An International Comparative Study on *Shariah* Governance Supervision of *Sukuk* Defaults[1]

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Abstract

As a relatively new class of asset in the global capital market, the sukuk market is facing a new challenge in the form of a recent series of high profile sukuk defaults. Generally though not always, sukuk defaults are the result of market and credit risk rather than structural problems or compliance with Shariah law. However, since all sukuk defaults have nothing to do with the validity of sukuk methodology, some scholars have questioned Shariah supervision over the default, with particular reference to the underlying structures in a court of law vis-à-vis conventional bonds. In this context all defaults have the potential to be complex because many bonds were issued in Western legal jurisdictions that may conflict with Islamic principles. Likewise, sukuk default now raises the question about the laws which govern those rights. A fundamental two-fold question to ask is; if a single framework can exist for all Islamic financial transactions; and, if there is a single approach interpreting the rights of the contracting parties in a jurisdiction, whether it is Islamic or not. These dilemmas have an impact on the Islamic banking and finance industry, market participants and financial instruments. A sound and effective Shariah governance system is important to ensure the fair, efficient and transparent operation of the Islamic finance, and at the same time protect investors. For this reason the paper examines how disputes over financial matters, whether Islamic or otherwise, are settled in Malaysia and other selected Muslim countries.

1.0 Introduction

Incidents of *sukuk* (Islamic debt instruments) default expose the vulnerabilities in Islamic finance, with most investors expecting to have no better legal redress than conventional bondholders because underlying assets have not been truly transferred to

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them. The current global financial and economic crisis is a first for the $1 trillion Islamic finance industry, which had up until recently been protected by cheap oil money; however, now legal provisions and protection clauses in *sukuk* worth billions of dollars are being tested for the first time. Islamic debts, or *sukuk,* are structured as being largely based on profit-sharing or rental agreements and their returns are derived from underlying assets. Islamic finance caters to investors who want to fulfil their religious duties and would like to avoid paying or earning interest, which is prohibited by Islamic law. Despite its earlier billing as a safer alternative to traditional banking due to its requirement for assets to underpin deals, Islamic bondholders may not have any more legal safeguards than their conventional counterparts if and when a default case arises.

The default of East Cameroon *sukuk* and Nakheel *sukuk* are good examples of investors and issuers being deeply affected, spreading to all parties including the government, employees and a country's citizens. This situation provoked the government into providing a mechanism to mitigate economic and financial norms being further damaged. Governments' failure to offer the best solutions to reduce the impact of *sukuk* default and protect the involved parties not only will have dire consequences for domestic economic and financial activities and governments' income, it will also damage the reputation of Islamic finance *per se*. Such events will seriously diminish investors' confidence in the Islamic financial system.

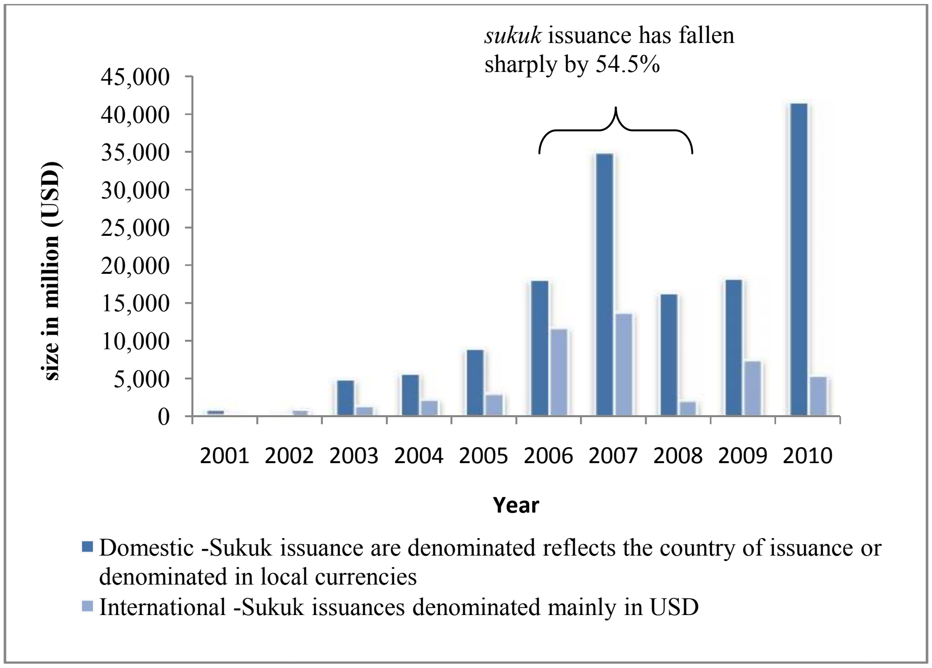
The major question has to be asked here, 'are there legal and governance approaches that work as protectors to deal with the related *sukuk*-related cases in those events?' During the 1990s in countries where the Islamic financial system functioned in parallel with the conventional system - typically former colonial countries - all Islamic cases pertaining to the banking and financial system were treated as the same as the conventional ones, due to the separation of Muslim personal matters and commercial business activities. The first type was settled in the *Shariah* (Islamic Law) court while the latter type was resolved in the civil court. This paper attempts to examine and compare the current legal and governance practices and changes in selected Islamic countries by assessing ex-post financial crisis occurred in those countries especially in 1990s and the series of Islamic *sukuk* defaults.

