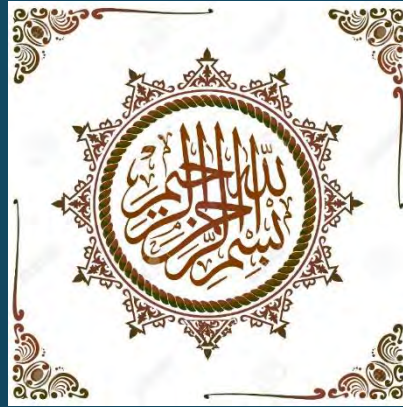




COMCEC
COMCEC
Coordination Office
Ankara, Turkey



Social Sciences University of
Ankara

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

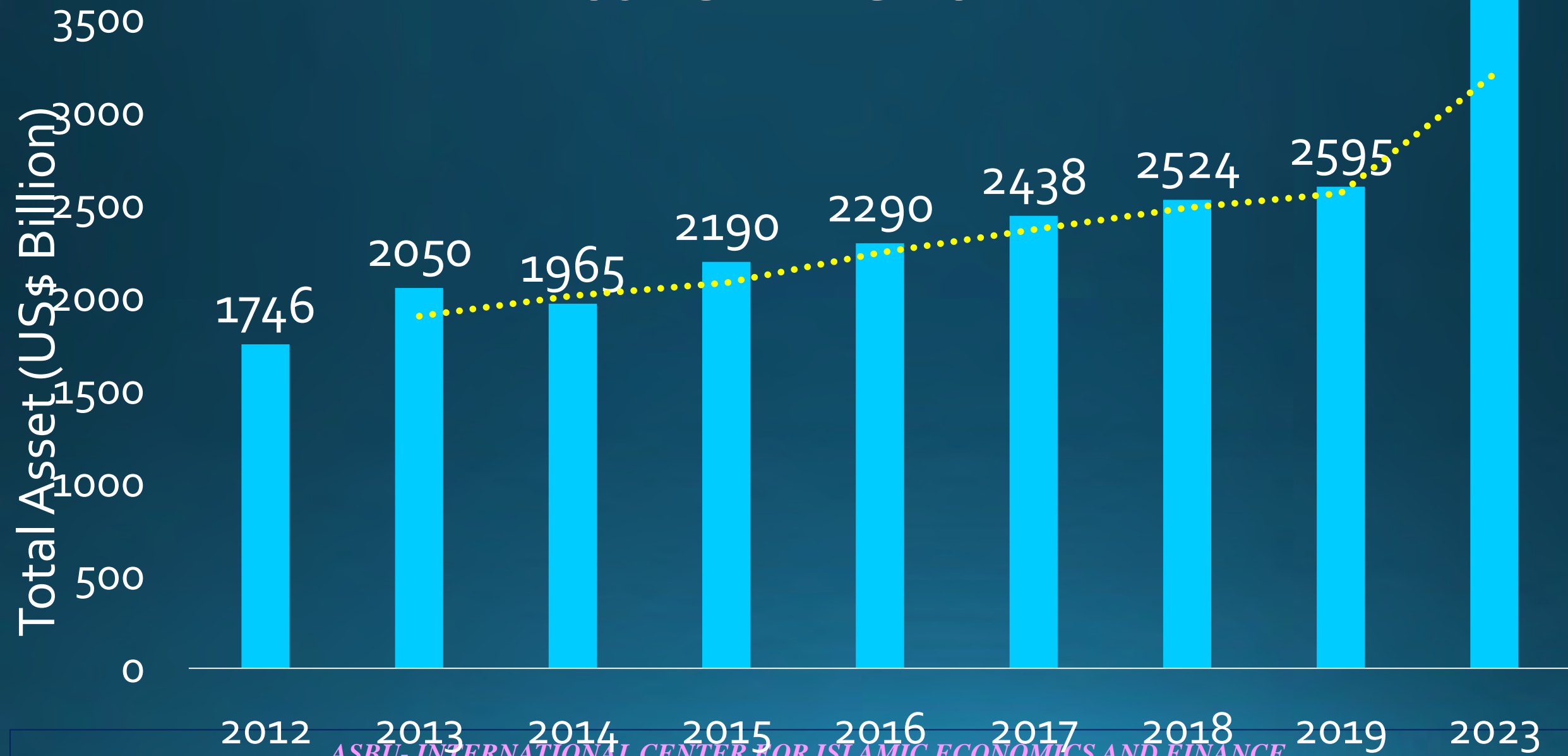
2.2 Literature review

❖ The survey includes

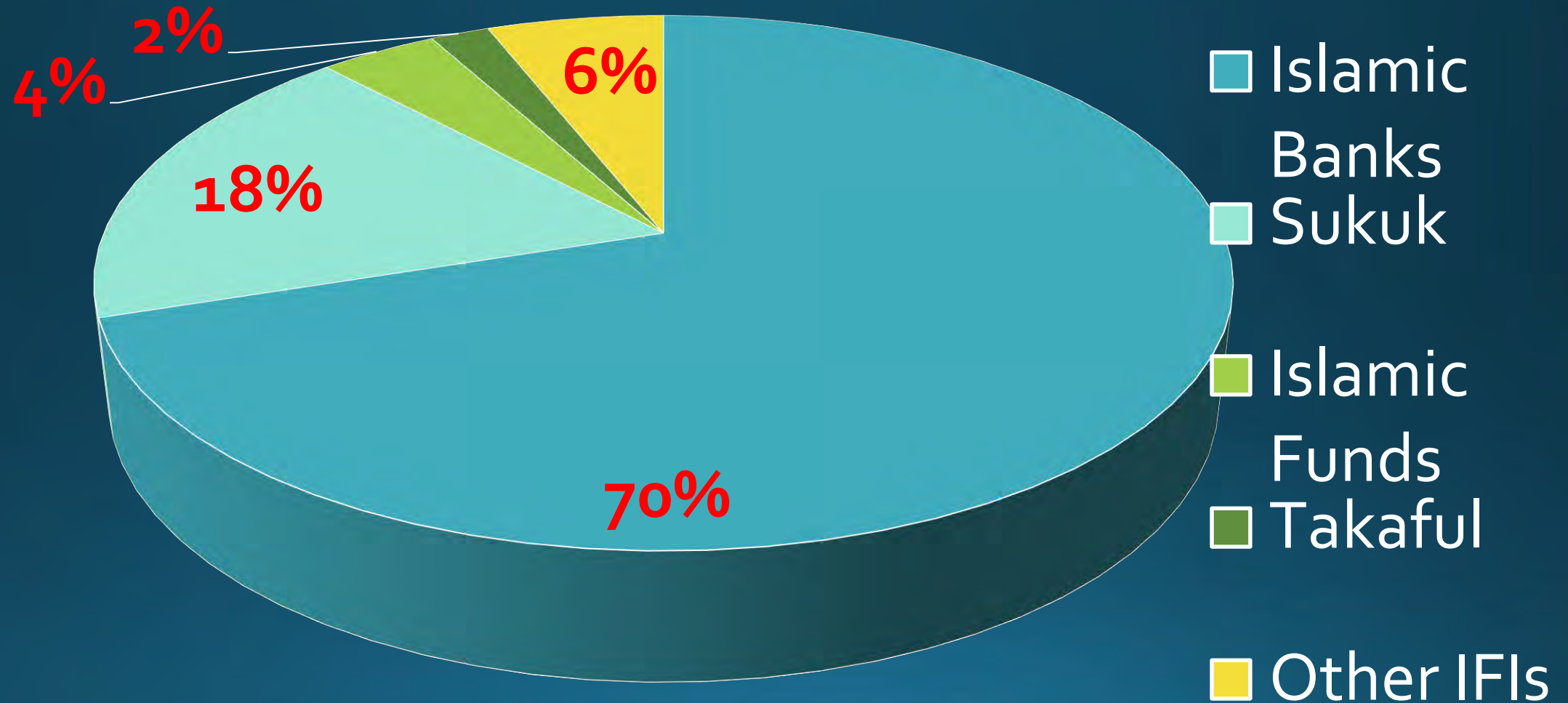
3.1 Structured questionnaires

3.2 Semi-structured interviews

GLOBAL ISLAMIC FINANCE INDUSTRY: CURRENT & PROJECTED GROWTH



ISLAMIC FINANCE ASSETS BY TYPE



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 & SHARIAH GOVERNANCE



Central Bank

Shariah Board

FIRST
TIER

IFIs



Shariah Board

BOD

SECOND
TIER

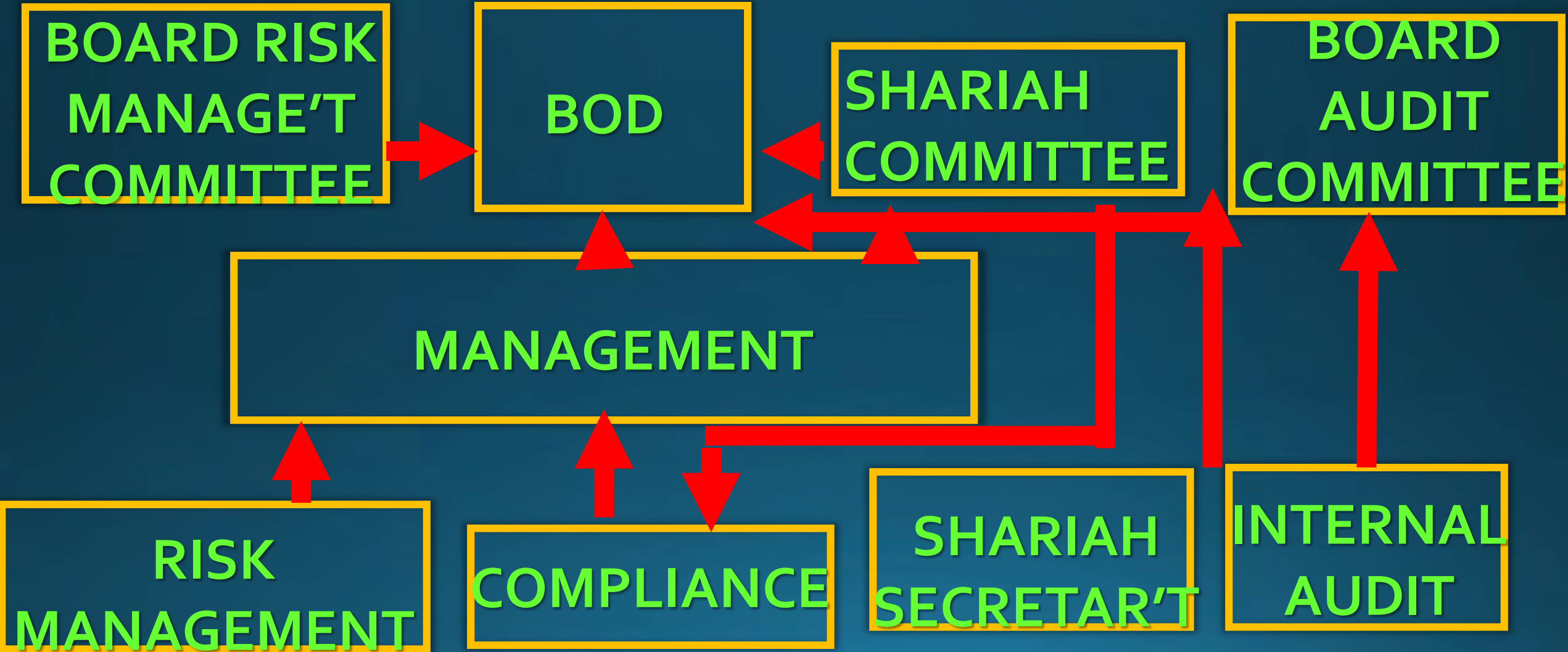


Internal Shariah Compliance
Department (ISCD)

Internal Shariah Audit
Department (ISAD)

SHARIAH GOVERNANCE FRAMEWORK

PRINCIPLES OF ISLAMIC FINANCE



SHARIAH GOVERNANCE REGULATIONS

1999	AAOIFI GSIFI No. 1: Shariah Supervisory Board:
1999	AAOIFI GSIFI No. 2: Shariah Review
1999	AAOIFI GSIFI No. 3: Internal Shariah Review
2001	AAOIFI GSIFI No. 4: Audit & Governance Committee
2005	AAOIFI GSIFI No. 5: Independence of Shariah Board
2005	AAOIFI GSIFI No. 6: Governance Principles for IFIs
2006	IFSB-3: Guiding Principles on Corporate Governance
2008	IFSB-6: Guiding Principles on Collective Investment
2009	AAOIFI GSIFI No. 7: Conduct and Disclosure for IFIs
2009	IFSB-8: Guiding Principles on Governance for Takaful
2009	IFSB-10: Shariah Governance Systems for IF Services

DIFFERENT REGULATORY APPROACHES

Features	Hands-off	Minimal	Engaged	Proactive	Commit'd
Specific IF laws / regulations	–	✓	✓	✓	✓
Internal Shariah Audit	–	–	✓	✓	✓
SSB at IFI	–	–	✓	✓	✓
Centralized SSB at regulatory level	–	?	?	✓	✓
External Shariah Audit	–	–	–	–	✓
Regulatory Shariah Audit	–	–	–	–	✓
ASBU- INTERNATIONAL CENTER FOR ISLAMIC ECONOMICS AND FINANCE					

