THE SHARIAH COMPLIANCE REPORT

Ethica sits down with Shariah department experts to identify industry best practices for Shariah compliance at the bank.

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Ethica works with Islamic finance scholars, product developers, Shariah auditors, and bankers across the Islamic banking world and one theme consistently emerges: there are a broad range of opinions on what exactly constitutes 'Shariah compliance.' Shariah boards often frown on what they see as expedience on the part of bankers, while bankers bemoan what they see as over precise meddling on the part of Shariah boards. Are interests to remain mutually exclusive? What is the common ground between bankers and scholars where Shariah compliance matters? Does a strong Shariah compliance policy improve customer retention? What is the remit of the Shariah department?

The purpose of Ethica's Shariah Compliance Report is to answer some of these questions and identify industry best practices. We sat down with experts who bring experience working inside Shariah departments, have executed transactions with scholars and bankers, and are experts in AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) standards, the most widely followed standard-setting body in the industry, and discuss Shariah compliance issues facing Islamic banks around the world.

OVERVIEW

Islamic banks vary in their approach to Shariah compliance – most take a limited view where their Shariah department exists only to vet contract language alone. It has little real say over how they are implemented, how transactions are recorded, and whether or not employees are trained well enough. Moreover, product development at these banks is often a function completely independent of the Shariah department and causes business interest to prevail over Shariah compliance.

Most Islamic banks have very small – sometimes only two member – Shariah departments to oversee the workings of over one hundred branches. Shariah departments here are either excluded from the bank's main activities or lack the commitment or resources to get actively involved.

Generally bank management and stakeholders view Shariah departments as an expense that hinders progressive banking. They fear Shariah audits highlight banking errors and add unnecessary hurdles.

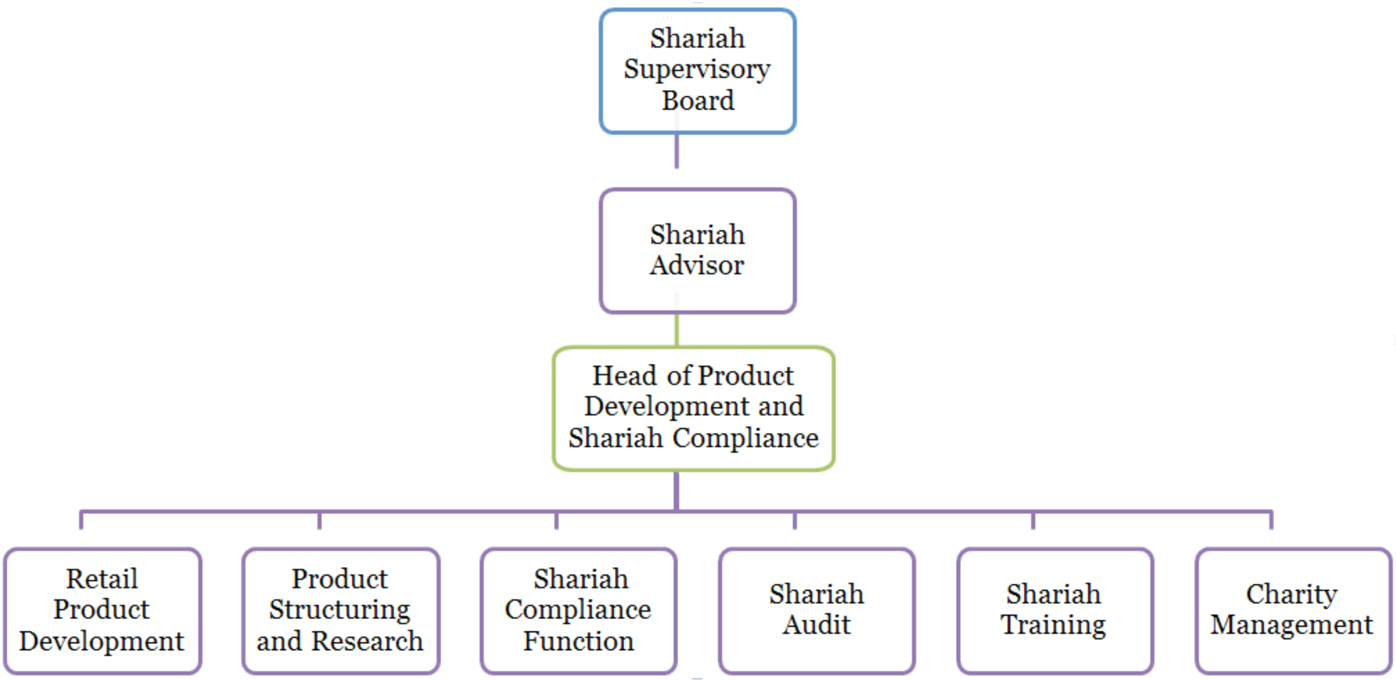
But talking to customers shows that a proactive Shariah department is what creates the solutions and goodwill for the bank and the resulting increase in business volume. When speaking of risk, risks such as liquidity risk, interest rate risk, and market risk are always highlighted, while the main risk an Islamic bank faces is the risk to its reputation.

