

Shariah Compliance: An Empirical Study on the Perceptions of Islamic Financial Institutions in Pakistan

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Abstract: This paper examines the importance of Shariah Compliance for Islamic Financial Institutions (IFI) in Pakistan along with the process followed to ensure it. Islamic Banking was initiated in Pakistan in early 2000s and by now a proper network exists with a market share of 13.6 % of Assets and 14.7% of deposits with a network of 21 Islamic Banking institutions, out of which 5 are full-fledged Islamic Banks and 16 conventional banks have standalone Islamic windows. This study contributes as being first of its nature to study the Shariah compliance in the context of Pakistan. For the study, mainly primary data was used. Interviews of Shariah Compliance Heads and Shariah Advisors were conducted. The results indicate that a Shariah Compliance acts as a vital element for Islamic banking in Pakistan and influences the operations carried out by them. Moreover, a proper Shariah Governance System is also implemented and followed by the Islamic Financial Institutions. In addition to this, Shariah Advisors also play a pivotal role in the whole procedure and are responsible for Shariah Compliance in the IFIs.

Keywords: Shariah Compliance, Pakistan.

1. Introduction

The performance and development of Islamic banking in Pakistan has been phenomenal in the last two decades. With the inception of Meezan Bank (Ltd), a new and promising era opened in the country leading to expansion of Islamic banking in the economy. Currently, the Islamic banking industry is enjoying a market share of 13.6 % of Assets and 14.7% of deposits with a network of 21 Islamic Banking institutions, out of which 5 are dedicated Islamic Banks and 16 conventional banks have standalone Islamic windows. The profit of Islamic Banks have increased in a quarter to Rs. 23 billion from Rs. 18 by the end of September 2018 (Islamic Banking Bulletin, 2018).

According to Muhammad, Mamman and Tangaza (2019, p.12) Islamic Banking can be defined as “an economic and financial framework which operates based on principles of Shariah law, Islamic law prohibits the giving and acceptance of riba (Interest) on money borrowed and lent. However, not all Muslims believe that the Qur’an states impose such prohibition, some interpreted such ban on pre-Islamic practices which enslavement a lot of people. Nonetheless, the Riba prohibition remains fundamental. The emphasis on profit sharing (equity) and Loss sharing (risk) time controversial, the prevailing Shariah interpretation of financial instruments which are Shariah compliant.”

According to Lahsasna and Hassan (2011), financial products in Islamic finance can be characterized as Shariah-based and Shariah-compliant products. Prevalent examples are Islamic financing products, equity based products, takaful (insurance) products, income based securities and Islamic derivatives.

Shariah compliance makes Islamic finance is different (Rusnah, 2011). Islamic finance has gained importance as it is considered to have all the activities in accordance with Shariah (Naser and Mountinho, 1997). It can be explained as adherence of operations with Shariah which is also known as Islamic law.

The study of measure taken for Shariah compliance in Pakistani Islamic Financial Institutions is believed to hold importance for both Pakistan and global Islamic banking. It is the primary qualitative study for the investigation of Shariah compliance in the Pakistani Islamic banking. The research discusses the process that how the IFIs ensure the Shariah compliance for their activities. Moreover, it discusses the process of ensuring compliance for both customers and general public.

2. Literature Review

2.1. Outline of Shariah Compliance

Generally, “Shariah-compliant” can be used to define anything that is permissible under the Islamic law. According to Islamic Finance, each finance based transaction needs to be Shariah-compliant. Moreover, Shariah compliance is based on five principles as provided in Figure 1 (Abdullah and Chee, 2010):