2.0 The issues regarding *sukuk* default

Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks. Development initially occurred through the marketing of a steadily expanding supply of *Shariah*-compliant financial instruments. This supply-driven model contributed to relatively slow growth until the mid-1990s, when demand rose and increasingly drove the development and wider acceptance of Islamic financial instruments. Rising awareness and demand for Islamic products, along with supportive government policies and growing sophistication of financial institutions, together raised the rate of growth (IFSL, 2010). Recent years witnessed a strong growth in global *sukuk* issuance and this mirrored what occurred during the 1970s, leading to an explosive growth in 2007. However, the *sukuk* market did not do well when the subprime crisis threatened to completely unravel the global finance industry. Unprecedented challenges had to faced when global *sukuk* issuance declined by more than 50% by then end of 2008 as shown in Figure 1 below.

This is the first such drop since 2001 when the *sukuk* market started to take off. The *sukuk* market did not do well the year after the subprime crisis hit in 2007. Total *sukuk* issuance plunged 66% year on year in 2008 (RAM, 2009) the global counterpart was immune to this fall-out. *Sukuk* issuance began slowing down in late 2008 partly due to the global economic downturn, and the international *sukuk* market faced lower levels of liquidity, resulting from declines in oil prices and less investor confidence (Ilias, 2009). Pricing issue problems and a shortage of committed investors (Rabindranath and Gupta, 2010) correspondingly resulted in declining *sukuk* issuance. The *sukuk* market fell back in 2008 but despite a recovery in issuance to $20 billion during 2009 (IFSL, 2010) the market was still being tested by its ability to deal with a series of high profile *sukuk* defaults as indicated in Table 1 below.

Figure 1: Total global *sukuk* issuance – sovereign, quasi-sovereign and corporate issue (all currencies) for the period 1st January 2001 - 31st December 2010



Source: Adopted from IIFM (2011)

Some scholars questioned *Shariah* supervision when defaults have occurred. The fact is that *sukuk's* relative security has received increased scholarly attention due to certain core principles that have contributed to insulating it from global financial disasters (Aziz and Gintzburger, 2009). As Islamic financial products, *sukuk* must be certified as *Shariah*-compliant by an expert in Islamic law. Certification of *sukuk* requires that the transaction adheres to a number of key principles that include backing by a tangible asset, prohibition of *riba* (usury), which is a risk that is shared amongst participants, prohibition of financial activities deemed to be incompatible with *Shariah*, such as drinking alcohol, conventional financial services, gambling and smoking tobacco. These certifications, furthermore, must adhere to the prohibition on *gharar*, or uncertainty about the subject-matter and terms of contracts – this includes a prohibition on selling something that one does not own. While some have argued that there is no such thing as a default in Islamic finance due to profit sharing and the risk avoidance nature of transactions, others are blaming the Islamic structures and have begun questioning the *Shariah* compliance of issuances (RAM, 2010a).

However, default profile *sukuk* occurrences have nothing to do with the validity of *sukuk* methodology. Mostly, *sukuk* defaults are the result of market and credit risk rather than structural problems or *Shariah* compliancy shortfalls. In fact, all defaults and potential defaults have been driven by credit market and credit risks (Remo-Listana, 2010). These deals would have gone wrong even if they were conventionally financed. These reminded all those involved in the market that defaults can and do happen in Islamic finance, as in other parts of the financial industry despite the fact that Islamic finance is all about ethical and moral finance and *sukuk* underlying assets at their core. In the case of East Cameroon Gas Company's *sukuk*, it filed for bankruptcy protection after its offshore Louisiana oil and gas wells failed to yield the expected return, partly because of hurricane damage (Fidler, 2009). In another example, that of Nakheel, there was definitely no *Shariah* compliance concern[4]. It was a relatively straightforward problem of excessive leverage and the failure of the underlying assets to generate sufficient cash flow to repay debts. The complications arose over the connection with a sovereign government. The cause of Dubai World's crisis was not Islamic finance but over-leveraging. Therefore default is more a consequence of the economic difficulties in the Middle East[5], rather than flaws in *sukuk* and Islamic finance *per se*. For the most part, the Nakheel *sukuk* was a casualty of over-optimism in the Dubai property market (RAM, 2010b).

Table 1: High profile *sukuk* defaults 2008 – 2010 in selected countries

Country	High profile *sukuk* default in 2008-2010

[4]*Sukuk* holders were also protected in the form of pledge vis-`a- vis 18.89% of unlisted Nakheel stock and a mortgage over the underlying assets. In terms of its structure, it is clear that the *sukuk* complies with the *Shariah* requirement to have real underlying assets from which revenue can be generated and shared with *sukuk* holders. The Nakheel *sukuk* had been structured in accordance with the *Shariah* guidelines (RAM 2010a).

[5]However, when the global financial crisis hit the Gulf countries, investors began losing confidence in the market. Private investments in commercial and residential estates dried up, particularly in Dubai - leading to a sharp plunge in property prices. Dubai property prices reportedly shrank 20% to 30% within 6 months; by the end of 2009, prices had plummeted almost 60%. Most of the much-hyped developments in Dubai had been either put on hold or shelved, including the Palm Jebel Ali and Dubai Waterfront developments (RAM 2010a).

