[Exposure Draft (AGEB 2/2023) of the]
AAOIFI Governance Standard (GS) __
Shari'ah Governance Framework

Contents

[ED of] AAOIFI Governance Standard (GS) ___ "Shari'ah Governance Framework" is set out in paragraphs 1-82.

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 Since its inception, the Islamic finance industry has experienced remarkable growth, attracting diverse groups of stakeholders and investors, ranging from individuals and institutions to governments.

PR2 The industry's rapid growth and impact highlight the critical need for a sound and effective Shari’ah governance framework. Such a framework is necessary to ensure that Islamic financial institutions continue to conform closely to Shari’ah principles and rules in all their operations and activities and fulfil their fiduciary responsibilities towards all stakeholders in a fair and transparent manner.

PR3 This necessity stems from the fact that Islamic finance is based on Shari’ah principles and rules, and that any deviation or non-compliance, as well as, non-fulfilment of fiduciary responsibilities may undermine the integrity of the industry. This may result in a loss of public trust and confidence and eventually hamper the industry’s growth in the long run.

PR4 This standard, along with a set of complementing standards, establishes and explains the minimum requirements and best practices for a Shari’ah governance framework.

PR5 This standard serves as a centre-point for the overall Shari’ah governance requirements covered in multiple governance standards and guidance issued by AAOIFI from time to time.

Introduction

Overview

IN1 This standard requires the implementation of a Shari'ah governance framework by Islamic financial institutions (IFIs / the institutions), where and to the extent applicable, other institutions including social finance institutions operating in line with Shari'ah principles and rules.

IN2 This standard outlines the core principles to establish the overall framework of Shari'ah governance for such institutions. It also defines the roles and responsibilities of, and expectations from, various stakeholders and the functions and organs of governance and management with regard to the implementation of such principles. In addition, it provides detailed guidance in respect of such functions and organs for which a separate AAOIFI Governance Standard (GS) does not exist.

Rationale for issuing this standard

IN3 The issuance of this standard is prompted by the need to:

a. establish the core principles of and develop an overarching framework for Shari'ah governance that is comprehensive, appropriately flexible, accommodating and adaptable to the evolving complexities of the Islamic finance industry; and

b. promote uniform Shari'ah governance best practices that can be implemented globally, promoting cross-border compatibility and facilitating international transactions.

[Exposure Draft (AGEB 2/2023) of the] AAOIFI Governance Standard (GS) __ Shari’ah Governance Framework

Objectives of the standard

1. The objectives of this standard, along with the complementing AAOIFI Governance Standards (GSs)[1], are to:

   a. improve the level of Shari’ah compliance in the Islamic finance industry;

   b. improve the quality of Shari'ah governance while optimising the costs by providing comprehensive guidance on minimum and best practises for various organs of Shari’ah governance;

   c. help regulatory and supervisory authorities (RSAs) and Islamic financial institutions (IFIs / the institutions) to fulfil their fiduciary responsibilities towards various stakeholders with regard to Shari’ah compliance and governance;

   d. provide greater harmonisation of Shari’ah governance structures and practices across jurisdictions, particularly as the number of institutions with cross-border operations increase;

   e. provide a higher level of transparency in Shari’ah compliance of an institution by standardising and streamlining the process of issuing and implementing Shari’ah rulings and auditing the implementation of the same;

   f. increase public confidence in the Shari’ah compliance of the institutions and reduce the reputational risk of Shari’ah non-compliance through improved Shari’ah governance structure, greater transparency and more effective accountability; and

   g. complement other standards issued by AAOIFI[2].

Scope

2. This standard applies to all IFIs, including Islamic windows, across all sectors. RSAs may choose to apply this standard to other institutions in their jurisdictions as appropriate. This standard shall also be applied insofar as practicable by the institutions other than IFIs adopting AAOIFI GSs, including social finance institutions.

[1] Particularly including GS 8 “Central Shari’ah 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”, GS 9 “Shari’ah Compliance Function”, GS 11 “Internal Shari’ah Audit”, SOAA 6 “External Shari’ah Audit”, [ED of] GS __ “Application of Shari’ah Governance Principles on Islamic Finance Windows” and [ED of] GS __ “Application of Shari’ah Governance Principles on Islamic Finance Subsidiaries / Associates”.

[2] Including the GSs, as well as, AAOIFI Shari’ah Standards (SSs), the AAOIFI Financial Accounting Standards (FASs), the AAOIFI Standards on Auditing and Assurance (SOAAs) and the respective codes of ethics issued by AAOIFI.

3. This standard also applies to the external stakeholders of the institutions (including RSAs) to the extent of their respective responsibilities as defined in this standard (along with the complementing standards).

