

Shariah Governance of Islamic Financial Institutions (IFIS): An Analysis of the Central Bank of Nigeria (CBN) Regulatory Guidelines

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Abstract. Governance structure of IFIs, as provided by the Central Bank of Nigeria (CBN) guidelines, establishes two levels of Shari’ah board at the upstream and downstream of the Islamic financial industry labeled as Financial Regulation Advisory Council of Experts (FRACE) and Advisory Committee of Experts (ACE) respectively. This work examines the Shari’ah governance structure of the banking industry as laid down in the Central Bank of Nigeria’s (CBN) guidelines with the aim of determining the level of compliance with the guidelines. The work recommends that Policies need to be put in place that would ensure adequate disclosure for ease of retrieval, such as through IFIs’ websites and annual reports, fatwa and Shari’ah pronouncements and other activities of FRACE and ACE to the operative personnel of IFIs and other stakeholders. Informing IFIs stakeholders on the composition, powers, competence, and decision-making of FRACE and ACE would also enhance the transparency of the process leading to Shari’ah pronouncement. The composition of FRACE and ACE should be expanded by adding more members for developing local talents and expertise for effective governance; IFIs should focus on training and development of ACE

members to avoid stagnation and obsolescence within the industry.

Keywords: Shariah, Governance, Islamic, Finance, Nigeria.

1. Introduction

In addition to the conventional financial standards which govern conventional financial institutions, Islamic financial institutions (IFIs) are further governed by *Shari’ah* standards. IFIs operate on the principles of Islamic Jurisprudence and significant number of the stakeholders of the financial system takes part in it because of its Shariah bias. This unique character of IFIs brings about the need to monitor the activities of the operators to ensure that they do not deviate from its core values and principles. It is for this reason that the banks regulatory authority in Nigeria, the Central Bank of Nigeria established and institutionalized levels of Shariah Governance structures at both macro and micro level of the financial industry. Financial Regulation Advisory Council of Experts (FRACE) was established at the regulatory (CBN/macro) level and Advisory Committee of Experts (ACE) at the financial

institutions/micro level. The two organs are known as Shariah Advisory Council (SAC) and Shariah Advisory Board (SAB) respectively in some jurisdictions like Malaysia. Within the micro level of the governance structure of IFIs a subset (internal Shariah Compliant unit) was created to serve as the first point of reference for Shariah compliance issues. The institution of the FRACE and ACE is thus, very crucial to the *Shari'ah* governance (SG) structure of IFIs as authoritative bodies ensuring *Shari'ah* compliance

Albeit, the Governance Structure is not globally straight jacketed; this is because, there is no single model of governance structure that can conveniently suit every country. Thus, each country is expected to develop its own structure that can cater for its specific needs and objectives; provided it complies with accepted standards and the regulatory framework of the particular state or country where it operates.

However, in jurisdictions like Nigeria where IFIs operate alongside conventional institutions, the regulatory institutions need to recognize the requirement for an institutional framework that is consistent with Islamic precepts and can meet internationally acceptable prudential requirements as well as providing a level playing field for both IFIs and conventional institutions in addition to the requirement for compliance with local legislations.

Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) are International Islamic Standards setting institutions. They are so recognized by the Central Bank of Nigeria. Therefore, their standards apply to the Nigerian Islamic finance industry except when they conflict with the local standards issued by Nigerian Accounting Standard Board (NASB) in which case, the local standards prevail. It must be stated that the provisions of the local standards are not intended to supersede the requirement of *Shari'ah* compliance but the motive was uniformity and harmonization. It is also arguable that conformity to NASB standards in case of conflict with international standards does not, on its own, authorize deviation from *Shari'ah* when

its provisions are read together with certain provisions of the guidelines that require all IFIs to comply with the rules and principles pertinent to Islamic finance model, and subjecting their operations to periodic examination and evaluation by internal review and audit unit. Thus, the provisions of the CBN Guidelines on the establishment, structure and role of ACE make the Committee masterpiece and the central tool of *Shari'ah* governance in IFIs.

The paper examines the governance structure of IFIs as provided by the CBN guidelines; although some of the guidelines are still exposure draft. The data used herein include interviews with some ACE members of some institutions and some members of FRACE as well as SEC officials; this is in addition to other primary and secondary sources used. The paper aims at examining the level of their compliance with the existing governance and regulatory regime that are specific to IFIs.

2. Conceptual Framework

IFSB defined SG as 'a set of institutional and organizational arrangements through which IFIs ensure that there is independent oversight of *Shari'ah* compliance over the issuance of *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review'. This definition viewed the concept from the scope of the ACE's role. Although AAOIFI did not define SG, yet its Governance Standards have defined *Shari'ah* Board (SB) as 'an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari'ah* compliance, and issuing legal rulings pertaining to Islamic banking and finance.' A similar definition was given by the IFSB; it refers to SB as 'a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and acting as special supervisors to the institutions.' It is instructive to note that all the definitions given above are tailored towards the role to be played by the ACE in the governance structure of IFIs which centers on *Shari'ah* compliance.

