



**ISLAMIC FINANCIAL SERVICES BOARD**

---

**EXPOSURE DRAFT**

**GUIDING PRINCIPLES ON *SHARĪAH* GOVERNANCE SYSTEM**

---

Comments on this Exposure Draft should be sent  
to the IFSB Secretariat not later than 15 May 2009  
at email [ifsb\\_sec@ifsb.org](mailto:ifsb_sec@ifsb.org) or facsimile +603-26984280

**December 2008**

## **ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit [www.ifsb.org](http://www.ifsb.org).

## TECHNICAL COMMITTEE

### Chairman

H.E. Dr. Abdulrahman A. Al-Hamidy – Saudi Arabian Monetary Agency

### Deputy Chairman

Dr. Mulya Effendi Siregar – Bank Indonesia

### Members\*

Mr. Khalid Hamad Abdulrahman Hamad	Central Bank of Bahrain
Mr. Hamid Tehranfar	Central Bank of the Islamic Republic of Iran
Dr. Sami Ibrahim Al-Suwailem	Islamic Development Bank
Dr. Mohammad Yousef Al-Hashel	Central Bank of Kuwait
Mr. Bakarudin Ishak	Bank Negara Malaysia
Mr. Pervez Said	State Bank of Pakistan
Mr. Mu'jib Turki Al Turki	Qatar Central Bank
Mr. Chia Der Jiun	Monetary Authority of Singapore
Mr. Osman Hamad Mohamed Khair	Central Bank of Sudan
Mr. Saeed Abdulla Al-Hamiz	Central Bank of United Arab Emirates

**\*In alphabetical order of the country the member represents**

## SHARĪAH GOVERNANCE WORKING GROUP

### Chairman

H.E. Dr. Abdulrahman A. Al-Hamidy – Saudi Arabian Monetary Agency

### Deputy Chairman

H.E. Mr. Osman Hamad Mohamed Khair – Central Bank of Sudan

### Members\*

Mr. Ak Shahrulazmi Pg Dr. Hj Ismail	Brunei Ministry of Finance
Mr. Ali Sakti	Bank Indonesia
Mr. Cecep Maskanul Hakim	Bank Indonesia
Mr. Faisal Adnan Al-Roudan	Central Bank of Kuwait
Mr. Rustam Mohd Idris	Bank Negara Malaysia
Dr. Md Nurdin Ngadimon	Securities Commission, Malaysia
Mr. Syed Azhan Syed Mohd Bakhor	Securities Commission, Malaysia
Mr. Abdul Ghani Endut	CIMB Islamic Bank Berhad, Malaysia
Mr. Mahmood Shafqat	State Bank of Pakistan
Mr. Abdullah Ahmed Ali	Qatar Central Bank
Mr. Tariq Javed	Saudi Arabian Monetary Agency
Mr. Mohammad Abdullah Al-Saab	Capital Market Authority, Saudi Arabia
Dr. Mousa Adam Eisa	The National Commercial Bank, Saudi Arabia
Mr. Hamad Abdulla Eqab	Albaraka Banking Group, Saudi Arabia
Mr. Nazeem Ebrahim	Oasis Crescent Capital (Pty) Ltd., South Africa
Mr. Abdalla Elhassan Mohamed ElBasheer	Central Bank of Sudan
Mr. Simon Gray	Dubai Financial Services Authority

**\*In alphabetical order of the country the member represents**

**ISLAMIC DEVELOPMENT BANK SHARĪAH COMMITTEE\***

**Chairman**

Sheikh Mohamed Mokhtar Sellami

**Deputy Chairman**

Sheikh Saleh Al Husayn

Sheikh Abdul Sattar Abu Ghodda	Member
Sheikh Hussein Hamed Hassan	Member
Sheikh Mohammad Ali Taskhiri	Member
Sheikh Mohamed Hashim Bin Yahaya	Member

\* In alphabetical order

**SECRETARIAT, ISLAMIC FINANCIAL SERVICES BOARD**

Professor Rifaat Ahmed Abdel Karim	Secretary-General
Professor Rodney Wilson	Consultant
Professor Simon Archer	Consultant
Mr. Madzlan Mohamad Hussain	Senior Project Manager

## TABLE OF CONTENTS

<b>ACRONYMS</b>	<b>v</b>
<b>INTRODUCTION</b>	<b>1</b>
Definition and Scope of <i>Shari'ah</i> Governance System	1
How to Use the Standard	5
<b>THE GUIDING PRINCIPLES</b>	<b>6</b>
Part I – General Approach to the <i>Shari'ah</i> Governance System	6
Part II – Competence	9
Part III – Independence	13
Part IV – Confidentiality	15
Part V – Consistency	17
<b>DEFINITIONS</b>	<b>19</b>
<b>APPENDICES</b>	<b>20</b>
APPENDIX 1: Key Terms of Reference for the <i>Shari'ah</i> Board	20
APPENDIX 2: Operative Procedures of the <i>Shari'ah</i> Board	22
APPENDIX 3: Basic Professional Ethics and Conduct for Members of the <i>Shari'ah</i> Board	24
APPENDIX 4: Minimum Competence Requirements for Members of the <i>Shari'ah</i> Board	26
APPENDIX 5: Examples of Performance Measures for the <i>Shari'ah</i> Board	27

## ACRONYMS

BOD	Board of directors
CIS	Collective investment scheme
IAH	Investment account holder
ICIS	Islamic collective investment scheme
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services (which, for the purpose of this document only, shall include Islamic windows operation, Islamic insurance/ <i>Takaful</i> institutions and Islamic mutual funds)
IOSCO	International Organization of Securities Commissions
IRR	Investment risk reserve
ISCU	Internal <i>Sharī'ah</i> compliance unit/department
ISRU	Internal <i>Sharī'ah</i> review/audit unit/department
OECD	Organisation for Economic Co-operation and Development
PER	Profit equalisation reserve
SSB	<i>Sharī'ah</i> Supervisory Board
TO	<i>Takāful</i> operation

**Bismillahirrahmanirrahim.**  
*Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi*

## INTRODUCTION

1. In recent years, the Islamic Financial Services Board (**IFSB**) has developed three Guiding Principles to help strengthen governance structures and processes in various segments of the Islamic financial services industry (**IFSI**) in line with its mandate to promote soundness and stability of the Islamic financial system.<sup>1</sup> It was noted that in all three projects, concerns over the roles and functions of the *Sharī'ah* boards,<sup>2</sup> which constitute part of the broader governance system, have been a recurring theme. This is inevitable, considering that compliance with *Sharī'ah* rules and principles is the *raison d'être* of the IFSI. In fact, other IFSB standards – such as those on risk management, capital adequacy and supervisory review process – also contain requirements and recommendations aimed at ensuring that an appropriate *Sharī'ah* governance system is in place.<sup>3</sup>
2. Consequently, the IFSB Council, during its ninth meeting in Jeddah, approved the preparation of a set of Guiding Principles on the *Sharī'ah* governance system, which is expected to:
  - (a) complement other prudential standards issued by the IFSB by highlighting in more detail to the supervisory authorities in particular, and the industry's other stakeholders in general, the components of a sound *Sharī'ah* governance system, especially with regard to the competence, independence, confidentiality and consistency of *Sharī'ah* boards;
  - (b) facilitate better understanding of *Sharī'ah* governance issues and how stakeholders should satisfy themselves that an appropriate and effective *Sharī'ah* governance system is in place;
  - (c) provide an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with *Sharī'ah* rulings; and
  - (d) provide greater harmonisation of the *Sharī'ah* governance structures and procedures across jurisdictions, especially since there are increasing numbers of IIFS with cross-border operations.

### Definition and Scope of *Sharī'ah* Governance System

3. The term “*Sharī'ah* Governance System”, despite being commonly used within the IFSI to refer to structures and processes adopted by stakeholders in the IFSI (from financial regulators to market players) to ensure compliance with *Sharī'ah* rules and principles, has never been properly defined in any of the existing standards.<sup>4</sup> In the interests of clarity,

---

<sup>1</sup> These include (i) Guiding Principles for Governance for Institutions offering only Islamic Financial Services (**IIFS** – excluding Islamic insurance/*takāful* institutions and Islamic mutual funds), also known as **IFSB-3** (2006); Guiding Principles on Governance for Islamic Collective Investment Schemes, also known as **IFSB-6** (2008) and Guiding Principles on Governance for *Takāful* Operations, also known as **IFSB-8** (2009).

<sup>2</sup> *Sharī'ah* boards are usually comprised of a panel of *Sharī'ah* scholars acting as special advisers to the institutions, and may alternatively be called a *Sharī'ah* Committee or *Sharī'ah* Supervisory Board. However, in recent years there has been an increasing trend for corporate entities, including IIFS themselves, to perform this function in the form of “*Sharī'ah* advisory firms”.