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

   a. External Shari'ah audit[3] – 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;

   b. Fatwa[4] – is a Shari'ah opinion presented to a person who seeks it with regard to an incidence that has already occurred (the Fatwa incidence) or is expected to occur. It does not refer to answering queries pertaining to hypothetical incidences;

   c. Islamic financial institutions (IFIs / the institutions)[5] – 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;

   d. Investment risk reserve (IRR)[6] – is the amount appropriated by an IFI out of the income arising from the assets pertaining to relevant profit and loss taking investors, in order to cushion against credit risk, market risk and equity investment risk mainly pertaining to residual future possible losses (after impairment and credit losses accounted for in line with the requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments") for the respective stakeholders arising from the respective assets and investments;

   e. Islamic finance window[7] – is a reporting entity comprising the 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 the form of either a licensed window or a virtual window. 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 4(c)];

   f. Management[8] – 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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[3] AAOIFI Standards on Auditing and Assurance (SOAA) 6 "External Shari'ah Audit"
[4] [ED of] AAOIFI GS 15 "Syndicated Financing"
[5] AAOIFI GS 12 "Sukuk Governance"
[6] [ED of] AAOIFI FAS ___ "Quasi-equity (including Investment Accounts)"
[7] AAOIFI FAS 40 "Financial Reporting for Islamic Finance Windows"
[8] 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 window, insofar and to the extent as allowed in line with the provisions of this standard];

g. Maqasid Al-Shari'ah[9] – are the higher objectives of Shari'ah (Islamic law), which are meant to protect and safeguard human beings through obedience to Allah Almighty as the Creator and in line with Shari'ah principles and rules, achieved through the preservation of their faith, life, intellect, progeny and wealth and the prioritisation of necessities followed by needs followed by embellishments and complimentary matters;

h. Public interest institutions[10] – 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];

i. Profit equalisation reserve (PER)[11] – is the amount appropriated by an IFI out of the income arising from the assets pertaining to profit and loss taking investors, in order to maintain a certain level of return on investment for such stakeholders (and the shareholders, as applicable) and hence is a tool for managing the rate of return risk (including the displaced commercial risk);

j. Senior management[12] – represents collectively the group of most senior members of the 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 the Islamic finance window, and such senior management of the

[9] [ED of] AAOIFI GS __ "Shari'ah Decision-Making Process"
[10] [ED of] AAOIFI GS __ "Governance and Management of Investment Accounts"
[11] AAOIFI FAS 35 "Risk Reserves"
[12] AAOIFI GS 12 "Sukuk Governance"

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];

k. Shari'ah non-compliance risk[13] – is the risk that arises from an IFI's failure to comply with Shari'ah principles and rules. This is a sub-set of operational risk and may in certain circumstances result in legal, financial or reputational risk;

l. Shari'ah principles and rules[14] – 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];

   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";

m. Shari'ah supervisory board (SSB) – is an independent body of specialised jurists in Fiqh Al-Muamalat (Islamic commercial jurisprudence). In addition, the SSB may preferably include advisors (referred to as "SSB advisors") who are experts in areas such as finance, economics, accounting or law, and have reasonable knowledge of Shari'ah principles and rules. The SSB is entrusted with the duty of reviewing and supervising the activities of an institution in order to ensure that it operates in compliance with Shari'ah principles and rules. The Fatwas and rulings (related to Shari'ah matters) of the SSB are binding on the institution; and

n. Those charged with governance (TCWG)[15] – 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".

[13] AAOIFI GS 11 "Internal Shari'ah Audit"
[14] AAOIFI FAS 40 "Financial Reporting for Islamic Finance Windows"
[15] [ED of] AAOIFI GS __ "Syndicated Financing"

Principles of Shari'ah governance

Principle 1: Shari'ah governance framework

5. An institution shall have in place a comprehensive Shari'ah governance framework which encompasses a set of institutional and / or system-wide mechanisms to ensure effective and independent oversight of Shari'ah compliance of its products, services, processes and business operations.

Principle 2: Role of regulatory and supervisory authorities

6. The regulatory and supervisory authorities (RSAs) shall have adequate understanding of Shari'ah non-compliance risks and accordingly ensure that the institution have in place an adequate and effective Shari'ah governance framework and reporting mechanism.

Principle 3: Central Shari'ah board

7. RSAs and / or governments are strongly recommended to establish and appropriately empower central Shari'ah boards[16] (CSB) in order to harmonise Islamic banking and finance practices in the jurisdiction in line with Shari'ah principles and rules.

Principle 4: Unique organs of institutional Shari'ah governance framework

8. The Shari'ah governance framework shall consist, at a minimum, of the following components / organs:

   a. Shari'ah supervisory board;

   b. Shari'ah compliance function;

   c. internal Shari'ah audit function; and

   d. external Shari'ah audit.

Principle 5: Role of those charged with governance and senior management

9. An institution shall clearly define the roles and responsibilities of those charged with governance, senior management and other organs in upholding the Shari'ah compliance of its activities and operations.

Principle 6: Shari'ah supervisory board

10. An institution shall have in place an independent, competent, empowered and adequately resourced Shari'ah supervisory board (SSB).

Principle 7: Shari'ah compliance function

11. An institution shall have in place a Shari'ah compliance function that is competent, empowered and adequately resourced to discharge its duties.

[16] Including national Shari'ah board and / or regulatory Shari'ah board

Principle 8: Internal Shari'ah audit function

12. An institution shall have in place an internal Shari'ah audit function that is competent, empowered and adequately resourced to discharge its duties.

