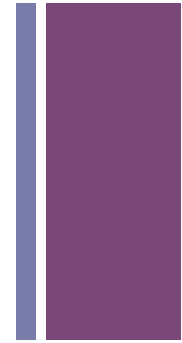


Shariah Governance

Zulkifli Hasan, PhD

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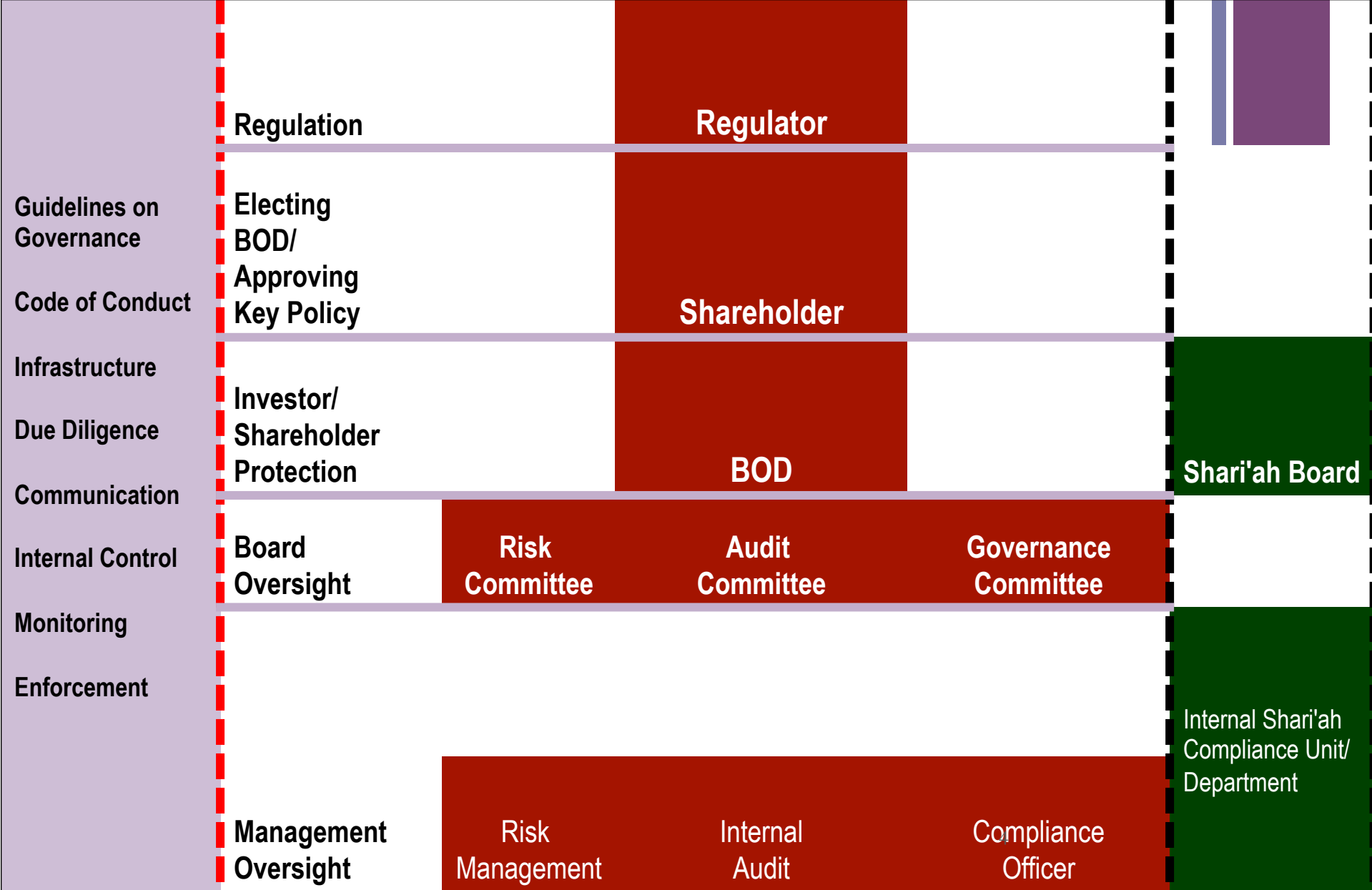
