External Shari'ah Audit Report

This is one of three Shari'ah-governance-related news items in this issue, as well as features on the subject. All, at least in part, call for the strengthening of external Shari'ah audits. Underlying these calls is a tacit assumption that as long as the matter of Shari'ah compliance is kept behind closed doors, there is a danger that Islamic financial institutions may be fudging the issue of Shari'ah compliance. This may or may not be true, although we suspect that the answer lies somewhere in the middle with some organisations beyond reproach and others being less than honest about Shari'ah compliance. The problem is that any failures to observe the letter and the spirit of the Shari'ah by a few tend to create a lack of trust in all Islamic financial institutions. This will do nothing to help the growth of the Islamic finance industry and therefore any attempts to encourage greater transparency and openness are to be welcomed.

The Islamic Finance Council UK (UKIFC) and the International Shari'ah Research Academy (ISRA) chose the Global Islamic Economy Summit in Dubai to launch a report, compiled from consultations with 35 practitioners in four countries, calling for stronger Shari'ah assurance and for external Shari'ah audits to be made mandatory in Islamic financial institutions around the world.

The report says that the current practice, where in-house boards of scholars self regulate Shari'ah compliance, brings into question the fitness of this model. The suggestion is that all Islamic financial institutions should be audited annually by independent and competent external auditors. The report also contains a jurisdictional analysis of current external Shari'ah auditing requirements in Oman and Pakistan, where it has already become mandatory. (As a later item in this section indicates, Bahrain is about to make external Shari'ah audit manadatory.) Implementation issues, the role of central banks, requirements for public reporting, the qualifications of external auditors and the need for a professional body for Islamic scholars are also covered.

Omar Shaikh, UKIFC

Commenting on the report, Omar Shaikh, Advisory Board member of the UKIFC said, 'Ensuring and maintaining the integrity of the Shari'ah is paramount to sustaining future confidence and growth in the Islamic finance sector. By providing an additional check, external Shari'ah audit will play an important role in providing reassurance to scholars, financial institutions and customers.'

IMF Question Current Governing Framework for Islamic Banks

In early 2017 the IMF published a report, *Ensuring Financial Stability in Countries with Islamic Banking*, which says that the current governing framework for Islamic banks 'contains many gaps that need to be closed through the development of a more comprehensive enabling environment that ensures IB (Islamic Banking) financial stability and sound development.' While acknowledging that only accounts for a small share of global banking assets, it points out that it has become systemically important in 14 of the 60 countries where IB is established.

In particular it points to the shortage of high-quality, liquid assets. It says that this has made it difficult for Islamic banks 'to manage liquidity, interact with central banks and develop money markets.' It suggests that 'international guidance and the active participation of the relevant authorities' are needed to increase the issuance of sukuk and other liquid instruments.

It also draws attention to the risk posed by hybrid products, which it describes as products that 'replicate aspects of conventional finance in an IB context.' The IMF believe these products pose new complex risks including reputational risk; they bring into question the applicability of existing prudential regimes and raise governance and consumer protection issues.

Lack of Shari'ah-Compliant Liquid Instruments – A Concern in Pakistan

In mid November Pakistan's *The News International* carried an interview with an unnamed banker expressing concern about the lack of liquid instruments to enable them to meet the requirements of the central bank's statutory liquid ratio (SLR). The central bank requires Islamic banks to maintain an SLR of 19% through their holdings in sovereign sukuk, but recently there has been a dearth of such sukuk issuance. This could force Islamic banks to hold cash at 0% with the central bank or be penalised for having holdings in non-SLR instruments.

In the longer term such a situation could compromise the Pakistan government's target of having Islamic banking assets reach a total of 20% of total banking assets by 2020. The problem is that to issue sukuk the Pakistan government needs assets to back up any sukuk issuance and, according to the *The News International*, there is a shortage of such assets, so the government is being forced to raise money from the international capital markets.