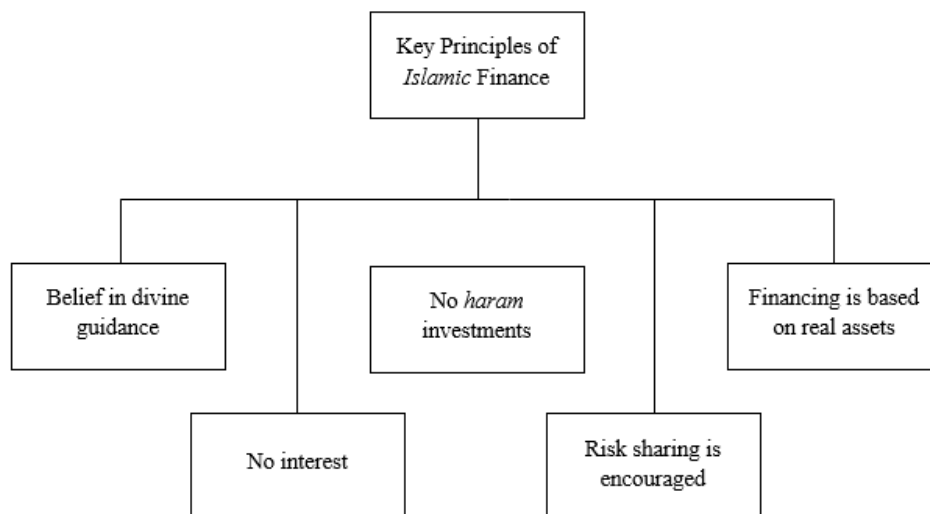


Figure 1: Main principles of Islamic Finance.

Alike understanding has been provided by Loqman (1999), Iqbal (1997), Aslam (2006). And Zaher and Hassan (2001).

Along with Shariah compliance acting as the pillar of Islamic finance, it also adds confidence to the stakeholders. Oppositely, non-Shariah compliance, along with hurting confidence, is also a source of opening door to numerous risks, for example reputational risk for an Islamic Financial Institution. Nevertheless, a formal Shariah governance system can lead to Shariah Compliance (Hasan, no date).

Non-Shariah compliance has various consequences, such as reputation damage resulting in outflow of investors and depositors, due to loss of confidence (Rusnah, 2011; Chapra and Khan, 2000 and Ahmed, 2010;). Alvi (2005) states that “investor confidence can only be boosted through the

conformity of Shariah compliance. Without rigid Shariah compliance regulations, nonconformity would result in declining investor confidence that can cause the failure of one bank to ultimately lead to a wide-ranging crunch on the financial system and possible crisis.”

According to Rahim (2008, p.1), “institutions that offer Islamic financial services are expected to operate by the code of Islamic ethics and must function within the limits of Shariah.” An appropriate Shariah compliance process is essential for the success and growth of the Islamic Finance industry (Thani, 2007). Therefore, Shariah compliance needs to be the main emphasis for the Islamic institutions (Vicary, 2005).

For assuring that the operations are compliant with Shariah, a suitable “Shariah Governance System” is compulsory, which can be explained as “the set of institutional and organisational arrangements through which an Islamic Financial Services Industry (IIFS) ensures that there is effective independent oversight of Shariah compliance” (Islamic Financial Services Board, 2009, p.2).

Islamic Finance is distinguishable from conventional banking on the basis of Shariah compliance making it vital for Islamic Financial Institution (IFI) to adhere to it (Ahmed.H, 2010; Rusnah, 2011; Grais and Pellegrini, 2006; IDB, IFSB and IRTI, 2007; Haniffa and Hudaib, 2007; IFSB, IRTI, IDB, 2010).

Numerous risks such as credit risks, markets risks, operational risks and liquidity risks are faced by a banking business. Due to a weak internal governance and control system IFIs face Operational risks (Rusnah, 2011; Chapra and Khan, 2000). Reputational risk is also associated to operational risk, mainly due to failure in operational obligations (Askari, Iqbal and Mirakhor, 2009).

