Sharia Supervisory Boards (SSB) in the U.S. and Islamic Corporate Governance (ICG)

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Abstract

Islamic finance, is a branch of Islamic Economics (IE), that is currently growing and evolving. Adl and Qist are core polices that are essential to the proper function of Islamic finance and thereby set the stage for Sharia compliant Islamic Corporate Governance (ICG). Analyzation of the proper organizational formation related to corporate governance is the focus of the following discourse. In addition, the role of Sharia Supervisory Boards (SSB) within countries who participate in the Organization for Economic Co-operation and Development (OECD) is discussed and compared to historic and current practices in the United States.

Keywords: Islamic corporate governance; Sharia; Boards; Islamic economics

Research Type: Theoretical

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Introduction

Justice is at the heart of the structure of Islamic economics philosophy. Thus, terms denoting justice are an important part of this philosophy. Etymologically speaking, there are two main terms that are used in the Arabic language to denote justice: *adl* and *qist.* Adl, is a legal set of qualitative rules that organize society to insure equality. Qist is the application of justice, it is a share of measurable objectives, or non-subjective quantitative answers to situations or questions. Examples of the differences between qist and adl can be seen in the following verses from *Sura Al-Nahel*, from the Holy Quran.

"*Indeed, Allah orders adl (justice) and good conduct and giving to relatives and forbids immorality and bad conduct and oppression. He admonishes you that perhaps you will be reminded"* (16:90).[1]

"*O you who have believed, be persistently standing firm in qist (justice), witnesses for Allah, even if it be against yourselves or parents and relatives. Whether one is rich or poor, Allah is more worthy of both*.

So, follow not (personal) inclination, lest you not be adl (fair). And if you distort (your testimony) or refuse (to give it), then indeed Allah is ever, with what you do, acquainted (Know)" (4:135).[2]

Qist is a concept that deals with specific quantities or shares that can be measured. In the Holy Quran, the word qist is used to denote measurable quantity. A derivation of qist is, *aqssat,* the word for installments. Obviously, installments describe a specific amount that is measurable. Moreover, *qistas* is the actual tool to measure a quantity for a balance. The following are clear examples of the qist used to indicate measures:

"*And observe the weight with qist (share of equity) and do not make the balance deficient"* (55:9).[3] "*And weigh with the qistas (true share) and straight balance*" (26:182).[4]

Therefore, with respect to Islamic finance, a branch of Islamic Economics (IE); or, when setting policies for Islamic Corporate Governance (ICG), adl is the legal definition of equality, and qist is the measurable definition of applied justice to equity.

The goal of the IE system is to structure a just economy. This includes the marketplace and all transactions that involve dealings that result in ownership. The core of Islamic Economics is balance of equality in opportunities, equity and ownership. It is a system where real justice is achieved through measurable means to accomplish an economic equilibrium. This system is in sharp contrast to the exploitation of labor found in capitalism and the oppressive policies of ownership that Communism dictates. Both systems lack just income distribution based on contributions. In contrast, Islamic Economics is a system of social and societal just

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[1] Holy Quran Sura Al-Nahel (16:90)

[2] Holy Quran Sura Al-Nisa (4:135)

[3] Holy Quran Surah Al-Rahman (55:9)

[4] Holy Quran Surah Al-Shu'ara (26:182)

distribution based on private capital and labor. Note, it is not only equal distribution found in Socialism, but just proportional distribution based on real productivity, not nominal, moral and ethical wealth, driven by greed and hoarding. Thus, the elements of productivity in Islamic Economics are: capital, labor, and risk.

All rulings of Islamic jurists, Fiqh of transactions and dealings (moamallat) have to adhere to this philosophy to practice applied IE. Although many of these rulings are simple and straight forward, such as the prohibition of gambling; others will require a deep understanding of macro and micro economics that applies the important sub-branch of Fiqh; termed the Fiqh of eventual results (or Fiqh al Mallat).

For the purpose of this paper, only one area of IE related to corporate governance will be the focus: the analyzation of proper organizational formation. This system is built on private property ownership. It supports enterprise and entrepreneurship monitored by setting a higher moral standard for private wealth to pursue growth and capital preservation.

The advisory role of the jurists within IE is to provide independent checks and balances, assuring proper adl and measurable qist. Shari'a committees or Shari'a Supervisory Boards (SSBs) were introduced for participants (agents) who desire or require a fiduciary body to oversee implementation of these measurable Islamic standards in trade and business conduct.

