IMPROVING SHARIAH GOVERNANCE IN ISLAMIC FINANCE

15.09.2020
OUTLINE

- Conceptual Framework and Methodology (1 & 2)
- Overview and Analysis of Shariah Governance (3)
- Issues and Challenges Observed in Member Countries (4)
- Lessons Learnt from the Selected Case Studies (5)
- Policy Recommendations (6)
OBJECTIVES OF THE STUDY

- Theoretical & legal nature of the SGF in IF
- Size, trends, structures, modes, & instruments of IF, & SGF
- SGF implementation models, regimes, roles, & SSB responsibilities
- SGF in selected countries, focusing on:
  - strength and weaknesses of different SG models,
  - based on, case studies of:
    - Shariah non-compliance risk due to diverse applications/misinterpretations of IF products.
CONCEPTUAL FRAMEWORK AND METHODOLOGY

- 3-stage approach to data collection & analysis
  - First stage:
    1.1 Collect primary & secondary data
    1.2 Case studies, reviewed
  - Second stage:
    2.1 Synthesis, conclusions, and recommendations
    2.2 Literature review
  - The survey includes
    3.1 Structured questionnaires
    3.2 Semi-structured interviews
GLOBAL ISLAMIC FINANCE INDUSTRY: CURRENT & PROJECTED GROWTH

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Asset (US$ Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>1746</td>
</tr>
<tr>
<td>2013</td>
<td>2050</td>
</tr>
<tr>
<td>2014</td>
<td>1965</td>
</tr>
<tr>
<td>2015</td>
<td>2190</td>
</tr>
<tr>
<td>2016</td>
<td>2290</td>
</tr>
<tr>
<td>2017</td>
<td>2438</td>
</tr>
<tr>
<td>2018</td>
<td>2524</td>
</tr>
<tr>
<td>2019</td>
<td>2595</td>
</tr>
<tr>
<td>2023</td>
<td>3809</td>
</tr>
</tbody>
</table>
ISLAMIC FINANCE ASSETS BY TYPE

- Islamic Banks: 70%
- Sukuk: 18%
- Islamic Funds: 4%
- Takaful: 6%
- Other IFIs: 2%
- Other: 4%
DEFINITION OF SHARIAH GOVERNANCE: IFSB

A Set of institutional and organizational arrangements that

- An International/national IFI uses to ensure
  - Effective independent oversight of Shariah compliance
    - over the issuance of relevant Shariah resolutions
  - Dissemination of information on Shariah, and an internal Shariah compliance review
    - for verifying Shariah compliance
COMPONENTS OF SHARIAH GOVERNANCE SYSTEM

- Institutional and organizational arrangements and procedures
- Effective and independent Shariah supervision
- Internal Shariah compliance review
- Issuing decisions and fatwas
- Dissemination of fatwas and resolutions
- Fulfill all business and operations contracts in IFIs
CORPORATE GOVERNANCE THEMES FOR ISLAMIC FINANCE INSTITUTIONS (IFIs)
BOARD OF DIRECTORS

- QUALIFICATIONS/EXPERIENCES OF DIRECTORS;
- NUMBER/PROPORTION OF INDEPENDENT DIRECTORS;
- CHAIRMAN IS NOT THE CEO;
- NUMBER OF BOARD MEETINGS/YEAR;
- FORMALIZED CODE OF ETHICS/BUSINESS CONDUCT
BOARD COMMITTEES

- Governance Committee;
- Executive Committee;
- Audit Committee;
- Remuneration/Nomination Committee;
- Risk Committee;
- Ethics and Compliance Committee
INTERNAL CONTROL & EXTERNAL AUDIT

- Proportion of independent members Audit Committee;
- Independent Chairperson of Audit Committee;
- Number of Audit Committee meetings;
- Existence of internal audit department/ unit;
- Internal audit reporting to Board/Audit Committee;
- External auditor appointed
RISK GOVERNANCE

- Board guidance on risk appetite/profile;
- Independent Risk Committee chair;
- Independent Majority of members of Risk Committee;
- Chief Risk Officer (CRO):
  - reports to the board of directors or Risk Committee;
  - a member of Executive/Risk Committee
SHARIAH GOVERNANCE

