and a Shariah Board. The
Companies Act 2006 (‘the 2006 Act’) does not specify whether one or two boards are required for a UK company; the 2006 Act only specifies the minimum number of directors (s 154), and it does not specify whether or not the directors must act as a board. Together with the legal acceptance of non-executive directors (‘NED’s’), it is evident that the two-tiered board structure of Islamic banks and financial institutions is legally unproblematic.

B. Policy documents and banking legislation: 'no obstacles, but no special favours'14

Since at least 2000, the FSA15 and the UK government have been rather supportive of Islamic finance. Sir Howard Davies, then Chairman of the FSA, stated in 2003 that the UK had “a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in London” and that well-managed Islamic banks would be “good for Muslim consumers, good for innovation and diversity in our markets and good for London as an international financial centre.”16

The UK government has sought to make Britain a welcoming jurisdiction for Islamic banking and finance through promotional publicity, and policy.17 Parliament has also enacted legal provisions to the same end. The Financial Services and Markets Act 2000 (‘the 2000 Act’) initiated this vector of legislative change; the Finance Act 2003 (‘the 2003 Act’) continued by eliminating multiple payment of Stamp Duty Land Tax on Islamic mortgages;18 the Finance Acts of 2005 and 2006 enacted further provisions intended to put Islamic products on an even footing with their conventional equivalents; the Finance Act 2007 clarified the tax framework with respect to sukuk (Islamic bonds).

C. Corporate governance of banks

Since the 1990's corporate governance and scholarship concerning it have risen in importance, with the aim of finding and implementing better ways of directing and controlling a company.19 The recent history of the subject may be traced through a succession of commissions and codes.20 Following the global economic crisis (beginning 2007-2008), in Britain and the rest of Europe and the US, the topic has gained urgency in the eyes of the public, legal academe, and the governmental (and non-governmental policy) establishments. The same is true a fortiori for one species of company in particular: banks. The reasons for this are not difficult to discern. Banks play a critical role in the economy, they tend towards opacity; and for these and other reasons they have historically been subject to heavy regulation.

Banks feature regulatory and risk profiles that distinguish them from other companies. Therefore the directly applicable company law is that specifically dealing with banks. Islamic banks mirror conventional banks in most respects, so the current literature on
financial services regulation applies equally to conventional and Islamic banks. The hallmark of Islamic banks, however, is the claim they make to religious conformity -- which is absent in any other type of bank in contemporary Britain. The distinguishing feature of the structure of Islamic banks flows from that religious claim: the Shariah Board. Since there is no counterpart in conventional banks, neither the literatures on conventional banking nor on the corporate governance of a conventional bank adds specific insight or analysis on the distinctive problems of governance of Shariah Boards.

3. Reconciling corporate governance and shariah

A. Compliance and the future of the Shariah Board

Setting aside other issues surrounding the introduction of Islamic banking in Britain, the remainder of this article will consider specifically the challenge inherent in the observation and adjudication of shariah in the banking sector in Britain. This requires an examination of Shariah Boards and the potential for voluntary and involuntary cooperation and compliance with standards of corporate governance, since it is these boards that are exclusively charged with the interpretation and enforcement of shariah in the running of Islamic banks. The exclusivity of the Board’s ambit is all the more evident given the inability, as well as the well-founded reluctance of the UK courts, to adjudicate matters of shariah concerning commercial, banking and other financial transactions (as outlined in 2.B above).

With the demise of the FSA and its replacement by new regulatory authorities, it is possible that the accommodations and the policy position outlined in 2.C. will change; the successor authorities and officials may accelerate the rate of reform that facilitates Islamic banking, they may slow that rate, or they may reverse it – depending ultimately on political will and assessments of the performance and potential of the Islamic banking sector in Britain (and abroad).

Since the motivation driving the FSA's accommodation of Islamic banking, along with that of the UK government more broadly (including HM Treasury, and UK Trade and Investment) was mainly economic -- although the FSA also acknowledged the domestic market of British Muslims (as quoted in section 2.B.), and the sector may have some advantages over conventional finance such as greater stability (by virtue of being backed by real assets), it is unlikely that the UK government will move to restrict the sector but will more probably continue with tax relief and legal and regulatory reforms to level the playing field between Islamic and conventional banks. There is some evidence suggesting that the UK government may even seek to more positively and vigorously promote Islamic finance and banking, and to advance London's claim
to being a centre for Islamic banks both within Europe and on a global scale.22

The leading motivation for current initiatives is, in a time of (relatively) low growth in Britain, to attract inward investment. The historic connections between Britain and large territories of the Muslim-majority world (albeit originally under the auspices of empire, and now through the Commonwealth, state, informal ties, and population flows) are indeed potential sources of capital, investment, and trade upon which the UK may capitalize by means of the Islamic finance and banking sector. These historic connections, coupled with the concomitant spread of English legal and political regime types (to variable degrees) across the British Empire, may now help to facilitate the adoption by the UK of regulatory law and policy developed in jurisdictions where regulators and the financial community possess more extensive and longer experience with institutionalising, collaborating and cooperating with, and policing Islamic financial institutions -- and the principles of shariah at the heart of those institutions.