Principle 9: External Shari'ah audit

13. An institution shall be subject to an external Shari'ah audit (ESA).

Principle 10: Islamic finance windows

14. An Islamic finance window of a conventional financial institution shall have a suitable Shari'ah governance framework in place to ensure effective Shari'ah compliance of its operations.

Principle 11: Islamic finance subsidiaries / associates

15. An Islamic finance subsidiary / associate of a conventional financial institution shall have a suitable Shari'ah governance framework in place to ensure effective Shari'ah compliance of its operations.

Principle 12: Considerations related to the business model and stakeholders' interests

16. An institution is responsible to ensure that it prudently recognises any considerations or exceptional circumstances arising from the business model or the related stakeholders' interests which may require it to apply proportionality and / or other considerations towards implementation of the principles of this standard.

Principle 13: Applicability to different sectors

17. The provisions of this standard may be suitably implemented using the proportionality criteria and as per the relevance for different sectors of the Islamic finance industry.

Principle 14: Transparency and disclosure

18. An institution shall be transparent in its Shari'ah governance to its shareholders, customers, other relevant stakeholders and market participants.

Principle 1: Shari'ah governance framework

> *"An institution shall have in place a comprehensive Shari'ah governance framework which encompasses a set of institutional and / or system-wide mechanisms to ensure the effective and independent oversight of Shari'ah compliance of its products, services, processes and business operations." (Paragraph 5)*

19. A Shari'ah governance framework refers to a set of institutional and / or system-wide arrangements through which an RSA / institution ensures that there is effective and independent oversight of Shari'ah compliance of the institution's products / services, processes and business operations. This means that there exists a governance framework which facilitates an institution to put in place measures to comply with Shari'ah principles and rules in all its activities.

20. The Shari'ah governance framework shall include arrangements to incorporate effective and independent oversight of Shari'ah compliance of the products / services offered by the institution. This entails, among other things, having in place effective procedures to design, structure and market these products / services while ensuring Shari'ah compliance at all times. Additionally,

Shari’ah governance extends to systems, processes, policies, procedures and codes of conduct, as well as, people. Other important aspects include training the staff concerned and creating an overall culture of Shari’ah compliance. In particular, there should be no violations of Shari’ah standards or ethical values while selling and marketing products and dealing with customers.

21. Since institutions market themselves to be Shari’ah-compliant, attracting, in particular, Shari’ah-conscious customers, it is of paramount importance that the institutions are not only Shari’ah-compliant in their operations, dealings and transactions, but are also perceived to be Shari’ah-compliant by their stakeholders, including the general public. A major incidence of Shari’ah non-compliance, or repeated failures in Shari’ah governance, can result in financial and reputational loss to an institution. This may also have consumer protection and risk management implications for the jurisdiction (such as loss of consumer confidence and / or higher operational risk due to Shari’ah non-compliance). In a worse-case scenario, it can lead to a systemic loss of confidence in all institutions, causing financial stability concerns. A sound Shari’ah governance framework, on the other hand, helps an institution to discharge its fiduciary and other responsibilities towards its stakeholders (including the general public) and leads to enhanced stakeholder confidence in its integrity and operations.

22. The main objectives of a Shari’ah governance framework for an institution are defined in line with the objectives of this standard as prescribed in paragraph 1.

Principle 2: Role of regulatory and supervisory authorities (RSAs)

“The regulatory and supervisory authorities shall have adequate understanding of Shari’ah non-compliance risks and accordingly ensure that the institution have in place an adequate and effective Shari’ah governance framework and reporting mechanism.” (Paragraph 6)

23. It is the responsibility of the RSAs to ensure effective Shari’ah governance of the institutions in their jurisdiction. RSAs are expected to play their role in establishing and overseeing a robust Shari’ah governance framework.

24. RSAs shall allow Shari’ah-compliant financial services to be offered only by licensed institutions, including Islamic finance windows. [Explanation: Conventional financial institutions shall not offer Shari’ah-compliant financial services except through their Islamic finance windows.]

25. RSAs are strongly recommended to develop suitable prudential guidelines and requirements for the implementation of Shari’ah governance frameworks in order to manage Shari’ah non-compliance risk by the institutions. RSAs shall consider adding suitable criteria enabling adequate Shari’ah governance (including Islamic finance knowledge, qualifications and experience) to complement the standard fit and proper criteria for the management and control positions of the institutions. RSAs shall ensure that the interests of the shareholders, investment account holders (IAHs) and other fund providers of the institutions are safeguarded, so that their funds, which have been collected with a promise of Shari’ah-compliant utilisation, are not utilised, directly or indirectly, for investing in / financing of conventional financial institutions (including the conventional parents of Islamic finance windows and Islamic subsidiaries / associates) or conventional financial instruments.

26. RSAs shall create a regulatory capacity that is commensurate with the size of the industry in their respective jurisdiction by investing in their own people and systems, and by enabling effective

institutional arrangements to supervise, inspect and proactively guide the institutions in the jurisdiction with regard to Shari'ah governance.

27. In jurisdictions with more than one RSA, the respective RSAs shall coordinate to implement the Shari'ah governance framework in a consistent manner.