<sup>3</sup> For example, the Guiding Principles on Risk Management, known as **IFSB-1** (2005) state the need for IIFS to establish appropriate policy and infrastructure in order to manage legal risk and *Sharī'ah*-compliant risk, which are considered part of the operational risks of IIFS – thus implicitly indicating the need for a robust and reliable *Sharī'ah* governance system to manage *Sharī'ah*-compliant risks. The standard on Supervisory Review Process, known as **IFSB-5** (2007), recommends that the supervisory authorities are expected to satisfy themselves that there are appropriate system in place, one of which relates to the roles played by the *Sharī'ah* boards.

<sup>4</sup> It is noted that besides the aforementioned IFSB standards, certain international bodies for Islamic finance, as well as some supervisory authorities, have issued their own guidelines in relation to *Sharī'ah* governance.

this document shall adopt the following definition of “*Sharī’ah* Governance System” and the other key terminologies:

“*Sharī’ah* Governance System” refers to the set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight<sup>5</sup> of *Sharī’ah* compliance over each of the following structures and processes:

- (a) *issuance of relevant Sharī’ah pronouncements/resolutions that govern the whole of its operation*

“*Sharī’ah* pronouncements/resolutions” refers to a juristic opinion on any matter pertaining to *Sharī’ah* issues in Islamic finance, given by the appropriately mandated *Sharī’ah* board. In jurisdictions where there is a central authority such as the national *Sharī’ah* board or *Fatwa* Council, that central authority has the power to issue such pronouncements/resolutions, resulting in the *Sharī’ah* board at the IIFS focusing only on ensuring that the IIFS is compliant with the pronouncements/resolutions issued by the central authority. Otherwise, generally, *Sharī’ah* boards at the IIFS themselves may perform this function.

Once a *Sharī’ah* pronouncement/resolution is actually implemented, it becomes a “*Sharī’ah* ruling” (*hukm al-Sharī’*) with full legal effect that binds the IIFS.

A *Sharī’ah* pronouncement/resolution shall only be issued through appropriate due processes, which amongst others, should involve rigorous deliberation among members of the *Sharī’ah* board over any proposed *Sharī’ah*-compliant products or transactions that require a *Sharī’ah* endorsement, as well as detailed scrutiny of the legal contracts and other documents relevant to the products or transactions;

- (b) *dissemination of information on such Sharī’ah pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with the Sharī’ah pronouncements/resolutions vis-à-vis every level of operations and each transaction*

Such a task would normally be undertaken by a designated “internal *Sharī’ah* compliance unit/department (ISCU)”, or at least a *Sharī’ah* compliance officer who is part of the IIFS’s compliance team. Besides equipping it with the appropriate compliance-monitoring skills and relevant knowledge of the *Sharī’ah*, the IIFS should ensure that the ISCU is separate and independent from the business units and departments.

---

<sup>5</sup> A key characteristic of independence is the ability to exercise sound judgement after fair consideration of all relevant information and views without influence from management or inappropriate outside interests. The IFSB-3 discussed this at length, and among other things requires that the professionalism and independence of the *Sharī’ah* board must be upheld with the highest respect. This concept is further reinforced in Appendix 3.



- (c) *an internal Sharī'ah compliance review/audit for verifying that Sharī'ah compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified*

IIFSB-3 sets out that *Sharī'ah* pronouncements/resolutions issued by the *Sharī'ah* boards should be strictly adhered to. The internal *Sharī'ah* review would therefore be assigned to someone adequately trained in *Sharī'ah* compliance review/audit, so that he or she would have a competent grasp of the process.

If the ISCU is part of the IIFS's compliance team, the internal *Sharī'ah* review/audit unit/department (**ISRU**) may be established to function in a similar manner to the IIFS's internal audit team. The major difference is that while the internal auditor will usually report to the Audit Committee, the ISRU will report to the *Sharī'ah* board.

Where appropriate, the internal *Sharī'ah* review/audit reports shall require or recommend the management of the IIFS to address and rectify any issues of *Sharī'ah* compliance.

- (d) *an annual Sharī'ah compliance review/audit for verifying that the internal Sharī'ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Sharī'ah board.*

The *Sharī'ah* board who issued the *Sharī'ah* pronouncements/resolutions can take charge of this process, having received feedback and reports from the ISRU. Alternatively, this task may be assigned to an external auditor or an external *Sharī'ah* firm.

The *Sharī'ah* board that carries out the *Sharī'ah* compliance review/audit shall produce reports, indicating whether the IIFS has complied with *Sharī'ah* requirements throughout the financial year. Where appropriate and if deemed necessary, there could be two sets of reports produced: a general statement of compliance that should be included in the annual report of the IIFS; and a more detailed account of compliance work undertaken addressed specifically to the supervisory authorities.

4. Another term that has been commonly used within the IFSI is "*Sharī'ah* scholars", which refers to persons who are engaged professionally by IIFS to provide expertise in the *Sharī'ah* compliance process. While the word "scholar" has been preferred as a direct translation for "*alim*" (*plural: ulama*), which connotes a person who is learned and expert, in the context of the IFSI we are actually referring to a more specialised level within *fiqh al-muamalat* (Islamic commercial laws) rather than *Sharī'ah* more widely or other areas of Islamic studies. Furthermore, that specialisation is dedicated towards providing expert opinions in the form of *Sharī'ah* pronouncements/resolutions related specifically to

Islamic financial services and usually not directly to the general public or businesses more widely. Therefore, again in the interests of clarity, it is important to stress the “professional” (as opposed to an “academic”) connotation associated with this role. Hence, this document adopts the term “members of the *Sharī'ah* board”, rather than “*Sharī'ah* scholars”, to refer to *ulama* who provide their professional services specifically within the IFSI. Other key terms carry the meaning and context as defined on page 19.

5. An illustration of how the *Sharī'ah* Governance System complements the existing governance, control and compliance functions within an IIFS, comparative to the scenario in a typical financial institution, is provided below:

FUNCTIONS	TYPICAL FINANCIAL INSTITUTION	ADDITIONS IN IIFS
Governance	• Board of directors	• <i>Sharī'ah</i> board
Control	• Internal auditor • External auditor	• ISRU • External <i>Sharī'ah</i> review
Compliance	• Regulatory and financial compliance officers, unit or department	• ISCU

6. In reality, the detailed scope of the *Sharī'ah* Governance System may vary from one jurisdiction to another, depending on the types of structures adopted by the IIFS as permitted by the authorities. Acknowledging this fact, this document shall further subscribe to the following premises:

- (i) The IFSB standards and guiding principles shall draw upon and complement one another, and form a coherent prudential framework. The requirements and recommendations in this document do not, in any manner, contradict or supersede the requirements and recommendations relating to the *Sharī'ah* Governance System that may have been mentioned in other IFSB standards and guiding principles.
- (ii) It is perfectly understandable that supervisory authorities may tailor the *Sharī'ah* Governance System adopted by IIFS in their respective jurisdictions to suit market realities and the stage of development of their IFSI. Each model may have its pros and cons, and supervisory authorities should have a clear understanding of these and justification as to which model would suit their requirements. In this regard, the conventional wisdom of “no single model” and “no single cure” as advocated by the internationally recognised promoter of good governance, the Organisation for Economic Co-operation and Development (**OECD**), is relevant.
- (iii) The burden of ensuring a sound and effective *Sharī'ah* Governance System should not be left to members of the *Sharī'ah* board alone. Every stakeholder in the IFSI, including the clients, management, shareholders and the supervisory authorities, should also play a part in sharing the responsibility.<sup>6</sup> Comprehensive guidance on the *Sharī'ah* Governance System would enable all stakeholders to understand and perform their roles in achieving the *Sharī'ah* governance objectives, and help to promote soundness and stability of the IFSI. Therefore, while *Sharī'ah* boards are expected to play a leading role in ensuring sound *Sharī'ah* governance, it is also reasonable to expect other organs of governance in an IIFS to share in upholding the *Sharī'ah* Governance System by executing their functions well and recognising the importance of complementing the work of the *Sharī'ah* board. In this respect, IIFS are expected to view the implementation of a *Sharī'ah* Governance System from a **comprehensive** perspective.

<sup>6</sup> Members of the *Sharī'ah* board are generally expected to be expert in both *fiqh al muamalat* and contemporary finance.

## How to Use the Standard

7. This document contains nine guiding principles (hereinafter collectively referred to as the **Guiding Principles**). The Guiding Principles are divided into five parts:

Part I	relates to the general approach to a <i>Sharī'ah</i> Governance System, whereby various <i>ex-ante</i> and <i>ex-post</i> processes considered as essential parts of good governance practices in other internationally recognised governance standards, such as the precise terms of reference for <i>Sharī'ah</i> boards, appropriate alignment of incentives, proper record-keeping, adoption of a professional code of ethics, etc., are adapted in order to strengthen the <i>Sharī'ah</i> Governance System.
Part II	in the area of competence, suggests various measures to ensure reasonable expertise and skill-sets in <i>Sharī'ah</i> boards, and to evaluate their performance and professional development.
Part III	aims at safeguarding the independence of <i>Sharī'ah</i> boards, particularly from the management of IIFS, by highlighting various issues arising from potential conflicts of interest and recommending how they should be managed.
Part IV	emphasises the importance of observing and preserving confidentiality by the organs of <i>Sharī'ah</i> governance.
Part V	focuses on improving consistency in terms of the professionalism of members of the <i>Sharī'ah</i> board, which would be crucial in enhancing their credibility and confirming their integrity through a set of best practices.

