AUDIT AND GOVERNANCE IN ISLAMIC BANKS: SELECTION AND TRAINING OF SHARI'AH ADVISORS

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ABSTRACT

Since its commercialization in 1970's Islamic finance has grown at a rapid pace. While there have been many studies dealing with the features of Islamic financial products, not much attention has been paid to the governance of *Shari'ah* (Islamic law), and the role of the *Shari'ah* advisors in Islamic financial institutions. Using the longitudinal case study of the Pakistani Islamic banking sector this study investigates the issues of selection and training of *Shari'ah* advisors in Islamic financial institutions. The study reveals a limited pool of *Shari'ah* advisors who may be serving multiple Islamic financial institutions in contravention of government banking regulations, and creating conflict of interest situations. The study also discusses how the dual role of internal and external religious auditor performed by the *Shari'ah* advisors adds to the potential for conflict of interest in Islamic banks. This paper identifies the need for government and private sector investment in educational infrastructure to expand the number of qualified *Shari'ah* advisors, and signals the likely necessity of further regulatory development.

INTRODUCTION

Since its commercialization in the 1970s, the Islamic financing system has experienced rapid growth and is today widely accepted and practised worldwide. However, the system continues to be criticised for a lack of uniformity in the way *Shari'ah* (Islamic religious law) principles are applied and supervised in Islamic financial institutions. The adherence to *Shari'ah* in business transactions in Islamic financial institutions is governed by *Shari'ah* supervisory boards (SSBs). While there has been an increase in research on Islamic finance, the focus has mainly been on the features of Islamic financial products. The topic of *Shari'ah* governance in Islamic financial institutions has not been thoroughly explored and in particular the selection and training of *Shari'ah* advisors remains largely ignored.

This article addresses this gap by exploring the selection and training of *Shari'ah* advisors in Islamic financial institutions in Pakistan. The central objective is to elucidate and compare the regulatory requirements and practice approaches to the selection and training of *Shari'ah* advisors in Pakistan's Islamic banking industry. This objective is central to the issues of advisor effectiveness and independence and their impact on efficient and *Shari'ah* compliant Islamic banking. Pakistan represents an important foundational site for such a study, given its record as the first country to adopt a purely Islamic banking system.

Given the paucity of extant knowledge with respect to both Islamic banking regulation and the processes of *Shari'ah* compliance monitoring and enforcement in the Islamic banking industry, a longitudinal field based case study research methodology has been employed in order to penetrate both institutional and social practices and behaviours. Field data has been collected by way of interviews, observation, and document analysis, with due regard being paid to the importance of environment and context.

The study addresses issues of *Shari'ah* advisor selection, advisor training, and consistency in application of *Shari'ah* principles, conflict of interest and comparisons with these governance elements across *Shari'ah* advisors and corporate financial auditors. The remainder of the article is organized as follows. The next section reviews the literature on Islamic finance and *Shari'ah* supervision, followed by a discussion on the methodology used. The findings of the study are then detailed, covering the issues highlighted above. The role of the *Shari'ah* advisors is then compared with characteristics of traditional financial auditors, followed by the concluding analysis.

LITERATURE REVIEW

Introducing Islamic Finance

The commercialization of Islamic financing and the establishment of Islamic financial institutions in the 1970s were undertaken to help attract those Muslims in the money market who had previously avoided the conventional interest-based financial system. According to *Shari'ah,* Muslims are prohibited from lending or borrowing money that has a *Riba* (interest) element. While similar prohibition existed in the Torah and Bible, the modern-day interpretation of this law in conventional financing tends to be on the use of excessive rates of interest (usury) (Saeed, 1996). On the other hand the majority of the Muslim jurists agree that Islam prohibits all forms of interest regardless of how small the rate of interest is (Gafoor, 1996). 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. These include profit and loss sharing products (*Mudaraba* and *Musharaka*); mark-up based products (*Murabaha*); leasing (*Ijarah*); and Islamic bonds (*Sukuk*) (Rammal, 2004). Islamic banking and finance products are now available in Muslim and non-Muslim countries and the assets of the sector are expected to reach the US$1 trillion mark by 2010 (Cihak and Hesse, 2008).