28. In addition to the responsibilities assigned under different provisions of this standard (or the complementing standards), RSAs shall be responsible for:

    a. working toward the development of a conducive legal and regulatory environment for the growth of the Islamic finance industry;

    b. developing and implementing a continuing professional development programme for their staff responsible for the development of Shari'ah guidelines and oversight of the institutions;

    c. providing all required resources, including adequate budget, access to information and human resources, as may be deemed necessary by RSA staff, as well as, the CSB, for proper discharge of their duties; and

    d. fulfilling its duties and responsibilities towards the CSB (where it exists) by providing it full operational independence.

29. Unless otherwise specified by the RSAs, jurisdictions shall follow the hierarchy of Shari'ah principles and rules set out in the definition of Shari'ah principles and rules (see paragraph 4(l) and the requirements of respective AAOIFI GS[17]).

Principle 3: Central Shari'ah board

"RSAs and / or governments are strongly recommended to establish and appropriately empower central Shari'ah boards (CSBs) in order to harmonise Islamic banking and finance practices in the jurisdiction in line with Shari'ah principles and rules." (Paragraph 7)

30. Requirements related to Principle 3 "Central Shari'ah board" are contained in the respective AAOIFI GS[18].

[17] [ED of] GS ___ "Governance Principles for Determination and Application of Shari'ah Principles and Rules"
[18] GS 8 "Central Shari'ah Board"

Principle 4: Unique organs of institutional Shari'ah governance framework

"The Shari'ah governance framework shall consist, at a minimum, of the following components / organs:

a. Shari'ah supervisory board (SSBs);

b. Shari'ah compliance function;

c. internal Shari'ah audit function; and

d. external Shari'ah audit[19] (ESA)." (Paragraph 8)

31. SSBs have been the most common way to seek Shari'ah-related opinions by an institution. SSBs include Shari'ah scholars who are engaged professionally by the institution to provide guidance and supervision, including on Shari'ah rulings related to products / services, transactions, operations, etc. (see paragraph 4(m)). To guide the day-to-day operations from a Shari'ah compliance perspective, an individual with Shari'ah background and knowledge is also considered necessary by most institutions as the head of Shari'ah compliance department (SCD) (in line with the requirements of respective AAOIFI GS[20]).

32. The Shari'ah compliance function provides a mechanism for ensuring the compliance of an institution's financial arrangements, contracts and transactions with Shari'ah principles and rules. It is an integral part of an institution's governance and control structure. SCD means a department (and includes a division, team, section or unit) entrusted with the responsibilities of Shari'ah compliance in accordance with the requirements of the respective AAOIFI GS[21].

33. The internal Shari'ah audit function is part of the governance organs of an institution, established in line with the requirements of the respective AAOIFI GS[22], being independent of management, with the primary objective to provide assurance to TCWG and the SSB in relation to the institution's adherence to Shari'ah principles and rules. Internal Shari'ah audit assesses the adequacy and effectiveness of intended controls pertaining to adherence to Shari'ah guidelines, whereas the Shari'ah compliance function is an ongoing process of monitoring the institution's overall activities and Shari'ah compliance environment.

34. The ESA provides an independent third-party assurance to the stakeholders of an institution about its compliance with Shari'ah principles and rules. ESA has become a good-practice globally and is increasingly considered essential for safeguarding the integrity, reputation and sustainability of an institution, especially those categorised as public interest institutions.

[19] See paragraph 56, whereby an external Shari'ah audit is mandatory for 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.
[20] GS 9 "Shari'ah Compliance Function"
[21] GS 9 "Shari'ah Compliance Function"
[22] GS 11 "Internal Shari'ah Audit"

Principle 5: Role of those charged with governance and senior management

"An institution shall clearly define the roles and responsibilities of those charged with governance, senior management and other organs towards upholding the Shari'ah compliance of its activities and operations." (Paragraph 9)

35. A comprehensive Shari'ah governance framework demands the creation of certain new organs of governance and management and the assigning of additional responsibilities to existing organs. It is important to note that Shari'ah compliance is the responsibility of each stakeholder of an institution and cannot simply be delegated to a few (for example, the SSB).

Those charged with governance (TCWG)

Roles and responsibilities of TCWG

36. TCWG of an institution (mostly referred to as the board of directors (BOD), along with its respective committees, particularly the audit and governance committee / audit committee) has an oversight responsibility to ensure that an effective and robust Shari'ah compliance environment and culture exist in the institution. They are responsible for establishing a good governance and control framework for the institution, developing a strategy for compliance with Shari'ah principles and rules, and oversight of the management in implementing the same and in achieving the desired objectives. TCWG may use any of their dedicated committees to assist for the purpose of fulfilling their responsibilities under this standard.

