

[Exposure Draft (AGEB 6/2023) of the]  
AAOIFI Governance Standard (GS) \_\_  
**Application of Shari’ah Governance Principles to Islamic Finance  
Windows**

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[ED of] AAOIFI Governance Standard (GS) \_\_\_\_ “Application of Shari’ah Governance Principles on Islamic Finance Windows” is set out in paragraphs 1-36.

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

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- PR1 This standard is one of the outcomes of the 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 Islamic finance windows of conventional financial institutions have become a notable trend as the Islamic finance industry continues to develop. With their wide-ranging acceptance and increased visibility, Islamic finance windows play a crucial role in expanding the availability of financial products and services compliant with Shari’ah principles and rules. However, having Islamic finance windows (versus full-fledged IFIs) results in additional risk factors for the Islamic finance industry as a whole, due to potentially weak Shari’ah governance and / or compliance and certain other risks unique to the windows model.
- PR3 It is of utmost importance to apply Shari’ah governance principles to Islamic finance windows in a holistic manner to ensure that their operations maintain integrity and Shari’ah compliance, while fulfilling their fiduciary responsibilities towards all stakeholders in a fair and transparent manner.
- PR4 This standard describes the requirements related to principle 10 “Islamic finance windows” as prescribed by [ED of] GS \_\_ “Shari’ah Governance Framework”.

## Introduction

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### Overview

- IN1 This standard requires the application of Shari’ah governance principles to Islamic finance windows of the conventional financial institutions, considering them within the definition of Islamic financial institutions (IFIs / the institutions), hence, making them subject to all relevant AAOIFI standards.
- IN2 This standard sets out the principles and requirements for the effective implementation of Shari’ah governance framework to Islamic finance windows, while prescribing certain specific governance requirements and allowing certain flexibilities. It provides guidance on the governance structure, reporting and disclosure requirements and other essential aspects of Shari’ah governance for Islamic finance windows.

### Rationale(s) for issuing this standard

- IN3 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 Governance Standards (GSs) to Islamic finance windows of conventional financial institutions;
  - b. prescribe the specific governance considerations for Islamic finance windows; and
  - c. foster transparency, accountability and confidence in Islamic finance windows and mitigate any systemic reputational risk.

# **[Exposure Draft (AGEB 6/2023) of the]**

## **AAOIFI Governance Standard (GS)\_\_\_**

### **Application of Shari’ah Governance Principles to Islamic Finance Windows**

#### **Objective of the standard**

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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 windows, while recognising their distinctive features, needs and challenges.

#### **Scope**

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2. This standard shall apply to all Islamic finance windows. (See paragraph 3(c))

#### **Definitions**

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3. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
  - a. External Shari’ah audit<sup>1</sup> – is an independent assurance engagement to provide reasonable assurance that an Islamic Financial Institution 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;
  - b. Islamic financial institutions (IFIs / the institutions)<sup>2</sup> – 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;
  - c. Islamic finance window<sup>3</sup> – is a reporting entity comprising Islamic financial services offered by a conventional financial institution through stand-alone branches and / or divisions [Explanation: 1. An Islamic finance window may be formed in compliance with Shari’ah principles and rules, with or without any legal or regulatory requirements and it can take form of either a licensed window or a virtual window<sup>4</sup>. 2. In the specific context of this standard, it is clarified that for the purpose of application of AAOIFI standards, an Islamic finance window is considered to be within the definition of an IFI (see paragraph 3(b))];
  - d. Management<sup>5</sup> – for the purpose of this standard, management is an organ, or combination of organs, that manages an institution’s operations and resources (including human

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<sup>1</sup> AAOIFI Standards on Auditing and Assurance (SOAA) 6 “External Shari’ah Audit”

<sup>2</sup> AAOIFI GS 12 “Sukuk Governance”

<sup>3</sup> AAOIFI FAS 40 “Financial Reporting for Islamic Finance Windows”, with adaptation of explanation for the specific context of this standard

<sup>4</sup> Note: Any such informal activity without a proper licensed window or a virtual window formed in line with Shari’ah principles and rules and a proper Shari’ah governance framework is discouraged by AAOIFI.

