

ISRA

International Shari'ah Research
Academy for Islamic Finance
الأكاديمية العالمية للبحوث الشرعية في المالية الإسلامية

Shariah Governance of Islamic Finance and Takaful Industry

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Introduction

- ▶ Shariah compliance **is the backbone of the operation** of Islamic financial institutions (IFIs) **as it gives legitimacy to their products and practices.**
- ▶ Shariah governance is structured to **ensure strict Shariah compliance in Islamic financial practices.**
- ▶ Many countries have developed their own SGF. Malaysia, as global Islamic finance hub, **has attempted to develop comprehensive Shariah governance framework** that **would guide and govern the Shariah aspects of Islamic finance industry.**

Corporate Governance

“Governance exists in order to translate the wishes of an organizational owners into organizational performance” -John Carter

Owner's
Wish

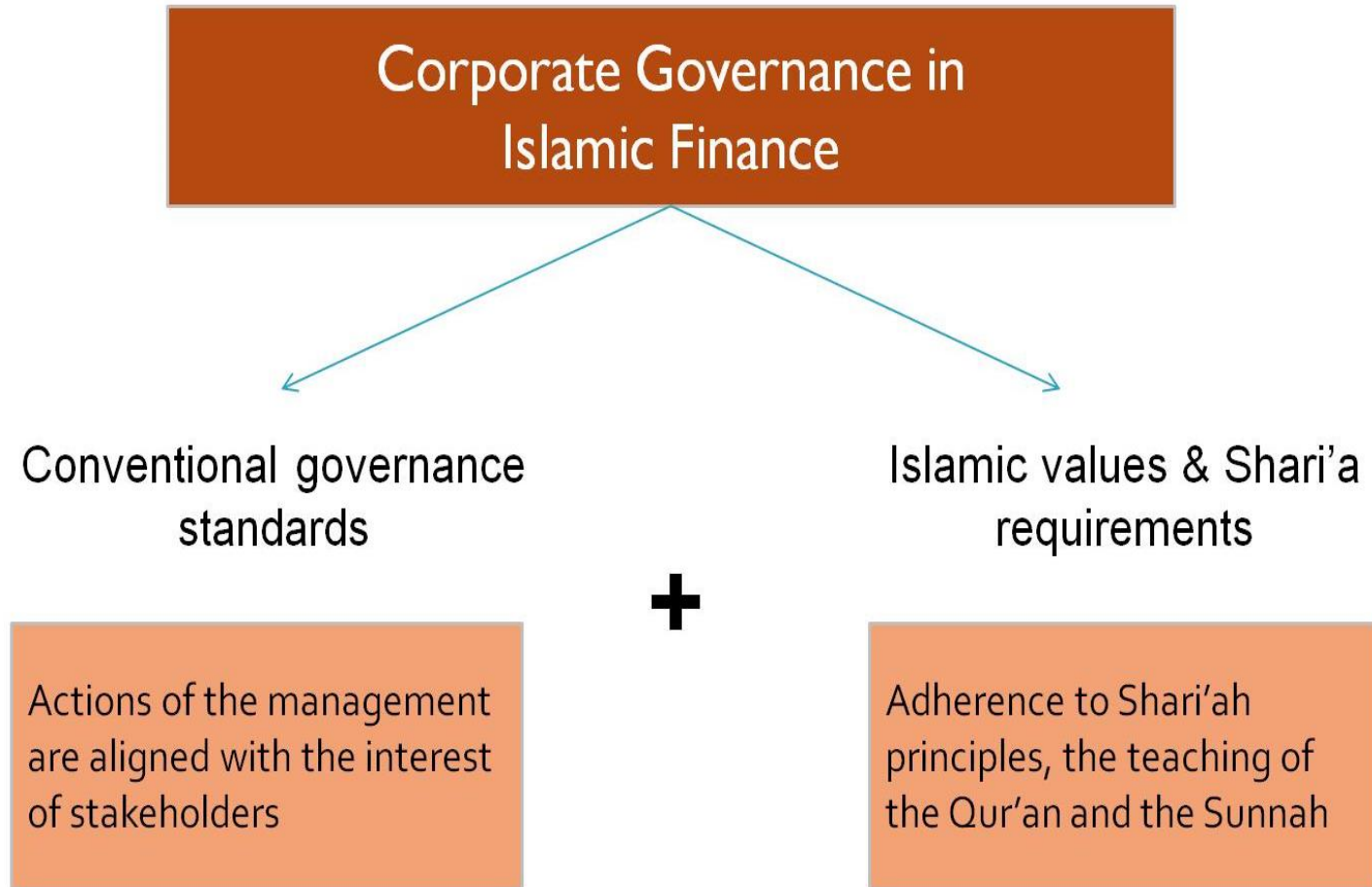
Board of
Directors

CEO

Staff

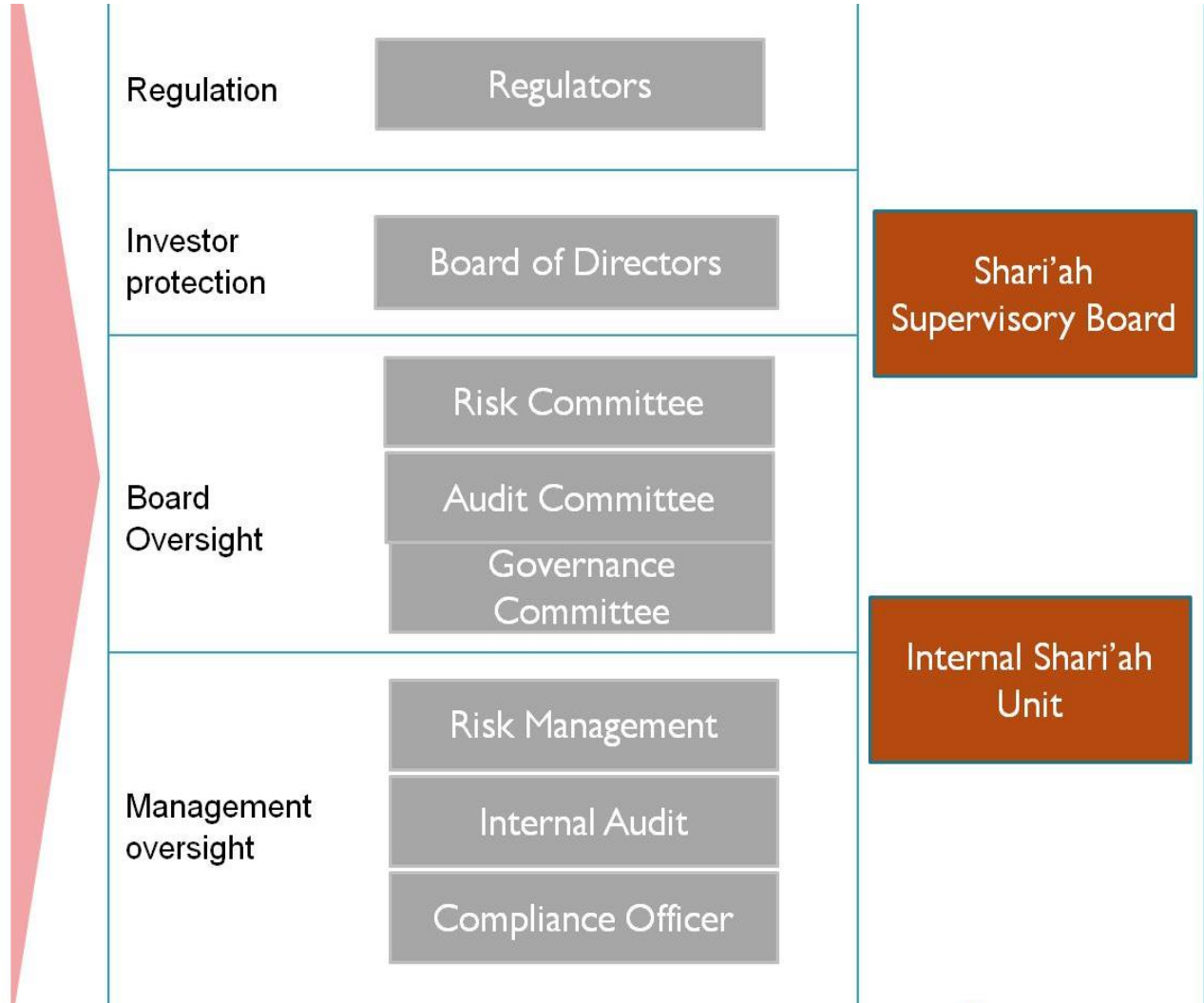
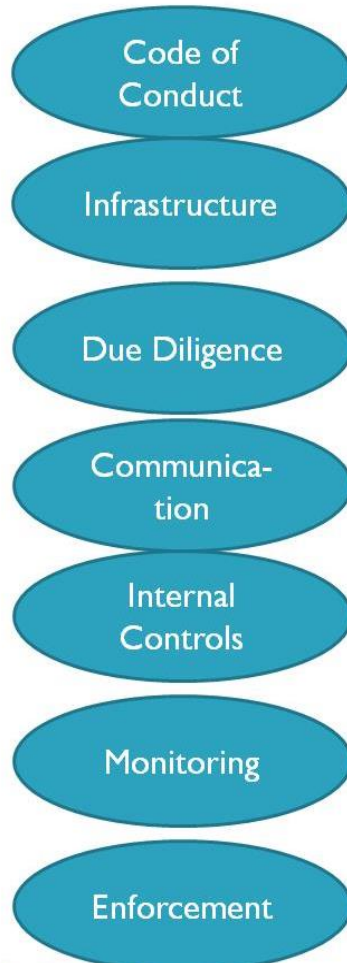
RELEVANT
RESULTS!

