



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

# Shariah Governance of Islamic Banking and Finance

**Prof. Dr. Mohamad Akram Laldin**  
Executive Director, ISRA



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# Introduction

- ▶ Shariah is **the backbone of Islamic finance industry** which provides the foundations and direction
- ▶ 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**



# Corporate Governance in Islamic Finance

## Corporate Governance in Islamic Finance

Conventional governance  
standards

Islamic values & Shari'a  
requirements

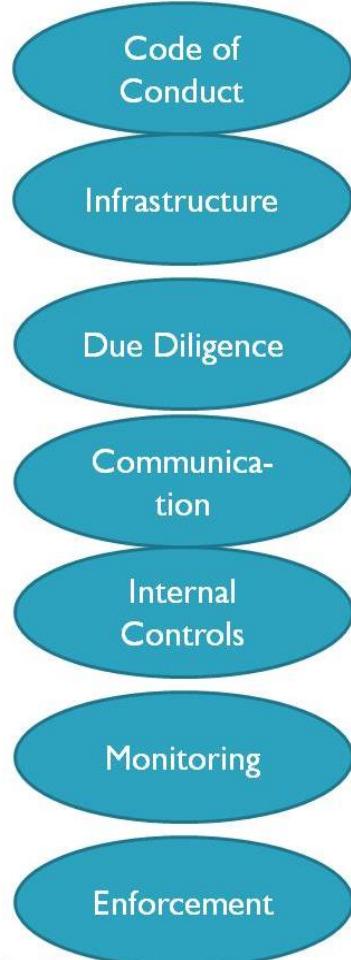


Actions of the management  
are aligned with the interest  
of stakeholders

Adherence to Shari'ah  
principles, the teaching of  
the Qur'an and the Sunnah

# Corporate Governance in IFIs

## Guidelines



## Regulation

Regulators

## Investor protection

Board of Directors

## Board Oversight

Risk Committee

Audit Committee

Governance Committee

## Management oversight

Risk Management

Internal Audit

Compliance Officer

Shari'ah Supervisory Board

Internal Shari'ah Unit

# 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-I 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?

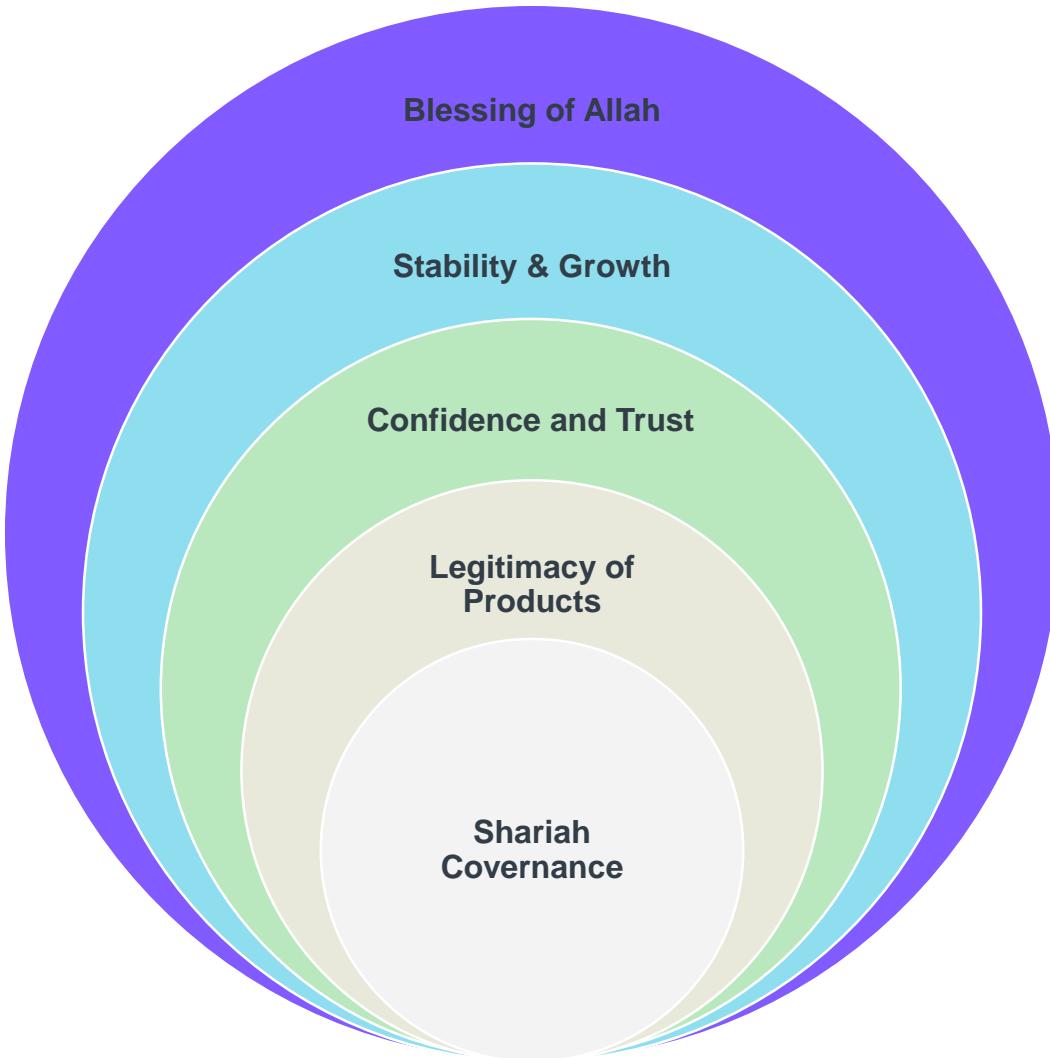
IFSB-10 Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services defines:

