

Shariah Governance in Financial Institutions

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Government of Senegal

BANQUE CHAABI DU MAROC

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SHARIAH AND FINANCIAL INSTITUTIONS

- Islamic financial products have similar objectives as conventional products – fulfilling the needs of customers but in a Shariah compliant way
- Islamic products and the institutions providing them are subject to conformity with the requirements of Shariah
- The financial institutions providing Islamic products have to conform to both – regulatory and Shariah requirements that vary for different types of the institutions

TYPES OF ISLAMIC FINANCIAL INSTITUTIONS

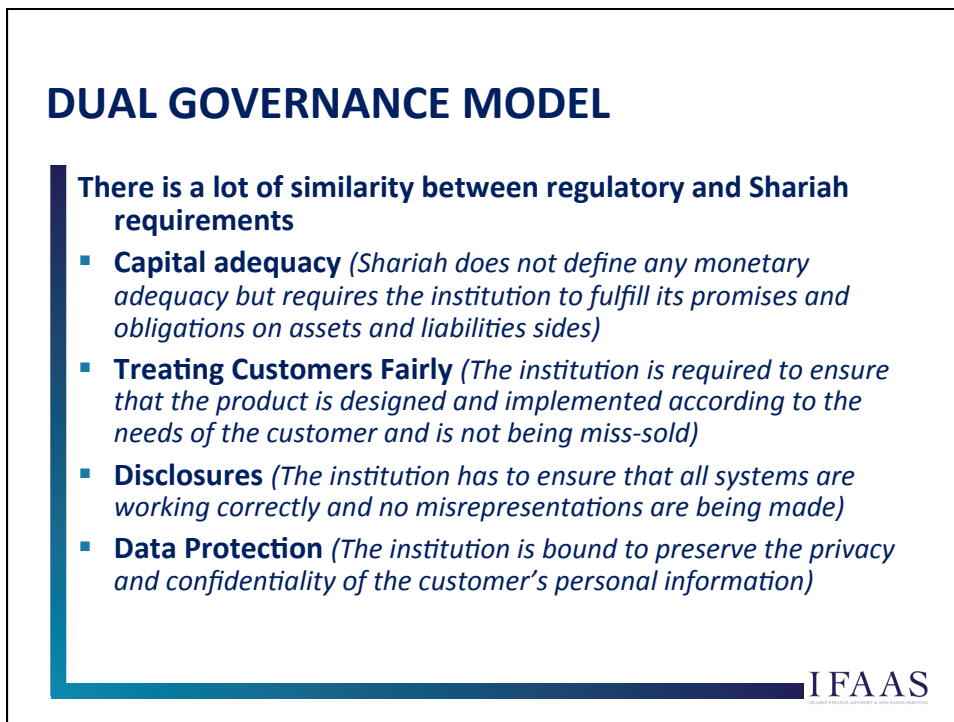
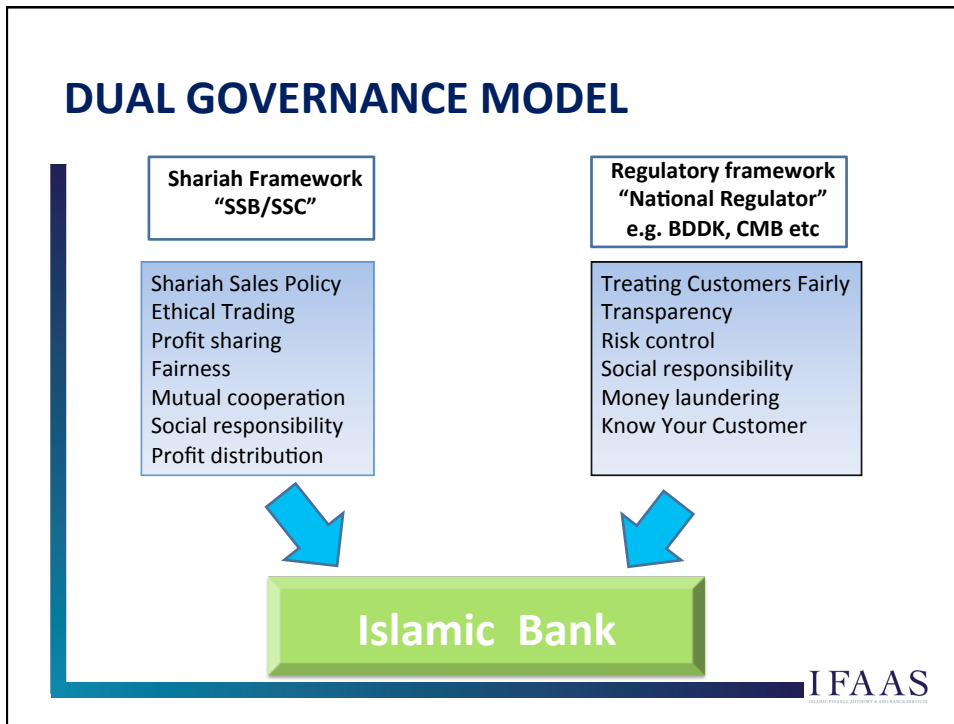
- Windows model – conventional institution carrying out Islamic financial transactions which are segregated from the other activities
- Branches – dedicated delivery channel just providing Islamic financial services
- Subsidiaries – separate legal entity owned by a parent company to specifically undertake Islamic financial activities
- Stand alone – totally independent structure