- Number of Shariah Board members;
- Duties of Shariah Board;
- Members (non-voting):
  - Can be apprentice members to be promoted later
- Number of Shariah Board meetings;
- Shariah review/audit department/unit;
- Statement on the use of prohibited income
TRANSPARENCY AND DISCLOSURE

• Corporate Governance Report;
  - Remuneration policy of Board members and senior executives disclosed;
  - Shariah (compliance/audit) report;
  - Risk management report;
  - Internal Audit / Control Report;
  - Corporate Social Responsibility Report
CORPORATE GOVERNANCE & SHARI'AH GOVERNANCE
DIVINE TEXT & ISLAMIC ECON

Islamic Financial Institutions

Management

Employees

Corporate Governance Culture

Standards of Behavior for Employee

Islamic Values and Beliefs

Society

Shareholders

Stakeholders
<table>
<thead>
<tr>
<th>Year</th>
<th>Document Title</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>AAOIFI GSIFI No. 1: Shariah Supervisory Board</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>AAOIFI GSIFI No. 2: Shariah Review</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>AAOIFI GSIFI No. 3: Internal Shariah Review</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>AAOIFI GSIFI No. 4: Audit &amp; Governance Committee</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>AAOIFI GSIFI No. 5: Independence of Shariah Board</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>AAOIFI GSIFI No. 6: Governance Principles for IFIs</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>IFSB-3: Guiding Principles on Corporate Governance</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>IFSB-6: Guiding Principles on Collective Investment</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>AAOIFI GSIFI No. 7: Conduct and Disclosure for IFIs</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>IFSB-8: Guiding Principles on Governance for Takaful</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>IFSB-10: Shariah Governance Systems for IF Services</td>
<td></td>
</tr>
</tbody>
</table>
## DIFFERENT REGULATORY APPROACHES

<table>
<thead>
<tr>
<th>Features</th>
<th>Hands-off</th>
<th>Minimal</th>
<th>Engaged</th>
<th>Proactive</th>
<th>Commit’d</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specific IF laws / regulations</td>
<td>–</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Internal Shariah Audit</td>
<td>–</td>
<td>–</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>SSB at IFI</td>
<td>–</td>
<td>–</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Centralized SSB at regulatory level</td>
<td>–</td>
<td>?</td>
<td>?</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>External Shariah Audit</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>√</td>
</tr>
<tr>
<td>Regulatory Shariah Audit</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>
SHARIAH CONTROL SYSTEM

- Shariah risk management: monitors non-compliance risks
- Shariah audit: independent assessment of overall Shariah compliance
- Shariah review: regular evaluation of the Shariah compliance of IFIs
- Research and Development: part of Shariah review unit, covers innovation, product development and structuring
LESSONS FROM THE FINANCIAL REGULATION THEORY

- Regulation Theory and the Received Doctrine
- Finance of Gambling, Debt Trade & Ponzi Scheme
- Micro and Macro-Prudential Regulation
- Regulatory Differences Between Islamic & Conventional Banks
INSIDIERS: CHALLENGES & OBSTACLES OF SG

- national Restrictions
- Shariah Non-Compliance
- intern'l convent standards
- Public credibility and (BOD) and the SSB conflict
- Digitization & Fin Tech impact
- Shareholders’ value and Conflict with Intern'l
- Ignoring Intern'l
- Fatwas Inconsistency

Scores: 3.37, 3.29, 3.25, 3.21, 3.21, 3.17, 3.15, 3.09, 3.03, 2.99
## ADDITIONAL MECHANISMS IN IFIS

<table>
<thead>
<tr>
<th>Functions</th>
<th>Conventional FIs</th>
<th>Additions in IFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Board of Directors</td>
<td>SSB</td>
</tr>
<tr>
<td>Control</td>
<td>Internal Auditor</td>
<td>Internal Shariah review/audit unit/dep</td>
</tr>
<tr>
<td></td>
<td>External Auditor</td>
<td>External Shariah review</td>
</tr>
<tr>
<td>Compliance</td>
<td>Regulatory and financial compliance officers, unit or dept</td>
<td>Internal Shariah compliance unit/department</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SG Survey (SGS) for IFIs,
• 40% answered: don’t have an external Shariah audit function.
- Barriers to SSB independence
- Financial relations of SSB members with IFIs.
- Family or personal relations with the management.
- Receiving payments from several IFIs.
- Receiving services and rewards from the IFIs.
- Continuity in the same IFI for a long time.
SSB CODE OF CONDUCT