“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.”

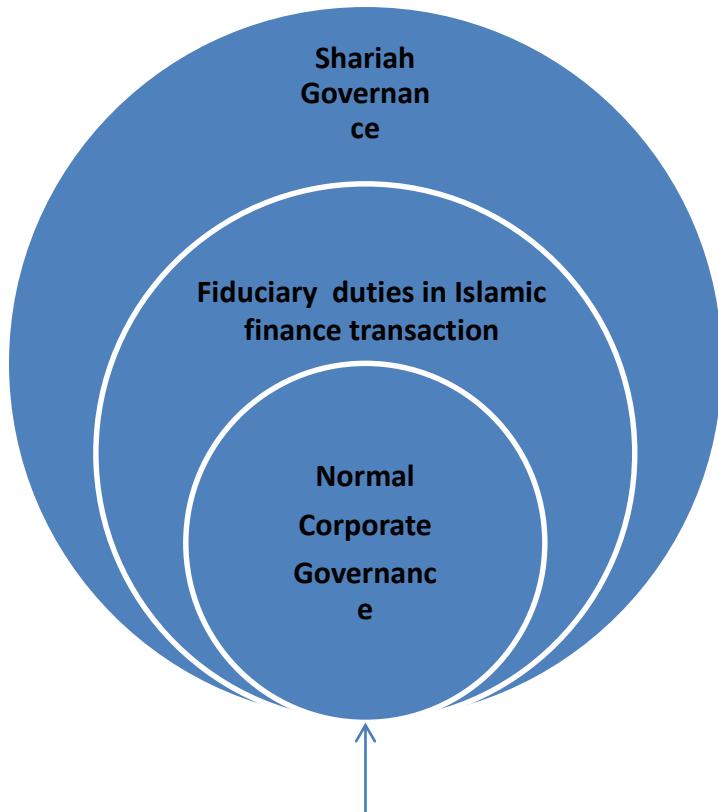
This requires:

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



*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

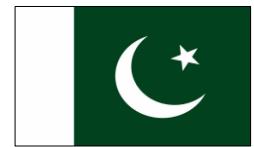
Kuwait Model

Bahrain Model

U.A.E Model

Saudi Arabia Model

Qatar Model



- 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.

## FUNCTIONS AND DUTIES OF BOARD OF DIRECTORS - PAKISTAN

The BOD shall be ultimately **responsible and accountable for ensuring full conformity of the IBI's operations with Shari'ah principles**. The BOD needs to be fully cognizant of the risk of Shari'ah non-compliance and its potential implications on the reputation and business of the IBI.

The BOD should also be fully aware of its fiduciary responsibility, particularly, towards Investment Account Holders (IAHs) /Profit and Loss Sharing depositors (PLS depositors) who accept risks that are almost similar to those of the shareholders but without having any voting rights and fora like Annual General Meetings (AGMs) to express their concerns on the IBI's performance

The BOD **shall meet the SB at least on a half yearly basis to:**

- a) have **a detailed briefing on the Shari'ah compliance environment, the issues/weaknesses (if any), and recommendations to improve Shari'ah compliance environment**, and
- b) **ensure timely and effective enforcement of the SB's decisions, fatawa, observations and recommendations**



# ROLE OF SHARIAH BOARD - PAKISTAN



- The **SB shall be empowered to consider, decide and supervise all Shari'ah related matters of the IBI**. All decisions, rulings, fatawa of the SB shall be binding on the IBI whereas SB shall be responsible and accountable for all its Shari'ah related decisions.
- The **SB shall cause to develop a comprehensive Shari'ah compliance framework for all areas of operations of the IBI**. All products or services to be offered and/or launched by the IBI shall have prior approval of the SB.
- The **SB shall review and approve all the procedure manuals**, product programs/structures, process flows, related agreements, marketing advertisements, sales illustrations and brochures so that **they are in conformity with the rules and principles of Shari'ah**.

