

# Shariah Governance in Islamic Finance

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# CG in IFIs








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**“A set of relationships between a company’s management, its BOD, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined” (IFSB, 2006).**

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**In the context of IFIs: “a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders; provision of proper incentives for the organs of governance such as the BOD, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and compliance with Islamic Shari’ah rules and principles” (IFSB, 2006).**

## Role of CG

Roles and Functions	Typical FI	Exclusive to IFIs
<p><b>Mechanism to address agency problems and conflict of interest amongst member of organization (Hart, 1995)</b></p>		
<p><b>To facilitate access to external finance, Lower cost of capital, Lead to better operational performance and reduce risk of contagion from financial distress (Claessens, 2003)</b></p>		
<p><b>Mechanism to maintain and to improve growth and able to prove the efficiency, stability and trustworthiness (Grais and Pellegrini, 2006).</b></p>		
<p><b>The need to reassure stakeholders that their activities are fully complied with <i>Shari'ah</i> principles (Grais and Pellegrini, 2006).</b></p>		

## Key Participants of CG in IFIs

Key Participants	Interest	Functional Roles
<ul style="list-style-type: none"> <li>• <b>Regulatory /Supervisory authority</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Economic Stability and Compliance with the laws and regulation</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Set regulatory framework for sound and proper CG</b></li> <li>• <b>To supervise and monitor the effectiveness of CG and to check compliance with regulation</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b>Shareholders</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Wealth maximization; Satisfactory earnings per share; Dividends;</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Appoint fit and proper boards, management auditors and <i>Shari'ah</i> board</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b>IAH</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Repayment of deposits on the agreed terms; Protection of their interests and Profit</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>To monitor the investment performance</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b><i>Shari'ah</i> Board</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Compliance with <i>Shari'ah</i></b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>To ensure <i>Shari'ah</i> compliance and protect the rights and interest of depositors and other stakeholder.</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b>BOD</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Monetary and non-monetary compensation;</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>To set the IFIs direction and policies</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b>Management</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Monetary and non-monetary compensation and commitment to claims of the contract.</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>To implement policies set by the BOD</b></li> </ul>

## CG From Islamic Perspective

- The foundational framework of CG in Islam is based on the element of *Tawhid*, *Shura*, *Shari'ah* rules, principles of contract and property rights and maintained the private goal without ignoring the duty of social welfare. This entails that the CG in Islam is inclined towards the stakeholders model.
- Equitably protecting the rights of all stakeholders irrespective of whether they hold equity or not.
- CG model in Islam is a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders per se.

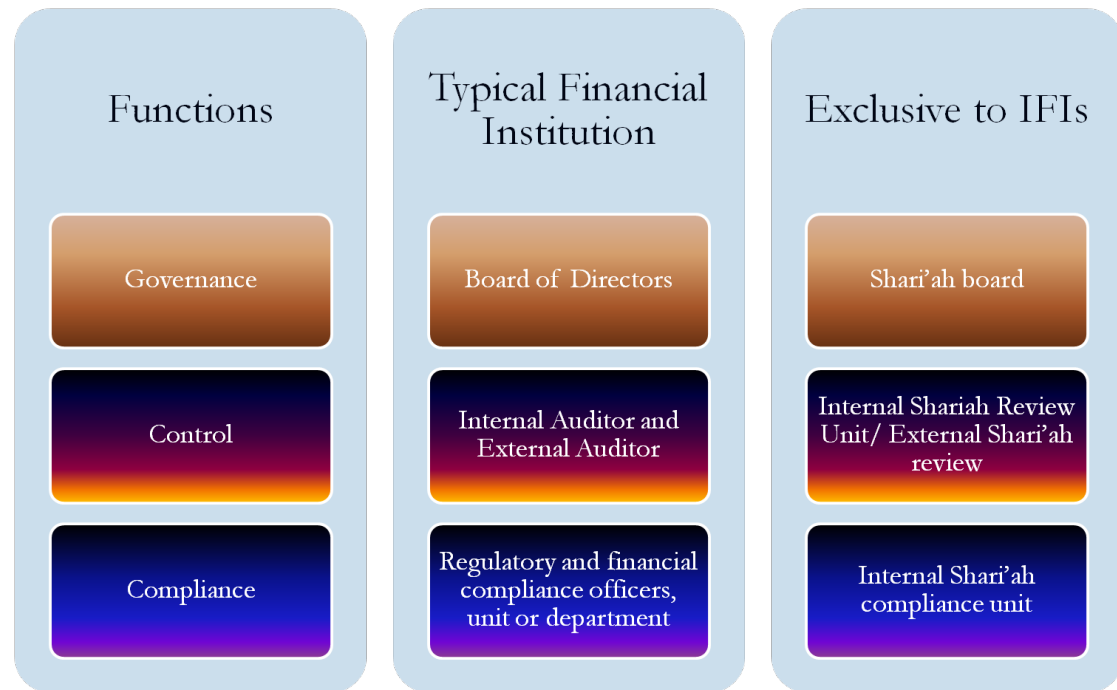
## Shari'ah Governance as part of CG in IFIs