8. The Guiding Principles provide some examples of current practices that can be considered as best practices. It must be appreciated, however, that as the IFSI continues to grow, best practices would – and should – also change as markets alter and develop, and as technology, financial engineering and improved coordination between supervisory authorities and market players make other strategies available. It is not the purpose of the Guiding Principles to prescribe every possible governance, control or compliance procedure. Instead, the IFSB will continue to review and revise these recommendations from time to time, and encourage stakeholders in the IFSI to do the same.
9. In its other standards, the IFSB recommends adoption of the “comply or explain” approach in relation to disclosures, as this approach is very pragmatic in terms of accommodating the diverse legal frameworks of the jurisdictions in which IIFS operate. Furthermore, it would facilitate the adoption of a governance framework that is commensurate and proportionate with the size, complexity and nature of each IIFS.<sup>7</sup> Therefore, IIFS are recommended to adopt the same approach whenever disclosing their compliance with this document to the relevant stakeholders.

---

<sup>7</sup> IFSB-3 explains that the “comply or explain” approach builds on the idea of market discipline, whereby stakeholders (including the supervisor) are empowered to react to unsatisfactory governance arrangements or sub-standard disclosures (which can be either false, substantially incomplete or misleading). The stakeholders’ sanctions may range from reputational damage for the IIFS, to loss of trust in the management – forcing some managers to quit, or to take legal actions based on contractual terms. Supervisory authorities particularly should have adequate enforcement mechanisms, ranging from the power to direct necessary disclosures, to imposing reprimands and fines in order to curb deliberate non-compliance.

## THE GUIDING PRINCIPLES

### Part I – General Approach to the *Sharī'ah* Governance System

**Principle 1.1: The *Sharī'ah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.**

*No “single model” and “one-size-fits-all” approach*

10. The IFSB has consistently required in its standards and guiding principles that every IIFS shall have adequate and effective access to a *Sharī'ah* board, who will have a clear mandate and responsibility for ensuring that the IIFS adheres to *Sharī'ah* rules and principles with respect to all Islamic financial products and services that it offers. In this respect, it is duly acknowledged that there are various *Sharī'ah* governance structures and models that have been adopted in different jurisdictions where IIFS are present.
11. Some supervisory authorities may decide that their responsibility for governance does not extend to the particular *Sharī'ah* governance structure adopted by an IIFS. As they are concerned only that IIFS have an effective system for managing the reputational risk related to *Sharī'ah* compliance, they permit IIFS to decide for themselves what kind of *Sharī'ah* Governance System to adopt. The market is left to determine freely which system lends sufficient credibility to the products and services that each IIFS offers. Other supervisory authorities are concerned with “market deficiencies” and the need for client protection. Therefore, they require that each IIFS should have a properly functioning *Sharī'ah* Governance System in place and will seek reassurance that this is the case. They also, through an open consultative process untied to any specific *Sharī'ah* board, issue circulars and directives relating to *Sharī'ah*-compliant products such as *sukuk*, etc.
12. A few other supervisory authorities seem to take the view that *Sharī'ah* boards have a significant role to play in monitoring the health of IIFS, similar to other professional advisers such as lawyers, accountants and auditors. They then impose a requirement that each IIFS must have a certain minimum number of members of the *Sharī'ah* board, who must also meet certain “fit and proper” criteria – similar to the assurance sought when banks are appointing their board of directors (**BOD**).
13. In some jurisdictions, supervisory authorities have their own *Sharī'ah* board that works together with them in issuing standardised *Sharī'ah* pronouncements/resolutions, as well as aligning relevant policy and regulatory frameworks with the *Sharī'ah*. Although they may be known by different names such as National *Sharī'ah* Advisory Council, National *Fatwa* Council, High *Sharī'ah* Board, etc., their functions are similar – i.e. to become the highest body issuing *Sharī'ah* pronouncements/resolutions for IFSI in the country. Some of these supervisory authorities have even gone one step further, whereby they prohibit the members of the national *Sharī'ah* panel from sitting on a *Sharī'ah* board of the market players. In addition, each member of the *Sharī'ah* board is restricted in terms of the number of *Sharī'ah* boards of market players that he or she can serve. This restriction is intended not only to minimise the conflict of interest and maintain an appropriate firewall to preserve confidentiality, but also (perhaps more importantly) to ensure that the members of a *Sharī'ah* board can dedicate adequate time and effort to each IIFS that they serve.
14. In line with internationally recognised corporate governance standards such as those issued by the OECD, IIFS should exercise proper discretion in choosing *Sharī'ah* governance structures so that they appropriately safeguard the fulfilment of fiduciary duties including good faith, care, skill and diligence towards all their stakeholders. Each IIFS should consider its size and, with a view to determining the impact of the number of

members upon effective decision-making, decide what size *Sharī'ah* board is most appropriate. IIFS should further take into account the scope and nature of their operations. As far as possible, an IIFS should aim for a *Sharī'ah* board with a mixture of experience and competencies.

15. In this respect, it is envisaged that the *Sharī'ah* governance needs and requirements of different types of IIFS which may be similar as a matter of principle, would be diverse as a matter of practice. For example, a conventional bank engaging in Islamic finance transactions on an ad-hoc basis, or an “Islamic window” of a conventional bank with a very limited offering of Islamic finance products, may not be expected to have an in-house *Sharī'ah* governance framework with the resources of a full-fledged IIFS or an Islamic window with a very broad range of Islamic finance products. Similarly, an Islamic collective investment scheme (ICIS) or an Islamic fund management operation may require different skill-sets from its *Sharī'ah* board compared to what could be expected from such a board in a *Takāful* operation (TO).

*Ex-ante considerations that should take place at the product design/development stage, before it is offered to the customers*

16. At the product design/development stage, an IIFS would want to ensure that its *Sharī'ah* Governance System covers the relevant *ex-ante* processes, namely (i) issuance of *Sharī'ah* pronouncements/resolutions, and (ii) compliance checks, before the product is offered to the customers.
17. Hence, prior to establishing or engaging its *Sharī'ah* board, an IIFS should be fully aware of its options, among others:
  - to appoint a reputable and credible *Sharī'ah* board;<sup>8</sup>
  - to support the *Sharī'ah* board by appointing an ISCU or an individual *Sharī'ah* officer; and
  - for the *Sharī'ah* board to have at least three members, possibly of different nationalities, or trained in different schools of jurisprudence, and to have a mix of more experienced and less experienced members of the *Sharī'ah* board. In addition to their *Sharī'ah* expertise, members of the *Sharī'ah* board should possess some exposure in the areas of commerce or finance – e.g. in retail banking or capital market products.

*Ex-post considerations that should be observed at product offering stage – i.e. after the product has been offered to the customers and transactions have been carried out*

18. For good risk management and progressive verification of product viability, an IIFS would want to ensure that its *Sharī'ah* Governance System covers the relevant *ex-post* processes – namely, internal *Sharī'ah* review and *Sharī'ah* governance reporting. Without such follow-up, the IIFS would not be able to monitor the consistency of its *Sharī'ah* compliance and effectively manage any *Sharī'ah* compliance risk that may arise over time.
19. Hence, an IIFS should be fully aware of the possibility of, among others:
  - ensuring that the *Sharī'ah* board is more focused, with more time spent on each assignment and conflicts of interest adequately managed, which may imply that its

---

<sup>8</sup> It is noted, however, that in some jurisdictions the regulatory framework permits the appointment of an individual member of the *Sharī'ah* board to execute the *Sharī'ah* governance function in an IIFS. While such an approach might be justified by the cost factor, it would almost certainly put an IIFS at a disadvantage in terms of the collective wisdom and credibility that can be achieved, compared with a panel of *Sharī'ah* board comprising several members. Furthermore, it might be argued that the independence of an individual member of the *Sharī'ah* board would be more questionable.

- members should not serve more than a limited number of clients;<sup>9</sup>
- letting the *Sharī'ah* board mandate and delegate some of its functions to the ISCU;
- hiring and nurturing young members of the *Sharī'ah* board with promising potential to expand the talent pool in the profession; and
- engaging other professionals such as lawyers, accountants and economists to assist and advise the *Sharī'ah* board, especially on legal and financial issues.

**Principle 1.2: Each IIFS must ensure that the *Sharī'ah* board has:**

- **a clear terms of reference regarding its mandate and responsibility;**
  - **well-defined operating procedures and lines of reporting; and**
  - **good understanding of, and familiarity with, professional ethics and conduct.**
20. In order for the *Sharī'ah* board to have a precise chain of command and accountability towards the respective stakeholders of the IIFS, it has to be equipped with:
- (i) a mandate that grants it appropriate powers to carry out its role and functions;
  - (ii) well-organised operative procedures with regard to meetings, the recording of meetings, decision-making processes and to whom its decisions will be passed for effective implementation, including processes to review those decisions whenever necessary; and
  - (iii) a sound code of ethics and conduct that would enhance the integrity, professionalism and credibility of the members of the *Sharī'ah* board.