The SSBs are comprised of a dual board or 2-tier board system-- conventional board and SSB. Conventional board of directors, are usually elected by shareholders or appointed by owners. The SSB is usually engaged through legal contracts. These Sharia Scholars, or jurists, are then hired by the board of directors to ensure proper Islamic conduct with dealings (transactions) and new products. This continuation of Islamic compliance practice, acts as a sale driven claim for marketing and publicity.

However, at times this relationship can be a conflict of interests where the hiring entity is part of the agency that is working from the prospective of different goals, profits. To circumvent this dilemma, in Malaysia, for example, SSBs by design were mandated, to be fully independent from any influences by the board of directors and the shareholders.[5]

To further resolve conflict of interests, a dispute resolution mechanism was introduced so that when disparate interests arise between the public and the institution, an independent third-party scholar is called upon to solve such events. This third party is an added layer of corporate governance, to assure the public trust in this unique 2-tier structure.

However, despite the initial intention of the third-party resolution mechanism, an alarming practice of SSBs has been systematically evolving. The formation of this body as a publicity stunt, or marketing gimmick-- by forming them based on well-known celebrated names

that in general lack a comprehensive understanding of their responsibility beyond transactions and product development (i.e. Islamic Corporate Governance, or ICG). This observation is

[5] Shari'a Audits, Malaysia Central Bank, Mohammad Bakr

found to be mainly true upon close examination of a sample of SSBs in the United States as compared to great advances elsewhere.

The focus of Islamic Corporate Governance (ICG) is Maqasid al Shariah.[6] It is generally accepted that the Maqasid are followed when the Fiqh maxims are followed. There are 322 Fiqh maxims that are well documented amongst jurists from different disciplines.[7] Many of them apply to micro transactions (Moamallat) based on sound Islamic contracts. When examined, the Maqasid emphasis is supposed to be the protection of the stakeholders, not only the marketability of an institution. The main mandate is the protection of shareholders' value or wealth second to public interests. In reality this protection should extend to all stakeholders of any given business, product or service, and any transaction that is directly or indirectly influencing wealth in an economy. The next section will introduce some background on principles of Corporate Governance.

The Organization for Economic Co-operation and Development (OECD)

The governments of the OECD countries, approved a revised version of the OECD's *Principles of Corporate Governance* adding new recommendations for good practice in corporate behavior with an emphasis to rebuilding and maintaining public trust in companies and stock markets. The revised principles respond to a number of issues that have in recent years undermined the confidence that investors have in company management. Stockholders have called on governments to ensure genuinely effective regulatory frameworks and on companies themselves to be truly accountable. They advocate an increased awareness among institutional investors, and an effective role for shareholders in executive compensation. They also urge strengthened transparency and disclosure to counter conflicts of interest.

The goal of corporate governance is to provide institutions with a body of rules and principles. The objective is that good practices will guide overall management of institutions. This has now come to imply that the whole process of managing a company, includes the incentive structure to address principal-agent issues; ensuring that in the long-term, executive management serves the best interests of the shareholders by creating a sustainable value of companies in conformity with the laws and ethics of the country.

All of the complex factors that are involved in balancing the power between the Chief Executive Officer (CEO), the board, and the shareholders are now considered to be a part of the corporate governance framework, including auditing, balance sheet and off- balance disclosure, and transparency. Hence, corporate governance refers to the method by which a corporation is directed, administered and controlled. It includes the laws and customs affecting company direction, as well as the goals for which it is governed. Corporate governance mechanisms, incentives and controls are designed to reduce the inefficiencies that arise from moral hazards and adverse selection. Corporate governance is also viewed as a process of monitoring performance by applying appropriate counter-measures and dealing with transparency, integrity and accountability. It organizes the way corporations

[6] Bhatti and Bhatti, Objectives of Islamic Law, 2009

[7] Mohammad Al-Zuhayli, *The Fiqh Maxims*, 2006

are accountable to shareholders and the public, as well as the monitoring of the executive management of organizations in running their businesses.

To be Shariah compliant corporate governance must follow Islamic norms. The following historic details are necessary to understand the general global practice to identify what is termed *orf,* or norms, which are based on an Islamic maxim of *aladah muhakimah*. Norms can set a ruling unless it is haram.