When an Islamic bank launches or when a conventional bank decides to become Islamic, one of its first priorities must be to create a product development and Shariah compliance department. This function coordinates with the Shariah Advisor, the Shariah Supervisory Board, and Management to perform the key role of ensuring that all of the bank's functions are Shariah-compliant.

In an ideal Islamic bank, the department performs the following functions:

1. Product Development, Shariah Compliance and Research
2. Shariah Audit
3. Additional Services

Sample Shariah Department Organizational Chart



Source: Pages 63 and 64 of Meezan Bank Annual Report 2012 (Section: Operations Review)

PRODUCT DEVELOPMENT AND RESEARCH

This function includes all the product development activities for corporate, commercial, retail, investment banking, and treasury. The research team must visit corporate and SME clients, interact actively with them on a routine basis along with business teams to ascertain their requirements and design processes accordingly. It must identify the ideal Islamic banking solution and structure it to meet the client's need in a Shariah compliant manner.

Designing Shariah-compliant solutions for businesses entails analyzing certain crucial aspects of a client's business which includes but is not restricted to the following:

- The business cycle
- The tenure (short term or long term)
- The rate of financing (fixed or variable)
- Existing market alternatives
- Payment flexibility (possibility of early repayment)
- The mode and nature of assets
- Adherence to basic Shariah principles
- Tax concerns
- Accounting treatment

- Regulatory framework
- Risk mitigation procedures

Product Development and Research personnel must know the Shariah and product requirement and also possess accounting expertise to equip them to customize and implement adequate solutions.

The benefit of a joint Product Development and Shariah Compliance Department is that combining the two functions creates a synergy that facilitates the bank's overall operations and fulfillment of objectives. When product departments are independent, business teams review transactions and the clients from a business perspective alone, they come up with solutions on their own, and put them before the Shariah experts – more often than not, these solutions are not the best alternatives or even not Shariah-compliant since the business department is focused primarily on the commercial side of the transaction.

The wrong solutions mean numerous process cycles before the solutions are consistent with the client's demand and Shariah principles. On the other hand, when the product development team has a Shariah background in addition to product development expertise, it is in a much better position to customize solutions that are effective and fall within Shariah parameters. It also increases the time to market aspect of the solution to the customers.

Another limitation with business teams is that Shariah-compliant product development expertise never really thrives because of high employee turnover. Every few years an employee leaves the bank with all his learning and is replaced with a new individual usually from a conventional banking background who needs to be trained all over again. In order to ensure quicker turnaround times and quicker solutions a combined product development and Shariah compliance and research department is key. It allows solutions to be delivered in as little as two to three days whereas two separate departments using a hit and miss approach fail to adequately serve clients. The joint product development and Shariah compliance department ensures consistent Shariah-compliance because the team not only structures the products but also the process flows with the business team's help. These processes get documented as a step by step guide for future reference.

