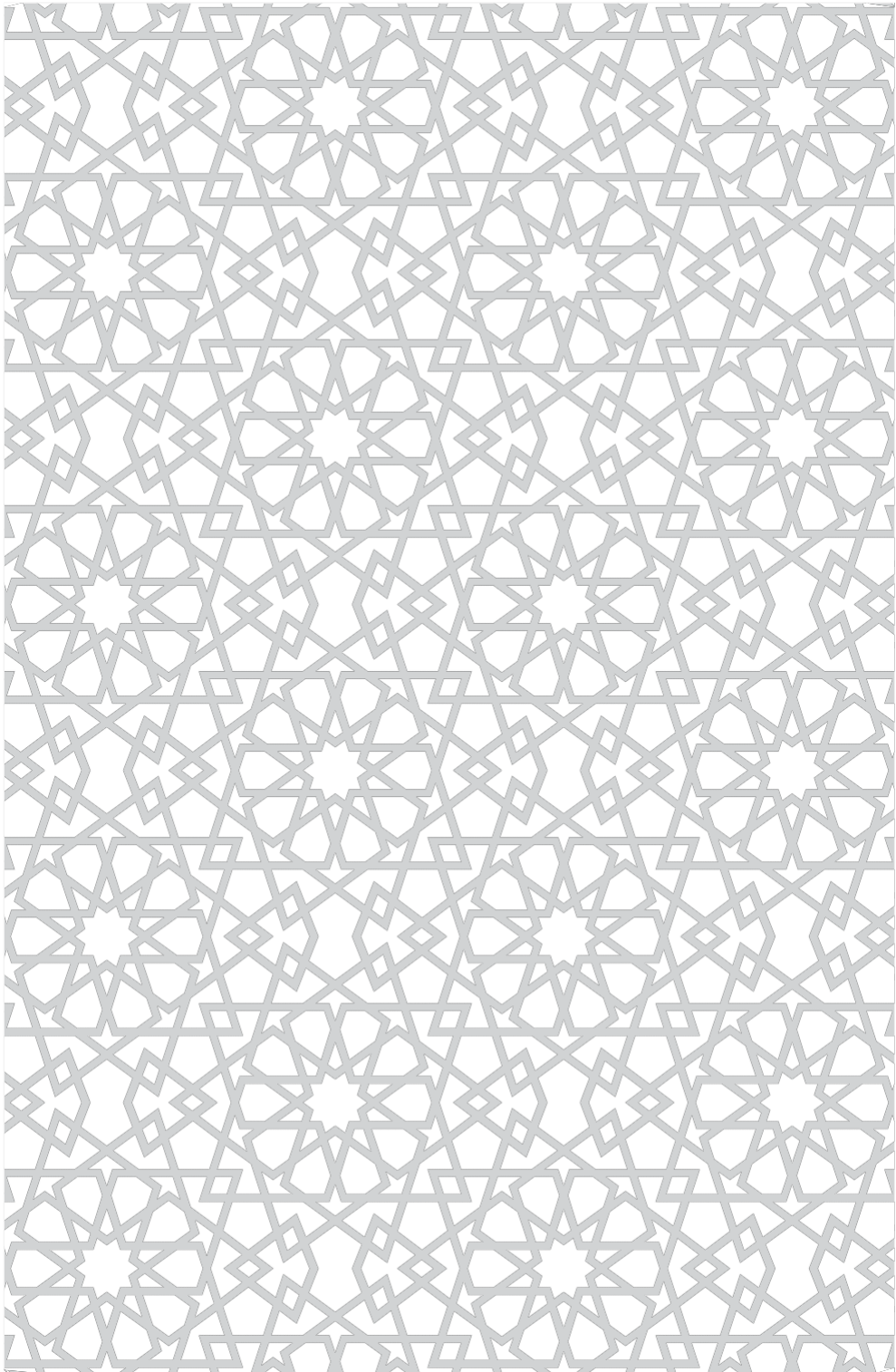


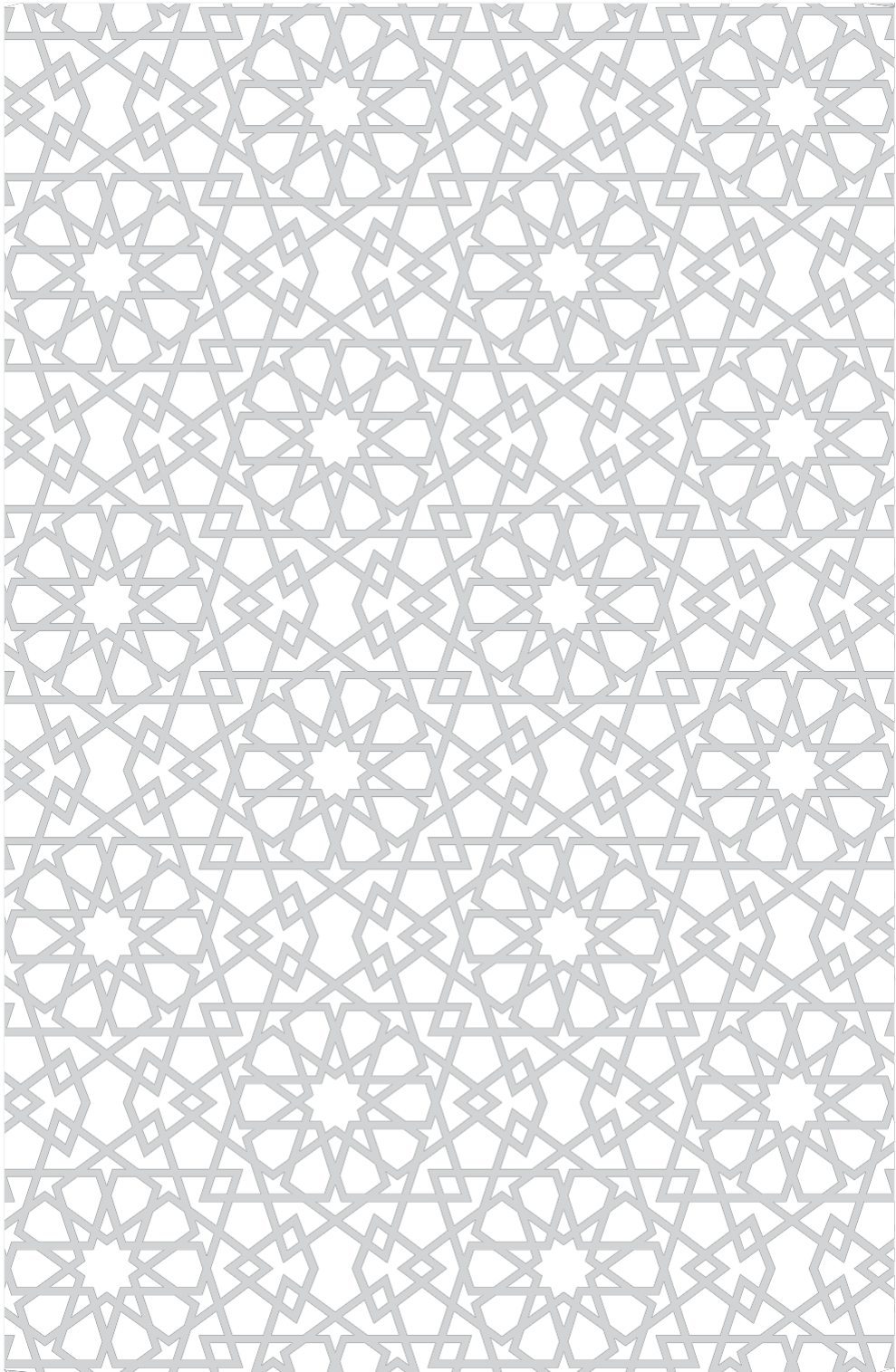
Governance Standard No. (1)

**Shari'a Supervisory Board:
Appointment, Composition and Report**



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Shari'a Supervisory Board: Appointment, Composition and Report

Introduction

1. The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the definition, appointment, composition, and report of the Shari'a supervisory board for ensuring compliance of the Islamic financial institution in all its dealings and transactions with Shari'a Rules and Principles. The main points are:

Definition of Shari'a Supervisory Board

2. A Shari'a supervisory board is an independent body of specialised jurists in Fiqh Al-Mua'malat (Islamic commercial jurisprudence). However, the Shari'a supervisory board may include a member other than those specialised in Fiqh Al-Mua'malat, but who should be an expert in the field of Islamic financial institutions and with knowledge of Fiqh Al-Mua'malat. The Shari'a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Shari'a Rules and Principles. The fatwas, and rulings of the Shari'a supervisory board shall be binding on the Islamic financial institution.

Appointment of Shari'a Supervisory Board and Fixing of Its Remuneration

3. Every Islamic financial institution shall have a Shari'a supervisory board to be appointed by the shareholders in their annual general meeting upon the recommendation of the board of directors taking into consideration the local legislation and regulations. Shareholders may authorise the board of directors to fix the remuneration of the Shari'a supervisory board.

4. The Shari'a supervisory board and the Islamic financial institution should agree on the terms of the engagement. The agreed terms would need to be recorded in an appointment letter.
5. The Shari'a supervisory board should ensure that the Islamic financial institution documents and confirms the Shari'a supervisory board's acceptance of appointment. The letter of appointment of Shari'a supervisory boards should generally include reference to the compliance of the Islamic financial institution with Shari'a Rules and Principles.
6. The Shari'a supervisory board shall appoint from among its members or any other person a supervisor(s) to help it in performing its duties.

Composition, Selection and Dismissal of Shari'a Supervisory Board

7. The Shari'a supervisory board shall consist of at least three members.

The Shari'a supervisory board may seek the service of consultants who have expertise in business, economics, law, accounting and/or others. The Shari'a supervisory board should not include directors or significant shareholders of the Islamic financial institution.

8. The dismissal of a member of the Shari'a supervisory board shall require a recommendation by the board of directors and be subject to the approval of the shareholders in a general meeting.

Basic Elements of the Shari'a Supervisory Board's Report

9. The Shari'a supervisory board's report should contain the following basic elements:
 - a) Title;
 - b) Addressee;
 - c) Opening or introductory paragraph;
 - d) Scope paragraph describing the nature of the work performed;
 - e) Opinion paragraph containing an expression of opinion on the compliance of the Islamic financial institution with Shari'a Rules and Principles;
 - f) Date of report; and
 - g) Shari'a supervisory board's signature.

A measure of uniformity in the form and content of the Shari'a supervisory board's report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur.

Title

10. The Shari'a supervisory board's report should have an appropriate title.

The addressee of the Shari'a supervisory board's report

11. The Shari'a supervisory board's report should be appropriately addressed as required by the circumstances of the engagement and local laws and regulations.

Opening or introductory paragraph

12. The Shari'a supervisory board's report should identify the purpose of the engagement.

Illustrative wording for an opening (introductory) paragraph is shown below:

"In compliance with the letter of appointment, we are required to submit the following report:

13. A scope paragraph should describe the nature of the work performed.

Illustrative wording for a scope paragraph is shown below:

"We have reviewed the principles and the contracts relating to the transactions and applications introduced by the Example Islamic Financial Institution during the period ended. We have also conducted our review to form an opinion as to whether the Example Islamic Financial Institution has complied with Shari'a Rules and Principles and also with the specific fatwas, rulings and guidelines issued by us."

Management's responsibility

14. A clear statement that the management of the Islamic financial institution is responsible for properly complying with Shari'a Rules and Principles.

Illustrative wording for Shari'a statement is shown below:

"The Example Islamic Financial Institution's management is responsible for ensuring that the financial institution conducts its business in accordance with Shari'a Rules and Principles. It is our responsibility to form an independent opinion, based on our review of the operations of the Example Islamic Financial Institution, and to report to you."

Scope paragraph

15. Confirmation that the Shari'a supervisory board has performed appropriate tests, procedures and review work as appropriate.
16. Where appropriate, examining, on a test basis of each type of transaction, evidence to support that the transaction and dealings entered into by the respective Islamic financial institution are in compliance with the Shari'a Rules and Principles.

Illustrative wording to explain the review process is shown below: "We conducted our review which included examining, on a test basis of each type of transaction, the relevant documentation and procedures adopted by the Example Islamic Financial Institution.

We planned and performed our review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Example Islamic Financial Institution has not violated Shari'a Rules and Principles."

17. Where appropriate, the report of the Shari'a supervisory board should include a clear statement that the financial statements have been examined for the appropriateness of the Shari'a basis of allocation of profit between the equity holders and the investment accountholders.
18. Where appropriate, the report of the Shari'a supervisory board should include a clear statement that all earnings that have been realized from sources or by means prohibited by Shari'a Rules

Governance Standard No.

(1):

and Principles have been disposed of to charitable causes.

19. Where an Islamic financial institution prepares a Statement of Sources and Uses of Zakah and Charity Funds, the Shari'a supervisory board's report should state whether the calculation of the Zakah is in compliance with Shari'a Rules and Principles.

Opinion paragraph

20. The Shari'a supervisory board's report should state whether the Example Islamic Financial Institution's contracts and related documentation are in compliance with the Shari'a Rules and Principles.

An illustration of these matters in the opinion paragraph is shown below:

In our opinion:

- a) The contracts, transactions and dealings entered into by the Example Islamic Financial Institution during the year ended ... that we have reviewed are in compliance with the Shari'a Rules and Principles;
- b) The allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by us in accordance with Shari'a Rules and Principles;
(where appropriate, the opinion paragraph shall also include the following matters:)
- c) All earnings that have been realized from sources or by means prohibited by Shari'a Rules and Principles have been disposed of to charitable causes; and
- d) The calculation of Zakah is in compliance with Shari'a Rules and Principles.

21. If the Shari'a supervisory board has ascertained that the management of the Islamic financial institution has violated Shari'a Rules and Principles or the fatwas, ruling and guidelines issued by its Shari'a supervisory board, then the Shari'a supervisory board has to report the violations in the opinion paragraph of its report.

Date of report

22. The Shari'a supervisory board should state the period covered by its report and date the report as of the completion date of the

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review.

23. The Shari'a supervisory board should not date the report earlier than the date on which the financial statements are signed or approved by management.

Shari'a supervisory board's signature

24. The Shari'a supervisory board's report should be signed by all members of the Board.

Publication of the Report of the Shari'a Supervisory Board

25. The report of the Shari'a supervisory board shall be published in the annual report of the Islamic financial institution.

Publication of Fatwas, Rulings and Guidelines of the Shari'a Supervisory Board

26. It is recommended that the Islamic financial institution publishes the fatwas, rulings and guidelines issued by its Shari'a supervisory board during the year.

Effective Date

27. This standard shall be effective for the financial statements for the financial periods beginning 1 Muharram 1419 A.H. or 1 January 1999 A.D.

Governance Standard No.
(1):

Adoption of the standard

The standard of Shari'a Supervisory Board: Appointment, Composition and Report was adopted by the Accounting and Auditing Standards Board in its meeting No. (13) held on 10-11 Safar 1418 A.H., corresponding to 15-16 June 1997 A.D.

Appendix

Example Report of Shari'a Supervisory Board

In the Name of Allah, The Beneficent, The Merciful
To the Shareholders of the Example Islamic Financial Institution
Assalamu Alaykum Wa Rahmatu Allah Wa Barakatuh

In compliance with the letter of appointment, we are required to submit the following report:

We have reviewed the principles and the contracts relating to the transactions and applications introduced by the Example Islamic Financial Institution during the period ended. We have also conducted our review to form an opinion as to whether the Example Islamic Financial Institution has complied with Shari'a Rules and Principles and also with the specific fatwas, rulings and guidelines issued by us.

The Example Islamic Financial Institution's management is responsible for ensuring that the financial institution conducts its business in accordance with Shari'a Rules and Principles. It is our responsibility to form an independent opinion, based on our review of the operations of the Example Islamic Financial Institution, and to report to you.

We conducted our review which included examining, on a test basis of each type of transaction, the relevant documentation and procedures adopted by the Example Islamic Financial Institution.

We planned and performed our review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Example Islamic Financial Institution has not violated Shari'a Rules and Principles.

In our opinion:

a) The contracts, transactions and dealings entered into by the

Example Islamic Financial Institution during the year ended ... that we have reviewed are in compliance with the Shari'a Rules and Principles;

b) The allocation of profit and charging of losses relating to

investment accounts conform to the basis that had been approved by us in accordance with Shari'a Rules and Principles;

(where appropriate, the opinion paragraph shall also include the following matters:)

c) All earnings that have been realized from sources or by means

prohibited by Shari'a Rules and Principles have been disposed of to charitable causes; and

d) The calculation of Zakah is in compliance with Shari'a Rules

and Principles.

We beg Allah the Almighty to grant us all the success and straight-forwardness.

Wassalamu Alaykum Wa Rahmatu Allah Wa Barakatuh

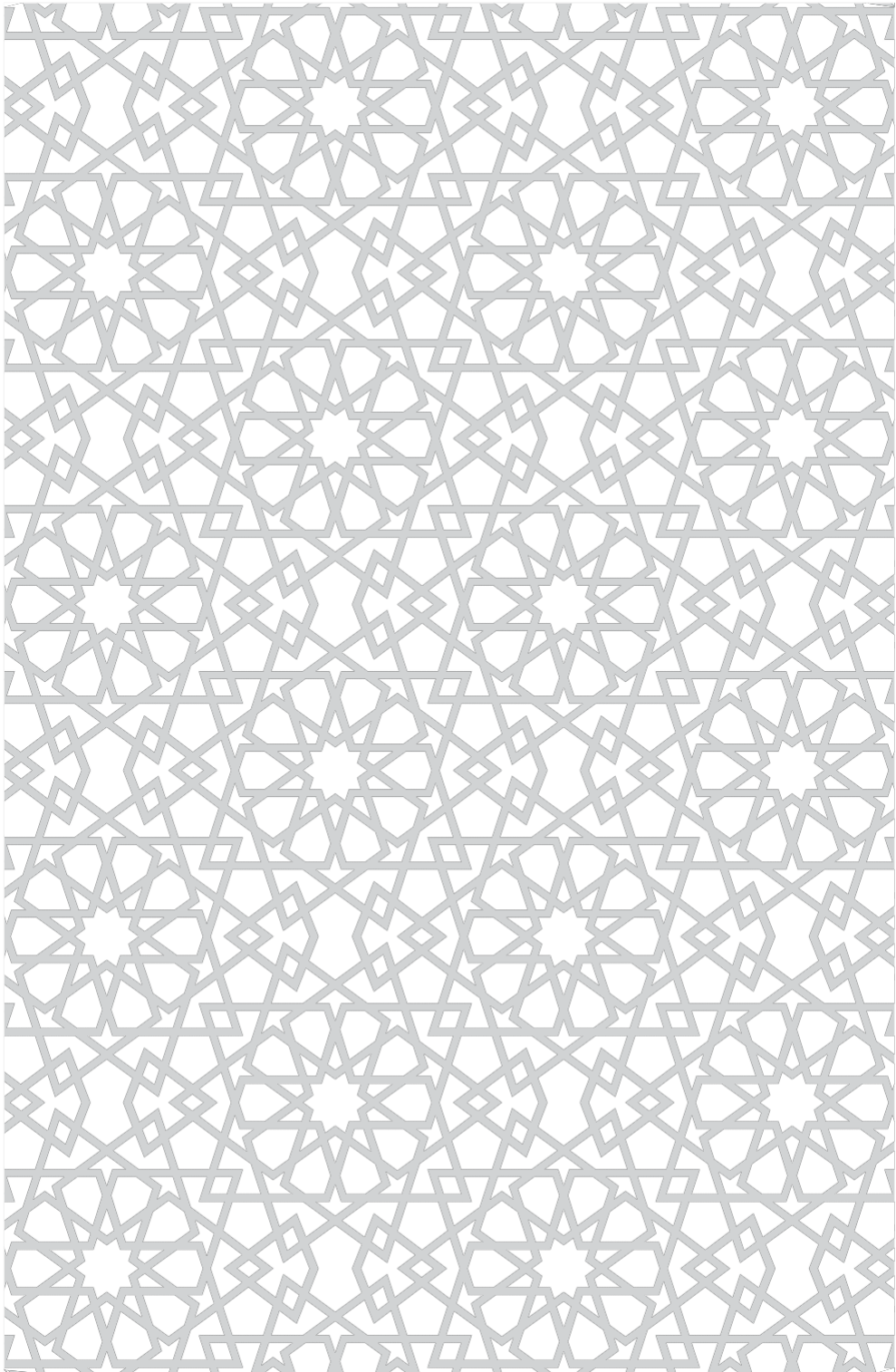
(Names and signature of the members of the Shari'a supervisory board)

Place and Date

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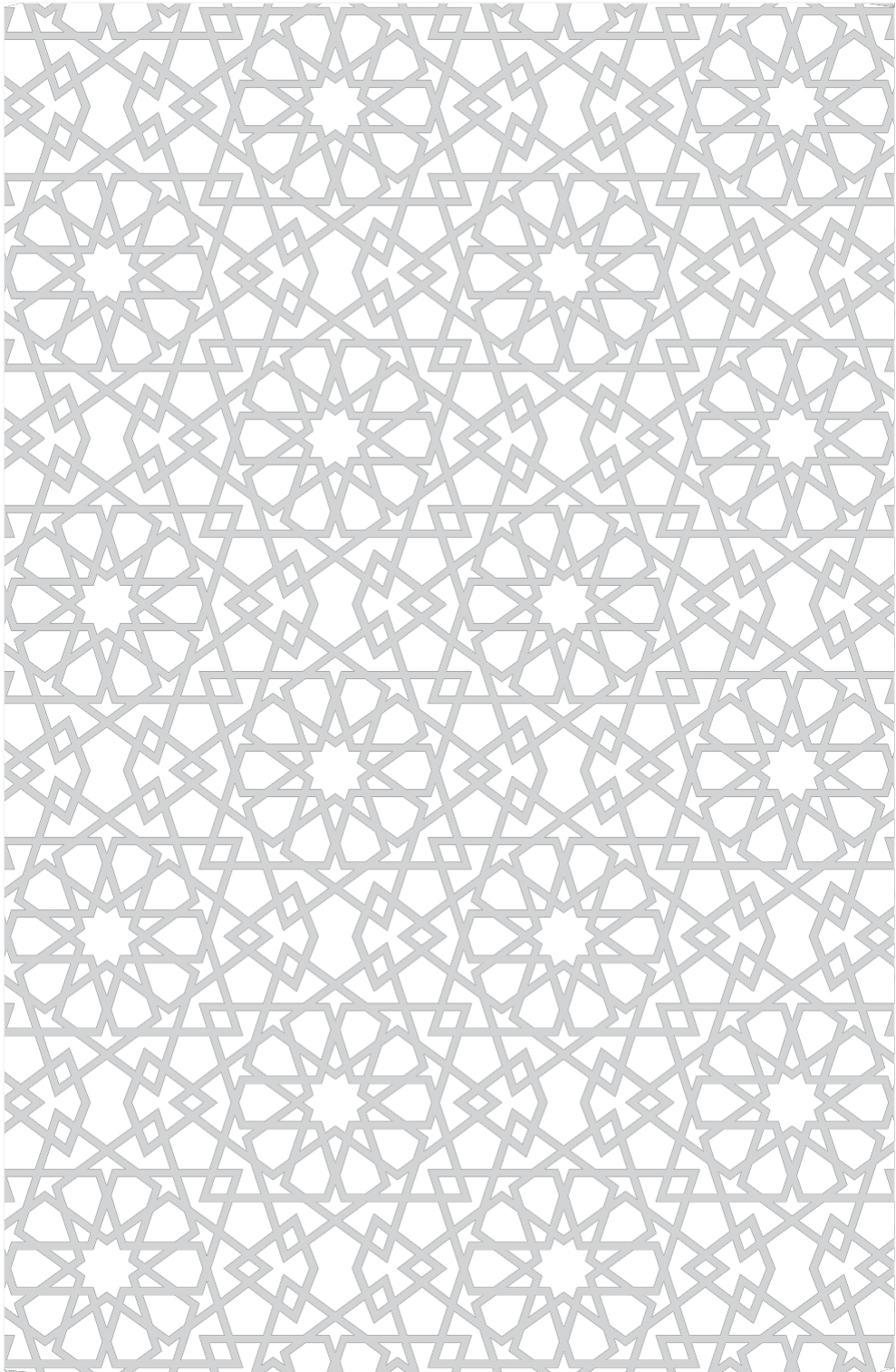
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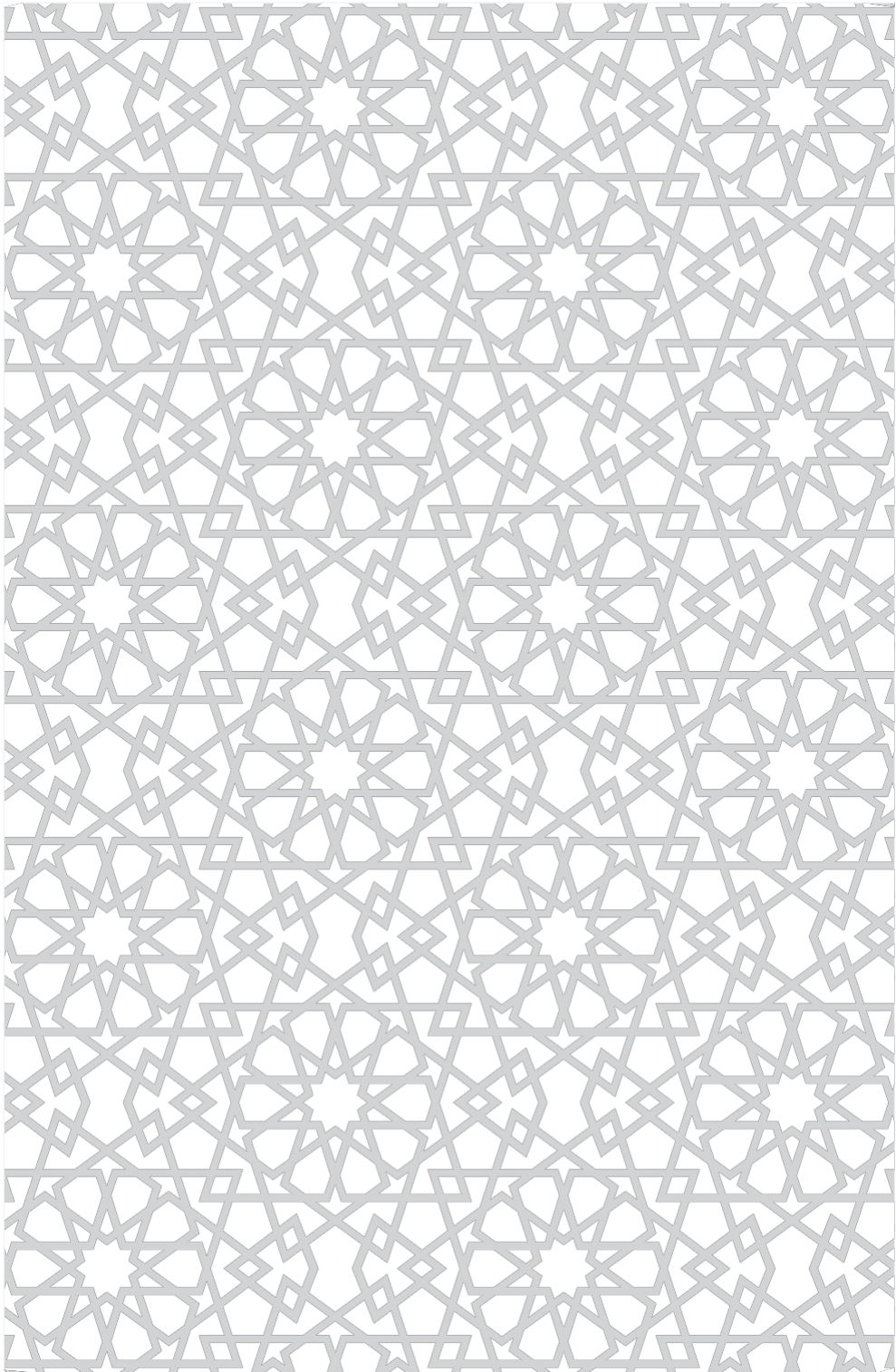
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Shari'a Review



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Shari'a Review

Introduction

1. The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance to assist Shari'a Supervisory Boards (SSB) of Islamic Financial Institutions (IFIs) in performing Shari'a reviews to ensure compliance with Shari'a Rules and Principles as reflected in the fatwas, rulings and guidelines issued by them (hereinafter, the Shari'a).⁽¹⁾ The appointment, composition and report of the SSB is dealt with in AAOIFI Governance Standard for Islamic Financial Institutions No. (1): Shari'a Supervisory Board: Appointment, Composition and Report.
2. This standard should be read in conjunction with ASIFI No. (1): Objective and Principles of Auditing with particular reference to paragraph 7, and ASIFI No. (2): The Auditor's Report with particular reference to paragraph 17. It follows that the objective of this standard as well as those of ASIFIs No. (1) and No. (2) requires close coordination between the SSB and the external auditor.

Definition and Principles of Shari'a Review

3. Shari'a review is an examination of the extent of an IFI's compliance, in all its activities, with the Shari'a. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.

The SSB shall have complete and unhindered access to all records, transactions, and information from all sources including professional advisers and the IFI employees.

(1) Where applicable, the fatwas, rulings and guidelines of a Higher Shari'a Supervisory

Board shall also apply.

Objective of the Review

4. The objective of a Shari'a review is to ensure that the activities carried out by an IFI do not contravene the Shari'a. The achievement of this objective requires that the Shari'a as defined in (para. 1) above is mandatory.

Responsibility for Compliance with the Shari'a

5. While the SSB is responsible for forming and expressing an opinion on the extent of an IFI's compliance with the Shari'a, the responsibility for compliance therewith rests with the management of an IFI. (Consideration should be given to the definition of management in relevant national legislation and regulations). To enable management to carry out this responsibility effectively, the SSB of the IFI shall assist by providing guidance, advice and training relating to compliance with the Shari'a. The Shari'a review of an IFI's does not relieve management of their responsibility to undertake all transactions in accordance with the Shari'a. It is the management's responsibility to provide to the SSB all information relating to the IFI's compliance with the Shari'a.
6. An IFI shall not restrict the Shari'a review as noted in paragraph 3 above. In case such restrictions are imposed, these shall be included in the SSB's review report to the shareholders.