B. Promising sources of prospective reform

Existing efforts to regulate the Shariah Boards of Islamic banks outside of the UK include voluntary codes advanced by trans-national non-governmental organisations (‘NGO’s’), such as the Islamic Financial Services Board (‘IFSB’), the Organisation of Islamic Conference (‘OIC’), and the Accounting and Auditing Organization for Islamic Financial Institutions (‘AAOIFI’). Prominent national efforts led by states themselves with the goal of improving the conformity of Shariah Boards with standards of governance have been made in Bahrain, Malaysia, and the Kingdom of Saudi Arabia.23

Whilst there are differences between the Arab and Asian centres of shariah learning and its application to banking (with their respective centres in the Arab Gulf and Southeast Asia), these differences are of little relevance to the development and improvement of Shariah Boards’ practice and regulation in a context such as the UK where governance challenges are essentially the same whatever the shariah orientation of any particular Board or the scholars serving upon it. Many but not all of these are the same challenges that have arisen in other jurisdictions in the past. For example concerning the conflicts of interest that may arise as shariah scholars not infrequently serve on the boards of multiple banks;24 or the training and certification of a sufficient number of scholars to supply the sector with the requisite shariah expertise coupled with an adequate understanding of modern economics and financial instruments.

As a source of possible ideas about reform and the promotion of sound governance of Shariah Boards, the case of Malaysia is particularly instructive for UK regulators for several reasons. Malaysia is a common law jurisdiction,25 and its legal system exhibits substantial similarities with that of the UK and English law. The political structure is also similar as Malaysia's government is a monarchy based on the UK’s Westminster model of parliamentary democracy -- although unlike Britain Malaysia possesses a number of written constitutions. Malaysia has the oldest continuous (over thirty years)
and most developed system of Islamic banking and finance globally, demonstrated by both its historical achievements and the current strengths of its ancillary institutions (courts, regulators) and practices (including arbitration and litigation.)

The Central Bank of Malaysia, Bank Negara Malaysia, has issued guidelines on profit-sharing and investment accounts, risk and disclosure of information, and the equalisation of profits. It is also the main governmental body that has dealt with the corporate governance of Shariah Boards. Under current regulations, Bank Negara Malaysia's governance framework for Islamic banks' Shariah Boards consists in the Shariah Advisory Council ('SAC') and the governing rules of Shariah Supervisory Boards.

The SAC seeks to address in the Malaysian context the problems elaborated in 1.B. and 1.C. above, by promoting the harmonisation of shariah, and by providing a court of appeal for banking-related disputes over shariah. Bank Negara Malaysia may consult the SAC on any questions concerning Islamic law; Islamic financial institutions along with arbitrators and courts may also refer questions to, and seek advice from, the SAC. The characteristics of Muslim people, and the diversity of their beliefs and orientations within Islam in Malaysia and the UK are obviously not the same. British Muslims' beliefs and ideas may be more variegated (due to their more diverse international origins -- past and present). This, coupled with the international reach and aspirations for Islamic finance operating in the UK, implies that the task of instituting a Shariah advisory or consultative council or other similar non-/statutory body may represent a greater challenge in the UK; not least among these challenges is the political reaction that could reasonably be anticipated to such a body, and the fraught relationship that it could have with secular ideals and practices.

However, instituting a central body would arguably help reduce the legal uncertainty (alluded to in 1.B.) to which Islamic banks in the UK are susceptible, due to the absence of a legal system as expert in shariah-related matters as that in Malaysia (which, as is evident, itself requires and relies upon the SAC). Malaysia's SAC provides a thought-provoking if not an instructive model to contemplate when considering how shariah-compliant banking and finance may be institutionalised, standardised and held to norms of corporate governance in Britain.