Compliance risk for IFIs is defined by According to the Basel Committee on Banking and Supervision, Compliance and the Compliance Functions in Banks (2005), Compliance risk is described as, “the risk of legal or regulatory sanctions, financial loss or loss of reputation a bank may suffer as a result of its failure to comply with all applicable law, regulations, codes of conducts and standards of good practice (together ‘laws, rules and standards’)...compliance should be part of the culture of the organization; it is not thus the responsibility of the specialist compliance staff” (As cited in Rusnah, 2011, p.11).

Shariah compliance is possible to be accomplished through an operative and suitable process for Shariah review (Musa and Daud, 2007). The process of compliance process can be segregated in two portions; ex-ante compliance and ex-post compliance (Rusnah, 2011; Rahim, 2008).

The ex-ante Shariah compliance portion “is basically the Shariah Advisory Council’s (SAC) supervision, monitoring and control tasks that take place upon and during implementation of the bank’s dealing. These activities include making sure that the banks and financial institutions comply with the Shariah rules and guidelines during the designing of the contracts and agreements, during the process of transactions, during the conclusion and execution of the contract, and up to the implementation of the terms of contract and liquidation” (Rahim, 2008, p.3).

IFSB (2009, p.8) described “Ex-ante considerations that should take place at the product design/development stage, before it is offered to the customers”. It comprises of issuance of Shariah resolutions and compliance checks.

The emphasis of the latter segment of the process is on compliance of the activities and supervision and monitoring of the products; though, majority of the IFIs understand the first segment to be sufficient for the process of Shariah compliance (Rusnah, 2011).

Rahim (2008, p.3), states that IFIs mostly do not practice ex-post Shariah compliance. He defines it as “Thorough and comprehensive Shariah audit to review and check the transactions that took place after the execution of the contracts. The ex-post Shariah compliance is basically to perform the random samples of completed transactions to ensure that these transactions conform to Shariah rules and guidelines. An internal audit or external audit may be required to perform this where the result of the audit needs to be reported to the management.”

Moreover, “Shariah governance is taken seriously by the management of the bank, and proper mechanisms are in place to ensure the bank’s operation are conducted in line with the Shariah requirements. The willingness and serious commitment from the top management are very critical in ensuring that an effective Shariah compliance review process takes place in a particular Islamic bank.” Rusnah (2011, p.34 and 36).

2.2. Contribution of Shariah Supervisory Board and Shariah Advisor for Shariah Compliance

The mechanism of Shariah governance is a distinctive attribute of Islamic banking. It can be accomplished through various methods by the IFIs and is extensively incorporated in a Shariah Control Committee (SCC). SCC can also be termed as Shariah Supervisory Board (SSB) (Qattan, 2005).

To guarantee provision of halal products to clients, the IFIs pursue Muslim scholars for confirmation. These scholars are identified as Shariah advisers and mostly are a member of Shariah Supervisory Boards (SSBs) (Rammal, 2006).

The functions and duties of Shariah Advisor and Shariah Supervisory Board (SSB) are not extensively discussed in literature. According to Choudhury and Hoque (2006) IFIs are mostly handled through a Shariah Advisor or the SSB.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines SSB as, “A Shari’ah supervisory board is an independent body of specialised jurists in fiqh al-mu’amalat (Islamic commercial jurisprudence). However, the Shari’ah supervisory board may include a member other than those specialised in fiqh al-mu’amalat but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh al-mu’amalat. The Shari’ah supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institutions to ensure that they are in compliance with Islamic Shari’ah rules and principles. The Fatwas and rulings of the Board shall be binding on the Islamic financial institution.” (as cited in Bakar, 2002, p.76).

According to Banaga, Ray and Tomkins (1994) the key tasks of a SSB are:

- Contract preparation
- Zakat rate determination and division
- Shariah review of the operations of IFI
- Meetings with the management
- To examine the transactions and activities to ensure them to be Shariah compliant
- Issuing Fatwa

SBP has also issued a detailed criterion to the IFIs, according to which the Shariah advisor was assigned the duty of assurance of operations in compliance with Shariah (Rammal and Parker, 2013).