Shari'a Review Procedures

7. Shari'a review is to be carried out in the following stages:
 - Planning review procedures.
 - Executing review procedures and preparation and review of working papers.
 - Documenting conclusions and report.

Each of the above stages is explained as below:

Planning and designing Shari'a review procedures

8. The Shari'a review procedures shall be planned so that it is completed in an effective and efficient manner. The plan shall be adequately developed to include a complete understanding about the IFI's operations in terms of products, size of operation,

and divisions. The planning shall include obtaining a list of all fatwas, rulings and guidelines issued by the SSB.

9. Understanding the activities, products and management's awareness and attitude towards compliance with the Shari'a is essential. This will have a direct effect on the nature, extent and timing of the Shari'a review procedures.
10. The plan shall be properly documented including the sample selection criteria and sizes, taking into consideration complexity, and frequency of transactions.

11. The review procedures shall be designed based on the above input.

The review procedures shall cover all activities, products and locations.

These procedures shall ascertain whether the SSB approved transactions

and products have been undertaken and all related conditions have been met.

Executing Shari'a review procedures and preparation and review of working papers

12. At this stage, all the planned review procedures are executed. The SSB

review procedures shall normally include:

- Obtaining an understanding of the management's awareness, commitment and compliance control procedures for adherence to the Shari'a;
- Reviewing of contracts, agreements, etc.;
- Reascertaining whether transactions entered into during the year were for products authorised by the SSB;
- Reviewing other information and reports such as circulars, minutes, operating and financial reports, policies and procedures, etc.;

- Consultation/co-ordination with advisors such as external auditors;
and
- Discussing findings with an IFI's management.

The execution of the above review procedures shall be documented in work papers which shall be complete, neat and cross referenced to review procedures.

Documenting conclusions and report

13. The SSB shall document their conclusions and prepare their report to the shareholders based on the work done and discussions held. The SSB report shall be read at the annual general meeting of the IFI. A detailed report, when warranted, shall also be issued to an IFI's management.

Quality Assurance

14. The SSB shall implement adequate quality control policies and procedures to ensure that the review is conducted in accordance with this standard.
15. Quality control procedures may include review of all work papers to ensure that review procedures were properly understood and executed. Additional discussions may be held with the IFI's management, if required, to ensure that all significant matters were covered during the review.

Report

16. The SSB report to the shareholders of an IFI shall be based on GSIFI No. (1): Shari'a Supervisory Board: Appointment, Composition and Report.

Responsibility for Implementation of the Standard

17. The responsibility for implementation of this standard, as well as that of GSIFI No. (1) Shari'a Supervisory Board: Appointment, Composition and Report, lies with the management of an IFI.

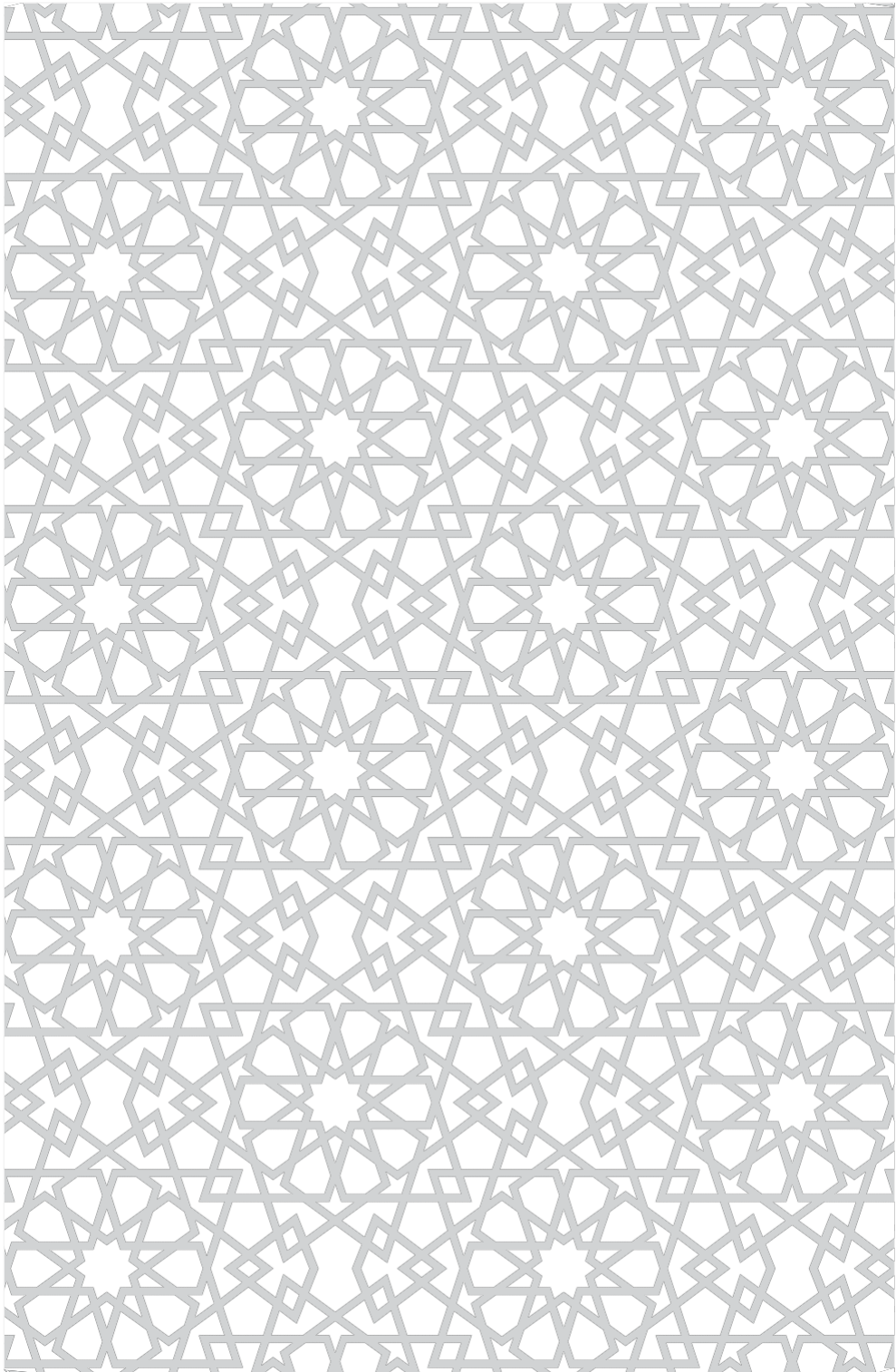
Effective Date

18. This standard shall be effective for financial statements for the financial periods beginning 1 Muharram, 1420 A.H. or 1 January 1999 A.D.

Adoption of the Standard

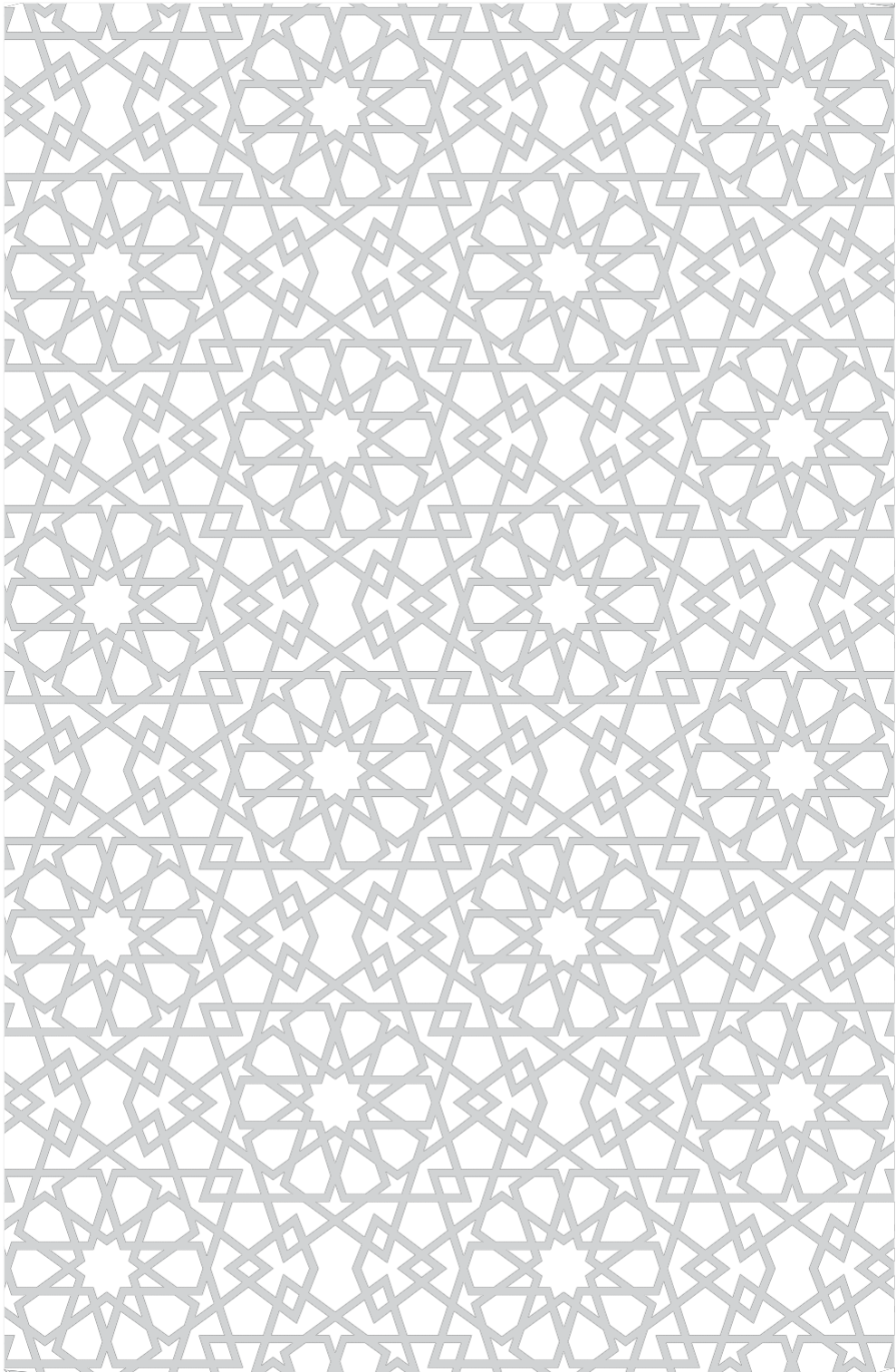
The standard of Shari'a Review was adopted by the Accounting and Audit- ing Standards Board in its meeting No. (15) held on 27-28 Safar 1419 A.H., corresponding to 21-22 June 1998 A.D.





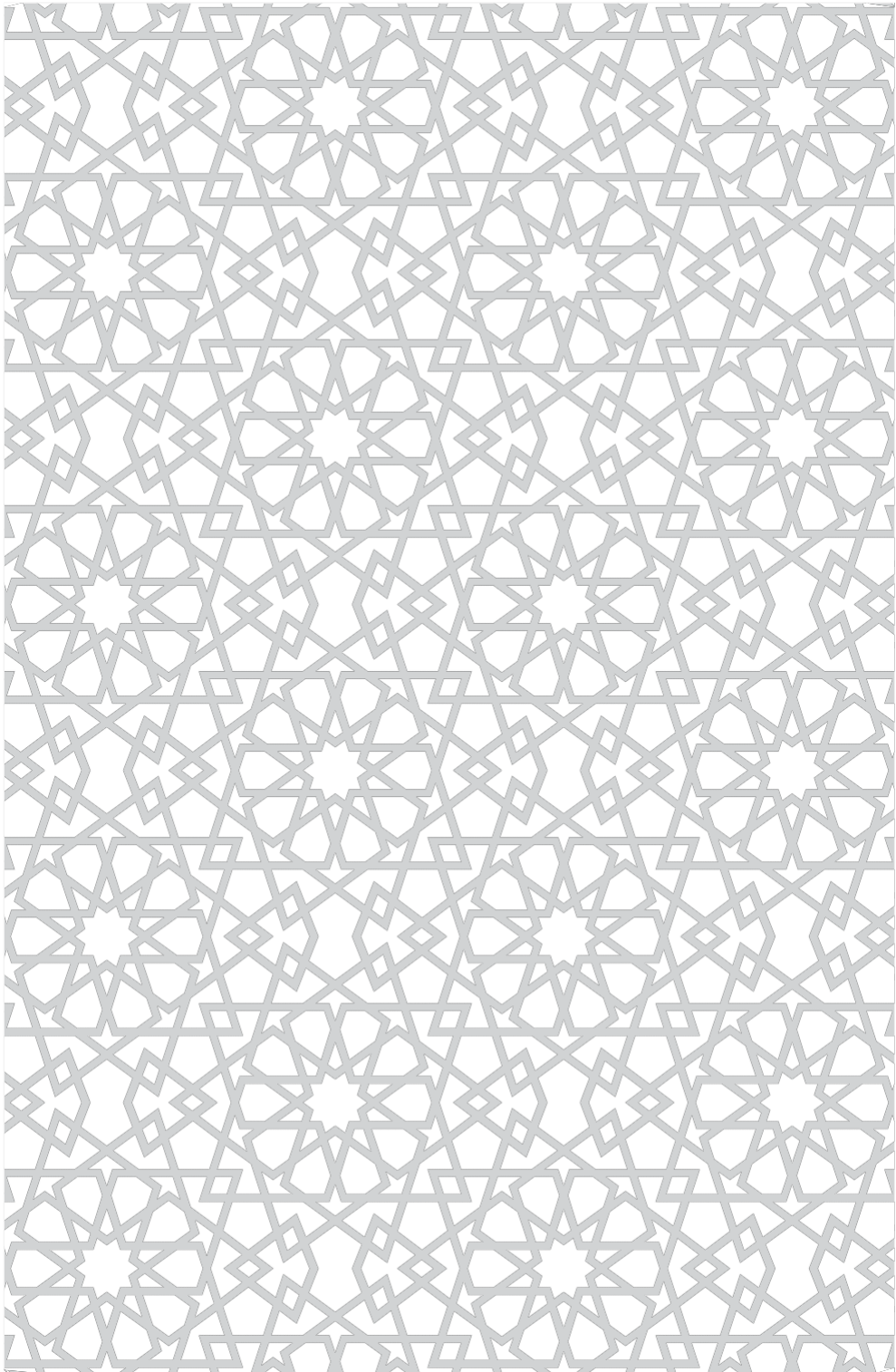
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Internal Shari'a Review



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Internal Shari'a Review

Introduction

1. The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the internal Shari'a review in institutions which conduct business in conformity with Shari'a rules and principles. The standard covers the following:



Objectives;



Internal Shari'a review ;



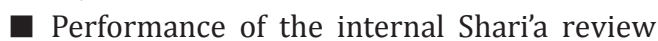
Independence and objectivity;



Professional proficiency;



Scope of work;



Performance of the internal Shari'a review work;



Management of the internal Shari'a review ;



Quality assurance and



Elements of an effective internal Shari'a review control system.

The standard also covers responsibility for its implementation.

Objectives

2. The internal Shari'a review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an Islamic financial institution (IFI). It shall be established within an IFI to examine and evaluate

the extent of compliance with Shari'a rules and principles, fatwas, guidelines, and instructions issued by the IFI's Shari'a supervisory board (SSB), hereafter referred to as Shari'a rules and principles.

The primary objective of the internal Shari'a review is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shari'a rules and principles as determined by the IFI's SSB.

Internal Shari'a Review

3. The internal Shari'a review is an integral part of the organs of governance of the IFI and operates under the policies established by the IFI. It shall have a statement of purpose, authority, and responsibility (charter). The charter shall be prepared by management and shall be consistent with Shari'a rules and principles. The charter shall be approved by the SSB of the IFI and issued by the board of directors. The charter shall be regularly reviewed.
4. The charter shall make clear that internal Shari'a reviewers are to have no executive authority or responsibility for the activities they review.
5. The internal Shari'a review may be carried out by the internal audit department/internal control department if properly qualified and independent. However, if separate unit is set up it shall have authority equivalent to the authority of the internal audit department/internal control department.

Independence and Objectivity

6. The organizational status of the internal Shari'a review shall be sufficient to accomplish its responsibilities. The organizational status of the internal Shari'a review shall not be lower than that of the internal audit department/internal control department.
7. The internal Shari'a reviewers shall have full and continuous support of the management and the board of directors. They shall have direct and regular communications with all levels of management, SSB and external auditors, which shall enhance the organizational status of the internal Shari'a reviewers. No scope limitation and restriction of access to documents, reports, etc., shall be placed on the internal Shari'a reviewers. The head of the internal Shari'a review shall be responsible to the board of directors. He shall ensure full Shari'a review coverage, adequate consideration of the internal Shari'a review reports, and appropriate action on the internal Shari'a review recommendations. The internal Shari'a reviewers shall be objective in performing their internal Shari'a review.

8. Objectivity includes independent attitude, which the internal Shari'a reviewers shall maintain in performing the internal Shari'a reviews. The internal Shari'a reviewers shall reach objective conclusions based on work performed and its results thereof.

Professional Proficiency

Staffing and supervision

9. The staff of the internal Shari'a review shall be proficient and shall have appropriate educational background and training relevant to internal Shari'a review. The head of the internal Shari'a review shall establish suitable criteria to meet the above.
10. Supervision is a continuous process, beginning with planning and ending with the conclusion of the internal Shari'a review assignment. The head of the internal Shari'a review shall be responsible for providing appropriate internal Shari'a review supervision and he shall ensure that internal Shari'a reviews are properly supervised. Appropriate evidence of the supervision shall be documented and retained.

Compliance with code of ethics

11. The internal Shari'a reviewers shall comply with the Code of Ethics for Accountants and Auditors of Islamic Financial Institutions issued by the Accounting and Auditing Organization for Islamic Financial Institutions.

Knowledge, skills and disciplines

12. The internal Shari'a reviewers shall possess the disciplines, knowledge and skills essential to the performance of internal Shari'a reviews. Proficiency in Shari'a rules and principles in general, and Fiqh Al- Mu'amalat in particular, is required in performing internal Shari'a reviews.

Continuing education and training

13. The internal Shari'a reviewers shall maintain their technical competence through continuing education.

14. The internal Shari'a reviewers are responsible for continuing their education in order to maintain their proficiency and keep informed about improvements and current developments.
15. The internal Shari'a reviewers shall participate in training their IFI's employees and other interested members of the public by holding regular meetings, courses and seminars. They may also disseminate knowledge by publishing and distributing pamphlets, brochures, etc., explaining principles of Fiqh Al-Mu'amalat in general, and in particular the fatwas, guidelines and instructions issued by SSB about the products and services offered by their IFI.

Due professional care

16. Internal Shari'a reviewers shall exercise due professional care in performing internal Shari'a reviews. Professional care shall be appropriate to the complexities of the internal Shari'a review being performed. In exercising due professional care, internal Shari'a reviewers shall be alert to the possibility of intentional wrongdoing.

Scope of Work

17. The scope of work of the internal Shari'a review shall encompass the examination and evaluation of the adequacy and effectiveness of the IFI's system of internal Shari'a control and the quality of performance in carrying out assigned responsibilities.

Shari'a rules and principles provide the direction as to the scope of work and the activities to be reviewed.

The purpose of the examination of the adequacy of the system of internal Shari'a control is to ascertain whether the established system provides reasonable assurance that the IFI objectives of compliance with the Shari'a rules and principles will be met efficiently and effectively. Also, the purpose of the examination for effectiveness of the system of Shari'a internal control is to ascertain whether the system was functioning as intended. The internal Shari'a reviewers are responsible for planning, organising and directing processes to determine whether reasonable assurance exists that Shari'a compliance objective as well as other objectives and goals are being achieved.

Performance of the Internal Shari'a Review Work

General

18. The internal Shari'a reviewers shall plan each internal Shari'a review assignment. Planning documentation shall include, but not limited to, the following:
- Obtaining background information about the activities to be re- viewed, such as locations, products/services, branches, divisions, etc.
 - Establishing internal Shari'a review objectives and scope of work.
 - Obtaining SSB fatwas, guidelines, instructions, prior year internal and external Shari'a review results and relevant correspondence including supervisory and regulatory agencies.
 - Determining the resources necessary to perform the internal Shari'a review.
 - Communicating with all individuals in the IFI who need to know about the internal Shari'a review.
 - Performing, as appropriate, a survey to become familiar with activities, risks, and controls to identify areas of the internal Shari'a review emphasis, and to invite reviewees' comments and suggestions.
 - Writing the internal Shari'a review programmes.
 - Determining how and when the internal Shari'a review results shall be communicated.
 - Obtaining approval on the internal Shari'a review work plan from the concerned authorities including the SSB of the IFI.

Examining and evaluating internal Shari'a review information

19. The internal Shari'a reviewers shall collect, analyse, interpret and document information to support their internal Shari'a review results. Information shall be collected on all matters related to the internal Shari'a review objectives and scope of work. Information collection shall include examination of documentation, analytical reviews, inquiries, discussions with management, and observations. Information shall be sufficient, reliable, relevant and useful to provide a sound basis for internal Shari'a review findings and recommendations. Working papers that document the internal Shari'a review shall be prepared by an internal Shari'a reviewer and reviewed by the head of internal

Shari'a review. These working papers shall support the internal

Shari'a review findings and recommendations. Working papers shall be appropriately prepared, completed, organised, reviewed and retained.

Reporting

20. The head of the internal Shari'a review shall discuss conclusions and recommendations with appropriate levels of management before issuing final written report. On completion of the internal Shari'a review, at least a quarterly written report shall be prepared which must be signed by the head of the internal Shari'a review, addressed to the board of directors and copied to the SSB and management.

21. The report shall be objective, clear, constructive and timely. The report shall present the purpose, scope and results of the internal Shari'a review, and it shall contain an expression of the internal Shari'a reviewer's opinion. The report shall also include recommendations for potential improvements and corrective action, and acknowledge satisfactory performance, when appropriate. The reviewees' views about the internal Shari'a review conclusions or recommendations shall be included in the internal Shari'a review report.

All disputes between management and internal Shari'a reviewers on matters relating to Shari'a interpretation shall be referred to the SSB for ruling.

Follow up

22. The internal Shari'a reviewers shall follow up to ascertain that appropriate action is taken on their reported internal Shari'a review findings. In addition, any other recommendations relating to Shari'a matters made by the SSB, external auditors, and regulatory agencies shall also be followed up. The management is responsible for rectification of non-compliance, prevention of non-recurrence of non-compliances, and ensuring that the agreed upon actions were carried out including their timing and extent of follow up.

Management of the Internal Shari'a Review

23. The head of the internal Shari'a review shall properly manage the internal Shari'a review. He shall also perform the following:
- Establish plans to carry out the responsibilities of the internal Sha- ri'a review;
 - Provide written policies and procedures to guide the members of the internal Shari'a review; and
 - Establish a programme for selecting and developing the performance of the internal Shari'a review staff.
24. The head of the internal Shari'a review shall ensure that the inter- nal and external Shari'a review efforts are properly co- ordinated to ensure adequate Shari'a review coverage and to avoid duplicate efforts.

Quality Assurance of Shari'a Review

25. The head of the internal Shari'a review shall establish and maintain an effective and efficient quality assurance programme to evaluate the operations of the internal Shari'a review.

Elements of an Effective Internal Shari'a Review Control System

The following are the main components of an effective system of internal Shari'a control:

Employees

26. An IFI shall have a system in place which ensures that only qualified, experienced, and committed employees are recruited and retained. The system shall ensure that employees are continuously trained and developed in related disciplines, especially Fiqh Al-Mu'amalat. Their performance shall be regularly assessed and appropriate action shall be taken. Employees shall be honest and loyal to their IFI. In all cases, prior consent of the IFI's SSB shall be secured before any employee is appointed in the internal Shari'a review (in accordance with the by- laws of the IFI) in order to ascertain the employee's positive attitude towards compliance with Shari'a rules and principles.

Segregation of duties

27. The internal Shari'a reviewers shall not undertake any operational activities of the IFI.

Control procedures

28. An IFI's management shall establish controls, policies and procedures, to achieve the IFI's objective of compliance with Shari'a rules and principles.

Responsibility for Implementation of the Standard

29. The responsibility for implementation of this standard lies with the management of an IFI.

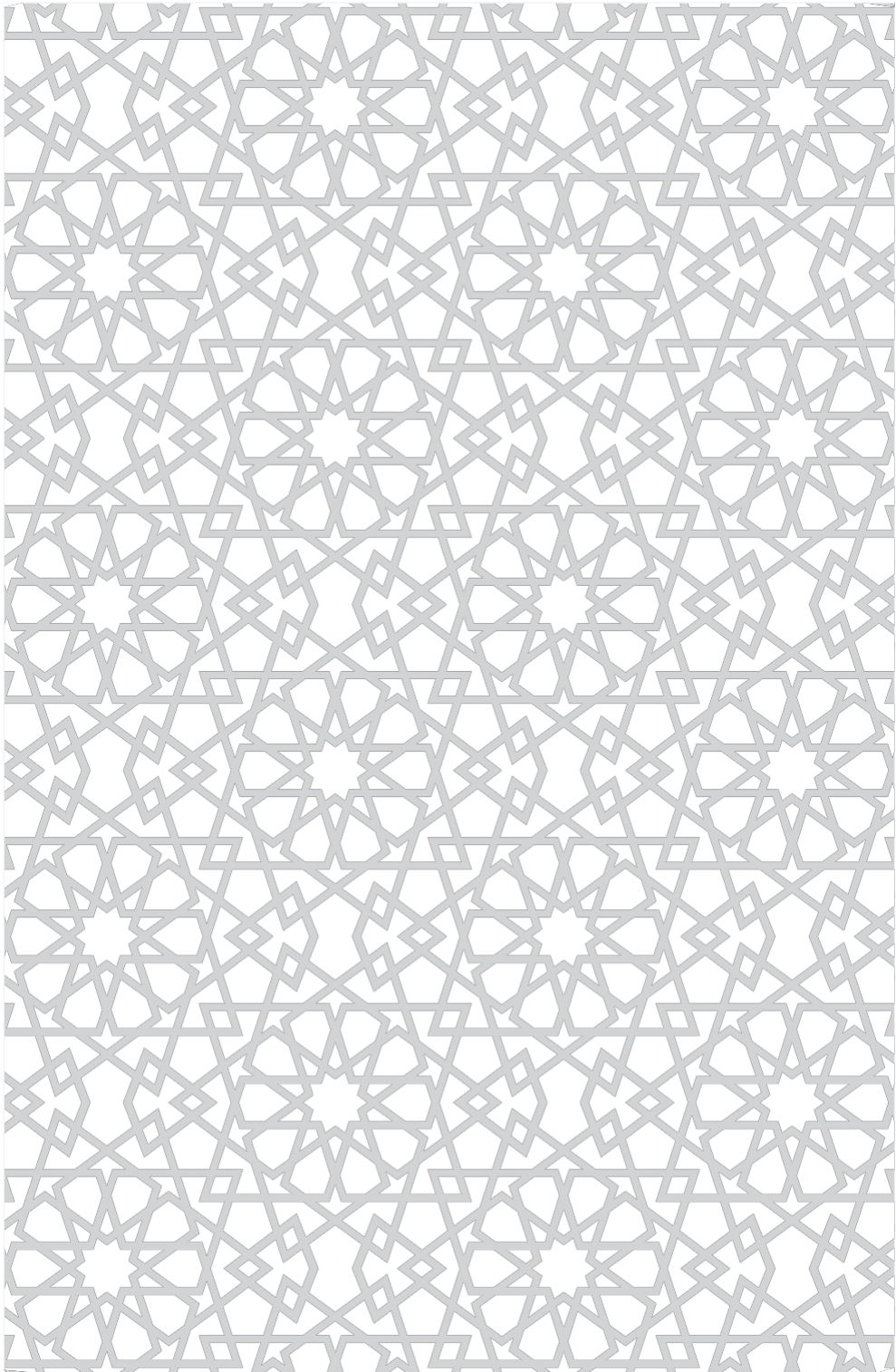
Effective Date

30. This Standard shall be effective for financial periods beginning 1 Mu- harram, 1421 A.H., or 1 January, 2000 A.D.

Adoption of the standard

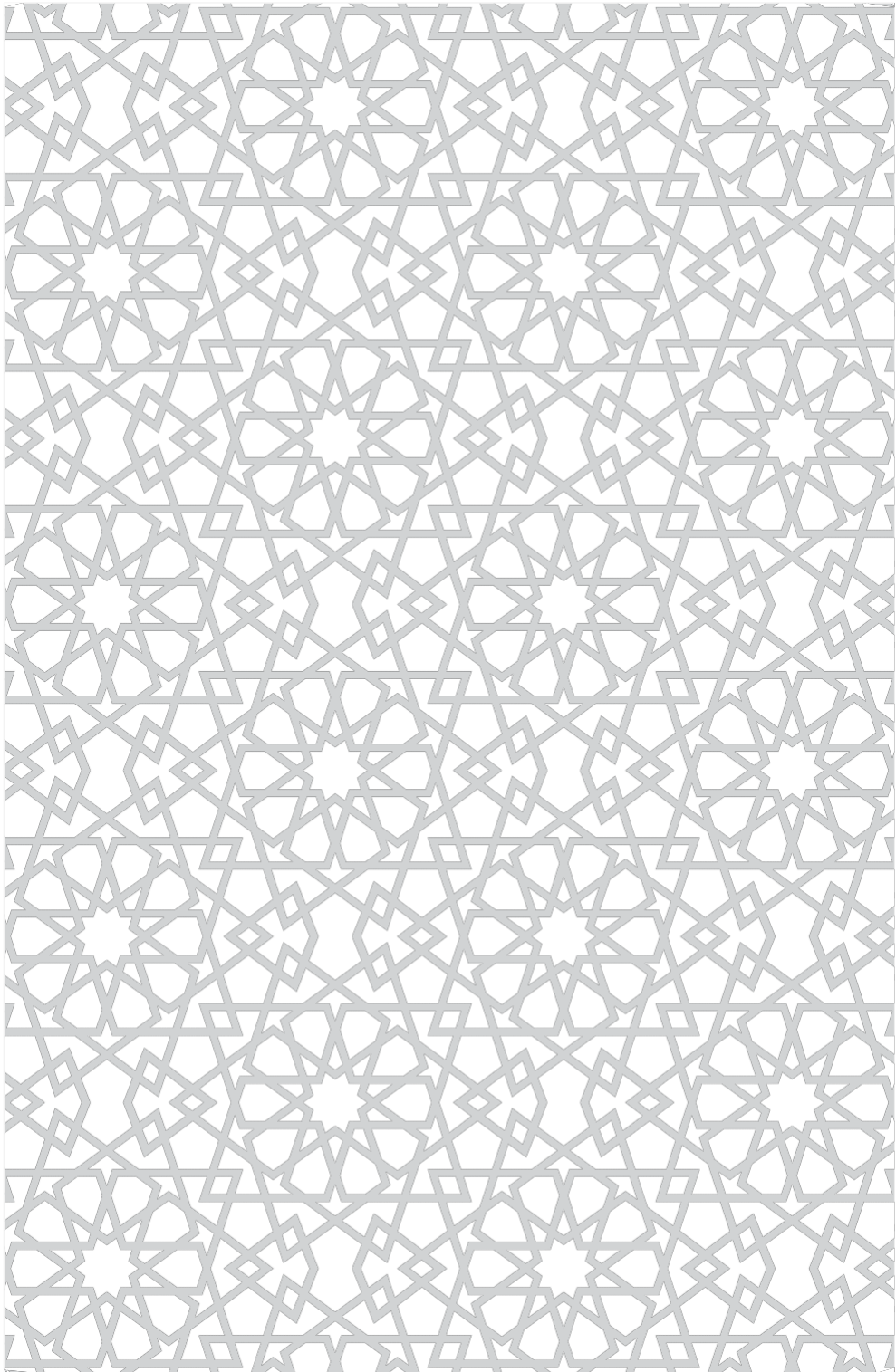
The Internal Shari'a Review standard was adopted by the Accounting and Auditing Standards Board in its meeting No. (17) held on 29 Safar - 1 Rabi' I, 1420 A.H., corresponding to 13-14 June 1999 A.D.