37. TCWG have the ultimate responsibility of institutionalising a robust Shari'ah governance framework at the institution that is commensurate with the size, complexity and nature of the business (to be comparable with other governance and control functions). In fulfilling this responsibility, they shall:

    a. approve policies relating to governance structure and reporting arrangements, Shari'ah non-compliance risk management and other areas that are material to the effective implementation of Shari'ah governance within the institution;

    b. oversee the implementation of the CSB's rulings (if any) and decisions, rulings and guidance of the SSB within all business and functional lines, including any business or risk implications arising from such implementation;

    c. oversee the implementation of the internal control framework (including ensuring the independence of Shari'ah compliance and internal Shari'ah audit functions) to prevent systematic Shari'ah non-compliance and any rectification measures to resolve incidences or circumstances of Shari'ah non-compliance or that may result in Shari'ah non-compliance;

    d. oversee the performance of senior management and other officers entrusted to implement the Shari'ah governance framework such that they are satisfied that the measures of their performance are aligned with Shari'ah governance objectives; and

    e. promote a sound corporate culture which reflects the importance of adhering to Shari'ah requirements in product development and marketing, strategy formulation, business operations, risk management practices and other aspects that promote end-to-end compliance with Shari'ah principles and rules.

Capacity development of TCWG

38. The members of TCWG shall, individually and collectively, develop and strengthen their knowledge and understanding of Islamic finance continuously, as well as, keep abreast of the developments that may impact Islamic finance business, to fulfil their responsibility to the institution.

TCWG's interaction with the SSB

39. TCWG shall have due regard for any decision or advice of the SSB on any Shari'ah issues relating to the products / services, transactions, operations, processes or activities of the institution. This requires the TCWG to:

a. give sufficient attention to the facts, rationale and basis for any decisions or advice of the SSB before arriving at its own decision;

b. give fair consideration to the implications of implementing any decisions or advice of the SSB;

c. put in place a resolution mechanism to deal with any differences in views between TCWG and the SSB in a manner that does not undermine the independence and the authority of the SSB; and

d. maintain a record of deliberations between TCWG and the SSB in matters where differences in views exist, and their respective resolutions.

40. TCWG shall establish effective communication with the SSB on all matters relating to Shari'ah requirements, Shari'ah governance and Shari'ah non-compliance risk to enable both parties to effectively discharge their respective responsibilities under the Shari'ah governance framework. TCWG shall regularly review the quality and frequency of their engagement with the SSB.

TCWG's role in ensuring independence and effective performance of the SSB

41. TCWG shall take reasonable steps to ensure that the SSB is free from any undue influences that may hamper its members from exercising their professional objectivity and independence in deliberating issues brought before them.

42. TCWG shall establish a written policy to identify, assess and manage any conflicts of interest arising from any additional activities or services performed by any SSB member for the institution or their other external professional commitments. This shall include policies relating to the involvement of an SSB member in the provision of consultancy services to any clients of the institution, with or without remuneration.

43. TCWG shall allocate sufficient resources for continuous development of skills and expertise of the SSB. This shall include allocating adequate budget, having in place plans for the professional development of SSB members, and regularly updating such plans to ensure that each member possesses the requisite knowledge and skills to fulfil his responsibilities.

44. TCWG shall establish a formal process to assess, at a minimum annually, the performance and effectiveness of the SSB and each of its members. The assessment must consider the competence,

knowledge and contribution of each member to the overall functioning of the SSB[23]. However, in no case shall they perform such an assessment, except to the extent of administrative assessment. [Explanation: Such assessment cannot be performed by the senior management in any manner, whatsoever].

45. TCWG shall also seek periodic authorisation from the shareholders to fix and review the SSB members' remuneration.

46. Certain additional requirements related to principle 5 "Role of those charged with governance and senior management" are contained in the relevant AAOIFI GSs[24].

Senior management

Roles and responsibilities of senior management

47. Senior management has the responsibility to implement the Shari'ah governance framework and to ensure that Shari'ah compliance is embedded in the day-to-day functioning of the institution. The management is responsible for ensuring that the operations of the institution, particularly the financial arrangements, contracts and transactions entered into by the institution with its customers and other stakeholders and related policies and procedures, are, in substance and in their legal form, in compliance with the requirements of Shari'ah principles and rules. The senior management is also responsible for the design, implementation and maintenance of appropriate internal control procedures with respect to such compliance and maintenance of relevant accounting records.

48. The chief executive officer (CEO) or equivalent, leading the senior management, has primary responsibility for the day-to-day management of the institution. In fulfilling the senior management's responsibility towards Shari'ah compliance, the CEO and the senior management shall:

    a. establish a management structure and reporting arrangement that provides a clear scope of accountability between the business lines and the internal control functions that are involved in managing Shari'ah non-compliance risk, including the accountability of the head of SCD;

    b. implement effective Shari'ah governance policies, procedures and practices in accordance with the direction given by TCWG;

    c. implement the rulings of the CSB (if any);

    d. implement the decisions, rulings and guidance of the SSB;

    e. implement an effective communication policy that supports a sound understanding of Shari'ah matters across the institution;

[23] See Appendix B of the [ED of] GS __ "Shari'ah Supervisory Board: Functions and Operations" for an illustrative performance assessment template

[24] GS 4 "Audit and Governance Committee for Islamic Financial Institutions", GS 6 "Statement on Governance Principles for Islamic Finance Institutions" and other relevant GSs

f. conduct regular assessment to evaluate the quality of operational support provided to the SSB and address inadequacies (if any); and

g. report to TCWG, on a timely basis, any significant Shari'ah non-compliance incidents.