**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.

# 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

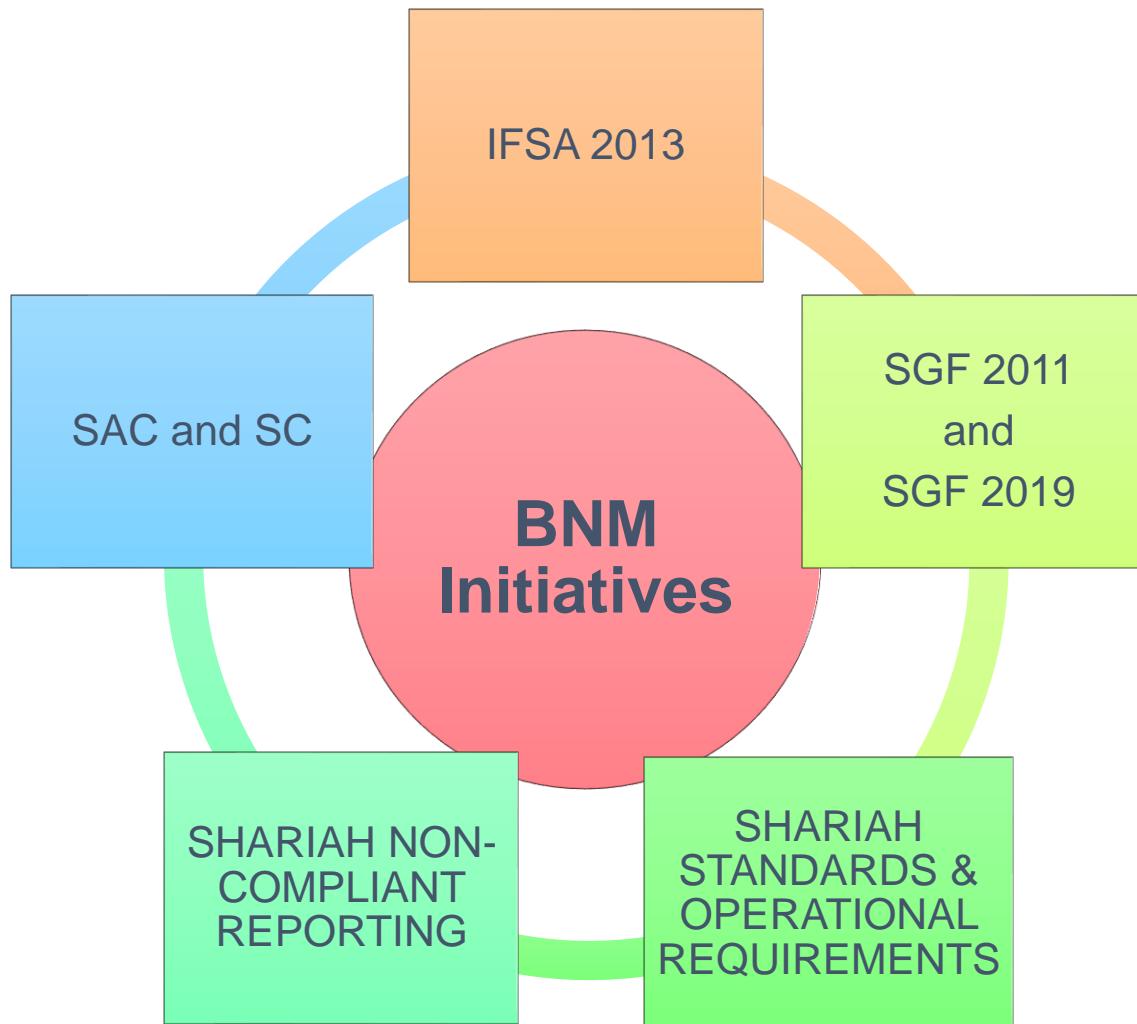
#### Paragraph 8.1:

"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:

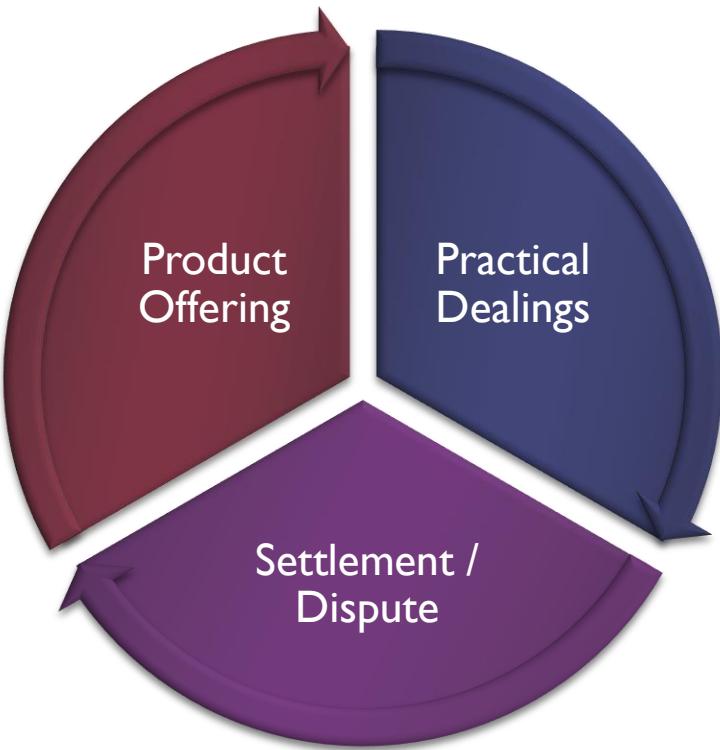
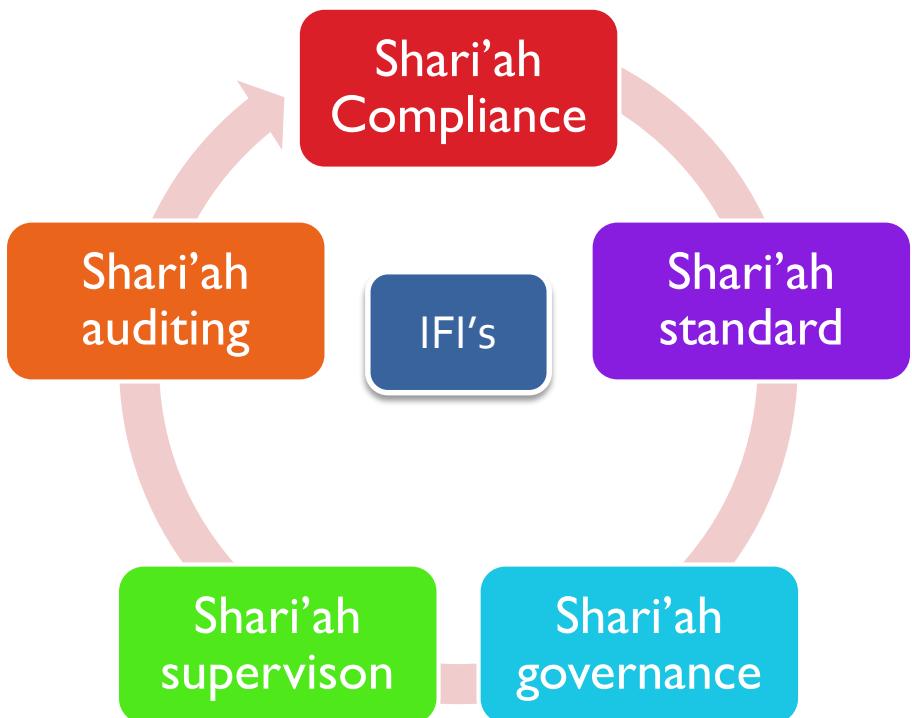
"The board must clearly articulate in the Director's Report its oversight accountability for Shariah governance implementation and the IFI's overall compliance with Shariah."