*Terms of appointment*

21. Principles of good governance, prudent risk management and professionalism require the appointment of the *Sharī'ah* board to be made formally in writing and with the terms of reference clearly set out. The appointment letter, which becomes the contract of service for the members appointed to serve on the *Sharī'ah* board of the IIFS, is the primary document that determines the form of relationship, level of fiduciary duties, and chain of accountability between the *Sharī'ah* board, the IIFS and its stakeholders. As it is legally a binding contract between the two parties, at the minimum, the terms of reference should contain the information set out in **Appendix 1**.
22. As the legal framework in most jurisdictions holds the BOD as the body ultimately responsible with regard to the governance of an IIFS, the *Sharī'ah* board has to be clear on the limits of its own power.<sup>10</sup> Respect for each other's role and function is crucial, as good governance requires all organs of governance to work *with*, and not against, one another. The BOD, the *Sharī'ah* board, the management, the supervisory authority, as well as other stakeholders such as the customers, suppliers and the public, should always seek to improve communications among themselves in order to avoid misunderstandings and confusion, in line with the *Quranic* injunction in *Surah Al-Maidah* verse 2: "*Help ye one another in righteousness and piety, but help ye not one another in sin and rancour; Fear Allah, for Allah is strict in punishment.*"

*Operative procedures and line of reporting*

<sup>9</sup> It is important to ensure there are appropriate firewalls that can neutralise any potential conflicts. For example, it may be acceptable for a *Sharī'ah* scholar to become a member of the *Sharī'ah* board for IIFS operating in different segments of the IFSI or in different jurisdictions.

<sup>10</sup> Any intervention by a *Sharī'ah* board shall always be in relation to compliance with the *Sharī'ah* and not exceed the mandate of the *Sharī'ah* board. *Sharī'ah* boards should also be careful not to make pronouncement to the public without consulting the BOD or the management in relation to its duties and responsibilities to the IIFS. In any event, whenever there arise serious and irreconcilable differences of opinion between the *Sharī'ah* board and any other organ within the IIFS, including the BOD and the management, the *Sharī'ah* board shall put on record in its report or statements directed to the shareholders its concerns over any *Sharī'ah* compliance issues. However, before any announcement on *Sharī'ah* compliance issues from the *Sharī'ah* board is made available in the public domain, the board should inform the supervisory authorities so that they would be in a position to make a timely intervention and review the situation, notably by anticipating any adverse reaction from the relevant stakeholders.

23. A clear set of rules and bylaws on how meetings shall be conducted, decisions made and recorded, and reports prepared and submitted, will provide much-needed direction for the *Sharī'ah* board in understanding the level of their accountability. This also would facilitate the relationship between the *Sharī'ah* board and other organs within the IIFS's set-up, thus allowing them to work more effectively with one another without ambiguity over responsibilities and overlapping of tasks. **Appendix 2** recommends some best practices that could be adopted by the IIFS in respect of their operative procedures.
24. It is strongly recommended that IIFS develop an in-house capability by having a dedicated ISCU comprised of *Sharī'ah* officers with appropriate qualifications and experience.<sup>11</sup> Those in-house officers can, among other things:
- (i) become the first point of reference for *Sharī'ah* compliance issues, with an advisory/consultancy role delegated by the *Sharī'ah* board;
  - (ii) handle the processing and secretarial matters relating to issues to be raised to the *Sharī'ah* board; and
  - (iii) provide input for executive decisions to be made by the senior management.

#### *Professional ethics and conduct*

25. In the absence of an internationally recognised code of ethics and conduct for members of *Sharī'ah* boards, the IIFS shall establish its own appropriate code of ethical conduct to be complied with by its *Sharī'ah* board. This code of ethical conduct may be developed together and in consultation with members of the *Sharī'ah* board, who should be reminded of it prior to their appointment or the renewal of their service as members of the *Sharī'ah* board to the IIFS. Revisions and improvements to the code of ethical conduct should be carried out from time to time, also with full participation from the *Sharī'ah* board. Supervisory authorities might be interested to satisfy themselves that adequate systems are in place to monitor compliance with this code, and to ensure that any misconduct is swiftly and effectively dealt with. Some basic “do’s” and “don’ts” for members of the *Sharī'ah* board, including the duty to avoid a conflict of interest with the IIFS, are set out in **Appendix 3**. This also relates directly to the issue of independence, which will be elaborated on in Part III.

## **Part II – Competence**

### **Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the *Sharī'ah* Governance System fulfils an acceptable fit and proper criteria.**

26. It has been common for supervisory authorities to require the BOD and senior management of IIFS to comply with certain minimum criteria in order to ensure the public’s confidence that the IIFS they are dealing with are competent, honest, financially sound and will treat them fairly. In view of the importance of the persons mandated with overseeing the *Sharī'ah* Governance System in the decision-making process of IIFS, it is appropriate that certain “fit and proper” criterion be imposed on members of the *Sharī'ah* board as well as officers of the ISCU and ISRU.
27. The BOD of IIFS should consider the following criteria when assessing the fitness and propriety of individuals to serve on the *Sharī'ah* board as well as officers of the ISCU and ISRU:
- (i) good character – i.e. honesty, integrity, fairness and reputation; and
  - (ii) competence, diligence, capability and soundness of judgement.

---

<sup>11</sup> Please refer to Appendix 4 for some recommendations on the minimum competence required for an internal *Sharī'ah* officer.

It should be noted that the above list is not exhaustive and, accordingly, the BOD should consider all other relevant matters on a case-by-case basis – in particular, aspects that are relevant to the segments of the IFSI they are in, and the jurisdiction’s legal and regulatory framework.

### *Good character*

28. Good character – i.e. honesty, integrity, fairness and reputation – are qualities that are demonstrated over time. In determining a person’s good character, and to guide the hiring criteria to be applied before appointing someone to serve on the *Sharī’ah* board, the IIFS should, just as when considering nominations for the BOD, the chief executive officer or key senior management, put in place a transparent process<sup>12</sup> that considers all the appropriate factors, including, but not limited to:
- (i) whether the person has been convicted of a criminal offence, particularly an offence relating to dishonesty, fraud or financial crime;
  - (ii) whether the person has been the subject of any adverse findings or any settlement in civil proceedings, particularly in connection with banking or other financial business, misconduct or fraud;
  - (iii) whether the person, or any business in which the person is a controlling shareholder or has a controlling interest or exercises significant influence, has been investigated and disciplined or suspended by a regulatory or professional body, a court or tribunal, whether publicly or privately;
  - (iv) whether the person has been the owner, manager or director of a company, partnership or other organisation that has been refused registration, authorisation, membership or a licence to conduct trade, business or profession, or has had that registration, authorisation, membership or licence revoked, withdrawn or terminated;
  - (v) whether, as a result of the removal of the licence, registration or other authority, the person has been refused the right to carry on a trade, business or profession requiring a licence, registration or other authorisation;
  - (vi) whether the person has been a director, partner or otherwise involved in the management of a business that has gone into receivership, insolvency or compulsory liquidation while the person was connected with that organisation or within a reasonably short period (e.g. one year) after the person’s departure from the institution;
  - (vii) whether the person has been dismissed, asked to resign, or resigned from employment or from a position of trust, fiduciary appointment or similar position because of questions about honesty and integrity;
  - (viii) whether the person has ever been disqualified from acting as a director or serving in a managerial capacity because of wrongdoing;
  - (ix) whether the person has not been fair, truthful and forthcoming in dealings with customers, superiors, auditors and regulatory authorities within the past ten years and has been the subject of any justified complaint relating to regulated activities; and
  - (x) whether the person demonstrates a readiness and willingness to comply with the requirements and standards of the regulatory system and other legal, regulatory or professional requirements and standards.

---

<sup>12</sup> While in most jurisdictions the regulatory framework might be that the supervisory authority requires such process to be overseen and executed by the BOD, in other jurisdictions where the regulation on this issue is less clear, IIFS may leave this process to the *Sharī’ah* board to conduct their own self-screening, or for the senior management to do it. Since it has been well accepted as good governance practice that the Nomination Committee (where it exists, or where it does not, the Audit Committee) will nominate the external auditor and the shareholders will approve their nomination, similarly it is recommended that such a committee nominates the *Sharī’ah* board for the shareholders to approve. In any event, what is most important is that the “fit and proper” screening process should be established, and that process should be transparent to the stakeholders.