It is deducible from the above that the oversight function for *Shari'ah* compliance is discharge by

the ACE through issuance of *Shari'ah* pronouncements, dissemination of information and *Shari'ah* review. However, such task, which is aimed at achieving vibrant *Shari'ah* compliant industry, is not performed unilaterally or as sole responsibility of ACE but complimented by all other organs of governance within the institutions as a collective responsibility. ACE is expected to play a leading role in that, while it is reasonable of other organs of governance in IFIs to partake in upholding the SG Structure by executing their functions diligently and recognizing the importance of complementing the work of the ACE. Consequently, IFIs should implement SG principles from a comprehensive perspective than viewing it as ACE's business.

3. Legal Framework for SG in Nigeria

The CBN Guidelines for Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria (CBN GRSINFSN) were issued pursuant to the Non-Interest banking enabling Section 33 (1) (b) of the CBN Act 2007; Sections 23(1) 52, 55(2), 59(1) (a), and 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended) and Section 4(1)(c) of the Regulation on the Scope of Banking Activities and Ancillary Matters, No.3, 2010. While CBN Act empowers the Bank to issue guidelines for the regulations of any person or institution under its supervision, BOFIA exempted Profit and Loss (PLS) banks from display of interest rates in the banking hall. Other relevant sections of BOFIA in addition to the general regulatory and supervisory powers, allow the CBN to collect fines imposed by the law for non-compliance with the law and its regulations; to operate to the exclusion of Companies and Allied Matters Act (CAMA) 1990; and to grant operational licence and impose/vary conditions for the grant of such licence.

The guidelines are to be read together with the provisions of other relevant sections of BOFIA 1991 (as amended), the CBN Act 2007, Companies and Allied Matters Act (CAMA) 1990 (as amended) and any other circulars/guidelines issued by the CBN from time to time.

It is in exercise of these series of powers within the various banking and financial regulatory laws that the CBN established *Shari'ah* Advisory bodies for both itself and for all institutions offering Non-Interest financial services in the country.

4. Islamic Financial Institutions (IFIs) in Nigeria

The guidelines did not define IFIs but made reference to Non-Interest Financial Institutions (NIFIs) operating under the principles of Islamic Commercial Jurisprudence. NIFI means a bank or Other Financial Institution (OFI) under the purview of the CBN, which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services based on established non-interest banking principles of profit and loss sharing in accordance with Islamic commercial jurisprudence. The reference to NIFIs under the CBN guidelines means:

- i. Full-fledged Islamic bank or full-fledged Islamic banking subsidiary of a conventional bank;
- ii. Full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank;
- iii. Full-fledged Islamic microfinance bank;
- iv. Islamic branch or window of a conventional bank;
- v. Islamic subsidiary, branch or window of a non-bank financial institution;
- vi. A development bank regulated by the CBN offering Islamic financial services;
- vii. A primary mortgage institution licensed by the CBN to offer Islamic financial services either full-fledged or as a subsidiary; and
- viii. A finance company licensed by the CBN to provide financial services, either full-fledged or as a subsidiary.

Islamic finance includes Islamic banking and insurance, Islamic capital and money market. Therefore, IFIs encompasses all institutions

within the finance industry that are operated based on Islamic commercial jurisprudence. However, this paper is limited in scope to IFIs under the regulatory purview of the CBN; therefore, the article would limit its search light to the institutions listed in the CBN guidelines as captured above except where the context demands otherwise. It is instructive to note that so far, only the 1st, 3rd and 4th category of the institutions on the above list have been granted license by the CBN to operate non-interest banking in Nigeria. But the article focuses only on the 1st and the 4th institutions on the list.

5. Branding in IFIs in Nigeria

Researches undertaken by Central Bank of Nigeria (CBN) and National Insurance Commission (NAICOM) indicated significant religiously based objections to conventional finance structures. Given the increasing number of requests from persons, banks and other financial institutions desiring to offer financial products and services based on Islamic commercial jurisprudence in Nigeria, the CBN, NDIC and NAICOM have developed SG framework for the regulation and supervision of IFIs.

In 2010 the CBN released guidelines on SG for NIFIs and issued another guideline for the operation NIFIs in 2011. The new guidelines are the outcome of the review of the earlier guidelines issued based on the recommendations of various stakeholders. Both Guidelines provided for the establishment of ACEs. In the earlier Guidelines ACEs were referred to as *Shari'ah* Advisory Council at the regulators level (the CBN) and *Shari'ah* Advisory Committee (SAC) at the institutions' level. The new guidelines changed the nomenclature of labeling ACEs from *Shari'ah* Advisory Council and *Shari'ah* Advisory Committee (SAC) to Advisory Council of Experts which is referred to as Financial Regulation Advisory Council of Experts (FRACE) at the regulators level and Advisory Committee of Experts (ACE) at the institutions level.

Takaful Company is required to have, as part of its registration requirements with NAICOM, a name that should include such word or terminology that connotes *takaful* operation.