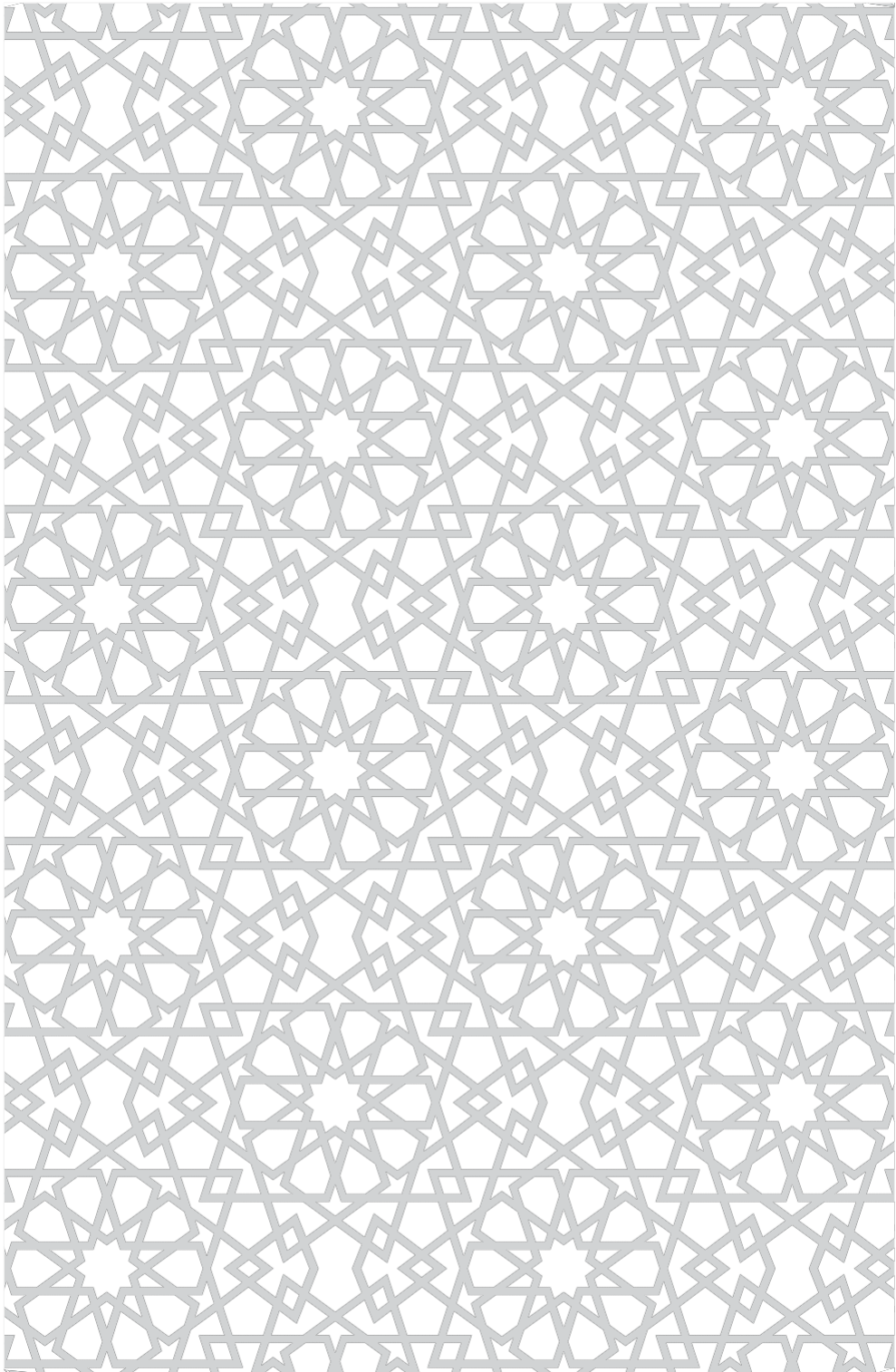
Governance Standard No. (4)

**Audit and Governance Committee
for Islamic Financial Institutions**



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Audit and Governance Committee for Islamic Financial Institutions

Introduction

1. The purpose of this Governance Standard for Islamic Financial

Institutions (GSIFI) is to define the role and responsibilities of an Audit and Governance Committee (AGC) for an Islamic financial institution (IFI). The standard also highlights the requirements for establishing such a committee for an IFI and specifies the prerequisites for an effective AGC.

Importance of AGC

2. The importance of the AGC (known internationally as the Audit Committee) for an IFI emanates from its role in:
 - a) Achieving the fundamental objectives of an IFI, by enhancing greater transparency and disclosure in financial reporting; and
 - b) Enhancing the public's confidence of the IFI as genuine in its application of Shari'a rules and principles.

Functions of AGC

3. The AGC has gained widespread acceptance as a prerequisite for organizations seeking to demonstrate a commitment to higher standards of corporate governance. The AGC assists the board of directors in exercising independent and objective monitoring through the following functions:
 - a) Preserving the integrity of the financial reporting process.
 - b) Safeguarding the interests of shareholders, investors and other corporate stakeholders.
 - c) Providing additional assurance on the reliability of financial information presented to the board of directors, if the AGC is to be considered effective.
 - d) Acting as an independent link between the IFI's management and

its stakeholders.

Responsibilities of AGC

The responsibilities of the AGC shall comprise the following:

Review of internal controls (including internal audit)

4. The AGC's role with regard to internal controls is to ensure that the IFI has the appropriate controls in place and that these controls are functioning properly, as well as to monitor the implementation of management's strategy. The AGC shall have a sufficient understanding of the IFI's business and its control environment to make pertinent inquiries concerning systems of internal control. Implicit in such a function is extensive interaction with the IFI's management, its internal and external auditors and the ability to gauge the significance of problems and issues raised by these parties.

The specific responsibilities associated with this function include:

- a) Comprehending the major risks to which the business is exposed.
- b) Monitoring management's control consciousness as it relates to the significance attached to controlling the IFI's policies, procedures, methods, and organizational structure.
- c) Reviewing the pressures on management to achieve results (e.g., remuneration arrangements, and market expectations).
- d) Monitoring the adequacy of management reporting processes.
- e) Reviewing resources and skills, scope of responsibilities, overall work programme and reporting lines of internal audit.
- f) Reviewing the effectiveness of internal control systems, particularly focusing on major findings of internal audit, the external auditor's management letters and of any other reports from regulatory bodies together with management responses.
- g) Reviewing the findings of central bank inspections and other regulatory bodies together with management responses and ensuring that appropriate actions have been taken to comply with the central bank inspectors' requirements.
- h) Reviewing the IFI code of ethics and the effectiveness with which it is implemented.
- i) Reviewing the effectiveness of the IFI's system for monitoring compliance with Shari'a rules and principles and legal requirements as

well as considering the adequacy of controls over significant areas where loss or embarrassment could be caused to the IFI.

- j) Ensuring that the management of IFI has implemented the procedures that govern its relationship with the related parties.

Review of accounting practices and audit plan

- 5. Financial reporting of transactions, projects and other activities in progress at a particular point in time includes recognition, measurement and disclosure of such activities. The outcome of such activities is subject to uncertainty and their measurement involves the use of accounting assumptions and judgment.

The specific responsibilities associated with this function include:

- a) Understanding areas in the IFI exposed to high degrees of risk and uncertainty, with particular reference to judgmental areas involving estimates, contingent liabilities and significant claims.
- b) Reviewing the IFI's accounting policies and practices and reporting requirements, with particular emphasis on the implications of new accounting standards and proposed changes in the IFI's accounting policies and on areas in which choices exist between accounting methods or policies.
- c) Reviewing the nature and scope of the audit with particular reference to high-risk areas or locations and the resources and skills of the auditors.
- d) Ensuring coordination between internal and external auditors and ensuring that the independence and professional integrity of auditors is not compromised.
- e) Considering any issues related to the appointment, resignation or dismissal of members of the Shari'a Supervisory Board (SSB), chief internal auditor and/or the external auditors and reviewing proposals to appoint new members of the SSB, external auditors and/or chief internal auditor.

***Review of interim and annual accounts and financial reports
(inclusive of matters arising from the audit)***

- 6. The over-riding principle with respect to the AGC's review of all the above-mentioned reports is to ensure their completeness, fairness

and accuracy. The AGC shall review these reports (interim and annual accounts and financial reports) before their submission to the IFI's board of directors. The review shall satisfy the AGC as to the fair presentation of reported earnings and the completeness of disclosures in the annual report and accounts. In addition, the AGC shall be briefed by the management on the latter's methodology with respect to developing and summarizing interim financial information. Also, the AGC shall be aware of any review procedures performed by the external auditors on interim financial statements.

The specific responsibilities associated with this function include:

- a) Ensuring compliance with Shari'a, legal and regulatory requirements.
- b) Ensuring compliance with all Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards and determining the appropriateness and effect of any changes in accounting policies and practices.
- c) Reviewing the treatment of significant areas of judgment, accounting estimates and unusual transactions.
- d) Reviewing significant adjustments arising from the audit.
- e) Determining the appropriateness of the going concern assumption as the basis on which the accounts are prepared and if applicable, of the proposed statement by the directors that the company is a going concern.
- f) Presenting a balanced and comprehensible assessment of the company's position that relate to the responsibilities of the AGC.

Ethics

7. The fundamental principles governing the operation of an IFI have

been enunciated in AAOIFI's Code of Ethics for Accountants and Auditors of Islamic Financial Institutions.⁽¹⁾ The AGC shall be governed by the principles listed below and shall endeavor to ensure that the IFI adheres to the same set of ethical values:

- a) Faith-driven conduct.
- b) Professional competence and diligence.
- c) Trustworthiness.

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(1) AAOIFI's Code of Ethics for Accountants and Auditors of Islamic Financial Institutions, Sections 2 and 3.

- d) Religious legitimacy. e) Objectivity.
- f) Professional conduct and technical standards.

In order to ensure adherence to these fundamental values, it is imperative that the AGC of an IFI should work to facilitate Shari'a reviews by the SSB and the internal audit function of the IFI.

Reviewing the compliance with Shari'a rules and principles

- 8. The duties of the AGC also include the review of the reports produced by the internal Shari'a review and the SSB to ensure that appropriate actions have been taken. The AGC may invite a member of the IFI's SSB to attend its meeting, as and when required.

Reviewing the use of restricted investment accounts' funds

- 9. In the case of Islamic banks, funds are mobilized from investors based on Mudaraba contract or agency for both unrestricted and restricted investment accounts. The latter represents off-balance sheet accounts, and this places a greater responsibility on the Islamic bank's management to ensure that the funds are invested in accordance with the terms of the agreement and that profits are allocated according to the agreed terms between the Islamic bank and holders of investment accounts which should be in compliance with Shari'a rules and principles. Co-ordination between the AGC, internal Shari'a reviewers and external auditors is imperative for the effective monitoring of restricted investment accounts.

Establishing the AGC

- 10. The specific structure of the AGC shall vary according to the IFI and the country in which it is established. However, certain features in terms of establishing the AGC and practicing its responsibilities include:

11. *Constitution*

- a) The AGC shall be formally established by the board of directors from its non-executive members. The board of directors shall also appoint the chairman of the AGC. The AGC shall be vested with sufficient authority to carry out its responsibilities with independence and integrity.
- b) The Terms Of Reference (TOR) of the AGC shall be set out in writing and state clearly the AGC's powers and responsibilities and empower it to investigate any matters within its jurisdiction.

- c) The TOR will be used by the board of directors, AGC members, management, outside legal counsel, SSB, internal Shari'a reviewers and external auditors.
The Standard provides a sample TOR of the AGC applicable to an IFI as an Appendix.

12. Membership

a) Attributes

AGC members shall be knowledgeable about the business of the institution and applicable regulations and laws to deal adequately with the accounting and auditing matters the AGC will face. They shall understand the related Shari'a rules and principles, and their application to various products and services offered by the IFI and shall have sufficient knowledge of AAOIFI's standards.

b) Term of office and size

The term of office of an AGC shall match the term of the members of the board of directors. The AGC shall not have less than three members, and these should represent a balance of views and experience.

c) Remuneration

The AGC members' remuneration may be based on a recommendation by the board of directors to the general assembly meeting or on the prevailing laws and regulations applicable in the country.

13. AGC planning and meetings

The AGC shall –with the consent of the board of directors– prepare internal by-laws to govern the AGC meetings and who should attend the meetings without the right to vote.

Reporting

- 14. The reports of the AGC shall be submitted to the board of directors through the chairman of the board and copied at the same time to the chief executive officer. The names of the AGC may be mentioned in the annual reports. It is also recommended that the AGC's chairman shall report to the chairman of the board of directors any significant matters of concern that arose at the last meeting to the AGC. The board of directors shall also discuss the work of the AGC based on its quarterly report.

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Effective Date

15. This Standard shall be effective for financial periods beginning 1 Muharram, 1423 A.H. or 1 January 2002 A.D.

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Adoption of the Standard

The standard of the Audit and Governance Committee for Islamic Financial Institutions was adopted by the Accounting and Auditing Standards Board in its meeting No. (21) held on 8 Safar 1422 A.H., corresponding to 2 May 2001 A.D.

Appendix

Specimen Terms of Reference

Constitution

The board of directors hereby resolves to establish a committee of the board to be known as the Audit and Governance Committee (AGC).

Membership

The board of directors shall appoint the AGC members from the non- executive members of the board. The AGC shall not have less than three members. A quorum shall consist of a majority of the members.

The chairman of the AGC shall be appointed by the board of directors. (All other requirements with respect to membership of the AGC are explained in more detail in item 12 (a-c) of the Standard.)

Attendance at Meetings

The Terms Of Reference (TOR) shall state the persons who shall be invited to attend the meetings of AGC; for example, the finance director, the head of internal audit and representatives from other technical departments, external auditor, representative from the SSB and the internal Shari'a review. It shall also be stated whether the AGC shall meet at least once a year with the external auditors in the absence of any management executive.

The head of internal audit shall be the secretary of the committee.

Frequency of Meetings

The TOR shall state the number of meetings which must be held by the AGC annually.

Authority

The AGC is authorized by the board of directors to investigate any activity within its terms of reference. It is authorized to seek any

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information

it requires from any employee and all employees are directed to cooperate with any request by the AGC.

The AGC is authorized by the board of directors to obtain outside legal or other independent professional advice and to secure the attendance of outsiders with relevant experience and expertise if it considers this necessary.

Responsibilities

The responsibilities of the AGC shall be:

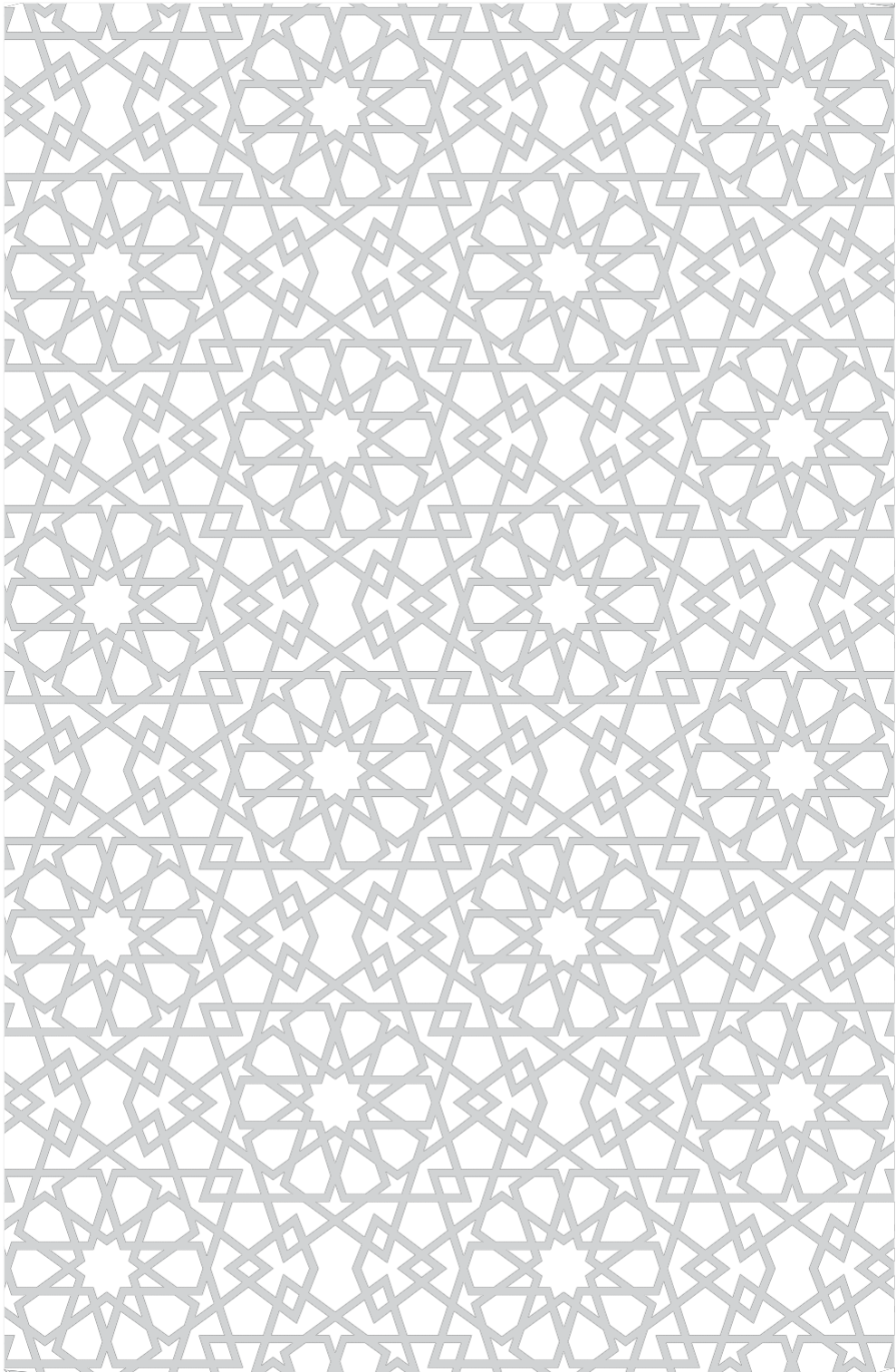
- a) To consider the appointment of the Shari'a supervisory board, external auditor, and/or the chief internal auditor, the audit fee, and any questions of resignation or dismissal. This will include reviewing skills and resources of the external auditor.
- b) To discuss with the external auditors before the audit commences the nature and scope of the audit, and ensure co-ordination where more than one audit firm is involved
- c) To review the interim and annual financial statements before submission to the board of directors, focusing particularly on:
 - Any changes in accounting policies and practices;
 - Major judgmental areas;
 - Significant accounting adjustments resulting from the audit;
 - The going concern assumption;
 - Compliance with the accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions;
 - Compliance with regulatory bodies, stock exchange and legal requirements; and
 - Compliance with the procedures that govern the relationship between management and related parties.
- d) To discuss problems and concerns arising from the external and internal audits, and any matters the external and internal auditors may wish to discuss (in the absence of management where necessary)
- e) To review the reports of regulatory bodies together with management responses

- f) To review the internal audit programme, consider the major findings of internal audit investigations and management's response, and ensure co-ordination between the external and internal auditors
- g) To keep under review the effectiveness of internal control systems, and in particular to review the external auditor's management letter and management's response
- h) To ensure compliance with Shari'a rules and principles by implementing recommendations contained in reports produced by the SSB and the internal Shari'a reviewers
- i) To coordinate with the internal Shari'a reviewers, internal and external auditors to ensure that restricted investment accounts are managed according to Shari'a rules and principles
- j) To consider other topics, as defined by the board of directors

Reporting Procedures

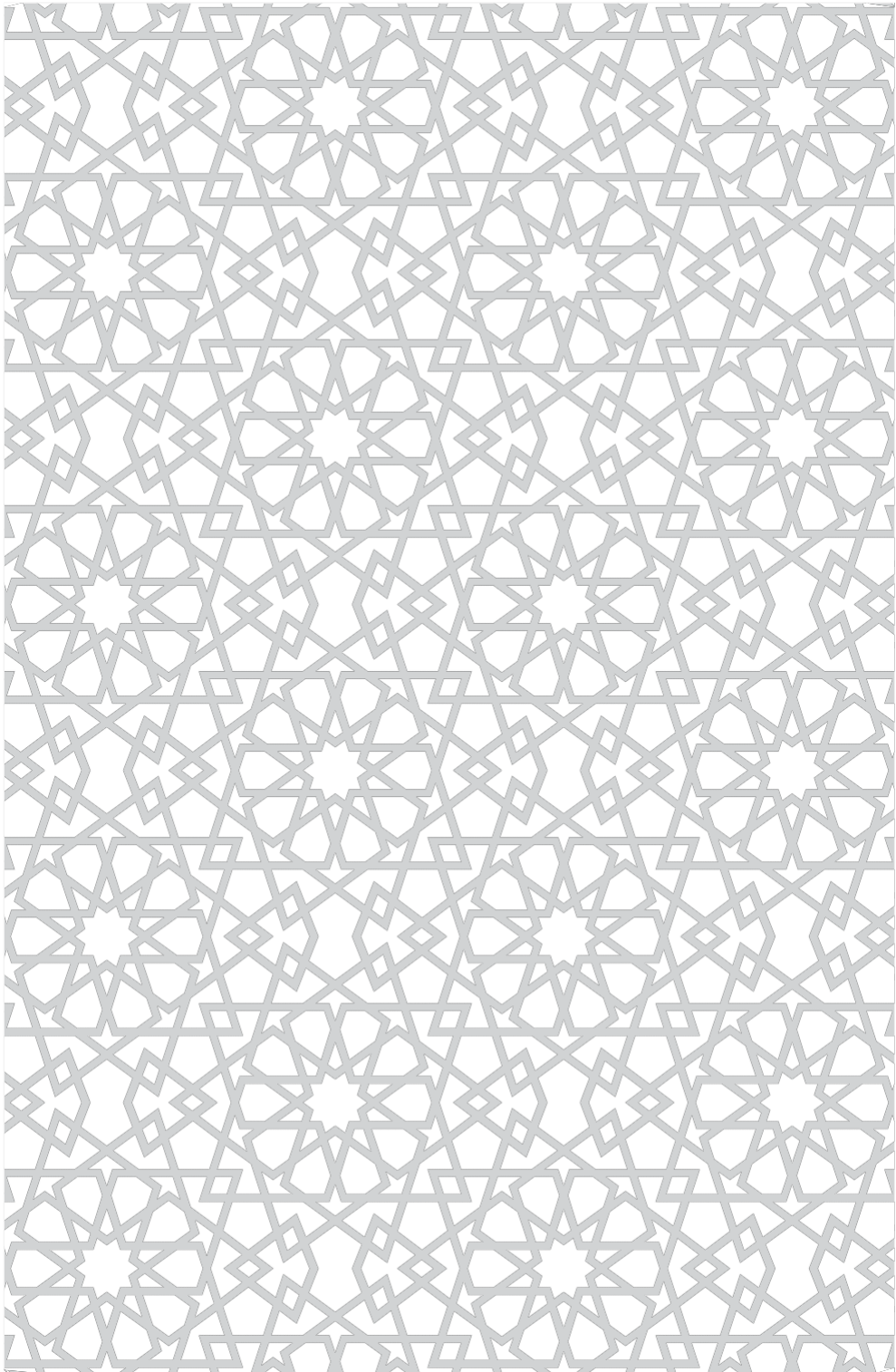
The secretary shall circulate the minutes of meetings of the AGC to the board of directors.





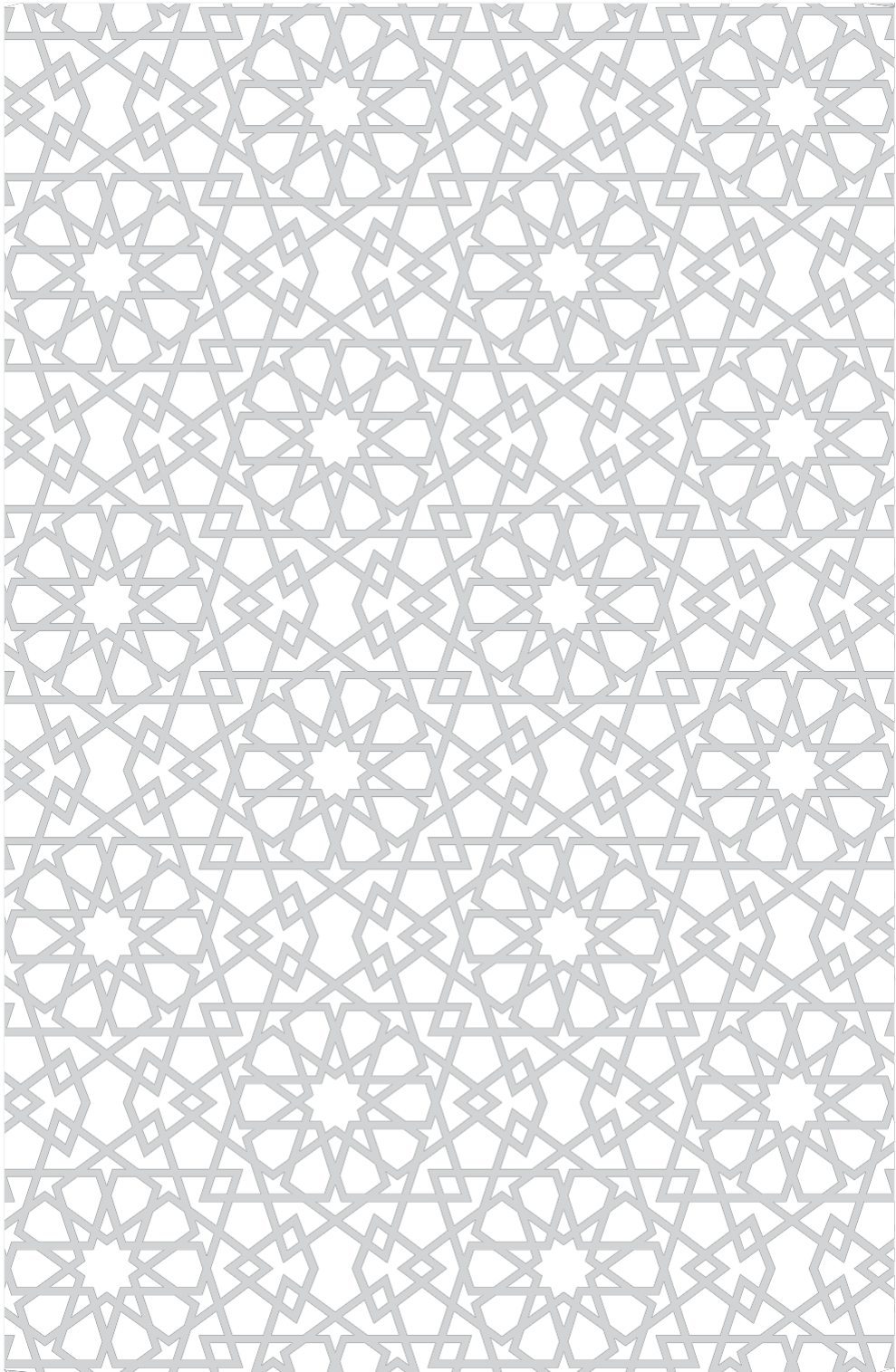
Governance Standard No. (5)

**Independence of Shari'a
Supervisory Board**



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Independence of Shari'a Supervisory Board

1. Introduction

The purpose of this standard is to provide guidance for members of Shari'a Supervisory Boards (SSBs) of Islamic Financial Institutions (IFIs) pertaining to its independence, monitoring of such independence and ways to resolve issues of independence. (para. 1)

2. Independence

Independence, for the purpose of this standard, is "An attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and in an objective way". The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests (neutral). (para. 2)

3. Importance of Independence of SSBs

The importance of the independence of SSB members for an IFI emanates from its role in:

- a) Enhancing the public confidence in the IFI as compliant in its application of Shari'a rules and principles.
- b) Achieving the fundamental objectives of an IFI by enhancing independence and objectivity of its SSB. (para. 3)

SSB Members have a responsibility to the public who rely on the services provided by them that require independence. The public includes clients, credit grantors, governments, employers, employees, investors and others who rely on the objectivity and integrity of SSB members to ensure Shari'a compliance with regard to activities of IFI. (para. 4)

4. Objectivity

Objectivity is an independent mental attitude which SSB members should maintain in performing Shari'a supervision. SSB members are not to subordinate their judgment on Shari'a supervision matters to that of others. (para. 5)

Objectivity requires SSB to perform Shari'a supervision in such a manner that they have an honest belief in their work. SSBs should avoid potential and actual situations that impair their ability to make objective professional judgments. (para. 6)

SSB members should not be employee of the same IFI. (para. 7)

SSB and its members should not be involved in any manner with regard to managerial decisions and operational responsibilities of the IFI. (para. 8)

When SSB members are or were within the engagement or immediately preceding an engagement period, an officer of a client or partner/ employee of an IFI, the preceding period should be not less than three years. (para. 9)

5. Continuous Assessment

SSB members should continuously assess their relationships with their IFIs to identify any situations that may impair independence and resolve it or report to the SSB such situations in which an issue of independence impairment is present or may reasonably be inferred, and how to resolve it. (para. 10)

6. Basis of SSB Independence

Similar to AAOIFI Code of Ethics for Accountants and Auditors of IFIs and the Code of Ethics for the Employees of IFIs, SSB independence standards and rules are derived from the Shari'a rules and principles. Accordingly, this standard should be read in conjunction with these two codes. (para. 11)

7. Resolution of Issues of Independence Impairment

When faced with potential and/or actual issue of independence impairment

SSB members should follow the following to resolve the issue:

- a) Document the issue.
- b) Review the issue internally within the SSB.
- c) If the issue still exists after the internal review by the SSB, the SSB member with the issue of independence impairment must resign and General Assembly of the IFI must be notified.
- d) In all above levels of conflict resolution, consideration must be given to local laws and regulations. (para. 12)

8. Responsibility for Implementation of This Standard

Responsibility for implementation of this standard lies with the management of an IFI. (para. 13)

9. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram, 1429 A.H., or 1 January 2008 A.D. (para. 14)

Adoption of the Standard

The Standard on Independence of Shari'a Supervisory Board was adopted by the Accounting and Auditing Standards Board in its meeting No. (29) held on 29 Rabi' II, and 1 Jumada I, 1426 A.H., corresponding to 7 and 8 June 2005 A.D.

