

New Shari'ah Governance Standards for Islamic Financial Institutions

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Background

A strong and a well-functioning financial system is crucial to any economy. It is therefore imperative to ensure that financial institutions, which play a core role in the economic stability and development of a country, are secure and stable. This can only be achieved through effective internal and external regulation. To this end, the notion of 'Corporate Governance' becomes very important from the perspective of internal regulation.

To put it simply, 'Corporate Governance' is the way an entity polices itself. It comprises a set of internal rules, policies and procedures defining the functions, roles and responsibilities of various stakeholders within an entity, such as the board of directors and the senior management.

Last year the Central Bank of the UAE ('Central Bank') issued the Corporate Governance Regulations together with the Corporate Governance Standards (together the 'Regulations') which are applicable to all banks licensed by the Central Bank. Our previous article on the Regulations can be found [here](#). The Regulations briefly cover corporate governance requirements for banks offering Islamic financial services in Article 14 thereof.

The Central Bank issued the Shari'ah Governance Standards for Islamic Financial Institutions (the 'Standards') on 3 May 2020 ('Effective Date').

Scope and Application of the Standards

The Standards, which are effective from the Effective Date, outline the mandatory minimum requirements applicable to the following financial institutions in respect of their corporate governance framework and practices:

1. all financial institutions in the UAE licensed by the Central Bank that conduct all or part of their activities and business in accordance with provisions of Islamic Shari'ah ('Islamic Financial Institutions'). For Islamic Financial Institutions operating within a group, such Islamic Financial Institutions must ensure compliance with the Standards on solo and group levels; and

2. branch offices of foreign financial institutions in the UAE licensed by the Central Bank that conduct all or part of their activities and business in accordance with provisions of Islamic Shari'ah ('Branch Offices'). Compliance by Branch Offices with the Standards, however is not mandatory if they establish arrangements equivalent to the Standards. Such equivalent arrangements must be submitted to the Central Bank for approval.

It should be noted that the Central Bank and the Higher Shari'ah Authority at the Central Bank ('HSA') previously issued various regulations, standards, circulars, notices and resolutions which deal with some aspects of corporate governance. The Standards make it clear that they should be read in conjunction with the earlier issued regulations, standards, circulars, notices and resolutions of the Central Bank and the HSA.

As per the Standards, Islamic Financial Institutions are required to set a Shari'ah governance framework ('IFI Governance Framework'):

1. in accordance with its size and complexity of its operations;
2. incorporating a three pronged defensive approach independent of each other comprising a business line, internal Shari'ah control function and internal Shari'ah audit function; and
3. containing the minimum requirements specified in the Standards,

within 180 days from the Effective Date and to submit it the Central Bank for approval. All Financial Institutions must fully comply with the requirements of the Standards within one year from the Effective Date.

Key Highlights of the Standards

The Standards comprehensively provide the roles and responsibilities of the Board of Directors of the Islamic Financial Institution ('Board'), senior management and certain committees and departments of an Islamic Financial Institution. Briefly listed below are their main responsibilities.

1. Board of Directors

Ultimate responsibility for ensuring that a comprehensive IFI Governance Framework is put in place and that the Islamic Financial Institution is in compliance with the IFI Governance Framework and Islamic Shari'ah (i.e. resolutions, fatwas, regulations and standards issued by HSA and resolutions and fatwas issued by the Islamic Financial Institution's Internal Shari'ah Supervisory Committee ('ISSC'), in relation to licensed activities and businesses of the Islamic Financial Institution) rests with the Board.

The Board is required to hold at least one meeting with the ISSC each financial year to discuss issues pertaining to Shari'ah compliance.

2. Board's Risk Committee

The Board's Risk Committee is generally responsible for supervising and monitoring the management of Shari'ah non-compliance risk, setting controls in relation to each type of risk and overseeing the implementation of the Shari'ah non-compliance risk framework;

3. Board's Audit Committee

The Board's Audit Committee is generally responsible for evaluating the effectiveness of the policies approved by ISSC, assessing the effectiveness and adequacy of internal and external Shari'ah audit and reviewing and checking compliance with reports prepared by the Internal Shari'ah Audit Division/Section and external Shari'ah auditors.

4. *Senior Management*

The senior management is generally responsible for executing and managing the Islamic Financial Institution's activities and business in compliance with Islamic Shari'ah.

5. *ISSC*

1. the ISSC is the central committee which is responsible for the overall monitoring of and compliance by the Islamic Financial Institution with Islamic Shari'ah and resolutions, fatwas, regulations and standards issued by HSA. The ISSC, accordingly, is generally responsible for supervising and approving all businesses, activities, products, services, contracts, documents and codes of conduct of the Islamic Financial Institution. Any fatwas and/or resolutions issued by the ISSC are binding upon the Islamic Financial Institution;
2. in relation to Branch Offices, the Branch Office must have its own ISSC, which is separate from any Shari'ah committee (or equivalent) of the parent entity. The ISSC of the Branch Office is independently responsible for carrying out the roles and responsibilities set out in the Standards;
3. the ISSC is required to issue an annual report stating the extent of the Islamic Financial Institution's compliance with Islamic Shari'ah. The report issued by the ISSC is to be submitted to HSA for review and approval before presenting it to shareholders at the general assembly of the Islamic Financial Institution;
4. the final annual accounts of the Islamic Financial Institution must be reviewed and approved by the ISSC;
5. the Standards also provide for the composition of the members of the ISSC, their eligibility criteria and manner of appointment as well as the criteria for ensuring independence of ISSC members;
6. the Standards further require an Islamic Financial Institution to develop performance assessment criteria of the ISSC in accordance with the parameters listed therein.

6. *Internal Shari'ah Control Division or Section*

Internal Shari'ah Control Division/Section supports the ISSC in its duties. The Internal Shari'ah Control Division/Section, however cannot issue fatwas or resolutions.

The Internal Shari'ah Control Division/Section is required to carry out the following functions:

1. ISSC Secretariat Function;
2. Shari'ah Consultations Function;
3. Shari'ah Research and Development Function;
4. Shari'ah Compliance Function; and
5. Shari'ah Training Function, each as detailed in the Standards

7. *Internal Shari'ah Audit Division or Section*

The Internal Shari'ah Audit Division/Section is generally responsible for undertaking Shari'ah audits and

monitoring the Islamic Financial Institution's compliance with Islamic Shari'ah.

The Internal Shari'ah Audit Division/Section is required to submit reports to the ISSC and to the Board Audit Committee at least bi-annually.

Conclusion

The issuance of the Standards is a welcome development as it provides a comprehensive corporate governance framework for Islamic Financial Institutions that was lacking in the Regulations. All Islamic Financial Institutions are encouraged to undertake a full review of their existing internal policies and procedures and develop an IFI Governance Framework in accordance with the Standards.

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