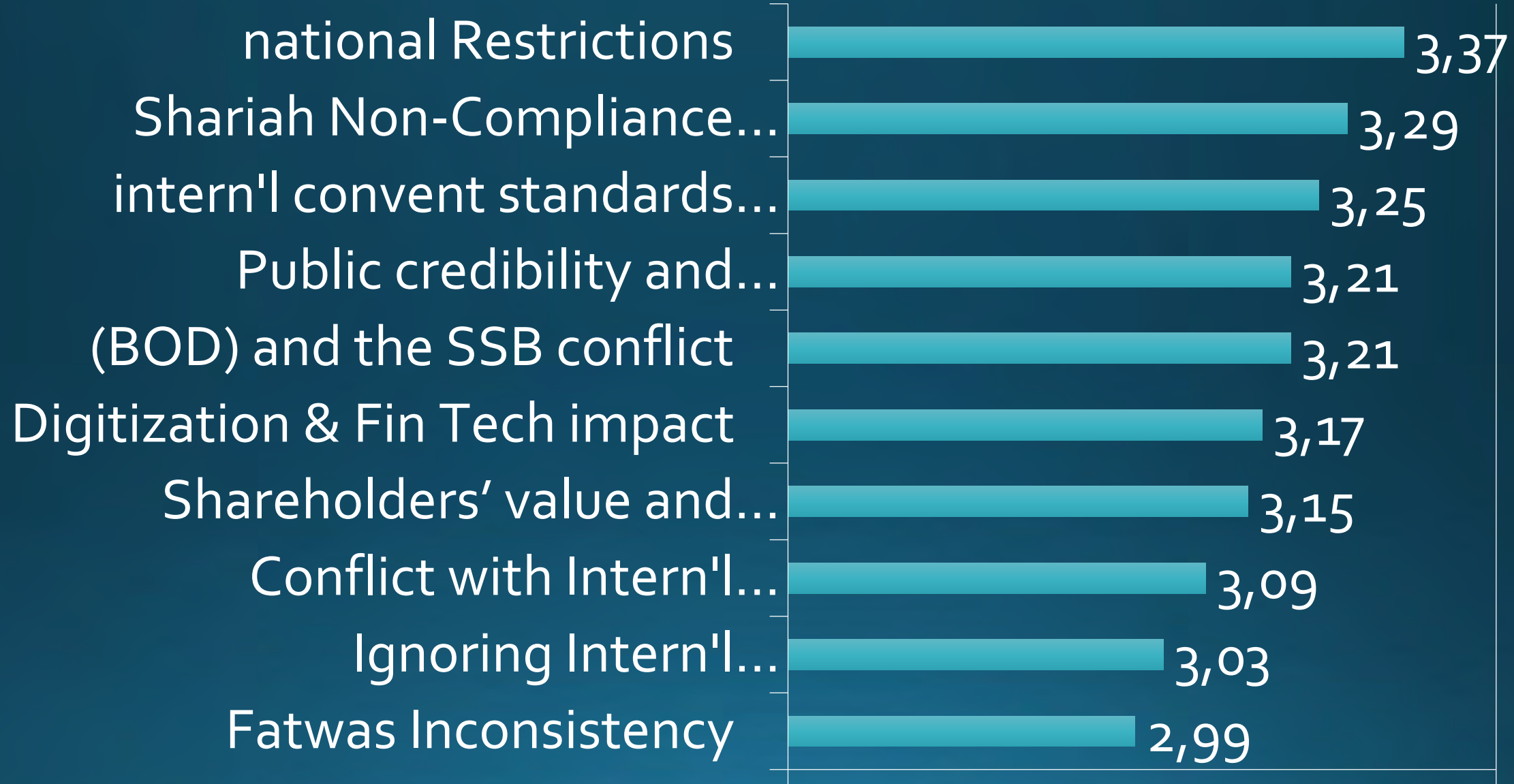
SHARIAH CONTROL SYSTEM

- ❑ **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

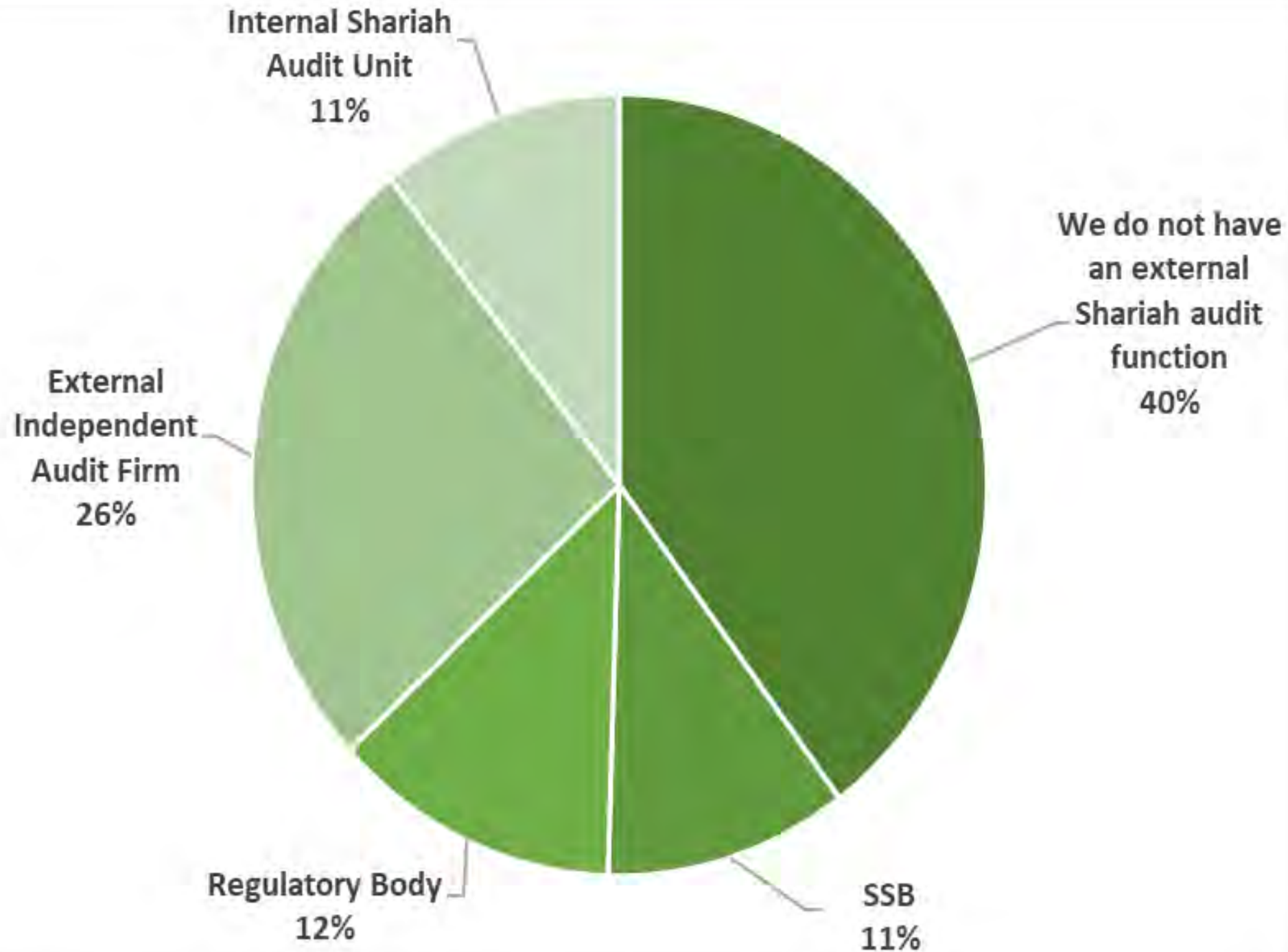
INSDIERS: CHALLENGES & OBSTACLES OF SG



ADDITIONAL MECHANISMS IN IFIS

Functions	Conventional FIs	Additions in IFIs
Governance	Board of Directors	SSB
Control	Internal Auditor External Auditor	Internal review/audit unit/dept External Shariah review
Compliance	Regulatory and financial compliance officers, unit or dept	Internal compliance unit/department Shariah

- 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.

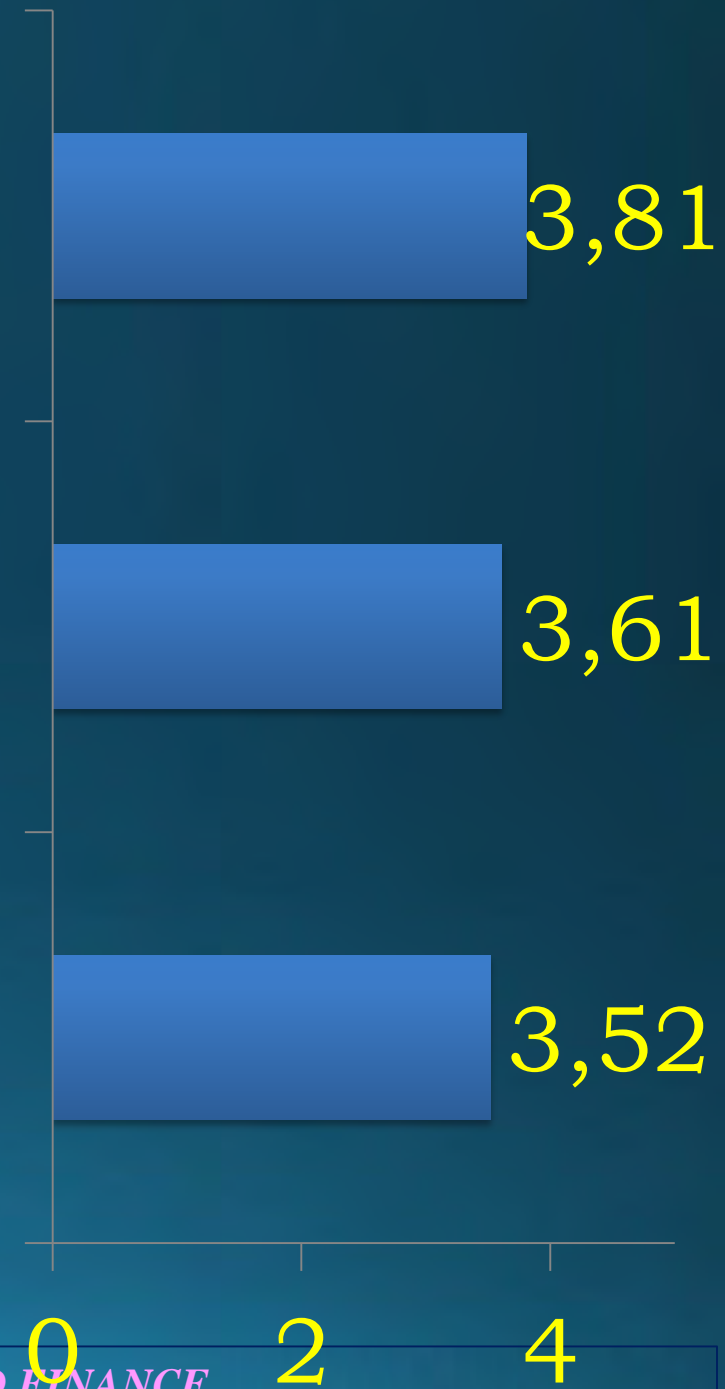
❖ Receiving services and rewards
from the IFIs.

❖ Continuity in the same IFI for a
long time.