Appendix

Examples of Possible Issue of Independence Impairment

SSB members, during their engagement period, should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with independence, objectivity and integrity. Examples of situations or conditions or circumstances that may indicate actual or apparent lack of independence are as follows:

■ **Financial involvement with, or in the affairs of, clients**

Financial involvement with an IFI affects independence and may lead a reasonable observer to conclude that it has been impaired. Such involvement, which may be direct or indirect, can arise in a number of ways. Examples are shares ownership, guarantees, etc.

■ **Personal and family relationships**

Personal and family relationships to a third degree of relationship with an SSB member can affect independence. There is a particular need to ensure that an independent approach to any assignment is not endangered as a consequence of any personal or family relationship. The kind of relationship that may impair independence is between the SSB member and a member of the Board of Directors, CEO or any other member of the executive/management team of the IFI.

■ **Fees**

When the receipt of recurring fees from an IFI or group of connected IFIs represents a large proportion of the total gross fees of an SSB member, the dependence on that IFI or group of IFIs should inevitably come under scrutiny and could raise doubts as to independence. Additionally, when there is a large proportion of unpaid fees for prior periods, this could be seen as an impairment of independence.

■ **Contingency fees**

Shari'a supervision services should not be offered or rendered to an IFI under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or when the fee is otherwise contingent upon the findings or results of such services.

■ **Performance-related bonus**

Shari'a supervision services should not be offered or rendered to an IFI under an arrangement whereby the SSB benefits from bonus payment related to the performance of the IFI.

■ **Goods and services**

Acceptance of goods and services from an IFI may be a threat to independence. Acceptance of undue hospitality poses a similar threat. Acceptable goods or services are those that are within the normal courtesies of social life.

■ **Actual or threatened litigation**

Litigation involving an SSB member and an IFI may cause concern that the normal relationship with the client is affected to the extent that an SSB's independence and objectivity may be impaired.

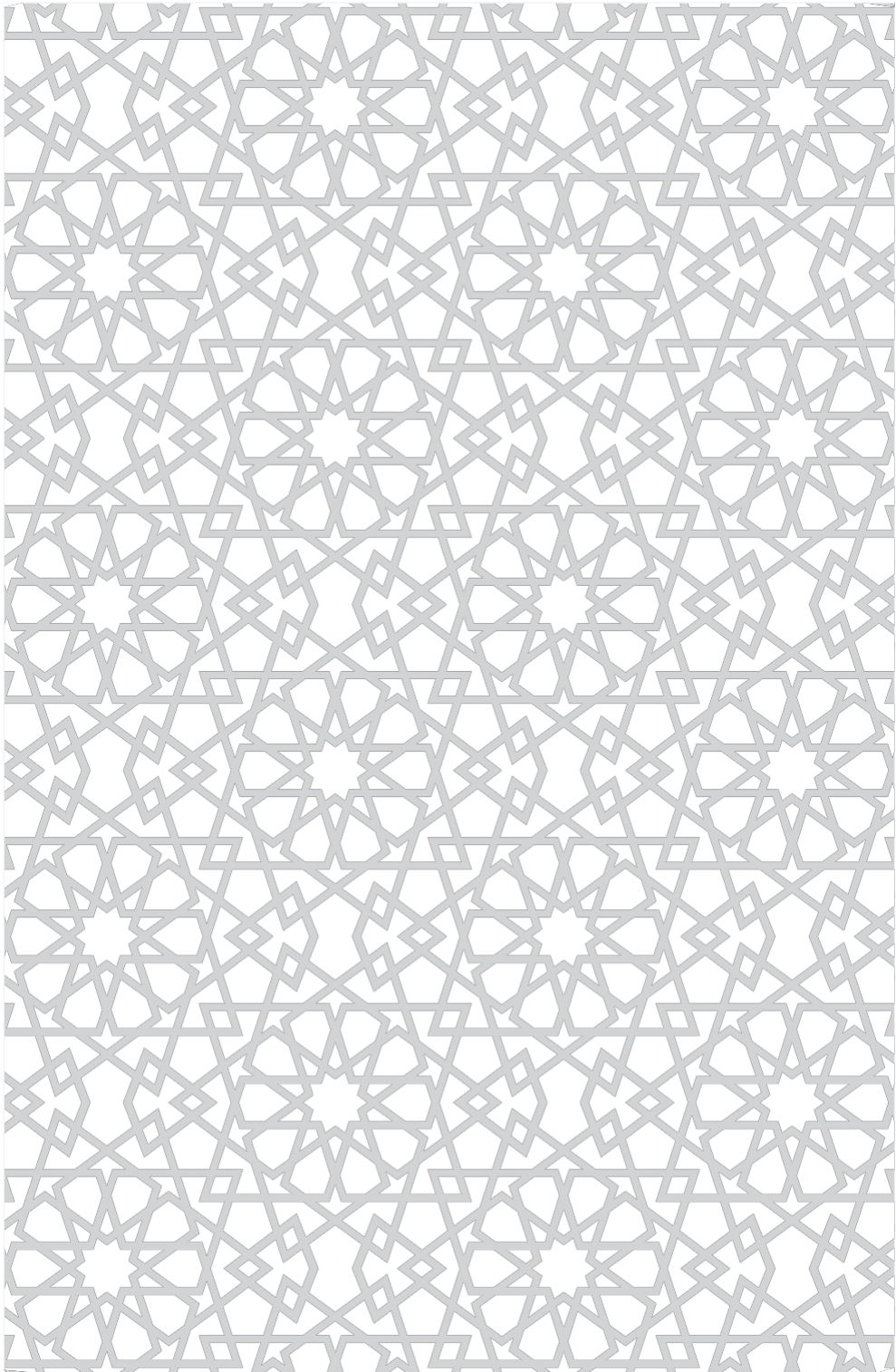
■ **Long association of SSBs with IFIs**

The continuation of the same SSB member on a Shari'a supervision engagement over a prolonged period of time may pose a threat to independence. The SSB member should take steps to ensure that independence and objectivity are maintained on the engagement. There is a concern that a long involvement by an SSB member with a client could lead to a close relationship which could be perceived to be a threat to independence and objectivity. An IFI should take steps to provide for an orderly rotation of SSB servicing on the engagement, so as to ensure that at least one SSB member should be rotated every five years.



Governance Standard (No. 6)

**Statement on Governance Principles
for Islamic Financial Institutions**



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Statement on Governance Principles for Islamic Financial Institutions

1. Introduction

Governance practices play a vital role in ensuring that businesses are run in a prudent and sound manner. A loss of confidence in financial institutions has the potential to create severe economic dysfunction, adversely affecting the general community in which they operate. (para. 1)

Financial institutions are different from other types of businesses due to their public purpose. There are more stakeholders in banks and other financial services institutions than in other businesses. Indeed, in an Islamic financial institution (IFI), the list of stakeholders is even wider. The interest of *Rab Al-Mal* and providers of other forms of capital are exposed to the risk of being prejudiced if governance practices are focused on benefits to owners or equity-holders. (para. 2)

Those charged with governance of IFIs are held to the highest fiduciary standards since they are accountable not to the equityholders who appointed them only but also for the safety of all key stakeholders as well as the community the IFI serves. (para. 3)

Financial institutions that develop strong governance practices win public confidence and, thereby, promote trust amongst their equity-holders, investors and other parties dealing with them. In IFIs, governance practices are also expected to lead to enhanced Shari'a compliance structures. (para. 4)

2. Rationale for Establishment of the Framework

A Statement on Governance Principles for Islamic financial institutions is necessary in order to support the development of sound governance practices within IFIs as well as establish the basis for standards setting by AAOIFI on individual aspects of governance.

(para. 5)

This Statement on Governance principles (the “Statement”) represents the framework for governance in IFIs and form part of the pronouncement of the AAOIFI. (para. 6)

The purpose of the Statement is as follows:

- a) To lay down the key principles and concepts relevant to governance in IFIs.
- b) To assist IFIs as well as their stakeholders to appreciate the respective roles of those charged with governance.
- c) To establish the foundation upon which the development of future governance or compliance standards will take place.
- d) To provide the necessary inter-linkage between the various current and future standards applicable to IFIs. (para. 7)

The Statement recognizes the complexity of the concept of governance structures and, therefore, focuses on the principles on which it should be based. (para. 8)

The governance principles are founded on the need for structures leading to enhance compliance, transparency, accountability, fairness and equitable treatment of stakeholders. (para. 9)

3. Objectives of the Statement

The overall aim of the Statement is to encourage the efficient use of economic resources by IFIs and equally to require accountability for the stewardship of those resources. (para. 10)

More specifically, the Statement seeks to ensure that those charged with governance and those employed by an IFI, as well as those associated with an IFI in any important functional capacity shall perform their respective roles effectively and in a manner that is consistent with Shari’a. (para. 11)

The Statement is intended to serve as the minimum standard in the establishment of governance structures in an IFI. The principles set forth will also provide the foundation for AAOIFI in its effort to set

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governance standards in relation to some or all of the individual principles or aspects of the principles framework set out herein in future. (para. 12)

4. Basis for Governance

Governance has to do with a wide range of aspects including those relating to social responsibility, business ethics and culture, board and management accountability as well as the respective roles of other parties carrying out a functional role in relation to an IFI's business. These roles have a bearing on how the IFI's business strategies, policies, operations or control frameworks are designed, implemented and monitored. (para. 13)

Governance practices are defined and practiced differently depending upon the relative national regulatory approaches, legal systems, cultural influences, powers of owners, boards of directors, management, etc. (para. 14)

For the governance structure to be effective, an IFI would need to consider its unique business model characteristics. (para. 15)

4/1 Enhancing confidence

The financial services industry (whether conventional or Islamic) is one in which 'trust' is vital. Trust is the cornerstone upon which an IFI operates. (para. 16)

The interest of those who have effective control over an institution can differ from the interests of those who supply equity and other funding, making sound governance structures necessary. In an IFI, this aspect is accentuated since a significant portion of the risk bearing funds mobilized is derived from parties other than equity holders. (para. 17)

Sound governance practices serve to enhance public confidence and therefore, it is necessary that those charged with governance as well as those having an influence on them pay appropriate attention. (para. 18)

Confidence in an IFI cannot be developed without several important measures, one of which is a transparent governance structure. (para. 19)

The Board of Directors (BOD), Shari'a Supervisory Board (SSB), management, employees and other parties dealing with

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or working for an IFI have to strive to enhance confidence and trust which are vital to the survival and growth of its business.
(para. 20)

4/2 Shari'a compliance

Governance in the context of an IFI, therefore, goes well beyond the boundaries of 'corporate governance' in the conventional context since it has social and religious connotations to it as well. As a matter of fact, an IFI exists due to its ability to conduct its commercial activity in accordance with Shari'a. (para. 21)

An IFI has been established to assist investors in using the funds in a beneficial manner consistent with Shari'a. The choice of investing in or dealing with one IFI versus the other is predicated on the evaluation of and the institution's ability to operate strictly in accordance with Shari'a in the absence of which there can be a lack of confidence in the IFI. Therefore, an IFI must have mechanisms to comply with Shari'a in all their financial and other dealings. (para. 22)

4/3 Business model

The business model of an IFI is characterized by contracts that are designed to be compliant with Shari'a, making it unique. The risks associated with such contracts are also unique and both the IFI and its clients should recognize its distinguishing features. (para. 23)

While equityholders' capital should be protected and their interests safeguarded, risks attributable to client funds handled though restricted, unrestricted or other forms of risk bearing instruments are quite significant. (para. 24)

4/4 Stakeholders' interests

It is important for those charged with governance to understand who the key stakeholders are to allow the establishment of a governance structure that is characterised by high levels of accountability. (para. 25)

Those charged with governance are accountable towards the interests of all key stakeholders of the IFI. (para. 26)

An IFI's interaction with stakeholders has much to do with dissemination of timely and sufficient financial and non-financial information regarding its operations and performance.

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(para. 27)

An IFI should therefore understand and respond to the transparency needs of its stakeholders. For this, BOD and management of the IFI should ensure that its stakeholders are recognized and that their information needs are addressed. (para. 28)

4/5 Social responsibility

The governance structure will aim to align, as nearly as possible, the interests of the stakeholders, of those charged with governance and of the society. (para. 29)

The principles of Shari'a strike a balance between the interest of the individual and those of the society to which he or she belongs. IFIs have been established to assist in using wealth and financial resources in a manner beneficial to investors as well as to the community at large. (para. 30)

An IFI, therefore, plays an important role in the promotion of an atmosphere in which commercial activities can be undertaken in compliance with Shari'a in the best interest of the wider societal content. (para. 31)

4/6 Business ethics and culture

Codes of ethics in an IFI comprise values that are derived from Shari'a. Such values underpin the behaviour of all persons employed by or associated with the IFI in carrying out or undertaking their respective duties or obligations to the institution. (para. 32)

5. Principles of Governance

5/1 Principle (1): Effective Shari'a compliance structures

An IFI should establish an effective structure for ensuring Shari'a compliance. Such structure should cover effectiveness of the role played by BOD, SSB, management, and auditors in so far as they relate to Shari'a compliance. (para. 33)

5/1/1 Appropriate governance structures should be in place to allow for a transparent Shari'a compliance process. (para. 34)

5/1/2 Interaction between the SSB or its members and managements should be transparent. (para. 35)

5/1/3 The responsibility for the conduct of the overall affairs of the IFI in accordance with Shari'a rests with the BOD. The SSB should report on compliance based on its review. (para. 36)

5/2 Principle (2): Fair treatment of equityholders

An IFI should provide the equityholders voting rights, adequate opportunity to have a dialogue with the institution, ability to select members of the governing BOD and SSB and also ensure fair disclosure of financial and banking practices adopted to allow them to make appropriate decisions regarding their investment in the IFI. (para. 37)

5/2/1 Necessary governance mechanisms should be in place to safeguard the interests of the equityholders who assume the risks inherent in the business of the institutions they own. (para. 38)

5/2/2 Equityholders should have access to vital corporate information about the conduct of the overall affairs of the IFI to allow them to make an informed judgment and exercise their voting rights. (para. 39)

5/2/3 The BOD and management should be accountable to the equity-holders and responsible for managing successful and productive relationships with the equity-holders. (para. 40)

5/2/4 Controlling equityholders should safeguard the interests of minority equityholders. (para. 41)

5/3 Principle (3): Equitable treatment of fund providers and other significant stakeholders

An IFI should ensure equitable and unbiased treatment of fund providers and other significant stakeholders and associated investments as well as in relation provision of adequate financial and non-financial information to allow them to take appropriate decisions regarding their dealing with the institution. (para. 42)

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5/3/1 Necessary governance mechanisms should be in place to safeguard against the risks of inequitable treatment of fund

providers and other significant stakeholders. Such measures could be provision of certain rights to those parties to help in their decisions and related measures. (para. 43)

5/3/2 Fund providers and other significant stakeholders of an IFI should be provided with adequate and timely information about major changes to its business that can have material consequences to their interests in the IFI. (para. 44)

5/4 Principle (4): Fit and proper conditions for board and management

An IFI should lay down a set of criteria to govern the appointment of persons to serve on the BOD and SSB as well as for appointment of management. (para. 45)

5/4/1 Selection of members of BOD, SSB and management should be transparent and based on a predefined set of criteria. (para. 46)

5/5 Principle (5): Effective oversight

The BOD should play an effective role in leadership, direction and monitoring the implementation of its policies as well as in promoting a sound control Shari'a compliant culture within the IFI. (para. 47)

5/5/1 The primary role of the BOD is to carry out its responsibilities in the best long-term interest of the IFI and its stakeholders. The BOD should set the appropriate tone for risk, compliance, and other control activities consistent with Shari'a. (para. 48)

5/5/2 The BOD should set a clear strategic plan that sets forth the IFI's business strategy and management plans to implement it. (para. 49)

5/5/3 The BOD should establish a well-aligned management structure that fosters proper segregation of duties and enhances accountability and effectiveness of management oversight. (para. 50)

5/5/4 A sound internal controls framework is comprised of an effective control environment, an assessment of key risks, control

activities, timely and effective information and communication processes, and an oversight/monitoring process. (para. 51)

5/5/5 Regular evaluation of effectiveness of the BOD is necessary in enhancing accountability. The BOD should set effective financial and non-financial performance measures for periodic assessment of effectiveness of governance. (para. 52)

5/6 Principle (6): Audit and governance committee

An IFI should have an audit and governance committee whose role and responsibilities should be set in appropriate terms of reference which should include, among others matters, the process for financial reporting, internal controls, internal audit oversight, external audit oversight and Shari'a compliance. (para. 53)

5/6/1 The audit and governance committee should be composed of non-executive members of the BOD and should maintain its independence from executive authority as practicable. (para. 54)

5/7 Principle (7): Risk management

The BOD of an IFI should be actively involved in setting the risk appetite and should make sure that there are appropriate policies and systems for identification, measurement, analysis, reporting and mitigation of risks. (para. 55)

5/7/1 The BOD should understand its role and that of management in the area of risk management. Management is responsible for assessing and managing the IFI's exposure to various risks. The BOD is responsible for ensuring that the IFI has a process in place to assess and manage risks and to ensure that both management and the BOD receives timely and accurate information on key risk areas. (para. 56)

5/7/2 The BOD should approve the IFI's risk strategy and set tolerance levels for risks the IFI assumes and should

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establish the framework for management of the risks it
takes on in its business. (para. 57)

5/7/3 The BOD should have a thorough understanding of the risks in relation to the IFI's business as well as the internal and external risks that could prevent it from achieving its strategic objectives. (para. 58)

5/7/4 The BOD should establish a programme for succession planning and leadership development that should also cover training and continuing education on subjects related to the IFI's business. (para. 59)

5/8 Principle (8): Avoidance of conflicts of interest

An IFI should set appropriate governance structures to ensure that members of BOD, members of SSBs, management and staff as well as external parties, such as external auditors, rating agencies, and other parties with substantial dealings with it avoid conflicts of interest. (para. 60)

5/8/1 The IFI should identify all situations of potential conflicts of interest and institute codes and policies to ensure situations leading to such conflicts are avoided at all times. (para. 61)

5/8/2 Those charged with governance should act in a manner that is free and objective in perspective. (para. 62)

5/9 Principle (9): Appropriate compensation policy oversight

An IFI should set appropriate governance structures in relation to remuneration policies for BOD, SSB and management. Compensation policies should be developed on an independent and transparent basis. (para. 63)

5/10 Principle (10): Public disclosures

An IFI should adopt high standards of reporting and satisfy the information needs of owners, investment accountholders, other counterparties, regulatory, Zakah and other related agencies. The IFI should maintain high standards of transparency and market discipline to build trust with shareholders and other stakeholders. Accurate, adequate, timely and fair reporting of financial and non- financial performance measures should be ensured. (para. 64)

5/11 Principle (11): Code of conduct and ethics

An IFI should adopt policies, procedures consistent with Shari'a to promote a code of ethical and responsible behaviour by members of BOD, members of SSB, management and employees. (para. 65)

5/12 Principle (12): Appropriate enforcement of governance principles and standards

An IFI should have a mechanism to ensure that the principles and standards on governance are adhered to and monitored. (para. 66)

6. Governance Structures

6/1 Those charged with governance

For the purposes of this Statement, those charged with governance are normally persons accountable for ensuring that the entity achieves its objectives with regards to effectiveness and efficiency of operation, compliance with Shari'a and applicable laws, and reporting to relevant parties. Those charged with governance include management only when it performs such functions. (para. 67)

6/2 Governance structures

It is recognized that uniform structures will not take into account the diversity of circumstances and experience among entities and within the same entity over time. (para. 68)

An IFI shall use diligence and care in translating the individual principles in laying down the enforcing policies for adoption. The BOD should provide sufficient guidelines to those affected and establish a governance structure that is effective. (para. 69)

For purposes of this statement, governance structures comprise all or some of the following that an IFI finds necessary to adopt the principles laid out herein.

- a) A structure through which the governance objectives of the IFI are set, and the means of attaining those objectives and monitoring performance are determined.

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- b) Mechanisms in place for efficient use of resources and equally to require accountability for the stewardship of those resources.

- c) The system by which the IFI is directed and managed while encouraging it to create value, provide accountability and establish control systems that commensurate with risks involved.
- d) A system of checks and balances for ensuring that those charged with governance act in the best interests of the IFI's stakeholders for producing long-term value to the IFI's stakeholders while maintaining the highest standards of ethics and professional confessional conduct. (para. 70)

6/3 Limitations

Governance is concerned with a variety of interactive qualitative elements including aspects of human values and human behaviour and thinking abilities. Integrity is an important human characteristic upon which successful governance processes impinge. (para. 71)

Persons with high integrity are more likely to promote more transparent behaviour in their day-to-day performance of their respective roles in furtherance of the overall goals of the IFI. Thinking abilities of members of BOD and management also come to the fore in the day-to-day processes involved in relation to activities relating to strategic planning and decision making, etc. (para. 72)

Accordingly, there is no one-size fits all structure that would guarantee effectiveness or soundness in governance frameworks. (para. 73)

In this sense, good governance is not just a matter of prescribing particular structures or a matter complying with pre-established rules. (para. 74)

Adoption of the Statement

The Statement on Governance Principles for Islamic Financial Institutions was adopted by the Accounting and Auditing Standards Board in its meeting No. (30) held on 19 Shawwal 1426 A.H., corresponding to 21 November 2005 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

AAOIFI was established in 1991 as a standard-setting body and has thus far issued 30 Shari'a standards, 25 accounting statement/standards, 5 auditing standards, 5 governance standards, and 2 codes of ethics.

Prior to the issuance of the initial set of accounting standards, AAOIFI issued financial accounting statements entitled: "Objectives of Financial Accounting for Islamic Banks and Financial Institutions", and "Concepts of Financial Accounting for Islamic Banks and Financial Institutions".

These two financial accounting statements essentially established the 'framework' for financial accounting rules to be followed by IFIs as well as formed the basis for AAOIFI's accounting standards. The two statements provided the basic guidelines for recognition, measurement and disclosure of financial transactions for purposes of financial statements preparation.

Expanded Role of the AAOIFI

While the need for accounting and auditing standards was most felt in late 1980s leading to the establishment of AAOIFI, the need for governance standards has arisen in recent years due to the divergence in the practices followed by IFIs.

In 1998, the statute of the AAOIFI was amended to include the objective
- "to also develop banking practices thought relating to the activities of
Islamic financial institution". With this broader mandate, the AAOIFI
commenced work in areas of 'best practices' and has now issued 5

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standards namely:

1. Shari'a Supervisory Board: Appointment, Composition and Report.
2. Shari'a Review.

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3. Internal Shari'a Review.
4. Audit and Governance Committee for Islamic Financial Institutions.
5. Independence of Shari'a Supervisory Board.

The governance standards issued thus far aimed at addressing some of specific issues affecting IFIs.

Although there exists a 'framework' of principles to guide the IFIs and AAOIFI in relation to accounting practices in the form of the two general statements specified above, no framework existed in respect of the governance practices and standards.

Therefore, the Statement on Governance Principles for Islamic Financial Institutions has been developed to provide the framework for governance practices and standards.

Appendix (B)

Basis for Development of the Statement

The Statement on Governance Principles for Islamic Financial Institutions is based upon an initial study carried out by a committee established for this purpose.

The study focussed on:

- Firstly, studying some of the current pronouncements or standards in the area of governance in various countries;
- Then, assessing whether any identified current pronouncements or standards (that might indeed be appropriate to conventional institutions) were relevant to governance structures in an Islamic financial institution having considered the internal and external environment within which it operates; and
- Finally, providing an illustrative set of key principles to be considered within the Framework.

Just what constitutes governance, in itself, is still a topic of wide debate in the corporate world. Corporate governance has only recently emerged as a discipline in its own right. The importance of the subject is widely recognized but the terminology and analytical tools are still emerging.

Several regulatory bodies, standard-setting or voluntary organizations have done much work on the subject of governance. The principles laid down by these authorities have been considered in developing the Statement where found appropriate.

Appendix (C)

Meeting Stakeholder Information Needs

An important objective of a governance structure will be to provide accurate, adequate and timely information so as to allow the various stake- holders to make informed decisions about their ownership, rights, con- tinued association with the IFI, etc. The following table illustrates some governance issues relevant to key stakeholders.

Key stakeholders	Possible role of governance practices
Equityholders	Equityholders of an IFI are potentially interested in information concerning: a) Financial health –financial position, results and cash flows. b) Roles and responsibilities of BOD. c) Roles and responsibilities of SSB. d) Management structure. e) Risk management practices and risk mitigation measures. f) Compensation practices and remuneration paid to directors and managements.
Shari’a Supervisory Board (SSB)	Assurance that all key transactions and dealings requiring examination from a Shari’a compliance standpoint are brought to the attention of the SSB. Assurance about whether information presented by the BOD or management to the SSB is accurate and reliable.
Internal Shari’a	Appropriate information and evidence to confirm compliance with requirements of the CSR

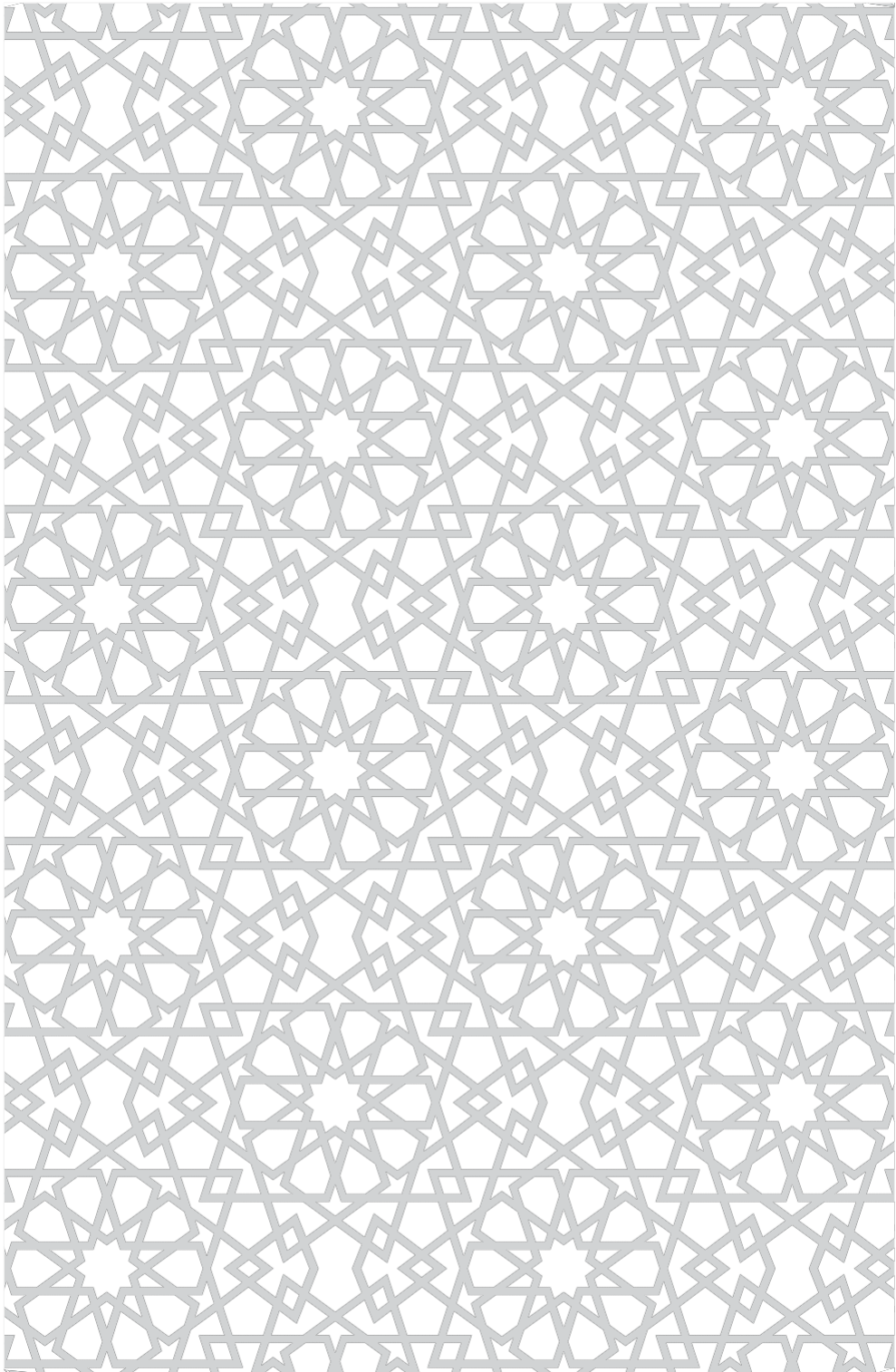
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Restricted investment accountholders	All of the above plus assurance about truth and fairness of the net assets attributable to their funds and about appropriate compliance and risk management practices in relation to
Unrestricted investment accountholders	All of the above plus the following: a) Legal implications of commingled funds and corresponding assets. b) Status of their funds in the event of failure of the Mudarib. c) BOD's and management's measures to ensure their interests are safeguarded and decisions relating to their funds are free from bias. d) Appropriate risk management measures in
Regulatory bodies and institutions that have an interest in safety and soundness of the financial sector	All of the above plus the following: a) Confirmation that the IFI is using sound principles to manage and control its operations, its risks and the compliance activity. b) Assurance that the IFI is properly safeguarding its clients. c) Assurance that the BOD and management maintain high standards of ethics and transparency and

The governance structure should, therefore, be aimed at meeting the stakeholders' information needs.

