SHARIAH GOVERNANCE FRAMEWORK - SHARIAH COMPLIANCE RISK MANAGEMENT

MOHD NAZRI BIN CHIK
Assistant General Manager, Shariah

4th Asia Islamic Banking Conference, June 2013
This presentation intends to:

1. Discuss theoretical and practical key basic principles of Shariah governance.

2. Understand the evolution of Shariah governance.

3. Understand the framework of the available guidelines and governance standards on Shariah governance such AAOIFI and IFSB documents.

4. Describe the Shariah compliance risk management as the moving forward area of Shariah governance.
SG is relatively new to discourse of Islamic finance, but is significant to lead the market confidence on the credibility of the industry.
First attempt to officially define "Shariah governance" has been initiated by IFSB-10 – Shariah governance system

“A set of institutional and organisational arrangements through which IFIs ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review.”

<table>
<thead>
<tr>
<th>Functions</th>
<th>Common Corporate Governance</th>
<th>Additional for IFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Board of Directors</td>
<td>Shariah Committee</td>
</tr>
<tr>
<td>Control</td>
<td>Internal Audit Division, External Auditor</td>
<td>Internal Shariah Review, Shariah Review by Shariah Committee, Shariah Audit</td>
</tr>
<tr>
<td>Compliance</td>
<td>Regulatory and Financial Compliance Division</td>
<td>Internal Shariah Compliance (Research)</td>
</tr>
<tr>
<td>Risk Management</td>
<td>Risk Management Division (Credit, Market and Operational Risk)</td>
<td>Shariah Compliance Risk Management</td>
</tr>
</tbody>
</table>
Shariah governance aims to ensure Shariah compliance...

- In actuality
- In the perception of the outsiders – reputation/public confidence

Good Shariah governance requires:
- Independence & judgment
- Consistent improvement
- Competency & professionalism
- Integrity & accountability
IFSB-10 and BNM SGF laid out the guiding principles of SG based on the established principles of corporate governance.

Oversight, accountability & Responsibility
- Clear demarcations on accountability & responsibility
  - Board overall accountability
  - SC accountability on decisions, views & opinions
  - Management’s responsibility in providing adequate support

Independence
- Recognition by board on SC’s independence
- Appropriate reporting structure
- SC decision shall not be set aside
- Access to necessary info by SC
- Appointment & removal of SC

Competency
- Comply to fit & proper requirement
- Continuous training provided to key internal stakeholders
- Performance assessment for SC
- Succession planning program for SC

Confidentiality & consistency
- Duty to observe confidentiality on sensitive info obtained by SC
- Restriction on SC membership in IFI within same industry
- Structured decision making process
- SC should not undermine SAC rulings
BNM Shariah Governance Framework (2011) proposed the model of Shariah governance framework for IFI operating in Malaysia.
Since establishment of first Islamic bank in 1983, Shariah governance has developed gradually to strengthen Shariah compliance.

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>Islamic Banking Act 1983</td>
</tr>
<tr>
<td>2004</td>
<td>Guidelines on the Governance of the Shariah Committee for Islamic Financial Institution</td>
</tr>
<tr>
<td>2009</td>
<td>Central Bank of Malaysia Act 2009</td>
</tr>
<tr>
<td>2010</td>
<td>Shariah Governance Framework for Islamic Financial Institutions</td>
</tr>
<tr>
<td>2013</td>
<td>Islamic Financial Services Act 2013</td>
</tr>
</tbody>
</table>

- Repeals the Islamic Banking Act 1983 and Takaful Act 1984
- Shariah Compliance and Shariah Governance provisions specifically covered under Section 27 to Section 38 of the Act.
- Set out the expectation of BNM on Shariah governance structures, processes and arrangements, duties and responsibilities of Board, management and Shariah committee as well as Shariah compliance functions to ensure Shariah compliance.
- Provides specific clauses on Shariah Advisory Council in the Sections 51 to 58 as well as the power of BNM to issue guidelines on Shariah matters in Section 59.
- Provides the duties and responsibilities of the internal Shariah Committee in advising the respective IFIs on Shariah matters (superseded by the Shariah Governance Framework for Islamic Financial Institutions)
The key objective of the new Islamic Financial Services Act 2013 is to ensure Shariah compliance.