There is a general misconception that a Shariah department must only be represented by a Shariah scholar or group of scholars. The right approach is to include a variety of experts on the panel such as chartered accountants, business management specialists, and lawyers, to name a few, who work alongside the scholars to create and deliver effective solutions. These specialists must also be well versed in AAOIFI Standards and all the laws of sale and contracts in order to be strong supports to the business. Such a proactive approach means fewer errors and, therefore, fewer charity penalties post audit. It is a tried and tested method that promotes the bank's growth by turning around solutions in a matter of days.

The main concepts of all new products must be approved by the Shariah Board, an entity separate from the Product Development and Shariah Compliance Department. Thereafter, the Shariah Advisor is entitled to approving any other products based on an already approved theme. For existing products, the involvement of the Shariah Advisor and/or the Shariah Board depends on the level of change required. If the modification is a repetition or a change undertaken earlier, then the bank already has the approval in place to execute the transaction. If it is a minor change which does not affect the Shariah essence of a contract it need not be referred back to the Shariah Advisor or Shariah Board. For major changes, the Shariah Advisor must be referred to and upon his discretion the Shariah board may or may not be involved.

Importantly, neither the Shariah Advisor nor the Shariah Board are the bank's employees. The Shariah Advisor serves the bank in an advisory capacity only, however, he must visit the bank almost daily to ensure regular interaction. The Shariah Board should consist of at least three members with a senior scholar serving as its Chairman. The Shariah Board should ideally meet every quarter or at least twice a year to review overall matters related to the Shariah, approve new products and ideas, examine the issues highlighted during Shariah audits, and provide direction to the bank for enhancing Shariah compliance. The Product Development and Shariah Compliance Department must report to the Shariah Advisor and the Shariah Board to have continuous supervision.

In addition to monitoring specialized product design, the Shariah compliance team's role includes reviewing and monitoring the Islamic bank's:

- Pool Management and profit distribution procedures
- Investment banking transactions
- Funding, financing, investment and foreign exchange related activities

SHARIAH AUDIT

Shariah Audit is a periodic activity. It must be designed as a formal, structured process based on standard operating procedures and programs. It should involve a review of documents which entails going over a checklist to see whether or not documents are genuine and their entries are correct. The aim of the Shariah Audit is not to penalize for mistakes but in fact to ensure mistakes are learned from and improvements made accordingly.

The Shariah Audit must also include an evaluation of the bank's environment, customer reading material and staff dress-code to see if it all complies with the Shariah. It entails staff interviews, particularly the branch and operation manager's to determine their knowledge and understanding of Islamic banking. It must include a check on the methods of profit distribution and assigning weightages. At a financing branch the audit must determine the degree of Shariah compliance of financing transactions. At a deposit branch the audit should focus on branch environment and staff awareness. The audit team must also visit clients to determine whether or not proper procedures are in place.

Errors if any should be presented in the Shariah Advisor's Report. Errors must also be reported to the Product Development, Research and Shariah Compliance team which directs them to review post product approval process flows. If the Product Development team is not a part of the Shariah Department, then it is likely that the problem never may get communicated.

Once reported the error serves as a precedent to help avoid similar mistakes in the future and likewise informs other branches of the latest findings and measures to prevent them from repeating the same errors.

This is the synergy between the different teams within the department that enables the Islamic bank to function effectively as a whole – its perspective, objectives and activities directed to one goal – ensuring 100% Shariah compliance and ultimately 100% customer satisfaction.

As an industry best practice and as guideline given by top scholars in the field, it is strongly recommended that every year a Shariah Audit must be conducted for all the financing units, department or branches in a bank. Transactions within each unit must be checked via sampling. It is also recommended that a Shariah review is conducted at the time when the financing limits are renewed annually.

The Product Development and Shariah Compliance unit must also check sample transactions for each client to determine their conformity to Shariah rulings. This process of refinement exists to avoid mistakes that would otherwise show up in an audit.

Post Audit Corrective Measures

If the Shariah Audit discloses a serious error, the transaction should be stopped or put on hold and put before the Shariah Advisor and Product Development team. The transaction may be allowed to continue but only after the correction of error or with a revised process flow.