### *Competence and capability*

29. The IIFS should ensure that members of the *Sharī'ah* board demonstrate the competence and ability to understand the technical requirements of the business, the inherent risks therein, and the management processes required to conduct its operations effectively, with due regard to the interests of all stakeholders. In assessing the competence and capability of a person, all relevant factors should be considered, including, but not limited to:
- (i) whether the person has demonstrated, through qualifications and experience, the capacity to successfully undertake the responsibilities of the position;
  - (ii) whether the person is physically, mentally and emotionally fit to perform his or her duties;
  - (iii) whether the person has ever been disciplined by a professional, trade or regulatory body, dismissed or requested to resign from any position or office for negligence, incompetence, fraud or mismanagement; and
  - (iv) whether the person has a sound knowledge of the business and the responsibilities of the position.
30. It follows that members of the *Sharī'ah* board and officers of the ISCU and ISRU should at least possess the appropriate knowledge and skills in order for them to adequately execute their duties and responsibilities. IIFS should be diligent by carrying out background checks on candidates to be appointed to the respective positions. A list of minimum competencies is set out in **Appendix 4**.

### *Sharī'ah advisory firm*

31. In the context where a *Sharī'ah* advisory firm is appointed by an IIFS, such a firm should have sufficient expertise and resources to carry out its work. A *Sharī'ah* advisory firm should not undertake any *Sharī'ah* audit/review work beyond its capacity and expertise. The IIFS should reserve the rights to check and ensure, from time to time, that the firm has the relevant expertise and adequate resources to perform its role properly. The management of the *Sharī'ah* advisory firm should appoint a dedicated team whose members should be competent in general, and in particular in the context of the work to be carried out by the team; and the team should have the manpower and resources to carry out the *Sharī'ah* audit/review work to the standards expected by the IIFS.

### **Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its *Sharī'ah* board, as well as its ISCU and ISRU, if any.**

32. In order to enhance professionalism and effectiveness of persons serving as members of the *Sharī'ah* board, the ISCU or the ISRU, as the case may be, an IIFS is encouraged to facilitate and sponsor appropriate training for their continuous professional development. Training policies shall be established with adequate consideration given to training needs to ensure compliance with the IIFS's operational and internal control policies and procedures, and all applicable legal and regulatory requirements to which the IIFS generally, and members of the *Sharī'ah* board and internal *Sharī'ah* officers particularly, are subject. Adequate training should be provided both initially and on an ongoing basis.
33. When they are first appointed to the positions, the IIFS shall ensure that members of the *Sharī'ah* board and internal *Sharī'ah* officers receive appropriate training (including with regard to their role and responsibilities and how to discharge their duties). This should include an orientation and induction program to ensure that incoming members of the *Sharī'ah* board and internal *Sharī'ah* officers are familiar with the IIFS's business and governance practices. Where appropriate, a mentoring programme whereby the more experienced members of the *Sharī'ah* board and internal *Sharī'ah* officers would provide guidance and tutelage to their less experienced counterparts should be encouraged.

34. It is equally important that IIFS allocate resources so that members of the *Sharī'ah* board and the internal *Sharī'ah* officers can receive further relevant training, particularly on relevant new laws, regulations and changing commercial risks, from time to time, as it is unfair and unrealistic to expect them to be knowledgeable about industry-specific issues unless they are adequately trained. IIFS can tailor the types of training for members of the *Sharī'ah* board and internal *Sharī'ah* officers so that they are equipped with industry-specific knowledge such as on banking, collective investment schemes and *takāful*, in accordance with the latest trends and developments happening in the marketplace.
35. Exchange of knowledge and expertise between members of the *Sharī'ah* board and internal *Sharī'ah* officers with the BOD, senior management, and other staff on the operational side of the IIFS would lead to more effective communications across the organisation. Hence, members of the *Sharī'ah* board and internal *Sharī'ah* officers should be encouraged, from time to time, to conduct training for the other organs of governance to further develop the compliance capabilities of the IIFS.

**Principle 2.3: There should be a formal assessment of the effectiveness of the *Sharī'ah* board as a whole and of the contribution by each member to the effectiveness of the *Sharī'ah* board.**

36. IIFS shall adopt a process for assessing the effectiveness of the *Sharī'ah* board as a whole and the contribution by its each individual member to the effectiveness of the *Sharī'ah* board. This assessment process shall be notified to the members of the *Sharī'ah* board at the time of their appointment, so that they have a precise idea as to what is expected of them.
37. IIFS shall decide how the *Sharī'ah* board's performance may be evaluated and propose objective performance criteria. Such performance criteria, which allow for comparison with industry peers, should be developed together and in consultation with the *Sharī'ah* board and may include, for example, how the *Sharī'ah* board enhances long-term shareholders' value. These performance criteria should not be arbitrarily or unilaterally changed by the IIFS, and where circumstances deem it necessary for any of the criteria to be changed, the onus should be on the IIFS, through the BOD, to justify this decision.
38. Individual evaluation should aim to assess whether each member of the *Sharī'ah* board continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for attending relevant meetings, drafting *Sharī'ah* pronouncements/resolutions and any other duties). Examples of factors to be taken into consideration when assessing the performance of the *Sharī'ah* board are provided in **Appendix 5**.
39. IIFS shall act on the results of the performance evaluation and, where appropriate, consider nominations of new members to be appointed to the *Sharī'ah* board or seek the resignation of any member of the *Sharī'ah* board who fails to meet adequately the terms and conditions of his or her contract.

### Part III – Independence

**Principle 3.1: The *Sharī'ah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgement on *Sharī'ah*-related matters. No individual or group of individuals shall be allowed to dominate the *Sharī'ah* board's decision-making.**

40. In order to uphold the integrity and credibility of the *Sharī'ah* board, its members must not only be able to exercise independent judgement without undue influence or duress, especially from the management of the IIFS, but also to be *seen* to be truly independent. In this respect, it would be desirable for an IIFS to formalise the independence of the *Sharī'ah* board and its members by recognising the *Sharī'ah* board's roles and mandate.<sup>13</sup> The IIFS shall have in place an appropriate and transparent process for resolving any differences of opinion between the BOD and the *Sharī'ah* board. This process may include having direct access (after duly informing the supervisory authority) to the shareholders as a “whistleblower”. The supervisory authorities may be involved in this process of resolving differences, without compromising the binding nature of the pronouncements/resolutions of the *Sharī'ah* board.
41. A *Sharī'ah* board can only be deemed “independent” when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best interests of the IIFS by the *Sharī'ah* board. In the case of *Sharī'ah* advisory firms, it can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors.
42. Adapting from international best practices usually applicable to members of the BOD and senior management of IIFS, examples of such relationships that would deem a *Sharī'ah* board not to be independent include:
- (i) a member of the *Sharī'ah* board being employed by the IIFS or any of its related companies for the current or during the last financial year;
  - (ii) a member of the *Sharī'ah* board who has an immediate family member such as spouse, children or siblings who are, or who were during the last financial year, employed by the IIFS or any of its related companies as a senior executive officer;
  - (iii) a member of the *Sharī'ah* board, or his or her immediate family member, accepting any compensation or financial facility from the IIFS or any of its subsidiaries other than compensation for service on the *Sharī'ah* board for the current or immediate past financial year; or
  - (iv) a member of the *Sharī'ah* board, or his or her immediate family member, being a substantial shareholder of or a partner in (with a stake of 5% or more), or an executive officer of, or a director of any for-profit business organisation to which the IIFS or any of its subsidiaries made, or from which the IIFS or any of its subsidiaries received, significant payments in the current or immediate past financial year.<sup>14</sup>
43. The relationships set out above are not intended to be exhaustive, and are examples of situations that would deem a member of the *Sharī'ah* board or a *Sharī'ah* advisory firm to be not independent. If the IIFS wishes still to consider a member of the *Sharī'ah* board or

<sup>13</sup> In some jurisdictions, the appointment and/or termination of the *Sharī'ah* board or its members requires approval from the supervisory authority, and would also have to be announced publicly. The strength and independence of the *Sharī'ah* board could be enhanced by appointing a variety of members of the *Sharī'ah* board coming from different backgrounds.

<sup>14</sup> Supervisory authorities in different jurisdictions may have different opinions as to what is considered a significant payment; however, as a guide, any total payment received within the financial year that is 20% or more than the normal rate of fee received by members of the *Sharī'ah* board of similar stature and experience should generally be deemed significant.

*Sharī'ah* advisory firm as independent, in spite of the existence of one or more of these relationships, it should disclose in full the nature of that relationship and bear the responsibility for explaining why he or she or the firm should be considered independent.

44. In addition, wherever a conflict of interest is unavoidable, the member of the *Sharī'ah* board or *Sharī'ah* advisory firm should declare it in writing to the IIFS. They must similarly report any such conflict in regard to members of their family, business associates or companies in which they have an interest. Where there is such a conflict of interest, or a duty to another party, then they should abstain from participating in the relevant decision or action on behalf of the IIFS. Where a notification is made of a conflict, it should be recorded and retained by a designated officer.<sup>15</sup>
45. When a member of the *Sharī'ah* board has multiple *Sharī'ah* board responsibilities/appointments, he or she must ensure that sufficient time and attention is given to the affairs of each IIFS. The IIFS should decide if a member of the *Sharī'ah* board is able to and has been adequately carrying out his or her duties in serving his or her *Sharī'ah* board. Internal guidelines should be adopted that address the competing time commitments that are faced when members of the *Sharī'ah* board serve on multiple *Sharī'ah* boards.