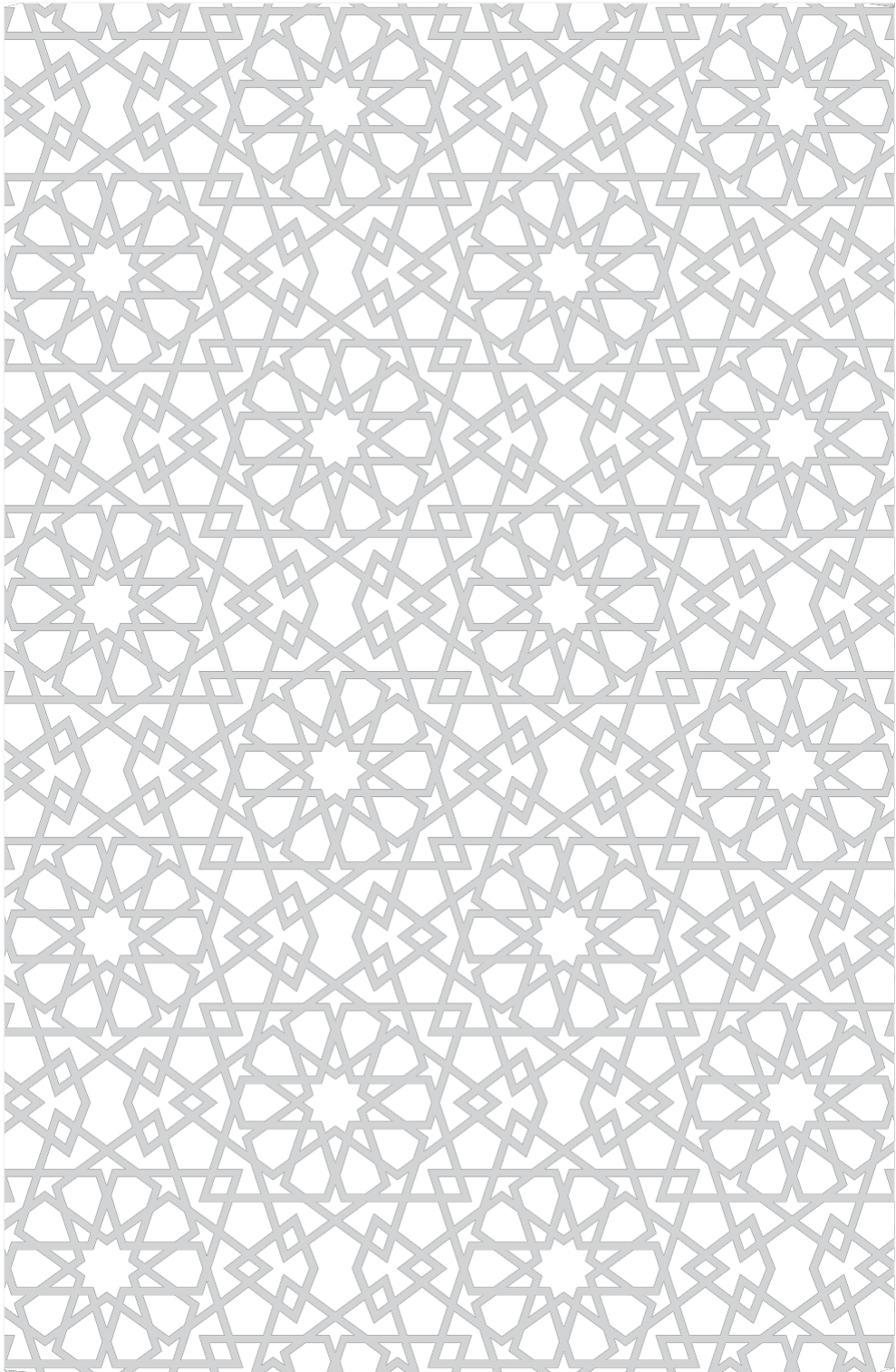
If an IFI intends to disclose information it knows (or is negligent in not knowing) to be material, and non-public, to a party or shareholder, it must provide prior or simultaneous, widespread public disclosure of that information.





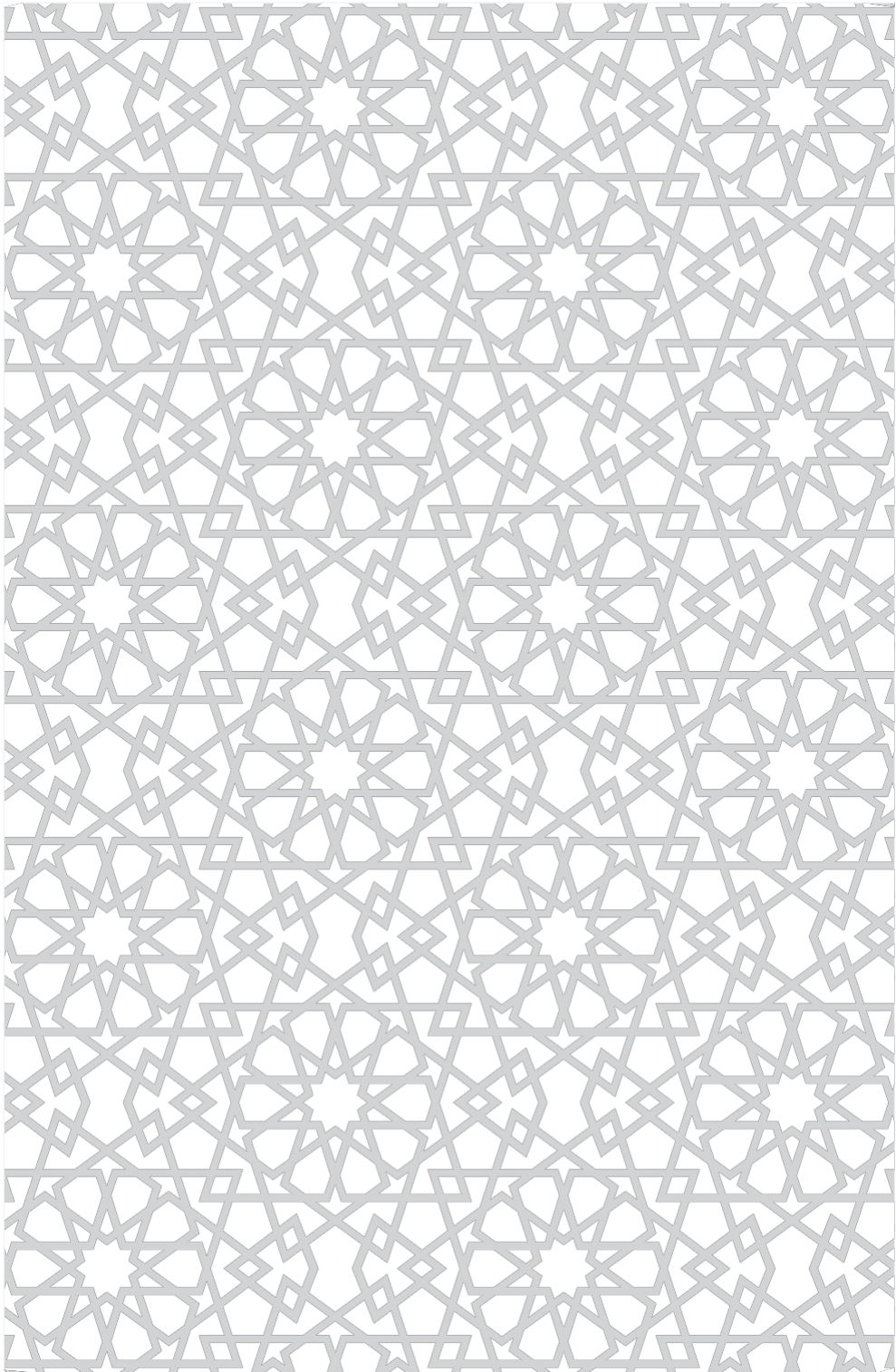
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**Corporate Social Responsibility,
Conduct and Disclosure for
Islamic Financial Institutions**



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Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions

1. Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards on the definition of Corporate Social Responsibility (CSR) for Islamic Financial Institutions, provide both mandatory and recommended standards to implement CSR in all aspects of the Islamic Financial Institution's (IFI)⁽¹⁾ activities and provide guidance on disclosure of CSR information to the IFI's stakeholders. (para. 1)

2. Scope of the Standard

The principles of this standard are applicable to all IFIs, regardless of their legal form, country of incorporation or size. However, the specific rules and provisions of this standard for activities, compliance and disclosure are classified into mandatory and recommended sections. The mandatory sections are applicable to all IFIs regardless of their legal form, country of incorporation or size. The recommended sections are only applicable to IFIs which have the capacity, financial or otherwise, to carry out or comply with such activities (para. 2).

Should the requirements of this standard contradict the IFI's charter or the laws and regulations of the country in which it operates, a disclosure should be made to that effect. Islamic Insurance companies may disregard provisions that are not applicable to their operations. (para. 3)

(1) The IFIs referred to in this standard are defined as any institution that plays the role of a financial intermediary that strictly abides by the provisions of the Shari'a. These include, but are not limited to Islamic banks and Islamic Insurance companies.

3. Definition of Corporate Social Responsibility for Islamic Financial Institutions

Corporate Social Responsibility (CSR) for IFIs refers to all activities carried out by an IFI to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions. (para. 4)

Religious responsibility refers to the overarching obligation of IFIs to obey the laws of Islam in all its dealings and operations. Economic responsibility refers to the obligation for Islamic banks to be financially viable, profitable and efficient. Legal responsibility refers to the obligation of IFIs to respect and obey the laws and regulations of the country of operation. Ethical responsibility refers to the obligation of IFIs to respect the mass of societal, religious and customary norms which are not codified in law. Discretionary responsibility refers to the expectation from stakeholders that IFIs will perform a social role in implementing Islamic ideals over and above the religious, economic, legal and ethical responsibilities. (para.5)

This standard does not focus on economic or legal responsibilities of IFIs as it is assumed that the management/accounting structure and other accounting and governance standards are designed to fulfill economic responsibilities, while legal responsibilities are codified and enforced by the state and its functions. (para. 6)

4. Objectives of the Standard

The primary objective of this GSIFI is to prescribe uniform standards on CSR activities and compliance for IFIs. It is not the intended objective of the standard to prescribe new principles and rules of conduct for IFIs, but to codify existing principles and rules in a comprehensive structured format. (para. 7)

The second objective of this standard is to ensure that the CSR activities and compliance of IFIs are communicated in a uniform, truthful, transparent and comprehensible manner to relevant stakeholders to whom the IFI owes a duty of accountability. (para. 8)

The objectives of this standard, as stipulated above, and the standard itself are intended to encourage IFIs to take a proactive role in applying CSR to all aspects of their operations. (para. 9)

5. Responsibilities Under This Standard

5/1 Structure of corporate social responsibility

The responsibilities under this standard are divided between mandatory and recommended conduct. Within mandatory conduct, there are specific responsibilities which an IFI must carry out, while there is guidance on the discretionary methods by which these specific responsibilities may be carried out. (para. 10)

5/2 Mandatory conduct

5/2/1 Policy for screening clients

IFIs shall implement a CSR policy for screening prospective clients. This policy must include

- a) Screening criteria
- b) The approval of the Shari'a Supervisory Board of the screening criteria. (para. 11)

The policy stipulating the screening criteria may include provisions:

- i. For review of the compliance of prospective client's investments with Islamic law, among other aspects, if any, based on the discretion of the IFI,
- ii. Requiring that effective screening processes are in place to prevent third parties from using the IFI to engage in criminal activities such as money laundering
- iii. For review of the prospective client's compliance with principles and rules of CSR as contained within this standard, particularly mandatory core conduct as stipulated in sections 5/2 (extended to the prospective clients).
- iv. For review of the impact of the prospective client's investment on the economy, society and the environment.

- v. Stating that any future abrogation of the terms of financing, as stipulated under this policy, will result in violation of contractual terms (with the remedy to be decided by the IFI). (para. 12)

If these policy terms form part of the contractual agreement with clients, a policy disclosure must be made to prospective clients stipulating these policy terms prior to contractual agreement. (para. 13)

5/2/2 Policy for responsible dealing with clients

IFIs shall implement a CSR policy for responsible dealing with clients, including provisions relating to avoidance of onerous terms on clients, marketing ethics, implementing responsible financing practices in all types of transactions with clients and dealing with late repayments and insolvent clients. This policy shall stipulate:

- a) That all contract forms have to be screened by the Shari'a supervisory board or its agent to avoid the imposition of onerous terms and conditions to clients who are in a weaker bargaining position relative to the IFI,
- b) Provisions to ensure that all marketing campaigns and documents are ethically balanced promoting business without an exclusive focus on profits that may induce inappropriate behaviour/consumption and unsuitable products inconsistent with Islamic, social and cultural norms,
- c) The obligations and rights of each party to transactions undertaken with the IFI,
- d) The due process and responsible terms and conditions under which financing is extended to clients, taking into consideration the client's ability to repay and the effect on the client's financial and overall well-being, through assessment of the client's present disposable income capacity,
- e) The remedies available, in the event that one or both

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parties violate their contractual terms,

- f) The opinion of the Shari'a Supervisory Board regarding late payment charges,
 - g) Late payment charges to be charged to clients, if any,
 - h) How the IFI allocates the late payment charges in its accounts (allocation to revenue or charity),
 - i) The conditions under which IFIs will defer collection of debt from insolvent clients. (para. 14)
- A policy disclosure shall be made to clients prior to execution of any contract. This policy disclosure shall form part of the contractual terms and conditions. (para. 15)

5/2/3 Policy for earnings and expenditure prohibited by Shari'a

IFIs shall implement a CSR policy for earnings and expenditure prohibited by Shari'a. (impermissible or haram transactions). This policy must include a due process procedure wherein the following must be documented for impermissible transactions:

- a) Specific description of each material transaction and aggregate description of accumulated immaterial transactions
- b) Revenue, expense, liability or asset amount of each material transaction and aggregate revenue, expense, liability or asset amount of accumulated immaterial transactions,
- c) Reasons for undertaking such transactions,
- d) The Shari'a Supervisory Board's verdict on the necessity of these transactions,
- e) How the IFIs intends to dispose of such revenues, assets or liabilities, and
- f) Recommendations for finding viable permissible or halal alternatives for similar impermissible transactions in the future. (para. 16)

The procedure above should be read in conjunction with and supplements any existing AAOIFI standards

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that re- late to earnings and expenditure prohibited
by Shari'a. (para. 17)

5/2/4 Policy for employee welfare

IFIs shall implement a CSR policy for employee welfare. This policy shall stipulate provisions for the rights and obligations of employees, including provisions affording fair treatment of all employees, avoidance of discrimination, as well as expected behaviour of all employees. This policy may include specific provisions relating to:

- a) Equal opportunity for all employees, regardless of gender, race, religion, disability or socio-economic background,
- b) Merit-based salary and promotion structure for all employees, regardless of gender, race, religion, disability or socio-economic background,
- c) Establishing long term incentive schemes and further development and training incentive schemes for all employees,
- d) Provisions for maternity leave and flexible work hours for female employees,
- e) Maximum allowable work hours under full-time, part-time and casual employment for all employees,
- f) Prohibition of discrimination including, and not limited to, gender, race, religion, disability or socio-economic background, penalties for such discrimination and avenues for complaints for such discrimination without any manner of recrimination (Appointment(s) should be made within the organization to deal with such discrimination; the person(s) appointed must be seen to be just and fair to all employees, regardless of the employee's gender, race, religion, disability or socio-economic background),
- g) Pro-actively establishing, monitoring and acting on realizable quotas/targets for employment of staff from disadvantaged backgrounds, with disabilities, from a minority group, and/or from under-represented groups in the formal economy (including females) (affirmative action).

- h) Elimination of child labour from the workforce and if not feasible, educational and familial support for children,
- i) Elimination of class and race barriers between higher and lower ranking employees,
- j) Expected behavior of all employees in line with the Code of Ethics for the Employees of Islamic Financial Institutions, k) Expected behavior (humility, modesty and mutual respect) of higher ranking employees towards lower ranking employees, vice versa, and
- l) Occupational health and safety measures to be taken by the IFI and by the employees (para. 18).

A policy disclosure must be made to all employees before commencement of the employment contract and preferably be disclosed in any form of media that is utilized to advertise employment vacancies. This policy disclosure should form part of the contractual terms and conditions. Efforts should be made to communicate this policy disclosure to all employees in their native language (language most frequently used by the employee). (para. 19)

5/2/5 Policy for Zakah

The terms and conditions under which a Zakah policy must be established are stated in Shari'a Standard No. (35), State- ment of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions sec- tion 4/6 and Financial Accounting Standard No. (9) on Zakah. (para. 20)

5/3 Recommended conduct

5/3/1 Policy for Qard Hasan

IFIs may implement a CSR policy for Qard Hasan for social reasons. The provisions of this policy may

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include matters pertaining to:

a) Establishing a Qard Hasan
fund,

- b) Maintaining a record of sources of Qard Hasan funding (depositors, shareholders and/or other parties) (sources of funds),
- c) Types of allowable beneficiaries of the Qard Hasan funds as determined by the bank (allowable uses of funds),
- d) Circumstances in which such loans are distributed to individuals (or to organizations),
- e) Contractual enforcement measures for debtors able to repay loans,
- f) Write off conditions for debtors unable to repay loans, and g) Developing a strategy to increase Qard Hasan loans from the sources referred to in 5/3/1b, which are to be used solely for charitable purposes, and proactively establishing, monitoring and acting on realizable quotas/targets for this particular strategy. (para. 21)

This policy may be monitored on a yearly basis. If implemented, this policy may supplement any provisions contained elsewhere in the AAOIFI standards including, Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions section 4/7. (para. 22)

5/3/2 Policy for reduction of adverse impact on the environment

IFIs may implement a CSR policy for reducing the impact of the IFI on the environment. The provisions of this policy may include matters pertaining to:

- a) Establishing organization wide guidelines on efficient and minimal usage of non-renewable resources,
- b) Initiatives to educate employees to efficiently use non-renewable resources and increase use of renewable resources,
- c) Incentives and initiatives to find alternatives to non-renewable sources of energy and materials for operations (e.g., e-mail bank statements instead of paper bank statements), or
- d) incentives and initiatives to recycle renewable sources of materials within the organization (para. 23).

The provisions of this policy may be reviewed on a yearly basis to implement new and innovative methods by which to minimize the environmental impact of the IFI (para. 24).

**5/3/3 Policy for social, development and environment based
in-vestment quotas**

IFIs may implement CSR policies for social, development and environment based investment quotas. This policy may include provisions for pro-actively establishing, monitoring and acting on realizable and profitable investment quotas/targets, based on the extent to which the investments directly or indirectly contribute to social, development and environmental causes. (para. 25)

Social Impact Investments: These policies may include quotas/ targets for social-impact investments, based on the role that the investments play in:

- a) Assisting poor and needy individuals and families,
by financing business opportunities and/or education,
- b) Assisting
orphans,
- c) Assisting heavily indebted individuals or families
with
unfortunate
circumstances,
- d) Assisting in the provisioning of health and medical
services
to impoverished communities or
areas,
- e) Assisting in the development of research and
education
facilities, particularly those that utilize and empower di-
sadvantaged individuals or
communities,
- f) Assisting the development of small and medium
sized
entrepreneurs and family

businesses,

g) Encouraging the development of Islamic and native societal

culture, and

h) Discouraging contemporary social ills and vices. (para. 26)

Development Impact Investments: These policies may include quotas/targets for development impact investments:

a) That offer significant growth potential for the country of operation or for another developing country,

b) That significantly contribute to the development of in-

frastructure in the country of operation or for another de- veloping country,

c) That have a significant proportion of small to medium size enterprises (SME) or indirectly rely on small to medium size enterprises (SME), and/or

d) That directly or indirectly assists in the alleviation of social and economic disadvantages and discrimination including, and not limited to, micro-finance industry and third-sector organizations. (para. 27)

Environmental Impact Investment: These policies may include quotas/targets for environmental impact investments, based on the role that the investments play in:

a) Protecting the environment,

b) Reducing the impact of development on the environment, c) Encouraging individuals and institutions to protect and preserve the natural environment and reduce the impact of

development on the environment, and

d) Increasing the use of renewable, sustainable sources of energy and/or reducing the reliance on scarce non-renewable sources of energy. (para. 28)

This policy may be monitored on a yearly basis, with revisions being made on based on quota/target performance. (para. 29)

5/3/4 Policy for par excellence customer service

IFIs may implement a CSR policy to develop par excellence customer service skills of employees and contractors. The provisions of this policy may include matters pertaining to:

a) Establishment of a code of conduct for all employees and contractors in dealing with customers (The code of conduct for customer service may include the provisions from the Code of Ethics for the Employees of Islamic Financial Ins- titutions section 6/3),

- b) Active measures to be taken by management to develop customer service skills of employees, and
- c) Surveys that provide customer service feedback on performance/quality and likely areas of improvement. (para. 30)

5/3/5 Policy for micro and small business and social savings and investments

IFIs may implement a CSR policy to assist micro and small business and social savings and investments. The provisions of this policy may include matters pertaining to:

- a) Encouragement of micro and small business savings through special features and terms for these types of investment depositors,
- b) Encouragement of social savings for marriages, children's education, community based programs and other social welfare programs through special features and terms for these types of investment depositors,
- c) Encouragement of both micro and small business savings and investment through combination features and terms for these types of investment depositors (e.g., savings deposit with higher rates of return and investment loans discounts etc), and
- d) Encouragement of both family savings and investment through combination features and terms for these types of investment depositors (e.g., savings deposit with higher rates of return and investment loan discounts etc). (para. 31)

5/3/6 Policy for charitable activities

IFIs may implement a CSR policy for charitable activities. The provisions of this policy may include matters pertaining to:

- a) Establishing a charity fund,
- b) Establishing avenues for voluntary donations by donors (e.g. from depositors, shareholders, clients,

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contractors and employees) for the charity,

- c) Establishing fund raising drives (emergency or otherwise)
from bank's clients through existing operational means,
- d) Specifying target groups, communities and institutions that
require assistance, including those described in policy for social impact based investment quota (section 5/3/4) and policy for environmental impact based investment quotas (section 5/3/5)
- e) Means by which charity may be distributed to prospective donees, and
- f) Contracting an agent or establishing a trust foundation to
distribute funds to allocated charities. (para. 32)

5/3/7 Policy for Waqf management

IFIs may implement a CSR policy for managing Waqf properties on behalf of their beneficiaries. The provisions of this policy may include matters pertaining to:

- a) Establishing a Waqf management department or allocating staff to a Waqf management function,
- b) Establishing rules and guidelines based on Shari'a for Waqf management,
- c) Establishing a fair rate structure for the provision of services by the bank, and
- d) Giving discounted rates and flexible terms for Waqf investment financing. (para. 33)

6. Disclosure Requirements and Presentation Treatment Options

6/1 Mandatory disclosure requirements

Disclosure should be made, in a separate CSR report contained within the annual report, of the material policies of the IFI with respect to its mandatory CSR conduct to satisfy the information needs of the IFI's stakeholders. Disclosure may

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also be made in other reports specifically targeted towards the general public. (para. 34)

It should be noted that while disclosures are meant to be comprehensive, the potential user groups of CSR information are wide and hence

disclosures should be designed with the intention of making them as understandable as possible for the general public.(para. 35)

6/1/1 Disclosure of policy for screening clients

Disclosure should be made, in the annual report, of the CSR policy on screening clients. This disclosure should stipulate

- a) The specific provisions of the screening policy including the benchmarks and/or criterion utilized to measure compliance with Islamic law, and
- b) Whether these have been approved by the Shari'a supervisory board. (para. 36)

6/1/2 Disclosure of policy for dealing with clients

Disclosure should be made, in the annual report, of the CSR policy on dealing with clients. This disclosure should stipulate the specific provisions of the CSR policy including:

- a) The defined procedure of the IFI on avoiding the imposition of onerous contractual terms on clients who are in a weaker bargaining position relative to the IFI,
- b) The provisions ensuring that marketing campaigns and documents are ethically balanced,
- c) The obligation and rights of both parties,
- d) The due process and responsible terms and conditions under which credit is extended to clients, including the process by which the client's ability to repay and the effect on the client's financial and overall well-being is assessed,
- e) The remedies available in the event that one or both parties violate their contractual terms,
- f) The Shari'a supervisory board's opinion on the permissibility

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- of charging late payment charges,
- g) Late payment charges levied on clients,
- h) How the IFI allocates the late payment charges in its accounts (allocation to revenue or charity), and
- i) The conditions under which the IFI will defer collection of debt from insolvent clients. (para. 37)

6/1/3 Disclosure of earnings and expenditure prohibited by Shari'a

Disclosure should be made, in the annual report, of the earnings and expenditure prohibited by Shari'a (impermissible or haram transactions) for the financial year, if any. This disclosure should stipulate the following items for the financial year:

- a) Aggregate descriptions, amounts, account classification (re-venue, expense, liability or asset) and reasons for undertaking these types of transactions,
- b) The SSB's verdict on the necessity of these transactions, c) How the IFI intends to dispose of such amounts,,
- d) The IFI's strategy to find viable permissible or halal alternatives, if any, for similar impermissible transactions in the future. (para. 38)

This comprehensive disclosure supplements existing disclosure required by other AAOIFI standards (Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions section 3/6). (para. 39)

6/1/4 Disclosure of policy for employee welfare

Disclosure should be made, in the annual report, of the IFI's policy for employee welfare. This disclosure should stipulate the provisions of the IFI policy and the measures taken to implement these provisions within the organization. (para. 40)

The disclosure may include the policy relating to affirmative action, including:

- a) Provisions of the policy, including targeted disadvantaged groups,
- b) Quotas/targets and achievements for the year, and
- c) Reasons for upward and downward revisions in quotas/target.

This disclosure may be included with the mandatory dis-

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closure of the policy for employee welfare. (para. 41)

6/1/5 Disclosure of policy for Zakah

Disclosure should be made for Zakah, in the financial statements, in accordance with the provisions of Financial Accounting Standard No. (1): General Presentation and Disclosure and Financial Accounting Standard No. (9) on Zakah. (para. 42)

6/2 Voluntary disclosure

Disclosure may be made of the material policies of the IFI with respect to its recommended CSR conduct to satisfy the information needs of the IFI's stakeholders. Disclosure may be made in other reports specifically targeted towards the general public. (para. 43)

It should be noted that while disclosures are meant to be comprehensive, the potential user groups of CSR information are wide and hence disclosures should be designed with the intention of making them as understandable as possible for the general public. (para. 44)

6/2/1 Disclosure of policy for social, development and environment based investment quotas

Disclosure may be made, in the annual report, of the CSR policy for social, development and/or environment based investments quotas and the extent of implementation of this policy for the financial year. The disclosure may include:

- a) The provisions of the policy,
- b) Classes of investments by ultimate purpose/beneficiary of investments (e.g., orphans, SME development, Islamic culture, reduction in tree logging, reduction in environmental greenhouse gases, increase in recycling, science and technology)
- c) The profitability of such investments for the year,

d) Quotas/targets and achievements for the year,
and

e) Reasons for upward and downward revisions in
quotas/
target (para. 45).

6/2/2 Disclosure of policy for par excellence customer
service

Disclosure may be made, in the annual report, of the CSR
policy for par excellence customer service. The disclosure
may include:

- a) Provisions of the policy,
- b) Measures taken by management to develop customer service skills, and
- c) Aggregate results of customer surveys demonstrating overall quality of customer service and areas of improvement. (para. 46)

6/2/3 Disclosure of policy for micro and small business and social savings and investments

Disclosure may be made, in the annual report, of the CSR policy for micro and small business and social savings and investments. The disclosure may include:

- a) Provisions of the policy;
- b) Features of the offer;
- c) Measures taken by management to implement the provisions of the policy;
- d) Quotas/targets and achievements for the year; and
- e) Reasons for upward and downward revisions in quotas/target (para. 47).