Bank Negara Malaysia's intervention in the operation of Shariah Supervisory Boards by means of guidelines and regulatory powers provide a standard by which the Shariah Boards of Islamic banks may be measured. In the case of Malaysia, the SAC possesses the power to review and reverse Shariah Boards’ decisions. Whether an enforcement-compliance and hierarchical model of this type is necessary or desirable in the UK depends upon the direction of Islamic banking and the extent to which
voluntary measures and guidelines are (or are not) effective.

Prima facie, depending upon the qualifications and the performance of the members of whatever kind of statutory or non-statutory body might be adopted in the UK, that body could boost the credibility of Islamic banks in Britain, in the eyes of domestic and international customers and investors alike; the Islamic 'windows' model (referenced in 1.4. above) and the absence of any organ or other method of harmonisation at present legitimately raises doubts in the minds of potential investors, as does the awareness of the legal uncertainty that results from the absence of such an institutional check. In any event creating a central advisory or enforcement body with a credible degree of independence from the UK government and the banks themselves would bolster the integrity, and improve the corporate governance, of Islamic banks and their Shariah Boards in Britain.

4. Conclusion

No single model or country can offer up a complete solution to any one issue, much less a complete solution to every issue of the many issues that inevitably will accompany the introduction or expansion of Islamic banking and finance in a new jurisdiction. Each country and its history is unique – as is the history and reality of Islamic banking and finance wherever it exists. Some of the pertinent issues, such as Board accountability and the review of Shariah Boards' decisions, are brought into deeper relief in Britain than they might be elsewhere as a consequence of the ongoing effort in that country to render the corporate governance of all companies (including banks) more transparent, effectual, and intelligent.

The position, authority and the management of Shariah Boards and the scholars sitting on them are topics that have raised and will continue to raise similar dilemmas in every host country in which Islamic financial institutions do business. This article has drawn on the example of one case, Malaysia, as it is a country featuring what is arguably the most fully developed system of Islamic banking, and one which also shares common legal ground for historical reasons with the UK. In Malaysia the SAC and allied guidelines of the central bank, Bank Negara Malaysia, comprise one effort to overcome obstacles not dissimilar to those presently appearing in what is still a fledgling industry in Britain.

The purpose of this article is to identify the most fundamental structural obstacles located between Islamic banks (and banks with Islamic windows operating) in the UK, and full compliance with the codes and norms of corporate governance. This article considered the necessity of reaching a uniform and consistent reading of shariah by board scholars. In so doing, it had regard for the institutional and regulatory underpinnings that might make such harmonisation possible by means of processes of
centralised reference, review and enforcement.

It is apparent from a global comparative perspective that the issues of concern in the UK surrounding corporate governance and Shariah Boards are not being encountered for the first time. Both regulatory authorities and Islamic bankers in Britain would be well advised to learn from the successes (as well as the failures) of banks and auxiliary institutions abroad, even as they must also take account of both the opportunities and the limitations posed by the national environment and its location in the global economy.

(Endnotes)


2. The chief source upon which this article draws the articulation of the challenges facing the adjudication of Shariah by the Shariah Boards of Islamic banks in the UK is: Abdul Karim Aldohni, The Legal and Regulatory Aspects of Islamic Banking: a comparative look at the United Kingdom and Malaysia, London: Routledge, 2011.

3. The former also include Citibank, Deutschebank, and HSBC; however, HSBC Amanah will be phased out in the UK in what some observers consider a nascent renunciation of the Islamic retail sector: Camilla Hall and Patrick Jenkins, “HSBC’s Islamic closures highlight dilemma” in Financial Times 7 October 2012, http://www.ft.com/cms/s/0/bdb5f212-0f1c-11e2-9343-00144feabdc0.html (accessed 14 November 2012.)


6. Enlightened share-holder value and the larger set of stakeholders as codified in s 172 of the 2006 Act. As there have been no cases, it is unclear what if any civil liability a Shariah Board might incur under s 174 of the 2006 Act and the standard of care, skill and diligence invoked therein; arguably the prerogatives and purpose of the Board would insulate it at least from any liability regarding its religious legal representations.