United States	In Oct 2008, the first US *sukuk*, East Cameroon Gas Company's (ECG) USD165.7 million issuance, defaulted. The ECG *sukuk*, at issuance, were rated at a low CC by Standard & Poor's. The company filed for bankruptcy protection after its offshore Louisiana oil and gas wells failed to yield the expected returns, partly because of hurricane damage.
Pakistan	JCR-VIS Credit Ratings in January 2009 assigned the *sukuk* of New Allied Electronics Industries (Pvt.) Limited (NAEIL) a 'D' rating on account of overdue payments on its debt instruments and for breach of bond covenants.
Kuwait	In May 2009, Kuwait's Investment Dar (not rated) announced that it had defaulted on the payment of the periodic distribution to holders of its USD100m Bahrain-registered *sukuk*, maturing in 2010. The default came as the company worked to restructure its entire debt, not just its *sukuk*. The company had USD3.7 billlion of total debt outstanding as of September 2008.
Saudi Arabia	A subsidiary of Saad Group, a Saudi Arabian conglomerate, announced that it was unable to meet its repayments on a *sukuk* (Islamic bonds) issue worth $650 million, which matures in 2012. Saad Trading Contracting and Financial Services informed the market that it is 'impossible for the issuer to perform its payment obligations under the *sukuk*'.
United Arab Emirates (UAE)	Fitch Ratings downgraded the Long Term Issuer Default Ratings of Tamweel PJSC in September 2009. Islamic bonds of Tamweel PJSC, the UAE-based mortgage lender, failed to benefit from Dubai's world debt accord after being the performing *sukuk* in the past five months. The downgrade followed the announcement by Dubai World, which was wholly owned by the government of Dubai, that it requested debt repayments until at least May 2010.

Source: Adapted from Kuwait Finance House (2010) and Dhesi (2010).

Since there is no *Shariah* issue pertaining to *sukuk* default, however, underlying concerns remain in that *sukuk* defaults have yet to be tested in the courts. All such defaults have the potential to be complicated since many bonds were issued under Western law (Berwin, 2009), which can conflict with Islamic principles. For example, in a 2004 case relating to the enforceability of a contract, the UK Appeals Court ruled that when *Shariah* and English law conflict, English law takes precedence (Fidler, 2009). With regard to Dubai World, Berwin (2009) noted that there is no guidance on whether any of many types of security provisions granted under a *sukuk* issue of this nature are legally enforceable. In the case of Nakheel *sukuk*, it was considered to be complicated by the fact that the key *sukuk* documents were governed by English law and there was the risk that the Dubai courts may have chosen not to enforce judgements by English courts. In addition, under Dubai law, no debt from the ruler or Government of Dubai may be extinguished by taking possession of assets. Dubai World is likely to fall under a wide interpretation of the Government of Dubai, adding further difficulty to any enforcement of the *sukuk* documents.

The majority of *sukuk* falls under the jurisdiction of the British courts and arbitrated by British law so long as this does not contradict the provisions of *Shariah* law (Nasser, 2009). Therefore, the legal matters surrounding default payment of *sukuk* that falls under the provisions of *Shariah* law are starting to emerge more clearly. Defaults have led to uncertainty about legal protections for investors. In some cases the concern has been that the investors may not have the right to own property assets posted as collateral for *sukuk* because most Gulf countries restrict foreign ownership of property. In other cases, confusion has arisen over whether investors have recourse to the assets that back them. *Sukuk* behave like conventional bonds but avoid Islam's prohibition on charging or receiving interest through a variety of complex lease agreements. The presence of land and other assets that allow *sukuk* to avoid interest have sometimes led investors to believe they can take ownership of those assets in the event of default (Howladar, 2010).

Even though most *sukuk* defaults are due to market risk and credit risk rather than *Shariah* problems or structural concerns, the prospect of losses has forced creditors to think about some of the uncertainties surrounding *sukuk* defaults. One important issue is that of enforceability, particularly in reference to any cross-border transactions because many *sukuk* are governed by English law but refer to assets located in the Gulf. Another issue is the specter of *Shariah* risk. Kuwait's Investment Dar is currently wrangling over the repayment of a separate type of debt to Blom Bank, a Lebanese bank, on the grounds that the transaction was not *Shariah*-compliant; an English court surprised many by ruling that the firm had an arguable case (The Economist, 2010).

3.0 *Shariah* governance system

Governing Islamic financial institutions and their financial instruments is an essential requirement of *Shariah* compliance. Internal corporate governance of Islamic financial institutions should be supported by external arrangements to ensure that all involved parties do their duty as stipulated by *Shariah* law. At this juncture, regulations and enforcement play the roles of external checks on the processes. In the Islamic banking and capital market sectors, *Shariah* is the final arbiter of compliance, and it goes hand-in-hand with the standard controlling procedure. The Islamic Financial Services Board (IFSB) defines *Shariah* governance as:

"*the set of institutional and organisational arrangements through which an IFFS*[6] *ensures that there is effective independent oversight of Shariah compliance*" (2009, p. 2).

In countries where the Islamic banking and capital market sectors work in parallel with the conventional banking and capital market sectors, and share the same broad structure of governance and legal framework, the main concern is about the legal solutions to conflicts, disputes, and arbitration processes. Most countries (except for Sudan and Iran[7]) that practice both the Islamic and conventional approach, experience legal uncertainties when conflicts and disputes cases concerning Islamic banking and financial services are heard in the civil courts, rather than in the *Shariah* courts. So far, no specific statute or law has been legislated for in most countries dealing with such disputes over Islamic financial institutions and financial instruments. Comparing the *Shariah* governance models and regulations in the selected countries and how they resolve disputes involving Islamic financial institutions and instruments will enable us to understand their implications for *sukuk* instruments.