- **Conceptual Framework of Shariah Governance**
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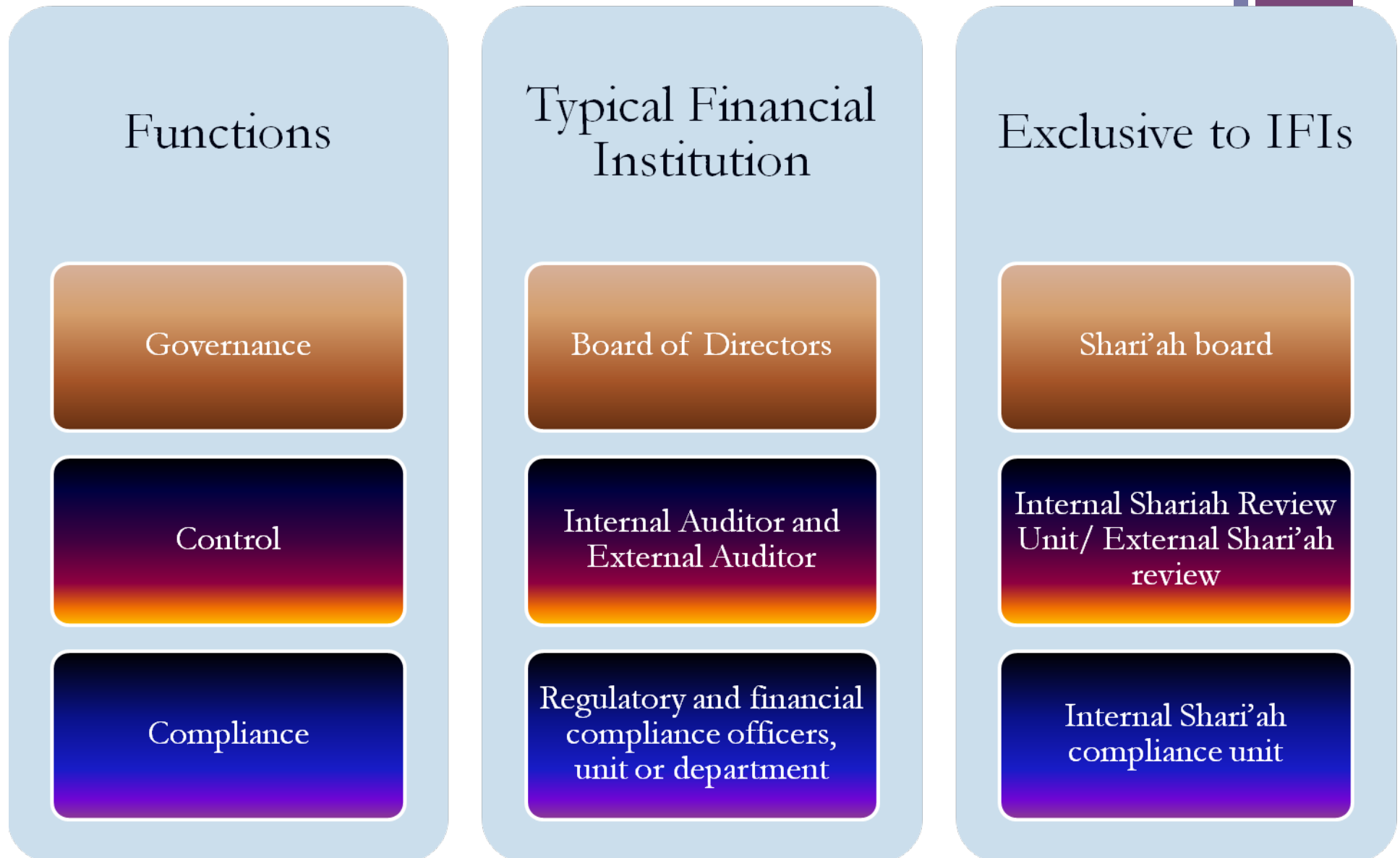
+ **Shari' ah Governance as part of CG in IFIs**