Historic Details

The OECD Principles of Corporate Governance, first published in 1999, have been widely adopted as a benchmark both in OECD countries and elsewhere. They are used as one of 12 key standards by the *Financial Stability Forum* for ensuring international financial stability; and by the World Bank in its work to improve corporate governance in emerging markets. In 2002, OECD governments called for a review of the Principles to take into account recent developments in the corporate sector. The OECD began the review of the principles in 2003. After an extensive review, the process led to the adoption of the current revised OECD principles of corporate governance in April 2004.

The revised text is the product of a consultation process involving representatives of both OECD and non-OECD governments, as well as of businesses, professional bodies, trade unions, civil society organizations, and international standard-setting bodies. In addition, the principles not only reflect the experience of OECD countries, but emerging and developing economics. The revised principles are non-binding in nature. It is up to the governments and market participants to decide on their own framework.

The revision confirmed the adaptability of the principles as a reference in varying legal, economic, and cultural contexts. "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spell out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance".[8]

The following are the main areas of the OECD principles and their annotation:
Principle 1: *Ensuring the basis for an effective corporate governance framework*. Annotation: The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

Principle 2: *The right of shareholders and key ownership functions*. Annotation: The corporate governance framework protects and facilitates the exercise of shareholders' rights.

Principle 3: *The equitable treatment of shareholders*. Annotation: The corporate governance

[8] Hussein Elasrag. "Corporate Governance in Islamic Finance: Basic Concepts and Issues." May 26, 2014, https://mpra.ub.uni-muenchen.de/56872/1/MPRA_paper_56872.pdf

framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunities to obtain effective redress for violation of their rights.

Principle 4: *The role of stakeholders in corporate governance*. Annotation: The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Principle 5: *Disclosure and transparency*. Annotation: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

Principle 6: *The responsibilities of the board*. Annotation: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and board's accountability to the company and the shareholders.

The main theme of the above principle lies in four basic principles. First, the mechanism of business ethics, secondly, the mechanism of decision making, third, in adequate disclosure and transparency, and lastly, the mechanism of book keeping and final accounts.

These OECD principles are so sound that even the non- members of OECD are implementing and adopting them.

The soundness of these principles has been proven by their adoption all over the world. Researchers have defined corporate governance in a variety of ways; the most widely cited definitions follow. The OECD defines Corporate Governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance *also provides the structure through which the objectives of the company are set,* and the means of attaining those objectives and monitoring performance are determined" [9] This definition provides important attributes of CG and emphasizes transparency, however, it does not directly deal with the intrinsic issue of the business objectives that should guide the distribution of rights and responsibilities within the corporation. Indeed, the objectives of a corporation's founders', whether these be the increase of shareholders' value or the pursuit of stakeholders' interest, can be expected to affect such a distribution and shape the institutional structure and systems. In particular, the distribution of rights and responsibilities among shareholders and other stakeholders would be driven by the interests of whoever establishes the corporation, and subsequently controls it.

The revised principles emphasize the importance of a regulatory framework in corporate governance that promotes efficient markets, facilitates effective enforcement, and clearly defines the responsibilities between different supervisory, regulatory, and enforcement authorities. They also emphasize the need to ensure transparent lines of management responsibility within companies so as to make boards and management truly accountable.

[9] Elasrag, "Corporate Governance in Islamic Finance: Basic Concepts and Issues," 2014.

Other issues addressed by the revised principles include institutional investors.

i. Disclosure of corporate governance policies, decisions on the use of voting rights and how conflicts of interest are managed that may compromise voting.

ii. Restrictions on consultations between shareholders about their voting intentions should be eased to reduce the cost of informed ownership.

Shareholder Rights

i. The rights of investors must be strengthened. Shareholders should be able to remove board members and participate effectively in the nomination and election processes.

ii. Shareholders should be able to make their views known about executive and board

remuneration policy and any equity component should be subject to their approval

Conflicts of Interest and Auditor Responsibility

i. A new principle calls for rating agencies and analysts to avoid conflicts of interest which could compromise their advice.

ii. The duties of the auditor must be strengthened and include accountability to shareholders as well as a duty to the company to exercise due professional care when conducting an audit.

iii. Auditors should be wholly independent and not be compromised by other relations with the company.