The cause of the error must be investigated to determine the appropriate course of action - was it the bank officer's mistake? Was the financing mode prescribed inappropriate?

If the transaction is impermissible, the corresponding income should be transferred to the charity account. Disciplinary measures must be prescribed if the mistake is intentional. In case the error is the client's, it should be investigated whether it occurred out of a lack of awareness or the client's indifference to Shariah prescriptions.

Disclosures & Annual Shariah Report

All the major activities of the bank's Shariah department and the results of the Shariah audit must be disclosed in the Shariah Board's or Shariah Advisor's report published within the bank's Annual Report.

The Shariah Report must state the number of branches audited and the resultant findings. It should mention the amounts transferred to the charity account owed to flawed transactions and where the charity is distributed. Major errors too must be disclosed along with the actions recommended to rectify them. The Shariah Advisor should follow up on his recommendations in the subsequent year's report.

The report must also disclose the research undertaken, the new products developed, the number of employee and client training sessions conducted. It should disclose the scope of the audit; the transactions covered. It must include an overall branch assessment and a review of how profit was distributed and the employees' level of Islamic banking knowledge.

All these disclosures offer transparency and keep the bank's clients and shareholders informed of the bank's activities and the measures it takes to ensure continued Shariah-compliance.

Refer: Pages 75-79 and 83 of Meezan Bank Annual Report 2012 (Section: Report of the Board Audit Committee; Shariah Advisor's Report – 2012; Statement of Sources and Uses of Charity Fund)

RATING

As part of the industry best practice an Islamic bank must have two rating processes Shariah Audit rating and employee rating.

Shariah Audit Rating

The bank's branches/departments/functions must be rated after Shariah Audits using an efficient rating system, like a five tier rating system (e.g. Excellent, Above Average, Good, Below Average, Poor) and the result of the Shariah audits should be linked to the annual appraisal of the branch and concerned staff.

For instance if a unit is rated "Poor" it affects its appraisal, promotions and increments and if a unit is rated "Excellent" it earns some type of reward or other performance enhancement incentive.

A unit rated "Poor" is also given extra support to bring it up-to-date with the latest training and performance improving activities.

Employee Rating

Starting from the CEO to the cashier at the front desk, ensuring Shariah-compliance is everyone's job. And it is strongly suggested that in the employees' annual appraisals due weightage must be given to the Shariah compliance mindset, knowledge and commitment to Shariah compliance.

Institutionalizing a penalty and reward system is a must to ensure good performance at both the branch and employee level.

ADDITIONAL SERVICES

SHARIAH TRAINING

The Islamic bank must have two types of training in place – one mandatory Islamic banking orientation and concept training for all the staff of the bank and a second type of more advanced and specialized product trainings for different functional areas. Ideally, every new employee must go through a basic orientation session covering a list of mandatory modules on Islamic banking products. The bank should also run a number of specialized courses ranging from shorter courses to advance and longer duration expert level courses; deliver face-to-face training and video training – modules should be designed based on specific job requirements. For instance, apart from the general orientation course, the Relationship Manager's training should be different from the Branch Manager's.

It is also very important that the bank conduct customer training workshops and general awareness seminars to educate clients on Islamic banking products and procedures. So the bank's training arm undertakes internal as well as external training. The employees of the department must be up to date with all the latest products and how they work as they themselves are key resources in training new and existing staff. Team members must be assigned different training functions where it should be one group's responsibility to ensure training takes place.

ADVISORY AND SUPPORT SERVICES

In order to promote Islamic banking, the bank may offer advisory and support services to other institutions as well. It can organize workshops and seminars to spread awareness of the Islamic financial system, offer alternative solutions and highlight common mistakes and the ways to avoid them. It could host forums for Shariah Advisors to update them of the latest research findings in the field.

CORPORATE SOCIAL RESPONSIBILITY

The Shariah department can also contribute towards CSR activities. Some banks have created Waqf based trusts independent to the bank which efficiently manage the distribution of charity to reliable and deserving institutions.