- 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.

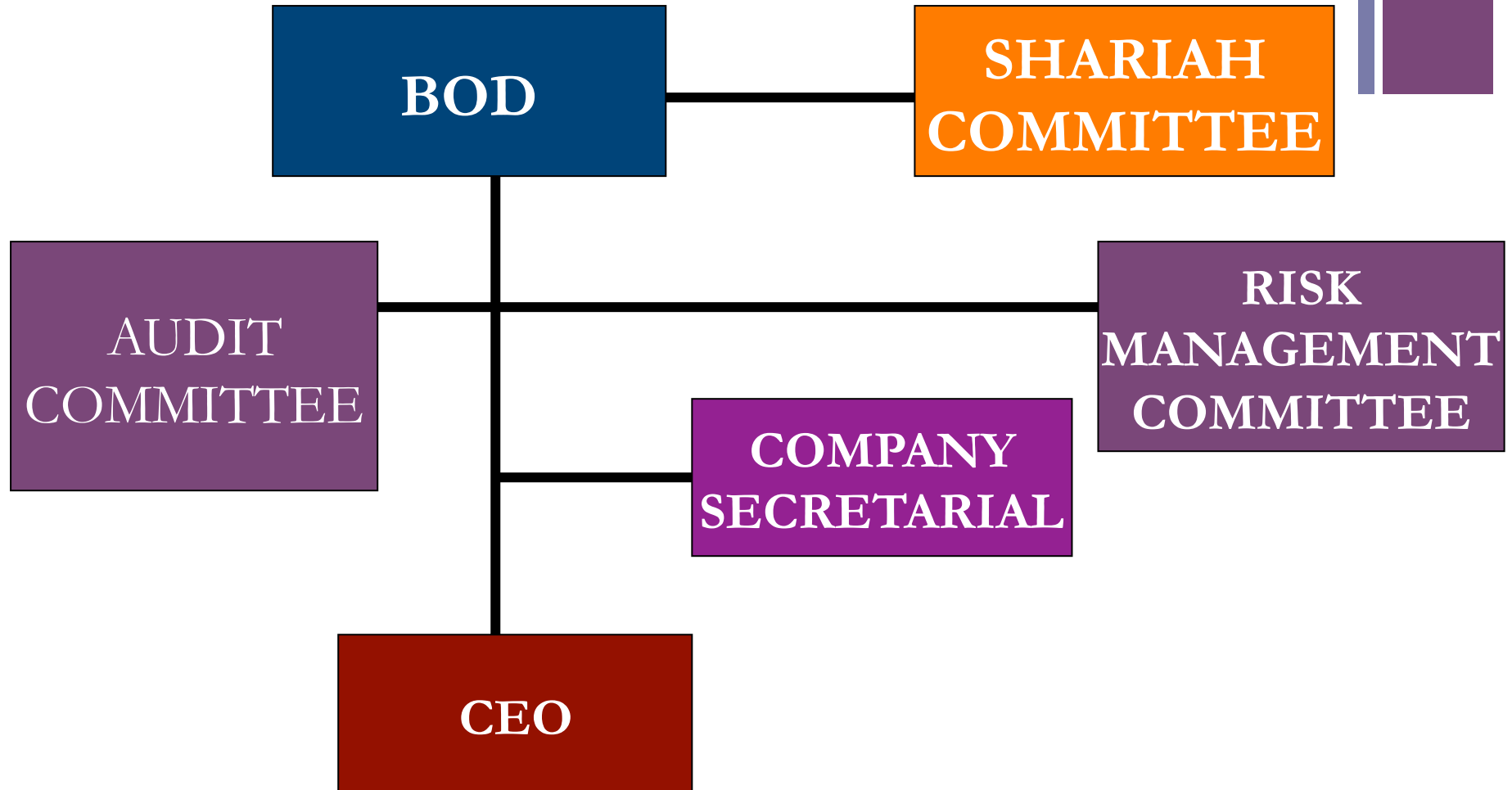
+Corporate Structure



+ How SG complements CG framework in IFIs?



+ Shariah Governance

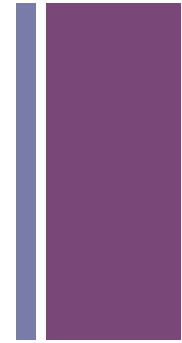


Why does SG matter?

<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.
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 th meeting in Sharjah, UAE on 26-30 th 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 (Graiss and Pellegrini, 2006).