Corporate Governance in Islamic Finance



Corporate Governance in IFIs

Guidelines





SHARIAH GOVERNANCE FOR ISLAMIC FINANCIAL INSTITUTIONS



What is Shari'ah Governance?

Shari'ah Governance is relatively new to the discourse of Islamic finance, but is significant to lead the market confidence on the credibility of the industry

Notion of Hisbah

Implemented since pre-modern Islamic societies

Shari'ah Committee

Faisal Islamic Bank is the first to establish SC, followed by other IFIs and regulators

AAOIFI Standards

Standards on *Shari'ah* Board & *Shari'ah* Review

IFSB, BNM and etc.

IFSB-1 defines SCRM & IFSB-10 defines *Shari'ah* governance system

First attempt to officially define Shari'ah governance has been initiated by IFSB-10 – *Shari'ah* governance system

What is Shari'ah Governance?

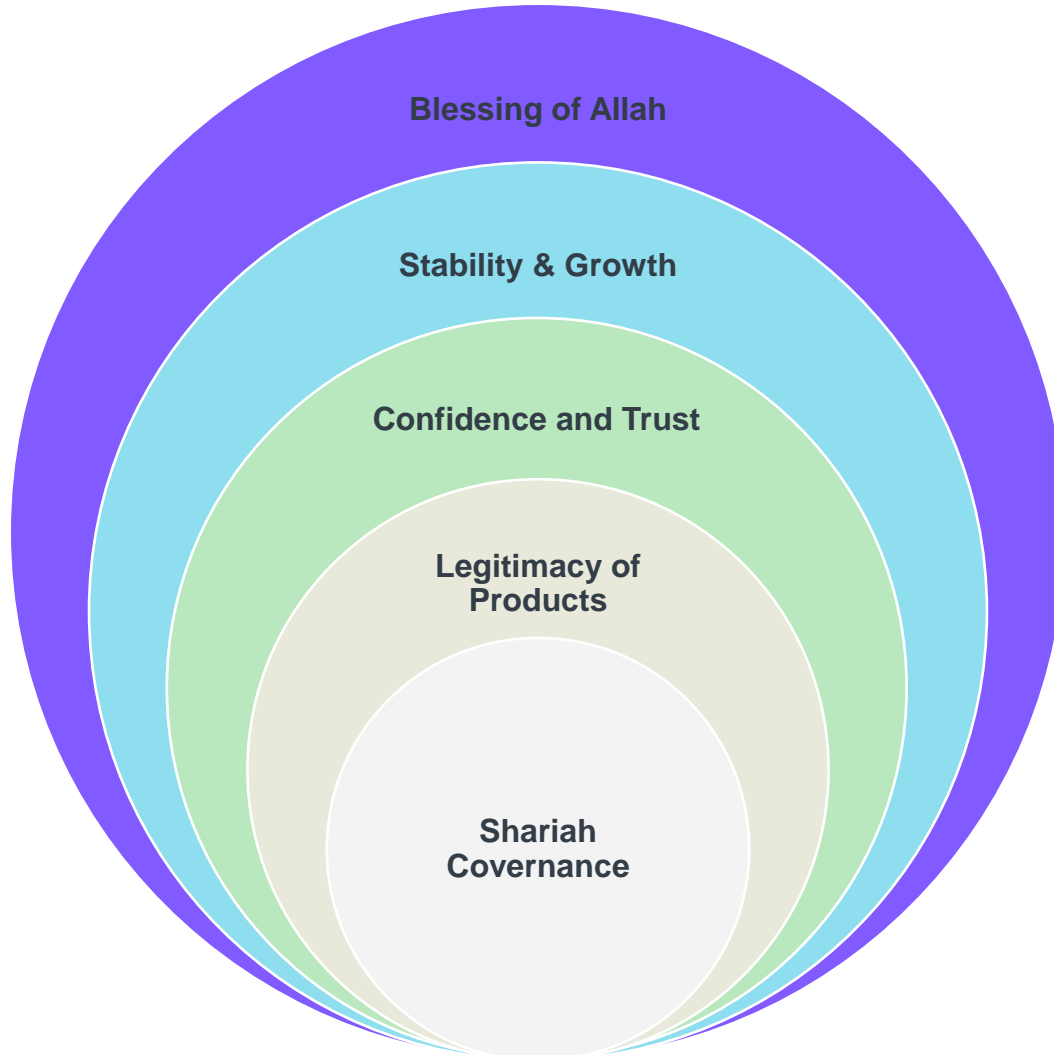
IFSB-10 Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services defines:

“A set of institutional and organisational arrangements through which Islamic financial institutions ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review.”