**Principle 3.2: In order to fulfil their responsibilities, the *Sharī'ah* board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis.**

46. The management of an IIFS has an obligation to supply the *Sharī'ah* board with complete, accurate and adequate information in a timely manner. Relying purely on what is volunteered by the management is unlikely to be enough in all circumstances, and further enquiries may be required if the *Sharī'ah* board is to fulfil its duties and responsibilities properly. Hence, the *Sharī'ah* board should have separate and independent access to the company's senior management for all the information it needs, while adhering to obligations of confidentiality.
47. Information provided should include background or explanatory information relating to matters to be brought before the *Sharī'ah* board, copies of disclosure documents, financial statements and risk assessment reports. As far as possible, such information should be tailored and presented in a manner that would assist the *Sharī'ah* board to analyse not only the form of, but also the substance surrounding, the issues brought before them.
48. The *Sharī'ah* board should have separate and independent access to the ISCU and ISRU, respectively, to check whether internal control and compliance procedures have been appropriately followed and that applicable rules and regulations to which the IIFS is subject have been complied with.
49. Where the *Sharī'ah* board has its own secretariat, the appointment and removal of members of the secretariat should be appropriately carried out in consultation with the *Sharī'ah* board.
50. IIFS shall have a procedure for the *Sharī'ah* board, either for each individual member or as a group, in the furtherance of their duties, to take independent professional advice, such as on legal, accounting, financial or valuation issues, if necessary, at the IIFS's expense.

---

<sup>15</sup> Reference should also be made to IFSB-4, which adopts IAS24 on related party transactions, and to the forthcoming IFSB Guiding Principles on Conduct of Business for IIFS (IFSB-9).

## Part IV – Confidentiality

### Principle 4.1: *Sharī'ah* board members should ensure that internal information obtained in the course of their duties is kept confidential.

51. In the performance of their duties, members of the *Sharī'ah* board or *Sharī'ah* advisory firms serving an IIFS may have access to files, records, draft materials and conversations that are, under the IIFS's internal procedures and by market practice, deemed confidential. Where a member of the *Sharī'ah* board or *Sharī'ah* advisory firm serves several IIFS simultaneously, the issue arises as to how they handle confidential or commercially sensitive information obtained in the course of performing their duties. It is a key concern of professional ethics that confidential or sensitive information obtained by a member of the *Sharī'ah* board or *Sharī'ah* advisory firm while serving an IIFS should not be used by them in ways that could be detrimental to that IIFS, particularly in ways that might give a competitive advantage to its competitors.
52. Confidential information here refers to information received by members of the *Sharī'ah* board or *Sharī'ah* advisory firm in the course of their duties that is not public and is not authorised to be made public. This includes information received under seal, expressly marked or designated by the IIFS to be kept confidential, or relating to the deliberative processes of the IIFS. Examples of confidential information are:
- (i) information on the development of new products and services that the IIFS plans to offer or get involved in;
  - (ii) the substance of draft opinions or decisions of the BOD or senior management;
  - (iii) internal memoranda, in draft or final form, prepared in connection with matters presented, or to be presented, before the *Sharī'ah* board or *Sharī'ah* advisory firms;
  - (iv) the content or occurrence of conversations among members of the *Sharī'ah* board concerning matters deliberated on in the meeting of the *Sharī'ah* board and representatives of the IIFS;
  - (v) the timing of a decision, or other business transaction, including the status of or progress on a business transaction or action not yet finalised (except as may be authorised by the BOD under the internal procedures of the IIFS);
  - (vi) views expressed by various parties in the course of discussions about a particular matter before the *Sharī'ah* board; and
  - (vii) any subject matter that the appointing IIFS has indicated should not be revealed, such as internal office practices, informal procedures, the content or occurrence of statements or conversations, and actions by a fellow member of the *Sharī'ah* board or *Sharī'ah* advisory firm.
53. Information that is not considered confidential includes *Sharī'ah* rules and principles, reports and pronouncements/resolutions of the *Sharī'ah* board published by the IIFS for public knowledge, and other information disclosed in public documents or proceedings.
54. The duty to observe confidentiality applies to all information with which members of the *Sharī'ah* board or *Sharī'ah* advisory firm are entrusted by their client, or which is brought to their attention during or at any time after the carrying out of their assignment. The same rules of confidentiality should be imposed on internal *Sharī'ah* officers. Confidentiality obligations do not end when a member of the *Sharī'ah* board or *Sharī'ah* advisory firm ceases to serve an IIFS or when a matter is completed or closed. Members of the *Sharī'ah* board and *Sharī'ah* advisory firms should observe the same restrictions unless they have obtained express authorisation from the IIFS that relieves them from such an obligation.
55. Nevertheless, to facilitate observance of confidentiality, an IIFS shall ensure that the terms of reference in the contract for service of the *Sharī'ah* board or its members

expressly set out that they shall preserve and secure the confidentiality and secrecy of business and market-sensitive information shared with them by the IIFS. An arrangement should be made to brief and/or clarify to the *Sharī'ah* board or its members the importance of careful preservation of confidential and market-sensitive information.

56. In the event that the *Sharī'ah* board or one of its members happens to leak or reveal confidential or market-sensitive information to inappropriate parties, the IIFS should at least have appropriate risk management and control processes in place to limit the damage of such leakage. Wherever possible, the IIFS should establish a process for taking disciplinary and/or other administrative actions against the *Sharī'ah* board or its members to ensure absolute accountability and appropriate remedy.

## Part V – Consistency

57. The interpretation of the *Sharī'ah* rules and principles based on the discipline of *fiqh al muamalat* is a matter of the professional judgement of members of the *Sharī'ah* board. However, members of the *Sharī'ah* board should be consistent in the opinions that they provide in serving the *Sharī'ah* boards of different IIFS. Consistency in this respect is related to competence and independence, as mentioned above, and also is a matter of professional ethics.

**Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of *Sharī'ah* pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its *Sharī'ah* board strictly observes the said framework and, wherever possible, promotes convergence of the *Sharī'ah* governance standards.**

58. Although members of the *Sharī'ah* board and *Sharī'ah* advisory firm should be fully aware that appropriate procedure and process must be adhered to before any *Sharī'ah* pronouncement/resolution is developed and concluded, IIFS also need to be careful as to how the *Sharī'ah* pronouncement/resolution is disseminated or issued to the press or the general public. The intellectual property of such *Sharī'ah* pronouncements/resolutions could actually be owned exclusively by the IIFS, depending on the terms of reference of members of the *Sharī'ah* board and *Sharī'ah* advisory firm. In this respect, bearing in mind that the *Sharī'ah* board or its members, as free agents, are generally allowed to provide service to any client other than the IIFS without any restriction, each IIFS may need to establish additional safeguards to ensure that *Sharī'ah* pronouncements/resolutions developed based on their business intelligence and internal information would not be exploited by inappropriate parties. In other words, the dissemination of the *Sharī'ah* pronouncements/resolutions might have to be restricted based on terms and conditions set by the IIFS.
59. More often than not, a majority of *Sharī'ah* boards at the IIFS mention in their *Sharī'ah* pronouncements/resolutions only whether a transaction conducted, or to be conducted, by the IIFS, or a product that the IIFS wishes to offer, is permissible or non-permissible. Rarely in their *Sharī'ah* pronouncements/resolutions do they make available supporting evidence that could be examined by other members of the *Sharī'ah* board. Furthermore, even when they do publish such evidence, the language used is often technical and not easily understandable by the general public. As a result, it is very difficult to improve public awareness in terms of understanding the basis of and justifications behind a *Sharī'ah* pronouncement/resolution. The industry could benefit by providing a wider access to *Sharī'ah* pronouncements/resolutions, as strong public support and appreciation of the *Sharī'ah* boards' roles can only come through better awareness of what the *Sharī'ah* boards have been and are still doing.

### *Ex-ante (at the product design/development stage)*

60. There are several steps that can be adopted by members of the *Sharī'ah* boards in order to appear more consistent in their decisions. In countries where there is a central authority issuing the *Sharī'ah* pronouncements/resolutions, the *Sharī'ah* board at the IIFS is usually required to follow and adopt such *Sharī'ah* pronouncements/resolutions as are issued by that central *Sharī'ah* authority. In jurisdictions where there is no such body, it is recommended that the *Sharī'ah* board follows and adopts the *Sharī'ah* pronouncements/resolutions issued by the OIC Fiqh Academy. If that is not possible – for example, where the OIC Fiqh Academy has yet to come up with a ruling on the product to be offered by the IIFS – the *Sharī'ah* board should exercise its best efforts in documenting and publishing the *Sharī'ah* pronouncements/resolutions issued by the *Sharī'ah* board and/or its members so that they can be openly assessed by the industry's stakeholders (subject to the appropriate observance of confidentiality).



