

[Exposure Draft (AGEB 7/2023) of the]
AAOIFI Governance Standard (GS) __
**Application of Shari’ah Governance Principles to Islamic Finance
Subsidiaries / Associates**

Contents

Contents	2
Preface	4
Introduction	5
Overview	5
Rationale(s) for issuing this standard	5
Objective of the standard	6
Scope	6
Definitions	6
Application of Shari'ah governance framework on Islamic finance subsidiaries / associates	8
Core components of Shari'ah governance framework for Islamic finance subsidiaries / associates	8
Overall requirements of relevant AAOIFI standards	9
Special considerations for Islamic finance subsidiaries / associates	9
Governance and management of an Islamic finance subsidiary / associate	9
Independence	9
Safeguarding the interests of stakeholders and fiduciary responsibility	9
Responsibilities and powers of the conventional parent	10
Conflict of interest in appointment of TCWG	10
Management reporting lines for an Islamic finance subsidiary	10
Information sharing and competition	10
Transactions and dealings with the conventional parent	10
Shared services and shared / leased premises	10
Internal fund placements	11
Reporting and disclosure requirements	11
Effective date	11
Appendices	12
Appendix A: Adoption of the standard	12
Members of the board	12
Reservation	12
Working group members	13
Executive team	13
Appendix B: Basis for conclusions	14
Appendix C: Brief history of the preparation of the standard	15

[ED of] AAOIFI Governance Standard (GS) ____ “Application of Shari’ah Governance Principles on Islamic Finance Subsidiaries / Associates” is set out in paragraphs 1-25.

Where the context so requires, the use of the masculine gender shall include the feminine gender and the singular shall include the plural and vice versa and the word “person” shall include any institution, corporation, firm, partnership, body corporate or other forms of association. The table of contents and headings do not form part of the text of the standard and are for the purpose of convenience and ease of understanding and may, at times, help in the interpretation of text only.

Preface

- PR1 This standard is one of the outcomes of a comprehensive Shari’ah governance framework project, which aimed to establish the guiding principles and rules, as well as, best practices for a sound and effective Shari’ah governance framework for Islamic financial institutions (IFIs / the institutions).
- PR2 The establishment and operation of Islamic finance subsidiaries / associates by conventional financial institutions is not a new practice, but is becoming increasingly more common. Particularly, in certain jurisdictions, Islamic finance windows are not allowed and hence conventional financial institutions willing to venture into Islamic finance have to take the route of establishing subsidiaries and / or associates. The trend of acquisition of (or investment in) smaller IFIs by larger conventional financial institutions has increased as well. Moreover, certain global conventional financial institutions have opted to incorporate Islamic finance subsidiaries in certain jurisdictions with stronger Islamic finance markets / consumer demand.
- PR3 AAOIFI Governance and Ethics Board (AGEB / the board) believes that Islamic finance subsidiaries’ / associates’ unique positioning, challenges and opportunities warrant special consideration. Their proximity to conventional institutions, as well as, the control and significant influence exercised on them by the conventional parent, increases the risk of inadvertent Shari’ah violations. Therefore, it is imperative that these entities exercise even greater caution, vigilance and adherence to the highest standards of Shari’ah governance.
- PR4 The board concluded that it is of utmost importance to apply Shari’ah governance principles to Islamic finance subsidiaries / associates in order to ensure that their operations maintain their integrity and Shari’ah compliance, while fulfilling their fiduciary responsibilities towards all stakeholders in a fair and transparent manner.
- PR5 This standard describes the requirements related to principle 11 “Islamic finance subsidiaries / associates” as prescribed by [ED of] GS ____ “Shari’ah Governance Framework”.