# BNM INITIATIVE TO ENSURE SHARIAH COMPLIANCE

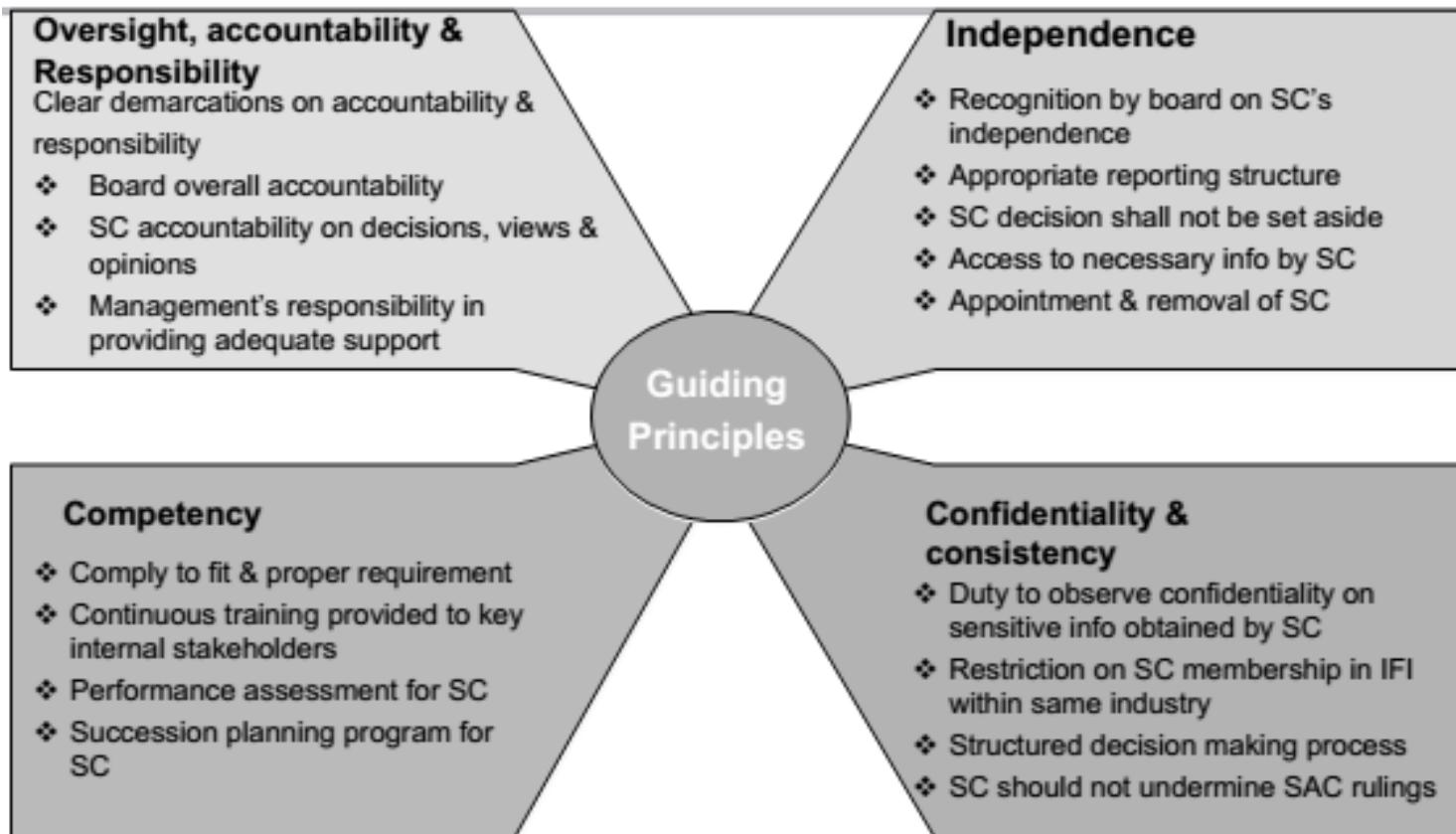


# SHARI'AH GOVERNANCE IS IN THE WHOLE OPERATIONS OF IFI'S

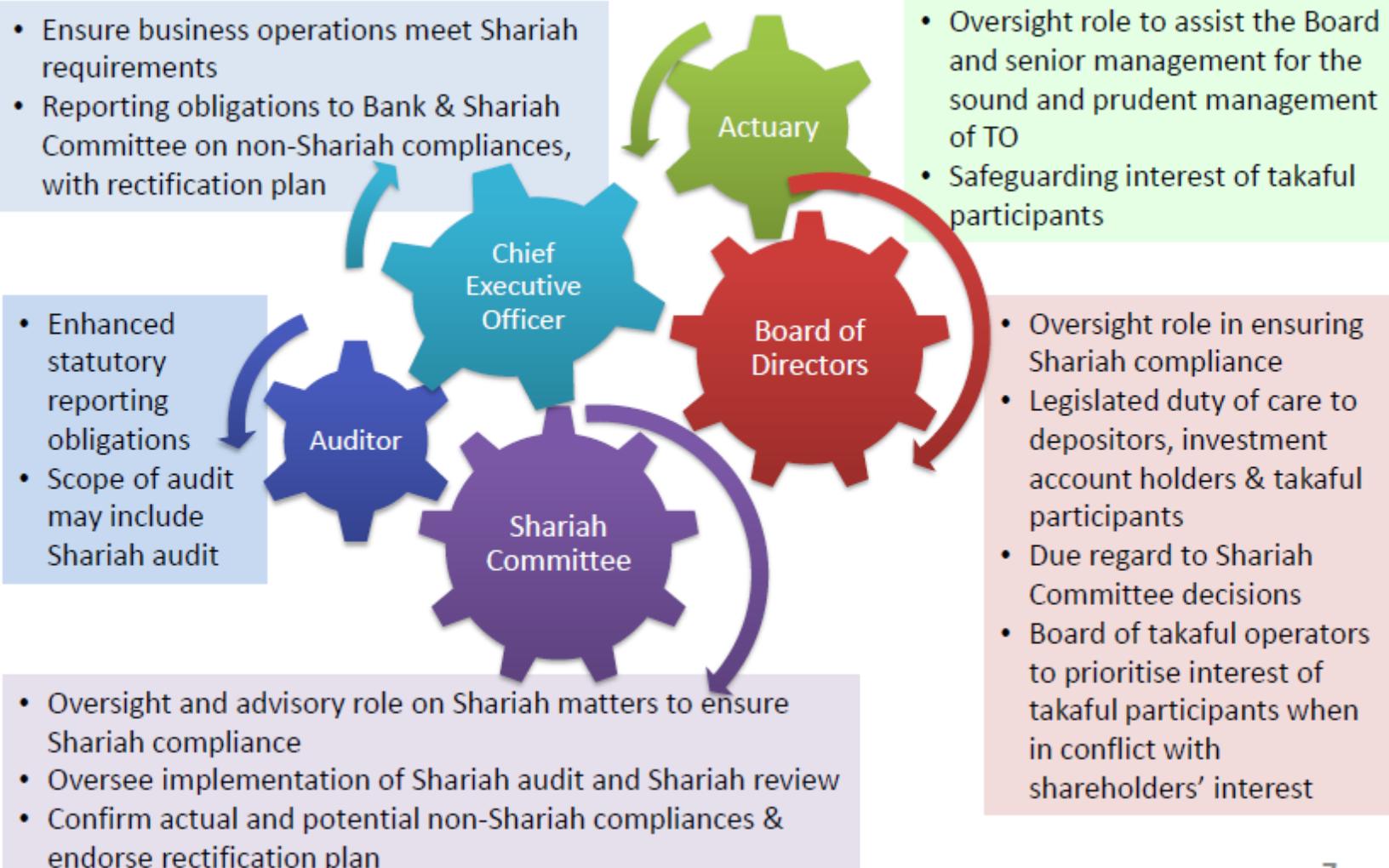
- ❑ The Shari'ah governance enters into all aspects of IFI's operation.
- ❑ Shari'ah governance is not only under Shari'ah board responsibility, but the whole stakeholders in IFI's industry.
- ❑ The shari'ah compliance is not only in operational processes, but now its chain continues even when disputes are brought to court.