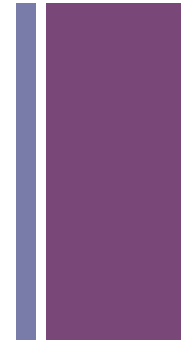
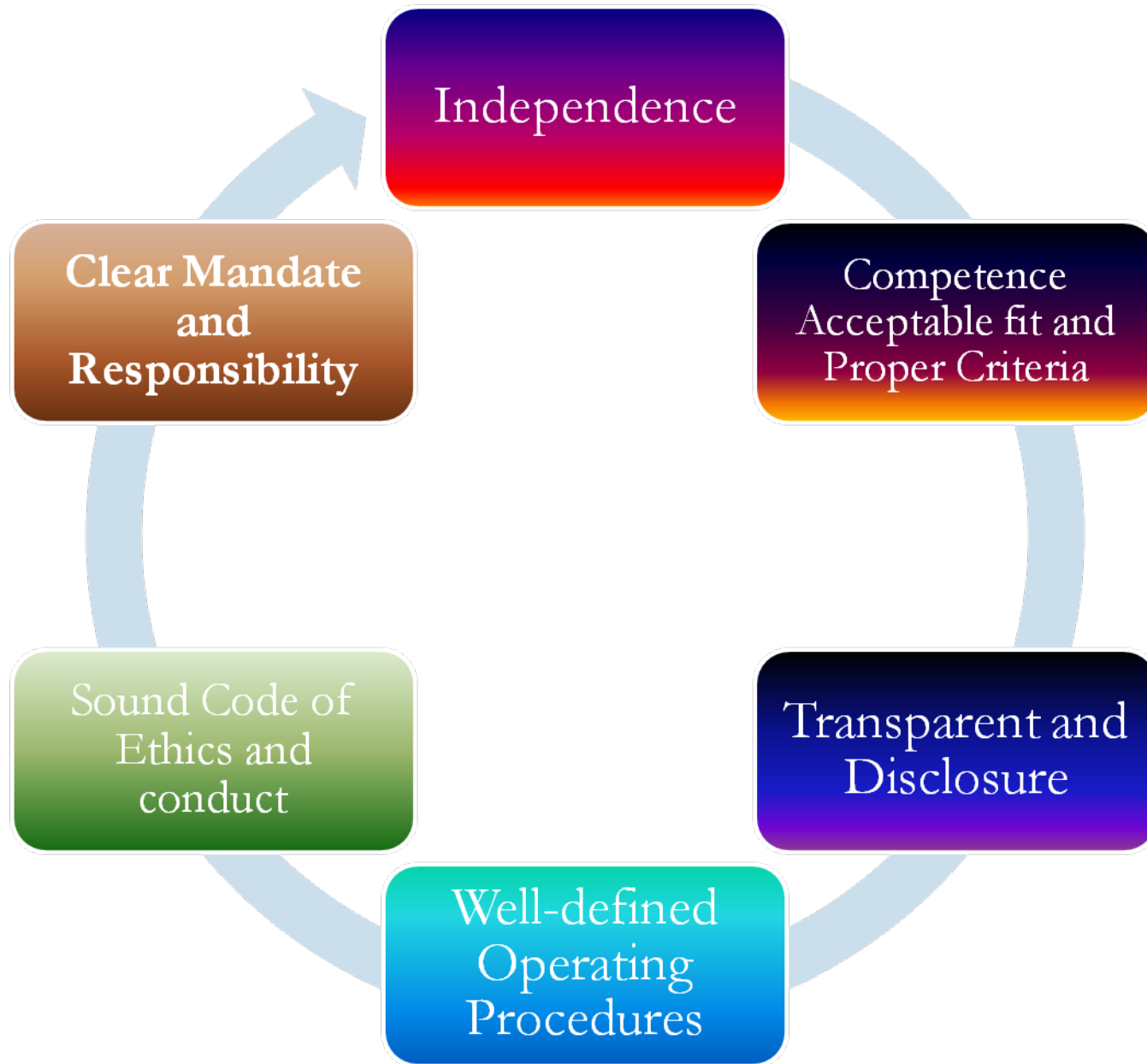
+ Definition