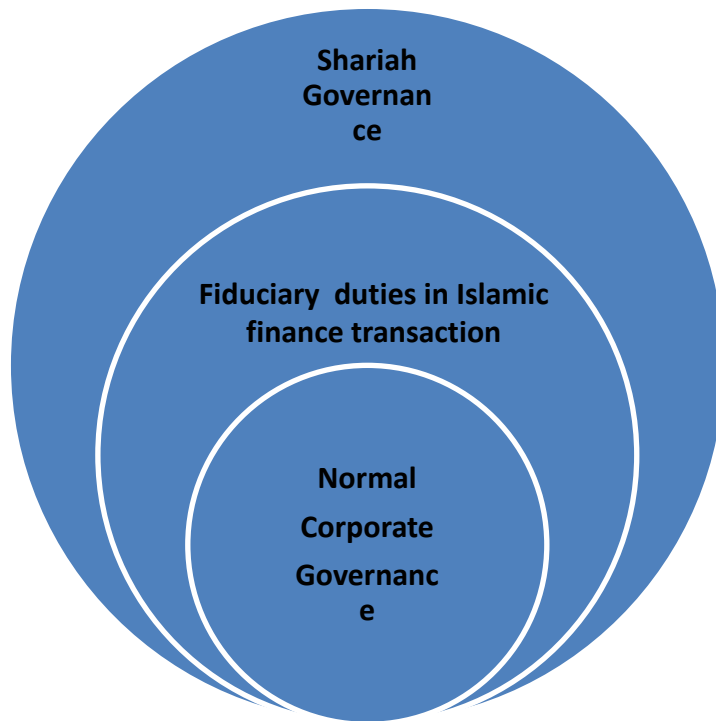
This requires:

1. **A set of institutional and organisational arrangement** – Board of Directors, Shariah committee, Shariah division, internal audit function.
2. An **effective independent oversight** on Shariah compliance
3. **Shariah pronouncements:** disseminations of info and an internal Shariah review– ex-ante and ex-post aspects of the Shariah compliance

SIGNIFICANCE OF SHARIAH GOVERNANCE



Shariah Governance plays an important role in instilling & shaping good corporate governance practices



Ensures compliance with Shariah rules & principles



Principles of Islamic finance place great emphasis on strong corporate governance values & structure, transparency, disclosure of information & strict adherence to Shari'ah principles.

SHARIAH GOVERNANCE MODELS IN SELECTED COUNTRIES

Pakistan Model

Indonesia Model

Kuwait Model

Bahrain Model

U.A.E Model

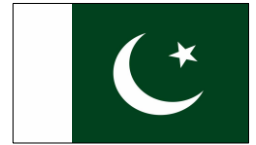
Saudi Arabia Model

Qatar Model

Algeria Model

Morocco Model

SHARI'AH GOVERNANCE FRAMEWORK-PAKISTAN



- In 2008, **SBP issued detailed set of instructions and guidelines** for Shari'ah compliance vide Islamic Bank Department Circular No. 2 of 2008
- However, keeping in view the developments taking place in the Islamic banking industry over the recent years, **some of the instructions and guidelines have been revisited and a comprehensive Shari'ah Governance Framework ('SGF or Framework') was developed in 2015.**
- The **SGF was further reviewed and updated in 2018.** This was due to the growing scale and complexity of IBIs in the country, which has triggered the need to strengthen the SGF.
- The primary objective of the Framework is to **strengthen the overall Shari'ah compliance environment of IBIs and explicitly define the roles and responsibilities of various organs of IBIs** including the Board of Directors (BOD), Executive Management (EM), Shari'ah Board (SB), Shari'ah Compliance Department (SCD), Product Development (PD), internal auditors and external auditors towards Shari'ah compliance.

INDONESIA



- The Shariah governance framework of Indonesia is similar to the Malaysian model, namely the **centralized model of Islamic finance supervision**.
- The National Shariah Board of **the Indonesian Council of Ulema is responsible for issuing fatwas in financial matters** which are considered binding upon the shariah boards of each IFIs.
- The **Shariah boards of individual banks have to refer to the National Shariah Board** for the final fatwas.
- The **Shariah board members of individual banks have to be highly qualified** in order to understand the fatwas, the source of the fatwas and to produce contracts and agreements in compliance with the fatwas.

QATAR



1. Practicing self regulation of Islamic banks
2. No Shariah Advisory Board at Central Bank of Qatar. **But has “Supreme Shariah Council” attached to Awqaf Ministry** –any issue can be directed to the Council for clarification
3. No restriction on Shariah advisors to be a member of Shariah Board in more than one Islamic Financial

U.A.E



1. Establishment of “**Higher Shariah Authority**” to supervise Islamic banks, financial institutions and investment companies.
2. This Authority shall be accorded the final authority in Shariah matters in Islamic banking and finance
3. It is worth mentioning that HSA has adopted AAOIFI’s Shariah Standards and is making them mandatory for all institutions offering Islamic financial services.

BAHRAIN



- Establishment of **National Shariah Board of the Central Bank of Bahrain** –to serve and to verify the Shariah compliance of its own products only.
- All other Islamic financial institutions shall establish “**Shariah Supervisory Committee**” and comply with the **AAOIFI's Governance Standards** for Islamic Financial Institutions.
- No restriction for the member of **National Shariah Board** to serve any financial institution, also no limitation to serve only one institution.

Saudi Arabia



- The Kingdom of Saudi Arabia has **come up with a Shariah Governance Framework (SGF)** for Islamic financial institutions (IFIs). The SGF, which will come into effect in July 2020.
- The SGF **emphasizes the duties and key responsibilities of the board** with regard to the implementation of Shariah governance within the IFIs
- The framework mentions that **the Board are responsible for effective implementation of Shariah governance within the IFI** and ensuring that its activities comply with the principles and provisions of the Shariah
- The **procedures of setting up a Shariah committee and the responsibilities that should be fulfilled by them** were also discussed in the SGF.

Kuwait



- After the issuance of the Shariah Supervisory Governance (SSG) Framework for Islamic Banks in Kuwait on January 1, 2018, the parliament recently approved amendments to some provisions of the law. Some are related to the monetary system and the central bank, but there are also **provisions paving the way for the formation of the Supreme Shariah Supervisory Board at the Central Bank of Kuwait (CBK).**
- The idea of a **Supreme Shariah Supervisory Board at the CBK** was spurred by **the increased number of Islamic banks in Kuwait** and the proliferation of Shariah opinions, which has caused market demand for uniformity in Shariah decision.
- In other words, the need to **establish a centralized Shariah board at the central bank has become vital to minimize the risk of Shariah matters** being brought to the courts, which in turn affects the reputation of IFIs in Kuwait.

Morocco



- Morocco has adopted, in 2014, a new banking regulation (law 103-12) which introduced a specific regulation related to Islamic banking.
- **In January 2017, Morocco's central bank approved the launch of Islamic "participatory" banking**, marking the beginning of a new era for the nation's financial sector.
- The Constitution of the Kingdom of Morocco considers **the Higher Council of Ulamas as the only entity in the country authorized to issue fatwas** in different matters, including Islamic banking and finance.
- The Higher **Council of Ulamas had created a specialized Committee in Islamic finance** composed of 9 members and 1 coordinator. The committee can add 5 experts who will assist the committee in its decisions and orientations.
- In each Islamic financial institution, a Sharia compliance officer takes in charge the compliance function and the audit function.