<sup>5</sup> 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, management includes such management of the conventional parent, which is involved in the functions related to the Islamic finance window, insofar and to the extent as allowed in line with the provisions of this standard];

- e. Public interest institutions<sup>6</sup> – 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];
- f. Senior management<sup>7</sup> – 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 an Islamic finance window, and such senior management of the conventional parent, which is involved in the functions related to the Islamic finance window, insofar as, and to the extent as, allowed in line with the provisions of this standard];
- g. Shari’ah principles and rules<sup>8</sup> – 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;
  - iii. the rulings of the central Shari’ah board for the respective jurisdiction [if there is one];

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<sup>6</sup> [ED of] AAOIFI GS \_\_ “Governance and Management of Investment Accounts”

<sup>7</sup> AAOIFI GS 12 “Sukuk Governance”

<sup>8</sup> AAOIFI FAS 40 “Financial Reporting for Islamic Finance Windows”

- 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
- h. Those charged with governance (TCWG)<sup>9</sup> – in line with the International Ethics Standards Board for Accountants (IESBA) pronouncement, is “the person(s) or organisation(s) (for example, a corporate trustee) with the responsibility for overseeing the strategic direction of an 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 principles to Islamic finance windows**

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- 4. An Islamic finance window 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 windows, as they are not separate legal entities and are housed within a conventional financial institution.

## **Objective and approach of the application of Shari’ah governance framework on Islamic finance windows**

- 5. As an identifiable unit within a conventional financial institution that provides a complete set of financial services e.g., from sourcing of funds to providing financing, making investments and providing services, an Islamic finance window has a fiduciary responsibility towards its fund providers and other stakeholders (primarily the shareholders of the conventional parent and the investment account holders (IAHs) and depositors, customers and participants of the Islamic finance window) in the same way that a full-fledged Islamic financial institution does. As far as practicable, an Islamic finance window’s funds shall be kept completely segregated on a day-end clearing basis from the conventional parent’s funds, including keeping separate accounts with the central bank and the clearing houses, where applicable.
- 6. Islamic finance windows of conventional banks and other financial institutions shall follow an “institution within an institution” model, allowing maximum independence of the Islamic finance window to pursue its activities without unnecessary and undue interference or influence from the management of the conventional parent.

## **Core components of Shari’ah governance framework for Islamic finance windows**

- 7. The Shari’ah governance framework of an Islamic finance window of a conventional financial institution shall consist of the same components / organs as any IFI, namely:
  - a. an SSB;
  - b. Shari’ah compliance function;

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<sup>9</sup> [ED of] AAOIFI GS \_\_ “Syndicated Financing”



- c. internal Shari’ah audit function; and
  - d. external Shari’ah audit.
8. The external Shari’ah audit shall be mandatory for Islamic finance windows as they are 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.

## **Special considerations for Islamic finance windows**

### *Overall requirements of relevant AAOIFI standards*

- 9. An Islamic finance window shall provide a Shari’ah compliant financial services under a governance framework that ensures its sanctity as an IFI. Accordingly, an Islamic finance window shall be subject to the requirements of relevant AAOIFI standards (including, in particular, the AAOIFI GSs related to the Shari’ah governance framework), as an IFI, in addition to, and subject to, the requirements of this standard.
- 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 windows. TCWG and the management also have their responsibilities to ensure adequacy of Shari’ah governance framework of an Islamic finance window.
- 11. The responsibilities, fit and proper criteria and other aspects of each of the Shari’ah governance framework’s components in an Islamic finance window shall be the same as prescribed in the relevant AAOIFI GSs<sup>10</sup>.

### *Organs of Shari’ah governance*

- 12. Shari’ah compliance department (SCD) shall work independently and report to the SSB, with administrative reporting to the head of Islamic banking. The head of the SCD shall be appointed by the head of Islamic banking in consultation with and after the due approval of the SSB.
- 13. The internal Shari’ah audit function shall be an independent function within the Islamic window. or exceptionally part of the overall internal audit function of the institution, provided that the relevant staff fulfils the fit and proper criteria for an internal Shari’ah auditor.
- 14. In addition to other duties, the internal Shari’ah auditor shall also make an assessment as to whether the funds have been adequately segregated and that the services to and transactions with the conventional parent (if any) are Shari’ah compliant and in accordance with this standard and the relevant regulations and guidelines issued by AAOIFI, the respective RSA and the SSB.