However, Islamic banks are not allowed to use certain words or terminologies like Islamic, Quranic etc. except with the consent of the Governor of CBN. IFIs shall, however, be recognized by a uniform symbol designed by the CBN. The symbol may not necessarily be such words like Islamic or *Shari'ah*. All the signage and promotional materials of its products and services shall bear the symbol to facilitate recognition by customers and the general public. Jaiz Bank Plc.; Stanbic IBTC Bank and Starling Bank that were issued license by the CBN to practice Full-fledged Islamic bank and Islamic windows of conventional banks respectively, have no such words or terminologies like Islamic or *Shari'ah* except in their products and services. Insertion of provisions into the Nigerian laws restricting the use of religious words/phrases in the branding of banking is with the aim of establishing a level and a common playing ground for both IFIs and conventional institutions.

In line with this understanding reference to *Shari'ah* Advisory in the initial guideline issued was reviewed and based on the recommendations of various stakeholders the nomenclature was changed to ensure that discrimination on any grounds in the participation by individuals or institutions as promoters, depositors or other relevant parties in any transaction regarding IFIs is discouraged and prohibited. Thus, the internationally recognized nomenclature for the Shariah Advisory Council (SAC) and Shariah Supervisory/Advisory Board (SS/AB) are FRACE and ACE respectively in Nigeria.

6. Governance Structure in IFIs in Nigeria

The *Shari'ah* governance (SG) in IFIs is structured by institutionalization of FRACE at the central and macro level, thus FRACE is the central *Shari'ah* governing body established at the CBN level with the powers of oversight functions on the IFIs, and its central role is advisory. Meanwhile, the advisory power of FRACE does not end at the CBN level; it is empowered to advise other regulatory agencies within the Islamic finance industry. Although, the advisory role is not automatic, it is based on referral by the particular agency concerned.

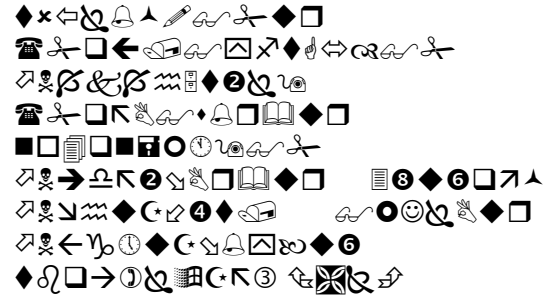
Therefore, it can press one to argue that the guidelines place FRACE as the central body in the industry irrespective of their classification and categorization. Thus, FRACE is the body responsible to resolve differences of opinion not only among different ACEs of IFIs and their members but across the whole industry.

FRACE is vested with the responsibility of screening and legalizing new products and services by endorsement and validation of application documents certified by ACE. To endorse the application, the ACE needs to give written juristic opinion and approval as a *prima facie* compliance of the products and services with the provisions of Islamic commercial jurisprudence. The responsibility of screening new products and services is a serious task which requires not only the knowledge of *fiqh al-mu'amalat* but also knowledge and skills in conventional finance given the pluralistic nature of the industry.

At the micro level, IFIs as part of their governance structure are required to establish ACE to ensure compliance with *Shari'ah* in their products and instruments development, operations, practices and management subject to the FRACE supervisory powers. This is an exclusive peculiarity of IFIs. The establishment of ACE as the center piece of SG in IFIs is an utmost necessity to determine its compliance with *Shari'ah*. This is because ACE is the checkmating body which ensures that the institution is governed in accordance with *Shari'ah*. It has been established that the operation of IFI without ACE leads to gross flouting of rules and noncompliance to the *Shari'ah*.

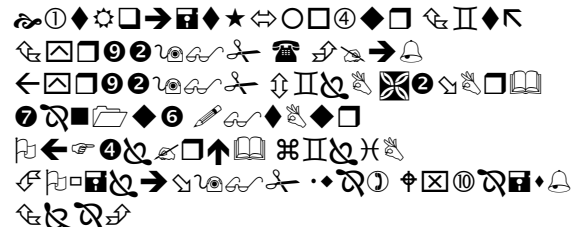
Because of the need to constitute competent and independent ACE for effective governance, the law sets a standard for required number of members as a minimum composition of ACE. The ACE is constituted with a minimum of three members while FRACE is constituted with a minimum of five members. The rationale behind the higher number for the constitution of FRACE is in the high volume and complexity of its functions as compared to ACE's functions and responsibilities that are limited to an institution. AAOIFI and IFSB set a standard of

three members as the minimum constitution of *Shari'ah* boards. It has been opined that higher number of ACE members is a determinant factor for effective governance, taking advantage of collective wisdom, higher credibility and surer independence. The strength in collective decision borne out of diverse experience expected from a Shariah board is epitomized in the Quran where Allah (SWT) says:



and those who answer the call of their Lord [i.e. to believe that He is the Only one Lord (Allâh), and to Worship none but Him Alone], and perform As-Salât (Iqâmat-as-Salât), and who (conduct) their affairs by mutual consultation, and who spend of what we have bestowed on them.

In further recognition of the need to arrive at excellent decisions, the guidelines allows ACE to engage the services of consultants who have expertise in the field of business, economics, law, accounting or any other field that will assist it in making informed judgment on the compliance of IFIs' products and services to *Shari'ah*. This provision exhibit the Muslims candor of humility in knowledge by which no scholar, however knowledgeable should claim its monopoly and recognizing that all knowledge belongs to Allah as He expressly declared:



and they ask You (O Muhammad) concerning the Rûh (the Spirit); say: "The Rûh (the Spirit): it is one of the things, the knowledge of which is Only with My Lord. and of knowledge, You (mankind) have been given Only a little."