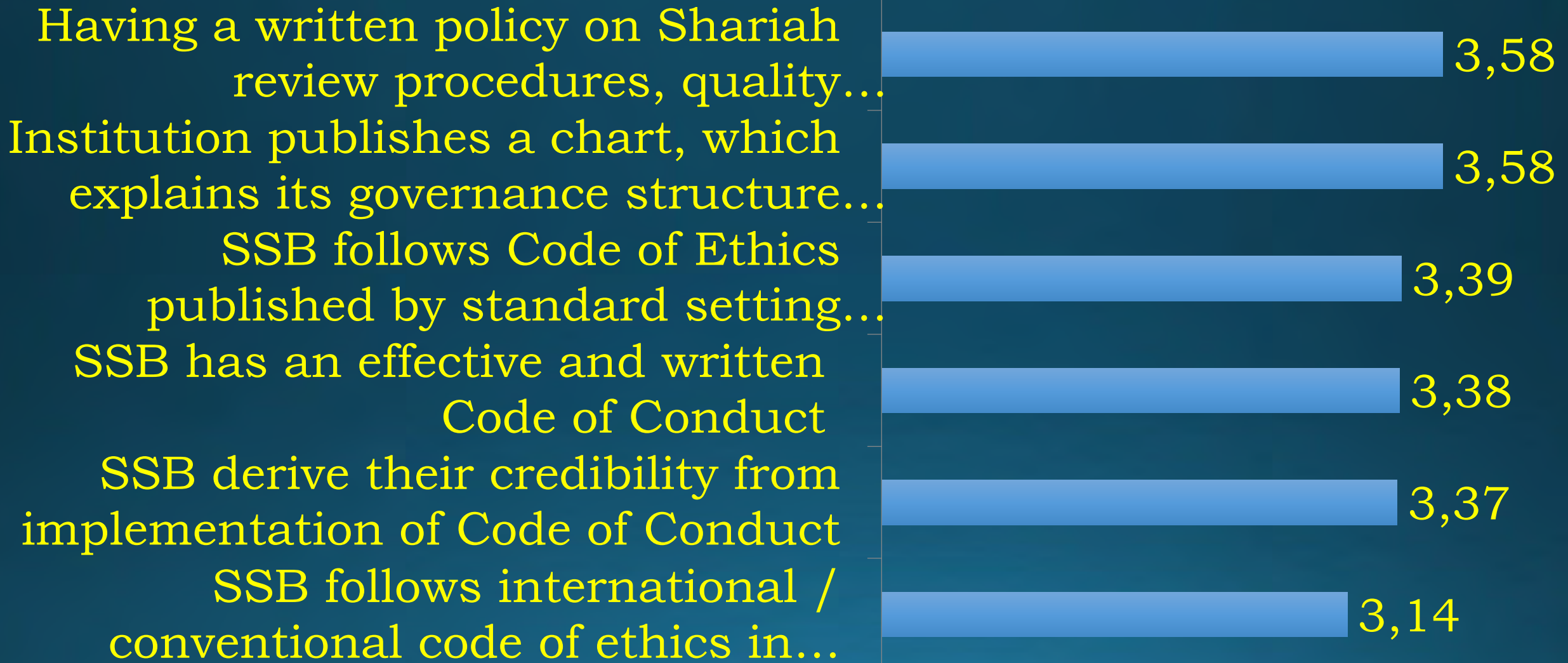
Independence

Transparency

Efficiency



SSB CODE OF CONDUCT



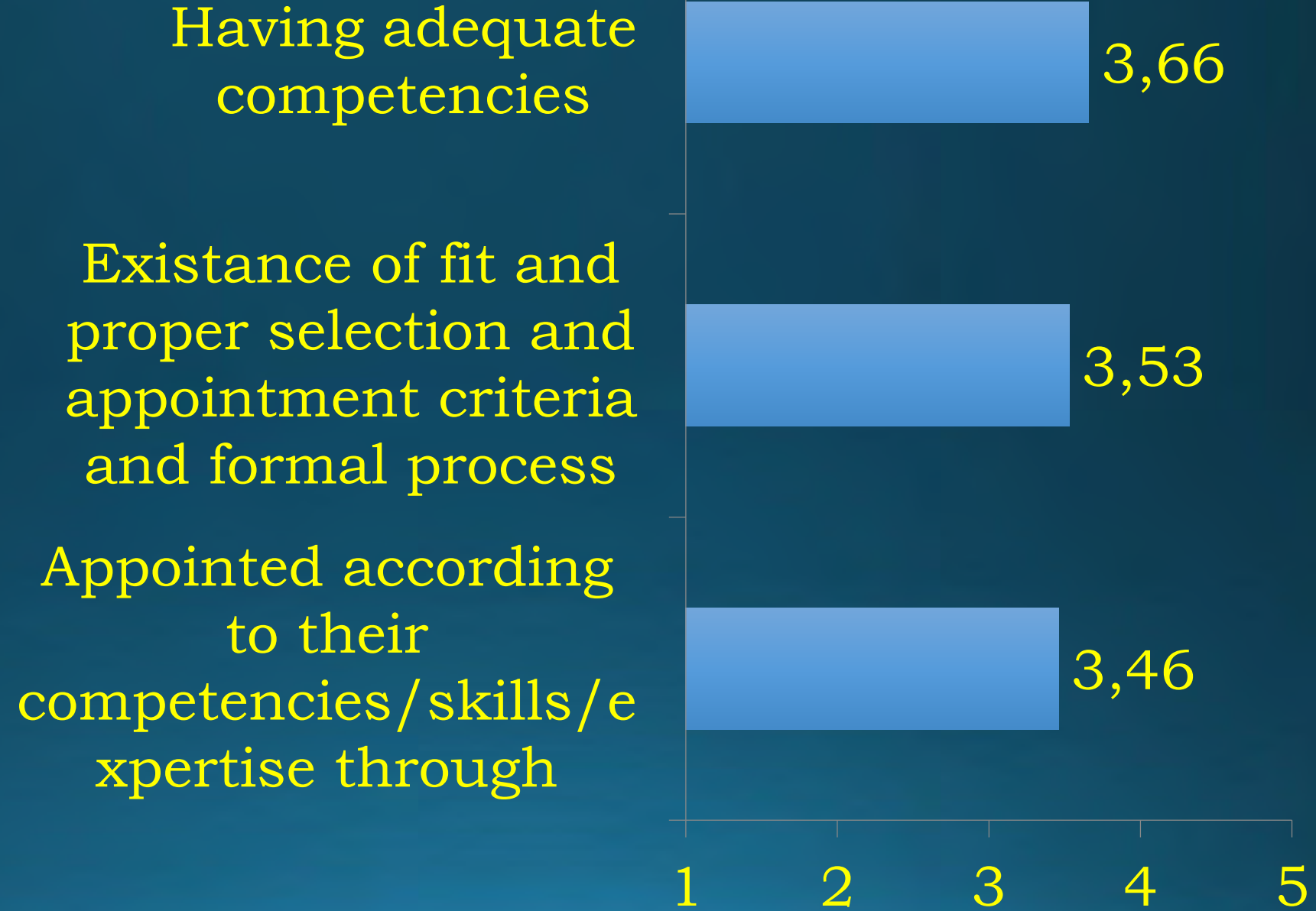
STANDARDIZATION BEST OPTION

□ 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



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.

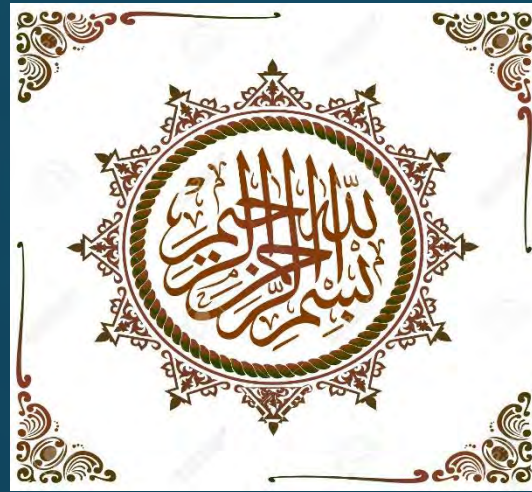
Thank you

QUESTIONS & ANSWERS



COMCEC

COMCEC
Coordination Office
Ankara, Turkey



Social Sciences University of
Ankara

IMPROVING SHARIAH 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

OUTLINE

□ 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

Infancy	Developing	Matured
Nigeria	Indonesia Turkey UK	Malaysia UAE

MALAYSIA

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

❑ 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

NIGERIA

- ❑ 1997: CBN Act legal foundation for IFIs
- ❑ 1999: CBN draft framework for IFIs regulation and supervision
- ❑ The IB Act requiring SSBs
- ❑ 2011: CBN: two Shariah Advisory bodies for itself and all IFIs
- ❑ 2011: The CBN all IFIs to establish a SAC/SSB
- ❑ 2013: The CBN: a national advisory body on IFIs, the FRACE
- ❑ 2015: The CBN Guidelines on Governance of FRACE

