

Shari'ah Governance Challenges for Islamic Banking, Islamic Capital Markets and Takaful (and windows)

Omar Mustafa Ansari

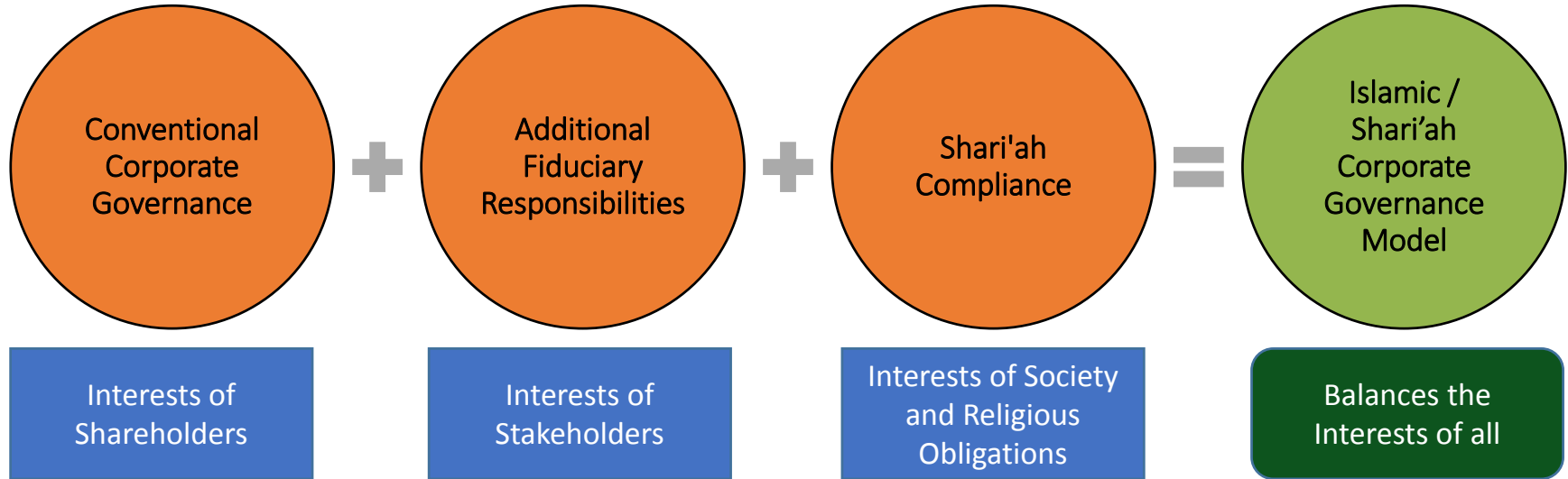


Introduction to Need and Features of Shari'ah Governance



What is Shari'ah Governance?

- Shari'ah Governance is about ensuring and managing the conformity of transactions and activities of the Islamic Banks to the precepts of Shari'ah
- Following are the components of the Shari'ah Governance model:



Why is Shari'ah Governance Critical?

LEGITIMACY:

Gives legitimacy to
Islamic Banking practices

PUBLIC CONFIDENCE:

Boosts confidence of
public at large when
banking activities and
practices are Shari'ah
compliant

RISK MITIGATION:

When the activities are
Shari'ah non-compliant,
the Banks are exposed to
Fiduciary and Reputation
Risks

What Happens When Shari'ah Governance is Weak or Non-Existent?+

Islamic Businesses Close Down

- **Ihlas Finance in Turkey (Feb 2001):**

No internal systems of control, No contingency or poor risk planning, scope of regulations unclear

- **Islamic Bank of South Africa (Nov 1997):**

Lack of supervision from regulatory authority, bad management, weak risk management, numerous loans to insiders

- **Islamic Investment Companies of Egypt (1988):**

Due to weak corporate governance, irresponsible management, improper regulatory framework, engagement in Shari'ah non-compliant activities

Islamic Businesses Suffer Huge Losses

- **Dubai Islamic Bank:**

- Fraud case involving USD 501 million
- 7 individuals including 2 executives were charged
- Fabrication of documents and bogus transactions to obtain huge amount of financing

- **BIMB:**

- Losses totaling RM 457 million
- No board members who were familiar with banking sector
- No sound and proper credit and debt collection

12 Principles of Governance according to AAOIFI GS No. 6

Principle 1 : Effective Shari'ah Compliance Structures

Principle 2 : Fair treatment of Equity holders

Principle 3 : Equitable treatment of fund providers and other significant stakeholders