*Ex-post (after the products have been offered to customers)*

61. From time to time, members of the *Sharī'ah* board should participate in various seminars, workshops and meetings of *ulama* specialised in *fiqh al-muamalat* to present and debate existing and new *Sharī'ah* pronouncements/resolutions. They must also expect to answer questions from shareholders and the public in a general assembly or similar forum. For better recording and dissemination of information, it would be helpful if they were to produce in the annual reports a section on *Sharī'ah* compliance by the IIFS and *Sharī'ah* pronouncements/resolutions issued by the *Sharī'ah* board and/or its members, including clarifying the process of how the *Sharī'ah* board reached its decisions.
62. The IIFS should ensure that the *Sharī'ah* board adopts a specified process for changing, amending or revising any *Sharī'ah* pronouncements/resolutions issued by it. Appropriate and timely disclosure shall be made to shareholders and/or the public whenever the *Sharī'ah* board and/or its members depart from or revise any of its *Sharī'ah* pronouncements/resolutions.



## DEFINITIONS

The following definitions provide a general understanding of the terms used in this document. The glossary is by no means an exhaustive one.

<i>Fiqh</i>	Knowledge of the legal rule pertaining to conduct, which has been derived from specific evidence in the <i>Sharī'ah</i> .
Institutions offering Islamic financial services (IIFS)	Those institutions offering Islamic financial services (which, for the purpose of these Guiding Principles only, shall also include (a) Islamic insurance ( <i>takaful</i> ) institutions, (b) Islamic mutual funds, and (c) Islamic window operations).
Islamic collective investment scheme (ICIS)	Any structured financial scheme that, fundamentally, meets ALL the following criteria: (a) investors have pooled their capital contributions in a fund (whether that fund is in a separate legal entity, or is held pursuant to a contractual arrangement) by subscribing to units or shares of equal value. Such units or shares constitute, in effect, claims of ownership of the undivided assets of the fund (which can consist of financial or non-financial assets), and give rise to the right or obligation to share in the profits or losses derived from those assets; (b) the fund is established and managed in accordance with <i>Sharī'ah</i> rules and principles; and (c) whether or not the ICIS is managed by the institutions that established or sponsored it, it is separately financially accountable from those institutions (i.e. it has its own asset-and-liabilities profile), but excluding <i>sukuk</i> , as defined under IFSB-6.
Members of the <i>Sharī'ah</i> board	The category of <i>Sharī'ah</i> scholars, or <i>ulama</i> , who are equipped with not just general knowledge of <i>Sharī'ah</i> or other disciplines, but more importantly have reached a specialised level of being learned and expert in <i>fiqh al-muamalat</i> . That specialisation is then dedicated to providing professional expert opinions in the form of <i>Sharī'ah</i> pronouncements/resolutions, specifically to IIFS, beyond mere academic discourse and often not directly to the general public or to corporations in other industries.
<i>Sharī'ah</i>	Divine Islamic law as revealed in the <i>Qur'an</i> and the <i>Sunnah</i> .
<i>Sharī'ah</i> advisory firm	An entity that, depending on its size and capacity, provides <i>Sharī'ah</i> audit reviews, as well as <i>Sharī'ah</i> -compliant product development, as part of its professional services.
<i>Sharī'ah</i> board	Specific body set up or engaged by the IIFS to carry out and implement its <i>Sharī'ah</i> Governance System.
Stakeholders	Those with a vested interest in the well-being of an IIFS, including: (i) employees; (ii) customers; (iii) suppliers; (iv) the community; and (v) supervisors and governments, based on the unique role of IIFS in national and local economies and financial systems.

## APPENDICES

### APPENDIX 1: Key Terms of Reference for the *Sharī'ah* Board

#### 1. Reporting Structure

The *Sharī'ah* board will report administratively to the Board of Directors (BOD). This reporting structure particularly reflects its independence from the management of the IIFS.

The *Sharī'ah* board shall put on record in its report or statements directed to the shareholders its concerns over any *Sharī'ah* compliance issues. Where appropriate, the supervisory authorities may be involved in this process with the consideration that pronouncements/resolutions of the *Sharī'ah* board shall be binding on the IIFS.

#### 2. Primary Duties

- (i) Advising the BOD on *Sharī'ah*-related matters.
- (ii) Reviewing and endorsing *Sharī'ah*-related policies and guidelines. For this purpose, the IIFS should also have a *Sharī'ah* Process Manual which specifies the manner in which a submission or request for *Sharī'ah* pronouncements/resolutions should be made to the *Sharī'ah* board, the conduct of the *Sharī'ah* board's meeting and the manner of ensuring operational compliance with any decision of the *Sharī'ah* board.
- (iii) Endorsing and validating relevant documentation for new products and services, including contracts, agreements or other legal documentation used in the IIFS's business transactions.
- (iv) Overseeing the computation and distribution of *Zakat* and any other fund to be channeled to charity.
- (v) Assisting and advising relevant parties that serve the IIFS, such as its legal counsel, auditor or other consultants, upon request.
- (vi) Put on record, in written form, any opinion that it gives on *Sharī'ah*-related issues.

*\* In case the IIFS operates within a jurisdiction where there is a central/national/highest body that is mandated to issue Sharī'ah pronouncements/resolutions for IFSI in the country (the "Central Sharī'ah Body")*

- (vii) Adopt any *Sharī'ah* pronouncements/resolutions issued by the Central *Sharī'ah* Body and address any arising issues.

#### 3. Appointment, Resignation or Termination of Service

The *Sharī'ah* board shall be informed of:

- (i) whom within the IIFS is authorised to appoint or terminate its service or the service of its members;
- (ii) how long is the tenure of the appointment; and
- (iii) whether specific reasons and/or a certain notice period need to be served before the contract of service is terminated by either party.

Benefits and remuneration, including professional fees, should be stated from the outset.

#### 4. Delegation of Powers

The *Sharī'ah* board shall be empowered to reserve rights to delegate some of its functions to the ISCU or internal *Sharī'ah* officers of the IIFS in endorsing and validating product guidelines, marketing advertisements, sales illustrations and brochures used to describe particular products.

The exercise of any such power to delegate must be made expressly and be properly recorded in writing.

5. Review of Terms

If necessary, the terms of reference may be reviewed and updated by the *Sharī'ah* board, in consultation with the BOD, and subject to any minimum standard terms that may be required by the relevant Central *Sharī'ah* Body and/or the supervisory authority.

## APPENDIX 2: Operative Procedures of the *Sharī`ah* Board

(To guide meeting proceedings, the decision-making process and the passing of decisions for effective implementation, including processes to review those decisions whenever necessary)

### 1. Presentation of Request for Decisions on *Sharī`ah*-related Matters

All proposal papers submitted to the *Sharī`ah* board by the management of the IIFS must clearly state the purpose of the paper and be presented to the *Sharī`ah* board by the officers in-charge, with sufficient and adequate details, to facilitate evaluation of the proposals. Where appropriate, other relevant organs of governance shall also be provided with a copy of the proposal papers.

All papers for presentation shall be submitted to the secretary of the *Sharī`ah* board for onwards distribution to members of the *Sharī`ah* board not later than one week prior to the *Sharī`ah* board's meeting. Any paper submitted after the cut-off time shall be presented to the *Sharī`ah* board only upon approval of the Chairman.

### 2. Reports by the *Sharī`ah* Board

At the end of any consultation between the IIFS and the *Sharī`ah* board, the *Sharī`ah* board shall have the discretion to produce its reports in the form of:

- (i) a fact-finding report;
- (ii) (an *ex-ante*) report in relation to product design and development;
- (iii) (an *ex-post*) internal *Sharī`ah* audit/review report on the products offered to customers; and
- (iv) an annual *Sharī`ah* compliance report.

Fact-finding reports and reports in relation to product design and development shall be submitted to the CEO/Managing Director of the IIFS.

An internal *Sharī`ah* audit/review report on products offered to customers should be made available to the Audit Committee of the IIFS.

The annual *Sharī`ah* compliance report should be submitted to the BOD for onwards distribution to shareholders, and upon request, should be made available to the supervisory authority and members of the public, including investment account holders (**IAH**).

### 3. Chairman

One of the members of the *Sharī`ah* board shall be elected as its Chairman. The Chairmanship should preferably be on a rotation basis, such as whenever there is a reappointment of the *Sharī`ah* board.

In the event that the Chairman is unable to attend the meeting, the members shall elect one of themselves to become the Alternate Chairman to preside over the meeting.

### 4. Secretariat

The Managing Director or any other person as empowered by the BOD shall, upon consultation with the *Sharī`ah* board, appoint the IIFS's head of the ISCU or the internal *Sharī`ah* officer.

ISCU or the internal *Sharī`ah* officer shall be the secretariat for the *Sharī`ah* board. If there is no ISCU or internal *Sharī`ah* officer within the IIFS's set-up, this function may be carried out by other officials such as the company secretary, head of the product development department or the head of the legal department.