Ideally the Shariah department should partner with other Islamic financial institutions to launch Islamic finance initiatives and publish research papers and articles on Islamic obligations and rites – all of this goes towards promoting public awareness of the ethos of the Islamic value system which in turn goes a long way in determining the direction of the overall economy.

Refer: Pages 69 and 70 of Meezan Bank Annual Report 2012 (Section: Corporate Social Responsibility)

APPENDIX: SELECTIONS FROM THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTION'S (AAOIFI) GOVERNANCE STANDARD FOR ISLAMIC FINANCIAL INSTITUTIONS

Governance Standard for Islamic Financial Institutions No.1

Shari'a Supervisory Board: Appointment, Composition and Report

Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the definition, appointment, composition and report of the Sharia' supervisory board for ensuring compliance of the Islamic financial institution in all its dealings and transactions with Islamic Shari'a Rules and Principles.

Definition of Shari'a Supervisory Board

The Shari'a supervisory board is an independent body of specialized jurists in fiqh almua'malat (Islamic commercial jurisprudence). However, the Shari'a supervisory board may include a member other than those specialized in fiqh almua'malat, but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh almua'malat. The Shari'a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Shari'a Rules and Principles. The fatwas and rulings of the Shari'a supervisory board shall be binding on the Islamic financial institution.

Governance Standard for Islamic Financial Institutions No. 2

Shari'a Review

Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance to assist Shari'a Supervisory Boards (SSB) of Islamic Financial Institutions (IFIs) in performing Shari'a reviews to ensure compliance with Islamic Shari'a Rules and Principles as reflected in the fatwas, rulings and guidelines issued by them. The appointment, composition and report of the SSB is dealt with in AAOIFI Governance Standards for Islamic Institutions No.1 Shari'a Supervisory Board: Appointment, Composition and Report.

This standard should be read in conjunction with ASIFI No.1: Objective and Principles of Auditing with particular reference to paragraph 7 and ASIFI No.2: The Auditors Report with particular reference to paragraph 17. It follows that the objective of this standard as well as those of ASIFIs No.1 and No.2 requires close coordination between the SSB and the external auditor.

Definition and Principles of Shari'a Review

Shari'a review is an examination of the extent of an IFI's compliance, in all its activities, with the Shari'a. The examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars etc.

The SSB shall have complete and unhindered access to all records, transactions and information from all sources including professional advisers and the IFI employees.

Governance Standard for Islamic Financial Institutions No. 3

Internal Shari'a Review

Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the Internal Shari'a review in institutions which conduct business in conformity with Islamic Shari'a rules and principles. The standard covers:

- Objectives
- Internal Shari'a review
- Independence and objectivity
- Professional proficiency
- Scope of work
- Performance of the internal Shari'a review work
- Management of the internal Shari'a review
- Quality assurance and
- Elements of an effective internal Shari'a review control system

The standard also covers responsibility for its implementation

Objectives

The internal Shari'a review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of the Islamic financial institution (IFI). It shall be established with an IFI to examine and evaluate the extent of compliance with Islamic Shari'a rules and principles, fatwas, guidelines and instructions issued by the IFI's Shari'a supervisory board (SSB), hereafter referred to as Sharia' rules and principles.

The primary objective of the internal Shari'a review is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shari'a rules and principles as determined by the IFI's SSB.

Internal Shari'a Review

The internal Shari'a review is an integral part of the organs of governance of the IFI and operates under the policies established by the IFI. It shall have a statement of purpose, authority and responsibility (charter). The charter shall be prepared by management and shall be consistent with Islamic Shari'a rules and principles. The charter shall be approved by the SSB of the IFI and issued by the board of directors. The charter shall be regularly reviewed.

Governance Standard for Islamic Financial Institutions No. 4

Audit & Governance Committee for Islamic Financial Institutions

Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to define the role and responsibilities of an Audit & Governance Committee (AGC) for an Islamic financial institution (IFI). The standard also highlights the requirements for establishing such a committee for an IFI and specifies the pre-requisites of an effective AGC.