Such consultants may attend meetings but shall not exercise voting right when giving a *Shari'ah* opinion. Therefore, the engagement of firm of consultants in discharging the duties of ACE would enhance the quality of its decisions to reach the status of excellence described by the Prophet (SAW) in the following tradition:

إن الله يحب إذا عمل أحدكم عملاً أن يتقنه

Certainly, Allah loves that when any of you does a work, he should perfect it.

The IFSB recommends that Shariah board should be comprised of members who are trained in different schools of jurisprudence with *Shari'ah* expertise and different lengths of experience, and where appropriate, comprise of different nationalities. This idea of having members of mix expertise and experience on the Board is premised on the need for having a consistent supply of highly competent and qualified members that would create adequate time and opportunity to grooming a new group of people who can acquire the relevant competence and experience.

Certainly, the best way of achieving this is through a mentoring system whereby the more experienced members can guide and supervise the less experience ones. The more experienced members, due to their high reputation and experience and because of scarcity of *Shari'ah* talents, will usually have a lot of other commitments such as serving on other Boards. Hence, in terms of time allocation, it is likely that the less experienced members can dedicate more time to studying the issues and proposals for deliberation at the Board, thus allowing an efficient and effective learning curve between the two. The combination of different caliber of experience and expertise would nurture a better balance between experience and fresh ideas, which would likely facilitate innovations as well as harmonization throughout the Board's deliberations.

Although the guidelines on the governance of ACE and FRACE did not make suggestion of mixed nationality and school of thought in its composition yet, it is desirable that ACE should be comprised of members of other different

nationalities. However, this should be done in a way to promote the development of local talents and expertise. Indeed, such composition enhances and develops local talents and expertise, but it may attract additional cost on the market players, particularly the IFIs that have just taken off in the Nigerian finance industry. despite the fact that the CBN guidelines did not provide for mix nationalities in FRACE and ACE, examination of their composition reveals that the industry is amenable to the idea.

One of the duties of the CBN and NIFIs for ensuring good SG is provision for continuous training and professional development opportunity to FRACE and ACE members respectively. While the CBN have proven record of developing FRACE members by sponsoring them to conferences, workshops and seminars within Nigeria and outside, none of the NIFIs has sponsored its ACE members to attend a single workshop or conference. It is therefore expedient for the CBN to monitor the NIFIs compliance with these provisions of the guidelines which serve as a gateway to developing local talents and expertise as well as having qualitative output.

7. Relationship between ACE and the BOD of NIFIs

The relationship between the ACE and the Board of Directors (BOD) of IFIs is although described by IFSB as contract for service; the provisions of the ACE guidelines make the relationship to appear as contract of service. The Black's Law Dictionary define contract for service "service contract" as contract to perform a service; especially a written agreement to provide maintenance or repairs on a computer product for a special term. However, the Supreme Court of Nigeria in *Iyere v. Bendel Feed and Flour Mill Ltd.*, held that contract of service is contract of employment where it says: "A contract of employment connotes a contract of service or apprenticeship, whether express or implied, and if it is express, whether it is oral or in writing.

The difference in the two types of contract above is appreciated when comparing the level

of influence an employer has on how an employee does the work he is employed to do and how a service provider like ACE members would ordinarily carry out his function independently. The ACE guidelines concentrate the powers to appoint ACE, determine the remuneration of its members and terminate their appointments in the BOD. The BOD is also required to make the remuneration at a level commensurate with the expected duties and functions of the ACE. These powers place the BOD on the status of an employer and the ACE on the status of an employee of the BOD.

The reporting relationship between the ACE and the BOD of IFIs requires an establishment of a mechanism that should be operated conveniently and efficiently, in order to obtain from the ACE rulings which will ensure true *Shari'ah* compliance. IFIs are required to refer all Shariah related issues to the ACE and implement the latter's decision and advice. The ACE on the other hand is required to directly report to the BOD of IFI while maintaining dotted reporting line relationship with the MD/CEO. All cases of non-compliance with principle of Islamic banking shall be recorded by ACE and reported to the BOD with recommendation for appropriate remedial measures. In case the *Shari'ah* non-compliance is not effectively or adequately addressed or no remedial measures were taken by the IFI, the ACE shall inform the CBN. These provisions are intended to bar the institution from *Shari'ah* and reputation risk that may break the growth and sustainability of the institution. However, they raise a serious issue on the independence of the ACE and possibility of sustaining their independence in such situation of conflict. A more appropriate and transparent process for resolving any differences of opinion between the BOD and the ACE include having direct access to the shareholders as a "whistle-blower" in addition to informing the CBN.

The employer and employee relationship of the BOD and the ACE also raises a concern on the institutions' possible inclination to appoint ACE that would be sympathetic to their business interests. An employee cannot be hostile to his employer, unless an end to the relationship is

intended. Thus, the aim of the reporting relationship may not be achieved as it cannot be operated conveniently and efficiently under the present arrangement. Some international best practices recommended avoiding undue influence and compromise of ACE decisions through avoidance of all forms of fiduciary relationship between the ACE members and the NIFIs, their members and shareholders.