3.1 *Shariah* governance system in Malaysia

Malaysia's Islamic banking and financial industry started in 1963 with the establishment of Lembaga Tabung Haji, which specializes in pilgrimage saving funds and management. This was followed by the introduction of Bank Islam Malaysia in 1984. Since then the industry has rapidly developed by including other industries such as the takaful (i.e. Islamic insurance) industry and Islamic capital market (with

[6] Institutions offering Islamic financial services

[7] These two countries have fully-fledged Islamic banking and finance systems in place.

divergent financial instruments). Currently, there are 17 fully-fledged Islamic banks and nine *takaful* operators in Malaysia. From the total of 957 listed stocks in the capital market, 89% of them are listed as being *Shariah*-compliant stocks.

Malaysia operates parallel Islamic and conventional banking and financial systems, and these share the same governance structure and legal framework. Two institutions govern the Islamic and conventional banking and financial industries in Malaysia: Bank Negara Malaysia or BNM (Central Bank Malaysia) and Securities Commission (SC). Firstly, BNM regulates banking financial institutions (including Islamic banks and windows, insurance and *takaful* companies. There are four statutes governing the Islamic banking and *takaful* industries and these are: Central Bank of Malaysia Act 2009; Islamic Banking Act 1983; Takaful Act 1984; and the Banking and Financial Institutions Act (BAFIA) 1989. The Central Bank of Malaysia Act 2009 replaced the Central Bank of Malaysia Act 1958. The later act deals with Islamic banking, the central roles of the *Shariah* Advisory Council (SAC) in BNM's activities and the *Shariah* Committee concerning those of individual banks and *takaful* companies. Overturning the 1958 Act is viewed as a landmark in enhancing the roles of *Shariah* advisors. Amending Section 124 of the BAFIA 1989 in 1996 enabled conventional banks to open the Islamic windows.

The SC governs the capital market, including financial intermediaries such as fund management companies, asset management companies and financial securities. Under this governance structure, the regulation of *sukuk* instruments comes under the supervision of the SC. The main act under the SC operates is the Capital Market Services Act (CMSA) 2007. This statute combines the Securities Industry Act 1983, Futures Industry Act 1993 and Part IV of the Securities Commission Act 1993. There are guidelines developed by the SC that govern how institutions and financial instruments must operate. The main guidelines relating to *sukuk* are the Islamic Securities Guidelines (*Sukuk* Guidelines). The BNM has the same amendment where the central rulings on *Shariah* matters in the capital market come under the authority of the SC's *Shariah* Advisory Council.

The main feature of the Islamic banking and financial industry in Malaysia is its centralized *Shariah* rulings at the regulatory and individual financial institutions levels. Individual financial institutions are required to have their own *Shariah* Committee that oversees their operations. This structure is designed to ensure consistency in *Shariah* rulings and practices. Any internal discrepancy in the process of issuing judgments on financial institutions' activities and financial instruments must be referred to the *Shariah* Advisory Council at the BNM.

Even though there is a planned rulings process and governance structure for Islamic banking and finance, legal practices with regard to conflicts, disputes and the arbitration process are managed differently. Court cases involving Islamic financial institutions and the capital market are heard in the civil court, rather than the *Shariah* court. Seyed Ibrahim (2008) lists several reasons entailed to those actions by referring to the unreported case *Bank Islam Malaysia Berhad v Adnan bin Omar* on the issue of guarantee in BBA financing. The main reason is closely linked to the segregation of federal and states' lists in the Federal Constitution of Malaysia. While the federal lists (List 1) incorporate the banking and the relevant organizations 'constitutions, states' lists include *Shariah* matters that deal with Muslims' personal matters such as marriage, inheritance, *waqf* (voluntary giving) and *zakat* (Islamic tax). As such, legal matters pertaining to the Islamic banking and financial industry are handled by the civil court.

Although this issue up till now remains unsolved, efforts have been made by the government and non-profit organizations to deal with it satisfactorily. The BNM through the Central Bank of Malaysia Act 2009 under Section 56 (1) promotes the role of its *Shariah* Advisory Council by emphasizing the courts and arbitrators accept its rulings and advice in the event of conflicts and disputes on Islamic banking and *takaful*. The SC through the new Section 316F (1) of the Capital Market Services Act (CMSA) 2007 (amended in 2010) posits the same direction. Non-profit organizations such as the Kuala Lumpur Regional Centre for Arbitration (KLRCA) has engaged in arbitration practices and has demonstrated its interest in dealing with the Islamic banking and financial industry by issuing the Rules of the Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) 2007 (Abdul Mutallip, 2008). This rule provides a structured guideline for managing the arbitration process in this industry.

3.2 *Shariah* governance system in Indonesia

Islamic banking in Indonesia started in 1992 with the enactment of the Banking Act No. 7/1992; and when Bank *Muamalat* was established as the first bank operating in accordance with Islamic principles. The Banking Act No.7/1992 was amended by Act No. 10/1998, to provide an opportunity to conventional banks to open an Islamic window**.** Since that time, the growth of Islamic banking in Indonesia has progressed quickly. By 2008 there were 3 fully-fledged Islamic banks, 19 *Shariah* business units and 92 *Shariah* rural banks. This tremendous growth required equally strong legislation to regulate it. One closely linked aspect that deserves attention relates to the settlement of disputes in Islamic banking (Muneeza et al., 2010).