- Having a written policy on Shariah review procedures, quality...
- Institution publishes a chart, which explains its governance structure...
- SSB follows Code of Ethics published by standard setting...
- SSB has an effective and written Code of Conduct...
- SSB derive their credibility from implementation of Code of Conduct...
- SSB follows international / conventional code of ethics in...
STANDARDIZATION BEST OPTION

- HANDBOOK FOR ISLAMIC FINANCE PRODUCTS, CONTAINING:
  - Annotation
  - Shariah rules, economic rationale,…
  - Samples: Contracts, MOUs, feasibility studies, fin. inst. prospectuses
EDUCATIONAL & HUMAN DEVELOPMENT CHALLENGES

- A lack of qualifications in SSB’s members
- Shortage of qualified Shariah members
- A high concentration of a few members

- Having adequate competencies
- Existance of fit and proper selection and appointment criteria and formal process
- Appointed according to their competencies/skills/expertise through
CONDITIONS FOR SSB MEMBERS’ REPUTATION

- Not declared as bankrupt, or a bankruptcy petition
- No criminal offense involving financial crimes
- Not found guilty of serious criminal or any other offense punishable with one year or more in jail
- Not subject to orders of detention, supervision, restricted residence or banishment
- Not subject to any adverse findings or any settlement in civil or criminal proceedings with regard to investment, financial or business, etc.
ROLE OF SSB & TECHNICAL CHALLENGES

- Examination of contracts, transactions, and forms,
- Examination of Islamic financial transactions procedures,
- Approving the IFI balance sheet,
- Reporting and clearly expressing opinions on the degree of reliability of the transactions,
- Report on the Shariah VIOLATIONS, explain the reasons and effect for the violation,
- Report on the adherence to Shariah compliance, ethics, and social responsibility.
Thank you

QUESTİONS & ANSWERS
IMPROVING SHARI’AH GOVERNANCE IN ISLAMIC FINANCE

SESSION-2: LESSONS LEARNT FROM THE CASE STUDIES AND POLICY RECOMMENDATIONS
CASE STUDIES

5 OIC MEMBER &
1 NON-OIC MEMBER COUNTRIES
5 OIC member countries
- Indonesia
- Malaysia
- Nigeria
- Turkey
- The United Arab Emirates

1 Non-OIC member country
- The U. K.

Malaysia: among the most-developed IF systems in the world.

Turkey: among the top ten countries in the Islamic financial sector.

UAE: one of the top 3 Islamic finance markets.

Nigeria: a population of about 200 million, 51% as Muslims.

Indonesia: largest Muslim population with 99% Muslims.

London a growing global hub of IF.
CRITERIA OF CASE STUDIES

Selection Criteria

- The report uses case studies of five OIC countries (Malaysia, Nigeria, Turkey, Indonesia, and the United Arab Emirates) and one non-OIC country (the United Kingdom) to provide an in-depth examination of the developments in promoting Islamic finance governance.

- Different criteria were used for determining case studies countries:
  - Ensure regional diversification,
  - Assuring the representation of countries that have different level of development,
  - Taking into consideration size of Islamic financial industry in relevant countries.