Islamic Finance in Pakistan

The Government of Pakistan launched its Islamic banking and finance 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 would ultimately be phased out by 1984, thus making Pakistan the first country in the world that would follow a pure Islamic financial system. 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 (Ahmad, 1995).

Pakistani banks were seen as pioneers in the Islamic finance sector and introduced innovative products such as *Murabaha*, which is a mark-up based product (Ahmad, 1995; Khan and Bhatti, 2006). In *Murabaha* the bank purchases the asset on behalf of the client and then re-sells it later to the client at a price that includes the original cost of the asset and an agreed upon mark-up amount. These products were adopted worldwide but many critics claimed that these products were similar to interest-based financial products.

In 2002 the Supreme Court of Pakistan declared that Pakistan would follow a dual-financing system (Khan and Bhatti, 2006) similar to the one implemented in Malaysia. To help implement the Government of Pakistan’s aim of establishing the country as the regional hub for Islamic finance, the State Bank of Pakistan (the country’s central bank) promotes Islamic banking through their Islamic Banking Department and has issued a number of licenses for the establishment of new Islamic banks. As of June 30, 2009 there were six Islamic banks and

12 Islamic windows (conventional banks that offer Islamic financial products) operating across Pakistan with a network of 528 branches (State Bank of Pakistan, 2009).

Shari'ah Supervisory Boards

Extant literature on Islamic finance mainly focuses on the areas of new product development and customer satisfaction. The quality of the financial institution's governance and control is considered to be important for clients (Haron, Ahmad and Planisek, 1994; Ahmed, 2002), 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 summarized in this section.

The actions of Islamic financial institutions are guided by a religious control body known as the *Shari'ah* Supervisory Board (SSB), which consists of a number of *Shari'ah* advisors (Rammal, 2006). The purpose of the SSB is to ensure that the financial institutions operate in conformity with *Shari'ah* and to provide clarification in regards to any *Shari'ah* related questions that the financial institutions may have (Usmani, 1998; Safieddine, 2009). These SSBs are hired by the financial institutions and act as an internal control body in the organization, therefore enhancing the credibility of the bank in the eyes of its customers, and bolstering its Islamic credentials (Algaoud and Lewis, 1997).

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) – a body established in 1991 in Bahrain to help regulate the financial reporting and auditing of Islamic financial institutions – has set standards for the appointment and composition of SSBs. According to the standard, the authority to appoint SSB members should be vested in the annual general meeting of all shareholders of the institution. The justification for such action is that SSBs members will be free from any undue pressure from the management board if they do not have the power to appoint or dismiss them. The AAOIFI standard also specifies that the presence of three *Shari'ah* advisors is the minimum number required in a SSB (Bakar, 2002).

Banaga, Ray and Tomkins (1994) conducted a joint practitioner-academic study on external audit and corporate governance in Islamic banks. Some of the SSB functions listed by Banaga et al (1994) include:

- 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.
- Holding regular meetings to discuss all enquiries received from the management. The minutes of these meetings are usually recorded.
- 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*[1] 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.

[1] *Zakat* is the amount of money that every adult, mentally stable, free, and financially able Muslim 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).

The role of the SSB can therefore be seen to be similar to that of company auditors. Even though the financial institution compensates them, the SSB members are expected to retain their independence (Karim, 1990; Algaoud & Lewis, 1999). Just like auditors, SSBs certify at the end of the year whether the financial institutions operations were in conformity with *Shari'ah*. This task includes reviewing products and policies of the financial institution, and deciding on whether a new financial instrument introduced by the organization is religiously acceptable.

Theoretically if the SSB refuses to endorse a product, the 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 of Islamic financial institutions conducted by Warde (1998) revealed that in many cases the *Shari'ah* review is treated as a routine matter, with boards approving decisions already made by the financial institution's management.

While the duties of the *Shari'ah* advisors have been briefly discussed in some academic literature, the areas of training, experience and selection of *Shari'ah* advisors in Islamic financial institutions have been largely ignored. This study is therefore unique as it reveals, details and critiques the practice of selection and training of *Shari'ah* advisors by Islamic financial institutions in Pakistan.