The National *Shariah* Board was formed by the Indonesian Council of Ulemas in 1999, as an independent body duly recognized by the Bank Indonesia. It is responsible for issuing *Shariah* rulings on the products of Islamic banks. Bank Indonesia issues regulations for Islamic banking products based on *fatwa* (Islamic religious ruling) issued by the National *Shariah* Board. Broadly, this National *Shariah* Board's main function is two-fold: first, issuing fatwa concerning products and transactions of Islamic financial institutions; and second, recommending *Shariah* supervisory boards be established in the Islamic financial institutions. In this way the National *Shariah* Board avoids conflicting fatwas that may arise among such supervisory boards (Akhtar, 2007). To encourage the development of banks based on *Shariah* principles, the Indonesian government determined that the business activities of public banks wishing to engage in *Shariah* banking practices could be done either through the formation of new *Shariah* banks or business units, the conversion of conventional banks into banks based on *Shariah* principles, or the opening of new *Shariah* branches by conventional commercial banks. Any banks, business units or branches so established are not allowed to conduct conventional business activities that are contrary to *Shariah* principles and must abide by the following rules:

• The bank or business unit's business activities and products must be in line with *Shariah* principles (i.e. *Shariah*-compliant products);

• The bank or business unit must form a *Shariah* supervisory board and set out the board's duties; and the bank must set out the preconditions for its branch office if it formerly operated conventional business activities but intends to operate business activities based on *Shariah* principles (Bastian and Teja, 2004).

During the initial growth of Islamic banking in Indonesia, there was confusion as to which court was competent enough to hear cases regarding Islamic finance. Indonesia maintains a dual court system - one for civil matters and one for *Shariah* matters. Both regarded themselves as being competent to settle such disputes. Civil courts were generally not academically qualified to judge financial matters pertaining to *Shariah* law, but the jurisdiction granted to religious courts was limited to hearing cases relating to marriage, probate, wills and endowments.

The problem was, however, that the jurisdiction of the civil courts did not extend to *Shariah* matters, within which Islamic banking disputes were subsumed. On the other hand, the jurisdiction of the religious courts was limited to personal legal matters which did not cover banking disputes, and was confined to: a) marriage, and b) inheritance matters such as testamentary succession, *hiba* (gift) and *waqf*. There was no possibility of any deviation since the matter was clearly spelled out in section 49 of Act No. 7 of 1989 (Rasyid, 2008). This inconsistency was rectified in February 2006 by expanding the jurisdiction of the religious courts to adjudicate on disputes concerning Islamic economic matters, including Islamic banking. Religious scholars took the first step in setting up a qualified body to hear such disputes, by creating an ad hoc tribunal known as 'Bayarnas' or the National *Shariah* Arbitration Body (Colon, 2011). However due to the banks' and their customers' very poor knowledge of the Islamic law of arbitration the National *Shariah* Arbitration Body could not function effectively due to the fact that a dispute cannot be arbitrated unless an arbitration agreement was reached by both parties (i.e. the bank and customer). Consequently, disputes brought to arbitration by both parties lacked the necessary legal foundations and could not thus be legally arbitrated. Any award made in such arbitration was not enforceable (Muneeza et al., 2010). In this context, Islamic banking disputes are resolved through a mix of *Shariah* and civil law. In fact, conflicts that emerged with the rise of Islamic banking have contributed to that country's legal development in what it categorises as religious and civic law, as well as to the development of the Indonesian commercial arbitration system.

3.3 *Shariah* governance system in Bahrain

The financial system of Bahrain is governed by five laws: the Central Bank of Bahrain and Financial Institutions Law 2006; the Bahrain Stock Exchange Law 1987; the Commercial Companies Law 2001; The Anti-Money Laundering Law 2001; and the Financial Trust Law 2006. The legal provision for the implementation of Islamic finance in Bahrain is documented in the CBB Rule Book Volume 2, Islamic Banks[8]. The Central Bank of Bahrain Rule[9] requires all banks to establish an independent *Shariah* Supervision Committee that complies with AAOIFI's governance standards for Islamic financial institutions (see Table 2). All banks must comply with all AAOIFI issued accounting standards as well as *Shariah* pronouncements issued by

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[8] See Central Bank of Bahrain's website at http://cbb.complinet.com/cbb/microsite/laws.html

[9] Refer to The Central Bank of Bahrain Book Volume 2, Islamic Banks, Part A, High Level Control, Section 1.3.15

the *Shariah* Board of AAOIFI. This rule or section provides a clear legal requirement for the establishment of the *Shariah* board in Islamic financial institutions in Bahrain. Failure to do so constitutes non-compliance with this Central Bank of Bahrain directive. The National *Shariah* Board of the Central Bank of Bahrain verifies *Shariah* compliance of its products only yet its authority is different to other *Shariah* boards operating in Malaysia, Sudan, Indonesia, Pakistan and Brunei, in that it does not have authority over other Islamic financial institutions (Hasan, 2010b). In particular, there is no restriction for members of the National *Shariah* Board to serve any financial institution, and there is no limitation to serve only one institution. Each bank must have a separate *Shariah* body that reviews and verifies compliance. The *Shariah* review function may be located in the internal audit section of a bank. With reference to Islamic financial disputes, the Civil Court of Bahrain has comprehensive jurisdiction over civil and commercial matters except those relating to *Shariah* disputes (Radhi, 2003).

The Gulf Cooperation Council (GCC) countries' Commercial Arbitration Centre is a Bahrain-based centre providing maximum flexibility in its rules. Although there is a mandatory provision for enforcement of awards by local judicial authorities, this is subject to the arbitration agreement being deemed null or an award being annulled on the basis that an arbitrator has not been correctly appointed. This may therefore leave awards open to technical and substantive challenges according to local requirements. Further, there is no specific provision for the arbitration of disputes of *Shariah*-compliant arrangements, although the flexible nature of the rules would appear to allow such disputes to be resolved through this body (Akhtar, 2008).