Selected Case Study Countries According to their Islamic Finance Development Level:

<table>
<thead>
<tr>
<th>Infancy</th>
<th>Developing</th>
<th>Matured</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>Indonesia</td>
<td>Malaysia</td>
</tr>
<tr>
<td></td>
<td>Turkey</td>
<td>UAE</td>
</tr>
</tbody>
</table>
Issues and Challenges
- Different Shariah resolutions
- Different background scholars
- Shariah committee remuneration

Recommendations
- Communicating Shariah requirement to practitioners
- Criteria for Shariah committee appointment
- Better communication between the Shariah committee and BOD

MALAYSIA

- 1983: IBs must have Shariah Boards
- 2004: Guidelines on SB governance
- 2011: The SGF for IFIs
- 2019: BNM: latest SGF
Issues and Challenges

- IF Misconception
- Limited knowledge of IFIs standards
- Limited accessibility to Shariah compliance information
- Absence of IFI regulations

Recommendations

- More awareness about IF
- Expand ACE to include local talents and expertise for effective governance
UAE

- 1985: Islamic Banking Law required IFIs to establish SSBs
- 2004: Dubai International Financial Centre established.
- 2016: High Shariah Authority.
- 2018: AAOIFI Shariah Standards was adopted

Issues and Challenges
- SGF is largely vested with the SSBs of IFIs
- DIFC is exempted from the HSA
- Unclear terms & conditions for HSA, SSB members
- No rules for the appointment of SSB members
- Transparency: fatwas are not published

Recommendations
- Subject IFIs to HSA for Shariah governance and compliance
- More awareness of SGF among IFIs and public
- Improve Shariah audit function within HSA and IFIs
- Regulatory provisions on SGF
INDONESIA

Regulatory Body: OJK
- 1998: Shariah banks allowed
- 1999: DSN established within the MUI
- 2000: DSN duties & responsibilities set
- 2008: Shariah Banking Act No: 21
- 2017: KNEKS established to harmonize activities & regulations of IF and halal business
Issues and Challenges

- No Shariah audit, standards or procedures
- Shariah experts can sit on multiple SSBs
- Some DSN members are also SSB members
- No legal basis for the DSN
- Many IFIs have no
  - Shariah compliance specialists
  - Shariah advisory unit
- DSN and OJK have different requirements for SSBs

Recommendations

- SGF can be more effective if DSN is decentralized
- Reduce the need for Shariah experts by establishing regional SSBs, or, increasing capacity to train more experts
- OJK can define the SSB’s position in IFI structure
ISSUES AND CHALLENGES

- Poor perception management for IF
- Conflicts between decisions of Shariah boards
- Lack of qualified human capital in the IF sector
- Doubts related to the Shariah compliance of IF products
- Lack of regulation by the government

RECOMMENDATIONS

- SGF should be linked to int’l IF standards
- Central Advisory Boards for IFIs other than IBs
- Separate legislation for IFIs
- SSBs response to new developments
UK

- 2000: Financial Services and Markets Act
- 2001: Islamic Finance Working Group
- 2005: Finance Act, governs Islamic financial transactions
- 2006: Companies Act rules for all kinds of companies
- 2013: FSA split into: FCA and PRA

Issues and Challenges
- Shariah unrecognised as a system of law
- No single codified body of Islamic law
- FCA has no Shariah scholars for reviewing the compliance
- IFIs control own Shariah governance
- Shariah boards in IFIs:
  - advisory role
  - members can sit on multiple SB boards

Recommendations
- Develop SGF for IFIs
- A central body must monitor Shariah governance
- FCA must understand how SB affects firm conduct
Survey Results and Analysis
## Respondents to Questionnaire by Country / Group

<table>
<thead>
<tr>
<th>Region</th>
<th>Groups</th>
<th>Countries</th>
<th># responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>OIC</td>
<td>Arab Region</td>
<td>Palestine, Iraq, Bahrain, Algeria, Jordan, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, UAE, Yemen, Kuwait, Tunisia</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>Asian Region</td>
<td>Afghanistan, Indonesia, Malaysia, Pakistan, Turkey, Brunei Darussalam, Maldives</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>African Region</td>
<td>Nigeria</td>
<td>7</td>
</tr>
<tr>
<td>Non-OIC</td>
<td></td>
<td>United Kingdom</td>
<td>6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td></td>
<td><strong>124</strong></td>
</tr>
</tbody>
</table>
RESPONDENTS BY PROFILE