❑ 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

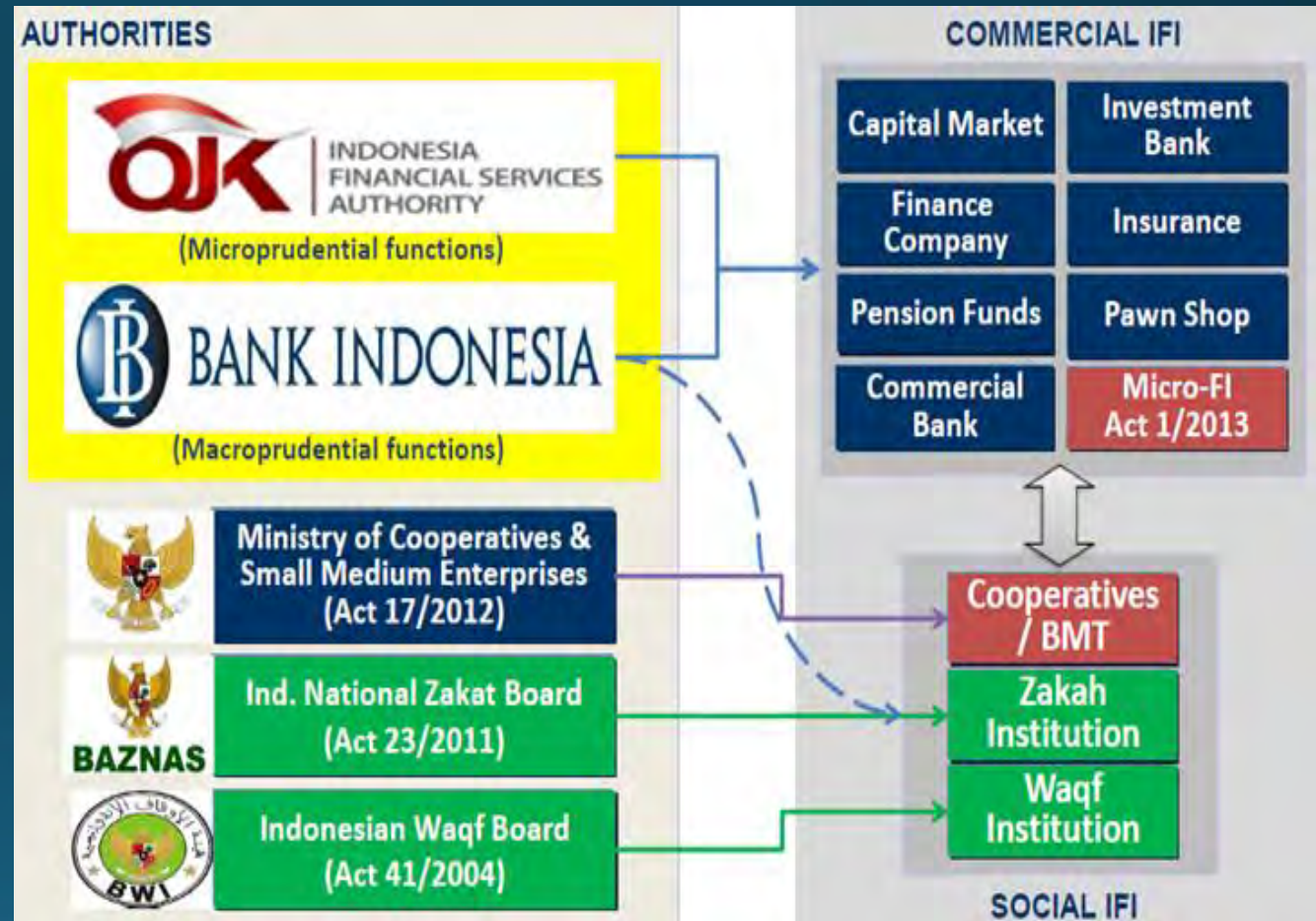
❑ Recommendations

- ❖ 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

TURKEY

Regulatory Body: MTF, BDDK

- ❑ 2005: SFHs become Participation Banks
- ❑ 2018: Central SAB as affiliated to TKBB
- ❑ 2019: Public Oversight Accounting and Auditing Standard Authority: ethic norm and auditing standards based on AAOIFI's

❑ 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

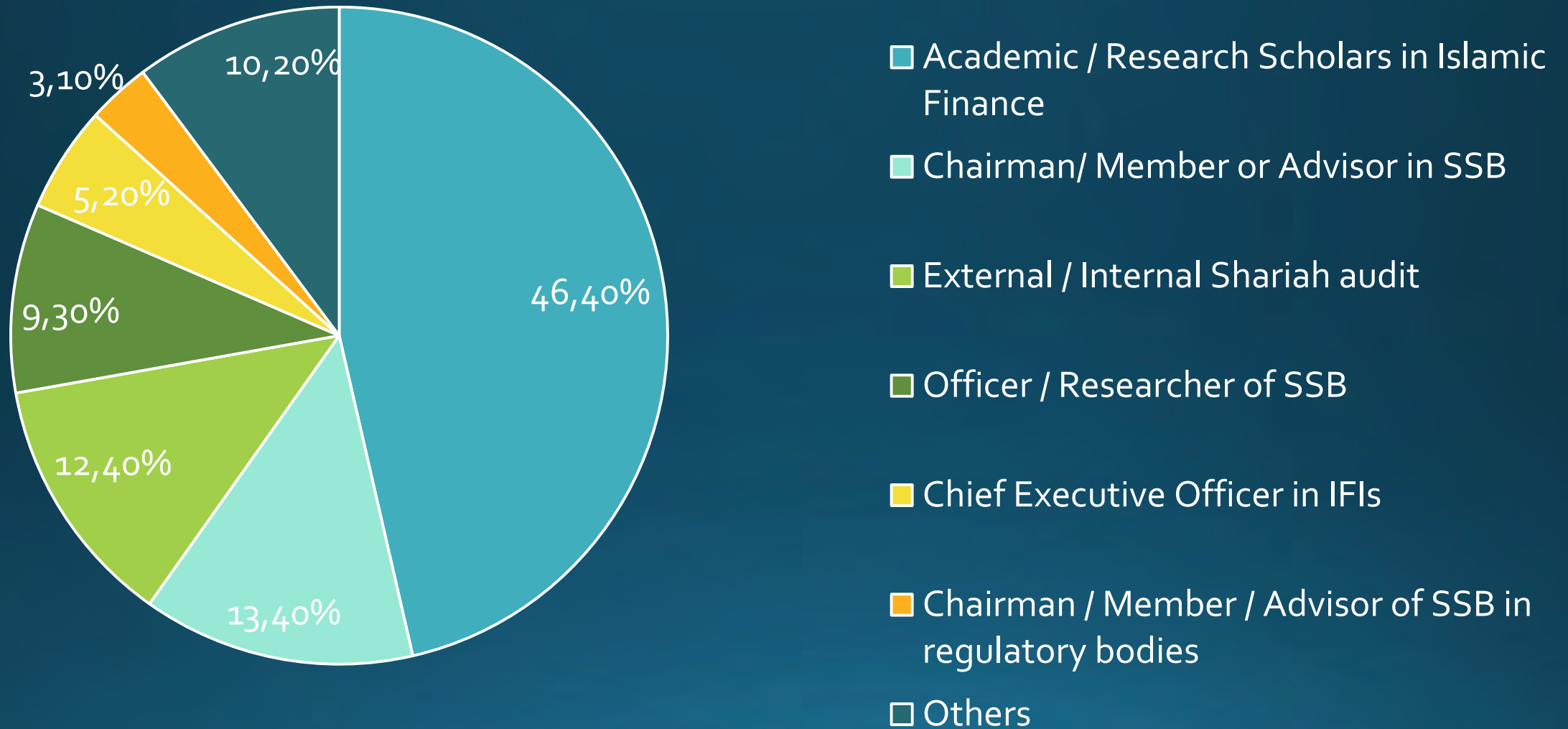
- ❖ Develop SGF for IFIs
- ❖ A central body must monitor Shariah governance
- ❖ FCA must understand how SB affects firm conduct