Table 2 Regulatory and governance frameworks in the selected Middle East countries

Country	**Regulatory bodies**
Bahrain	Central Bank of Bahrain (CBB) controls licensing and supervision of banks (conventional and Islamic banks), insurance providers, investment business licensees, other financial providers and Bahrain Stock Exchange (BSE). CBB also acts as the Listing Authority for companies and instruments listed on the Bahrain Stock Exchange (BSE). **Dual financial system.**

Country	Regulatory bodies
Jordan	Central Bank of Jordan (CBJ) is responsible for supervising the banks. The Jordan Securities Commission is in charge of legislation and regulation of the securities and non-banking financial services, and is also responsible for monitoring two other entities, The Amman Stock Exchange and The Securities Depository Centre. The Insurance Commission is responsible for regulating and supervising the insurance industry. **Dual financial system.**

Source: adapted from Chapra & Khan (2000)

3.4 *Shariah* governance system in the UAE (United Arab Emirates)

Shariah governance in the UAE except Dubai is regulated by the Federal Law No. 6 of 1985. In the UAE, Islamic financial institutions are regulated by the UAE Central Bank. Article (5) of the above-mentioned federal law entails the establishment of a Higher *Shariah* Authority under the Ministry of Justice and Islamic Affairs with the objective of greater supervision of Islamic banks, financial institutions and investment companies. It also offers its opinion on matters pertaining to Islamic banking and finance matters. In addition to the Higher *Shariah* Authority which is a government established body, *Shariah* scholars in the UAE have voluntarily initiated the establishment of a central committee of the *Shariah* supervisory board for the purpose of harmonizing and standardizing *Shariah* practices (Dar, 2009). Article (6) of the 1985 federal law clearly stipulates that a *Shariah* Supervision Authority shall be formed with a minimum of three members to render their transactions and practices in accordance with the principles and provisions of *Shariah* law. The *Shariah* advisors sitting on the Higher *Shariah* Authority are appointed by the government and at the individual Islamic financial institutional level by the Board of Directors. Islamic financial institutions cannot simply appoint their *Shariah* board members as they see fit. Instead they are required to submit proposed names of *Shariah* advisors to the Higher *Shariah* Authority for its approval.

In the UAE consideration is being given to the introduction of a new law establishing a higher *Shariah* Council which could oversee the work of the *Shariah* boards of the seven Islamic banks now operating in the country (Elewa, 2008). The UAE is current considering replacing the 1985 federal law with a new one establishing a higher *Shariah* Council to supervise Islamic financial activities in accordance with Islamic precepts (Elewa, 2008). This replacement would be similar to the Malaysian system, where there are national *Shariah* boards serving both the Bank Negara Malaysia and Securities Commission. Only these bodies have the power to issue *fatwa*, the remit of the *Shariah* boards of each financial institution being confined to ensuring that activities in the institutions comply with the *fatwa*. This contrasts to what is occurring in the GCC, where in the absence of national *Shariah* authorities, the boards of each financial institution can issue their own *fatwa* (Wilson, 2009).

In hearing routine disputes on Islamic finance matters, the United Arab Emirates houses three main arbitration centres. These are the Dubai International Arbitration Centre (DIAC), the Abu Dhabi Commercial Conciliation and Arbitration Centre (ADCCAC), and the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA). The last one is a specialty forum created by the Islamic Development Bank to cater to the Islamic finance industry's needs (Ahmed, 2011). However, the main challenges for DIAC and ADCC are the requirement for an award to be ratified by local courts in order for it to be enforced, and the ability of any party to challenge an award on the basis of even a minor technical irregularity. There is, furthermore, no concept of legal professional privilege or confidentiality in arbitration proceedings in the UAE, which may defeat the whole object of the parties opting for arbitration (although Western firms have introduced these concepts into their dealings with one another there as a matter of convention) (Colon, 2011).

The IICRCA was established in 2005 by the Islamic Development Bank and the General Council for Islamic Banks and Financial Institutions. This Dubai-based centre aims to provide a *Shariah*-based arbitration facility. It was established to mediate disputes and to adjudicate on financial and commercial clashes which can arise between these institutions and or third parties, in accordance with *Shariah* principles (Ahmed, 2011). It was not until 2007 that its operations, under the control of Secretary-General Dr. Abdul Sattar Khuwaildi, actually began. Due to the lack of transparency and disclosure, it is even not clear how many arbitration awards were made under the IICRCA scheme; to what types of companies; from which jurisdictions and whether there were any cross-border cases. The major drawback of the IICRCA is that the main language of arbitration is Arabic, which is makes it difficult for foreign parties to understand, especially when they have non-*Shariah*-compliant contractual agreements in place with Middle Eastern counterparts who have opted to use the IICRCA as an arbitration body. The awards made are supposed to be binding on all relevant parties, but the centre does not go further to ensure enforcement (Parker, 2011).