Stakeholder Rights and Whistle-Blower Protection

i. The Principles make reference to the rights of stakeholders, whether established by law or through mutual agreements.

ii. A new principle advocates protection for whistleblowers, including institutions through which their complaints or allegations can be addressed and provides for confidential access to a board member. [10]

The Normative Function

The stakeholder theory is one of the few theories that deal with CG. Agency theory is the predominant theory; covering organizational management and business ethics that addresses morals and values in managing an organization **7**. The normative approach to stakeholders' theory, identified as the core of the theory, examines the function of the

[10] Elasrag, 2014.

corporation and identifies the "moral or philosophical guidelines for the operation and management of the corporation" [11]

The Normative Function approach identifies the proper function when applied to SSBs, as the most effective approach accompanied by other management approaches such as the instrumental approach. It is inherent that the focus of management is to add value to its shareholders. Conversely, the focus of SSBs is primarily the community, who are considered the **normatively legitimate stakeholders.** SSBs are supposed to independently identify practices that influence these specific stakeholders foremost. This function, when understood by SSBs, adds more responsibility and duties to the members of an SSB to clearly understand the overall strategy, and the measurable results of the institution to carry out its mission in compliance. In addition to jurists, this task requires the Islamic Financial Institutions (IFIs) and the SSB in particular, to be structured to include independent scholars and experts. It is important for the individual institution to understand that good corporate governance can make a world of difference. It facilitates access to external finance, especially when the corporate governance structure clarifies and creates enforceability of investor rights.[12]

The Current Practice

Due to its presumed independence, SSBs are not a standard setting body in itself, but rather assist other regulatory and standard setting organizations in establishing and maintaining good governance practice among IFIs, unlike conventional board of directors. It should be noted that SSBs are committees of Islamic scholars. Therefore, among one of its many jobs is to verify the new products presented by IFIs comply with Shari‘a. These scholars' functions in SSBs are similar to members of boards in conventional corporations (i.e. they are not employed by IFIs but receive honoraria), and they have the right to be members of Shari‘a boards in different IFIs simultaneously. The latter is noted as there are few dozen countable Shari‘a scholars who are familiar with both Islamic law and modern financial needs in the world. Although the numbers of such scholars are growing, they still lag behind the growth of the finance industry's need in having the necessary advice by other scholars to explain the complexities of today's marketplace.

The first ever Shari‘a board was established by Egypt's Faisal Islamic Bank in 1976 and soon other IFIs followed this example. Today, law requires Shari'a boards of IFIs, in the majority of Islamic countries. However, even when the law does not require it, established. Shari‘a boards have become an important part of IFIs to ensure proper practice by the agency.

Recently, many economists and others have criticized Shari'a boards in particular for being part of weak corporate governance or agency theory problems in IFIs. This is mainly because of the lack in dealing with conflict of interests. To tackle these kinds of problems, Malaysia -- the first country in the world to have regulated scholars-- limits each member of a Shari‘a board to a maximum of three IFIs simultaneously at the onset of their term, and later, one seat

[11] Thomas Donaldson and Lee E. Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications." *Academy of Management Review*: Academy of Management, (1995).
[12] Wafik Grais and Matteo Pellegrini, "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options*." World Bank Policy Research Working Paper 4052*, November 2006.

per bank and one per Islamic insurance firm. As of yet, this restriction has not been applied to firms in the stock market.

Malaysia first passed laws regulating SSBs in 1984. In fact, no IFI entity is allowed to operate without establishing an SSB. In 1989, Malaysia went even further by establishing a central SSB under the auspices of the Bank Negara Malaysia (the Malaysian Central Bank). Twenty years later, two types of Sharia boards are in operation; a national board under the Malaysian Central Bank, and a second Shari'a board under the regulatory body of the stock market. Decrees by the King of Malaysia appoint board members for the national board.