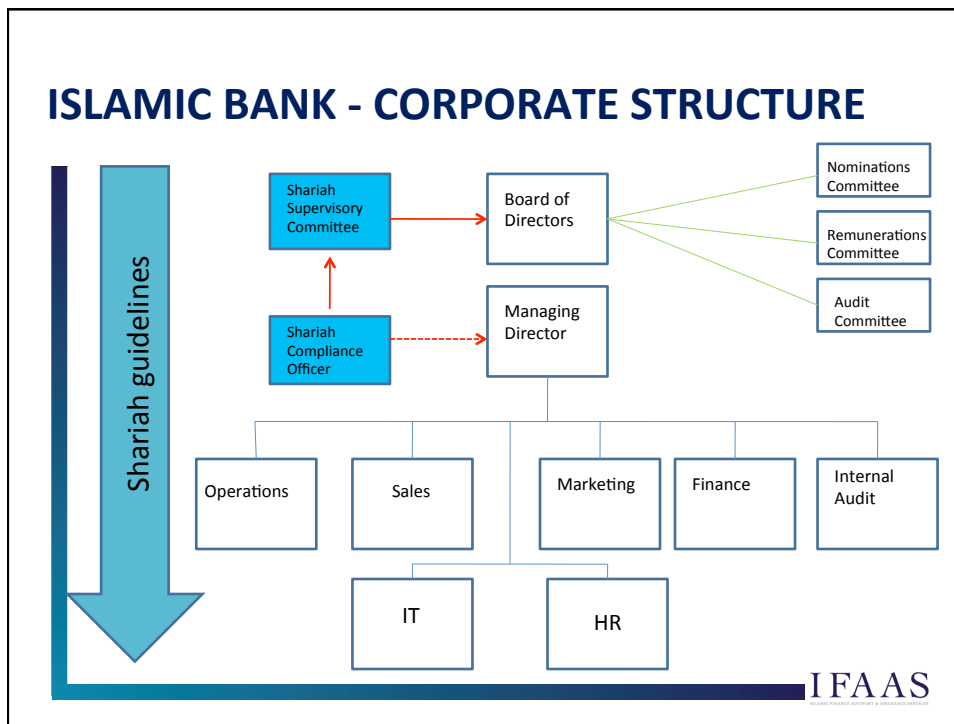
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SHARIAH REQUIREMENTS FOR FI'S

- Islamic window of conventional institution
 - Segregation of funds
 - No separate balance sheet required
- Islamic subsidiary of financial institution
 - Clean funds (*may be provided by the mother company*)
 - Separate balance sheet required (*may be incorporated into the group balance sheet*)
- Fully-fledged Islamic financial institution
 - Shariah fully embedded in the governance model of the FI
- All models need a Shariah Board/Shariah Supervisory Committee (SSC) to supervise the Shariah compliance
- All models operate on dual governance structures

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SSC - DEFINITION

- The SSC is an independent regulatory body of specialised Muslim scholars entrusted with the duty of providing guidance, supervision and certification of Islamic financial products to ensure that they are in compliance with Shariah rules and principles
- However the onus is on the management to raise matters with the SSC whose role is more akin to a regulator (such as BDDK or CMB) than to an internal department or management committee
- The SSC may also include other experts in areas of Islamic financial institutions with knowledge of Islamic jurisprudence relating to commercial transactions