3.5 *Shariah* governance system in Kuwait

In Kuwait, *Shariah* governance practices are regulated by Article 93 of the Central Bank of Kuwait (CBK). Kuwait employs self-regulation of Islamic financial institutions because there is no *Shariah* board operating in the Central Bank of Kuwait. Chapter 3, Section 10, Article 93, Central Bank of Kuwait provides that Islamic financial institutions shall have an independent *Shariah* Supervisory Board appointed by the bank's General Assembly. Regarding the composition of this board, this article stipulates a minimum of three members and there is no limitation of serving more than one Islamic financial institution (Grais and Pellegrini, 2006). Since there is no *Shariah* board in the Central Bank of Kuwait to act as the highest *Shariah* authority in Islamic banking and finance, this may raise an issue of dispute settlement in cases where members of the *Shariah* board have conflicting opinions. In a case where conflict among members does erupt with reference to a *Shariah* rule, the board of directors of the designated bank may transfer the matter to the *Fatwa* Board in the Ministry of Awqaf and Islamic Affairs. This board will then act as the final authority on the matter (Shanmugam and Zahari, 2009).

The CBK Law is silent about the status of decisions made by the Fatwa Board that should be binding on all Islamic financial institutions. However, Article 100 of the Central Bank of Kuwait clearly states that Islamic law is supreme in that Islamic financial institutions are subject to the provisions not only of the Central Bank of Kuwait but also to Islamic *Shariah* principles. This is a strong legal proviso that has made *Shariah* the supreme law governing Islamic banking and financial matters in Kuwait. Kuwait's judicial system enables the civil courts to have jurisdiction over all commercial matters and this includes banking and finance disputes (Hasan, 2010a).

3.6 *Shariah* governance system in Saudi Arabia

The development of Islamic finance in Saudi Arabia is considered to be unique. Unlike other GCC countries, Saudi Arabia does not have a written constitution since *al-Quran* and *al-Sunnah* are considered to be the constitution but its system of law is based on the pronouncements of the King and Council, which are strongly backed by the *Shariah* law. The administrative structure of Saudi Arabia was established by the Organic Instructions of the Hijazi Kingdom in 1926 and subsequently supplemented by the Statute of the Council of Deputies of 1932 and the Constitution of the Council of Ministers in 1958. Banking and finance in the kingdom is controlled by the Saudi Arabian Monetary Agency (SAMA) which was established by order 103/1377 in

1957 and functions under the Banking Control Law 1386 (1966) as amended by decree 2/1391 (Pepper, 1992). However, not all Islamic financial institutions in Saudi Arabia are supervised by the SAMA since some are monitored by the Saudi Ministry of Commerce (Al Sayed 2005 in Hasan, 2010b). Since there is a lacuna in the regulatory framework pertaining to Islamic finance in Saudi Arabia, its *Shariah* governance system differs from other jurisdictions. The notion of having a *Shariah* governance system operating in Islamic financial institutions is not due to any legal and supervisory requirements but rather as a voluntary initiative and a indirect influence from the market. In other words, the *Shariah* governance model in Saudi Arabia is much more self- regulated than elsewhere (Selvam, 2005). In regard to banking disputes, the SAMA established the Banking Dispute Committee in October 1987 to hear cases on banking matters including Islamic finance, whereas and not in the *Shariah* court as practiced in pre -1987 (Hasan, 2010a).

4.0 Supervision over *sukuk* default in Malaysia as a model for *Shariah* governance

One of the distinctive features of Islamic finance is the existence of the *Shariah* board, which oversees Islamic financial institutions' corporate governance structures. Deliberating on *Shariah* governance in the Muslim countries selected for this study, in reality the *Shariah* governance system varies greatly in scope from one jurisdiction to another, depending on the types and structures adopted by the Islamic financial institutions and what the religious authorities permit to be offered. It is perfectly understandable that supervisory authorities may tailor their particular *Shariah* governance system adopted by Islamic financial services in their respective jurisdictions to suit market realities and the stage of development that their Islamic Finance Information Service (IFSI) has reached. According to IFSB (2009) each model may have its advantages and disadvantages, and supervisory authorities should have a clear understanding of these and are able to justify which model would suit their requirements. In this regard, the universal wisdom of "no single model" and "no single cure" as advocated by the internationally recognised promoter of good governance, the Organisation for Economic Co-operation and Development (OECD), is relevant. Legal wrangles took centre stage in Islamic finance in 2009 as worsening economic conditions triggered defaults and exposed problems in legal systems, some of which struggled to deal with *Shariah* banking disputes for the first time. *Sukuk* holders rank in priority of payment when defaults occur and the competence of civil courts to adjudicate on Islamic banking disputes has come to the fore in this $1 trillion industry. Referring to *sukuk* default, lawyers, bankers and *Shariah* scholars in

Malaysia, which has the world's largest *sukuk* market, are looking into civil law provisions which may conflict with *Shariah* law and impede the use of Islamic finance. Islamic banking matters in Malaysia are heard in civil law courts, with one judge dedicated to hearing these disputes (Reuters, 2010). In a *sukuk* report published in late 2010, Standard and Poor's commented that "Malaysia was the first country to tackle this problem" (New Horizon, 2011).