Under the second type agency, SSB Shari'a audits are monitored by multi-independent boards on two different levels. The Malaysian law goes further and gives the regulators the right to approve any member of an SSB, including foreign members. The law also obligates any declared Shari'a opinion that passes as a resolution on the SSB level to be published to the public.[13] It should be noted that many of these remarkable changes came as a result of the 1997-1998 Asian economic crisis and financial scandals abroad, such as the famous Enron debacle.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards have defined Shari'a boards' duty as directing, reviewing and supervising the activities of the IFIs in order to ensure that they are in compliance with Shari'a principles. AAOIFI standards have also made it mandatory for all IFIs to elect their Shari'a board members through the shareholders annual general meeting upon the recommendation of the board of directors, taking into consideration local legislation and regulations. Furthermore, the standards states that these members should not be chosen from among directors and majority shareholders of the IFI. Maintaining and formalizing the internal regulatory role of Shari'a boards is considered vital as these internal bodies are best placed to assist their individual organizations in achieving Shari'a compliance, and thus play an important role in the overall regulatory environment. [14]

Factors Influencing the US IFIs

The current practice in the U.S. falls short in this functionality due to two main factors. The first factor is the lack of oversight by the SSB to review general practices or products; at best, jurists review a sample of the data provided by management. The second factor is the wide gap in communication between jurists and other scholars in the field (i.e. economists and other academics) to explain the complexities of macro and micro issues that are related to the U.S. market, and provide proper analysis to the SSB members. A case in point to illustrate this functionality, or lack of, is the issue of banking where conventional banks operate based on interest-based financing. Conversely, Islamic institutions seek interests-free risk sharing funding.

Conventional banks are not supposed to own investments, and Islamic funding is supposed to structure many transactions based on partnerships. This leads to the engineering

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[13] Mohammad Bakr ,*Shari'a Audits*, Malaysia Central Bank.

[14] Elasrag, 2014.

of products (in line of Islamic funding) that provide quasi-financing products under the name of Islamic banking. The real operation of these institutions is partnering, leasing, or trading based on real cost plus, and not covert lending. Thus, the proper functionality is funding real investments and real trades where the funding mainly is provided from investors not depositors; without any hint of guarantees on deposits provided, as seen in conventional banking.

From the management viewpoint, the naming of this operation as a bank is marketable, and can be done based on a **promise** to exercise due diligence. However, this due diligence is the responsibility of the manger (agent), and it is for the SSB to accept the claim and approve this promise has been fulfilled in general terms and practice. This acceptance is usually done at an annual meeting. This quasi self-regulated Islamic practice can only be challenged when a dispute arises, and a third-party jurist is called as an independent counselor to issue a binding opinion. Research has shown that institutions seek to appoint SSB members who will provide consensual opinion to their practice. And to exasperate the conflict, they are actually finding some who are more than willing to provide this practice.

Although regulators in every region are getting more effective in enforcing strict rules and laws of industry related conduct, the missing piece in all of these efforts in the U.S. is a regulated SSB. Much needed work is being presented throughout the industry where more and more standards and regulations are met. However, in general SSBs still lag behind. The standard practice of a functional SSB is still lacking an independent audit by the SSB. There are several indications that press this conclusion; one indication is the many board seats that are held by few scholars, who lack language skills to conduct their own analysis. Added to this is lack of experience in the U.S. marketplace, and the necessary knowledge to understand the macro picture.

This paradigm then elicits the following questions:

When do these members actually do the monitoring? What are the free and independent mechanisms employed to carry an audit? Who is carrying the audits? What level of transparency is practiced where the stakeholders are informed? What is the quality of the data that is being collected and shared? Is there a risk of trade secrets that are being shared in different boards that present a threat to stakeholders' value? Why do the same members hold these positions for many years without evaluations? Is there a level of complacency by management? Why are many positions are held cross-continents where there are regional scholars that can better serve? How much knowledge and familiarity of the different localities is needed to carry these functions that are different from one marketplace to another? What type of continued education is currently in place for members of SSBs relevant to each marketplace? What is the standard to determine compensation for these members?

Legal Framework

Most importantly though, good corporate governance needs (measurable) mechanisms in place to ensure compliance with the principles expressed through regulatory action and corporate charters. Companies strive to assure their shareholders that they intend to comply with their own standards by creating compliance boards and designating oversight responsibilities to specific directors. Regulators also get involved with ensuring companies are complying with the rules and regulations set by the policy makers. A robust legal system is also vital to ensuring compliance. Shareholder litigation in the United States has served a critical role in defining corporate governance standards for American corporations and in motivating directors to comply with minimum standards. Providing stakeholders, a mechanism to air grievances against errant directors creates an environment where directors are more likely to comply with established standards of corporate governance.[15] The SSB covers five main areas: "[1] ensuring compliance with overall Islamic banking fundamentals, [2] certifying permissible financial instruments through *fatwas*, [3] verifying that transactions comply with issued *fatwas*, calculating and paying zakat, [4] disposing of non-*Sharia* compliant earnings, and [5] advising on the distribution of income or expenses among shareholders and investment account holders."[16]

Few marketplace participants openly expressed lack of understanding to this process and were challenging the need for it. One practitioner in the U.S. said, "We only message the data to the members of SSB and the public on as needed basis." Another said, "There is neither a need nor a desire to have a functioning SSB once we have reached a certain market share."