**Section 28** of the Islamic Financial Services Act 2013, on Shariah compliance provides:

1) An institution shall at all times **ensure that its aims and operations, business, affairs and activities are in compliance with Shariah.**

2) For the purpose of this Act, a **compliance with any ruling of the Shariah Advisory Council** in respect of any particular aim and operation, business, affair or activity shall be deemed to be a compliance with Shariah in respect of that aims and operations, business, affair or activity.
To ensure strict adherence to the Shariah, IFSA 2013 imposed severe punishment on non compliance to the Act

**FINANCIAL**

- Shariah non-compliant income due to invalidation of contract (‘aqad)
- Capital adequacy ratio (CAR) impact

**NON-FINANCIAL**

- Against the commands of Allah SWT
- Impediment of Allah’s SWT blessing or *barakah*
- Jeopardize business reputation

**IMPACT OF SNC**

Contravention of the Islamic Financial Services Act 2013:

Section 28(5) of the Act provides

Imprisonment for a term not exceeding eight years; or
Fine not exceeding twenty-five million ringgit; or both.
SHARIAH COMPLIANCE RISK MANAGEMENT: EXPERIENCE OF MALAYSIA & BANK ISLAM MALAYSIA BERHAD
Risk of any financial institution should be managed systematic manner and process, and SCR is not excluded

A possibility of financial loss (whether in absolute terms or relative to expectations) that is inseparable from the opportunity for financial gain.

Oxford Dictionary of Finance and Banking

Risk management is a process for identifying, assessing, and prioritizing risks of different kinds. Once the risks are identified, the risk manager will create a plan to minimize or eliminate the impact of negative events.
Shariah compliance risk is a part of operational risk...

“The risk of loss resulting from **inadequate or failed**
internal processes, people and systems or from
external events, which includes legal risk and
**Shariah non-compliance risk** but excludes
strategic and reputation risks”.

**Definition from BNM’s Capital Adequacy Framework**
for Islamic Banks (CAFIB) & IFSB

**Definition of Shariah Non-Compliance Risk:**

“The risk that arises from the Bank’s **failure to comply**
with the **Shariah rules and principles determined by the relevant Shariah regulatory councils.**”

**Definition from Islamic Financial Services Board (IFSB)**
Despite the absence of guiding principles for managing SCRM, Basel Sound Practices on Operational risk may serve as a guide...
Briefly, BNM’s Shariah Governance Framework requires risk management control process to support overall Shariah compliance function.

PRINCIPLE 7: There shall be a robust Shariah compliance function, comprising review and audit functions, supported by risk management control process and internal research capacity.

Para 7.15
Shariah risk management is a function to systematically identify, measure, monitor and control of Shariah non-compliance risks to mitigate any possible of non-compliance events.

Para 7.16
The Shariah risk management control function shall form as part of the bank’s integrated risk management framework.

Para 7.17
Due to technicality and complexity in managing the risk of non-compliance to the Shariah, the function shall be performed by risk officers that have suitable qualifications and/or experience in the subject matter.
The SCRM function, as part of the ERM, is responsible to

1) Facilitating the process of identifying, measuring, controlling and monitoring Shariah non-compliance risks inherent in the bank’s operations and activities.

2) Formulating and recommending appropriate Shariah non-compliance risk management policies and guidelines.

3) Developing and implementing processes for Shariah non-compliance risk awareness in the bank.
At Bank Islam, the Risk Management Framework communicates its vision and strategies in managing risks includes SCRs.

The RMF is supported by various polices and guidelines.
Managing SCR is a “collective responsibility” of the enterprise and Bank Islam adopts “3 lines of defence” concept

**1ST LINE OF DEFENCE**

Line Management (including Business and Support Heads, Branch Managers, BRO, SRO, DORC and all staff)

RESPONSIBLE for ongoing oversight of risk and control at day to day work level.

**2ND LINE OF DEFENCE**

Operational Risk Mgmt Dept, Compliance, Shariah Compliance Risk Mgmt Unit, Operational Risk Control Committee

ESTABLISH and maintain ORM and SCRM Framework, assessing monitoring, reporting & controlling risk on a bank wide level.

**3RD LINE OF DEFENCE**

Internal Audit (Including Shariah Audit)

PROVIDE INDEPENDENT ASSURANCE to Board of Directors and Senior Management that Risk Management processes and tools are effectively implemented.

“3 LINES OF DEFENCE CONCEPT”
The business is also the SCR owner. To better manage the SCR, dedicated BROs/ SROs/ DORCs are appointed and trained...

---

**“Risk Owner” Concept**

| Identification | To ensure DORC conducts group discussion with key personnel to identify all Shariah compliance risks (SCR) and to develop and implement appropriate internal controls to effectively mitigate the identified SCR.  
  | To instill SCR aware culture across the division. |
|----------------|--------------------------------------------------------------------------------------|
| Assessment & Measurement | To assess the identified SCR twice a year and when a new SCR identified (using tools to be provided by Shariah Division)  
  | To make recommendations to improve control and minimize SCR |
| Control and Monitoring | To take appropriate remedial rectification measures or follow up to resolve Shariah non-compliances (SNC) and control mechanism to avoid recurrences.  
  | To facilitate Shariah Division during Shariah review exercise |
| Reporting | To immediately refer all possible SNC events to Shariah Division.  
  | To timely report the progress status update for rectification measures of SNC to Shariah Division |
The established RM processes is adopted and tools are developed. SCRM Department champions its implementation bank-wide