Replacing the Central Bank of Malaysia Act 1958 by the Central Bank of Malaysia Act 2009 has created more uncertainty in the legal framework governing Islamic finance. Amending the Central Banking Act 2009 has meant inserting a new provision (Part VII) which covers Islamic financial business practices. The *Shariah* Advisory Council of Bank Negara Malaysia is now a body established under section 51 of the Central Bank of Malaysia Act 2009 and has positioned the *Shariah* Advisory Council as the peak authority for determining Islamic law as it applies to Islamic financial business matters. The mandates of the SAC, among others, are to ascertain the relevant Islamic law on any financial matter and issue a ruling upon reference made to it, as well as to advise the banks and the Islamic financial institutions on any *Shariah* issues relating to Islamic financial issues. The SAC will assume a more authoritative role in the determination of *Shariah* matters. According to the Central Bank of Malaysia Act 2009, if any question concerning a *Shariah* matter arises in any proceedings, the courts or arbitrator shall take into consideration any published rulings of the SAC or refer such a question to the SAC for a ruling. The SAC's ruling pursuant to such a reference made thereto will be binding on the courts. Here, the issue in *Beximco* is unlikely to arise in Malaysia because it has a well-developed dual financial system, whereby the Islamic financial system operates in tandem with the conventional system. Although disputes in relation to Islamic banking and financial transactions in Malaysia fall within the jurisdiction of civil courts, a *muamalat* division was established in the High Court in 2003 with a designated judge to hear Islamic banking and *takaful* cases.

The legal system in Malaysia is based on a set of written and unwritten laws. Among the written laws are the Federal Constitution and legislation enacted by Parliament and State Assemblies. The unwritten laws comprise the principles of English common law adapted to local circumstances, case law and local customary law. Muslim law is also an important source of law applicable only to the Muslim population on matters relating to family, inheritance, etc. and administered by a separate system of courts. The legal documentation for Islamic finance transactions is premised on the principles of the Law of Contracts and other principles of English common law. Accordingly, disputes in Islamic financial transactions are dealt with in the civil courts. In Malaysia, although the regulatory treatment between conventional debt securities and Islamic securities are similar, the current regulatory framework clearly distinguishes Islamic securities from conventional debt securities, as Islamic securities are not debt securities *per se*. Accordingly, *sukuk* investors have contractual rights and rank as creditors rather than equity holders (SC, 2009). Effectively, the interests of *sukuk* investors are protected and enforceable.

4.1 The upside of *sukuk* default on *Shariah* governance

The defaults facing various *sukuk i*n the current financial market are therefore not entirely problematic. Nor can it be said that those defaults alone represent a maturation of the *sukuk* market. Instead, each default represents another incremental opportunity for increased knowledge about the relevant *sukuk* and its underlying structures and to understand and address the risks facing those *sukuk* transactions. This is due to it being impossible to eliminate the risk of default; just as you cannot eliminate that risk with conventional bonds. The important point is that like other financial tools, these instruments are also exposed to elements such as credit risk. Current defaults in *sukuk*, though unfortunate in a number of respects, are likely to prove catalysts for the maturation of the *sukuk* market rather than serve as indications of achieving maturity. The upside of the *sukuk* default has been how such an event inspired the Malaysian parliament to pass new legislative provisions entrenching *Shariah* sanctity in financial contracts by requiring the judiciary to refer and take lead on all *Shariah* matters involved in any court dispute arising from an Islamic financial transaction. This new legislation has given a tremendous boost of confidence to the *sukuk* market because for the first time anywhere in the world there is absolute certainty about the validity of Islamic financial contracts.

Notwithstanding recent defaults, *Shariah* concerns and market conditions the United Kingdom has introduced legislation or amended existing legislation to facilitate Islamic financing techniques with a view to promoting Islamic finance. In 2009, the United Kingdom government followed through on other initiatives designed to support the country as a centre for global finance and to ensure conventional and alternative finance are treated on the same basis. Specifically, it consulted with various parties on the legislative framework for those alternative finance investments or *sukuk* to have similar economic characteristics to conventional instruments. Following this consultation, the government announced on 21 January 2010 that it intended to introduce measures to provide clarity on the regulatory treatment of corporate *sukuk*, reducing the legal costs for these types of investments and removing unnecessary obstacles to their issuance (IFSL, 2010). Furthermore, at a more domestic level the Muslim Arbitral Tribunal (MAT) in the United Kingdom provided yet another example of the principle of choice of law in Islamic dispute resolution. Although most known for family law arbitration, the MAT hears a range of issues, including commercial and debt disputes. According to its procedural rules, the MAT will in arriving in its decision take into account the laws of England and Wales and the recognised Schools of Islamic Sacred Law[10]. Finally, the MAT states that its overriding objective is to ensure that a judgement is secured in accordance with the *Quranic* Injunctions and Prophetic Practice. In this context the MAT has had some success, as indicated by a 15% increase in the use of the MAT by non-Muslims in 2009 (The Christian Institute, 2010).

5.0 Conclusion

In proceedings relating to Islamic banking business, Islamic financial business or any other business which is based on *Shariah* principles, the Malaysian courts may consider any written directives and the ruling of the *Shariah* Advisory Council of the Bank Negara Malaysia and Securities Commission. All *Shariah* Advisory Council rulings in such cases are binding on Islamic financial institutions, courts and arbitrators. The *Shariah* Advisory Council's ruling pursuant to such reference made there will be binding on the courts. To complement the court system, specific arbitration rules for Islamic banking and Islamic financial services have also been developed, enabling disputes for both domestic and international cases to be dealt with by the Kuala Lumpur Regional Centre for Arbitration (KLRCA) (www.klrca.com.my). Therefore, including KLRCA, this mandate represents an important step because previously rulings bound the arbitrator, but now the courts are better able to apply *Shariah* rulings. This new mandate creates more certainty in the legal framework of Islamic finance in Malaysia, particularly on how disputes over financial matters are settled, regardless of whether they are Islamic or conventional in origin.

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[10]See Procedure Rules of the Muslim Arbitration Tribunal Rule 8(2), available at http://www.matribunal.com/procedure_rules.html.

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