6/2/4 Disclosure of policy for Qard Hasan

Disclosure may be made, in the annual report, of the CSR policy for Qard Hasan. The disclosure may include:

- a) Whether there is a formal scheme operated by the bank for depositors, shareholders and other parties to place their funds for the use of Qard Hasan borrowers,
- b) Provisions of the policy/scheme including conditions for those unable to repay the loans,
- c) Sources of funding for Qard Hasan

loans,

d) Aggregate purposes for which the Qard Hasan loans have

been made,

e) Quotas/targets to increase internal and external Qard Hasan

funding and achievements for the year in this regard,

and

f) Reasons for upward and downward revisions in quotas/

target. (para. 48)

The disclosure requirement should be read in conjunction with and supplements any disclosure recommended by the existing AAOIFI Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions section 4/7 and Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions section 4/7. (para. 49)

6/2/5 Disclosure of policy for charitable activities

Disclosure may be made, in the annual report, of the CSR policy for charitable activities. The disclosure may include:

- a) Provisions of the policy,
- b) Aggregate classes of charitable activities by ultimate beneficiary and amounts distributed to each aggregate class,
- c) Quotas/targets and achievements for the year, and
- d) Reasons for upward and downward revisions in quotas/target. (para. 50)

This disclosure will supplement any disclosure recommended by the existing AAOIFI Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions section 4/6 and Financial Accounting Standard No. (9): Zakah (para. 51).

6/2/6 Disclosure of policy for Waqf management

Disclosure may be made, in the annual report, of the CSR policy for Waqf management. The disclosure may include:

- a) Types of Waqf managed by the IFI,

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b) Financial and other services offered to the Awqaf by
the

IFI. (para. 52)

7. Responsibility Under This Standard

7/1 Compliance and attestation
function

It is the responsibility of the board of directors of the IFI to
ensure compliance with the provisions of this standard.

The Board of

directors shall ensure that an independent compliance audit is performed prior to its attestation of CSSR conduct. (para. 53)

The compliance function will comprise testing of compliance, in form and in substance, with mandatory CSR conduct provision as well as recommended CSR conduct provisions which have been adopted by the IFI. (para. 54)

The attestation by the board of directors of the IFI will comprise a signing declaration containing:

- a) A statement which stipulates that management has proactively engaged in the mandatory and voluntary provisions of the CSR standard in all its conduct; and/or
- b) A statement which stipulates that management's representations in the annual report regarding its CSR conduct fairly represent management's actual conduct. (para. 55)

7/2 Implementation function

The responsibility for implementation of this standard lies with the management of an IFI. (para. 56)

8. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram 1431 A.H. or 1 January 2010 A.D. (para. 57)

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Adoption of the Standard

The Standard on Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions was adopted by the Accounting and Auditing Standards Board in its meeting No. (35) held on 6 Rabi' II, 1430 A.H., corresponding to 2 April 2009 A.D.

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (31) held in Manama, Kingdom of Bahrain on 17 Jumada I 1427 A.H., corresponding to 13 June 2006 A.D., the Accounting and Auditing Standard Board decided to develop a new standard on Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions.

Subsequently, a consultant was commissioned to prepare a preliminary study and exposure draft of the Standard on Investments in Associates. Preparation of the preliminary study and exposure draft was overseen by the Auditing and Governance Standards Committee.

The preliminary study and exposure draft were discussed by the Auditing and Governance Standards Committee through a series of meetings and telephone conference calls.

The preliminary study and exposure draft were also deliberated by Accounting and Auditing Standard Board in its meetings No. (33) held in Manama, Kingdom of Bahrain on 24 Jumada I, 1429 A.H., corresponding to 29 May 2008 A.D., and No. (34) held in Manama, Kingdom of Bahrain on 14 Dhul-Qa'dah 1429 AH., corresponding to 12 November 2008 A.D.

Listening session for the exposure draft was convened in Manama, Kingdom of Bahrain on 24 Safar 1430 A.H., corresponding to 19 February 2009 A.D., to gather comments from the Islamic finance industry as well as accounting and auditing professions.

The exposure draft was revised in light of the comments made in Accounting and Auditing Standards Board meeting No. (34) and the listening session.

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The Accounting and Auditing Standards Board adopted the Standard on Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions at its meeting No. (35) held on 6 Rabi' II, 1430 A.H., corresponding to 2 April 2009 A.D.

Appendix (B)

Reasons for the Standard

The reason for this standard is to provide specific guidance to IFIs to engage in productive CSR activities and disclose the nature of these activities to their stakeholders. Since there is no comparable standard generally and specifically for IFIs, this is an important standard to ensure the legitimacy and reputation of IFIs are preserved.

The rationale for this standard stems from the significant variation in the practice and understanding of CSR by IFIs. A number of research papers indicate that IFIs have widely varying CSR practices, with some IFIs really delivering high quality CSR initiatives and reports, whereas other IFIs are simply not interested in CSR. The papers also suggest that CSR activities are misunderstood as any activity that is not directly aligned with profit incentives. As a result, a number of IFIs engage in supporting activities that are not within the definition of social responsibility as espoused by Islamic scholars and thinkers. Rather, they are perceived to be marketing ploys to enhance the reputation of the IFI, with little direct social or environmental improvement.

The Islamic perspective on social responsibility is that the activities must directly assist individuals or societies to enhance their living or environmental conditions or assist them to better comply with religious rules and norms. Islam discourages the boasting of socially responsible activities to enhance one's own image. However, this does not necessarily imply that institutions representing stakeholders should not be accountable. Indeed, Islam encourages accountability and therefore IFIs should be held accountable by their stakeholders for the extent of engagement in social activities.

Appendix (C)

Basis for Conclusions

CSR derives itself from core principles in the Noble Qur'an. The three major foundational principles for CSR are the vicegerency of mankind on earth, divine accountability and the duty on mankind to enjoin good and forbid evil.

Vicegerency

The principle of vicegerency denotes that mankind is the representative of Allah on earth and as such Allah has entrusted mankind with stewardship of Allah's Possession. Allah states this principle in the Qur'an: *{ "...Verily, I am going to place (mankind) generations after generations on earth..."}*⁽¹⁾ and Allah further states: *{ "And it is He Who has made you generations coming after generations, replacing each other on the earth..."}*⁽²⁾

Divine Accountability

The principle of divine accountability flows from the vicegerency principle and denotes that individuals will be accountable to Allah for all of their actions on the Day of Judgment. This principle is expounded in several verses of the Qur'an, two of which are: *{ "...Certainly, Allah is Ever a Careful Account Taker of all things"}*⁽³⁾ *{ "So whosoever does good equal to the weight of an atom (or a small ant), shall see it. And whosoever does evil equal to the weight of an atom (or a small ant), shall see it."}*⁽⁴⁾ This divine accountability is the basis for all actions of a Muslim.⁽⁵⁾ and in turn the representative organizations of Muslims.

(1) [Al-Baqarah (The Cow): 30]. (2) [Al-An'am (The Cattle): 165]. (3) [Al-Nisa' (The Women): 86].

(4) [Al-Zalzalah (The Earthquake): 7-8].

(5) One who submits to the Will of

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Allah.

Enjoining Good and Forbidding Evil

The principle of enjoining good and forbidding evil encapsulates the responsibilities that Allah places on Muslims as trustees and vicegerents. Allah says: *{“The believers, men and women, are Awliya’ (helpers, supporters, friends, protectors) of one another; they enjoin (on the people) Al-Ma’ruf (i.e. Islamic Monotheism and all that Islam orders one to do), and forbid (people) from Al-Munkar (i.e. polytheism and disbelief of all kinds, and all that Islam has forbidden)...”}*⁽¹⁾ and in another verse, Allah states:

{“You [true believers in Islamic Monotheism, and real followers of Prophet Muhammad and his Sunnah (legal ways, etc.)] are the best of peoples ever raised up for mankind; you enjoin Al-Ma’ruf (i.e. Islamic Monotheism and all that Islam has ordained) and forbid Al-Munkar (polytheism, disbelief and all that Islam has forbidden)...”}⁽²⁾ This responsibility is overwhelming and encompasses all aspects of a Muslim’s life. It comprises a prescription towards positive (permissible and recommended) actions and a prescription against negative (impermissible and not recommended) actions. IFIs have generally ensured their operational status by avoiding negative actions. However, their approach to positive actions has been varied due to a lack of standards in the area.

The combination of these principles denotes a divine accountability for each Muslim to enjoin good and justice and forbid evil and injustice. These core principles therefore constitute the basis of individual social responsibility.

Collective Religious Duty and Islamic Financial Institutions

IFIs came into existence as a collective religious obligation (Fard Kifayah)⁽³⁾ on the larger community (Ummah). This obligation is to operate a financial intermediary for individuals in the larger community wishing to comply with Islamic law (Shari’a). In this special position, IFIs are able to perform the obligations that individuals cannot perform themselves. The IFIs are therefore representatives for individuals who:

(1) [Al-Tawbah (The Repentance): 71].

(2) [Al-’Imran (The Family of Imran): 110].

(3) Fard Kifayah refers to a collective religious duty which, if performed by some, would exempt others from performing it. However, if it is not performed by any, the entire

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community is sinful.

- i. Invest their money as shareholders or investment accountholders;
- ii. Have co-operative, partnership or borrowing relations with the IFI;
- iii. Are employed by the IFI;
- iv. Have other explicit contractual relations with the IFI; and
- v. In addition to the above, have an implicit social contract with the IFI as part of the larger community (Ummah).

Second, IFIs hold a position of significant responsibility in society as financial intermediaries which source and allocate funds. The example set by IFIs has an impact on other individuals, institutions and organizations.

These two points denote that IFIs are a *Fard Kifayah*.⁽¹⁾ It is therefore pertinent that IFIs play a role in encouraging the right type of behavior and activities while discouraging the wrong type of behavior and activities.

Islamic Corporate Social Responsibility

The core foundations of CSR are the same as the foundations for individual social responsibility of each Muslim; that is to enjoin right and to forbid wrong. The definition of right and wrong in Islam can be defined in various dichotomies which are overlapping. In their legal form, right refers to everything that is permissible or recommended (Halal and Mustahab respectively), while wrong refers to everything that is impermissible or not recommended (Haram and Makruh respectively). From the perspective of Islamic jurisprudence, right refers to what is just while wrong refers to what is unjust.

However, because IFIs are a collective religious obligation (Fard Kifayah), the definition of right and wrong are sometimes of a different nature than those that apply to individuals. This is because IFIs have a special religious and financial position in society.

Religiously, IFIs have a responsibility to comply with the form and substance of Islamic law in all aspects of their operations. This is because they are in an exemplary position. This means that all aspects of its operations

(1) *Fard Kifayah* refers to a collective religious duty which, if performed by some, would exempt others from performing it. However, if it is not performed by any,

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should be conducted in a permissible or recommended manner while no aspect of its operation should be conducted in an impermissible or not recommended manner. If it is conducted in an impermissible or not recommended manner, it is an obligation to disclose to its stakeholders the reasons for that particular conduct.

Financially, IFIs are intermediaries which mobilize funds from investors and allocate funds to projects and other investments. In this context, it is the responsibility of IFIs to mobilize funds from permissible and recommended sources and invest funds in permissible and recommended projects. Further, IFIs are also in an exemplary position as financial intermediaries and hence can significantly impact the conduct of the IFIs stakeholders.

Mandatory and Recommended Conduct Classifications

The classification between mandatory and recommended conduct is based on the Qur`anic principle of not imposing responsibilities on individuals (and in extension organizations) by Allah greater than what they can endure. This is clear in Allah's Saying: *{“Allah burdens not a person beyond his scope...”}*.⁽¹⁾

(1) [Al-Baqarah (The Cow): 286].

Appendix (D)

Definitions

Clients

Clients in this standard are defined as those individuals who and corporations which execute a sale, lease, borrowing or partnership agreement with the IFI. This does not include Investment Accountholders or depositors of any type.

Contractors

Contractors in this standard are defined as businesses or corporations that provide services to the IFI in return for a contractually agreed consideration. Contract workers are differentiated from employees because they do not have a direct contractual relationship with the IFI.

Customers

Customers in this standard are defined as all individuals and institutions that execute any type of contract in which the Islamic bank provides a good or service in return for valuable consideration.

Deposit Customers

Deposit customers in this standard are defined as those individuals and institutions which execute a contract to place funds with the IFI for safe keeping, deposit or investment. This does not include shareholders of any type.

Employees

Employees in this standard are defined as individual who work directly for the IFI in return for valuable consideration. This includes all ordinary connotations of the word employee including full-time, part-time, casual, seasonal, contract and project based employment. Employees do not include contract workers working for a business or corporation other than the IFI.

Employees are differentiated from contract workers because employees have a direct contractual relationship with the IFI, whereas contract workers do not have a direct contractual relationship with the IFI.

Investment Deposits

Investment deposits in this standard are defined as deposits placed by customers for the purposes of gaining an investment rate of return, and not for the sole purpose of safe keeping. These include investment accountholders.

Investment Assets

Investment assets in this standard are defined as those assets that bring a future economic benefit invested in by the IFI for the direct purpose of gaining a return and not for an operational purpose (e.g. fixed assets).

Qard Hasan

Qard Hasan in this standard is defined as a non-interest bearing loan intended to allow the borrower to use the loaned funds for a period of time with the understanding that the same amount of the loaned funds would be repaid at the end of the period.

Waqf

Waqf (plural Awqaf) in this standard is defined as an inalienable religious endowment in Islam.

Zakah

Zakah is a fixed religious obligation calculated by reference to net assets (including cash) that have appreciated or have the capacity to appreciate in value over a specific period of time except for assets that have been acquired for consumption or use in the production of revenues. Zakah is a religious obligation on wealth for every Muslim, including a child or an insane person, must meet provided his net assets are liable for Zakah.

Appendix (E)

Examples of Disclosure Format and Presentation

Notes:

The purpose of this example is to illustrate the application of some of the provisions of this standard. The example is not intended to illustrate the only acceptable method for the presentation of or the disclosure of CSR activities and compliance. Furthermore, the example does not reflect all requirements of the standard.

It should be noted that while disclosures are meant to be comprehensive, the potential user groups of CSR information are wide and hence disclosures should be designed with the intention of making them as understandable as possible for lay people.

The disclosures may be supplemented, if possible, with images of the tangible benefits resulting from CSR activities and compliance.

Example of Comprehensive CSR Report

<p>In the Name of Allah, The Beneficent, The Merciful</p> <p>(Name of Institution)</p> <p>Islamic Corporate Social Responsibility Report</p> <p>For the year ended xxx</p> <p>(Name of Institution) is engaged in implementing ideals of Islamic Social Responsibility to the best of its ability in all aspects of its operations. In line with these ideals, (Name of Institution) has applied best practice standards on Islamic Corporate Social Responsibility issued by the Accounting and Auditing Organization for Islamic Financial Institutions.</p>

These standards stipulate mandatory and recommended forms of Islamic Corporate Social Responsibility activities and compliance. (Name of Institution) has implemented both mandatory and recommended forms of Islamic Corporate Social Responsibility.

The implementation of these standards in true Islamic form and substance by the management of (Name of Institution) is attested by the board of directors in its report to shareholders. Presented below is a summary of the compliance and initiatives undertaken by (Name of Institution) during the year ended xxx.

Social Responsibility within the Organization

Employee welfare

[State policy and affirmative action initiatives for employee welfare here]

Internal environmental preservation policy

[State policy for reduction of environmental impact and initiatives, targets and achievements for the year here]

Earnings and expenditure prohibited by the Shari'a

[State policy for impermissible transactions and detailed information for the year here]

Social responsibility in its relationship with customers and clients

Par excellence customer service

[State policy for customer service, initiatives, targets, achievements and survey results for the year here]

Late repayments and insolvent clients and avoiding onerous terms

[State policy for late repayments and insolvent clients and avoiding onerous terms here]

Qard Hasan

[State policy for Qard Hasan and detailed information for the year including beneficiaries of Qard Hasan here]

Special features

[State policy on encouragement of entrepreneur and social savings and investments here and initiatives, targets and achievements for the year here]

Social Responsibility in Screening Its Investments

Screening of clients for compliance with Islamic principles and social responsibility

[State policy on screening of clients and contractors here]

Investment quotas based on industry, social impact and environmental impact

[State policy on investment quotas and initiatives, targets and achievements for the year here]

Social Responsibility in Its Relationship with Greater Society

Zakah

[State policy on Zakah and detailed information about Zakah for the financial year here]

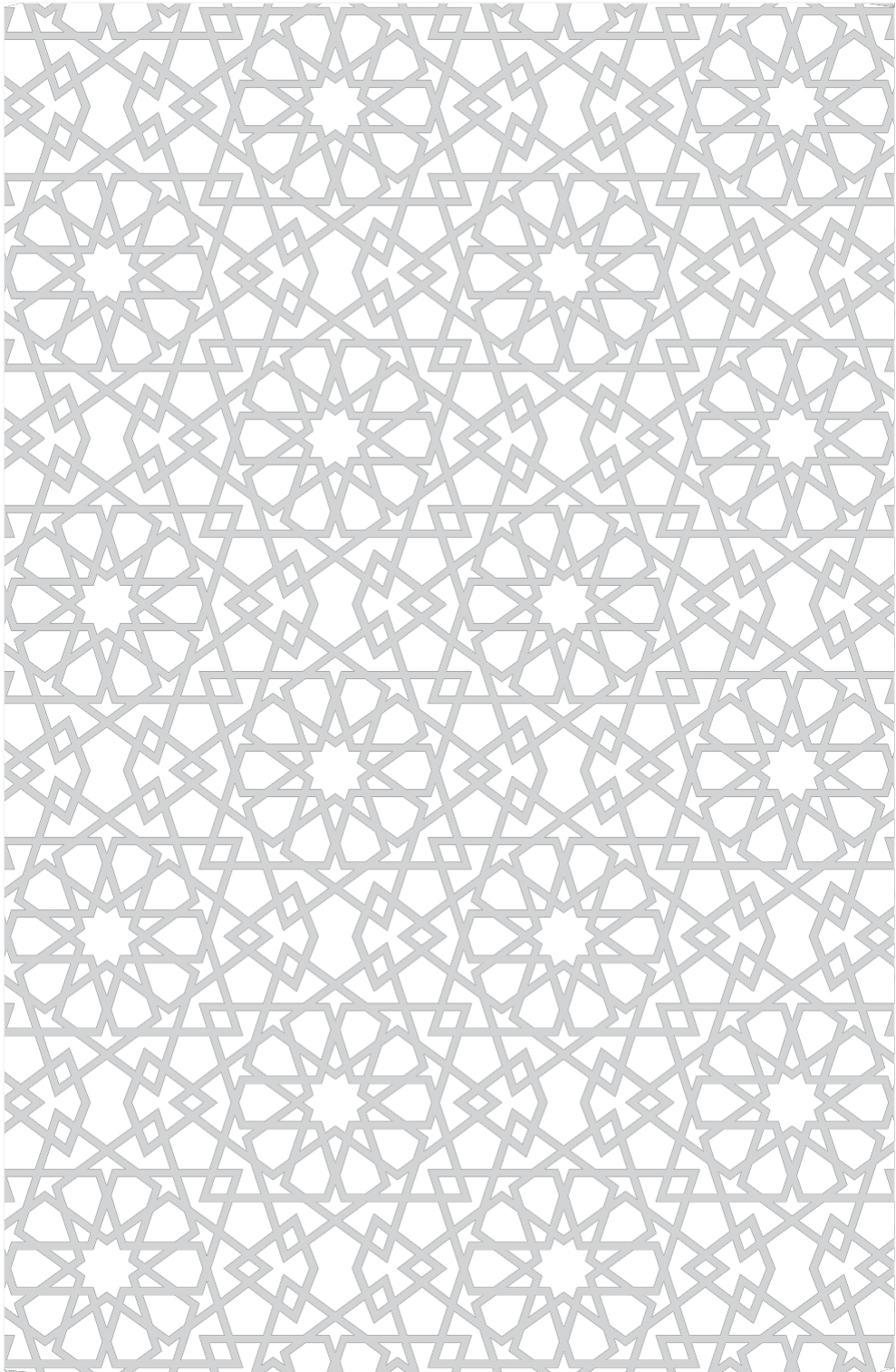
Charitable activities

[State policy on charitable activities and detailed information on charitable activities for the financial year here]

Waqf management

[State policy on Waqf management here and detailed information on types of Awqaf managed, services offered to Awqaf, and initiatives for the financial year here]





Governance Standard for Islamic Financial Institutions No. 8

Central Shari'ah Board

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Governance Standard for Islamic Financial Institutions (GSIIFI) No. 8 "Central Shari'ah Board" is set out in paragraphs 1-56.

Preface

- PR1 With the growth and expansion of Islamic banking and finance, a central or national approach has emerged across the globe with respect to Shari'ah boards that function at the level of the wider Islamic finance industry, advising or supervising products, practices, operations, etc.
- PR2 Previously, many regulators and government authorities depended on the Shari'ah boards in individual Islamic banks and financial institutions to evaluate and decide whether their products and operations were in compliance with Shari'ah principles and precepts. To a major extent, this approach was also being followed by AAOIFI, whereby after defining the core principles of Shari'ah in the form of its Shari'ah standards, AAOIFI had defined the governance principles for individual banks' Shari'ah Supervisory Boards (SSBs) only.
- PR3 The above approach, in some cases gave rise to conflicting rulings and eventually conflicting practices and products of Islamic banking and finance that confused clients and investors. If the confusion persists the credibility of Islamic banking and finance as a whole may be jeopardized.
- PR4 Certain jurisdictions were quick to introduce a centralized approach that aimed to oversee the application of Shari'ah principles and rules relating to Fiqh al-Muamalat (Islamic commercial jurisprudence) to the various facets of Islamic banking and finance activities across their national economies. Other countries followed this model. Over time, many countries opted for the same approach by introducing central Shari'ah boards (CSBs) for their respective jurisdictions.
- PR5 Two main models are currently prevalent; centralized (central Shari'ah board – alongside SSBs at individual institution level) and non-centralized (individual institution's Shari'ah board). AAOIFI, by issuance of this standard, does not intend to give preference to one model over the other. Within the centralized model, there are mainly two categories; countries that follow a single central body and countries that follow multiple central bodies.
- PR6 This governance standard seeks to provide comprehensive foundations that would help define the key terms of reference and principles for such boards. It aims to provide guidance to Islamic finance industry and its regulators worldwide on this important aspect of governance, and to standardize the global regulatory practices in this respect. CSBs are expected to adopt the AAOIFI Shari'ah Standards and accordingly to follow the applicable requirements of Shari'ah Standard No. 29 "Stipulation and Ethics of Fatwa in the Institutional Framework".
- PR7 This standard encourages, but not mandates, the creation of CSBs. AAOIFI, through its GSIFI 1 "Shari'ah Supervisory Board: Appointment, Composition and Report" read with other GSIFIs, has mandated existence of SSBs at all IFIs.

Introduction

Overview

- IN1 The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to provide guidance on the definition, scope of work, responsibilities, appointment, composition, independence and terms of reference of a CSB and other relevant issues. This standard aims to facilitate compliance of the regulatory bodies establishing, or having established, CSBs with Shari'ah principles and rules.
- IN2 It aims to provide framework on governance for CSBs worldwide, and to standardize global regulatory practices in this area. It also presents, but not mandates, a country-level approach for regulating the Islamic finance industry within borders, including products, practices, operations, etc.

Rationale for issuing this standard

- IN3 This standard aims to establish an advanced degree of harmonization and convergence in the work of Shari'ah Supervisory Boards (SSBs) of Islamic financial institutions (IFIs) to iron out the situations of inconsistencies and differences between the fatwas, rulings, decisions and applications by such entity-level boards. This will allow consistency in products and services offered by the IFIs and the promotion of standardized practices. This will, in turn, increase the credibility of the Islamic finance industry and boost the confidence of its clients and investors in IFIs and their offerings.

Governance Standard for Islamic Financial Institutions No. 8

Central Shari'ah Board

Objective of the standard

1. The objective of this standard is to provide guidance on Central Shari'ah Board (CSB / the board) in terms of appointment, composition, functioning and independence, based on best practices of governance.
2. The standard recommends and encourages formation of CSBs to achieve greater level of harmony in the practices of Islamic banking and finance within a jurisdiction.

Scope of the standard

3. This standard applies to governance for CSBs or similar bodies to oversee and advise in respect of Shari'ah matters to regulators and government authorities.
4. This standard does not apply to Shari'ah supervisory boards and other institution-level boards and committees as they are covered by separate standards².

Definitions

5. For the purposes of this standard, the following terms have the meanings attributed below:
 - a. Appointing authority – is a government, government authority, regulatory or self-regulatory body, or equivalent that appoints a CSB of either type;
 - b. Central Shari'ah Board (CSB) – a broad level board or similar body of specialized jurists in Fiqh al-Muamalat (Islamic commercial jurisprudence) and experts in Islamic banking, finance, economics, law, accounting, etc. providing guidance and advice on Shari'ah matters, with limited supervision, that is established in a specific country or jurisdiction for providing uniformity and harmony in the products and practices with regard to Islamic finance through fatwas, rulings and guidelines. The CSB's decisions are applicable on a broader base in the jurisdiction rather than a single institution. It has two basic types i.e. a national Shari'ah board² and a regulatory Shari'ah board³;
 - c. Shari'ah Supervisory Board (SSB) – is an independent body of specialized jurists in Fiqh al-Muamalat (Islamic commercial jurisprudence). The SSB may also include a member(s) other than those specialized in Fiqh al-Muamalat, called expert member(s) who is(are) expert(s) in areas such as banking, finance, economics, accounting, law etc. and have knowledge of Fiqh al-Muamalat. The SSB is entrusted with the duty of directing, reviewing and supervising the

¹ AAOIFI GSIFI 1 and 4

² National Shari'ah board is a central Shari'ah board formed at a national level by a government or government authority having multiple regulatory regimes under its direct or indirect ambit.

³ Regulatory Shari'ah board is a central Shari'ah board formed by a regulatory or a self-regulatory or similar body for a jurisdiction having one or more industry segment(s) under its ambit as defined by the regulator.

activities of an IFI in order to ensure that it is in compliance with Shari'ah principles and rules. The Fatwas and rulings of the SSB are binding on the IFI;

- d. Independence – is “an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and objectivity”. The principle of objectivity for this purpose expects fairness, intellectual honesty and an attitude which is free of conflicts of interest.

Appointment, composition and dismissal

Appointment

First appointment

6. Board members for the first time constitution of a CSB, or first time reconstitution after adoption of this standard, shall be appointed by the appointing authority, considering factors relating to composition, independence and fit and proper test prescribed by this standard.

Subsequent appointments

7. For any subsequent appointment of the CSB, the appointing authority shall additionally take into consideration the rotation requirements, as well as, self-evaluation requirements setup in line with the provisions of this standard.

Nomination committee

8. The appointing authority shall consider, if necessary, the formation of a nomination committee for the purpose of nominating suitable candidates for the CSB, with adequate terms of reference aimed at improving the process of appointment by bringing in more transparency.

Remuneration

9. The appointing authority shall be responsible for fixing and paying the remuneration of the members duly considering the best practices and suitability of remuneration with regard to ensuring independence of individual members.
10. The remuneration payable to all members shall be equal, subject to paragraph 11. Remuneration may be set up on a retainer basis, time basis or attendance of meeting basis, or a combination thereof. The remuneration shall be disclosed to the general public via appropriate channels.
11. Additional remuneration may be paid to members performing additional functions e.g. spending time on additional responsibilities as chairman or vice chairman, performing secretarial function for the board or undertaking research on the instructions of the board, according to a time based formula.

Terms of reference for appointment

12. Terms of reference of the appointment shall be defined by the appointing authority in line with the requirements of this standard duly considering the laws and regulations in force, which shall be ratified by the board in its first meeting after appointment / reappointment.
13. An appointment letter shall be issued by the appointing authority to address each member in person with engagement terms and terms of reference. This shall include a reference to the time commitment expected from each member with regard to the tasks of the board.

Tenure of the board's term and re-appointments

14. The term of the board is recommended to be between 3 to 5 years.
15. There shall be a rotation policy carefully devised by the appointing authority which shall consider, among others, maintaining independence, continuity of the board to a reasonable extent⁴ and improved level of governance and self-evaluation⁵ of the board, as well as, determining a suitable cooling-off period for re-appointment.

Composition and selection

Composition

16. The CSB shall consist of a sufficient number of members to provide diversified exposure to the board and to enable it to discharge its functions and duties efficiently and effectively. It shall include relevant experts to allow the board to have access to accurate and relevant professional advice whenever needed.
17. The board shall comprise of Shari'ah scholar members and expert members.
18. The recommended minimum number of total members of the board, based on market factors, is:
 - a. In case of a board catering to a single industry segment e.g. banking or insurance – minimum 5 members; and
 - b. In case of a board catering to multiple industry segments – minimum 7 members.
19. The majority of the members shall be the Shari'ah scholar members selected from amongst recognized Shari'ah scholars within or outside the country. They shall meet the fit and proper criteria applicable to Shari'ah scholar members.
20. The chairman, as well as, vice chairman (or chairmen) (if any) shall be elected from amongst the Shari'ah scholar members, by themselves.
21. Expert members shall inter-alia include experts in areas of accounting, finance, law, banking and economics, among others, both from the academia and the industry / profession. They shall have a

⁴ In other words, all the board members shall not retire / rotate at the same time so that the board functioning may have adequate level of continuity.

⁵ This includes rotation of such members whose performance, attendance or contribution is below par.

demonstrable commitment to the cause, and considerable level of understanding of the functions of Islamic banking and finance by virtue of relevant education, research or practical experience. They shall meet the fit and proper criteria applicable to expert members.

22. For any decision to be taken there shall be a proper quorum in which a majority of Shari'ah scholars consistent with their proportion in the composition of the CSB shall be present. However, in case of a Shari'ah ruling (which is a Shari'ah matter in view of the chairman), the view of the majority of Shari'ah scholar members shall prevail.
23. Subject to the requirements of paragraph 19, the appointing authority shall ensure that a balance is struck between Shari'ah scholar members and expert members in the composition of the board.

Diversity

24. The composition of a CSB should preferably reflect diversity, duly considering Shari'ah values, including, but not limited to, the following aspects:
 - a. representation from within the country / jurisdiction and globally acclaimed scholars / experts;
 - b. representation from different schools of thought in the country / jurisdiction; and
 - c. representation of different fields of expertise, knowledge and experience relevant to Islamic finance industry.