Survey Results and Analysis

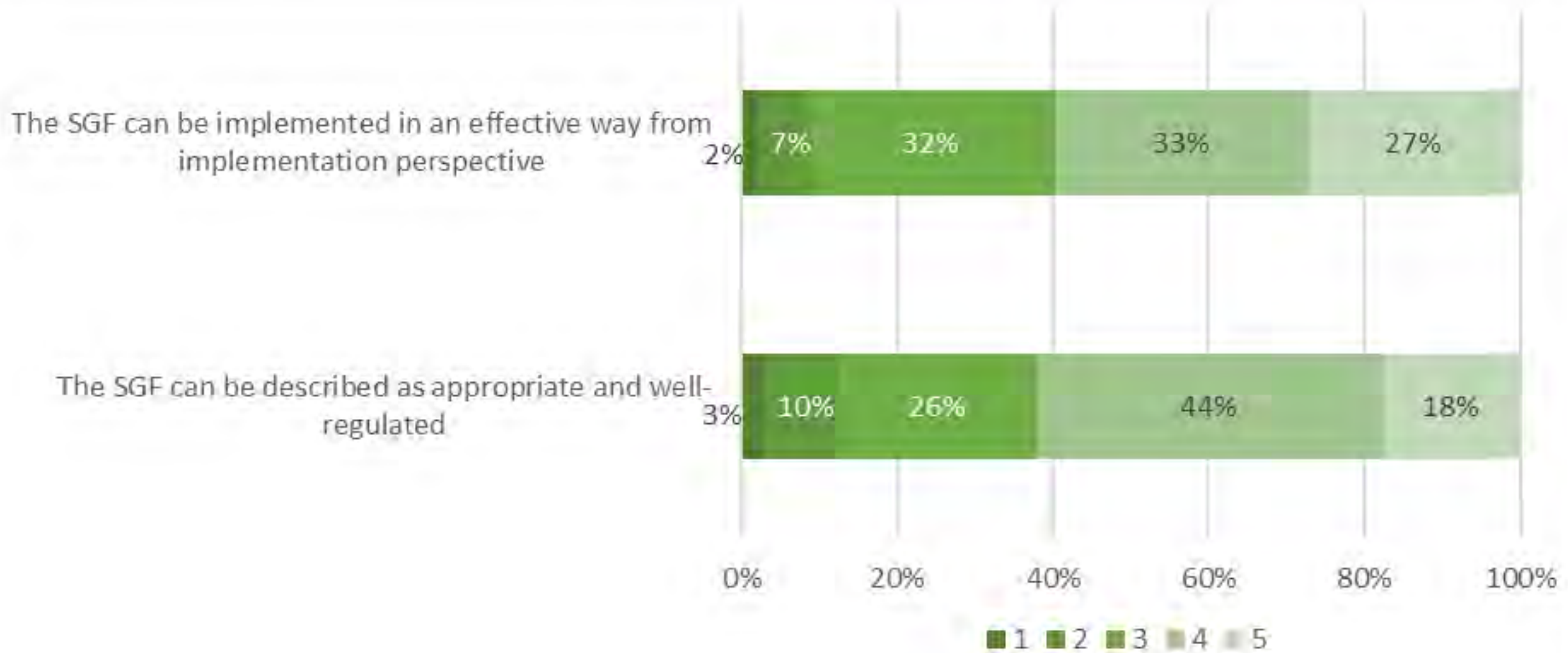
RESPONDENTS TO QUESTIONNAIRE BY COUNTRY / GROUP

Region	Groups	Countries	# responses
OIC	Arab Region	Palestine, Iraq, Bahrain, Algeria, Jordan, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Syria, UAE, Yemen, Kuwait, Tunisia	60
	Asian Region	Afghanistan, Indonesia, Malaysia, Pakistan, Turkey, Brunei Darussalam, Maldives	51
	African Region	Nigeria	7
Non-OIC		United Kingdom	6
TOTAL			124