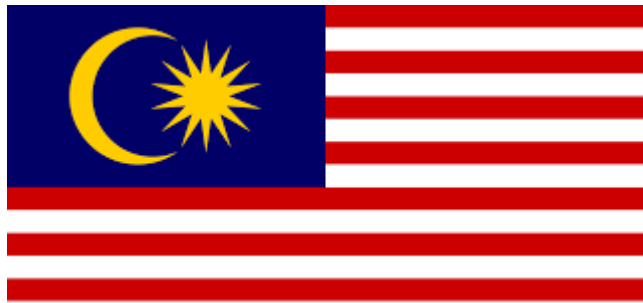
Algeria



- Algeria issued new act about Islamic finance (Act No. 20-02), which was published on March 15, 2020. **The act defines the banking operations and activities related to Islamic finance and the rules and conditions applied to them.**
- In addition, the **National Shariah Committee of Fatwa for IFIs** was **established on 1st April 2020** under the patronage of the Islamic Supreme Council in Algeria. This is in line with the practice of many countries that have a centralized Shariah Board.
- **The role of the National Shariah Committee of Fatwa** is mainly to **issue fatwas and related decisions governing the work of the financial institutions in Algeria** and to provide the certificate of Shariah compliance for IFIs.



OVERVIEW OF BNM SHARI'AH GOVERNANCE FRAMEWORK



BNM - SGF

- Malaysia adopts dual banking system and attempts to regulate Islamic banking industry in line with **International Best Practices** while capturing its **Distinct Characteristics** as inspired by Shari'ah.
- To ensure **strict Shariah compliance** in Islamic banking and finance practices, the Malaysian authority **develop Shariah governance framework (2011)** that would guide and govern the Shariah aspects of Islamic banking and finance industry.
- Malaysia has developed its Shariah Governance Framework since 1983 in its first Islamic Banking Act.
- The **climax** of this effort is the issuance of **IFSA 2013** as a new comprehensive Islamic financial Services Act published in the Gazette on 22 March 2013.
- IFSA 2013 attempts to address this challenge by providing comprehensive legal framework for Islamic finance industry, in line with:
 - Shari'ah framework
 - Domestic legal and regulatory framework
 - International standards/regulations

BNM'S SHARIAH GOVERNANCE FRAMEWORK

- Effective date **1 January 2011** with full enforcement 1 July 2011.
- **Objectives:**
 - Set out the **expectation of BNM on Shariah governance** structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Shariah.
 - Provides a **comprehensive guidance** to the Board, Shariah Supervisory Council and management of the Bank in discharging its duties in matters relating to Shariah; and
 - **Outlines the functions** relating to Shariah review, Shariah audit, Shariah risk management and Shariah research.





Shariah Governance

BNM Shariah Governance Framework of Islamic Financial Institutions (2011)

Paragraph 1.3 (i):

The board has oversight on Shariah compliance aspects of the IFI's overall operations.: "The board is ultimately responsible for the establishment of an appropriate Shariah governance framework of an IFI."

Paragraph 2.8:

"The Shariah Committee is expected to perform an oversight role on Shariah matters related to the institution's business operations and activities. This shall be achieved through Shariah review and the Shariah audit functions.

BNM's Shariah Governance - 2019

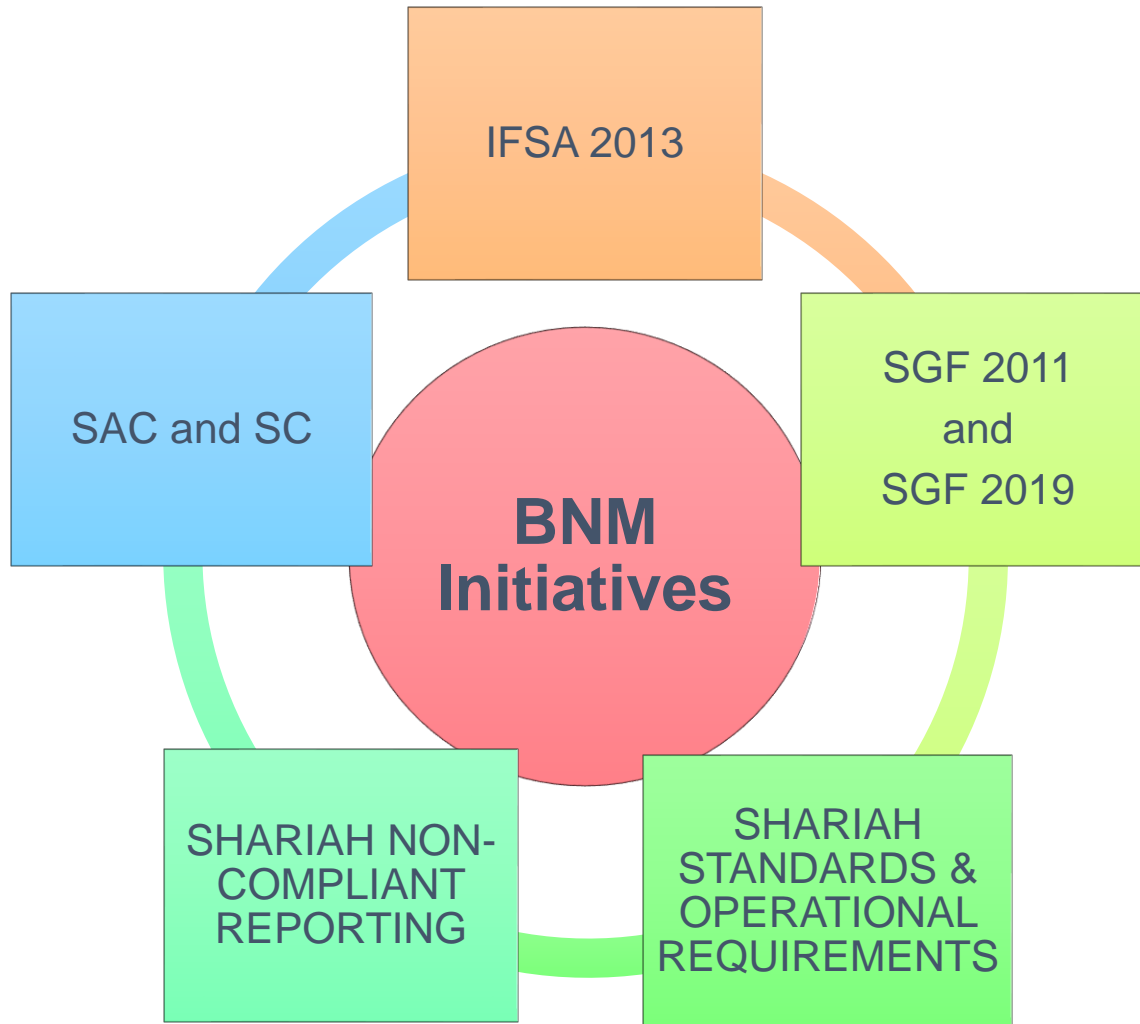
Paragraph 8.1:

"As part of the board's responsibility to promote the sustainable growth and financial soundness of an IFI, the board has the overall responsibility to institutionalize a robust Shariah governance framework that is commensurate with the size, complexity and nature of the IFI's business. The board's oversight accountability over Shariah governance must reflect the integration of Shariah governance considerations within the business and risk strategies of the IFI."