SSC - COMPOSITION AND SELECTION

- The SSC should be appointed by the shareholders in their Annual General Meeting upon the recommendation of the BOD taking into consideration the local legislation and regulations
- The SSC shall consist of at least three members of whom one will be elected as the chairman by the fellow members
- The SSC should not include directors (executive or non-executive) or significant shareholders of the financial institution
- Islamic financial institution is required to have a minimum of one officer, preferably a person with knowledge in Shariah, who will serve as the secretariat to the Shariah Committee (this function may be outsourced)

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SSC - DISMISSAL

- The dismissal of a member of the SSC shall require a recommendation by the board of directors and be subject to the approval of the shareholders in the general meeting
- SSC members are disqualified if they have acted in a manner which may cast doubt on their fitness to hold the position of a Shariah Committee member
- SSC members are dismissed if they have failed to attend most of the meetings scheduled for Shariah Committee in their appointment period without a reasonable excuse

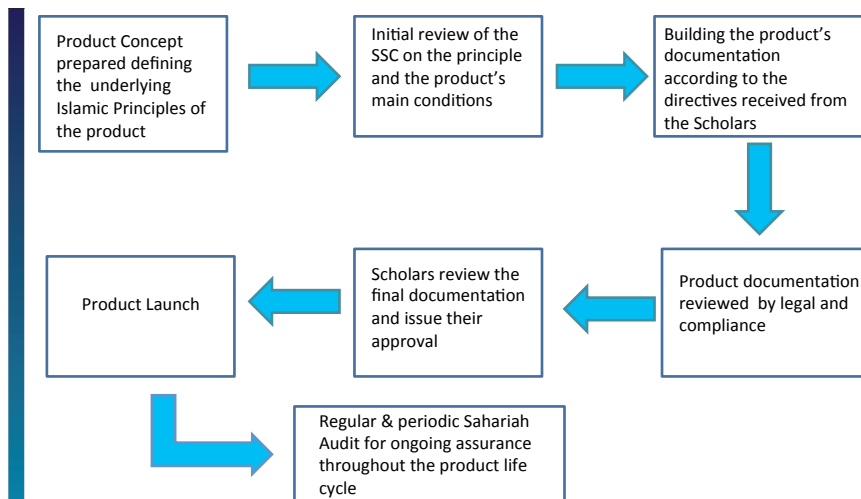
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SSC - MORALS AND REQUIREMENTS

- SSC member should be Muslim, with faith and belief, mature, wise and fair in his rulings
- SSC member should not agree on something if he is not satisfied with its interpretation
- SSC member should have a good reputation in the community
- Members of the SSC should have wide knowledge and a degree in Islamic Shariah and especially in “Fiqh Al Mu’amalat” (*jurisprudence of financial dealings*)
- They should have knowledge in business, economics, accounting and finance

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EXAMPLE OF SSC AT WORK



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SSC - MEETINGS

- The number of SSC meetings will differ from one IFI to another, but usually they will have 3 to 4 meetings a year
- Decisions will be taken by majority of votes
- A follow-up will be conducted in every meeting to resolve pending Shariah issues
- The SSC issue fatwas (ruling), guidelines and approve investment agreements and products documentation
- It is recommended that the IFI publishes the fatwas, rulings and guidelines

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SSC - TERMS OF REFERENCE

- The SSC Terms of Reference will be very similar to any other committee of the IFI and it will include the following:
 - 1- Objectives: mainly to ensure Shariah compliance of the IFI
 - 2- Duties and responsibilities: defining the scope of work required from the SSC
 - 3- Membership: describing the requirement of each member and the term of the appointment
 - 4- Meetings: defining the minimum numbers of meetings and the procedures of each meeting
 - 5- Authority: defining the authority of the SSC and tools available for them to implement their rulings

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SSC - POWERS AND AUTHORITIES

- The SSC fatwas (rulings) and guidelines are binding on the IFI
- Shariah compliance is the backbone of Islamic banking and finance
- The SSC gives legitimacy to the practices of Islamic banking and finance
- The SSC boosts the confidence of the shareholders and the public that all the practices and activities are in compliance with the Shariah at all times

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SSC – YEAR END SHARIAH REPORT