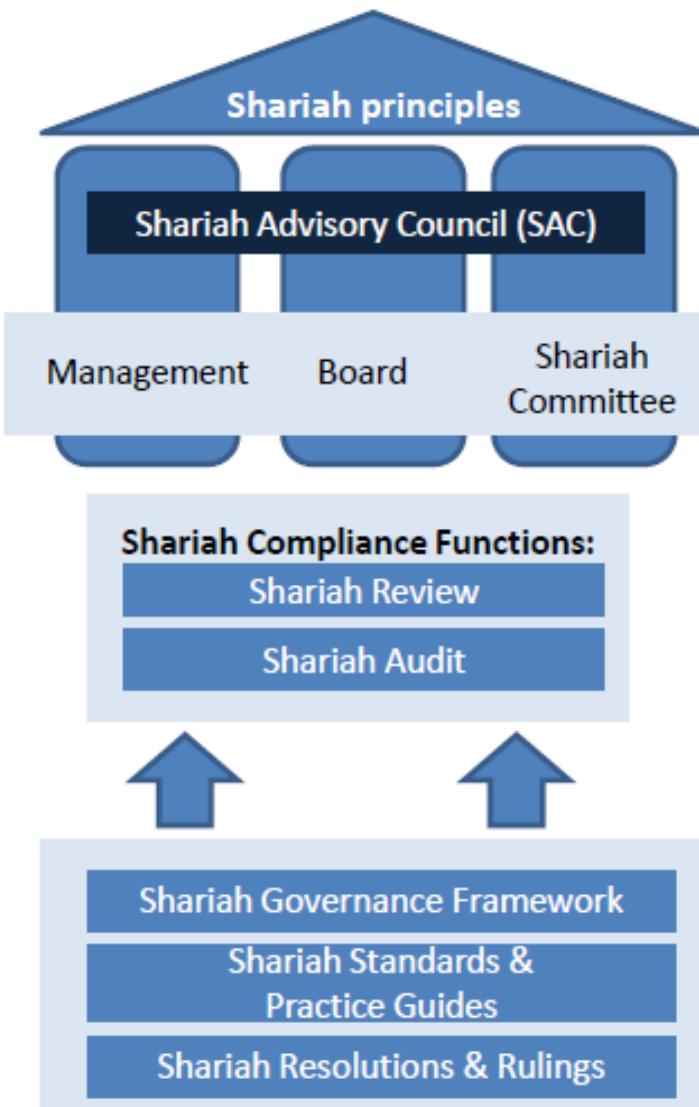
# FRAMING SHARIAH GOVERNANCE FRAMEWORK



# 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**

# IFSA – BNM ENFORCEMENT & REMEDIAL ACTION FOR SHARIAH NON COMPLIANT EVENTS

## Issue Direction of Compliance (Sec 167-168)

- ❑ Power may be exercised where BNM satisfied that Islamic bank:
  - ✓ Is carrying or about to carry its business, affairs & activities in a manner which is contrary to Shariah.
  - ✓ Is committing or about to commit an act that is unsafe or failed to act in a manner that is necessary to maintain safety of Islamic banks.
  - ✓ Is conducting business in a manner detrimental to the interests of depositors, policy owners, participants, users, creditors or the public.
  - ✓ Has failed to manage its business in a manner that is consistent with sound risk management & good governance practices.
- ❑ Opportunity to make representations prior to issuance of direction of compliance

## Civil Actions & Administrative (Sec 245-257)

### Civil Action

*“Where it appears to BNM that there is a reasonable likelihood that any person will contravene or has contravened or will breach or has breached or is likely to fail to comply with or has failed to comply with.....”*

BNM may seek court order to impose:

- Monetary penalty (general & for both body corporate & individual)
- Civil penalty of not more than RM25million
- Indemnity – seek compensation
- Injunction order
- Order to comply
- Order to remedy breach or mitigate the effect of breach

### Administrative

Monetary penalty (for non criminal offence)

- Body corporate: not exceeding RM5 million
- Individual: not exceeding RM1 million
- Order to comply certain act
- Order to remedy/mitigate the effect of breach
- Reprimand –including requiring person in breach to issue public statement

# IFSA – STRENGTHENED SHARI'AH COMPLIANCE REQUIREMENTS

## Duty of Islamic Banks to Ensure Shari'ah Compliance (sec 27-38)

Compliance with rulings of SAC BNM

Internal Policies & Procedures Consistent with Shariah Requirements

To develop Shariah Audit Function

## ***ISLAMIC BANKS TO ENSURE END TO END SHARIAH COMPLIANCE***

“Duty of Islamic Banks to ensure its aims, operations, business, affairs and activities are in compliance with Shariah at all times” – Sec 28

## **BNM SUPERVISORY POWER:**

- ✓ To issue **Shariah Standard & Practice Guide**
- ✓ Severe **penalties** for Shariah Non Compliance
  - Islamic Banks must **report on non compliance**, cease the non compliance business & submit rectification within 30 days.
  - **Failure** – imprisonment not exceeding 8 years or fine not exceeding RM 25 million or both

## THE ROLE OF BOARD IN SGF - BNM



# ROLE OF THE BOARD OF DIRECTOR - IFSA

## 2.1 The board is ultimately accountable and responsible on the overall Shariah governance framework and Shariah compliance of the IFI, by putting in place the appropriate mechanism to discharge the aforementioned responsibilities.