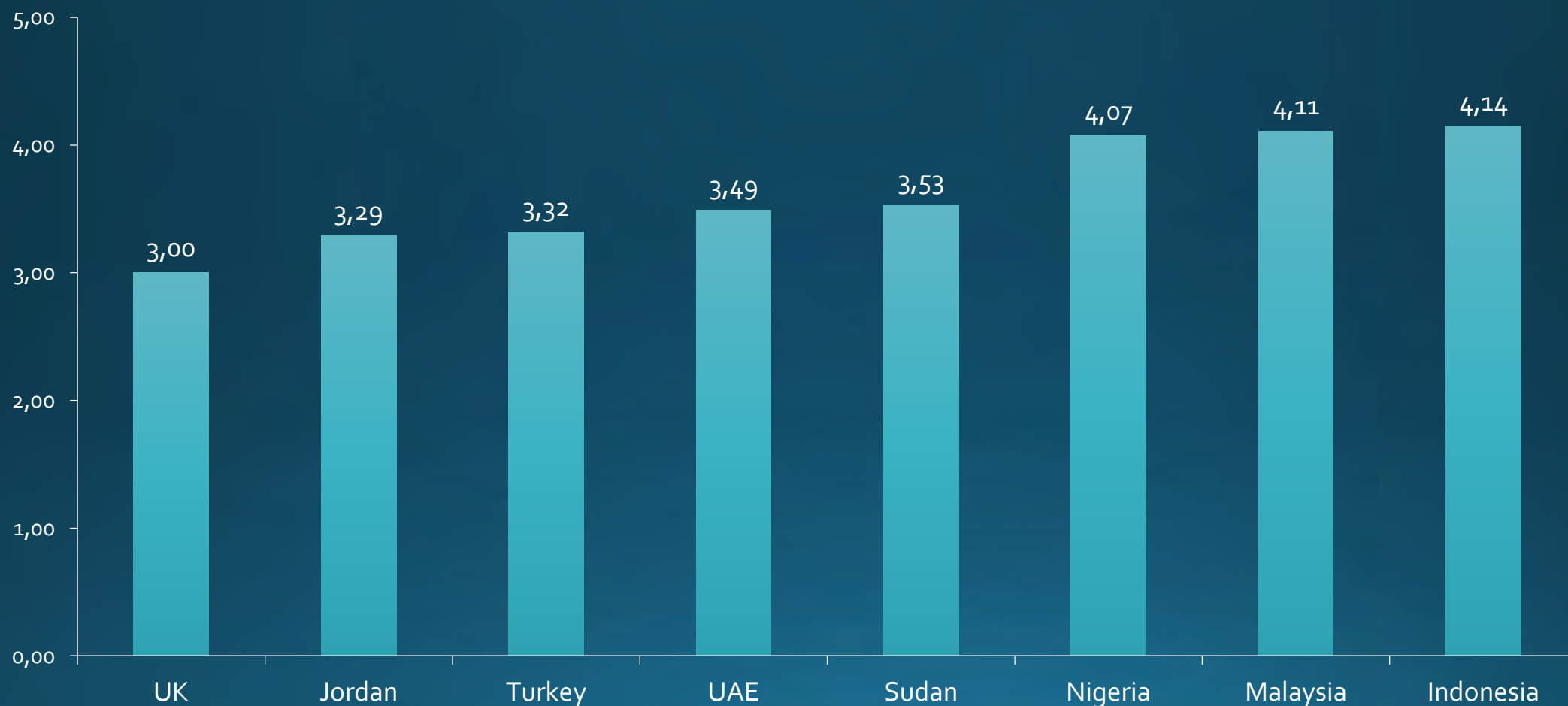
RESPONDENTS BY PROFILE



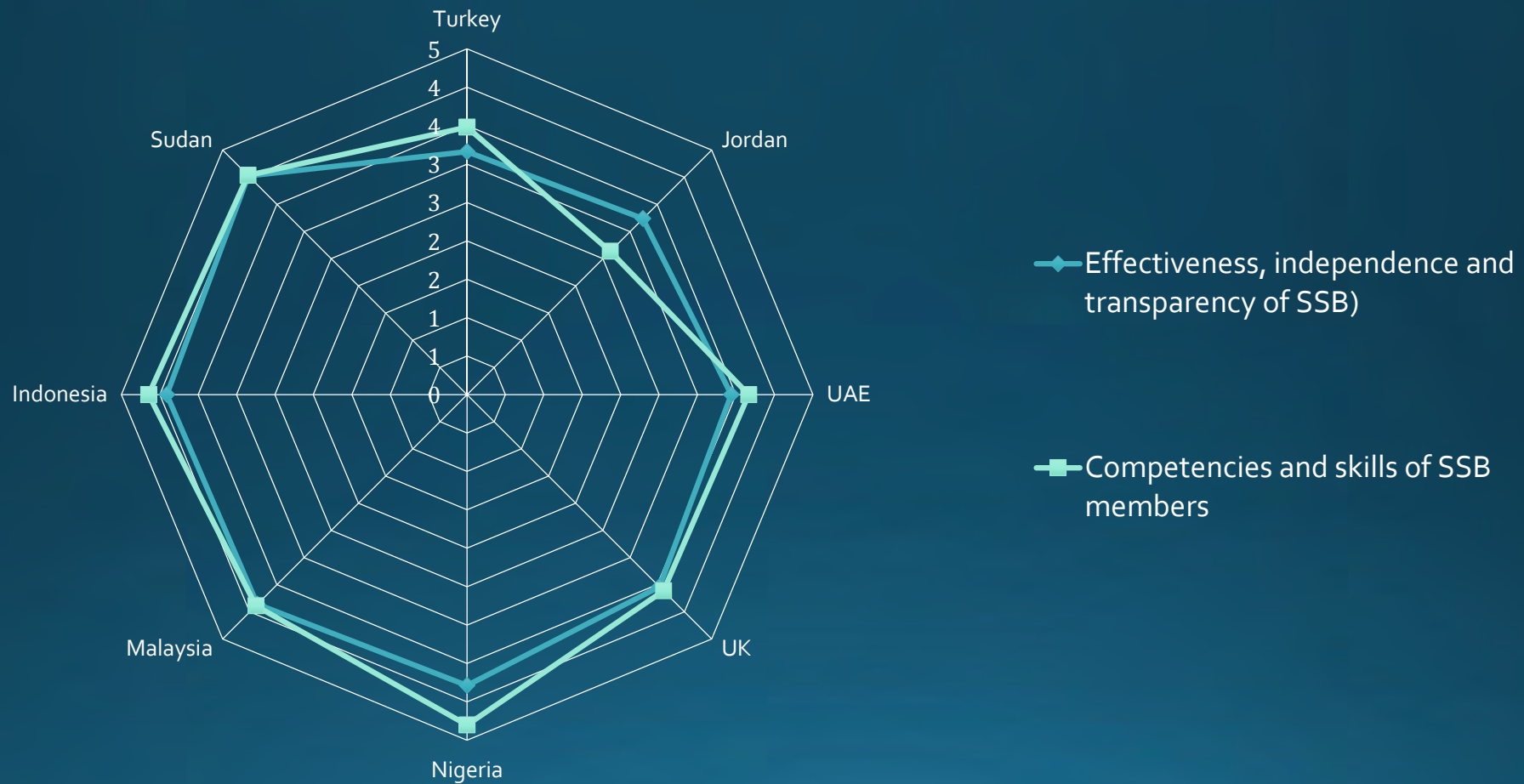
The Effectiveness and Impact of SGF



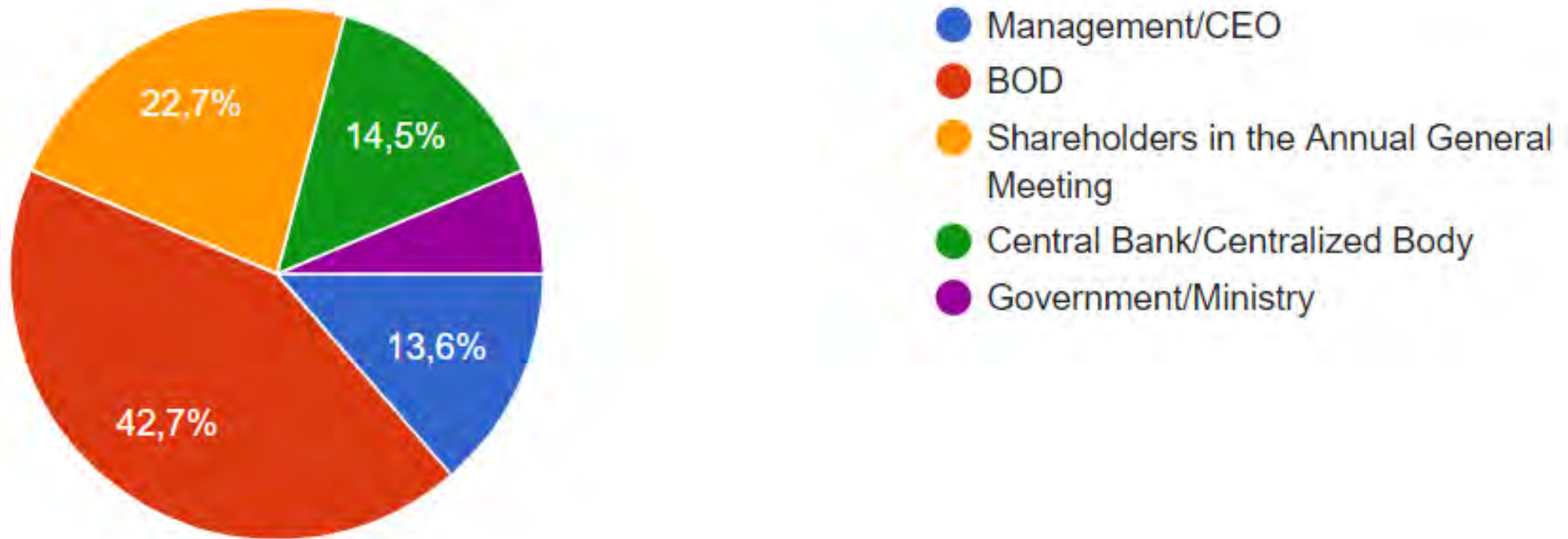