2.3. Profile of Shariah Compliance in Pakistan

Shariah compliance holds a fundamental role in Islamic finance. Emphasis is made on Shariah compliance by the State Bank of Pakistan (SBP). A three-tiered system is initiated by, which has three pillars, (a) a Shariah Board at SBP, (b) Shariah Advisor for every IFI and (c) a system of Shariah Audit. The Shariah Board and officials of Islamic Financial Institutions hold the responsibility of Shariah Compliance (Hassan, 2007).

Customers prefer Shariah Compliance even on the cost of return (Naser, Ahmad, & Al-Khatib, 1999; Gerrard and Cunningham, 1997). In a study conducted on the customers of Pakistani Islamic

Financial Institutions by Lee and Ullah (2011), it was assessed that Shariah compliance plays the most significant part when it comes to competitiveness and returns. Almost 90 per cent of the Pakistani customers preferred withdrawal of their deposits in result of any non-Shariah compliance disclosure by any IFI. Moreover, 75 per cent of the customers are attracted towards Islamic banks due to Shariah compliance. Whereas the levels of satisfaction are 90 percent with the product profile and services of IFIs, of the customers, the findings display that 90 per cent of the consumers were content with product line and services of IFIs.

Furthermore, another initiative for Muslim investors for Shariah complaint solutions, KMI-30 (KSE Meezan Index) was introduced in Karachi stock Exchange in September 2008. It tracks the most thirty Shariah-complaint stocks (www.kse.com.pk).

3. Research Method

The research is focused on the Shariah Compliance practices in Islamic Financial Institutions.

Qualitative research can be explained as “A situated activity that locates the observer in the world. It consists of a set of interpretive, material practices that makes the world visible. These practices...turn the world into a series of representations including field notes, interviews, conversations, photographs, recording, and memos to the self. At this level, qualitative research involves an interpretive, naturalistic approach to the world. This means that qualitative researchers study things in their natural settings, attempting to make sense of, or to interpret, phenomena in terms of the meanings people bring to them (Denzin and Lincoln, 2003, p.3).”

According to Silverman (1997), in-depth interviews help in gaining information about the social world. Miles and Huberman (1994, p.1) “qualitative data are more likely to lead serendipitous findings and to new integrations; they help researchers to get beyond initial conceptions and to generate or revise conceptual frameworks”.

To analyze the data gathered thematic analysis was used. Boyatzis (1998, p. 145) ponders thematic analysis as a reliable method for generation of results and states, “Thematic analysis with reliability allows the interpretive social scientist to generate qualitative hypotheses that provide a basis for a positivist social scientist to conduct qualitative or quantitative hypothesis testing as part of the building process of science.”

Being unique and new topic in the lieu of Pakistan and as due to absence of quantitative data, qualitative research was opted. No specified parameters are available for the size of the sample in qualitative research (Patton, 1990). Presently, there are five Islamic banks and sixteen Islamic windows, whereas when the research was conducted five Islamic banks existed, whereas there were twelve Islamic windows.

The primary sources employed to address the research problem were mainly interviews. They were conducted to discuss the process of Shariah compliance and what measures were taken to ensure that their products were Shariah compliant. Moreover, secondary sources like reports of Shariah Advisors, Annual reports and checklists managed by IFI to carry out audit were analysed. Guidelines for Shariah compliance issued by SBP were also investigated.

The researcher established an interview guide, comprising of a question set. The interview list was organized after literature review study. As the interviews were semi-structured, questions were added during the interview.

Most of the interviewees had master’s degree or a Madrasa Degree (Islamic Educational institutions) and were age ranging between 35-50 years. Mostly held experience of 10 or more years working with an IFI. The Shariah Advisors interviewed were qualified and experienced Islamic scholars, which were attached with the Islamic Financial Institutions.

4. Results and Decisions

To examine the Shariah compliance process this study was conducted. Moreover, the role of Shariah Advisors was also investigated. The findings are arranged thematically.