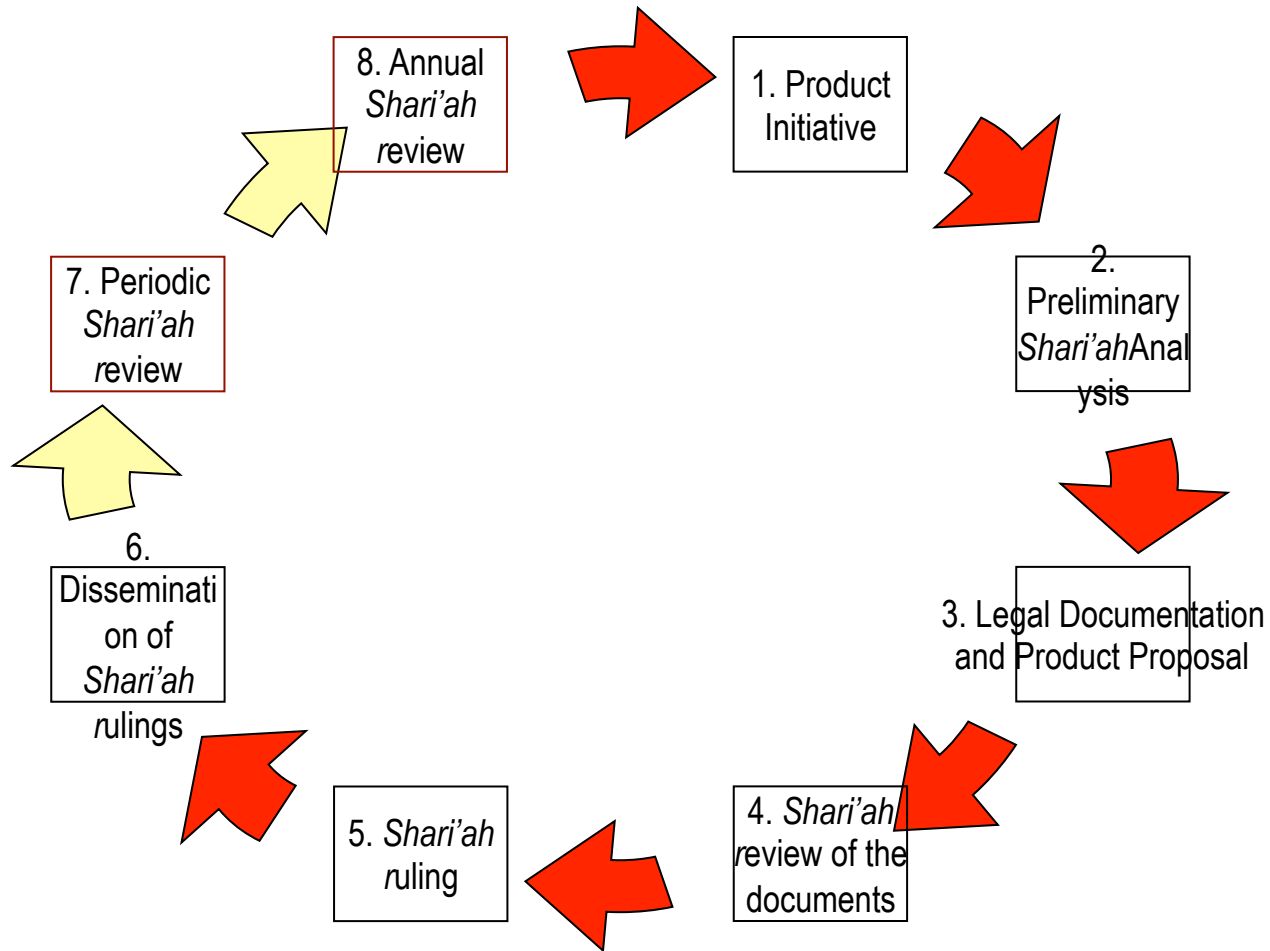
- **The IFSB-10 defines the *Shari'ah* governance system as “a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and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



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Elements of Good Shari' ah Board



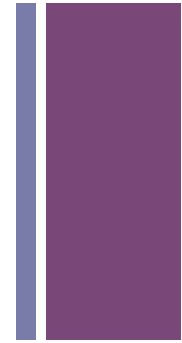


Issue	Governance Approach
Independence of SB	Method of appointment Clear mandate
Competency, Conflict of Interest and Confidentiality	Restriction on multiple appointments Term of reference Declaration in writing Training
Consistency of the rulings	The adoption of AAOIFI standards Centralized Shari' ah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

Types of Disclosure	Qualitative and Quantitative Disclosure
Financial and Risk Disclosure	<ul style="list-style-type: none"> ■ Corporate information ■ Capital structure ■ Capital Adequacy
Disclosure for IAH	<ul style="list-style-type: none"> ■ Policies, procedures, product design, product type and profit allocation basis of investment accounts
Risk Exposure and Risk Mitigation	<ul style="list-style-type: none"> ■ RM objectives, policies and practices, the structure and organisation of the relevant risk reporting and measurement systems, measures and indicators of risk exposures, policies for hedging and/or mitigating risk, and strategies and processes for monitoring the continuing effectiveness of risk management tools and techniques such as hedging and other risk mitigants.
Governance Disclosure	<ul style="list-style-type: none"> ■ The rights of IAH ■ Compliance with <i>Shari`ah</i> rules and principles, ■ Financial reporting in respect of investment accounts

+ Why?

- the sake of *Shari'ah* compliance
- Islamic financial products must be genuinely legitimate and comply with the *Shari'ah* principles
- in 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
- meant to address a specific type of risk exclusive to IFIs, known as *Shari'ah*non-compliance risk.



+ Institutionalization of Shariah Board

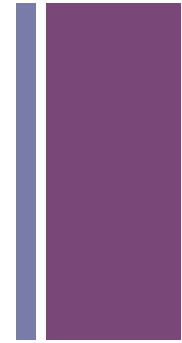
- The AAOIFI Governance Standard No.1 defines a *Shari'ah board* as “an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari'ah* compliance and issuing legal rulings pertaining to Islamic banking and finance”
- “a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and act as special advisers to the institutions”

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- **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.**

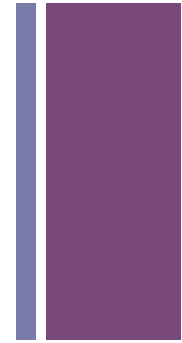
+ History

- 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.