- Academic / Research Scholars in Islamic Finance: 13,40%
- Chairman / Member or Advisor in SSB: 12,40%
- External / Internal Shariah audit: 9,30%
- Officer / Researcher of SSB: 5,20%
- Chief Executive Officer in IFIs: 3,10%
- Chairman / Member / Advisor of SSB in regulatory bodies: 10,20%
- Others: 46,40%
The Effectiveness and Impact of SGF

The SGF can be implemented in an effective way from implementation perspective:

- 2% of respondents rate the SGF as 1
- 7% rate it as 2
- 32% rate it as 3
- 33% rate it as 4
- 27% rate it as 5

The SGF can be described as appropriate and well-regulated:

- 3% of respondents rate the SGF as 1
- 10% rate it as 2
- 26% rate it as 3
- 44% rate it as 4
- 18% rate it as 5
Effectiveness and Impact of SGF in Selected Countries

- UK: 3.00
- Jordan: 3.29
- Turkey: 3.32
- UAE: 3.49
- Sudan: 3.53
- Nigeria: 4.07
- Malaysia: 4.11
- Indonesia: 4.14
Effectiveness, Independence and Transparency of SSB and Competencies of SSB Members in Selected Countries
Who has the power to approve the appointment and dismissal of SSB members in your jurisdiction?
How many members are there in SSB in your institution?
Stakeholders Interest in Shariah Compliance in Selected Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jordan</td>
<td>3.24</td>
</tr>
<tr>
<td>Turkey</td>
<td>3.30</td>
</tr>
<tr>
<td>UK</td>
<td>3.77</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.73</td>
</tr>
<tr>
<td>UAE</td>
<td>3.83</td>
</tr>
<tr>
<td>Nigeria</td>
<td>4.00</td>
</tr>
<tr>
<td>Malaysia</td>
<td>4.15</td>
</tr>
<tr>
<td>Sudan</td>
<td>4.27</td>
</tr>
</tbody>
</table>
Code of Conduct of SSB in Selected Countries

- Jordan
- UAE
- Indonesia
- Malaysia
- UK
- Turkey
- Sudan
- Nigeria
Overall Success of Shariah Governance in Selected Countries

- Jordan
- UK
- Turkey
- Nigeria
- Indonesia
- Malaysia
- UAE
- Sudan

ASBU - INTERNATIONAL CENTER FOR ISLAMIC ECONOMICS AND FINANCE
IMPROVING SHARIAH GOVERNANCE IN ISLAMIC FINANCE

SESSION-3: POLICY RECOMMENDATIONS
Shariah Supervisory Boards (SSBs)

- Go for: a national SSB,
  - Institutional SSB’s, if any.
    - under direct supervision of the national SSB.

- Shariah boards composition:
  - Majority: monetary and financial economists.
  - Minority: Shariah experts.

- National SSB’s must consider all stakeholders interests.

- SSBs should not be limited to issuing fatwas.

- The national SSB:
  - disallow membership of more than one national or institutional SSB.

- Pronouncements of national & institutional SSB’s
  - To be collected, indexed and made public.

- SSB members must attend all meetings.
Regulatory Environment

- **Banking Law**
  - Definitions of all IF Products
  - Regulator to add new products

- **Financial Market law**
  - Definitions of IF instruments
  - Prohibit debt & pure risk trade.

- **Products & Instruments Handbook**
  - Issued by the regulator

Involving Stakeholders

- **Investment account holders, IAHs**
  - Vote in GA and BOD in proportion to resources
    - At start of the FY as % of IFI capitalization

- **IAH share of BOD seats**
  - To largest accounts.

- **IFI management remuneration**
  - Partly as IFI stock.
Optimal Shariah Governance Components

- Banking and financial market laws with all IF rules.
- Regulatory rules:
  - IFI’s supervised for strict application.
- IF advisory board, to
  - Advise regulator
  - Vet new products
  - Rule on issues related to IFIs daily operations

Standard Setters

- Conflict of rules by standard setters.
  - Resolve by regulator
- Ultimate standard setter.
  - The national SSB
- AAOIFI and IFSB
  - Must abide by the resolutions of the OIC International Fiqh Academy.
Thank you

QUESTIONS & ANSWERS