Paragraph 22.1:

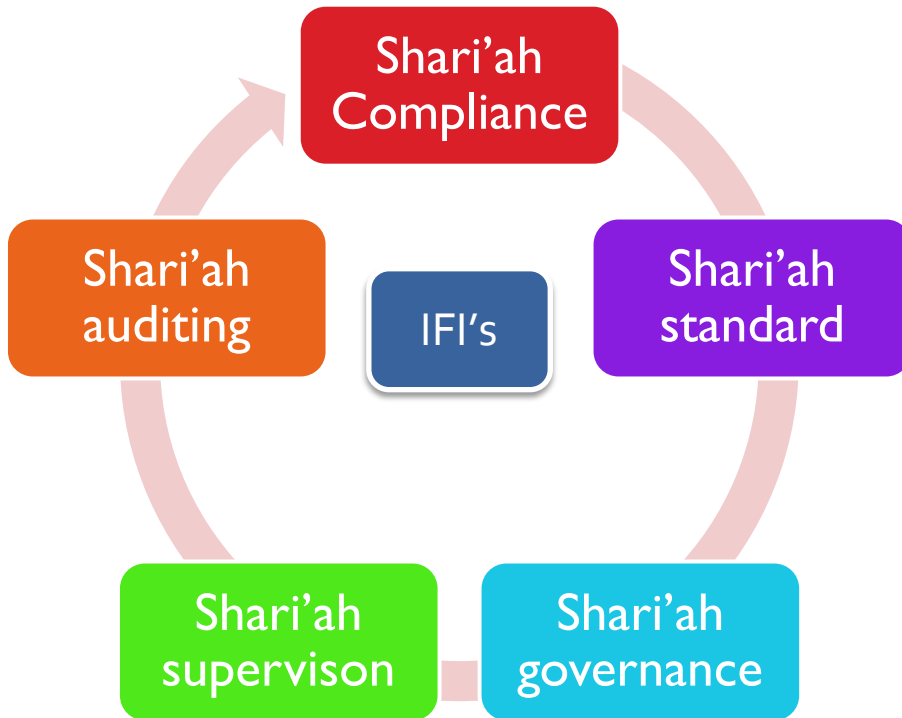
"The board must clearly articulate in the Director's Report its oversight accountability for Shariah governance implementation and the IFI's overall compliance with Shariah."

BNM INITIATIVE TO ENSURE SHARIAH COMPLIANCE

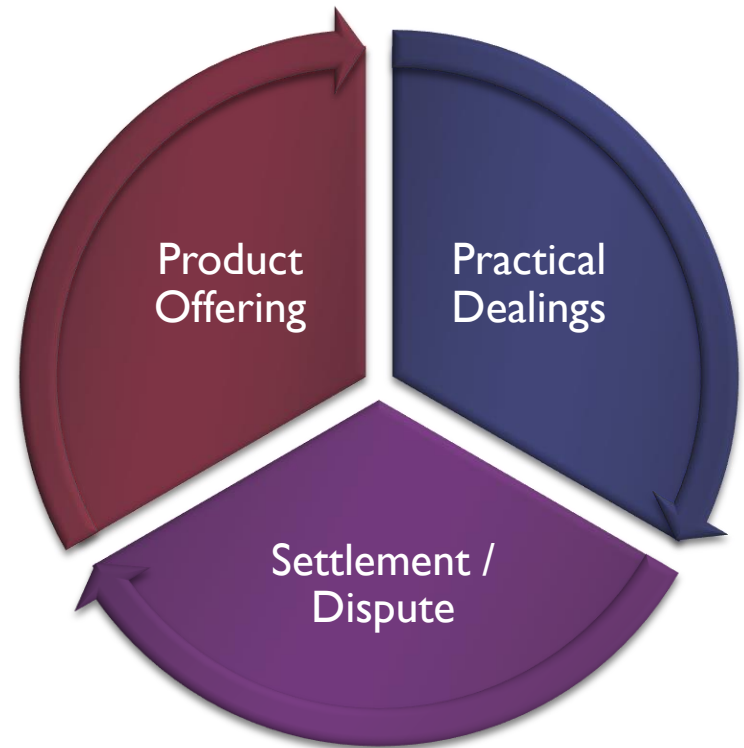


SHARI'AH GOVERNANCE IS IN THE WHOLE OPERATIONS OF IFI'S

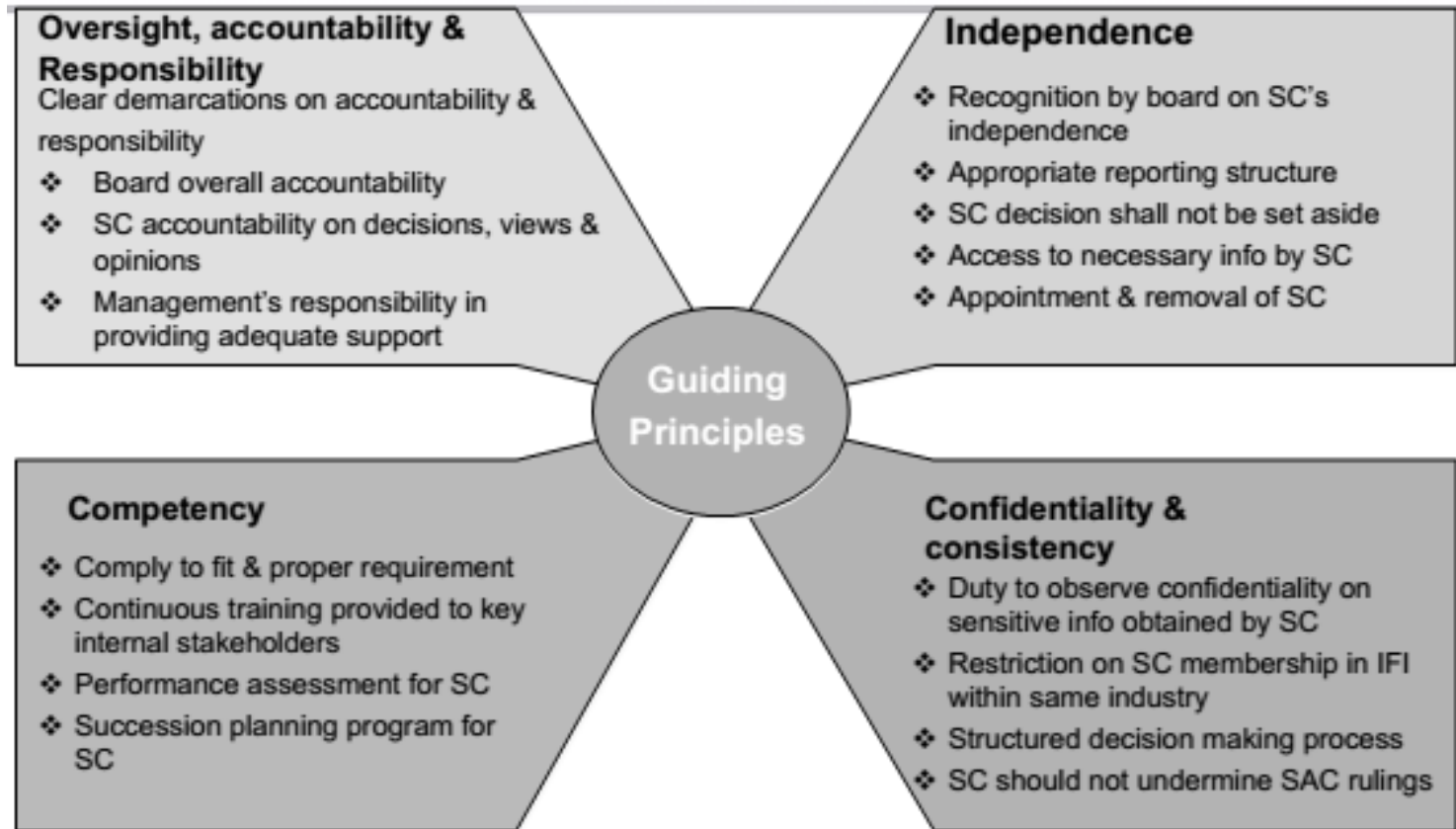
- ❑ The Shari'ah governance enters into all aspects of IFI's operation.
- ❑ Shari'ah governance is not only under Shari'ah board responsibility, but the whole stakeholders in IFI's industry.



