SHARED RISK & REWARD

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Improving Shari'ah Audit Transparency

The UK Islamic Finance Council and ISRA released an insightful analysis, "Enhancing Shari'ah Assurance" looking at the areas where Islamic finance could improve the process of Shari'ah certification, audit and disclosure (you can request a copy from IFC).

The report covered briefly the issue of Islamic financial institutions' purification of non-Shari'ah-compliant activities, where incidental income from non-Shari'ah-compliant sources or penalty fees collected to ensure timely payment by customers is identified and donated in a way that does not benefit the IFI, either directly or indirectly.

The report identified that "the disclosure of purifications and charitable disbursements is limited" and suggested that the Shari'ah audit should include testing of both the identification of non-Shari'ah-compliant income and its distribution. This is much broader than just whether the IFI recognizes the penalty fees as income or not.

The review should identify "the nature of the charities supported and their social impact", confirmation that management has not benefited from the disbursement and identification of whether the charities are 'related parties' (e.g. they have close connections with the management of the IFI).

I think this is an important recommendation and the degree to which the Shari'ah review is documented and made available for scrutiny by investors, customers, and the broader public will provide greater confidence in the oversight of Islamic financial institutions.

There are genuine (and some not genuine) critiques of how IFIs handle non-permissible income and whether there are ways that the disbursements could provide hidden benefits for the IFI and its management (the report mentions using the penalty income for sponsorship, where the institution would receive non-monetary benefit from the additional publicity).

This may seem nitpicky, but there are important rationales behind more intense scrutiny of the use of non-Shari'ah-compliant income by Islamic financial institutions, and it is easier to put in tough rules ex ante than it is to clean up the damage caused if an IFI were to be found using non-permissible income for its (or its management's benefit). Additional disclosure is required as well to allow for comparison between the review practices between IFIs and also provide assurance that the audit process was conducted with sufficient rigor.

Until next week,
Blake Goud

Reading List

UK Islamic Finance Council and ISRA: Enhancing Sharia'ah Assurance (request a copy here)

Shari'ah Auditor Qualifications (Shared Risk & Reward [pdf])

ISRA Exec Dir on Shari'ah board governance (Sharing Risk)

Blog Posts This Week

Islamic finance may be tapped by European companies shut out of the markets by the debt crisis

On balance, arbitration including Shari'ah experts is positive for Islamic finance

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