- The SSC will issue an annual report stating whether the IFI's activities, operations, contracts, documents, financial statements and income are in compliance with the Shariah rules and principles
- This report usually forms an integral part of the IFI's annual report
- The Shariah Committee report will be addressed to the shareholders
- This reporting structure reflects the status of the Shariah Committee as an independent body of the Islamic financial institution

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ROLE OF SHARIAH COMPLIANCE OFFICER (SCO)

- Independent role within the institution
- Coordinate closely with the SSC for all Shariah related issues
- Ensures implementation of all SSC directives and resolutions
- Assist the IFI departments in carrying out their daily activities according to Shariah principles
- Carries out Shariah audit of the different functional areas
- Reviews products, policies and procedures throughout their lifecycle
- Reports any Shariah non compliance activity directly to the MD and the SSC
- May be outsourced, if required

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STANDARDISATION IN ISLAMIC FINANCE

Organisation	AAOIFI	IFSB	IIFM
Full name	Accounting & Auditing Organisation for Islamic Financial Institutions	Islamic Financial Services Board	International Islamic Financial Markets
Domain	Shariah Governance, Products, Accounting, Auditing and ethics	Prudential requirements (Financial stability, Capital adequacy, Risk management)	Islamic financial contracts (Commodity Murabaha, Forex Swaps etc)
Main clients	Financial institutions	Regulators & other authorities	Financial institutions
Base	Bahrain	Kuala Lumpur (Malaysia)	Bahrain

- All organisations working in different spheres
- No conflict or competition between them
- Mutually complementary services overseen by individual independent SSC's

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SHARIAH STANDARDS (AAOIFI)

- AAOIFI (Accounting & Auditing Organisation for Islamic Financial Institutions) is an independent body established in 1990 under an agreement between a number of Islamic Financial Institutions and is now based in Bahrain
- AAOIFI's objective is to formulate and issue Shariah, accounting, ethics and governance standards for the international IFIs and standardise the Islamic financial industry
- There are 30 Shariah Standards issued (to date) covering all known Islamic financial principles yet the work is still in progress
- The standards are released by consensus of AAOIFI Shariah Board consisting of Shariah scholars from all major schools of thought and regions of the world
- AAOIFI is a member of the International Accounting Standard Board

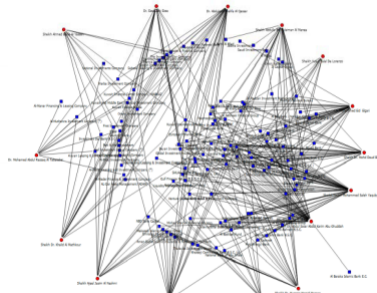
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DIFFERENT MODELS OF SHARIAH GOVERNANCE

- Malaysian Model – centralised Shariah governance
 - Shariah Advisory Council of Bank Negara Malaysia
 - Highest and ultimate authority on Islamic financial matters in the country (BNM Act 2009)
 - Guidance, validation, and arbitration (by ruling) on all Islamic finance matters
 - Shariah Supervisory Committee required at each Islamic Financial Institution to complement SAC
- Bahrain Model - institutional Shariah governance
 - Each institution is required to have its own SSC
 - AAOIFI Shariah standards are compulsory
- UK Model – institutional Shariah governance
 - Each institution has its own SSC
 - FSA being a secular body does not involve in Shariah
- Other Models

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CONTROVERSIES IN SHARIAH GOVERNANCE



Source: Funds @ work

A study in 2010 demonstrating that a small minority of scholars is sitting on the majority of the Shariah Boards / Supervisory Committees triggered a widespread debate over the issue of Shariah governance.

- Conflicts of interest
- Confidentiality
- Fees (scholars for dollars?)
- Scarcity of scholars VS high demand
- Finding problems or finding solutions?
- Dialogue between the deaf?
- Consistency issues
- Who takes the blame?
- Expectation management
- Resource planning

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CHALLENGES IN SHARIAH GOVERNANCE

- The scholars of different schools of thought (Madhabs) with different interpretations and opinions
- The number of scholars qualified in the jurisprudence of dealings (Fiqh-ul-muamalat) relatively limited
- The level of familiarity of the scholars with modern day financial services is limited
- Most of the management of IFI's coming from conventional backgrounds with no or very little understanding of Shariah
- The expectations of the stakeholders (regulators, shareholders, customers and the management of IFI's) from Islamic finance are very unrealistic
- More emphasis is required on training and Shariah audit

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