Another issue is the premise of managing transactions and issuing products based on few Shari'a compliant contracts. There are few contracts that are usually involved to operate an IFI business. These contracts vary between partnerships agreements and agency agreements. The main premise of these institutions to investors, which is the source of funding, is based on a fiduciary promise to adhere to best practices to manage risks. This promise or *wa'd* is general in nature even if it clearly stipulates legal understandings, unless the SSB has access to information independently, and can analyze related data this promise can be violated by management without

any monitoring unless challenged by an investor or (depositor) at a later stage. It is apparent that the instrumental approach which uses empirical data to identify the connections that exist between management (the agent) to stakeholder groups, and the achievement of corporate goals (most commonly profitability and efficiency goals) is needed to be able to measure the success of the agent separately by the SSB. This should be done in coordination with financial audits.

What mechanisms are in place to measure the success of the SSB as a fiduciary if any of these contracts are violated for the lack of monitoring management? If it is a normative approach only, then only the definition of adl can be applied. The definition of qist is left up to management or the agent solely to define and achieve. We see this clearly in the excessive fees that are charged by management on these contracts (i.e. Mudarabah fees) in the

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[15] Emily Samra. "Corporate Governance in Islamic Financial Institutions." University of Chicago Law School: Chicago Unbound (2016). https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1019&context=international_immersion_program_papers.

[16] Nasser Saidi. *Corporate Governance in Islamic Finance*. Accessed 2012. http://nassersaidi.com/wp-content/uploads/2012/08/Corporate-Governance-in-Islamic-Finance-Islamic-Wealth-ch33-FEB-2009.pdf.

marketplaces.

There is also a lack of clarity when applying risk analysis and related higher fees than normal to the consumer for instance.

In light of the Baker & Griffith's 2010 research, another point that requires separate research, is the issue of moral hazard being insufficiently addressed in the formation of SSBs, which as a result, is not addressed by D&O insurers in the United States.[17] It is, however, necessary to ensure that the moral hazard is optimally addressed and that the incentives for careful acts of management from liability law continue to be retained as much as possible.[18] Attracting qualified SSB members to accept joining an SSB is an important point to underscore. Emily Samra's *Corporate Governance in Islamic Financial Institutions 2016*, has addressed this need.

Conclusion and Recommendations

More empirical data, in adherence to the mandate, needs to be provided to SSBs that will offer quantifiable results. For example, assume a credit union for narrow banking is launched for the community in X region, the SSB should be analyze a parallel set of data. This is the core of its responsibility other than profitability--data that is more of an Environmental, Social and Governance (ESG) focus, in addition to traditional data to be declared in compliance. Data, demographics, environment and policy, are the core of the Wa'd contract to be fulfilled to the stakeholders. More attention should be given regarding the criteria for forming these boards.

It should not be left to the agency to decide the formation of the SSB. Management (agent) may resist new measurable standards based on cost, where this is a legitimate reason then a third-party agency should be employed to have the final decision.

Many board members boards have redundancy in skills and knowledge. Therefore, where there are five or six members of the same skills, management should replace duplicate sets of skills by replacing with multiple sets of expertise. Another reason that might be used as a pretext to resist change, is the issue of the scarcity of scholars who possess the needed knowledge and skills. This is not substantiated by any real research or studies, and can be solved by introducing members of different backgrounds to each SSB. This can facilitated where a board has three or more members one should be a jurist, one a lawyer and the third an academic in related fields.

Institutions are contracting members based on name recognition by the public to establish credibility. While SSBs are supposed to be established based on credibility, it is clear that there is an emphasis on name recognition over functionality and substance, which presents moral hazard issues. Moral hazard relates to the 'post-decision' (hidden action) by the agent,

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[17] Tom Baker and Sean Griffith. *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation*. Chicago: University of Chicago Press, 2010.