Introduction

Overview

IN1 The standard sets out the principles and requirements for the effective implementation of Shari'ah governance framework to Islamic finance subsidiaries / associates of conventional financial institutions. It necessitates that all the common requirements of relevant AAOIFI Governance Standards (GSs) shall apply to the Islamic finance subsidiaries / associates, being licensed as Islamic financial institutions (IFIs / the institutions). Additionally, it provides guidance on the unique governance structure, reporting and disclosure requirements and other essential aspects of Shari'ah governance in Islamic finance subsidiaries / associates, particularly those emanating from the relationship with their respective conventional parents, which exercise control / significant influence on them in respect of the governance processes and managerial decision-making.

Rationale(s) for issuing this standard

- IN2 The issuance of this standard is prompted by the need to:
- a. define the approach towards the application of various requirements of AAOIFI's Shari'ah governance framework as contained in relevant AAOIFI GSs to the Islamic finance subsidiaries / associates of conventional financial institutions;
 - b. prescribe the specific governance considerations for Islamic finance subsidiaries / associates; and
 - c. foster transparency, accountability and confidence in Islamic finance subsidiaries / associates and mitigating the respective systemic reputational risk.

[Exposure Draft (AGEB 7/2023) of the]

AAOIFI Governance Standard (GS) __

Application of Shari’ah Governance Principles to Islamic Finance Subsidiaries / Associates

Objective of the standard

1. The objective of this standard is to establish a comprehensive framework for the consistent and effective application of Shari’ah governance principles to Islamic finance subsidiaries / associates of conventional financial institutions, while recognising their distinctive features, needs and challenges.

Scope

2. This standard shall apply to all Islamic finance subsidiaries and Islamic finance associates of conventional financial institutions. (See paragraphs 3(b) and (c))

Definitions

3. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
 - a. Conventional parent [or conventional controlling / influencing institution] – in the specific context of this standard, is a conventional financial institution which controls, or exercises significant influence on, an Islamic finance subsidiary or Islamic finance associate, respectively;
 - b. Islamic finance associate [of a conventional financial institution] – in the specific context of this standard, is an independent Islamic financial institution, legally constituted and licensed as such, which is subject to significant influence of a conventional financial institution (directly or through a common conventional parent institution), in terms of its governance and managerial decision-making;
 - c. Islamic finance subsidiary [of a conventional financial institution] – in the specific context of this standard, is an independent Islamic financial institution, legally constituted and licensed as such, which is controlled by a conventional financial institution, in terms of its governance and managerial decision-making;
 - d. Islamic financial institutions (IFIs / the institutions)¹ – 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. Management² – for the purpose of this standard, management is an organ, or combination of organs, that manages an institution’s operations and resources (including human

¹ AAOIFI GS 12 “Sukuk Governance”

² AAOIFI GS 9 “Shari’ah Compliance Function”

resources). Management's functions include, inter alia, risk assessment, objective setting, planning, organising, staffing, leading or directing and controlling an institution. Management includes such directors and employees who are involved in the above-mentioned functions, irrespective of their designations. It may also refer to specific departments and / or the whole organisational management collectively [Explanation: In the specific context of this standard, the management includes such management of the conventional parent, which is involved in the functions related to the Islamic finance subsidiary / associate, insofar and to the extent as, allowed in line with the provisions of this standard and the relevant regulatory requirements];

- f. Public interest institutions³ – are the institutions that are of significant public relevance because of the nature of their business, their size or the number of their stakeholders. In the specific context of this standard, public interest institutions shall include:
 - i. all listed institutions or entities (i.e., their common shares are listed and publicly traded on a stock exchange);
 - ii. all institutions or entities that have publicly traded securities other than common shares e.g., Sukuk; and
 - iii. all retail Islamic financial institutions (IFIs), that deal with a large number of common stakeholders e.g., investment accountholders, depositors, unitholders, participants and employees, etc. [Explanation: the number of investment accounts, unitholders or participants for the purpose of this standard shall be considered large if it is in excess of 10,000 unless differently defined by the respective regulator];
- g. Senior management⁴ – represents collectively the group of most senior members of management who are responsible for overall decision making for the originator, individually or collectively [Explanation: In the specific context of this standard, the senior management includes the head of Islamic finance subsidiary / associate, and such senior management of the conventional parent, which is involved in the functions related to the Islamic finance subsidiary / associate, insofar and to the extent as, allowed in line with the provisions of this standard];
- h. Shari'ah principles and rules⁵ – comprise “the Shari'ah principles and rules defined by the following hierarchy, as appropriate:
 - 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;