<ul style="list-style-type: none"><li>✓ To approve and review the objectives, strategies, policies and processes of the investment account</li></ul>	<ul style="list-style-type: none"><li>✓ To ensure the investment operations are performed in accordance with the fiduciary duties and agency duties</li></ul>
<ul style="list-style-type: none"><li>✓ To ensure establishment of effective risk management policies</li></ul>	<ul style="list-style-type: none"><li>✓ To ensure the management of investment accounts is conducted by personnel with the appropriate competency and investment Expertise</li></ul>
<ul style="list-style-type: none"><li>✓ To approve disclosure policies to ensure reliable, relevant and timely information are disseminated to the IAH</li></ul>	

# ROLE OF THE BOARD OF DIRECTOR



*Islamic Banks to ensure end to end Shariah compliance*

# FUNCTIONS AND DUTIES OF BOARD OF DIRECTORS – SGF 2019

The responsibility of the BOD is 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 commensurate with the size, complexity and nature of the IFI's business.

**Approve policies** relating to governance structure and reporting arrangements, **Shariah non-compliance risk management** and other areas that are material to the effective implementation of Shariah governance within the IFI.

**Oversee the implementation of rulings of the SAC** and **decision or advice of the Shariah committee** within all business and functional lines, including any business or risk implications arising from such implementation

**Oversee the implementation of internal control environment** to prevent Shariah non-compliance and any **rectification measures** to resolve incidences or circumstances that may result or has resulted in Shariah non-compliance



# FUNCTIONS AND DUTIES OF BOARD OF DIRECTORS - SGF 2019

**Oversee the performance of senior management** and other officers entrusted to implement Shariah governance framework such that the board is satisfied that the measures of their performance is aligned with Shariah governance objectives.

**Promote a sound corporate culture** which reflects the importance of adhering to Shariah requirements in product development and marketing, strategy formulation, business operations, risk management practices and other aspects that promote end-to-end compliance with Shariah.

A director must continuously **develop and strengthen his understanding on Islamic finance and the relevant Shariah governance policies** to fulfil his responsibility to the IFI.



## THEREFORE, THE BOARD HAVE TO UNDERSTAND THE PRINCIPLES OF SHARIAH

### BNM SGF Section IV, Paragraph 4.1:

The board and management are expected to **have reasonable understanding on the principles of the Shariah and its broad application** in Islamic finance. The Shariah Committee is expected to have sufficient knowledge on finance in general, and Islamic finance in particular, to enable the Shariah Committee to comprehend Shariah issues brought before them. The Shariah Committee members are expected to constantly equip themselves with relevant knowledge on Shariah and finance as well as attend relevant training programs.

# INTERACTION WITH SHARIAH COMMITTEE

- The board must establish **effective communication with the Shariah committee** on all matters relating to Shariah requirements, Shariah governance or Shariah non-compliance risks to enable both parties to effectively discharge respective responsibilities under the Shariah governance framework.
- The board **must allocate sufficient resources for the continuous development of skills and expertise of the Shariah committee**. This shall include allocating adequate budget, having in place development plans for Shariah committee members and regularly updating such plans to ensure that each member possesses the requisite knowledge and skills to fulfil his responsibilities.
- The board must establish a **formal process to assess, at minimum annually, the performance and effectiveness of the Shariah committee** and every individual Shariah committee member. The **assessment must consider the competence, knowledge and contribution** of each Shariah committee member to the overall functioning of the Shariah committee.

# RECOMMENDATIONS

## SHARIAH



## ISLAMIC FINANCIAL SYSTEM

- Shariah is the **backbone of Islamic finance 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!**

## **Lead With Passion Expand The Options**

## ABOUT

The International Shari'ah Research Academy for Islamic Finance (**ISRA**) was established in 2008, by Bank Negara Malaysia (the Central Bank of Malaysia), as an initiative to promote applied research in the areas of **Shari'ah and Islamic finance**. **ISRA** also acts as a knowledge repository for matters related to Shari'ah and fatwas (resolutions) in the Islamic finance industry.

# ACTIVITIES & CONTRIBUTIONS

## **ISRA** contributes towards:

- Research
  - Publication
  - Events
  - Talent Development

# WEBSITE & KNOWLEDGE PORTAL

- **URL:** <http://www.isra.my>
  - **URL:** <http://ifikr.isra.my>

ISRA Consultancy Sdn Bhd (ICSB)

**ISRA**'s business arm offers a wide range of services pertaining to Shari'ah matters in Islamic finance including **advisory, research, training and translation.**

**URL:** <http://consultancy.isra.my/>

# WEBSITE & KNOWLEDGE PORTAL