<table>
<thead>
<tr>
<th>Identification</th>
<th>Assessment &amp; Measurement</th>
<th>Control &amp; Monitoring</th>
<th>Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Profiling</strong></td>
<td><strong>MASA-Shariah</strong></td>
<td><strong>MASA-Shariah &amp; SNCTR</strong></td>
<td><strong>MASA-Shariah, KRI &amp; SNCTR</strong></td>
</tr>
<tr>
<td>• Identify and document SCR to develop risk profile:</td>
<td>• Assess and measure SCR on half yearly basis (role of BRO/SRO and DORC)</td>
<td>• Document actions taken/ required to mitigate SCR</td>
<td>• Report risk</td>
</tr>
<tr>
<td>1. Risk description</td>
<td></td>
<td>• Ensure resolution</td>
<td>• Shariah non-compliance event</td>
</tr>
<tr>
<td>2. Causal factors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Controls</td>
<td></td>
<td>SNC Tracking</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• SNC Tracking Report (SNCTR) mostly driven SCRM Unit</td>
<td></td>
</tr>
<tr>
<td><strong>1ST LOD</strong></td>
<td><strong>2ND LOD</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• SCRM Unit actively drives identification of SCR and document SCR control &amp; residual risk (SCR Profile)</td>
<td>• Monitor submission.</td>
<td>MASA-Shariah</td>
<td>• Report risk:</td>
</tr>
<tr>
<td></td>
<td>• Validate residual risk</td>
<td>• Monitor resolution of actions taken</td>
<td>1. KRI</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2. SNCTR</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>3. Non Halal Income</td>
</tr>
<tr>
<td></td>
<td></td>
<td>SNC Tracking</td>
<td>• Analyze and monitor</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Develop Shariah Policy, Guidelines</td>
<td>Report to Board/ BRC, SSC, MRCC, ORCC</td>
</tr>
</tbody>
</table>

1ST LOD

2ND LOD

4th Asia Islamic Banking Conference
Shariah risk mapping (risk identification) is the most critical stage in ensuring robust SCR management.

MASA-Shariah (self assessment) – medium and high

<table>
<thead>
<tr>
<th>Risk</th>
<th>Task</th>
<th>OIC</th>
<th>Comply (Y/N)</th>
<th>Shariah Requirement</th>
<th>Additional Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1 – Customer is not eligible to transact.</td>
<td>Financing application creation.</td>
<td>PFE</td>
<td>Y</td>
<td>Customer must have capacity to enter into transaction.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Handle offer acceptance</td>
<td></td>
<td></td>
<td>Granting financing to customers who are clearly known not to have the capacity to pay it is prohibited (haram).</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S2 – Appointment of Agent Form is not completed and signed.</td>
<td>Financing application creation.</td>
<td>PFE</td>
<td>Y</td>
<td>Shariah Compliance Policy - All documents relating to the products and services must be approved by the SSC.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>To perform as an agent, the Bank must be appointed by the principal.</td>
<td></td>
</tr>
</tbody>
</table>
Reporting of SCR is extended to and made compulsory by the regulator in the Islamic Financial Services Act 2013

Section 28 (3) of Islamic Financial Services Act 2013:

Where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah or the advice of its Shariah Committee or the advice or ruling of the Shariah Advisory Council, the institution shall:

(a) Immediately notify the Bank and its Shariah Committee of the fact;

(b) Immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and

(c) Within thirty days of becoming aware of such non-compliance or such further period as may be specified by the Bank, submit to the Bank a plan on the rectification of the non-compliance.
The Board and Shariah Committee, in addition the Management, is made accountable in addressing Shariah non-compliance event

Actual Shariah Non-Compliance (SNC) Event

1. Report on actual SNC shall be submitted to BNM on an “immediate”* basis as and when necessary.

2. Within the 14 days – required to obtain the confirmation from the SSC.

3. The Bank is required to submit to BNM the rectification plan (approved by the Board and SSC) within 30 days after the confirmation by SSC.

4. In the event that no Board meeting will be held within such 30 days, the Bank is required to exhaust other means to obtain the Board’s approval on the rectification plan prior to submission to BNM.

*Note: “Immediate” is defined as within 14 working days upon realization of the event
Shariah Compliance Risk Management- Moving Forward..

- It is time that Shariah governance must go beyond the scope and area of Shariah advisory, review and audit.

- Strong Shariah compliance risk management is crucial to lead the market confidence on the credibility of the industry.

- Global central banks should put greater emphasis on the implementation of Shariah compliance risk management.

- A global Shariah compliance risk management framework is vital to ensure strong Shariah governance in the industry.
والسلام
THANK YOU