All financial institutions, whether conventional or Islamic, play a role in society. Hence they are expected to be responsive to the different needs of stakeholders. However, IFIs due to their *Shari'ah* background and identity are expected to be more socially responsible than their conventional counterparts whose operations and functions are primarily based on profit maximization. The existence of ACE within the institutions' governance structure guides the BOD in shaping the institutions towards not only socially responsible investments but also observance of other ethical standards which are only possible with independence of the ACE. Reputational risks which would be occasioned by unduly influencing the oversight function of the ACE by the BOD would make the institutions unsustainable in the long run. Therefore, the ACE and BOD relationship should be restructured for independence of the ACE from the influence of the management and the BOD. ACE is not a hindrance to the management; rather it is the steward of the very identity of the institution.

8. Relationship between FRACE AND ACE

The guidelines define the relationship and working arrangement between the ACE and the FRACE. The relationship is regulatory and supervisory; the activities of ACE as regards, particularly the ex-ante and the ex-post operations are subject to ratification by FRACE. It is observed that the centralization of the relationship is aimed at checkmating the operations of IFIs for effective SG structure. This necessitates referring conflicts of opinions among members of the ACE to FRACE for ruling.

The guidelines presumed a situation of divergence of opinion on a matter between ACE and the FRACE, in such circumstance, the opinion of the FRACE shall ultimately prevail. However, the scenario of conflicts between ACE and FRACE is not a comparable scenario. FRACE is a supervisory body; therefore, the ACE decisions are subject to ratification by FRACE. Conflicts of opinion between ACEs or between Central ACEs of other financial sectors' regulatory bodies, such as between NAICOM and SEC, should have been the scenario, whereas FRACE is the body that has the final say in resolving the conflicting opinion. The scenario can be subsumed by the provisions of the guidelines where it allows FRACE to give opinion to other regulatory agencies of the financial sector.

The relationship of FRACE and ACE promotes convergence of SG standards within the industry. The supervisory and regulatory powers vested on FRACE centralize SG whereby IFIs' operations have to be Okayed by the FRACE through their ACEs. It could be argued that, the empowerment of FRACE to give expert opinion and assistance on matters referred to it by all the regulatory agencies in the financial sector, which include Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), NAICOM and PENCOM is aligned to centralized SG in all the sectors of the industry. This is a step towards harmonization of (*fatawa*) Shari'ah rulings in the Nigerian IFIs. Moreover, this may serve as a panacea to the problem of divergence of *fatawa* in other areas of life that need collective *Ijtihad* to arrive at the *fatwa*, particularly on matters of collective concern to the Muslim community in the country.

9. Internal Shariah Compliance Unit (ISCU)

An Internal Shari'ah Compliance Unit (ISCU) of NIFIs is responsible for verifying whether Shari'ah compliance requirements have been satisfied, and any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified. *Shari'ah* pronouncements and resolutions issued by the ACE are to be strictly adhered to and observed. The ISCU is therefore manned by someone or

some people adequately trained in *Shari'ah* compliance review and auditing, with good grasp of the process for full compliance.

The ISCU is part of the IFIs' compliance team, it is established to function in strengthening internal SG structure and report to the ACE where appropriate. The ISCU reports should require and recommend to the management of the IFIs to address and rectify any issue of *Shari'ah* compliance.

The task of dissemination of information on *Shari'ah* pronouncements and resolutions of the Shariah Board is undertaken by ISCU. The unit is equipped with appropriate compliance-monitoring skills and relevant knowledge of the *Shari'ah*. The staffs of the Unit are expected to combine the skills of Islamic finance and conventional finance. They are to acquire the relevant and appropriate training to enhance their *Shari'ah* compliance review and auditing skills and serve as the first point of reference for *Shari'ah* compliance issues. The Unit is to be separated from and independent of the business units and departments. The Unit works in full cooperation with ACE and provides the ACE with the necessary information, including the internal *Shari'ah* compliance reports, to advise on the scope of audit and reviews required.

CBN guidelines require that all IFIs must have an internal review mechanism that ensures compliance with *Shari'ah*. The unit may also serve as the secretariat to the ACE. The appointment and removal of members of the unit shall be appropriately carried out in consultation with the ACE.

The wordings of the guidelines requiring the establishment of ISCU signifies that its establishment is mandatory. The law also requires production of internal *Shari'ah* compliance reports for digestion by ACE in order to appreciate the areas that should be reviewed for *Shari'ah* compliance. *Shari'ah* compliance report of IFIs is also required to be made accessible by the public. This would build reputation and open a way for development. While the IFIs have complied with the guidelines in part by institutionalizing the

compliance unit, they have not yet prepared *Shari'ah* compliance report for circulation and accessibility to the stakeholders and the general public.