- IFIs shall have adequate system of controls including Shari'ah governance (SG) system.
- SG is a set of institutional and organizational arrangements through which IFIs ensure that there is independent oversight of Shari'ah compliance.
- IFIs shall have in place a Shari'ah board (SB) to review and ensure that all financing proposals are Shari'ah compliant at all times.
- Internal/External Shari'ah review unit to assist the SB for Shari'ah-compliance purpose.

# Corporate Structure

Guidelines on Governance	Regulation	Regulator			
	Electing BOD/ Approving Key Policy	Shareholder			
Infrastructure	Investor/ Shareholder Protection	BOD			Shari'ah Board
Due Diligence					
Communication	Board Oversight	Risk Committee	Audit Committee	Governance Committee	
Internal Control					
Monitoring					Internal Shari'ah Compliance Unit/ Department
Enforcement	Management Oversight	Risk Management	Internal Audit	Compliance Officer	

# How SG complements CG framework in IFIs?





## Why does SG matter?

<i>The Investment Dar Company v Blom Developments Bank</i>	TID claims that the wakala based deposit in the amount of USD10m did not comply with the <i>Shari'ah</i> and therefore should be considered void.
<i>Judgment on BBA</i>	The High Court decreed that the profit derived from BBA facility is unlawful. The defaulters of BBA facility were only liable as to the original facility amount and not the selling price (Hasan, 2014).
Kleinwort Benson	One of the factors that lead to the closure of KB in 1986 was due to investor's reservation about the absence of a <i>SB</i> (Iqbal, 2002: 47) .
The Majma' Fiqh declaration on <i>Tawarruq</i>	Resolution on <i>Tawarruq</i> at the 19 <sup>th</sup> meeting in Sharjah, UAE on 26-30 <sup>th</sup> April 2009 which confirmed its impermissibility
Statement of 85% of potential <i>Shari'ah</i> non-compliance sukuk	Has negated in some way public confidence on legitimacy and Islamicity of the sukuk. Sales of sukuk dropped 50% in 2008 and prices fell at an average of 1.51% (Kettel, 2008: 38). According to Bloomberg, sales of global sukuk had dropped to USD856 million in 2008 (Sobri, 2008: 16).
Misused of funds by BCCI	Due to weak supervision on SG, it is found that BCCI has misappropriated the funds obtained from IFIs in non- <i>Shari'ah</i> portfolio (Grais and Pellegrini, 2006).

# Definition

The IFSB-10 defines the *Shari'ah governance* system as “a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review.



The term Shariah Committee or Shariah Supervisory Council or Shariah Advisory Council has been used interchangeably for the past 21 years. IBA 1983 used the term Shariah Supervisory Council while BAFIA 1984 used the term Shariah Advisory Council. The term Shariah Committee has been introduced by Bank Negara Malaysia in the Guidelines and Procedures for Shariah Committee issued in December 2004. CBA- SAC refers to the national Shariah Advisory Council and SC the Shariah Committee at the individual IFIs.

# Objectives

(i) Religious;

(ii) Social;

(iii) Economic;

(iv) Legal; and

(v) Governance.