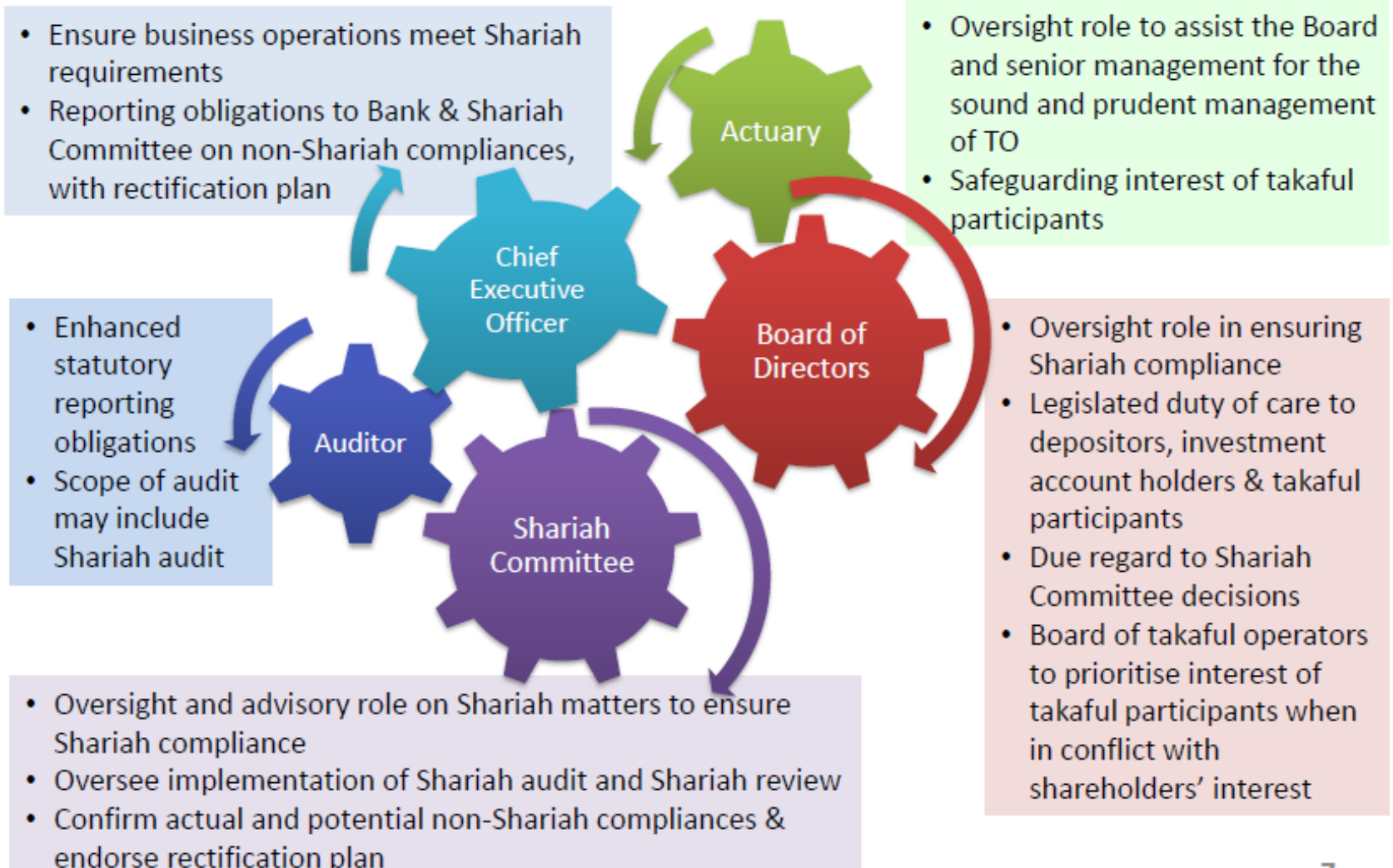
- ❑ The shari'ah compliance is not only in operational processes, but now its chain continues even when disputes are brought to court.



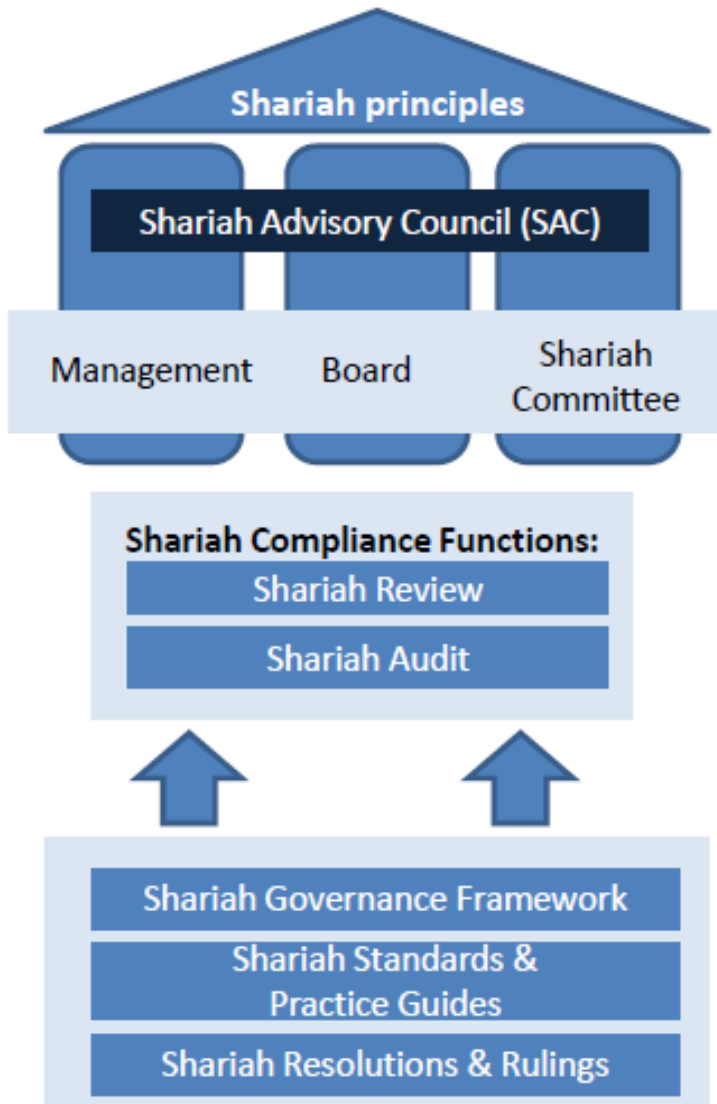
FRAMING SHARIAH GOVERNANCE FRAMEWORK



CODIFICATION & SPECIFICATION OF SPECIFIC ROLES AND RESPONSIBILITIES OF KEY FUNCTIONARIES



BOD HAS LEGISLATED DUTY OF OVERALL OVERSIGHT ON SHARIAH COMPLIANCE PRACTICES...