10. Shari'ah Review and Auditing

Maslaha of the *Ummah* (welfare of the Community) is the key objective of *Shar'iah*. The *Maslaha* relates to the affairs of *Ummah* both in this world and the hereafter as oppose to the goal of conventional finance industry that is built mainly on maximization of profit. In lined with *Maslaha* principle, IFIs need to appoint and elect ACE consisting of competent persons on *Shariah* affairs, it shall be responsible for liaising with the BOD to ensure that ex-ante and ex-post operations of the industry are based on *shari'ah* compliant guidelines. However, it is a fact that, the scarcity of *Shari'ah* talents is one of the major challenges of Islamic finance industry globally, thus, lack of skilled and competent *Shari'ah* auditors is not an exception to the current *Shari'ah* talents phenomenon. Malaysia, a country that prides itself as the hub of the industry is still facing the challenge of lack of enough *Shari'ah* officers who are both skilled in *Shari'ah* as well as auditing.

The *shari'ah* audit pillars SG framework of IFIs by providing independent assurance to IFI's diverse stakeholders on matters related to IFI's operations which include products development and services delivery. This effectively ensures that IFIs are operating strictly within a *shari'ah* based operating environment. *Shariah* audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *Shariah* compliance.

Auditing is a specialized discipline that branches out from accounting. The concept consists of two pillars; auditor who undertakes the responsibilities of attesting that the organization being audited has operated within the prescribed pre-agreed rules, standards or regulations and the organization itself. Audit covers areas that are not limited to financial, management and

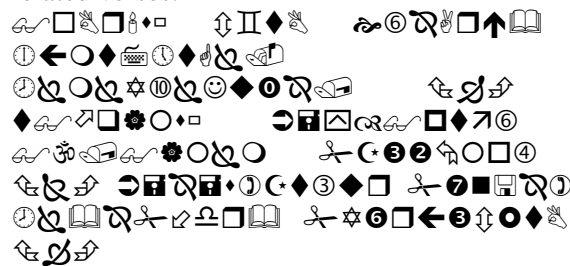
performance audit. Various definition of audit were proffered particularly in relation to the conventional financial audit, the American Accounting Association (AAA) defines auditing as: "A systematic assessments of evidences regarding economic events and to ascertain the correspondence of the two and communicate the results to interested users". For the International Federation of Accountants (IFAC) auditing is: "An independent examination of financial statements or related financial information of an entity whether profit or not, irrespective of its size, or legal form, when such examination is conducted with a view to expressing an opinion thereon". The definitions proffered above are based on conventional auditing philosophy. However, they can be tailored towards achieving the objectives of *Shari'ah*. This is because, financial statement of IFI can be examined with the aim of expressing an opinion as to whether the process has complied with *Shari'ah* or not.

Audit process is usually performed at auditee's premises where the auditor will comprehensively assess systems and records of the auditee for accuracy and validity. The process involves analyzing firm's relevant risks as well as identifying system's loopholes and subsequently recommending the necessary controls. These functions cannot be performed without having understood the client's business processes and environment. In the financial audit, auditing activities and the independent expression of audit opinions practically adds credence to the financial statements produced by firm's management. Accordingly, this helps building confidence among financial statement users in relying on the audited financial statements to make appropriate and relevant decisions. Conventional auditing is primarily guided by professional standards called the International Standards on Auditing (ISA) issued by IFAC through the International Auditing and Assurance Standards Board (IAASB).

Shari'ah based auditing is seen as a new concept, the earliest being after the emergence of IFIs few decades ago. The Islamic history however explains the reverse whereby the institution of *hisbah* was noted to have been established during the time of Prophet

Muhammad (Peace be upon Him) to perform functions similar to the contemporary auditor's. The aim was to establish an institution for the purpose of enjoining good and forbidding evil in general as oppose to the modern auditing focusing specifically on economic and commercial activities. It forms an integral part of wider effort in establishing just economy in the society. Therefore, the contemporary role of the *Shari'ah* auditor resembles the role of *muhtasib* (*hisbah* administrator) in the traditional *hisbah* institution in the early period of Islam. The *muhtasib* audits and checks on compliance and subsequently suggests recommendations on worldly matters from *Shari'ah* perspective.

Auditing has been justified by various verses in al-Qur'an. The followings are several audit related verses:



then, as for Him who will be given his record In his Right hand, He surely will receive an easy Reckoning, and will return to his family In joy!

Although the verse focuses on accountability and reward in the hereafter where people would be rewarded or punished based on the audit outcome. However, its interpretation can be extended to financial auditing since one is enjoin to conduct all his affairs in accordance with *Shari'ah*. In the same vein, Umar (RA) cautioned on the need to examine ones affairs internally before he would be call for examination by the creator when he said:

قال سيدنا عمر رضي الله عنه: "حاسبوا أنفسكم قبل أن تُحاسبوا، وزنوا أعمالكم قبل أن توزن عليكم، واعلموا أن ملك الموت قد تخطاكم إلى غيركم وسيتخطى غيركم إليكم، فخذوا حذركم."

"Judge yourselves before you are judged. Evaluate yourselves before you are evaluated. And remember that death isolate you to overtake others as he will isolate others to overtake you. Be ready for the greatest investigation, the day of Judgment" Umar Bin Khattab (RA)

In the context of Islamic financial system, *Shari'ah* audit represents a system of checkmating and evaluating the operations of IFIs for *Shari'ah* compliance. The notion of sanction and reward in the system comes in the form of public perceptions of whether the public perceives its performance as negative or positive as well as confidence towards the *Shari'ah* based products offered by the IFIs. The AAOIFI and IFSB on the other hand use the term *Shari'ah* Audit and *Shari'ah* review interchangeably without further categorization. The rationale for auditing is to ascertain SG in the institution concerned.