Three main themes were identified, all having subthemes. Which are provided in Table 1:

Table 1: Themes and Sub-themes of the research.

	MAIN THEME	SUB-THEME
1.	Importance and attitude of IFIs towards Shariah compliance	<ul style="list-style-type: none"> i- Definition of Shariah Compliance: ii- Significance of Shariah Compliance for IFIs iii- Consequences of Non-compliance iv- Importance of Shariah Compliance for customers v- Charity for income purification
2.	Process of Shariah compliance in IFIs:	<ul style="list-style-type: none"> i) Shariah Compliance framework ii) General measures taken to ensure Shariah compliance <ul style="list-style-type: none"> a) Adoption of Shariah compliance as a culture b) emphasis on staff training c) creating awareness among customers iii) Specific measures for conforming Shariah Compliance
3.	Shariah Advisor's perspective on Shariah compliance	<ul style="list-style-type: none"> i) Importance of the Shariah Advisor: ii) Shariah advisor's responsibilities

4.1. Importance and Attitude of IFIs Towards Shariah Compliance

The results reflected that Shariah compliance was a significant factor for the IFIs and various measures were carried out to make sure by every organization. As discussed below:

i) Definition of Shariah Compliance

The understanding of Shariah Compliance and the definition discussed by the interviewees agrees with Abdullah and Chee (2010). Moreover, the general understanding was that by fulfilling the principles of Shariah means to be Shariah compliant, which is an ongoing process.

ii) Significance of Shariah Compliance for IFIs

The significance of Shariah compliance was discussed and the conclusions depicted that IFIs placed a lot of emphasis on it. It was also evaluated that numerous efforts and steps were taken to adhere to Shariah compliance in the activities of the IFIs. The answers given by the interviewees exhibited the important Shariah compliance for the IFIs. Moreover, all the needed steps were employed.

The findings depict the significance for Shariah compliance in the IFIs. The results agree with Vicary (2005), who stated that the main focus of all IFIs should be on Shariah compliance. Furthermore, it is also in accordance with relevant to Ahmed (2010), IDB, IFSB and IRTI (2007), Haniffa and Hudaib (2007), IFSB, IRTI, IDB (2010), Grais and Pellegrini (2006), and Rusnah (2011), who have discussed that Shariah compliance plays an important role for the IFIs, making it unique from traditional banking.

iii) Consequences of Non-compliance

The consequences of non-compliance were also brought into discussion with the risk associated with non-compliance. All the interviewees held the opinion that it is They considered it to be a grave subject, resulting in various risks such as financial, operational and reputational.

Their views agree with Rusnah (2011), Chapra and Khan (2000) and Ahmed (2010), who have provided the risks associated with non-compliance.

iv) Importance of Shariah Compliance for customers

The viewpoint of customers on Shariah Compliance was also taken from the interviewees. The results discussed different types of customers, from which for one segment Shariah compliance holds immense importance whereas for others it had less importance.

The results exhibit that customers take Shariah compliance as a serious issue and it plays the role of a decisive feature to prefer IFIs. The results are in accordance with Lee and Ullah (2011), who discussed that Shariah compliance is vital for the customers in comparison to other characteristics.

v) Charity for income purification

The charity collected by IFIs comes from various sources, out of which one is non-compliant income, which mainly comes from non-compliant transactions and purification of dividends.

The importance and significance of Shariah compliance is highlighted in this segment. Generally, it can be understood that the findings are in accordance with the previous findings.