Codification of **duty** on Islamic financial institutions to ensure its aims, operations, business, affairs and activities are **in compliance with Shari'ah at all times.**

- **Compliance** with rulings of Shariah Advisory Council a determinant of "compliance with Shariah"
- **Reporting** obligations on non-Shariah compliances imposed on Islamic financial institutions
- Bank empowered to assess **rectification plan** to address **non-compliances**
- Backed by comprehensive **enforcement tools** to address **non-compliances**

Regulatory Requirements for Takaful ...

Shariah compliance in all aspects

Prudential	Governance	<ul style="list-style-type: none"> Duties & responsibilities of board of directors, senior management, appointed actuary & external auditor Minimum expectation for TO on outsourcing of takaful activities, functions or processes 	<ul style="list-style-type: none"> Duties & responsibilities of the Shariah Advisory Council & Shariah Committee Fiduciary duties of takaful operator (TO) Stature of participants in takaful
	Assets, Investments & Liabilities	<ul style="list-style-type: none"> Diversification rules, basis for valuation & safekeeping of assets Investment limit permissible Determination & provisioning of liability 	<ul style="list-style-type: none"> Invest in Shariah-compliant instruments Management of takaful fund Accounting treatments
	Solvency	<ul style="list-style-type: none"> Capital adequacy based on risk profiles Stress test process that commensurate to nature, complexity & sophistication of the business 	<ul style="list-style-type: none"> Qard to rectify deficit in takaful fund
	Product Requirements	<ul style="list-style-type: none"> Sound risk management practices in developing, managing & controlling product risk 	<ul style="list-style-type: none"> Shariah endorsement on product Fees, charges & surplus distribution
Reporting, market conduct & market protection		<ul style="list-style-type: none"> Disclosure & presentation of reports & statements Minimum standard on product transparency & disclosures 	<ul style="list-style-type: none"> Separation of funds Disclosure on aqad, fees, profit sharing ratio

Effective supervisory assessment on safety & soundness of TOs under Risk-Based Supervisory Framework

Fundamentals for sound takaful development in Malaysia ...



Effective & efficient consumer protection
 Establishment of BNM LINK, Financial Mediation Bureau & dedicated division in High Court

World class talent pool & IF learning hub
 ■ Establishment of IBFIM, INCEIF & ICLIF
 ■ Fund for Shariah Scholars in Islamic Finance

Strong institutional framework
 ■ Dedicated department in Bank Negara Malaysia for Islamic Banking & Takaful
 ■ Establishment of Malaysian Takaful Association

Institutional Capacity Enhancement
 Minimum paid-up requirement increase to RM100 m

Robust Shariah governance structure
 ■ Establishment of Shariah Advisory Council of BNM (SAC)
 ■ Restrict SAC members to sit in SC of TOs

Facilitative Legal Framework
 Development of Islamic Financial Services Act

World class talent pool & IF learning hub
 ■ TO to have Appointed Actuary
 ■ Creation of ISRA as IF research centre
 ■ Publication of Shariah standard

Strong institutional framework
 Increase no. & diversity of players e.g. TO (12) and RTO (4)

Institutional Capacity Enhancement
 ■ Risk-Based Capital Framework
 ■ Takaful Operational Framework

Robust Shariah governance structure
 CBA amendments:
 ■ SAC as a highest authority for the ascertainment of Islamic law on IF
 ■ Rulings of SAC shall be binding on IFIs, courts or arbitrators

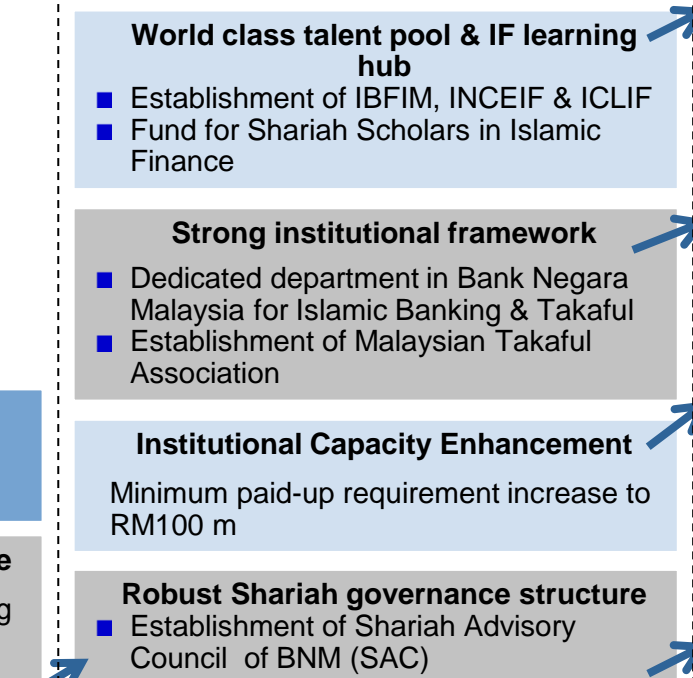
Facilitative Legal Framework
 Takaful Act 1984 (TA) provides platform for separate regulatory structures

Robust Shariah governance structure
 Foundation for Shariah governance setting in TA :
 ■ Business aims & operations must be Shariah compliant
 ■ Takaful operator (TO) to establish Shariah Committee (SC)

Inception stage
 Instituting foundations of Islamic finance

Intermediate stage
 Institutional building, activity generation & market vibrancy