³ [ED of] AAOIFI GS __ “Governance and Management of Investment Accounts”

⁴ AAOIFI GS 12 “Sukuk Governance”

⁵ AAOIFI FAS 40 “Financial Reporting for Islamic Finance Windows”

- 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 (FASs) 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 institution”; and
- i. Those charged with governance (TCWG)⁶ – in line with the International Ethics Standards Board for Accountants (IESBA) pronouncement, are “the person(s) or organisation(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”.

Application of Shari’ah governance framework on Islamic finance subsidiaries / associates

- 4. An Islamic finance subsidiary / associate of a conventional financial institution shall have in place a suitable Shari’ah governance framework to ensure effective Shari’ah compliance of its operations. Special considerations become necessary for Islamic finance subsidiaries / associates, as these are subject to control / significant influence by their conventional parent with regard to their governance processes and managerial decision-making.
- 5. An Islamic finance subsidiary / associate, being a separate legal entity having its own license to operate as an IFI, shall be subject to the provisions of this standard irrespective of the percentage of ownership of the conventional parent (whether being 100%, majority or minority) insofar as the conventional parent has the ability to exercise control / significant influence in respect of governance processes and managerial decision-making.

Core components of Shari’ah governance framework for Islamic finance subsidiaries / associates

- 6. The Shari’ah governance framework of an Islamic finance subsidiary / associate shall consist of the same components / organs as any IFI, namely:
 - a. an SSB;
 - b. Shari’ah compliance function;
 - c. internal Shari’ah audit function; and
 - d. external Shari’ah audit.

⁶ [ED of] AAOIFI GS __ “Syndicated Financing”

7. The external Shari’ah audit shall be mandatory for Islamic finance subsidiaries / associates as public interest institutions, after a period of three years from the effective date of this standard. During this period and for all other institutions, compliance with this principle is strongly recommended.

Overall requirements of relevant AAOIFI standards

8. Islamic finance subsidiaries / associates shall provide Shari’ah compliant financial services under a governance framework that ensures their sanctity and independence as IFIs. Accordingly, Islamic finance subsidiaries / associates shall be subject to the requirements of relevant AAOIFI standards (including, in particular, the AAOIFI GSs related to the Shari’ah governance framework), as full-fledged IFIs, in addition and subject to the requirements of this standard.
9. The responsibilities, fit and proper criteria and other aspects of each of the Shari’ah governance framework’s components of Islamic finance subsidiaries / associates shall be the same as prescribed in the relevant AAOIFI GSs⁷.

Special considerations for Islamic finance subsidiaries / associates

10. The central Shari’ah board (CSB) (in the markets where it exists) has a role to play in the Shari’ah governance framework applicable to Islamic finance subsidiaries / associates. TCWG and the management also have their responsibilities to ensure adequacy of Shari’ah governance framework of an Islamic finance subsidiary / associate.

Governance and management of an Islamic finance subsidiary / associate

Independence

11. An Islamic finance subsidiary / associate shall be and act as an independent IFI in all respects, without unnecessary and undue interference or exercise of control or influence from the management of the conventional parent.

Safeguarding the interests of stakeholders and fiduciary responsibility

12. The governance and business model of an Islamic finance subsidiary / associate shall take into consideration the interests of key stakeholders in the Islamic finance subsidiary / associate, including investment account holders (IAHs) and minority shareholders. The Islamic finance subsidiary / associate also has a fiduciary responsibility towards its IAHs and depositors, customers and / or participants, and it shall ensure fair and equitable treatment for all stakeholders.
13. TCWG of an Islamic finance subsidiary / associate shall bear the full fiduciary responsibility towards its stakeholders, including the shareholders and the IAHs of the Islamic finance subsidiary / associate. This fiduciary responsibility cannot be transferred or delegated to TCWG of the conventional parent simply because of the ownership.