Effectiveness and Impact of SGF in Selected Countries



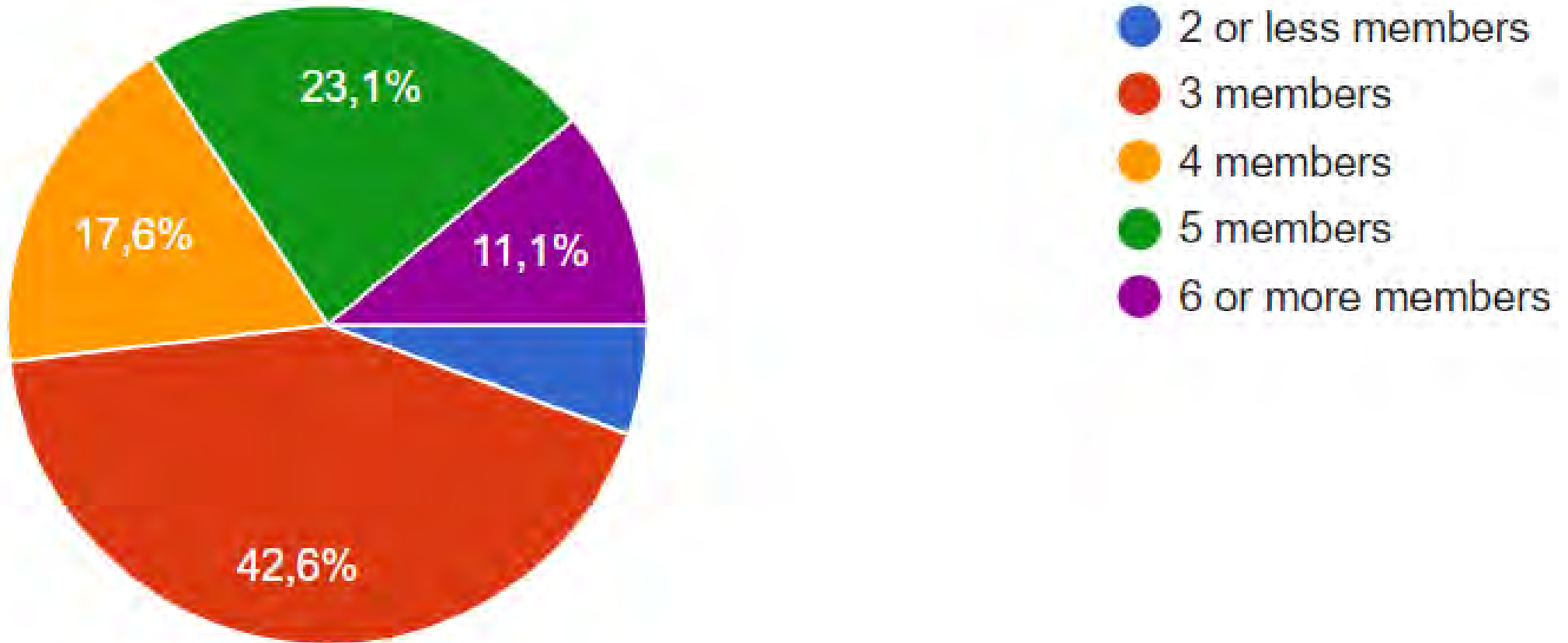
Effectiveness, Independence and Transparency of SSB and Competencies of SSB Members in Selected Countries