METHODOLOGY OF THE STUDY

Case studies may be framed as in a variety of ways, according to the central focus of investigation. They can be categorised and designed as illustrative, descriptive, exploratory, or explanatory, or some mix of these. Additionally they can take the form of single, collective, comparative, layered or embedded. The methodology applied in this study is that of a field based case study employing an embedded case study design. That is to say, it focuses upon a number of Islamic banks and windows within the Pakistan Islamic banking industry (Stake, 2000; Yin, 2003; Parker, 2003; Scapens, 2004).

By directly interacting with research subjects in the field, their practices and interpretations could be investigated at close quarters, offering the prospect of eliciting previously unavailable contextualized accounts and interpretations of these. The use of cases facilitated the researchers' ability to study an object with many dimensions and then to draw the various elements together to create a workable interpretation (Selltiz, Wrightsman, and Cook 1976; Stake, 1995; Yin, 2003). Particularly in such a developing field as Islamic banking, where almost no research into corporate governance has to date been conducted, direct contact within naturally occurring organisational settings offers important insights into processes, attitudes and behaviours. Through the application of multiple methods including interviews, observations, and documentary analysis, first level accounts and understandings of organisational practices can be obtained (Ferreira and Merchant, 1992; Merchant and Van der Stede, 2006).

Adopting this approach the researchers aimed to penetrate organisational participants' socially constructed worlds, their cultures, thinking, language and behaviours. By experiencing their world in this way, the research endeavoured to understand organisational situations and practices holistically (Parker, 2003; Ahrens and Chapman, 2006). Utilising this holistic inductive approach to deriving key concepts and relationships from the field, the study focuses upon eliciting the key structures and processes involved in the selected Islamic banking cases with a view to penetrating manifest practices and perceptions as well as latent agendas and meanings of actors and their institutions.

Thus in order to meet this study's objectives, the research focused upon the social and institutional practices evident in the cases studied, interpreting them within their micro and macro situational contexts (Scapens, 1990; Dawson, 1997; Cresswell, 1998). This is crucial for the subject under discussion in this paper, given the intertwining of cultural, religious and business beliefs, perceptions and practices in the emerging Islamic banking phenomenon. From this specific detailed perspective, emerging themes are developed from specific empirical data derived *in situ* in the field (Ferreira and Merchant, 1992; Ahrens and Dent, 1998; Groenewald, 2004).

For the purpose of this study the Pakistani Islamic banking industry is defined as one case study with a range of different banking organizations embedded within it. A longitudinal approach was taken where data was collected over a period of five years, 2003-2007. The selection of Pakistan was based upon a number of criteria. Pakistan was the first country to declare itself an Islamic republic. In addition it was the first country to attempt to install Islamic banking as the exclusive form of banking available in the country. Furthermore it was one of the first countries in the world to institute Islamic banking.

In order to understand the application of *Shari'ah* rules and the role of the SSBs in Islamic banks and Islamic windows, in-depth comparative research was conducted on individual organizations. These included two Islamic banks and four Islamic windows operating in Pakistan. In order to protect the identity of the institutions and the interviewees, the names of the financial institutions are not disclosed in this paper. Six banks were selected as individual cases. Two are specialist Islamic banks established as publicly listed companies between 2002 and 2005, with major shareholders across Pakistan and the Middle East. Both have branches spread across Pakistan. Four other banks selected for study are commercial banks providing Islamic financial options through a dedicated Islamic Branch (Islamic windows). These all commenced operations between 2004 and 2006. The sizes of their banking operations varied from 50 to 1500 branches spread across Pakistan. Their foundations varied from being privatized former government owned bank to a publicly listed company with branches spread across the globe.

Data Collection

Primary Data. 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 with over a period of five years (2002-2007) across various cities in Pakistan. These interviewees were identified by employing both purposive and snowball sampling techniques (Miles and Huberman, 1994; Bernard, 1998; Creswell, 1998; Hammersley and Atkinson, 2000; Silverman, 2000; Neuman, 2003). For a breakdown of the interviewees' background please refer to Table 1.