# Why?

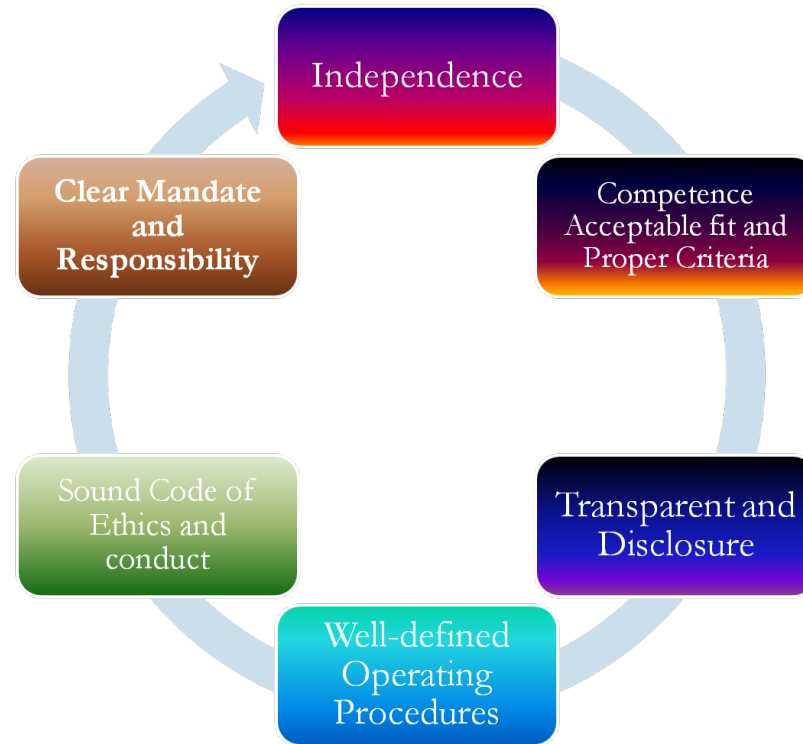
*Shari'ah* compliance

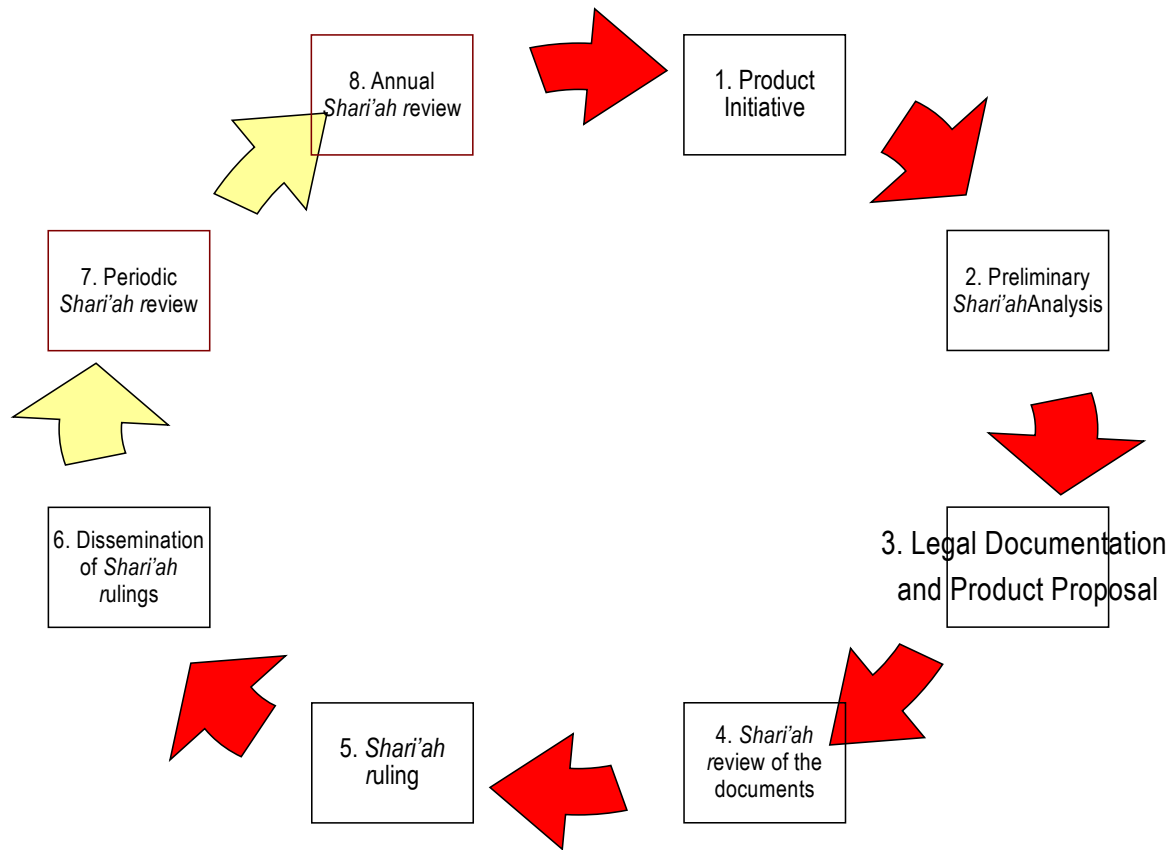
Islamic financial products must be genuinely legitimate and comply with the *Shari'ah* principles

Promoting moderation and justice in financial transactions and therefore enhancing the public confidence in IFIs on the aspect of compliance in its application of *Shari'ah* principles

To address a specific type of risk exclusive to IFIs, known as *Shari'ah* non-compliance risk.