4.2. Process of Shariah Compliance in IFIs

The results depict numerous ways and various steps by which IFIs carry out and ensure Shariah Compliance. A proper Shariah compliance framework has been implemented. In addition, few general and specific measures are adopted to ensure Shariah compliance. As discussed below:

i) Shariah Compliance framework

The findings show IFIs have implemented a proper Shariah compliance framework at various levels for their activities. The results are in accordance with Thani (2007), who emphasized on the presence of a Shariah compliance framework.

ii) General measures taken to ensure Shariah compliance

The findings depict that various general measures are adopted by the IFIs to improve and ensure Shariah compliance in the organization, which are discussed in this section:

a) Adoption of Shariah compliance as a culture

It was brought into discussion during the interviews that how is Shariah compliance understood by the IFIs. Is it adopted as a culture or is it responsibility of the management; the results portrayed that it was widely believed to be duty of every employee in the organization to follow and adopt Shariah compliance in the daily activities.

b) emphasis on staff training

The results depicted that the IFIs place a lot of emphasis on staff training. As they considered that a better and trained staff can contribute more towards Shariah compliance.

c) Creation of customer awareness

It was also brought into discussion that customer awareness should also be enhanced in relevance to Shariah compliance, resulting in improvement in the level of Shariah compliance.

iii) Specific measures for conforming Shariah Compliance

Along with general measures, IFIs carry out specific measures too. The results portray that internal Shariah review and audits are carried out by IFIs to ensure Shariah compliance. Moreover, at the time of product design and execution, Shariah compliance is also ensured.

These measures are constant with Musa and Daud (2007), who hold the stance that a proper system should be in place to ensure Shariah compliance. Furthermore, the findings also agree with Rahim (2008), Rusnah (2011) and IFSB (2009). They have classified the process of Shariah compliance into two parts, ex-ante and ex-post. Moreover, it was also assessed that IFIs conduct internal audits, which is in agreement with Rahim (2008). Generally, it can be stated that various energies are being employed by IFIs for Shariah compliance through a comprehensive process of Shariah review.

4.3. Shariah Advisor's Perception on Shariah Compliance

According to the results, Shariah advisors hold a key role for ensuring Shariah compliance in the IFIs. The importance and role were discussed in the interviews. Moreover, secondary sources were also studied.

i) Importance of the Shariah Advisor:

Shariah advisor holds a prime position in the operations and activities of IFIs. The results highlight the importance of Shariah Advisor for ensuring Shariah compliance. Moreover, all necessary steps were taken to ensure proper hiring of a Shariah Advisor. The findings agree with Rammal and Parker (2013), who state that SBP has emphasized on the position of Shariah Advisor and made him the focal point to ensure Shariah compliance in the institution. Moreover, Islamic Banking Department (IBD) of SBP makes sure that proper steps have been taken for the appointment of a Shariah Advisor. In addition, the findings are consistent with Hasan (no date), who states that in Pakistan, Shariah Advisor holds the foremost authority of Shariah compliance.

Though, this fact cannot be ignored that biasness can occur as the Shariah Advisor are not answerable to anyone and most of them are the same since the instigation of the IFIs.

ii) Shariah Advisor's Responsibilities

According to the results, Shariah Advisor is involved in the daily operations and activities, in addition to his other responsibilities. Furthermore, the approval of any new product lies with the Shariah Advisor, before approval from the management. The results are in accordance with the duties and tasks provided by Banaga, Ray and Tomkins (1994).

Additionally, it also agrees with Haniffa (no date), who highlighted the contribution of Shariah Advisor forex-ante and ex-post Shariah governance. For the first part, policy making, and product approval is done, while for ex-post the process of Shariah review is devised. Apart from these duties, Shariah report is prepared and Shariah review is conducted.

5. Conclusion

Globally, Islamic Finance is expanding and giving positive results. It has become an essential part for any economy now. However, the true essence of Islamic banking should not be ignored, and all the

products offered must be Shariah Complaint. The results highlight the contribution of IFIs and SBP for Shariah compliance.

The study faced various limitations also, but the major hinderance was that some Shariah Scholars in Pakistan were not ready to talk on this topic, along with shortage of literature on this topic in Pakistan. However, this study has contributed for literature and can provide a benchmark for other studies. In addition to this, it can help policy makers also.

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