8. Hanafi, Hanbali, Maliki, and Shafi’i; Shi’i Islam possesses distinctive legal traditions.

9. Two cases dealt with second jurisdictions that brought Islamic law before English courts: Glencore International AG v Metro Trading International Inc [2001] 1 Lloyd’s Rep 284; Harley v Smith [2010] EWCA Civ 78. The three other reported cases, taken together, support the proposition that the UK courts are unwilling to apply or adjudicate Islamic law: Islamic Investment Company of the Gulf v Symphony Gems NV and ors 2002 WL 346969 (QBD(Comm Ct)), Shamal Bank of Bahrain v Beximco Pharmaceuticals Ltd and ors 2003 EWHC 2118 (Comm), [2003] 2 All ER (Comm) 894, appeal decision in [2004] 2 Lloyd’s Rep 1; Investment Dar Company KSCC v Blom Development Bank Sal [2009] EWHC 3545 (Ch). In Shamil, it was upheld on appeal that the parties cannot have intended a secular court, such as the English court, to decide an issue in Islamic law. Arbitration is a possible alternative still in its youth, and one which has been tried in other jurisdictions (notably Singapore) with mixed success.

10. An example is the now infamous intervention of an esteemed scholar, Sheikh Muhammad Taqi Usmani, who disrupted the sukuk (Islamic bond) markets by stating that sukuk were religiously impermissible. Bilal Rasul, “Identifying the Main Regulatory Challenges for Islamic Finance,” in Susi Crawford et al., eds., Islamic Finance: Instruments and Markets, Huntingdon: Bloomsbury Information Ltd, 2010, p. 21-24 at 22.


15. On 1 April 2013 the FSA was abolished and replaced by two subsidiaries of the Bank of England titled the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA); 1 April 2013 “UK Financial Regulation Overhauled” http://www.bbc.co.uk/news/business-21987829 (accessed 2 April 2013).


21. Conventional and Islamic banks share (to a greater or lesser degree), several issues, such as those relating to systemic risk and liquidity management. Islamic banks in the UK have several additional issues in need of redress; these include deposit insurance, the existence and reliance upon a lender of last resort, and heightened legal uncertainty.


26. Aldohni, op cit., 183


28. A key document is its publication of “Guidelines on the Governance of Sharia Committee for the Islamic Financial Institutions” (December 2004)

29. BNM/GPS1

Bibliography

Books and Articles


Hall, Camilla and Patrick Jenkins, “HSBC’s Islamic closures highlight dilemma,” Financial Times 7 October2012.


Rasul, Bilal, “Identifying the Main Regulatory Challenges for Islamic Finance,” in Susi Crawford et al., eds., Islamic Finance: Instruments and Markets, Huntingdon, Bloomsbury
specific insight or analysis on the distinctive problems of governance of Shariah
feature of the structure of Islamic banks flows from that religious claim: the Shariah
financial services regulation applies equally to conventional and Islamic banks. The
Companies Act 2006
HM Treasury, “The Development of Islamic Finance in the UK: the Government’s Perspective”

Islamic Finance in the UK: Regulations and Challenges,” UK Financial Services
Saudi Arabia Financial Services Authority (2006)

(1992)

the UK: Critical Appraisal,” International Journal of Islamic and Middle

no author, “London could become western hub for Islamic finance, says Government,“ 13

no author, “UK Financial Regulation Overhauled” 1 April 2013, bbc.co.uk

Guidelines, Rules and Regulations, and Policy Papers
Ainsley, Michael, et al., “Islamic Finance in the UK: regulation and challenges efforts
underway” (2007)

“Cadbury Committee: Report on the Financial Aspect of Corporate Governance”
(1992)


“Corporate Governance Regulations in the Kingdom of Saudi Arabia” Kingdom of
Saudi Arabia Financial Services Authority (2006)

“Islamic Finance in the UK: Regulations and Challenges,” UK Financial Services
Authority (2007)


“Guidelines on the Governance of Sharia Committee for the Islamic Financial Institutions”

“Guidelines on the Recognition and Measurement of Profits Sharing Investment
Account as Risk Absorbent” Bank Negara Malaysia (updated 2011)


HM Treasury, “The Development of Islamic Finance in the UK: the Government’s Perspective”
(2008)


Turner Review: A regulatory response to the Global Banking Crisis” (2009)

Walker Review, “A review of corporate governance in banks and other financial industry
terities: final recommendations” (2009)


Statutes (all UK)

Companies Act 2006
Financial Services and Markets Act 2000
Finance Act 2003
Finance Act 2005
Finance Act 2006
Finance Act 2007

Cases
Glencore International AG v Metro Trading International Inc [2001] 1 Lloyd's Rep 284
Islamic Investment Company of the Gulf v Symphony Gems NV and ors 2002 WL 346969 (QBD(Comm Ct))
Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and ors 2003 EWHC 2118 (Comm), [2003] 2 All ER (Comm) 894, appeal decision in [2004] 2 Lloyd's Rep 1