Insert Table 1 about here

For the purposes of this study, interviews took an ethnographic form of negotiated interaction between interviewer and interviewee. This allowed the interview to become more a form of discourse within which questions and responses could be contextually grounded and jointly constructed by both interviewer and interviewee. This permitted the elicitation of stories of "what happens" and discourses about "how it happens". The semi-structured interview questioning was therefore employed. Semi-structured interviews utilize 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; Fontana and Frey, 2000; Flick, 2002).

This approach 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 gathered from experts in the area of Islamic finance in Pakistan. The interviews sought to elicit specific structures, processes and their motivations and to related these to their meaning for and impact upon interviewees. Questioning, including the use of informal probe and follow-up forms of questioning, tried to cover all aspects of the topic relevant to the central research objective and to maximise interviewee self-revelatory comments about how processes were experienced. Questioning covered experience/behaviour, opinions/values, knowledge, background/demographics, and past/present/future categories. This interview methodology offered the study a number of relevant and distinct advantages, given the emerging state of Islamic banking and the relative dearth of available information about its structures and processes. It allowed the interviewing researcher to tackle complex issues not readily amenable to effective pursuit via questionnaire. It also elicited spontaneous answers and unprompted responses from interviewees while additionally allowing the possibility of probing their knowledge and views more deeply. Additionally it facilitated greater access to context and an ability to observe interviewee non-verbal behaviour (Bailey, 1982; Rubin and Rubin, 1995; Glesne, 1999)

To gain insight into the working of the SSBs, interviews focused on a number of key issues:

- The routine daily operations of SSBs
- Differences in operational characteristics and requirements between a specialist Islamic bank and a bank that operates Islamic windows.
- The minimum requirements for an individual to be a *Shari'ah* advisor or member of a SSB.
- The processes by which new Islamic financial products are introduced into banks.
- The role played by the SSB in new product approval.

Other questions dealt with the training of *Shari'ah* advisors and bank staff; the regulatory framework in which banks and SSBs operate; and the history of Islamic financing's introduction into Pakistan and its future.

The interviews were conducted in Urdu and English. One of the researchers' 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 transcribed. This 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.

In addition to conducting interviews, the researchers also analysed memos and guidelines issued by the State Bank of Pakistan, and documents issued by the individual case study organizations provided background information about the topic area 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 and advisory boards. Other documents included the banks' financial reports as well as *Shari'ah* audits. Table 2 provides a list of documents that were used for the purpose of this study.

Insert Table 2 about here

Secondary Data. 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.

Insert Table 3 about here

Data Analysis

For the purpose of this study, data analysis focused on the identification of themes and the development of associated categories that would help explain behaviours and relationships (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 categorized (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 categorized 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 stabilized 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 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).

FINDINGS

The findings of this study relate to the selection and training of *Shari'ah* advisors in Islamic financial institutions in Pakistan. The actual practices of 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.

Selection of *Shari'ah* Advisors

The State Bank of Pakistan had no established rules and regulations for *Shari'ah* supervision in Islamic financial institutions up until a few years ago. In 2004, the State Bank of Pakistan issued 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, 2004). 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 minimum educational qualification specified by the State Bank of Pakistan is *Dars-e-Nizami* (the basic syllabus that is followed by the majority of Islamic religious schools in South Asia). 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, 2004).

In relation to the advisor's track record, the circular states that the candidate must not have been previously terminated or 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, 2004).

The State Bank of Pakistan also requires that the *Shari'ah* advisor has not been convicted of 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, 2004).

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* (profit-sharing agreement) 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, 2004).

Since the *Shari'ah* advisors are expected to protect the interests of the banks' customers, the banks are required to provide the State Bank with the names and qualifications of the individuals that have been selected as *Shari'ah* advisors. This acts as a control measure to ensure that the selected individuals meet the minimum qualification criteria developed by the State Bank of Pakistan.