Removal and termination

25. The appointing authority may decide to remove / terminate engagement of a member of the board, after providing him adequate opportunity of being heard, if, and only if,:
 - a. a professional misconduct is proven against such member or if he is in breach of a principal term of reference; or
 - b. the member has not attended the minimum number of meetings during the year without a legitimate reason.

Functions of the CSB

26. The CSBs shall focus on harmony of Islamic banking and finance practices:
 - a. globally, through adoption of AAOIFI Shari'ah standards and / or other widely accepted Shari'ah standards, which do not conflict with AAOIFI Shari'ah standards;
 - b. locally, by providing principles, rulings, guidelines and other functional support as prescribed in this standard, primarily considering global practices and having regard to the local context.

27. This standard encourages that all CSBs should primarily have advisory function coupled with a limited level of supervisory authority as set out in paragraph 33. It is expected that regulators will develop an escalation mechanism for the matters of significance to be brought before the CSB.
28. The functions of the board may be divided in three broad categories which are:
- advisory and Fatwa;
 - regulations; and
 - oversight and limited supervision.

Fatwas

29. Fatwas (rulings) function of a CSB is the function of the appointing authority through the following:
- Issuing Fatwas and decisions in relation to its area of work;
 - approving Sukuk structures and documentation for sovereign and government Sukuk (or other similar Instruments), as referred to it by the appointing authority; and / or
 - validating product structures and their documentation, services and tools offered by IFIs, as referred to it by the appointing authority / regulator.

Advisory

30. Advisory function of a CSB is the function of supporting the regulator through the following:
- providing advisory on specific issues and matters relating to Islamic banking and finance, as referred to it by the appointing authority / regulator (e.g. defining broad principles for profit and loss calculation and distribution among investment accountholders);
 - subject to its approval / acceptance, providing Shari'ah expertise to the courts of law, when requisitioned, for any issues related to Islamic finance and banking; and
 - providing advisory to the regulator to resolve and settle complaints and issues raised by customers of IFIs or disputes amongst IFIs with regard to Shari'ah matters.
31. Most of the functions of a CSB related to advisory and Fatwa are passive (reactive) in nature i.e. the board provides Fatwa or advice or guidance only when asked for it by the appointing authority or the regulator. The board shall be proactive in nature when, and only when, the following conditions are met:
- It concludes that a major non-compliance of Shari'ah principles and rules has occurred, which has not been taken care of by the appointing authority;
 - It concludes that a perception in the market exists that such non-compliance is in the knowledge of, or with the due approval of, the board; and

- c. It concludes that unless a proactive step is taken with respect to such matter, the larger stakeholders' interest will be compromised.

Regulations

- 32. Regulations related function of a CSB is of an advisory nature, supporting the function of the appointing authority through the following:
 - a. adopting Shari'ah standards for the jurisdiction;
 - b. providing Shari'ah consultation to the regulators, government and relevant authorities with regard to various laws, rules and regulations;
 - c. reviewing and approving regulatory body's directives related to Islamic finance to ensure Shari'ah compliance;
 - d. approving a code of ethics for IFIs (e.g. by adopting AAOIFI code of ethics); and
 - e. coordinating with other national Shari'ah boards, central Shari'ah boards and relevant bodies to establish uniform best practices in the areas relating to Islamic banking and finance.

Oversight and limited supervision

- 33. Oversight and supervision related functions of CSBs are meant for supporting the appointing authority through the following:
 - a. settling any difference of opinion or disagreement between the SSBs of IFIs and the regulator;
 - b. supervising and guiding the Shari'ah compliance inspection and surveillance function of the regulator and providing Shari'ah views on the key issues brought before it; and
 - c. Holding periodic meetings with SSBs of IFIs on a need basis to discuss Fiqh issues and their solutions with regard to key Islamic banking and finance matters, specifically with reference to the direction of product innovation in the jurisdiction.

Other key functional provisions

Decisions

- 34. The decisions of the board shall be by majority of votes at a meeting duly constituted with the requisite quorum.
- 35. The CSB shall take into account both the letter and spirit of Shari'ah when issuing its fatwas. No decision shall be taken which is not in line with the spirit of Shari'ah as determined by Maqasid-e-Shari'ah.
- 36. Dissenting opinions shall be documented and attached with the majority decisions.

37. The decisions of the board relating to advisory and Fatwa, along with the basis of conclusion (Fiqh or other), shall be compiled and published on a regular basis provided such publication and disclosure does not violate any law, rules, regulations, or the policy of the regulator in this regard, in the country of jurisdiction⁸.

Secretariat

38. In order to facilitate the work and functions of the board, a secretary to the board shall be appointed either from amongst the members of the board, or an officer of the appointing authority, or an individual specifically employed for this purpose, subject to the approval of the board.
39. The secretary shall:
- maintain the records of the board including the record of minutes and resolutions / rulings;
 - be responsible for all communication with the appointing authority / regulator and other parties; and
 - supervise and coordinate the research function as needed to support the functioning of the board.
40. The secretary shall be provided with, by the appointing authority, the resources and team as may be requested for the purpose by the board.

Self-evaluation and reporting

41. The board shall conduct self-evaluation exercises from time to time, but not later than on an annual basis. For this purpose the board shall develop self-evaluation criteria for individual members and for the board collectively, and shall agree the same with the appointing authority beforehand. This is to ensure that the board is able to discharge its functions and responsibilities over the period of assessment.
42. A report of annual performance of the board, along with self-evaluation, shall be prepared and submitted by the board to the appointing authority / regulator.
43. The board and the appointing authority / regulator with mutual coordination shall agree on all or part of the report to be made public, in order to enhance stakeholder confidence on the system.

Confidentiality

44. Subject to the requirements of paragraph 37, the board and its members shall maintain confidentiality of information and documents at all times, except what is already in public domain or when information or documents are requisitioned by a court of competent jurisdiction or any proceedings of regulatory nature in due process of law. For this purpose, detailed guidelines may be provided by the appointing authority, or in absence of the same, the board may itself develop such guidelines.

⁸ This shall include policy with regard to the dissenting opinions.

Responsibilities of the appointing authority / regulator

45. In addition to the responsibilities assigned under different provisions of this standard, an appointing authority / regulator shall be responsible:
- a. to provide full operational independence to the board;
 - b. to develop and implement a continuing professional development (CPD) program for the members of the CSB;
 - c. to cause to develop a succession planning mechanism for the CSB; and
 - d. to provide all required resources including adequate budget, access to information and human resources, as may be deemed necessary by the board for proper discharge of its duties.

Fit and proper criteria

46. The appointing authority shall develop separate fit and proper criteria for the Shari'ah scholar members as well as the expert members of the board.
47. The selection and appointment of the members of CSB shall be carried out in accordance with the fit and proper criteria, with due care and maintaining high level of independence and merit.
48. The broad parameters for setting up the fit and proper criteria for both types of members are provided below.

Shari'ah scholar members

49. The fit and proper criteria for Shari'ah scholar members shall be developed considering the following key parameters:
- a. well-versed in Fiqh and Usul al Fiqh;
 - b. suitable academic qualification – traditional or contemporary (or a combination thereof);
 - c. suitable practical experience (preferably 10 but not less than 5 years) in the area of Fiqh al-Muamalat;
 - d. suitable practical experience, or research and academic experience, in the fields of Islamic finance, economics, banking, law, business and other relevant fields;
 - e. good command of Arabic and common business language(s) in the jurisdiction;
 - f. suitable understanding of economics, law, banking, finance and related fields as per scope of the board including insurance and capital markets;
 - g. demonstrable interest in and commitment to the field of Islamic banking and finance;

- h. good standing, reputation and market recognition;
- i. ability to devote sufficient time; and
- j. Independent and free from conflict of interest.

Expert members

50. The fit and proper criteria for expert members shall be developed considering the following key parameters:
- a. basic understanding of Shari'ah principles, and preferably some degree of understanding of Fiqh al-Muamalat as applicable to Islamic banking and finance;
 - b. well-versed and having a high standing in their respective field of knowledge and experience;
 - c. suitable academic and / or professional qualification;
 - d. suitable practical experience, or research, or academic experience in the relevant technical fields;
 - e. demonstrable interest and commitment to the field of Islamic banking and finance;
 - f. good standing, reputation and market recognition;
 - g. ability to devote sufficient time; and
 - h. Independent and free from conflict of interest.

Independence

Considerations for selection and appointment

51. The following independence considerations shall be maintained while selecting and appointing the board members:
- a. the board shall not include directors, officers or staff members of the appointing authority or the relevant regulator (if different than the appointing authority);
 - b. the board shall not include directors, significant shareholders⁷, officers or staff members of an IFI which is subject to supervision of the appointing authority or relevant regulator;
 - c. on the first time formation of the board, the Shari'ah scholar members of the board shall not include more than one-third members from those who work as Shari'ah advisors, Shari'ah board members or in similar capacities with an IFI or are a significant shareholder of an IFI,

⁷ To be defined e.g. having 5% of shareholding or so.

which is subject to supervision of the appointing authority or relevant regulator, whereas, on subsequent formation of the board, no such member shall be included in the board; and

- d. on the first time formation of the board, the expert members of the board shall not include more than one-third members from those who have significant financial dependence on either the appointing authority or the relevant regulator (if different than the appointing authority) or on an IFI or are a significant shareholder of an IFI which is subject to supervision of the appointing authority or relevant regulator, whereas, on subsequent formation of the board, no such member shall be included in the board.

Considerations for functioning

52. Central Shari'ah board shall develop or adopt its own Independence guidelines and code of conduct.
53. This shall focus on an understanding that the board is independent in nature and deals with the appointing authority, any relevant regulator and the industry players on an independent basis. The board shall not be a part of the reporting line or internal structure of the appointing authority.
54. The individual members shall always disclose their conflict of interest whether permanent or temporary in nature and the same shall be dealt with in a professional manner in line with the code of conduct developed.

Effective date

55. This standard shall be effective from 1 January 2018.

Transitional provision

56. In respect of matters prescribed by this standard related to setting up terms of reference and appointment of members, constitution and reconstitution of CSBs, the same shall be applicable on any such event occurring on or after the effective date.

APPENDICES

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Governance and Ethics Board's meeting No. 5 held on 22-23 Dhul-Qa'dah 1438H corresponding to 15-16 August 2017 and was duly approved and adopted.

Members of the Board

1. Dr. Ishrat Husain – Chairman
2. Sh. Esam Ishaq – Deputy Chairman
3. Dr. Abdulbari Mashal
4. Dr. Abdurrahman Habil
5. Mr. Ahmad Mishari Al Faris
6. Mr. Ebrahim Sidat
7. Mr. Fawad Lalque
8. Dr. Gaffar Abdalla Ahmed Khalid
9. Dr. Hussein Said Salfan
10. Mr. Mehmet Sirin
11. Mr. Mohammad Farrukh Raza
12. Dr. Mohammad Mahdy Mohammad Radwan
13. Mr. Kazi Mohammad Mortuza Ali
14. Mr. Sohaib Umar
15. Dr. Walid Hegazy

Reservation

The standard was approved unanimously.

Working group and team

1. Mr. Ebrahim Sidat – Chairman
2. Mr. Mohammad Farrukh Raza
3. Dr. Hurriyah El Islamy
4. Dr. Walid Hegazy
5. Mr. Omar Mustafa Ansari (AADIFI)
6. Mr. Mohammad Majd Bakir (AADIFI)
7. Ms. Zahra Jassim AlSarafi (AADIFI)
8. Mr. Syed Siddiq Ahmed (AADIFI)

Appendix B: Basis of conclusion

The need for a central Shari'ah board (CSB)

- BC1 The board discussed the standard's rationale and agreed that the need for a centralized approach with respect to Shari'ah boards stems broadly from the need for a solid governance structure at the level of the IFIs and their regulators. Regulators and government authorities are no longer dependent solely on Shari'ah supervisory boards (SSBs) in individual IFIs to assess and find out whether their products and operations are in compliance with Shari'ah.
- BC2 The board agreed that consistency in products and services offered by the IFIs and the promotion of standardized practices will enhance the credibility of the Islamic finance industry at large, and will also boost the confidence of customers and investors in the IFIs and their products and offerings.
- BC3 To induce individuals to invest their savings with Islamic banks and financial institutions, it is essential that trust is developed and nurtured between IFIs and such individuals to realize their objectives. In the absence of trust in the ability and / or willingness of IFIs to do so efficiently and in full compliance with Shari'ah, the public may refrain from dealing with them. One of the ways to build this trust is to remove conflicting rulings and practices at the level of IFIs. The Quran highlights the importance of delivering on duties, including trust (Amanah) by those who shoulder them:
- "Surely, Allah commands you to deliver trusts to those entitled to them, and that, when you judge between people, judge with justice." [4:58].
- BC4 The board considered that adoption of AAOIFI standards (particularly Shari'ah standards in this context) worldwide helps in the industry harmonization. However, complete harmonization of structures may neither be desirable nor achievable since different countries have different structures in accordance with their constitutional and legislative frameworks and social contexts. Imposing a specific structure may compromise the uniqueness of those structures and cause complications in some jurisdictions. This increases the need for existence of CSBs.

The need for individual Shari'ah supervisory boards (SSBs) for IFIs

- BC5 After due discussion, the board agreed that the existence of the CSB does not preclude the diversity of opinions. The board also considered the fact that the supervisory functions of the individual IFI shall continue to rest with the respective SSBs. Accordingly, the board decided that in order to allow more flexibility for different models of Shari'ah governance, AAOIFI shall not propose to eliminate individual SSBs at institution level which are dealt with under GSIFI 1, 2 and 5 in detail.

The formation of a nomination committee

- BC6 The standard suggests that the appointing authority of a CSB should form a nomination committee for the nomination of suitable candidates. This is generally believed to be good governance practice, also suggested during public hearings. The board concluded after deliberations that the inclusion of a nomination committee in the nomination process will increase transparency and enhance confidence in the CSBs.

Re-appointments

- BC7 The standard stipulates that the appointing authority shall have a rotation policy that considers determining a suitable cooling-off period for the re-appointment of CSB members. Due to concerns regarding the limited resources in some countries, the determination of a suitable cooling-off period was left to the discretion of the appointing authority.

Engagement of experts

- BC8 The standard stipulates that expert members should be part of the CSB alongside the Shari'ah scholars. The Board deliberated the matter of experts' involvement and concluded that they are a vital component of a CSB, as they provide technical expertise and experience with respect to issues and matters with practical implications. The Shari'ah basis for seeking aid from persons who are not Shari'ah scholars by profession stems from the Quranic verse:

"One of the two women said, "Dear father, hire him: the best man you can hire is someone who is strong, trustworthy". [28:26].

- BC9 The board disagreed with some proposals calling for Shari'ah scholar members appointing the expert members, as it would create disparity amongst them. Additionally, after due deliberations, the Board removed the clause in the exposure draft preventing expert members from having voting rights, for the same reasons, as well as, for ensuring proper input as needed. The board agreed to divide the voting rights into two categories. For Shari'ah rulings, the voting rights will be reserved only for the scholar members, while for all other matters all members shall enjoy equal voting rights.

Functions of the CSB

- BC10 The standard prescribes the broad functions of the CSB. Amongst the listed functions are advisory and Fatwa. The board members discussed the functions and concluded that in essence, the very existence of the CSB revolves around rendering advice / Fatwa (on products, practices, operations, and so on) and limited supervision, in a manner that removes confusion resulting from conflicting rulings, practices and products of Islamic banking and finance. The board agreed that giving full supervisory rights to the CSB may cause complications in many jurisdictions and the objectives of instating a CSB will be best met in giving it an advisory role with limited supervision.

Selection criteria

- BC11 The standard stipulates the fit and proper criteria for both; Shari'ah scholars and expert members. In essence, Shari'ah does not differentiate between individuals, whether on the basis of their race, color, descent, gender, etc. Prophet Mohammad (peace be upon him) has said: "There is no merit for an Arab over non-Arab (and vice versa), nor for white over black, except for righteousness."⁸

⁸ Recorded by Al-Baihaqi and authenticated by Al-Albani.

Number of CSB meetings

- BC12 The board decided to leave the minimum number of meetings to each CSB based on the unique circumstances of the jurisdiction.

Removal and termination

- BC13 The standard stipulates that the appointing authority may decide to remove / terminate the engagement of a member of the CSB if a professional misconduct is proven against such member. The Board deliberated at length as to whether the term "professional misconduct" should be clearly defined in the standard, and decided against it because it is a legal term for which uniform definition may not be suitable to all jurisdictions and in all circumstances.

Reporting and disclosure

- BC14 After due deliberations, it was agreed that a report of annual performance of the CSB, along with self-evaluation, shall be prepared and submitted to the appointing authority. This is necessary for the purpose of transparency and in line with good governance practices.
- BC15 The matter of making the report public as well as disclosing the members' remuneration was discussed by the board and during the public hearings. It was decided to make publishing the report and disclosing the remuneration mandatory to enhance the transparency and market confidence.

Independence

- BC16 The matter of independence of CSB and its members was discussed extensively by the board and in the public hearings held. The board decided that conflict of interest shall be avoided at all times and hence the CSB shall not include members from the appointing authority or an IFI supervised by the appointing authority. Considering the resource constraints in some jurisdictions, and to facilitate the first time formation of the CSB, exemptions have been granted as per clauses (c) and (d) of paragraph 51.

Appendix C: Brief history of the preparation of the standard

- H1 The newly formed AAOIFI Governance and Ethics Board (AGEB / the board) held its first meeting on 21 Jumada II 1437H, corresponding to 30 March 2016 in the Kingdom of Bahrain. In this meeting overall approach and plan of the standard was discussed and approved.
- H2 On the 28-29 Dhul-Hijjah 1437H, corresponding to 30 September and 1 October 2016, the second board meeting was held in the Kingdom of Bahrain. The preliminary study of the project was discussed and the members emphasized the need for harmonization. Key points of discussion were the definition, functions, enforceability and nature whether advisory or supervisory.
- H3 The first working group meeting was held on 22 Safar 1438H, corresponding to 22 November 2016 via video conferencing. The members discussed the draft standard as well as the contents of the survey and agreed on the name of the standard.
- H4 The third meeting of AGEB was held on the 22-23 Rabi' I 1438H, corresponding to 21-22 December 2016, in the Kingdom of Bahrain. The board reviewed in detail the content of the standard and agreed on various changes to be incorporated and approved issuance of the same as exposure draft for obtaining industry comments at large.
- H5 Public hearings on the exposure draft of the standard were held in the Kingdom of Bahrain, Pakistan, United Arab Emirates and Turkey between the months of Rajab to Ramadan 1438H corresponding to April to June 2017.
- H6 The second working group meeting was held on 8 Dhul-Qa'dah 1438H corresponding to 1 August 2017, through video conferencing. The comments of the public hearings as well as the comments received on the exposure drafts from industry at large were discussed and the necessary changes were recommended in light of the same. Comments and views of the Shari'ah Board's Committee for Review of Accounting and Governance Standards were also obtained.
- H7 The fifth meeting of the Board was held on 22-23 Dhul-Qa'dah 1438H, corresponding to the 15-16 August 2017 in the Kingdom of Bahrain. The Board in this meeting considered all the comments received on the exposure draft from experts and the recommendations of the working group.
- H8 The sixth meeting of AGEB was held on the 17 -18 Rabi' I 1439H, corresponding to 6 - 7 December 2017 in Bahrain. The standard was approved for publishing in the meeting.
- H9 The twelfth meeting of AGEB was held on 7-8 Dhul-Qa'dah 1440H, corresponding to 10-11 July 2019 in Karachi, Pakistan. The Board approved the insertion of the basis of conclusion as Appendix B and the "brief history of the preparation of the standard" to be reassigned as Appendix C.

Governance Standard for Islamic Financial Institutions No. 9

Shari'ah Compliance Function

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Governance Standard for Islamic Financial Institutions (GSIFI) No. 9 "Shari'ah Compliance Function" is set out in paragraphs 1 to 71.

Preface

- PR1 AAOIFI's strategy of developing governance standards is primarily focused towards addressing the additional governance needs of Islamic financial institutions (IFIs), namely the matters related to Shari'ah compliance and those related to the additional fiduciary responsibilities. While developing the revised strategy and medium-term plan of the AAOIFI Governance and Ethics Board (the Board) it was decided to consider the efforts for strengthening and standardizing the Shari'ah compliance function for the IFIs on a priority basis.
- PR2 Shari'ah compliance function is one of the core organs of governance for an IFI. While a number of organs of governance related to Shari'ah compliance such as the Shari'ah Supervisory Board, internal Shari'ah review / audit, external Shari'ah audit, etc. are supposed to be independent of the management, the Shari'ah compliance function remains the key responsibility of the management of an IFI. Having an AAOIFI standard in this area will facilitate uniformity of practices across jurisdictions and also among the IFIs within the same jurisdiction. It is also likely to lead the management towards accepting responsibility for Shari'ah compliance.
- PR3 The aim of this standard is to provide a framework for establishing and managing a robust Shari'ah compliance function within IFIs and for standardizing its practices across the globe. It also highlights key areas that are necessary for developing a Shari'ah compliance function and assists in framing a risk-based approach to Shari'ah compliance considering key stakeholders.

Introduction

Overview

- IN1 The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to set harmonized principles for Islamic financial institutions (IFIs) on the concept and role of Shari'ah compliance as a function and department within the IFI with an objective to standardize global practices in this area.
- IN2 The standard sets out the requirements for functional and departmental operations to ensure compliance with Shari'ah. Shari'ah compliance is viewed as both a function within IFIs that constitutes part of their governance and control set-up, and as a department which is designed to achieve the broader goal of Shari'ah compliance as a management responsibility. The standard prescribes, inter alia, the key considerations for instituting the Shari'ah compliance function as well as a set of compliance techniques and tools. It sets out the roles and responsibilities of the Shari'ah compliance department. It discusses the reporting line and respective responsibilities, including the responsibilities of various organs of governance towards Shari'ah compliance.

Rationale of this standard

- IN3 While the Shari'ah compliance function may be rightly termed as the backbone of an IFI, there exist observable inconsistencies in the approach, responsibilities, modus operandi, reporting lines and the control structure in the processes amongst IFIs not only globally but also within the same jurisdiction. Additionally, the different governance frameworks are also observed to have notable inconsistencies with each other. The decision to develop a GSIFI in this area was taken so that the practices may be harmonized, standardized and improved within the industry.
- IN4 This standard aims to establish an advanced degree of harmonization and convergence in the area of Shari'ah compliance within IFIs. It envisions this function as an integral part of an IFI's governance and control structure, and elaborates on specific key objectives of the IFI with regards to its compliance with Shari'ah principles and rules. Standardization of practices in this area will allow IFIs and their Shari'ah compliance functions / departments to have clear-cut guidelines designed to help them direct their strategic mandates and better oversee the obligations related to accountability and the financial reporting process, among others.
- IN5 Establishing proper practices in the area of Shari'ah compliance is expected to allow consistency in the overseeing process undertaken by the IFIs and the promotion of standardized practices. This will, in turn, increase the credibility of Shari'ah compliance and boost the confidence of the broader stakeholders of IFIs and the industry.

Governance Standard for Islamic Financial Institutions No. 9

Shari'ah Compliance Function

Objective of the Standard

1. The objective of this standard is to set out a comprehensive framework for Shari'ah compliance function for the IFIs comprising of the following:
 - a. defining the role of Shari'ah compliance as part of governance, controls and practices of the IFIs; and
 - b. the establishment of a Shari'ah compliance department within IFIs and its key functions, responsibilities and structure.

Scope

2. This standard sets out the requirements for establishing and operating the Shari'ah compliance function within the IFIs including:
 - a. the function (being a phenomenon) as an integrated part of the IFI's strategy, processes, people and technology to ensure compliance with Shari'ah principles and rules in all relevant functions; and
 - b. the establishment, scope and operations of a Shari'ah compliance department (SCD) to achieve the overall objective of Shari'ah compliance and to lead the integrated efforts for the same as a management's responsibility.

Definitions

3. For the purpose of clarity and interpretation of this standard, the following short definitions are relevant:
 - a. external Shari'ah audit – is an independent assurance engagement to provide reasonable assurance that an IFI complies with the Shari'ah principles and rules applicable to its financial arrangements, contracts and transactions during a specific period based on a specific set of Shari'ah principles and rules contained in the criteria (for Shari'ah compliance);
 - b. internal controls – for the purpose of this standard shall be considered the systems and processes established by the IFI, duly approved by those charged with governance and senior management, for assuring achievement of the IFI's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies, particularly, the Shari'ah principles and rules (which shall prevail in case of conflict);

- c. internal Shari'ah review / audit function – is a function as a part of the governance organs of an IFI with a primary objective to ensure that the management of an IFI discharges its responsibilities in relation to the implementation of the Shari'ah principles and rules²;
- d. Islamic Financial Institutions (IFIs) – are financial institutions that operate in line with Shari'ah principles and rules performing banking, insurance / Takaful, capital markets and similar activities and include the stand-alone branches, divisions and windows of conventional financial institutions that offer products and services in line with Shari'ah principles and rules;
- e. management – for the purpose of this standard is an organ, or combination of organs, that manages an IFI's operations and resources (including human resources). Management's functions include, inter alia, risk assessment, objective setting, planning, organizing, staffing, leading or directing, and controlling an IFI. Management includes such directors and employees who are involved in the above-mentioned functions, irrespective of their designations. It may also refer to departments and / or the whole organizational management collectively;
- f. self-review threat – for the purpose of this standard is the situation in which a reviewer or decision maker or arbiter reviews and provides his own opinion, view or decision in respect of a matter in which he was responsible for, or part of the team responsible for, the work that has been performed earlier in respect of such matter;
- g. senior management – for the purpose of this standard represents collectively the group of most senior members of the management who are responsible for overall decision making for the IFI, individually, or collectively;
- h. Shari'ah compliance – is the mechanism of ensuring compliance of the IFI's financial arrangements, contracts and transactions with Shari'ah principles and rules;
- i. Shari'ah Compliance Department (SCD) – for the purpose of this standard means a department (and includes a division, team, section or unit) entrusted with the responsibilities of Shari'ah compliance in accordance with this standard;
- j. Shari'ah compliance function – means as defined in paragraph 4;
- k. Shari'ah non-compliance risk – is defined as the risk that arises from an IFI's failure to comply with Shari'ah principles and rules (see "I" below). This is a sub-set of operational risks and may in certain circumstances result in legal, financial or reputational risks;
- l. Shari'ah principles and rules – comprise "the Shari'ah principles and rules defined by the following hierarchy, as appropriate:

² See GSIFI No. 3 "Internal Shari'ah Review". In certain jurisdictions this function is called "internal Shari'ah audit" according to their respective governance frameworks. Internal Shari'ah review shall not be confused with the Shari'ah compliance function as referred to as Shari'ah review in certain jurisdictions as it is a management function and is not independent of the management.

- i. the Shari'ah standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI);
 - ii. the regulations issued by the respective jurisdiction's regulator insofar as these entail the regulatory Shari'ah requirements;
 - iii. the rulings of the Central Shari'ah Board for the respective jurisdiction (if there is one);
 - iv. the requirements of the applicable Financial Accounting Standards as issued by AAOIFI insofar as these entail Shari'ah related requirements; and
 - v. the approvals and rulings given by the Shari'ah Supervisory Board of the IFI."
- m. Shari'ah review – "is an examination of the extent of an IFI's compliance, in all its activities, with the Shari'ah"². It is the responsibility of the SSB of the IFI to conduct Shari'ah review;
 - n. Shari'ah Supervisory Board (SSB) – is an independent body of specialized jurists in Fiqh al-Muamalat (Islamic commercial jurisprudence). The SSB may also include a member(s) other than those specialized in Fiqh al-Muamalat, called expert member(s), who is (are) expert(s) in areas such as banking, finance, economics, accounting, law, etc. and have knowledge of Fiqh al-Muamalat. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of an IFI in order to ensure that it is in compliance with Shari'ah principles and rules. The Fatwas and rulings of the SSB are binding on the IFI; and
 - o. those charged with governance – in line with the IESBA pronouncement, are "the person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager"³.

Overall Shari'ah compliance function: responsibility and key considerations

- 4. Shari'ah compliance function is an integral part of an IFI's governance and control structure, catering to certain crucial objectives of the IFI related to its compliance with Shari'ah principles and rules.

Primary responsibility

- 5. Management of an IFI shall ensure that a robust and effective Shari'ah compliance function exists in the IFI and remains in operation.
- 6. Those charged with governance of an IFI shall ensure that the management discharges its responsibilities with regard to the existence and continuous operations of the Shari'ah compliance

² GSIFI No. 2 "Shari'ah Review"

³ International Ethics Standard Board for Accountants (IESBA) pronouncement on the definition of those charged with governance.

function in the IFI in line with paragraph 5 and other requirements of this standard, and the other organs of Shari'ah governance in line with respective GSIFs.

7. In line with paragraphs 5 and 6, the management and those charged with governance are collectively responsible and accountable for Shari'ah compliance of the IFI in their respective area of responsibility. It is with their actions, behavior and commitment that the IFI can develop and nurture a culture of Shari'ah compliance.
8. The management and those charged with governance, in their respective ambit of responsibilities, shall encourage and actively perform effective oversight on the IFI's compliance with Shari'ah principles and rules. They shall respectively establish, and cause to establish, proper reporting and management information systems (IS or MIS) protocols to manage and escalate matters of significance.
9. The management shall ensure that all relevant documentation with respect to Shari'ah principles and rules, including Fatwas, policies, procedures, workflows, approved products, legal agreements and contracts, marketing practices, etc. are available to responsible staff for their guidance and compliance.
10. The senior management shall assign clear and detailed responsibilities to departmental heads for the implementation of Shari'ah principles and rules.

Shari'ah compliance and organizational commitment

11. Shari'ah compliance function requires collective effort, action and commitment of those charged with governance, management, employees and SSB. As a result, an organizational culture should emerge that promotes and enhances the IFI's compliance with Shari'ah with respect to its core (e.g. IFI's financial arrangements, contracts and transactions) but also with regard to the overall values, culture and environment being in line with the letter and spirit of Shari'ah.
12. The requisite culture of Shari'ah compliance mandates actionable steps, reporting, follow ups, rewards and penalization for its establishment and maintenance. Through alignment of various incentives, rewards, corrective and punitive actions each function, department, employee and other relevant stakeholders shall be motivated and directed to perform in accordance with the Shari'ah compliance guidelines, regulations, policies and procedures.