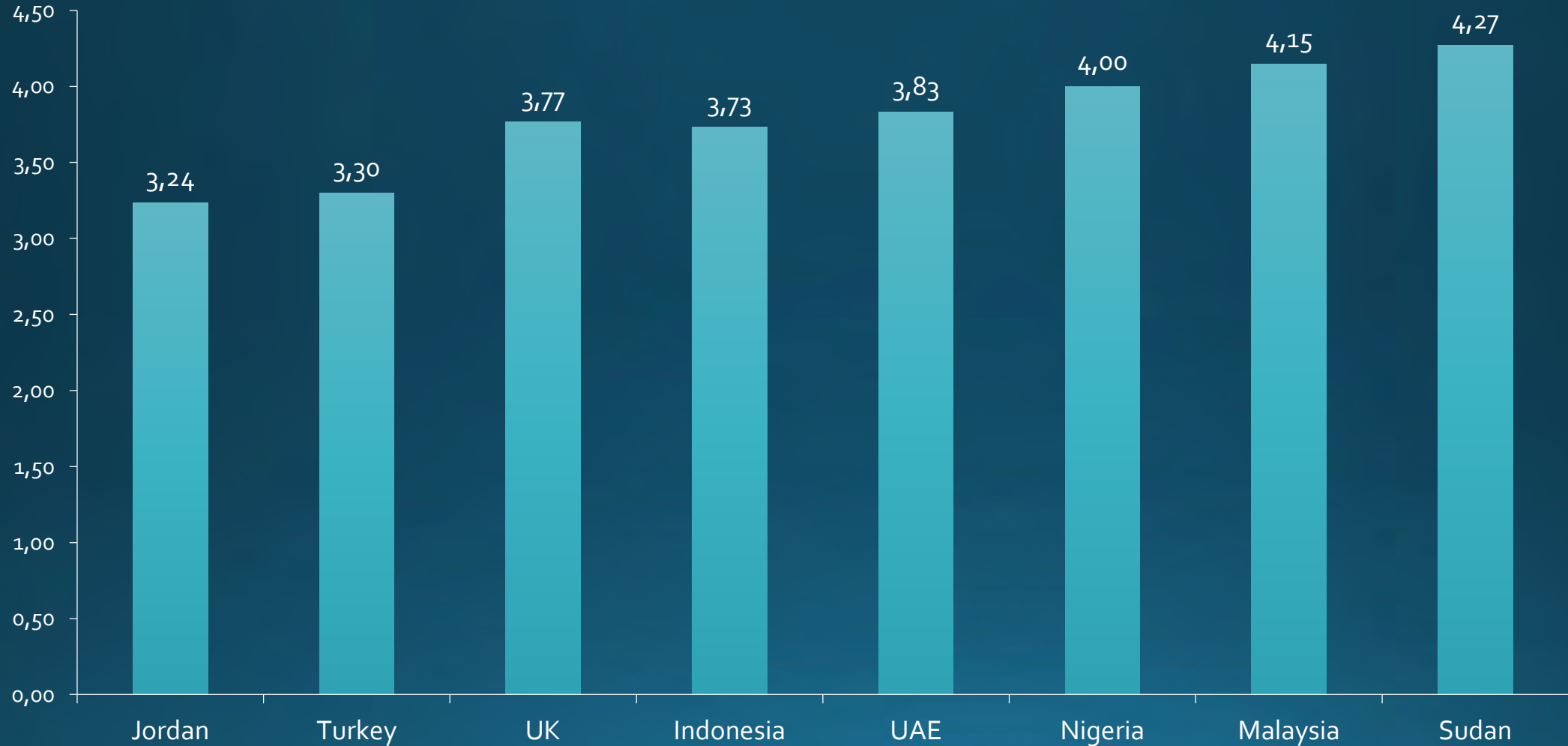
Who has the power to approve the appointment and dismissal of SSB members in your jurisdiction?



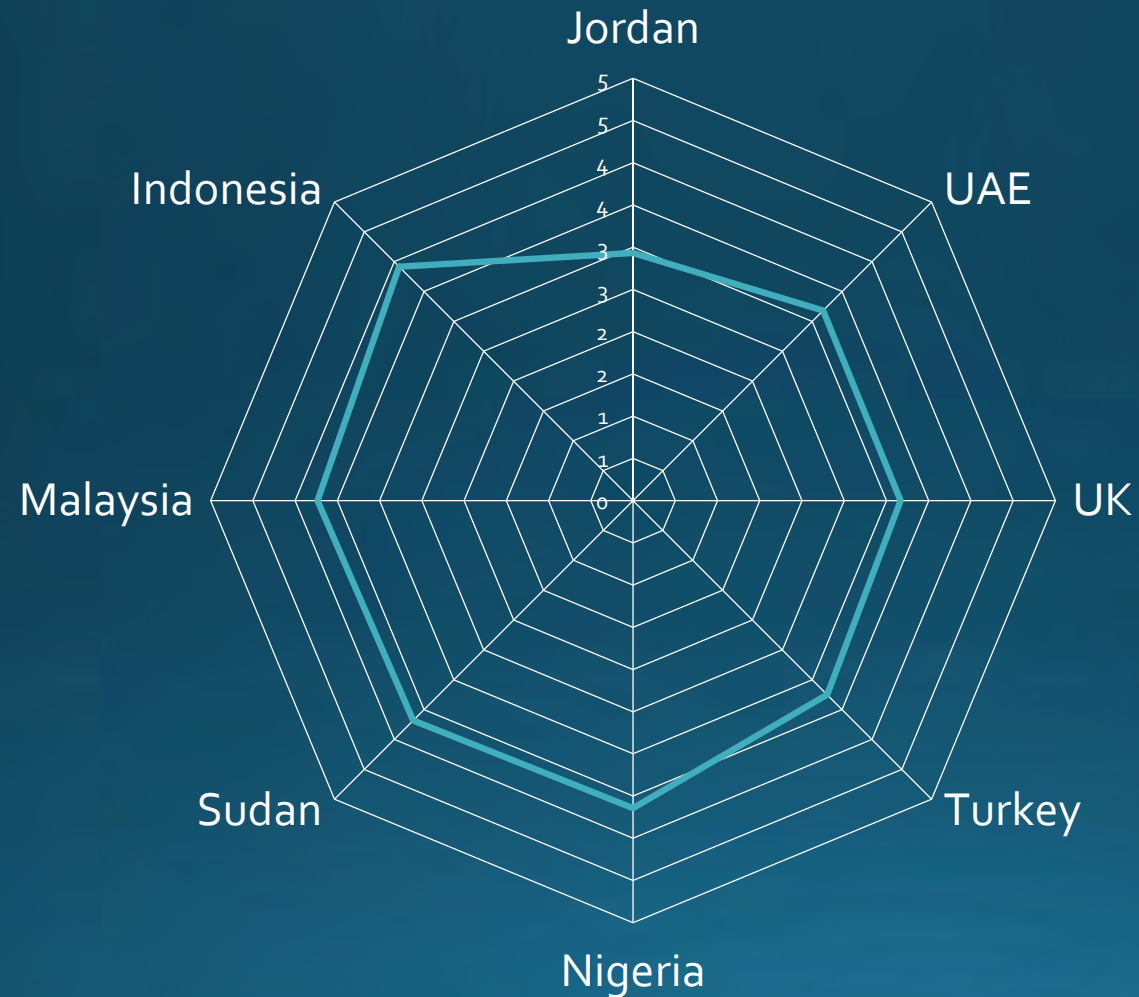
How many members are there in SSB in your institution?



Stakeholders Interest in Shariah Compliance in Selected Countries



Code of Conduct of SSB in Selected Countries



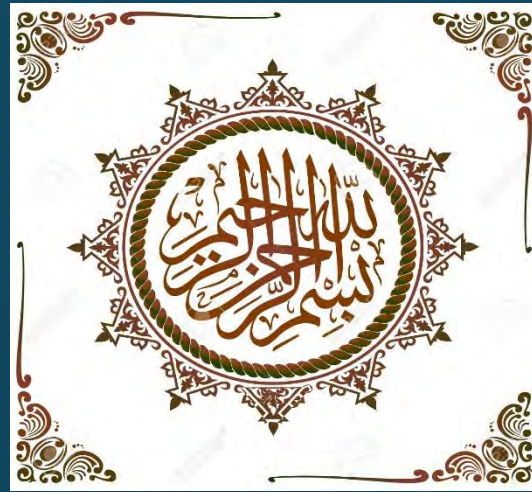
Overall Success of Shariah Governance in Selected Countries





COMCEC

COMCEC
Coordination Office
Ankara, Turkey



**Social Sciences University of
Ankara**

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.

❑ IFIs 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