Training of *Shari'ah* Advisors

Reviewing the State Bank circular shows that the educational requirement for *Shari'ah* advisors is focused 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 are trying to introduce new Islamic products. Part of the product's 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 Islamic financing industry is relatively new, there are not many institutions in Pakistan that provide training in Islamic banking. This shortage of training facilities is highlighted by the fact that there are over 55 colleges and professional institutions offering education in Islamic finance in Britain but only a handful of such institutions in Pakistan (Beckford, 2009). 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 religious schools only providing training in religious interpretation of the Quran, *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 institution in Karachi. Established in the early 1950s, the institution is one of the oldest centres for Islamic education in Pakistan. Since it commenced its operations, the institution has attracted students from Afghanistan, Burma (now Myanmar), Indonesia, India, Malaysia, Iran, Turkey and other Muslim countries. The institution provides education from basic level to post-graduate degrees and a student who intends to undertake their entire schooling and education in the institute would spend 16 years in the institution. In Islamic financing education and interpretation, the institution is served by religious scholars who are *Shari'ah* advisors to Islamic financial institutions. The graduates from this institution also serve on *Shari'ah* boards of many Islamic financial institutions. The Pakistani industry therefore relies quite heavily on the services of this institute for the training of *Shari'ah* advisors. The institution 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 institution was used for training not just the *Shari'ah* advisors but also other staff in the bank who dealt with 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 financial products. Having some basic knowledge about *Shari'ah* meant that staff were 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 at the [institute in Karachi] [which] is recognised worldwide as a leader in the training of Fiqh (*Islamic jurisprudence). *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.

Another institution 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 financial 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 with the finer details of the products and the reasoning for its use. While the *Shari'ah* advisor of the banks can help assist in the training, it is not physically possible when the operations of the banks are spread across several locations and the advisors are not available on a daily basis.

> *"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 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 *Shari'ah* board 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.

Variation in Application

While the training provided to *Shari'ah* advisors in Pakistan is standardized in academic content, the findings reveal that the application of the Islamic laws varies across different 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* while further studies undertaken by the *Shari'ah* advisors give them the ability to be able to interpret religious text. But the interpretation is not consistent across the industry. Some *Shari'ah* advisors believe that products like *Murabaha* (cost plus mark-up) 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. These schools of thought vary in their interpretation of the Quran and the application of Islamic principles in the day-to-day and business activities of Muslims.

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" – Shari'ah* scholar.

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.

> *"I have read the case of Egypt where till today some Maulanas* (religious scholars) *believe that [using] 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.

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.

Conflict of Interest

The State Bank of Pakistan's document titled 'Fit and Proper Criteria for *Shari'ah* Advisors' (State Bank of Pakistan, 2004) specified that *Shari'ah* advisors can only act as advisor for one financial institution. Acting as a *Shari'ah* advisor or being a member of SSB in another financial institution was seen as a conflict of interest and was not permitted by the State Bank of Pakistan. Despite this prohibition, many of the *Shari'ah* advisors in both Islamic banks and Islamic windows were either members of SSBs or were the resident *Shari'ah* advisors for more than one Islamic financial institution. This breach of the State Bank's requirements was well-known amongst members of the banking fraternity. As discussed earlier, *Shari'ah* advisors are employed by banks but are meant to act as unbiased and independent auditors. The employment of the *Shari'ah* advisors by a financial institution is meant to ensure that the advisors do not work for other organizations. The practice of employing *Shari'ah* advisors in multiple financial institutions in Pakistan clearly breaches the expectations of unbiased independent advisors.

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. The agency reported that the shortage of appropriately qualified scholars "raises concerns over the ability of SSBs to provide enough rigorous challenge and oversight" (Ainley, Mashayekhi, Hicks, Rahman and Ravalia, 2007:17).

An explanation for this conflict of interest is that there are only a handful of Islamic scholars globally who are specialists in *Shari'ah* application in business and hold sway over Islamic financial institutions. 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. One way banks are overcoming this shortage is by hiring scholars and advisors who are already performing their duties in other organizations.