5. Frequency of Meeting  
The *Sharī'ah* board shall meet regularly to carry out periodic reviews to monitor *Sharī'ah* compliance of the operations of the IIFS generally. However, as and when necessary, the *Sharī'ah* board can hold a meeting if the IIFS urgently requires its advice and opinion on *Sharī'ah*-related matters.

6. Quorum for Meeting  
The *Sharī'ah* board should determine a quorum for its meeting as appropriate, based on the total number of members sitting on its panel. For example, a *Sharī'ah* board comprising five members may set its quorum as three.

In the event the IIFS includes professionals who are not *ulama*, such as lawyers, accountants or economists who have some knowledge of *Sharī'ah* but are not particularly trained in that discipline, as members of the *Sharī'ah* board, the quorum set should ensure that they would not dilute the value of decisions made by the *Sharī'ah* board on *Sharī'ah*-related matters. Although those professionals are treated as equal to the other members sitting on the *Sharī'ah* board, they should not vote on *Sharī'ah* matters.

Preferably, professionals such as lawyers, accountants and bankers can still be called in to advise the *Sharī'ah* boards during meetings, but they should not actually be part of the composition of the *Sharī'ah* board.

Members who are unable to attend but have valid reasons shall be recorded as "Absent with Apology", whilst absenteeism without valid reason shall be treated as "Absent without Apology", and the minutes shall be recorded as such.

7. Decision-making  
In the absence of a consensus, decisions shall be made on the basis of a majority vote of members of the *Sharī'ah* board who attend a meeting.

8. Attendance of the Senior Management  
Members of senior management of the IIFS may attend the *Sharī'ah* board meeting to represent the management's views on issues discussed in the meeting, but shall carry no voting or veto rights.

9. Power to Invite Relevant Officers to Sit in Meetings  
The Chairman – and in the absence of the Chairman, the Alternate Chairman – is empowered to invite any relevant officers to sit in its meetings.

It is recommended that representatives from the ISCU, risk management department and legal department shall be invited as Permanent Invitees. However, these invitees do not have voting or veto rights.

10. Minutes of Meetings  
The Secretary of the *Sharī'ah* board shall be responsible for recording the minutes of *Sharī'ah* board meetings. Any differences of opinion or dissenting opinions among members of the *Sharī'ah* board shall be referred to in the minutes.

All minutes of the *Sharī'ah* board meetings shall be submitted to the relevant internal control functions in the IIFs for their notification and further action.

All minutes must be properly archived by the secretary of the *Sharī'ah* board for future reference. Upon request, they shall be made available to the internal auditor, external auditor and examiner from the supervisory authority.

### APPENDIX 3: Basic Professional Ethics and Conduct for Members of the *Sharī`ah* Board

In the performance of his or her duties to any IIFS, a member of the *Sharī`ah* board is expected to conduct himself or herself at all times in a manner consistent with the principles governing the profession and of the organisation to which he or she belongs. The following principles apply in particular in the practice of the profession:

1. Independence  
While carrying out his or her duties, a member of the *Sharī`ah* board should always have complete moral, intellectual and professional independence. This applies both to the representation of a client's interests and to the settlement of conflicting interests between the member of the *Sharī`ah* board, the IIFS, the supervisory authorities and any other interested parties.
2. Personal Responsibility  
Members of the *Sharī`ah* board are solely responsible for their professional activity. They are responsible for their own work, and for the work carried out by those under their employment.
3. Care and Conscientiousness  
While practising his or her profession, a member of the *Sharī`ah* board must have due regard to the legal as well as the ethical requirements of his or her profession.

This calls for independence in all professional dealings and, in particular, the exercise of objectivity when judging the facts of a case.

Before accepting an appointment, a member of the *Sharī`ah* board should consider carefully and thoroughly whether he or she is in a position to carry out the engagement with due regard to his or her obligations and competence.

He or she shall always strive to:

- (i) uphold fairness and equity for all the stakeholders;
- (ii) act in a manner that preserves his or her honesty and integrity;
- (iii) exercise appropriate discretion in decision-making by taking into consideration not only the technical aspects of *Sharī`ah* compliance; and
- (iv) appreciate the diversity of opinions among various schools of thought and differences in expertise among his or her fellow members of the *Sharī`ah* board.

4. Confidentiality  
The duty to observe confidentiality applies to all information with which a member of the *Sharī`ah* board is entrusted by the IIFS or which is brought to his or her attention during or at any time after the carrying out of his or her assignment.
5. Alignment of Activities  
A member of the *Sharī`ah* board should undertake only such activities as are compatible with his or her profession and which do not contradict his or her professional obligations.

He or she shall always avoid being:

- (i) in a position of conflict of interest against the IIFS that he or she serves, including misusing the confidential information shared with him or her by the IIFS for any self-gain or self-serving purposes;
- (ii) associated with any unethical or illegal activity based on *Sharī`ah* principles as well as the law of the country, including contravening any of the requirements and standards of the financial, banking or corporate regulatory system;
- (iii) subject to any adverse findings or any settlement in civil or criminal proceedings with regard to investments, financial/business misconduct or fraud;

- (iv) dismissed in the capacity of employee or director/chairman from any institution, firm or a company on the grounds of fraud, misrepresentation or breach of trust;
- (v) in default of payment due or in payment of any taxes in an individual capacity or as a proprietary concern; and
- (vi) accused and convicted of any criminal offence involving financial impropriety or moral turpitude.

6. Disciplinary Sanctions

The Code of Conduct developed by the IIFS shall be enforceable on the members of the *Sharī'ah* board by application of disciplinary sanctions, which shall include a power of exclusion and termination.

7. Post-qualification Education

A member of the *Sharī'ah* board should strive to continuously improve his or her personal and professional development, particularly in terms of knowledge and skills in *Sharī'ah*, and especially in *fiqh al-muamalat*.

#### **APPENDIX 4: Minimum Competence Requirements for Members of the *Sharī'ah* Board**

An IIFS shall carry out a background check and verify that any person to be appointed to serve as a member of the *Sharī'ah* board shall at least have the following competencies:

1. Academic Qualification

He or she must at least hold a bachelor's degree/*ijazah* from a recognised university in the sciences of *Sharī'ah*, including Islamic transaction/commercial law (*Fiqh al-Mu'amalat*), and be able to demonstrate reasonable technical understanding of Islamic finance.

It is reasonable to expect a member of the *Sharī'ah* board to have good knowledge of written Arabic; and it is highly recommended that the member of the *Sharī'ah* board be able to converse in English, as this could help improve the clarity of communication between him or her and stakeholders of the IIFS.

2. Experience and Exposure

The level of knowledge expected from a member serving on a *Sharī'ah* board may vary according to the level of responsibility and the type of regulated activity to be carried out by the IIFS. However, a member of the *Sharī'ah* board is generally expected to be able to display an understanding of:

- (i) the *Sharī'ah* rules and principles that apply to the IIFS's proposed activities;
- (ii) the general legal and regulatory framework that may apply to the functions that it would perform; and
- (iii) the broad impact of introducing financial products to the market and the public generally based on the *maqasid al-Sharī'ah*.

Preferably, only a member of the *Sharī'ah* board who has at least three years' experience of making *Sharī'ah* pronouncements/resolutions, or at least four years' post-qualification experience in teaching or research in Islamic finance, should be appointed as Chairman of the *Sharī'ah* board.

He or she should be able to demonstrate specific skills in the financial services industry in accordance with the line of business of the IIFS; be it banking, capital markets or *takāful*.

3. Track Record

He or she must have a respectable character and be of good conduct, particularly in terms of honesty, integrity and reputation in his or her professional business and financial dealings.



## APPENDIX 5: Examples of Performance Measures for the *Sharī'ah* Board

The assessment process shall be objective and related to the accountability of the *Sharī'ah* board. It is important to ensure that it is transparent, so that it is not misused or abused by the BOD or senior management of the IIFS to force their will on the *Sharī'ah* board, or to compromise its independence.

### Collective Assessments

Did the *Sharī'ah* board:

1. demonstrate effective organisational accountability?
2. communicate effectively with other organs of governance, including the BOD, management and auditors?
3. properly identify and evaluate the organisation's exposure to *Sharī'ah* non-compliance risk and reputational risk, and effectively communicate that risk information to appropriate bodies in the organisation?
4. promote appropriate ethics and values within the organisation?
5. promote continuous improvement of an organisation's *Sharī'ah* control processes?

### Individual Assessments

Did each member of the *Sharī'ah* board:

1. demonstrate integrity and honesty?
2. strive for continuous self-improvement?
3. accept responsibility with due care and diligence?
4. strive to be diplomatic and sensitive to cultural differences?
5. strive to be observant/aware of contextual factors before coming to a decision?
6. exercise rational and logical reasoning?
7. demonstrate willingness to learn from others?
8. strive to be inquisitive (capable of asking intelligent and relevant questions)?