Shari'ah audit is a distinctive feature of the Islamic Finance system from its conventional counterpart, by which the role of certifying the validity and enforceability of Islamic financial contracts adopted is undertaken. Such role, which is established as a further requirement to the existing conventional governance system, does not exist in the conventional industry. Thus, *Shari'ah* audit forms an integral structure to the internal governance mechanisms of IFIs by providing the necessary supervision and monitoring towards the whole spectrum of IFI's operations.

One of the impediments for development of SG structure is the situation of having auditors ingrained with secular capitalist philosophy but unlettered in *Shari'ah* to audit IFIs on matters relating to *shari'ah* compliance. Perhaps the most observable problem in *Shari'ah* auditing is the lack of expertise and human talent to perform *Shari'ah* audit. Auditing on IFIs must ideally be done by auditors trained in accounting and audit, as well as having the necessary knowledge in *fiqh al-muamalat*. Recent survey conducted in Brunei reveals the fact that the existing compliance structure in IFIs is alarmingly inadequate to address the issues of *Shari'ah* compliance. It was argued that the reliance on internal *Shari'ah* review alone provides little assurance to IFI's customers on the entity's compliance level towards *Shari'ah* rulings in their operations.

ACE as part of its responsibilities must assist the internal audit of IFI on *Shari'ah* Compliance

Audit. *Shari'ah* Audit, in Islamic finance, is closely related to *Shari'ah* review save that whereas, Shariah Audit is periodic while Shariah Review is regular. The latter as been described as regular assessment on Shariah compliance in the activities and operations of the IFI by qualified Shariah officer(s), with the objective of ensuring that the activities and operations carried out by the IFI do not contravene with the Shariah.

Therefore, the responsibility of ACE in assisting internal audit for *Shari'ah* compliance is complimentary to the ACE's responsibility of upholding *Shari'ah* within the industry. These are tools that are installed as checks and balances to ensure compliance with principles of Islamic Commercial Jurisprudence.

11. Shari'ah Opinion and Advice

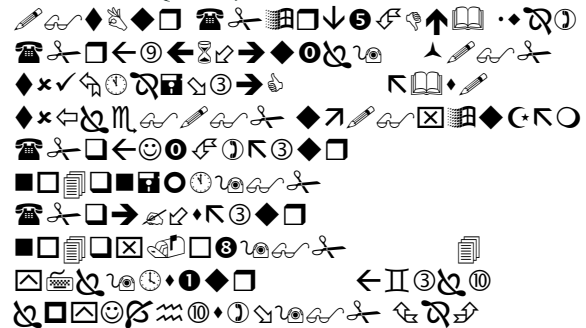
The role of ACE is primarily advisory in nature; it should advise the IFIs, through their BOD and management on Islamic jurisprudence-related matters so as to ensure Compliance with principles of Islamic Commercial Jurisprudence at all times. The advisory responsibilities of ACEs are at the institutional/micro level and no more.

The ACE has the responsibility to review and endorse internal policies and guidelines related to the principles underpinning Islamic finance. In the course of discharging the responsibilities, ACE shall make a periodic review of products and services to ensure that operational activities and transactions of the institution are made in accordance with the principles of *Shari'ah*. It is expected to endorse and validate relevant documents for new products and services upon their review with the aim of making an opinion of whether they comply with the principles of Islamic Commercial Jurisprudence or not. The process include; scrutiny of the terms and conditions contained in the forms, contracts, agreements or other legal documentation used in executing the transactions, the product manual, marketing materials, sales illustrations and brochures used to describe the product or service.

ACE must ensure that the necessary ex-post considerations are observed after the product

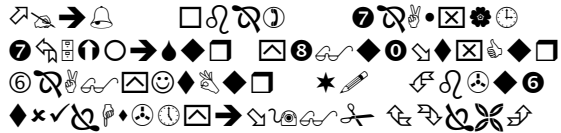
offering stage, namely the internal *Shari'ah* review processes, Shariah auditing and *Shari'ah* compliance reporting. This is in order to monitor the IFIs' consistency in compliance with the principles of Islamic finance and to effectively manage *Shari'ah* compliance risk that may arise over time. This means that the responsibilities of *Shari'ah* review and compliance reporting include not only ex-ante process of the products and services but include ex-post also.

The ACE should develop certain principles and policies and issue recommendations on how the IFI could best fulfill its social role. Thus, ACEs are not only expected, as a matter of responsibility, to promote and develop Islamic finance industry but are further expected to fulfill social roles. This has clearly strikes a line of distinction of this model from conventional finance. Islam requires a man to discharge not only personal responsibility but social as well in addition to the grand primary responsibility of *ibadah* (worship) to God. This has been clearly stated in al-Qur'an;



and they were commanded not, but that they should Worship Allâh, and Worship none but Him alone (abstaining from ascribing partners to him), and perform As-Salât (Iqâmat-as-Salât) and give Zakât: and that is the Right religion.