⁷ Presently, GS 1 “Shari’ah Supervisory Board: Appointment, Composition and Report”, GS 2 “Shari’ah Review”, GS 5 “Independence of Shari’ah Supervisory Board”, [ED of] GS ___ “Shari’ah Supervisory Board: Appointment and Composition”, [ED of] GS ___ “Shari’ah Supervisory Board: Review and Report”, [ED of] GS ___ “Shari’ah Supervisory Board: Functions and Operations of SSB” and [ED of] GS ___ “Governance Principles for Determination and Application of Shari’ah Principles and Rules”

Responsibilities and powers of the conventional parent

14. The conventional parent may influence decision-making at the Islamic finance subsidiary / associate at a strategic level only through board memberships and board committees, where it shall be represented in line with its shareholding percentage.

Conflict of interest in appointment of TCWG

15. In order to avoid conflict of interest, representatives of the conventional parent who are part of TCWG (normally, the board of directors) of an Islamic finance subsidiary / associate shall not be allowed to vote on any issue which is, or is reasonably perceived to be, benefiting the conventional parent at the cost of the interests of the stakeholders of the Islamic finance subsidiary / associate, or creating a reputational risk for the overall Islamic finance industry.
16. The conventional parent shall not appoint any members of its executive management heading, or significantly involved in, the business functions (barring the functions independent of the business functions, such as the heads of compliance, internal audit and risk management) as a member of TCWG of the Islamic finance subsidiary / associate. It can, however, appoint any of the non-executive members of its TCWG to the TCWG of the Islamic finance subsidiary / associate subject to the relevant regulatory requirements, and subject to compliance with the requirements of respective AAOIFI GS⁸.

Management reporting lines for an Islamic finance subsidiary

17. A conventional parent may have a dotted-line reporting of key business departments / functions with those of an Islamic finance subsidiary (but not an associate) whereby the conventional parent's function heads can have the right to certain relevant information (as approved by both the respective boards, subject to regulatory requirements) without having an authority to control or influence the managerial decision-making of the Islamic finance subsidiary.

Information sharing and competition

18. Any sharing of customer-level information between the Islamic finance subsidiary / associate and the conventional parent shall not be detrimental to the long-term interests of the minority shareholders and IAHs of the Islamic finance subsidiary / associate.
19. A conventional parent shall not devise any strategy or tactics to adversely influence competition from the Islamic finance subsidiary / associate (e.g., by prohibiting the Islamic finance subsidiary / associate from approaching certain categories of customers or business segments), if it is deemed to be against the interests of the minority shareholders and / or IAHs of the Islamic finance subsidiary / associate.

Transactions and dealings with the conventional parent

Shared services and shared / leased premises

20. The conventional parent and the Islamic finance subsidiary / associate can agree, for the purpose of cost saving, on a shared services arrangement on an arm's length basis to be approved by the TCWGs of both the institutions and the SSB of the Islamic finance subsidiary / associate. TCWG

⁸ See paragraphs 36-46 of [ED of] GS __ "Shari'ah Governance Framework"

representing the conventional parent shall abstain from voting at the time when TCWG of the Islamic finance subsidiary / associate votes on the arrangement.

21. Such a shared services arrangement shall take into consideration that no employee of the Islamic finance subsidiary / associate can be coerced, directly or indirectly, to work for the conventional parent, nor can the Islamic finance subsidiary / associate lease any part of its physical infrastructure or systems to the conventional parent.
22. If the Islamic finance subsidiary / associate decides to co-locate with its conventional parent, it shall ensure that this arrangement does not affect its brand identity in the perception of the general public.

Internal fund placements

23. An Islamic finance subsidiary / associate may receive funds from its conventional parent under a Shari'ah-compliant contract, in line with Shari'ah principles and rules. However, it cannot place funds with its conventional parent or with any other conventional financial institution, either directly or through a third party.