Principle 4 : Fit and Proper conditions for BOD and Management

Principle 5 : Effective Oversight

Principle 6 : Audit and governance committee

12 Principles of Governance according to AAOIFI GS No. 6 – contd.

Principle 7: Risk management

Principle 8: Avoidance of conflicts of interest

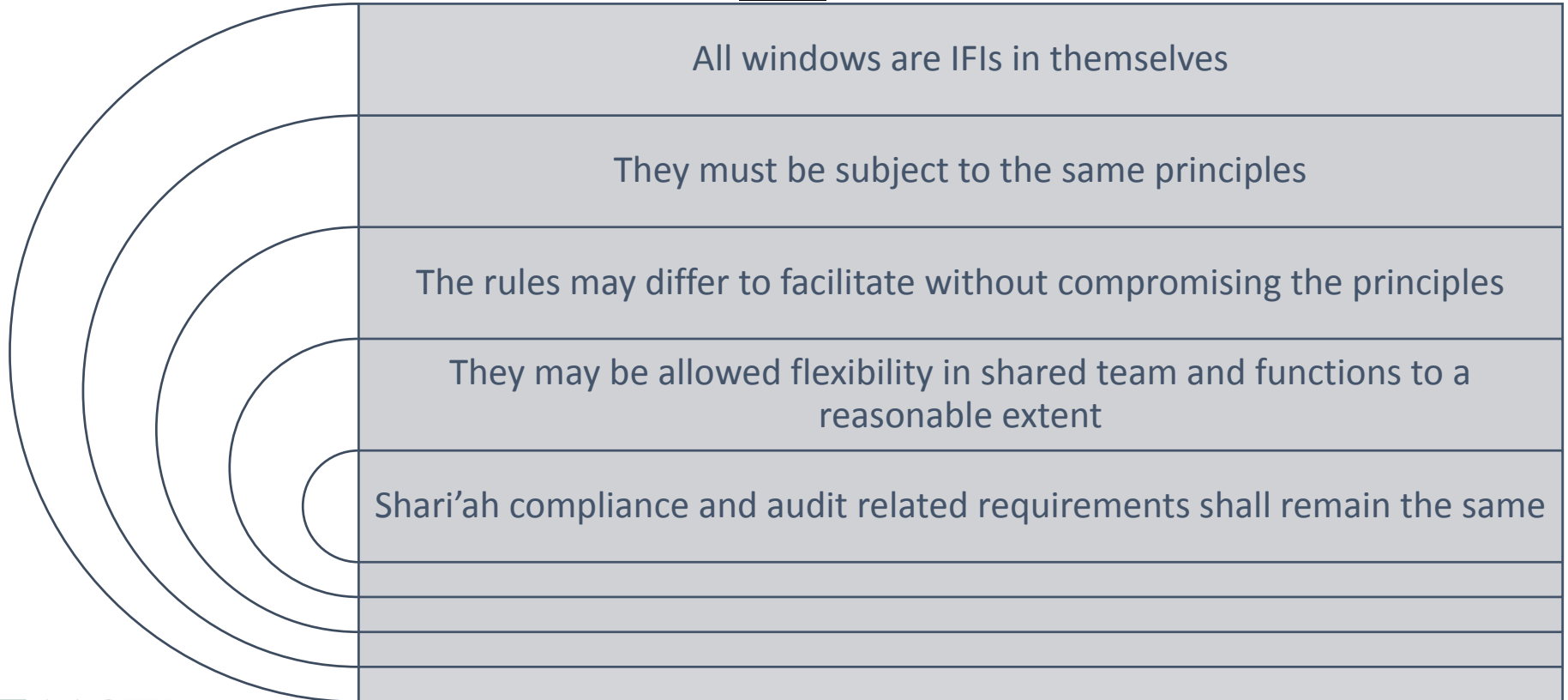
Principle 9: Appropriate compensation policy oversight

Principle 10: Public disclosures

Principle 11: Code of conduct and ethics

Principle 12: Appropriate enforcement of governance principles and standards

Approach towards windows





List of Key Shari'ah Governance Challenges



List of Key Shari'ah Governance Challenges

Challenge #1 : Changing the thinking style and mindsets of stakeholders with regards to the differences in conventional governance and Islamic governance model

Challenge #2 : Understanding the conceptual differences between the two governance models, their implications, and its implementation mechanism

Challenge #3 : How to take care of the interests of the investment account holders where there is a trust-based or fiduciary relationship involved?

Challenge #4 : How to take care of Policyholders' interests and safeguard the Takaful Risk Pool (whether based on Wakala or Waqf) in a Takaful set up?

Challenge #5 : How to set up the Shari'ah Governance infrastructure without making Islamic finance expensive?

List of Key Shari'ah Governance Challenges – contd.

Challenge #6 : Shari'ah Governance organs, no matter how good, are run by humans. How to tackle the challenge of “People Risk”?

Challenge #7 : The regulatory approach to Governance does not typically consider the impact of Shari'ah on different matters, such as capital adequacy requirements; or the laws and regulations are unclear; or violations are not penalized appropriately

Challenge #8 : Considering the overall human resource issues—both at regulatory and at institutional levels—in terms of availability, competency, motivation, ethics etc.

Challenge #9 : Lack of availability of or adoption of internationally benchmarked Governance standards; Lack of standardization of Shari'ah Governance framework resulting in inefficient processes and increased Shari'ah non-compliance risks



AAOIFI's Contribution in addressing the various Shari'ah Governance Challenges



AAOIFI's Contribution in addressing the various Shari'ah Governance Challenges

Establishment of a Governance and Ethics Board comprising of 15 experts and Shari'ah Scholars

Having issued 7 standards on Governance with 2 new standards to be issued soon

Standards issued thus Far:

- With regards to Principles of Governance
- on SSB
- on Shari'ah Review by SSB
- on Internal Shari'ah Review
- on Audit and Governance Committee
- on Independence of SSB
- on CSB

Standards to be issued shortly:

- on Shari'ah Compliance Function
- on Central Shari'ah Board

و الحمد لله في الأولى والآخرة



AAOIFI

ACCOUNTING AND AUDITING ORGANIZATION
FOR ISLAMIC FINANCIAL INSTITUTIONS