+ Models of Shariah Board

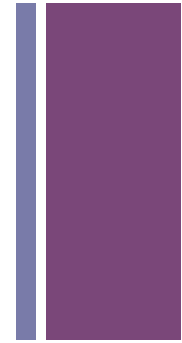
- internal and external *Shari'ah boards*, where the former refers to the in-house *Shari'ah board* of IFIs and the latter to the *Shari'ah boards* at national and international levels, *Shari'ah* advisory firms and individuals undertaking *Shari'ah* advisory services.





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

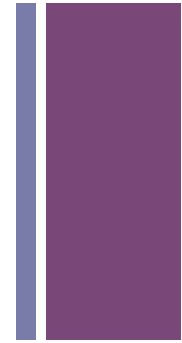
- Unlike the former model, this model centralizes the *Shari'ah board* for a whole group of companies. Although IFIs of this model are involved in cross border transactions, there is one central *Shari'ah board* that undertakes responsibility for matters pertaining to *Shari'ah* compliance. This model is practised by the Dallah al-Baraka Group. 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

- There are a few *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 government agencies such as the Ministry of *Awqaf* in the case of Kuwait.
- 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.
- Unlike the model in Malaysia, Brunei, Pakistan and Sudan, which also allows the establishment of *Shari'ah* boards at the institution level, the practice in Iran recognizes the Council of Guardians as the sole *Shari'ah* authority for IFIs. 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.

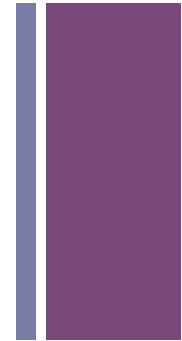
+ *Shari'ah boards* at International Level

- 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



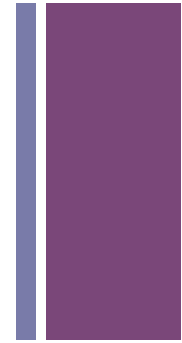
+ *Shari'ah* Advisory Firms

- 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 (IIF), 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, IIF and MSFA).



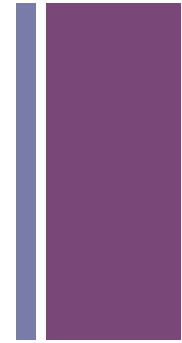
+ Individuals Undertaking *Shari'ah* Advisory Roles

- 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.



+ Appointment

- In contemporary practice, the members of the *Shari'ah board* are appointed by the shareholders in the annual general meeting (AGM) or by the BOD.
- In actual practice, numerous IFIs appoint members of their *Shari'ah board* through their BOD, as in the case of Malaysia and Pakistan.
- The practice is different in the case of the appointment of *Shari'ah board* members at the national level where the power is vested in the government, as in the case of the *Shari'ah board* of the Central Bank of Sudan and Malaysia. In Malaysia, the *Shari'ah board* of the BNM is appointed by the Yang di-Pertuan Agong on the recommendation of the finance minister pursuant to the CBA. On this basis, it can be concluded that there are various practices of the method of appointment of the *Shari'ah board* across jurisdictions.

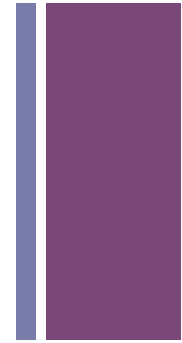


+ Composition

- most IFIs appoint three to six members on their *Shari'ah board*. The AAOIFI *Shari'ah board* is composed of not more than twenty members who are appointed by the Board of Trustees for a four-year term from among *Shari'ah* scholars. The AAOIFI governance standard requires at least three members at IFI level
- **To ensure that the SC would be able to function effectively, the composition of the Shariah Committee consist a minimum of five (5) members and their affairs will be managed by a shariah secretariat of the respective Islamic financial institutions**

+ Qualification

- *Shari'ah board* members are those who are experts in *Shari'ah* and law, specifically in the area of *fiqh al muāmalāt* and *usul al fiqh*. The reason behind this is that the *Shari'ah board* mostly deals with the issues related with commercial transactions.
- The AAOIFI governance standards and the IFSB-10 allow the appointment of an inexperienced person in *fiqh al muāmalāt* to be a *Shari'ah board* member with the purpose of strengthening the ability of the *Shari'ah board* to scrutinize and understand banking business and its operations, as in the case of the SBP and BNM.