The employment of *Shari'ah* advisors by multiple organizations 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 for this study 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 organizations:

> *"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…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 institutions. If the State Bank implemented its requirement that *Shari'ah* advisors would only be employed by one institution then there was a risk of brain drain as the advisors may choose to be part of organizations that may provide the highest compensation or join institutions that do not have operations in Pakistan and therefore do not breach the regulations. This issue also highlights the need for establishment of specialized training institutions that would help prepare future *Shari'ah* advisors and auditors and overcome the shortage of qualified *Shari'ah* advisors. The AAOIFI has introduced new course in this area and leaves the scope for more indigenous based programs to be introduced in Pakistan.

> *"There are other institutions [in Pakistan] 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 [them]?"* – Manager of Islamic bank.

The State Bank of Pakistan has recognized the shortage of qualified advisors and in September 2008 made an amendment to its "Conflict of Interest" section, allowing *Shari'ah* advisors to serve multiple financial institutions. This amendment not only demonstrates an acceptance by the State Bank of Pakistan of the ground reality of *Shari'ah* advisor shortage, it also identifies a trend in Pakistan where State Bank's regulations are regularly changed to respond to the industry's requirements. This trend indicates that the State Bank is yet to set up long-term objectives and aims for *Shari'ah* supervision that can be enforced in the Pakistani banking sector. The findings also show that the State Bank needs to play a more proactive role in the training of *Shari'ah* advisors and in the formulation of documentation that detail the procedures for *Shari'ah* supervision and audit.

THE AUDIT-GOVERNANCE DIMENSION

Two particular aspects of the *Shari'ah* advisor findings in this study bear brief comparison with characteristics of traditional corporate financial auditors. The question initially arises as to whether the role of the *Shari'ah* advisor approximates that of an internal or external corporate auditor. The internal auditor essentially safeguards corporate assets against misuse and in addition seeks to improve their organisation's control systems, governance and risk management, thereby adding value to the organization (Al-Twaijry, Brierley and Gwilliam, 2002; Lee, 2006; Zain and Subramaniam, 2007). Thus the internal auditor focuses upon ethics and organizational governance at the operational level, aiming to detect and prevent error and fraud (Coram, Ferguson and Moroney, 2008). This role now extends even beyond these compliance roles to include efficiency and effectiveness (Harrison, 2007). The external auditor's major role is to provide an independent evaluation and opinion on the financial reports presented by a corporation (Ladakis, 2005). Of course it must be noted that this role as elucidated in professional accounting and regulatory standards does suffer the much discussed expectation gap whereby the public often presumes that the auditor's role extends to guaranteeing 'correct' financial statements and insuring against fraud and illegal actions (Larkin, 2000; Frank, Lowe and Smith, 2001; Carcello and Neal, 2003; James, 2003; Spira, 2003).

Arguably, the *Shari'ah* advisor to some degree undertakes a role that resembles some elements of both internal and external corporate auditors. They resemble an internal auditor in that they evaluate and advise financial institution management on the compliance of banking products and financial instruments with *Shari'ah* principles (Spira, 1998). They also in part resemble an external auditor in that external parties such as regulatory bodies, financial institution customers and shareholders rely on their opinion and certification of this compliance.

The *Shari'ah* advisor conflict of interest issue outlined in this paper pertains predominantly to the prohibition of an advisor serving more than one financial institution, but being honoured more in the breach than in the observance. This situation bears comparison to an external corporate auditor building specialist knowledge in for example, the finance industry and auditing multiple financial institutions. Where the difference arises is in the degree to which the *Shari'ah* advisor is acting in a quasi-internal auditor role and from that perspective, engaging in a conflict of interest between different financial institution employers. In addition, there remains a risk of the *Shari'ah* advisor having interests in their 'client' organization prejudicial to their independence, or becoming overly familiar with their client organization and hence insufficiently objective and critical, or being financially dependent upon the client institution by way of the fees earned from that institution (Stapeldon and Fickling, 2001). Auditor independence and conflicts of interest have, since the international corporate frauds and crashes of the 1990s, been subject to tighter regulatory requirements in the forms of the Sarbanes-Oxley Act of 2002 in the USA, CLERP 9 amendments to the Corporations Act 2001 in Australia, and the Combined Code of Corporate Governance 2003 in the UK (Grey and Dale, 2005; Bir and Gay, 2006). Thus the issues of *Shari'ah* advisor potential conflicts of interest and associated potential threats to independence remain as significant as those faced by corporate financial auditors. In this still nascent stage of Islamic financial institutions governance development, both the adequacy of regulations and then their effectiveness, remain issues requiring further attention from researchers, regulators and practitioners alike.