# Elements of Good Shari'ah Board





Shariah Governance Process

## Institutionalization of Shariah Board

The AAOIFI Governance Standard No.1 defines a *Shari'ah board* as “an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari'ah* compliance and issuing legal rulings pertaining to Islamic banking and finance”

“a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and act as special advisers to the institutions”

# History

- The setting up of the institution of the *Shari'ah board* began in 1976 when the Faisal Islamic Bank of Egypt was established.
- It was the first to have a formal *Shari'ah board* consisting of selected *Shari'ah* scholars in Egypt.
- This practice was then followed by the Jordan Islamic Bank and the Faisal Islamic Bank of Sudan in 1978, the Kuwait Finance House in 1979, the Bank Islam Malaysia Berhad in 1983, and the Dubai Islamic Bank in 1999.
- Internal and external *Shari'ah boards* (in-house *Shari'ah board* of IFIs, *Shari'ah boards* at national and international levels, *Shari'ah* advisory firms and individuals undertaking *Shari'ah* advisory services.



# Shari'ah boards at Individual IFI Level

This model is the most prevalent practice of IFIs. Generally, an IFI is required to establish its *Shari'ah board* as stipulated in the article of association.

The internal *Shari'ah board* structure may vary from one board to another. The objective of the establishment of the *Shari'ah board*, as stated in the article of association, determines the nature of its governance structure.

This model lets an individual IFI establish its own *Shari'ah board*, regardless of its parent or group companies. For instance, HSBC Amanah has a different *Shari'ah board* in each of its subsidiaries to suit the legal environment of the local market.



## Central *Shari'ah* board for the Whole Group

- Centralised *Shari'ah* board for a whole group of companies. Although IFIs of this model are involved in cross border transactions, there is one central *Shari'ah* board that undertakes responsibility for matters pertaining to *Shari'ah* compliance.
- This model nevertheless seems to be inefficient in most jurisdictions, since a single *Shari'ah* board is incapable of handling numerous *Shari'ah* issues from various jurisdictions at one particular time



## National *Shari'ah* *boards*

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*Shari'ah boards* established by governments, particularly at the national level, either by the central bank or securities commission, such as in Malaysia, Indonesia, Brunei, Pakistan and Sudan, or by other ministry such as the Ministry of *Awqaf* in the case of Kuwait.

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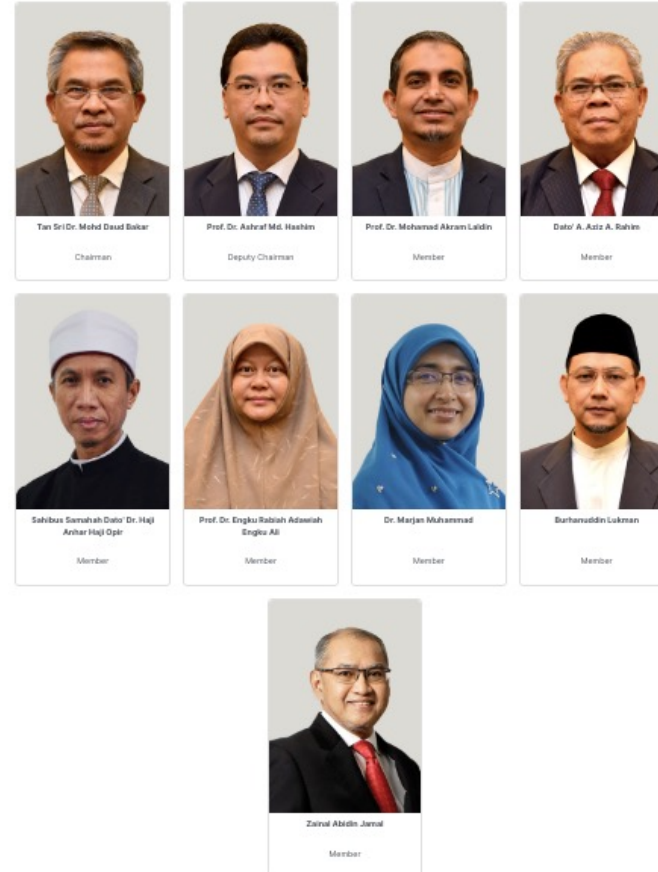
Another form of national *Shari'ah board* refers to the practice in Iran by which the Council of Guardians plays a role as the only institution that deals with Islamic banking and finance matters. The practice in Iran recognizes the Council of Guardians as the sole *Shari'ah* authority for IFIs.