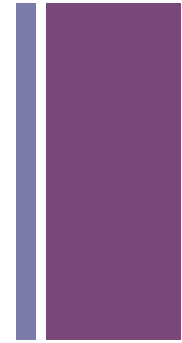


+ Shariah Compliance Review

- IFIs are required to undertake a *Shari'ah* review and internal *Shari'ah* review process for the purpose of ensuring that all transactions are in conformity with *Shari'ah* principles.
- The *Shari'ah* board examines the extent of *Shari'ah* compliance of the IFIs' products, activities and business transactions,
- The examination of the extent of *Shari'ah* compliance by an independent internal *Shari'ah* audit or as part of the internal audit based on the *Shari'ah* rulings, guidelines and instructions issued by the *Shari'ah* board.
- The *Shari'ah* board is normally assisted by this internal audit unit to review the *Shari'ah* compliance aspects in IFIs.

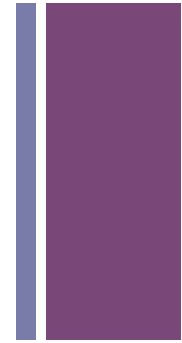
+ The SAC

- **The main objective of the establishment of the SAC is to advise the Islamic financial institutions on any Shariah matter and also to ensure compliance with the Shariah tenets and requirements in their operations**



+ The SAC and National Fatwa Committee

- **The National Fatwa Consultative Committee for Islamic affairs was established in 1970 and now is under the administration of JAKIM, Prime Minister's Department.**
- **This body has the authority to issue fatwa at national level to any matter referred by *Majlis Raja-raja*. *Majlis Fatwa Kebangsaan* consist of Chairman of the committee, Mufti for each state, five persons knowledgeable in Islamic law appointed by *Majlis Raja-raja* and a member of legal profession or judiciary appointed by *Majlis Raja-raja***



+ The SAC and State Fatwa Committee

- **The functions of the Fatwa Committee are to develop the Islamic law within the jurisdiction involving Muslim only.**
- **It has to advise the Ruler in all matters of Shariah and Mufti will be the chief authority in Islamic law matters in that state. The only recognized fatwa is legal rulings published by state Mufti with the consent of rulers and it has been gazzetted.**
- **The SAC' s Resolution binds IFIs, courts and arbitration.**

+ The Differences between SAC and Fatwa Committee

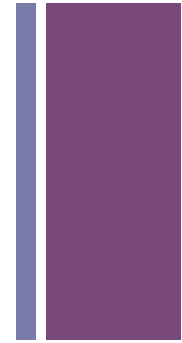
- **Committee Members**
- **State Fatwa Committee has their own members specifically provided in the Administration of Islamic Law whereby National Fatwa Committee consist of representatives of mufti from all states including selected members appointed by YDPA. State Fatwa Committee will be chaired by Mufti and National Fatwa Committee will be chaired by selected appointed person by YDPA.**
- **Open policy for the IFI to choose and appoint their members of the SAC**

+ Advisory Jurisdiction

- **National Fatwa Committee and State Fatwa Committee will discuss any matter which falls within the jurisdiction provided under the State List of Federal Constitution. This includes in the matter of Islamic family law such as marriage, divorce, ruju' maintenance, hadhanah, Islamic criminal offences and Islamic law of property.**
- **The SAC mainly issues resolution on muamalat and certain matters on ibadah.**

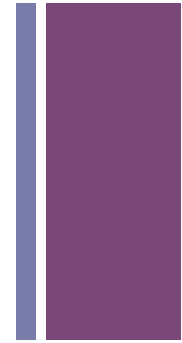
+ Enforcement of Fatwa

- **A Fatwa of National Fatwa Committee and State Fatwa Committee is not binding and enforceable unless and until it is published in the state's gazette.**
- **The SAC's resolution binds the court and arbitration to follow its decision.**



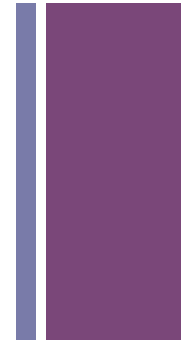
+ Subject Matter

- **In selecting the subject matter of fatwa, the former is subject to three occurrence, namely if it is ordered by the YDPA or if it is upon the request of the general public or on accord of the Mufti himself.**
- **The SAC will issue resolution upon request made by the IFI, customer, lawyers and etc. It concerns more on the parties involved in the banking business.**



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- **The SAC plays an active approach in selecting the subject matter of *fatwa*.**
- **Working hand in hand with the secretariats of respective banks, the SAC has to scrutinize the Shariah principles, suiting it to the proposed product, and in many instances they have to suggest for alternatives.**
- **The nature of studying the fiqh in the Islamic banking and takaful industry is also technical and in depth**