Senior management's responsibility towards capacity building

49. It is the senior management's responsibility to design and implement, with the support of the SSB and / or the SCD as appropriate, an effective continuous professional development and training programme for TCWG, the management and other organs of Shari'ah governance, as well as, for the employees of the institution.

50. Each member of the senior management shall continuously develop and strengthen his knowledge and understanding of Islamic finance, as well as, keep abreast of the developments that may impact the operations and activities of the Islamic finance industry.

Senior management's responsibility towards the SSB and other organs of Shari'ah governance

51. Senior management has overall responsibility for:

a. cooperating fully with the SSB and other organs of Shari'ah governance to support the fulfilling of their respective responsibilities;

b. providing complete and accurate information to the SSB prior to all meetings and on an ongoing basis such that it allows the SSB reasonable time to review and fully understand the information[25];

c. providing the SSB, the Shari'ah compliance function, the internal Shari'ah audit function and external Shari'ah auditors (as applicable) complete and unhindered access to all records, transactions and information from all sources, including professional advisers and the institution's employees;

d. observing and implementing Shari'ah rulings and decisions of the SSB;

e. ensuring that Shari'ah guidelines and Fatwas issued by the SSB are accessible at all times to those involved in the actual implementation process, as well as, other stakeholders;

f. ensuring that the information provided includes background or explanatory information relating to matters to be brought before the SSB. As far as possible, such information shall be presented in a manner that would assist the SSB to analyse not only the form, but also the substance, of the issues brought before them[26];

g. preparing a statement of compliance with Shari'ah principles and rules for the stakeholders, which testifies that it has, among others, followed the relevant Shari'ah standards and rulings, implemented a sound Shari'ah governance framework including internal controls,

[25] Also see the relevant requirements of [ED of] GS ___ "Shari'ah Decision-Making Process"
[26] Also see the relevant requirements of [ED of] GS ___ "Shari'ah Decision-Making Process"

fulfilled all the relevant contractual obligations and complied with the relevant code of ethics. A sample management report is annexed to the respective AAOIFI SOAA[27];

h. promptly notifying the SCD if a case of Shari'ah non-compliance comes to the its attention and acting on SCD's advice to rectify the situation;

i. ensuring that appropriate and timely disclosure is made to the stakeholders whenever the SSB departs from, or revises, any of its Shari'ah rulings;

j. ensuring that there is a continuous professional development programme for the SSB and providing adequate support and assistance; and

k. appointing an independent secretariat to serve the SSB (subject to the consent of the SSB) or entrusting the SCD with this task. The secretariat has the responsibility to provide operational support for effective functioning of the SSB, which includes:

    i. providing operational and administrative support to the SSB;

    ii. performing research and studies on Shari'ah issues as requested by the SSB;

    iii. coordinating between the SSB and the management / TCWG; and

    iv. ensuring proper dissemination of decisions and rulings of the SSB within the institution[28].

Principle 6: Shari'ah supervisory board (SSB)

"An institution shall have in place an independent, competent, empowered and adequately resourced Shari'ah supervisory board." (Paragraph 10)

52. Requirements related to principle 6 "Shari'ah supervisory board (SSB)" are contained in the relevant AAOIFI GSs[29].

Principle 7: Shari'ah compliance function

"An institution shall have in place a Shari'ah compliance function that is competent, empowered and adequately resourced to discharge its duties." (Paragraph 11)

53. Requirements related to principle 7 "Shari'ah compliance function" are contained in the respective AAOIFI GS[30].

[27] See Appendix B1 to the SOAA 6 "External Shari'ah Audit"
[28] See paragraphs 52-55 of GS 9 "Shari'ah Compliance Function"
[29] 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"
[30] GS 9 "Shari'ah Compliance Function"

Principle 8: Internal Shari'ah audit function

"An institution shall have in place an internal Shari'ah audit function that is competent, empowered and adequately resourced to discharge its duties." (Paragraph 12)

54. Requirements related to principle 8 "internal Shari'ah audit function" are contained in the respective AAOIFI GS[31].

Principle 9: External Shari'ah audit

"An institution shall be subject to an external Shari'ah audit (ESA)." (Paragraph 13)

55. An ESA shall be performed for an institution on an annual basis.

56. This principle is mandatory for 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.

57. Requirements related to principle 9 "external Shari'ah audit" are contained in the respective AAOIFI SOAA[32].

Principle 10: Islamic finance windows

"An Islamic finance window of a conventional financial institution shall have a suitable Shari'ah governance framework in place to ensure effective Shari'ah compliance of its operations." (Paragraph 14)

58. Requirements related to principle 10 "Islamic finance windows" are contained in the respective AAOIFI GS[33]. Certain transparency and disclosure requirements related to this principle are contained in the respective AAOIFI FAS[34].

Principle 11: Islamic finance subsidiaries / associates

"An Islamic finance subsidiary / associate of a conventional financial institution shall have a suitable Shari'ah governance framework in place to ensure effective Shari'ah compliance of its operations." (Paragraph 15)

59. Requirements related to principle 11 "Islamic finance subsidiaries / associates" are contained in the respective AAOIFI GS[35].