The verse spelt out the spiritual and mundane roles required of a man. Giving *Zakat*, though, is a spiritual duty, yet, it is also a social responsibility of, particularly, the rich to the poor. Therefore ACE is expected to express its informed opinion on both operational issues as well as social responsibilities of NIFIs. Compliance with *Shari'ah*, whether in spiritual or mundane affairs, is obedience to the command of God. To this effect Allah says:



Say (O Muhammad): "Verily, My Salât (prayer), My sacrifice, My living, and My dying are for Allâh, the Lord of the 'Alamîn (mankind, jinns and All that exists).

12. Shar'ah Pronouncements and Resolutions

Shari'ah pronouncements and resolutions, *Fatwa*, refers to juristic opinion on any matter pertaining to *Shari'ah* issues in Islamic finance, given by ACE. Once it is decided that a *Shari'ah* pronouncement and resolution should actually be implemented, it becomes a *Shari'ah* ruling *hukm al-Shar'i* with full legal effect that binds the IFIs. It is imperative for the ACE to make it clear to the IFIs whether it is issuing a resolution, recommendation or other remarks, so that there will be clear understanding of ACE's instructions, thus facilitating appropriate implementation of the instructions. The binding legal effect of a *Shari'ah* pronouncement and resolution is also subject to the relevant national legal and regulatory framework. However, in practice, the *Shari'ah* rulings are implemented by embedding them into the legal documentation of Islamic financial transactions; hence, they would generally bind the contracting parties, including the institution.

A *Shari'ah* pronouncement and resolution shall be issued only through appropriate due processes, which, amongst others, should involve rigorous deliberation among members of the ACE over any proposed *Shari'ah*-compliant products or transactions that require a *Shari'ah* endorsement, as well as detailed scrutiny of the legal contracts and other documents relevant to the products or transactions. The disclosure of the process leading to *Shari'ah* pronouncement and related information needs to be fully made as it forms part of the structure of SG. This is to build confidence on the governance structure. However, despite the clear provisions of the guidelines on this matter, information asymmetry problem still exist because of lack of disclosure.

13. Dissemination of Information

Dissemination of information on *Shari'ah* pronouncements and resolutions to the operative personnel of the IFIs who monitor the day-to-day compliance with the *Shari'ah* pronouncements and resolutions vis-à-vis every level of operations and each transaction is an important part of SG structure. Such a task would normally be undertaken by a designated ISCU, or at least a *Shari'ah* compliance officer who is part of the IFIs compliance team. The IFIs are required to equip their ISCU with the appropriate compliance-monitoring skills and relevant knowledge of *Shari'ah*. This is achievable by assembling a team of staff with the two different skill-sets. IFIs should also ensure that the ISCU is separate and independent from the business units and departments. Proper dissemination of information in SG structure builds the bridge that strengthens the fiduciary relationship between the institution and its customers as well as other stakeholders. It guards against reputational risk, *Shari'ah* risk and pools public confidence.

14. Conclusions and Recommendations

It has been established from the foregoing that IFIs in Nigeria have strived to comply with the structural requirement for SG as provided under the CBN guidelines in terms of establishing ACE and other Shariah compliance units. However, they have not performed to the expectation in some operational requirements. These include, lack evidence of training and development of ACE members and inadequate disclosure of the activities of the ACE and the Shariah compliance level of the institutions which leads to information asymmetry. Lack of accessibility to necessary Shariah compliance information not only by the public but also many stakeholders themselves portends a great confidence risk to the institutions. Although the CBN is showing leadership in the training and developing FRACE members but it needs to take go further to ensure that NIFIs also follow its steps in this direction.

The guidelines for the governance of FRACE and ACE issued by the CBN are a good start for the establishment of SG structure in the banking industry. However, their periodic review is

expedient in order to remedy the noticeable lacunae within them. This include lack of clear principles to forestall the possibility of the BOD appointing people who would serve their business interest and thereby jeopardise the integrity of the Committee and credibility of their decisions and pronouncements. Also, the ACE guidelines in particular, need to provide for convenient mechanism to secure the independence of ACE, especially when there is disagreement between it and the BOD. This will ensure that they give their opinion and insist on its implementation without being afraid of losing their contract for service.

On the whole, CBN guidelines have succeeded in centralizing *fatwa* process in the finance industry in the country and laid foundation for harmonization of *fatawa*. This was achieved by making the CBN FRACE the highest *fatwa* making authority with powers to attend to referrals from the FRACE of other regulatory authorities within the sector and the finality of its *fatwa* in case of disagreement.

In view of the above conclusions, it is recommended that policies should be put in place to ensure adequate disclosure of the activities of ACE with ease of retrieval, such as through IFIs' websites and annual reports. FRACE and ACE governance guidelines should be review to adopt international best practice like blocking all fiduciary relations to ensure transparency in the appointment process and treating ACE contract as "contract for service" not "contract of service", with whistle blower status, to secure their full independence. The composition of ACE should also be expanded by adding more members for developing local talents and expertise for effective governance. CBN should put pressure on NIFIs on the training and development of ACE members to avoid stagnation and obsolescence within the industry.

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