Advanced stage
 Strategic positioning & international integration

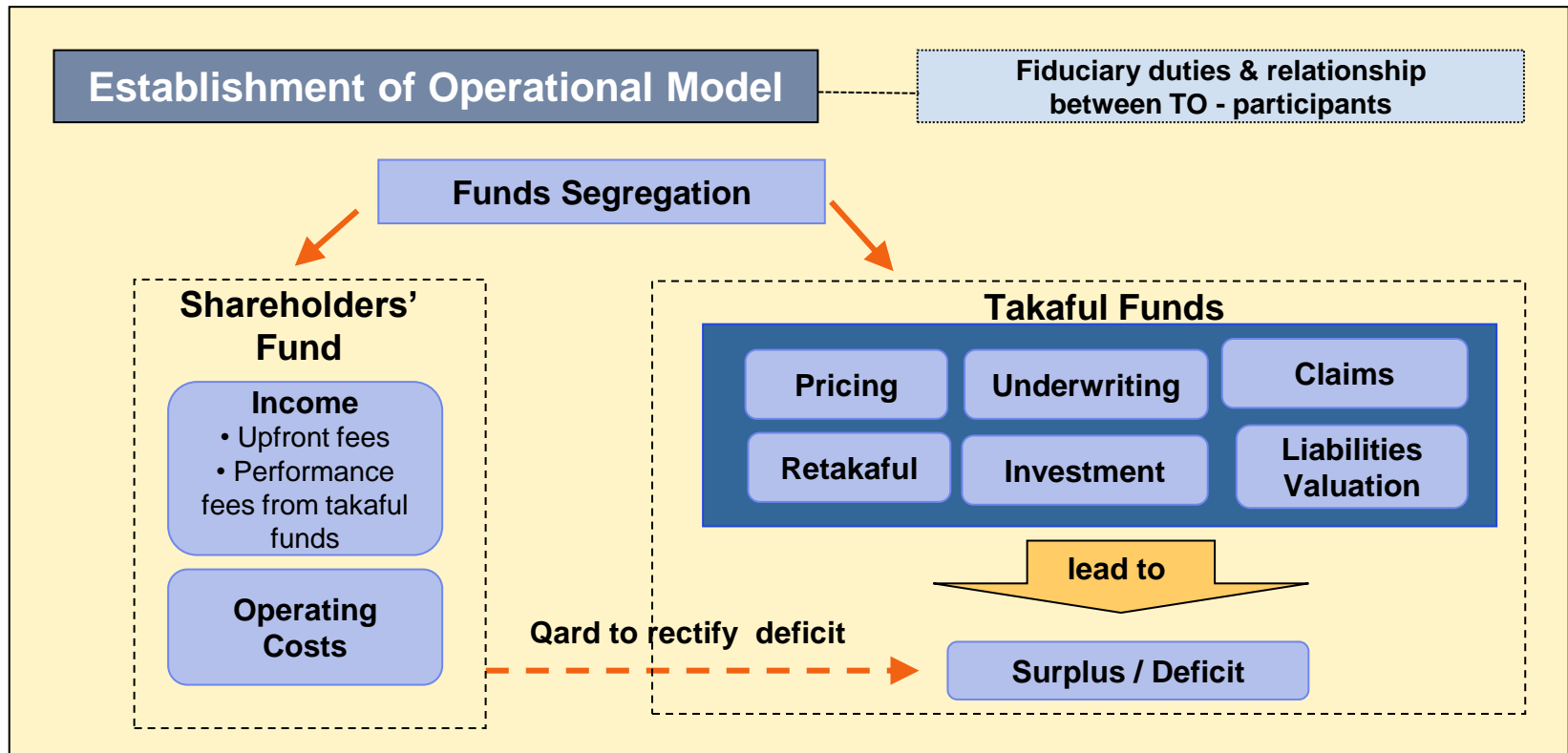


Takaful Operational Framework ...

Objectives & Principles

- Ensure uniformity with Shariah
- Safeguard interests of the participants
- Promote prudent management
- Enhance operational efficiency
- Build healthy takaful funds
- Promote uniformity in practices

Outlines requirements in the following areas....



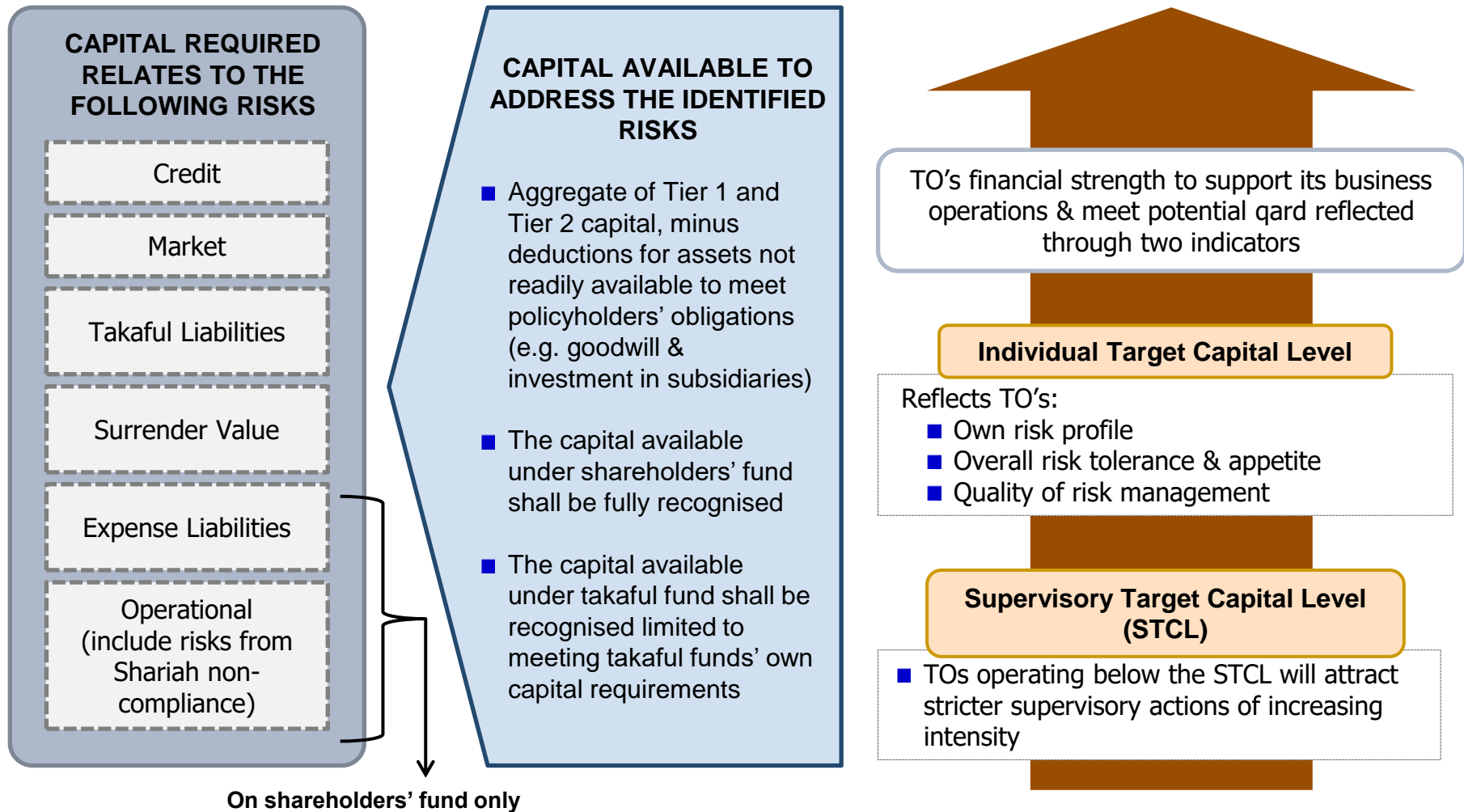
Supported by:

- Effective governance & oversight
- Adequate disclosure & transparency
- Sufficient & competent resources
- Efficient processes & procedures

Risk-Based Capital Framework for Takaful Operators (RBCT) ...

Objectives

- Enable all obligations under a takaful contract & costs of managing the takaful business are met
- Provide flexibility for takaful operator (TO) to operate at different risk levels as long as there is supporting capital
- Ensure availability of funds to provide interest-free loan (qard) should the need arise



RECOMMENDATIONS & THE WAY FORWARD

SHARIAH



ISLAMIC FINANCIAL SYSTEM

- Shariah is the **backbone of Islamic Finance and Takaful Industry** which provides the foundations and direction.
- A comprehensive **Shariah governance aims to ensure a strict Shariah compliance in Islamic financial services operations** and hence reducing Shariah non-compliance risk.
- A comprehensive framework of Shariah compliance and its implementation would realize our objective of **having a solid financial system based on Shariah.**
- **SGF provides a comprehensive legal framework** that is fully consistent with Shariah in all aspects of regulation and supervision.

THANK YOU!