With respect to the selection of auditors or *Shari'ah* advisors, while professional association standards or legal regulations may prescribe a shareholder vote as the requisite for auditor/advisor appointment, as Abdel-Khalik (2002) observed in relation to the Enron corporate scandal, the long recognized divorce between ownership and control in corporations means that management carries the proxy votes of shareholders into annual general meetings and thereby exercises dominant control over auditor appointments. In practice therefore, corporate directors and management determine who is appointed as auditor and any subsequent replacement (Ladakis, 2005). Thus both the corporate auditor and *Shari'ah* advisor in reality report to and are accountable effectively to management rather than shareholders.

In trying to address the problem of auditor selection and auditor client familiarity/independence, particularly since the high profile corporate frauds and crashes such as Enron, World.Com, regulators have paid considerable attention to tightening the rules regarding auditor rotation. In the US, the Sarbanes-Oxley Act 2002 mandates rotation of audit partners on an audit firm's engagement with a corporation every five years. A similar regulation applies in Australia through CLERP, the Corporate Law Economic Reform Program (Audit reform and Corporate Disclosure) Act 2004, and has also been adopted in the UK by the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in England and Wales (Spencer, 2004; Ladakis, 2005). However critics argue that audit *partner* rotation within the same audit firm involved in the audit engagement (compared with audit firm rotation) may be insufficient in limiting conflict of interest situations. They also point to the potential for the limited number of large audit firms to endorse each other's work, so that the intent of the tightening laws and regulations aimed at preventing auditor conflict of interest and enhancing auditor independence may still be thwarted (Segal, 2002).

Of course auditor rotation may also carry disadvantages such as lost auditor familiarity and expertise in the client's industry and business, negative impacts on cost and quality of audit, and limitations on rotation caused by a limited number of audit firm partners with particular specialist industry knowledge (Hamilton and Wright, 1982; Petty and Cuganesan, 1996; Catanach and Walker, 1999; Lin and Liu, 2009). Indeed some empirical studies have found that where audit firm rotation is not mandatory, short term audit tenures are associated with lower quality financial reporting whereas longer term audit engagements do not appear to produce declines in financial reporting quality or adverse impressions of audit firm independence among non-professional investors, and actually facilitate auditors better constraining extreme management financial reporting decisions (Johnson, Khurana and Reynolds, 2002; Myers, Myers and Omer, 2003; Kaplan and Mauldin, 2008). Further evidence suggests that corporate predisposition to shop for favourable audit opinions declines with an increasing length of auditor-client relationship (Ruiz-Barbadillo, Gomez-Aguilar and Biedma-Lopez, 2006). On the other hand, mandatory audit firm rotation appears to lead auditors to adopt less co-operative negotiating strategies with client firms (Wang and Tuttle, 2009). So opinion and evidence on the merits of compulsory audit firm and audit partner rotation do remain mixed (Catanach and Walker, 1999; Kend, 2004; Jennings, Pany and Reckers, 2006), especially as audit partner rotation also appears to produce some differential outcomes to audit firm rotation and presents potentially greater risks of persistent conflicts of interest (Bartholomeusz, 2002; Gates, Lowe and Reckers, 2007; Orin, 2008).

These same issues of managing conflict of interest and regulating the appointment, replacement and rotation of corporate financial auditors appear pertinent to the selection, roles and effectiveness of *Shari'ah* advisors. While there have been some early signs of regulations being established in such countries as Pakistan to address issues of *Shari'ah* advisor qualifications, experience, integrity and conflicts of interest, their implementation and compliance levels are still well short of the regulatory requirements. In addition, despite the constraints of a limited pool of available advisors, the potential for more rigorously addressing interlocking advisorships, advisor-client relations and associated conflicts of interest, remain considerable.