Reporting and disclosure requirements

24. An Islamic finance subsidiary / associate shall make adequate and duly segregated disclosures in their financial statements, in respect of related party transactions and balances with the conventional parent, in line with the requirements of relevant AAOIFI FASs. Additionally, it will identify the nature of contracts and transactions, particularly those in line with the requirements of paragraphs 20-23.

Effective date

25. This standard shall be effective on or after 1 July 2025. 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. _____ held on _____ H, corresponding to _____ and was duly approved.

Members of the board

1. Mr. Farrukh Raza (chairman)
2. Dr. Walid Hegazy (deputy chairman)
3. Dr. Abdulbari Mashal
4. Mr. Abdullah AlMoqbel
5. Dr. Abozer Magzoub
6. Dr. Ahmet AlBayrak
7. Dr. Ali Sartawi
8. Mr. Ebrahim Sidat
9. Ms. Ibtihal Al-Shamali
10. Dr. Mohammad Kabir Hassan
11. Mr. Moosa Khoory
12. Mr. Muzammil Kasbati
13. Mr. Sohaib Umar
14. Mr. Wael Merza
15. Dr. Zahid ur Rehman Khokher

Reservation

The standard was approved unanimously.

Working group members

1. Dr. Walid Hegazy (chairman)
2. Dr. Abdulbari Mashal
3. Mr. Abdulla AlMoqbel
4. Mr. Ebrahim Sidat
5. Mr. Farrukh Raza
6. Mr. Firas Hamdan
7. Mr. Sohaib Umar

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Ms. Zahra Jassim (AAOIFI)
3. Ms. Alyaa Adel (AAOIFI)
4. Mr. Farhan Noor (AAOIFI)
5. Ms. Merjan Abid (Consultant-researcher)

Appendix B: Basis for conclusions

BC1 [To be updated later]

Appendix C: Brief history of the preparation of the standard

- H1 AAOIFI and Islamic Financial Services Board (IFSB) agreed to collaborate and cater to the growing needs of the global Islamic finance industry, in various areas of mutual interest. One of the significant collaboration efforts was in the area of standardisation and harmonisation of Shari’ah governance practices across the globe. The institutions collaborated to issue the exposure draft of “IFSB-AAOIFI Revised Shari’ah Governance Framework for Institutions Offering Islamic Financial Services” on 16 Ramadan 1444H, corresponding to 7 April 2022 after completing the due process.
- H2 Based on extensive feedback received from stakeholders and considering the mandates of each organisation, both the institutions mutually agreed to separately review and, where necessary, issue relevant guidance / standards on Shari’ah governance within their respective areas of focus.
- H3 AAOIFI Governance and Ethics Board (AGEB / the board) in its 32nd meeting on 12 Safar 1445H, corresponding to 28 August 2023, via video conferencing, approved the formation of a working group and the initiation of the development process of exposure drafts of six individual governance standards, primarily containing the requirements of the joint exposure draft, which were not covered elsewhere in the existing governance standards.
- H4 Following the board's approval, two working group meetings were held to discuss the draft standards on 25 Rabi’ II 1445H, corresponding to 9 November 2023 and 2 Jumada I 1445H, corresponding to 16 November 2023, respectively. The members of the working group agreed on conceptual issues and recommended the draft standards for the approval of AGEB.
- H5 AGEB held its 34th meeting on 13-14 Jumada I 1445H, corresponding to 27-28 November 2023 in Bahrain, and approved the issuance of exposure drafts of six governance standards, including this standard. The board directed the secretariat to incorporate the necessary changes in light of the comments of the AGEB members and the discussions during the meeting. The board further approved a fast track due process for finalisation and issuance of these standards duly taking into account the effort and stakeholders’ feedback already incorporated in these standards.
- H6 After incorporating the board’s comments and necessary changes, this exposure draft was issued on 12 Jumada II 1445H, corresponding to 25 December 2023.