Preventive and detective controls approaches

13. Shari'ah governance and control structure encompasses both ex-ante and ex-post work of ascertaining adherence to Shari'ah with regard to IFI's operations. The Shari'ah compliance function is a crucial part of preventive controls and is mainly concerned with the ex-ante work.
14. Certain governance and control organs such as various types of audit and review, including internal Shari'ah review / audit and external Shari'ah audit are concerned with the ex-post work and hence are primarily detective controls.

Shari'ah compliance function and department

15. Shari'ah compliance is the responsibility of each and every individual within an IFI including management and those charged with governance. The function of Shari'ah compliance, therefore, needs to be integrated with each and every organ, and each and every function of the IFI. Accordingly, the Shari'ah compliance function is a broader term which includes the mechanism of ensuring Shari'ah compliance, the related controls and processes and the establishment of the Shari'ah Compliance Department (SCD).

Responsibilities of SSB

16. SSB shall keep an oversight of the overall Shari'ah compliance function and shall provide its input in this regard. It is necessary that those charged with governance interact frequently with the SSB to obtain its views on the overall state of Shari'ah compliance within the IFI.

Key considerations for instituting the Shari'ah compliance function

17. The nature and culture of an IFI will necessarily influence its Shari'ah compliance function. The factors affecting the Shari'ah compliance function include the type of institution (banks, Takaful operators, capital market institutions, others), organizational objectives, strategies, product offerings, size, level of maturity, etc. It is also necessary to understand the regulatory environment and management style and controls that are practiced in IFIs.
18. Shari'ah compliance function shall be instituted after considering the needs and expectations of various stakeholders such as owners, those charged with governance, customers, regulators, investors, management and SSB. Any function that ignores the stakeholders may remain deficient in meeting its core objectives and expose an IFI to significant risks of Shari'ah non-compliance.
19. The scope of the Shari'ah compliance function shall be clearly defined and shall also be communicated to the relevant staff. Clarity and communication of the scope are desired to avoid conflict and ensure a harmonious working relationship.
20. IFIs shall strive to identify compliance obligations for each department and key person(s) within that department who are responsible for ensuring Shari'ah compliance during the course of discharging their duties.

Shari'ah compliance function: controls and processes

Objectives and scope of Shari'ah compliance function

21. Shari'ah compliance function shall be developed in line with the requirements of this standard along with other GSIFs which collectively take a stakeholder approach of governance with due consideration to Shari'ah compliance and additional fiduciary responsibilities attached to IFIs.

22. The following chart developed in line with the five key pillars of the COSO integrated framework⁴ identifies the broad objectives and recommends an overall approach towards the Shari'ah compliance control environment.

⁴ Committee Of Sponsoring Organizations of the Treadway Commission

Control environment

- Setting the tone at the top - those charged with governance and senior management to demonstrate clear commitment towards Shari'ah compliance.
- Setting up the governance organs including those specific to IFIs with regard to Shari'ah compliance.
- Setting up foundations for Shari'ah compliance control consciousness.
- Control environment factors to include the values, operating style and culture, delegation of authority, technology, people, processes, etc.
- Setting up SCD to achieve the overall objective of strengthening Shari'ah compliance controls.

Risk assessment

- Risks related to Shari'ah non-compliance to be assessed, and different departments and business units to integrate their efforts for this purpose.
- Risk mitigation strategies to be developed for the identified risks, through coordinated efforts.

Control activities

- Integration of Shari'ah compliance function with the overall functions, controls and processes of the IFI.
- Definition of specific control activities - particularly the preventive controls under this standard and a mechanism of implementation of the same.
- Detective controls to be established, partially in line with this standard; other governance organs in line with respective GSIFs to be implemented.

Information and communication

- Communication of the Shari'ah compliance considerations.
- Communication of manuals, policies, procedures, standardized documentation and Fatwas as necessary.
- Information systems and technology to play their role.

Monitoring

- Monitoring mechanism, review requirements and detective controls under this standard.
- Detective and monitoring organs and controls under the scope of various GSIFs including Shari'ah review, internal Shari'ah audit, external Shari'ah audit and consideration of compliance with Shari'ah principles and rules by the external auditor.

Policies and procedures: manuals and Standard Operating Procedures (SOPs)

23. Those charged with governance and management, in their respective capacities as supervisor and executor, are responsible for introducing and approving a comprehensive Shari'ah compliance policy.
24. The risks, mitigation controls and related processes shall be integrated with the organization-wide manuals and SOPs, standardized documentation and other communication enabling compliance at the respective levels. Such manuals, SOPs and other documentation shall be subject to review of different organs of Shari'ah governance in their respective capacities, including but not limited to the SSB and SCD.

Risk assessment and monitoring of Shari'ah non-compliance

25. As a general principle IFIs shall adopt objective and risk-based monitoring of material risks relating to Shari'ah non-compliance. The risk management department of the IFI in close coordination with SCD shall document such risks and shall develop a robust mechanism of risk reporting and management. Such risk shall be considered as a significant sub-set of operational risk and shall be given adequate coverage in internal and regulatory risk reporting, including for the purpose of computation of regulatory capital requirements.
26. Those charged with governance and management, with due involvement of the risk management department and SCD, shall strive to develop a deeper understanding of risks that are typically faced by IFIs and devise or approve Shari'ah compliant strategies to mitigate such risks. They shall be fully cognizant of the applicable Shari'ah non-compliance risks relating to the IFI's business, their potential financial impact (e.g. in the form of forfeiture of Shari'ah non-compliant income and / or regulatory penalties) and/or the loss of reputation.

Communication and knowledge resources

27. IFIs shall establish a clear and transparent system of communication of risks, controls, processes and compliance considerations within all levels of management and employees as related to their areas of functioning.
28. IFIs shall develop clear protocols for internal communication with regard to Shari'ah compliance, including interaction with the organs of Shari'ah governance (such as SSB and SCD). These shall include, but not be limited to, types of documents that are required to be shared, level of detail, frequency of communication exchange on transactions and other documents, permanent access level to IT system(s), mode of communication and authorities to communicate between SCD and other departments, etc.
29. IFIs shall also develop a protocol regarding external communication related to Shari'ah compliance with various stakeholders such as regulators, customers and investors. Such a protocol shall define the nature of information, level of detail and review process with relevant business heads before disseminating such information.

Integration of Shari'ah compliance with people (human resources)

Hiring

30. The management shall ensure (where necessary, with due consultation of SCD) that all employees, independent contractors or agents appointed by the IFI (hereinafter referred to as "personnel") are suitable to perform their jobs and it is expected that with suitable training in line with the requirements of paragraphs 31 to 33 or without undergoing such training, have an adequate level of understanding of the IFI's products and services. It is recommended that all such personnel shall have understanding of, and firm belief in, the products and services of Islamic finance. This is necessary to ensure a smooth system of Shari'ah compliance and to avoid unnecessary reputational risks to the IFI, and on a broader spectrum, to the Islamic finance industry. SCD shall provide guidelines in this respect.

Training

31. The management shall ensure that it has provided basic Shari'ah related training to all its staff and in-depth training to the respective staff in their specific areas or functions. There shall be a system of continuous training and professional development which the management shall devise in coordination with SCD.
32. IFIs shall ensure that those charged with governance and senior management have a good understanding of Islamic finance, both the technical aspects and the overall broader framework vis-à-vis conventional finance. To achieve this goal, regular orientation and training programs shall be organized, at least on an annual basis.
33. IFIs shall conduct periodic assessment of their employees on basic Shari'ah knowledge relating to products, policies, procedure, regulations and guidelines in general, and comparatively in-depth knowledge in their respective areas of work. Such diagnostic assessment shall guide the training department in close coordination with the SCD to plan training sessions and focus on work areas that require further Shari'ah knowledge and expertise.

Personnel performance appraisals

34. IFI shall adopt a practice of non-tolerance towards Shari'ah non-compliance and take appropriate action against the personnel who fail to comply with Shari'ah principles and rules in their area of responsibility. Such actions shall reflect on the performance appraisals, increments, bonuses and promotions of non-compliant personnel. Similarly, personnel who consistently exhibit high level of Shari'ah compliance in carrying out their responsibilities shall be rewarded for their efforts. Additionally, the management shall ensure timely remedial and / or disciplinary action in case of any breach.

Technology – as a means for Shari'ah compliance

35. IFIs are encouraged to adopt relevant technological advancements in financial systems and strive to automate most of routine transactions in a Shari'ah compliant manner. As dependence moves away from human judgment and choice of bypassing certain steps in transactions, it is expected that Shari'ah compliance will gradually increase in routine matters.

36. Depending on the level of automation within the IFI, the SCD shall coordinate with the information systems team and the business units striving to incorporate system-based checks and flags that will provide preventive controls and initiate alerts to business as well as SCD regarding non-compliance with Shari'ah principles and rules in routine business transactions. Such automation may result in comprehensive filtering and significant time saving that can be utilized in other areas which require special attention of the SCD.
37. Where resources permit, the SCD shall adopt a technology-based mechanism for its own functioning and integrate the same with the organizational functions including business processes to reduce the lead time for transactions and to harmonize and standardize the practices.

Adoption of a comprehensive control framework

38. IFIs shall consider adopting a comprehensive internal control or enterprise risk management framework (e.g. those developed by COSO) and integrate the overall Shari'ah compliance function in such comprehensive framework.

Shari'ah compliance department: structure, scope and functioning

SCD's structure

39. SCD shall be led by a senior, experienced Shari'ah compliance professional and supported by an adequate team of staff with relevant education and experience.
40. Appointment and hiring of the head and staff of SCD shall be the responsibility of the management. The appointment of the head of SCD shall be subject to the concurrence of the SSB duly considering the specimen fit and proper criteria defined in Appendix "B".

SCD's key functions and reporting line

Management function

41. SCD is principally a part of management and shall report to, be accountable to, and be evaluated and appraised for performance by, the senior management in consultation with the SSB.
42. The following are the primary functions of the SCD to ensure Shari'ah compliance:
 - a. review and providing Shari'ah related input for the development of policies, procedures and processes affecting various departments in relation to new products;
 - b. from time to time, routine review of business transactions before these are executed on self-initiative or when referred to by the SSB, those charged with governance or the management;
 - c. supporting the SSB in performing its functions, particularly in documenting, communicating, incorporating the changes in and enforcing the SSB decisions;

- d. review of related documentation and communication with various outside stakeholders e.g. marketing documentation and communication before the commencement of marketing activities;
- e. developing Shari'ah compliance programs and conducting ongoing Shari'ah compliance reviews, as per a structured plan;
- f. providing assistance and input to the business side of the IFI in their communication with outside stakeholders including customers and the regulators in matters related to Shari'ah and Shari'ah compliance reporting;
- g. liaison with internal Shari'ah review / audit function, external auditors and external Shari'ah auditors;
- h. assisting the management in coming up with a continuous professional training and development regime;
- i. contributing as a researcher for the SSB / IFI on various matters related to new products, solutions and practices;
- j. assisting the management in facilitating Shari'ah decisions from the SSB on issues and queries raised by them or any other stakeholder;
- k. facilitating pre-approval formalities of business transactions through the SSB or by using powers vested in it by the SSB;
- l. coordinating with SSB to provide pre-approval of deviations from standard transactions or by using the powers vested in it by the SSB; and
- m. monitoring and enforcement of internal and external Shari'ah audit / review reports.

Additional considerations for SCD

- 43. SCD, in close collaboration with the risk management department, shall periodically conduct a thorough exercise (or update, as relevant) of identification, analysis and evaluation of Shari'ah non-compliance risk relating to products, services, processes, policies and general conduct of business (including marketing, interacting with customers, IFI's investments, etc.). It is recommended that a comprehensive Shari'ah related risk universe is prepared for easy reference.
- 44. SCD in IFIs shall strive to create awareness regarding the applicability of laws, rules and regulations across businesses and processes and how they translate into operational requirements for managing Shari'ah non-compliance risk through, for example, periodic seminars, discussion forums, circulars and working papers.
- 45. SCD shall follow a well-structured and standardized documentation policy for managing its records, sharing of the same with respective management and governance organs and enforcing access controls on the same.

46. SCD shall endeavor to jointly plan with various departments on achieving compliance milestones. Such a practice will enable departments to own the Shari'ah compliance process and pursue it as part of their operational and business goals.

SCD's ongoing compliance review process

47. SCDs shall perform a regular, ongoing assessment of the state of the overall compliance with Shari'ah principles and rules within the IFI focusing on areas that require special consideration. Such reviews shall be conducted with a view to further improve and strengthen the compliance function. These may include pre-approvals by SCD on selected transactions (involving potential high risk of Shari'ah non-compliance) as well as routine, random and, if necessary, snap checks of transactions on a real time basis.
48. The routine compliance review process plans shall be shared with relevant departments reasonably in advance along with identification of transactions involving potential high risk of Shari'ah non-compliance in order to ensure smooth functioning of the SCD and avoid unnecessary delays in transaction processing.

Coordination with, and dotted-line reporting to, the SSB

49. In order to ensure effective Shari'ah compliance mechanism, it is imperative that the SCD works in close collaboration with, and under the active supervision of, the SSB. Accordingly, notwithstanding anything contained in paragraph 41 with regard to its reporting to senior management, it shall establish a dotted-line reporting relationship with the SSB. Additionally, in line with the requirements of paragraph 52, in the absence of adequate resources, it shall assume the responsibility of the SSB secretariat as well.
50. SCD shall establish controls, procedures and methodology to conduct compliance reviews for various departments, functions and transactions. Such controls, procedures and methodology shall be part of a comprehensive Shari'ah compliance manual that shall be duly approved by the SSB.

Organizational independence of SCD

51. The SCD shall be a part of the management of an IFI. It shall, however, remain independent from business operations to maintain segregation of duties, neutrality of views and performance, and preserve work ethics. It shall particularly be independent of the following functions, except for providing reviews and inputs:
- a. managerial decision making;
 - b. finance-related functions;
 - c. legal;
 - d. marketing and sales; and
 - e. product development.

Secretariat of the SSB

52. The management shall provide adequate resources to the SSB so that a secretariat of the SSB is constituted within the IFI. In situations where the resources are constrained, the SCD may perform the function of SSB secretariat, subject to the condition that such dual functionality shall not result in self-review threats.
53. The secretariat of the SSB may be headed by the secretary of the SSB. If the SCD has taken up the responsibility of the SSB secretariat in line with paragraph 52, the head of SCD can absorb the additional role of the secretary to SSB. In such situations, all the functions of SSB secretariat defined in paragraphs 54 to 57 shall be considered part of the functions of SCD.

Functions and responsibilities of the SSB secretariat

54. The functions of the SSB secretariat shall, inter alia, include the following:
- a. serving as secretariat of the SSB including all logistic and documentation functions;
 - b. supporting and assisting the SSB in the review and issuance of its annual Shari'ah report; and
 - c. communicating and explaining the SSB's pronouncements to business and support functions of the IFI, following up and ensuring its compliance and submitting an "Actions Taken Report" to the management and the SSB.

Secretary to the SSB

55. The secretary to the SSB shall be appointed by the management on the advice of the SSB, whose performance shall be subject to supervision from the SSB.

Shari'ah review

56. The responsibility of the Shari'ah compliance of an IFI, as well as the responsibility for the implementation of Shari'ah compliance reporting and Shari'ah review process, is that of the management of the IFI.⁵ Accordingly, the SSB secretariat shall extend full support to the SSB in performing its functions including the Shari'ah review (in line with GSIFI No. 2) which forms the basis for the SSB's annual report on Shari'ah compliance of the IFI.
57. In the absence of the SSB secretariat (in situations referred to in paragraph 52) the SCD shall also assist the SSB in executing the Shari'ah review.

⁵ See paragraphs 5 and 17 of GSIFI No. 2 "Shari'ah Review".

SCD: human resources

Staffing and hiring

58. Availability and allocation of competent staff is a critical requirement for SCD. IFIs must strive to appoint adequate and sufficient⁶ staff in SCD.
59. The specialized nature of the SCD work scope requires that its staff have a deeper understanding of the Shari'ah in general and Fiqh al-Muamalat in particular. They shall also have a thorough understanding of business processes for assessing various transactions.
60. IFIs shall follow the fit and proper criteria for the appointment of the head of SCD (see Appendix "B" for a sample). IFIs shall develop their own criteria for SCD staff that shall be a multi-disciplinary team comprising of experts in Shari'ah, regulatory compliance and controls.
61. SCD staff shall exhibit professionalism in their work with various departments and functions. SCD staff shall be independent and free from any potential conflict of interest, and must be able to discharge their responsibilities without fear or favor.

Training and continuing professional development

62. IFIs shall ensure that there is a rigorous training and continuing professional development program instituted for the SCD staff.

Compliance techniques and tools

63. SCD may consider using the following broad steps for conducting its routine compliance reviews on an ongoing basis:
 - a. developing Shari'ah compliance manuals and SOPs for SCD itself, and their integration with the IFI's product and operational manuals;
 - b. developing and implementing a detailed tool kit (manual, or preferably system-based) for objectively measuring Shari'ah non-compliance risk and assessing the mitigating controls and their effectiveness in design and implementation. These may include quantitative measurement techniques, risk markers for those risks which are harder to quantify, risk universe of risky outcomes and forward-looking assessments, wherever applicable;
 - c. incorporating transaction walk-throughs into the process and their integration with the business to ensure smooth performance of the function without causing undue hindrance to the business activities;
 - d. creating coordination and communication means with the business processes and other relevant functions ensuring smooth and un-interrupted performance of the Shari'ah compliance function; and

⁶ The staffing shall be qualitatively adequate in terms of qualification and experience as well as quantitatively sufficient in numbers of staff commensurate with the size of the IFI.

- e. creating and communicating standards for periodically assessing the materiality level in respect of Shari'ah non-compliance risk to all relevant departments, such as definition and tolerance levels.

Escalation and follow-up of issues

- 64. An engaged escalation and follow-up process for identified non-compliance shall be part of the Shari'ah compliance function. The protocol shall clearly define how occasional, first time, frequent and continuous events of non-compliance shall be escalated to various levels of management in an IFI and to those charged with governance. SCD shall comply with such protocol to bring in increasing improvement in the overall state of Shari'ah compliance within the IFI.
- 65. SCD shall maintain an inventory of open issues of Shari'ah non-compliance identified during its work or by other organs of Shari'ah governance, as well as, other instructions and guidelines issued by SSB, and shall establish a mechanism of follow-up of the same. SCD shall also coordinate with the respective organs of Shari'ah governance and the management to develop action plans for resolution of such issues.
- 66. Occurrence and frequency of Shari'ah non-compliances shall be analyzed and patterns of such behavior / actions shall be identified. The focus shall be on identifying and eliminating the root causes of Shari'ah non-compliance. Necessary actions, including changes in processes and improvements in controls, shall be taken to eliminate such causes of routine and frequent Shari'ah non-compliances.

Compliance report of SCD

- 67. SCD shall develop periodic (quarterly and annual) reports for the use of senior management and SSB covering a summary of its activities, including the risks and issues identified during the period and their respective mitigation and resolution.
- 68. The following are the suggested broad contents of the annual report of SCD:
 - a. description of scope;
 - b. description of responsibilities;
 - c. description of routine activities and any specific reviews conducted;
 - d. summary of key risks identified and their mitigating controls recommended along with the status of implementation of the same;
 - e. summary of key issues identified, their respective resolution and the status of the resolution;
 - f. summary of follow up issues from the previous period;
 - g. summary of implementation report on the issues identified by other organs of governance; and

- h. recommendations for improvement.
- 69. Senior management of IFIs shall review the annual report of SCD and shall coordinate and communicate with SSB on the same, particularly with regard to any significant risks and issues identified which remain outstanding. SSB shall consider the SCD report(s) before finalizing its annual Shari'ah review report.
- 70. SCD may introduce Shari'ah non-compliance risk rating in its report. A quantitative Shari'ah non-compliance risk assessment will enable the senior management to assess the Shari'ah compliance status of the IFI and to take corrective actions.

Effective date

- 71. This standard shall be effective on IFIs on 01 July 2021. Earlier application is encouraged.

APPENDICES

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Governance and Ethics Board's meeting No. 8 held on 24-25 Shawwal 1439H, corresponding to 8-9 of July 2018 and was duly approved.

Members of the Board

1. Dr. Ishrat Husain – Chairman
2. Sh. Esam Ishaq – Deputy Chairman
3. Dr. Abdulbari Mashal
4. Dr. Abdurrahman Habil
5. Mr. Ahmad Mishari Al Faris
6. Mr. Ebrahim Sidat
7. Mr. Fawad Laique
8. Dr. Gaffar Abdalla Ahmed Khalid
9. Dr. Hussein Said Saifan
10. Mr. Hasan Gul
11. Mr. Kazi Mohammad Mortuza Ali
12. Mr. Mohammad Farrukh Raza
13. Mr. Mohammad Mahdy Mohammad Radwan
14. Mr. Sohaib Umar
15. Dr. Walid Hegazy

Reservation

The standard was approved unanimously.

Working group and team

1. Dr. Abdulbari Mashal – Chairman
2. Mr. Ahmad Mishari Al Faris
3. Mr. Mahmood Shafqat
4. Prof. Dr. Mohd. Ma'Sum Billah
5. Mr. Munir Ahmed
6. Mr. Zahid ur Rehman Khokher
7. Mr. Omar Mustafa Ansari (AAOIFI)
8. Mr. Mohammad Majd Bakir (AAOIFI)
9. Ms. Zahra Jassim AlSaraifi (AAOIFI)
10. Mr. Syed Siddiq Ahmed (AAOIFI)
11. Mr. Azmat Rafique (Executive Assistant)

Appendix B: Specimen fit and proper criteria

Head of Shari'ah compliance

- a. Well-versed in the operations and functions of Islamic banking or finance, the relevant Shari'ah principles and rules, including in particular the principles contained in the hierarchy in line with paragraph 3(i) of this standard, as well as, having an understanding of Fiqh al-Muamalat.
- b. Having a university degree in Shari'ah (Fiqh al-Muamalat or Usul al Fiqh), Islamic law, Islamic finance or an equivalent academic qualification **OR** having a university degree or professional qualification suitable for the position with significant additional understanding of (a) above.
- c. Preferably 10-years (but in no case less than 5-years, e.g. in case of new markets, if so allowed by the SSB) work experience in the area of Shari'ah compliance, Shari'ah advisory, internal or external Shari'ah audit, internal audit or other relevant areas.
- d. Having been approved by the SSB with regard to the necessary knowledge and skills in Shari'ah principles and rules applicable to the IFI and Fiqh al-Muamalat.

Appendix C: Basis of conclusion

Name and scope of the standard

- BC1 The board discussed the name of the standard i.e. Shari'ah compliance 'department', 'unit' or 'function' and the corresponding scope. The members discussed the principles and processes of the Shari'ah compliance function and the need of its existence as a function or department. It was concluded that 'function' is a broader and all-encompassing term to manage and supervise Shari'ah compliance in an institution, which includes broader processes and functions as well as a department or unit to support the function. The scope of the function and department were accordingly presented in the standard.

Primary responsibility

- BC2 The board deliberated and discussed the distinct roles and responsibilities of the SSB and the Shari'ah compliance function. It was agreed that the responsibility for the Shari'ah compliance function does not lie with the SSB (which is primarily responsible for Fatwa and supervision). While other organs of Shari'ah governance such as internal and external Shari'ah audit are expected to be independent of the management, it was concluded that the primary responsibility of the Shari'ah compliance function lies with the management of the IFI and hence the primary reporting of the function shall be to the management (see also BC4).

The use of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) key pillars

- BC3 The board discussed the use of COSO framework and its key pillars. The usage of the five pillars has been acknowledged in the standard and they are only used as a base to identify and categorize the Shari'ah compliance control environment. The standard has recommended the adoption of an effective control framework, and the board concluded that the COSO integrated framework provides a suitable option for the same.

Reporting line

- BC4 AAOIFI secretariat received several comments on the reporting line of SCD, both in writing and during public hearings held. The board thoroughly discussed the matter as it had led to a great deal of comments. In majority of jurisdictions, the reporting of the SCD is technically to the management and for routine functioning (dotted line) to the SSB. After considering the matter, the board confirmed that the SCD is principally part of the management and accountable to senior management and the management shall be accountable for Shari'ah compliance in respect of operations and practices of the IFI. Therefore, the board decided that the main reporting line of SCD should be to the management and dotted line reporting to the SSB.

Organizational independence of SCD

- BC5 The matter of SCD's independence from certain business operations was discussed at length. It was agreed that (except for providing reviews and inputs), the SCD should not be involved in the

managerial decision making, finance related functions, legal department, marketing and sales and product development.

- BC6 Certain members were of the view that the product development function should be handled by the SCD as practised in some IFIs. However, it was argued that this could create a self-review threat and hence SCD's role was envisioned to review the products rather than developing them. This does not restrict them from providing their input in the product development process. This involvement was noted to be more important in smaller IFIs and windows which have financial and human resource limitations. It was concluded that the SCD input is important but it shall not be considered as final approval of the product.

Role of the secretariat of the SSB and the SCD

- BC7 The members discussed in detail various elements of the proposed secretariat of the SSB and the SCD. It was emphasized that their roles must be made clear and should not be overlapping. The need for these two separate functions was also assessed. It was agreed that the secretariat shall provide logistical support to the SSB, such as arranging meetings, minute taking, preparing the working papers etc. It was also discussed and agreed that performing research should be the primary function of the SCD, and not that of the secretariat.
- BC8 The board also considered the issue of lack of resources in smaller institutions and the recommendation of creating separate departments of SCD and SSB secretariat. The board acknowledged the issue and agreed that in such situations these two functions may be merged as long as there is no conflict of interest. However, where resources are available, compliance with this recommendation is highly encouraged.

Pre-approvals

- BC9 'Pre-approvals of business transactions' and 'approvals of deviations from standard transactions' as functions of the SCD were also discussed by the board. It was argued that these two should be the responsibility of the SSB secretariat; however, after due deliberations it was agreed that SCD is in a better position due to its close monitoring and understanding of business functions to assist in arranging such approvals.

Appointment of Head of SCD and staff

- BC10 The board discussed the appointment of the Head of SCD / other staff with regard to the process and the eligibility criteria. The board deliberated on the appropriateness of the years of work experience and qualifications to hold the position of head of the SCD. The number of years of experience was voted to be minimum of 5 (in new markets) but preferably 10 years. It was also decided that IFIs shall have their own criteria for appointment of the SCD staff; however, in general they will be multidisciplinary and well versed in Shari'ah compliance and controls, and that the appointment of Head of SCD shall be subject to approval of the SSB with regard to relevant knowledge and skills (see Appendix B).

Compliance report of SCD and its frequency

- BC11 The board deliberated on the need and the frequency of periodic reporting by the SCD. It was suggested that the SCD reporting should be quarterly or half-yearly. It was also agreed that broad contents of the report should be suggested in the standard to synchronize the practices. It was also added that the SCD report is one of the bases of the SSB's annual report and hence the SCD shall issue its report within an adequate time period for the SSB. The members also agreed to rename this section to 'Compliance Report of SCD' to reflect the fact that it can be done periodically rather than only on an annual basis.

Outsourcing the SCD

- BC12 The board considered as to whether the standard should include an option of outsourcing the SCD, which may be of particular significance for smaller IFIs and certain jurisdictions where adequate resources may not be sufficiently available. It was discussed and concluded that there should be no outsourcing as the function is a management function and is unique in nature. However, in case of need the function may be allocated to different organs / departments in line with the requirements of this standard.

Appendix D: Brief history of the preparation of the standard

- H1 The newly formed AAOIFI Governance and Ethics Board (AGEB / the board) held its first meeting on 21 Jumada II 1437H, corresponding to 30 March 2016 in the Kingdom of Bahrain. In this meeting overall approach and plan of the standard was discussed and approved.
- H2 The working group's first meeting was held on 22 Jumada II 1438H corresponding to 21 March 2017 through video conferencing. The members discussed the preliminary study as well as the content of the standard.
- H3 The fourth meeting of AGEB was held on 29 Jumada II and 1 Rajab 1438H, corresponding to 28-29 March 2017, at College of Banking and Finance Studies, Muscat, Sultanate of Oman. An overview of the work performed and certain key questions were discussed and the board agreed on the approach towards the standard.
- H4 The second meeting of the working group was held on 10 Ramadan 1438H, corresponding to 5 June 2017 through video conferencing. The consultation notes and survey questionnaire were updated based on the remarks and insights presented by the esteemed members.
- H5 The fifth meeting of AGEB was held on 22-23 Dhul-Qa'dah 1438H, corresponding to 15-16 August 2017 in the Kingdom of Bahrain. The board reviewed the draft of the standard and had a detailed discussion on the content and wording of the same. After due process, the board approved the issuance of the same as an exposure draft and directed the secretariat to issue the same after making the changes as decided by the board.
- H6 Public hearings on the exposure draft of the standard were held in Egypt, Bahrain, Turkey and Lebanon between the months of Muharram and Shawwal 1439H, corresponding to October 2017 and March 2018.
- H7 The third working group meeting was held on 19 Shawwal 1439H, corresponding to 3 July 2018. The working group reviewed and discussed the public hearing comments and the comments received from the industry and necessary changes were recommended in the light of the same.
- H8 The eighth meeting of AGEB was held on 24-25 Shawwal 1439H, corresponding to 8-9 of July 2018, in Jordan. The board considered the comments received on the exposure draft and the recommendations of the working group. The standard was approved for publishing with instructions for making suggested changes and taking into consideration Shari'ah committee comments.
- H9 After due process the standard was issued on 28 Safar 1440H, corresponding to 6 November 2018.
- H10 The twelfth meeting of AGEB was held on 7-8 Dhul-Qa'dah 1440H, corresponding to 10-11 July 2019 in Karachi, Pakistan. The board approved the insertion of the "basis of conclusion" as Appendix C and the "brief history of the preparation of the standard" to be reassigned as Appendix D.