CONCLUSION

In relation to training of *Shari'ah* advisors, the study compares the requirements established by the State Bank of Pakistan with actual practice in the industry. The findings reveal that most of the *Shari'ah* advisors have been trained at one institution in Karachi. Some banks also make the effort to send their banking staff to train at this particular institute. In addition to the lack of available accredited training institutions, the educational requirements for *Shari'ah* advisors set up by the State Bank, and the time required to train as a *Shari'ah* advisor limits the number of advisors and banking staff who are thoroughly familiar with issues related to Islamic banking and finance. Overall the general bank staff are not well-versed in the *Shari'ah* requirements and this has the potential to create conflict in the organization, both between banking staff and between staff and *Shari'ah* advisors.

Even though many of the *Shari'ah* advisors are trained at the same institution in Karachi, this study has found that *Shari'ah* application in the organizations examined varied considerably. This variation was due to differing interpretations of the Quran by *Shari'ah* scholars. This variation is the product of the different Islamic schools of thoughts that do exist. Nonetheless, the efforts by the State Bank of Pakistan to present the industry with approved financing modes appear to have improved consistency in practice across the Pakistani Islamic banking sector. However interpretation and practice variation 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 institution. Since *Shari'ah* advisors are employed by banks, providing their services to another organization is viewed as a conflict of interest. But this prohibition is ignored by institutions and *Shari'ah* scholars are often found to be performing their duties for multiple organizations. The findings of this study reveal that due to a limited pool of *Shari'ah* advisors worldwide, the 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 findings have practical implications for the Islamic banking sector in Pakistan as well as worldwide. The results reveal that Pakistan needs to address the issue of training for *Shari'ah* advisors by investing in educational infrastructure and establishing new educational institutions that provide courses in Islamic finance. Doing so would allow Pakistan to improve the skills of future *Shari'ah* advisors and bank staff which in turn would facilitate the improved governance of *Shari'ah* principles in Islamic financial institutions, and reduce the potential for conflict between *Shari'ah* advisors and bank staff. To achieve this goal, the Pakistani government and the State Bank of Pakistan may productively work with Malaysia, U.K, and other Muslim and non-Muslim countries that have recently established similar educational institutes offering Islamic banking courses. The experience of these countries offers the prospect of Pakistan developing training courses that are consistent with the AAOIFI requirements and are globally accepted. A global effort to streamline the education and application of *Shari'ah* offers the best prospect for improving consistency of interpretation and practice across the industry.

The long-term benefit of investing in educational infrastructure is that the increase in the number of qualified *Shari'ah* scholars would help address the conflict of interest faced by the advisors. As more advisors will be available to provide their services, Islamic financial institutions will not be forced to employ an advisor who is already employed by another institution. This will help address the concerns of critics who have questioned the independence of advisors who are employed by multiple financial institutions.

Nonetheless, as our comparison with corporate financial auditor selection, rotation and conflict of interest debates and legislation in such countries as USA, UK and Australia demonstrate, the improved supply of qualified *Shari'ah* advisors, will not of itself automatically ensure appropriate levels of advisor independence and effective and consistent *Shari'ah* compliance advice. As the Islamic banking industry continues to grow and develop, these issues will require ongoing attention by the industry and regulators alike.

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Table 1: List of individuals interviewed

Role	Individuals interviewed	Total interviews including repeats
Executives from the Islamic Banking division of the State Bank of Pakistan	3	5
Managers of Islamic Banks	4	9
Managers of banks offering Islamic windows. *Islamic windows refer to bank branches run by conventional banks that offer Islamic banking products to clients. These branches operate independently from the rest of the bank's operation to ensure that the interest free operations do not utilize any of the interest bearing funds.*	6	13
Managers of banks offering conventional banking products.	5	12
Shari'ah advisors	4	6
Executives from advertising companies dealing with Islamic banking products	2	3
Executives of companies using Islamic banking products	4	9
Chief researchers of international Islamic banking regulatory bodies	2	4
TOTAL	**30**	**61**

Table 2: List of documents analysed

Islamic Banks	Commercial Banks
Standards and Publications published by the Islamic Financial Services Board.	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* Supervisory Boards. 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 Banks 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.

Table 3: 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.