[18] Weterings, Wim. "Directors' & Officers' Liability, D&O Insurance and Moral Hazard:More Control of Moral Hazard by D&O Insurers Needed to Increase the Incentives of Directors and Supervisory Board Members." *Tilburg Law School* (September 27, 2012). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2153129.

where it has consequences of information asymmetry when forming an SSB. As a result, this presents adverse selection problems of hidden information, and will certainly lead to future marketplace issues.

Due to the lack of regulation in the U.S., it is recommended, that for the time being, a carefully selected board of directors, when truly elected by the shareholders, should be given the authority to select SSB members. This might eliminate much of the management influence on this formation as a method to improve the 2-tier system. Indeed, this calls for a strong board that has cultivated strategic and functional understanding of the role of management and a viable SSB. However, the few market participants in the U.S. market are privately owned and operated and will take much more effort to educate. This represents a challenge where an independent body of scholars has to take steps to educate these IFIs or entities that make the public claim of Shari'a or Islamic ethics compliance. For example, a recommended entity could be *The Assembly of Muslim Jurists of America* (AMJA) or a committee of academics.

Islamic corporate governance must have clearly defined responsibilities and expectations for SSB members disclosure and transparency requirements, well-defined shareholder rights and mechanisms, both internal and external, to ensure compliance and hold board members accountable.[19] In addition, SSBs have to have present a clear mandate to stakeholders and measurable standards so that their performance can be reviewed. Further they must be independent and not showmen carrying rubber stamps to fulfill management goals.

According to Hawkamah's, *Policy Brief on Corporate Governance for Islamic Banks and Financial Institutions in the Middle East and North Africa Region*, (2011)[20] only 30% globally are currently independent.

In addition, SSBs members should not serve on the boards of similar business line to protect crucial proprietary trade and financial information.[21] A member serving on an Islamic mortgage company's SSB should not serve on the SSB of an Islamic bank, and a member of money management company's SSB should not be serving on a public equity hedge fund' SSB. The Malaysian case study can serve as helpful standards and practices in this regard.

It is recommended that SSB members must to have relevant expertise and knowledge base of the marketplace that they are serving. It is crucial that an SSB continuing education program is designed and implemented be well documented to ensure it is up to date encompassing an awareness of changes in the marketplace and at the regulatory level. The level of transparency to stakeholders has to be updated and shared in a timely basis. Any sensitive issues that may lead to material changes to the interests of the stakeholders should be shared with the SSB, and with any related parties that are directly affected by the event. This information should be accompanied by an interpretation by management and an independent party (if relevant) to help the stakeholders make proper decisions. It is

[19] Emily Samra. "Corporate Governance in Islamic Financial Institutions." University of Chicago Law School: Chicago Unbound (2016).

[20] Hawkamah, *Policy Brief on Corporate Governance for Islamic Banks and Financial Institutions in the Middle East and North Africa Region*, (2011), https://www.lw.com/thoughtLeadership/corporate-governance-for-islamic-banks-in-mena.

[21] Emily Samra, (2016).

imperative to bring these changes to the marketplace in order to achieve a practice that is based on just equality and measurable equity to the industry to protect the stakeholders from any future events that might prove to be adverse. When applying these standards, it will be beneficial to seek Directors &

Officers (D&O) liability insurance that offers directors and supervisory board members ample protection against directors' and officers' liability. This insurance should be extended to SSBs members as well.

Previously mentioned, there is a widely held belief that there are not enough scholars out there to fulfill the demand for SSBs. It should be pointed out that there are not any studies to support this claim. Looking once again to the Malaysian solution that forced the IFIs to provide training and education platforms to introduce more scholars and experts. In the Malaysian case, this claim by the IFIs was simply rejected and over the last decade the IFIs notion proved to be more of a fallacy. Islamic colleges in the U.S. can provide the much-needed education to preparing future SSB members to fulfill these roles in coordination with industry associations in the U.S.

Finally, it is critical for IFIs to recognize the changes in GC, especially with the ESG standards. When it comes to sustainability ESG factors are becoming the norm and are measurable. These central factors of environmental, social and governance provide the latest measurable ethical impact of any entity, IFIs can adhere to this standard based on the new orf in the marketplace, and provided an applied Islamic contribution to the current discourse.

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