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[31] GS 11 "Internal Shari'ah Audit"
[32] SOAA 6 "External Shari'ah Audit"
[33] [ED of] GS __ "Application of Shari'ah Governance Principles on Islamic Finance Windows"
[34] FAS 40 "Financial Reporting for Islamic Finance Windows"
[35] [ED of] GS __ "Application of Shari'ah Governance Principles on Islamic Finance Subsidiaries / Associates"

Principle 12: Considerations related to the business model and stakeholders' interests

> *"An institution is responsible to ensure that it prudently recognises any considerations or exceptional circumstances arising from the business model or the related stakeholders' interests which may require it to apply proportionality and / or other considerations towards implementation of the principles of this standard." (Paragraph 16)*

60. These considerations include the specific business model, the regulatory environment, the legal system and the overall business environment in which an institution operates, as well as, the status of development of the Islamic finance industry in the respective jurisdiction. Where appropriate, consideration should be given to the proportionality principle (see paragraph 62). Such considerations shall be applied in conjunction with the requirements of principle 13 "applicability to different sectors", where applicable.

Special treatment for participatory stakeholders

61. An institution shall develop and implement a comprehensive and well-defined strategy and policy framework for investment accounts and other participatory stakeholders, in line with the requirements of respective AAOIFI GS[36].

Proportionality considerations

62. The principle of proportionality, for the purpose of application of the requirements of this standard, takes into consideration the relative size and nature of an institution's operations, its business model and the relative stage of development of the Islamic finance industry in the respective jurisdiction. While applying the proportionality considerations, any flexibility allowed (or disallowed), in respect to local governance and regulatory requirements as applicable to all financial institutions (of similar size and nature of operations), shall be evaluated to assess the real need of application of such proportionality considerations.

Outsourcing

63. Unless otherwise prohibited by the respective RSA, an institution may decide to outsource specific components of the Shari'ah governance framework. The decision to outsource shall be made with the approval of TCWG, and only after conducting due diligence on the risks posed by third parties, taking into account their capacity and ethical considerations such as integrity, privacy, confidentiality and security.

Shari'ah compliance and fiduciary ratings

64. Institutions are recommended to seek Shari'ah compliance and fiduciary ratings from independent rating agencies (conducted in accordance with the requirements of respective AAOIFI GS[37]), in order to enhance their level of Shari'ah compliance and reinforce the public's confidence in the institution.

65. Issuers of Sukuk and other publicly offered Islamic finance and investment instruments are also recommended to seek Shari'ah compliance and fiduciary ratings from independent rating agencies

[36] [ED of] GS ___ "Governance and Management of Investment Accounts"
[37] GS 10 "Shari'ah Compliance and Fiduciary Ratings for Islamic Financial Institutions"

(conducted in accordance with the requirements of respective AAOIFI GS[38]), in order to enhance their level of Shari'ah compliance and reinforce the public's confidence in the respective instrument.

Principle 13: Applicability to different sectors

"The provisions of this standard may be suitably implemented using the proportionality criteria and as per the relevance for different sectors of the Islamic finance industry." (Paragraph 17)

66. In general, the provisions of this standard are fully applicable to the banking and Takaful segments. However, provisions of this standard can be applied to other segments such as Islamic capital markets, Islamic deposit insurance, Islamic microfinance and Islamic social finance institutions, with suitable flexibility based on the proportionality principle (see paragraph 62).

67. RSAs are expected to ensure that the provisions of this standard are implemented in full, in spirit and in principle, as per suitability and relevance to the sector / institution under consideration.

Islamic Capital Market

68. Institutions within the Islamic capital market (ICM) include issuers, fund managers and market intermediaries explicitly claiming the Shari'ah compliance of their products and services.

69. An institution shall ensure that the ICM products claimed to be Shari'ah-compliant have undergone a sound screening and approval process by a competent SSB.

70. For ICM, the SSB is comprised, in line with this standard, of three or more Shari'ah scholars. However, it may also be sourced under a service contract through an external Shari'ah consultancy firm provided that all governance and fit and proper criteria as outlined in this standard are complied with. Where a CSB exists in a jurisdiction, the ICM products shall be in compliance with the CSB requirements.

71. An institution marketing a product claimed to be Shari'ah-compliant in the ICM shall make appropriate disclosures should there be any material change affecting the Shari'ah compliance of the product.

Expectations from RSAs with regard to ICM

72. It is expected that the RSAs shall:

    a. clearly specify regulatory measures and remedial actions to be undertaken in the event of a change in status from a Shari'ah-compliant product to a Shari'ah non-compliant product;

    b. be transparent and consistent in their approach to dealing with matters of Shari'ah governance in the ICM; and

    c. have a mechanism in place to cooperate with other RSAs to manage cross-border activities in the ICM in the light of differing Shari'ah interpretations or differences in the relevant Shari'ah governance requirements.