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<sup>10</sup> 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” and [ED of] GS \_\_\_ “Governance Principles for Determination and Application of Shari’ah Principles and Rules”

15. The RSA may decide, based on the size of an Islamic finance window and the scope of its operations, to allow the outsourcing of the internal Shari’ah audit function. However, the Shari’ah compliance function and the SSB function cannot be outsourced.

## **Regulatory regime for Islamic finance windows**

16. It is necessary that a licensing regime is introduced for Islamic finance windows with the obligation to follow the minimum regulatory requirements of capital allocation and maintenance, governance and operations.
17. It is highly recommended that an Islamic finance window is allowed to spinoff into a fully or partly owned subsidiary of the conventional parent if and when it reaches a certain threshold of assets and regulatory capital.
18. If the conventional parent’s accounting framework is not designed to produce information for the Islamic finance window in line with the requirements of this standard, requisite changes shall be made to the accounting framework.

## **Reporting and disclosure requirements**

### *Separate accounting records and financial reporting*

19. Separate books of account shall be maintained for an Islamic finance window.
20. Conventional financial institutions offering Islamic financial services through an Islamic finance window, a branch or several branches that have separate accounts from their conventional branches, shall group those branches offering Islamic financial services together for financial reporting and shall prepare a supplementary set of accounting statements as per respective AAOIFI FAS<sup>11</sup>. These supplementary financial statements shall be published as an appendix to the financial statements of the conventional parent.
21. An Islamic finance window shall prepare a separate supplementary statement to be published in the notes to the financial statements showing in detail:
- a. the funds mobilised according to Shari’ah principles and rules and the assets financed by these funds; and
  - b. the income and expenses related to the Islamic banking services offered by the Islamic finance window.
22. An Islamic finance window shall disclose in detail:
- a. whether or not, and to what extent, it commingled funds related to Islamic financial business with funds related to conventional financial business;
  - b. the sources and applications of funds mobilised and invested;
  - c. the sources of funds used to cover a deficit if it occurs;

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<sup>11</sup> FAS 40 “Financial Reporting for Islamic Finance Windows”

- d. any income received that is prohibited by Shari'ah and the disposition of such income in accordance with the SSB guidelines;
- e. any reserves deducted from the funds mobilised according to Shari'ah principles and rules, the purpose of such reserves and to whom these reserves shall revert in case the activities in respect of which such reserves were deducted have ceased;
- f. the percentage of funds held by the Islamic finance window from the conventional parent and / or other conventional entities (in the form of capital allocated, deposits / investment accounts, etc.) in comparison to the total funds; and
- g. any other details as mandated by the respective RSA from time to time.

### *IT system*

- 23. The core banking / IT system adopted by an Islamic finance window shall be capable of recognising and distinguishing the unique nature of Islamic financial contracts, terminologies, transactions and processes. The core banking / IT system shall be capable of profit calculation and accounting treatment as per Shari'ah requirements, and the requirements of this standard.
- 24. There shall be proper systems for pool and treasury management at the Islamic finance window in order to fulfil the unique needs of funds segregation and profit calculation.

### *SSB's reporting responsibility with regard to segregation of Islamic finance window*

- 25. The SSB shall express an opinion in its report as to whether the Islamic finance window's funds were commingled with those of the conventional parent during the reporting period.

### *External auditor's certification with regard to segregation of Islamic finance window*

- 26. External auditors shall certify that separate controls and systems have been maintained to ensure that there is no commingling of funds of the Islamic finance window with the conventional parent.

## **Management and operations of Islamic finance window**

### *Responsibilities of TCWG*

- 27. The ultimate responsibility of an Islamic finance window is with TCWG of the conventional parent. TCWG are encouraged to include as an independent member (or an adviser), who is a person with experience and knowledge in Islamic finance. Specifically, they shall have a clear understanding of the risks specific to Islamic finance and applicable corporate and Shari'ah governance regulations.