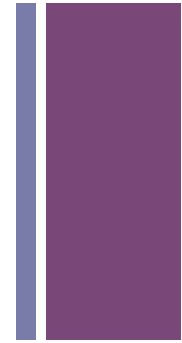


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- **Islamic financial institutions are not allowed to appoint any member of the SC in another Islamic financial institution of the same industry.**
- **For example, X is appointed as the SC member of Maybank Berhad. A is still eligible to be appointed as a member of Takaful Nasional. This is to avoid any element of conflict of interest and also for reasons of confidentiality within their respective institutions.**

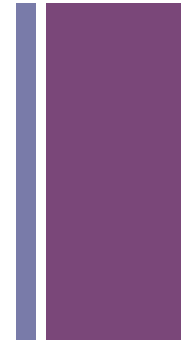
+ Roles of the SAC

- play significant roles in the harmonisation and standardisation of fatwas
- act as the highest *Shari'ah* authority of IFIs for the ascertainment of Islamic law for the purposes of Islamic banking business, takaful business, Islamic financial business or any other business which is based on Islamic principles and is supervised and regulated by BNM

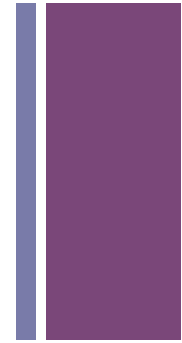


+ Roles of the SC

- **The primary objectives of the establishment of the SC are to advise Islamic financial institutions on any Shariah matter such as to its operation, to analyse and evaluate Shariah aspects of new products/schemes so as to ensure compliance with the shariah tenets and requirements in their operations.**



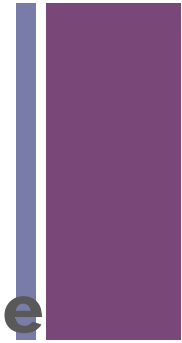
+ Concept and Structure of the Products



- **The SC will evaluate the concept and structure of the new product and will review the existing products.**



Documentation



- **The SC will vet meticulously and endorse all products documentation.**
- **to endorse and validate all relevant documentations and this includes the term and condition, the product manual, marketing advertisement, sales illustration and brochures used to describe the product.**

+Business Operations

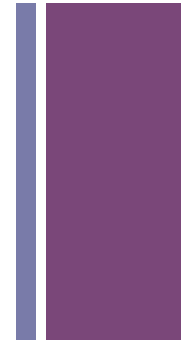
- **The SC will monitor the Islamic banking operations from time to time.**
- **advise the bank on shariah matters in order to ensure that the business operations of the Islamic financial institutions comply with shariah principles at all times. It includes the procedures for transaction, actual business operations, and system applicable to the banking operations.**

+ To Advise Related Parties On Shariah Matter Upon Request

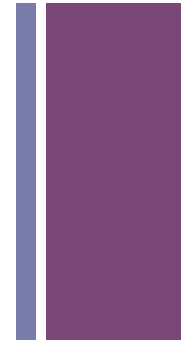
- **The related parties of Islamic financial institution such as its legal counsel, auditor or consultant, branches or even customer may seek advice on Shariah matters from the SC.**
- **There will be a syariah unit which administer of all request for the SC' s deliberation.**

+ To Provide Written Shariah Opinion.

- to record any opinion given.
- prepare written Shariah opinions.
- This written shariah opinion shall consist of issues, product structures and features, the SC' s opinion together with their reasoning from sources of Islamic law.



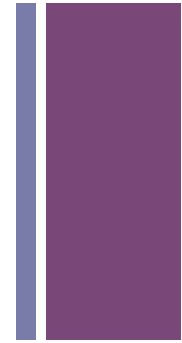
+ To endorse Shariah Compliance Manuals



- **the manual will specify the manner in which a submission or request for advice be made to the SC, the conduct of the SC's meeting and the manner of compliance with any Shariah decision.**
- **Islamic financial institution shall have a Shariah Compliance Manual which shall be regarded as a standard operational procedure for shariah governance.**

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

- **to assist the SAC of BNM on any matters referred by Islamic financial institution.**
- **explain the shariah issues involved and to provide recommendations for a decision.**
- **The explanation and recommendation must be supported by relevant shariah jurisprudential literature from the recognized sources.**



+ General Tasks and Duties

- **The SC also will deal with certain general duties and tasks relevant to their job scope and this includes to assist the related parties on shariah matter and to determine the zakat policy of the banks.**
- **Zakat is compulsory to every Muslim and Islamic institutions such as a bank.**

+ 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.