[38] GS 17 "Shari'ah Compliance and Fiduciary Ratings for Sukuk and Other Islamic Finance Instruments"

Islamic microfinance institutions / Islamic fintech platforms / other organisations working for financial inclusion

73. Considering the nature and the scale of activities of an organisation, RSAs may allow certain exceptions to the requirements of this standard and provide appropriate regulatory flexibility (see paragraph 74). The organisations not under prudential regulations wishing to offer Shari'ah-compliant services are encouraged to adopt the relevant and applicable principles of this standard.

74. An example of regulatory flexibility to facilitate operations is to allow the outsourcing of some of the Shari'ah governance functions to a third party, where for example, the RSA can allow smaller service providers to rely on a single member SSB. Alternatively, a number of such providers can collectively form an SSB and share the costs. They can also engage a Shari'ah consultancy firm to provide SSB services under a service agreement. Another option is voluntary Shari'ah services offered by Shari'ah advisers, Shari'ah advisory firms or SSBs (such as that of Islamic banks) to smaller service providers as part of their corporate social responsibility efforts.

75. For prudentially regulated entities, while selectively allowing the above flexibilities and / or exceptions, RSAs shall also ensure that the related risks are controlled and mitigated. For example, if a single Shari'ah consultancy firm is used by multiple entities for an outsourced SSB function, appropriate measures should be put in place to ensure that confidential information from one entity is not leaked to others.

Principle 14: Transparency and disclosure

"An institution shall be transparent in its Shari'ah governance to its shareholders, customers, other relevant stakeholders and market participants." (Paragraph 18)

76. The objective of transparency in Shari'ah governance is to provide shareholders, customers, other relevant stakeholders and market participants with the information necessary to enable them to assess the effectiveness of TCWG in ensuring Shari'ah compliance. This applies, in particular, to the Islamic banking, Islamic capital market and Takaful sectors. Disclosures shall be made through a formal disclosure policy of the institution and shall be clear, comprehensive, meaningful to users and consistent over time.

77. An institution shall disclose relevant and useful information that supports the key areas of Shari'ah governance in line with the principles contained in this standard. Such disclosures shall be proportionate to the size, complexity, structure, economic significance and risk profile of the institution.

78. Subject to regulatory requirements, institutions may provide disclosures detailing their annual Zakah obligations, method(s) used to determine their Zakah base and the recipients of Zakah contributions. The requirements related to appropriate disclosures in respect of Zakah are contained in respective AAOIFI FAS[39].

[39] FAS 39 "Financial Reporting for Zakah"

79. An institution shall present as part of its financial statements in line with the requirements of respective AAOIFI FAS[40] or in its annual report a statement (or disclosure) of sources and uses of charity funds, including prohibited / Shari'ah non-compliant income and other charitable funds.

Takaful

80. Investment is one of the key activities in Takaful that shall be in line with Shari'ah principles and rules. In addition to the disclosures specified in paragraph 81, Takaful and re-Takaful operators shall be required to disclose the following information for each fund:

a. the adopted Shari'ah screening methodology;

b. any purification payments made in respect of assets or businesses that were not fully Shari'ah-compliant; and

c. the amount of any purification payments held by the Takaful / re-Takaful undertaking and not yet paid.

81. Takaful institutions shall also ensure appropriate disclosures in respect of the following:

a. a brief about the overall Takaful model applied and the core Shari'ah principles and rules applicable thereto, including but not limited to the policy in respect of segregation of various Takaful participants' funds including investment funds, and the mutual relationship between these funds and the Takaful entity along with significant terms and conditions applicable thereto, in line with Shari'ah principles and rules;

b. policy in respect of Qard Hasan, its impairment, any regulatory requirements in respect of the same, along with any waiver or write-off requirements;

c. disclosures in respect of Qard Hasan, its movement (including receipts and payments, impairment and other adjustments), as well as, adequate future projections about the ability or otherwise of the Takaful funds to repay the Qard Hasan in the foreseeable future;

d. policy in respect of maintenance of regulatory reserve and solvency requirements, separately identifying the extent to which these pertain to the Takaful participants' funds and investment funds;

e. policy in respect of surplus and deficit determination in the Takaful participants' funds related to the risk-sharing / underwriting business, its attribution and distribution, in line with the Shari'ah principles and rules;

f. disclosures of various fees charged (such as Wakala) and incomes / surpluses shared (such as Mudaraba / Al-Wakala Bi Al-Istithmar (investment agency)) under different internal contracts by the Takaful entity to/with various Takaful participants' funds (including investment funds). Any surplus shared by the Takaful entity should be identified separately (if so allowed / required by the respective Takaful model / regulations);

[40] FAS 1 "General Presentation and Disclosures in the Financial Statements"

g. in case of involvement of a Waqf, disclosure of the significant aspects of the Takaful model involving the Waqf along with disclosure on the amounts attributable to Waqf, including seed money / Waqf corpus and other significant amounts;

h. disclosure of expenses and costs shared between different funds and the Takaful entity; and

i. in cases where the financial reporting model (due to regulatory or financial reporting regime requirements) does not account for the Takaful participants’ funds and the Takaful entity separately, the disclosure of all significant balances as consolidated in the financial statements attributable to the Takaful entity and the respective funds, as well as, transactions and balances among them.

Effective date

82. 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. 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

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.