### *Appointment of head of Islamic finance window*

- 28. The head of the Islamic finance window shall be a senior and experienced person in the hierarchy of the organisation. He shall be dedicated to the operations of the Islamic finance window and shall not perform any tasks that are not within the scope of the Islamic finance window. The head shall report directly to the CEO of the conventional parent for all kinds of business and performance matters. It is important that the CEO does not delegate this responsibility to another executive, in order to maintain the organisational status accorded to the Islamic finance window.
- 29. TCWG shall ensure that the head of the Islamic finance window has adequate knowledge, qualifications and experience in Islamic banking and finance and possesses at least a basic

understanding of Shari'ah principles and rules as they apply to Islamic financial products and processes. TCWG shall also ensure that the head of the Islamic finance window meets the fit and proper criteria in terms of integrity, character, market reputation and ethical conduct.

### *Maintaining operational independence of functions and business units*

30. All business units and functions (including products, sales, service and marketing) shall be directly managed by the Islamic finance window, while the control and support functions may be shared with the conventional parent provided that there are defined cost allocation and service level agreements.
31. Islamic finance windows shall operate through dedicated Islamic-only branches and dedicated staff for these branches serving only Islamic finance window customers. No customer-facing staff of any function shall serve both conventional and Islamic finance window customers.
32. The various functions of an Islamic finance window shall be organised in such a manner so as to ensure maximum independence of the Islamic finance window and avoid conflict of interest with the conventional parent. These shall be achieved through the following:
  - a. dedicated staff for business functions such as consumer, corporate, treasury reporting to the head of the Islamic finance window, with dotted-line reporting to respective department heads at the conventional parent;
  - b. dedicated staff for other business support functions, such as products, business intelligence, marketing, customer service, HR, legal, alternative channels, reporting to the head of Islamic banking, with dotted-line reporting to respective department heads at the conventional parent;
  - c. dedicated staff for various control functions, including but not limited to internal audit, compliance, credit administration, financial control and risk management, reporting to their respective department heads. These functions shall keep the head of the Islamic finance window informed in respect of their reports and observations; and
  - d. shared support functions (e.g., central operations and administration) with the conventional parent, provided a transparent cost allocation policy is designed and a service-level agreement is concluded with proper approvals from TCWG and the SSB.

### **Transactions and dealings with the conventional parent**

33. An Islamic finance window can receive funds from its conventional parent under a Shari'ah-compliant contract. However, it cannot place funds with its conventional parent, or with any other conventional financial institution, either directly or through a third party.

### **Specific considerations for Islamic finance windows in other than banking sector**

#### *Window Takaful operators*

34. In the Takaful subsector, A Takaful window operator shall give assurance that the funds of the Takaful participants are properly segregated from the funds of the conventional insurance policyholders and the Takaful window operator's shareholder funds. The expression of an opinion to that effect shall be included in the SSB report of the Takaful window operator.

*Management of Islamic collective investment schemes (ICIS) by conventional investment managers*

35. Conventional investment managers managing Islamic collective investment schemes (ICIS) shall also, segregate the Islamic investment management operations, insofar as practicable, and shall ensure that appropriate systems and mechanisms for monitoring ex-ante and ex-post Shari'ah compliance are in place and are effective. The Shari'ah governance framework for ICIS shall cater for the following processes:
- a. monitoring consistent compliance with Shari'ah principles and rules in its daily operations;
  - b. portfolio screening to ensure its investment portfolios remain within Shari'ah-permissible assets / projects; and
  - c. purification of Shari'ah non-compliant income (if any).

**Effective date**

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36. This standard shall be effective on or after 1 July 2025. Earlier application is encouraged.

## Appendices

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### Appendix A: Adoption of the standard

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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. Ms. Ibtihal Al-Shamali
9. Dr. Mohammad Kabir Hassan
10. Mr. Mohammad Shoaib
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**

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BC1 [To be updated later]



## Appendix C: Brief history of the preparation of the standard

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- 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 32<sup>nd</sup> 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 34<sup>th</sup> 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.