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All these national *Shari'ah boards* nevertheless have common functions as the highest *fatwa* authority for IFIs and aim at harmonizing and standardizing *Shari'ah* practices and all its decisions are final and binding.



# Shariah Advisory Council BNM



# Shariah Advisory Council (Securities Commission)



**Datuk Dr. Mohd Daud Bakar**  
Group Chairman,  
Amanie Advisors



**Dato' Ahmad Tajudin Haji Abdul Rahman**  
Former Managing Director,  
Bank Islam Malaysia Berhad



**Professor Dr. Ashraf Md Hashim**  
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Islamic University of Malaysia



**Dr. Shamsiah Mohamad**  
Former Senior Researcher,  
International Shari'ah Research Academy for Islamic  
Finance (ISRA)

# *Shari'ah boards* at International Level

A *Shari'ah board* at international level normally refers to an independent *Shari'ah* body established by the mutual cooperation of several Muslim countries, such as the AAOIFI and the IDB.



The AAOIFI *Shari'ah board* has different functions from the internal and national *Shari'ah boards* as it plays a role in developing *Shari'ah* standards and promoting uniformity of *Shari'ah* governance practice.



The IDB *Shari'ah board* provides internal *Shari'ah* advisory services to the IDB as well as being involved in developing the governance standard of IFIs. Usually, the composition of the AAOIFI and the IDB is comprised of the eminent *Shari'ah* scholars in the world from diverse backgrounds. All of these scholars are considered as the leading experts in *fiqh al mu'amalat* and enjoy high authority in the *Shari'ah* aspect of Islamic finance



# AAOIFI BOARD MEMBERS

# *Shari'ah* Advisory Firms

- A *Shari'ah* advisory firm is an organization which offers *Shari'ah* services, either as a supervisory or consultative function, such as the Institute of Islamic Banking and Insurance (IIBI), the International Institute of Islamic Finance Incorporated (IIIF), the Islamic Banking and Finance Institute of Malaysia (IBFIM), Yasaar Limited (YL), the Minhaj *Shari'ah* Financial Advisory (MSFA), Failaka International (FI), BMB Islamic (BMBI) and Taqwaa Advisory and *Shari'ah* Investment Solutions (TASIS).
- These organizations are business entities and not part of any IFIs as they provide consultative and supervisory services for various aspects of banking and finance including matters related with *Shari'ah*. In terms of ownership, the current practice shows that *Shari'ah* advisory firms are either owned by independent parties (e.g. IIBI), IFIs (e.g. BMBI and IBFIM), legal firms or even by *Shari'ah* scholars themselves (e.g. FI, YL, IIIF and MSFA).



## Individuals Undertaking *Shari'ah* Advisory Roles

- This form of *Shari'ah* advisory services is rarely utilized by IFIs. In the absence of an internal *Shari'ah board*, instead of hiring a *Shari'ah* advisory firm, IFIs may seek *Shari'ah* advisory services from individual *Shari'ah* experts. This model is more prevalent in the case of Islamic windows, IFIs in non-Muslim countries or small scale companies.

# Roles of the SC

To advise Islamic financial institutions on any Shariah matter so as to ensure compliance with the shariah tenets and requirements

Concept and Structure of the Products

The SC will vet meticulously and endorse all products documentation.

Business operations of the Islamic financial institutions. These include the procedures for transaction, actual business operations, and system applicable to the banking operations.

To Advise Related Parties On Shariah Matter Upon Request

To Provide Written Shariah Opinion

To endorse Shariah Compliance Manuals

To assist the SAC of Central Bank of Malaysia on reference for advice

General Tasks and Duties

# Roles of the Shariah Board of AAOIFI

Plays a role to achieve harmonization and convergence in the concepts and application among the *Shari'ah* board at the individual IFIs level

To develop the *Shari'ah* approved instruments and examining any inquiries from IFIs or any other relevant parties.

# Shariah Governance Issues

<b>Issues</b>	<b>Governance Approach</b>
Independence of SB	Method of appointment Clear mandate
Competency, Conflict of Interest and Confidentiality	Restriction on multiple appointments Term of reference Declaration in writing Training
Consistency of the rulings	The adoption of AAOIFI standards Centralized Shari' ah board