Importance of AGC

The importance of the AGC (known internationally as the Audit Committee) for an IFI emanates from its role in:

(a) Achieving the fundamental objectives of an IFI by enhancing greater transparency and disclosure in financial reporting; and

(b) Enhancing the public's confidence of the IFI as genuine in its applications of Shari'a rules and principles.

Functions of the AGC

The AGC has gained widespread acceptance as a prerequisite for organizations seeking to demonstrate a commitment to higher standards of corporate governance. The AGC assists the board of directors in exercising independent and objective monitoring through the following functions:

(a) Preserving the integrity of the financial reporting process.

(b) Safeguarding the interests of shareholders, investors and other corporate stakeholders.

(c) Providing additional assurance on the reliability of financial information presented to the board of directors, if the AGC is to be considered effective.

(d) Acting as an independent link between the IFI's management and its stakeholders.

Governance Standard for Islamic Financial Institutions No. 5

Independence of Shari'a Supervisory Board

Introduction

The purpose of this standard is to provide guidance for members of Shari'a Supervisory Boards (SSBs) of Islamic Financial Institutions (IFIs) pertaining to its independence, monitoring of such independence and ways to resolve issues of independence.

Independence

Independence for the purpose of this standard is "an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and objectivity." The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests. (neutral)

Importance of Independence of SSBs

The importance of the independence of SSB members for an IFI emanates from its role in:

(a) Enhancing the public confidence in the IFI as compliant in its applications of Shari'a rules and principles.

(b) Achieving the fundamental objectives of an IFI by enhancing independence and objectivity.

SSB members have a responsibility to the public who rely on the services provided by them that require independence. The public includes clients, credit grantors, governments, employers, employees, investors and others who rely on the objectivity and integrity of SSB members to ensure Shari'a compliance with regard to activities.

Governance Standard for Islamic Financial Institutions No. 6

Statement on Governance Principles for Islamic Financial Institutions

Introduction

Governance practices play a vital role in ensuring that businesses are run in a prudent and sound manner. A loss of confidence in financial institutions has the potential to create severe economic dysfunction, adversely affecting the general community in which they operate.

Financial institutions are different from other types of businesses due to their public purpose. There are more stakeholders in banks and other financial services institutions than in other businesses. Indeed, in an Islamic financial institution (IFI), the list of stakeholders is even wider. The interest of Rab al Maal and providers of other forms of capital are exposed to the risk of being prejudiced if government practices are focused on benefits to owners or equity-holders.

Those charged with governance of IFIs are held to the highest fiduciary standards since they are accountable not to the equity-holders who appointed them but also for the safety of all key stakeholders as well as the community the IFI serves.

Financial institutions that develop strong governance practices win public confidence and thereby promote trust amongst their equity-holders, investors and other parties dealing with them. In IFIs, governance practices are also expected to lead to enhanced Shari'a compliance structures.

Rationale for establishment of the framework

A Statement on Governance Principles for Islamic financial institutions is necessary in order to support the development of sound governance practices within its IFIs as well as establish the basis for standards setting by AAOIFI on individual aspects of governance.

This Statement on Governance principles represents the framework for governance in IFIs and forms part of the pronouncement of the AAOIFI.

The purpose of the Statement is as follows:

(a) To lay down the key principles and concepts relevant to governance in IFIs.

(b) To assist IFIs as well as their stakeholders to appreciate the respective roles of those charged with governance.

(c) To establish the foundation upon which the development of future governance or compliance standards will take place.

(d) To provide the necessary inter-linkage between the various current and future standards applicable to IFIs.

The Statement recognizes the complexity of the concept of governance structures and therefore focuses on the principles on which it should be based.

The governance principles are founded on the need for structures leading to enhance compliance, transparency, accountability, fairness and equitable treatment of stakeholders.

Governance Standard for Islamic Financial Institutions No. 7

Corporate Social Responsibility

Conduct and Disclosure for Islamic Financial Institutions

Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards on the definition of Corporate Social Responsibility (CSR) for Islamic Financial Institutions, provide both mandatory and recommended standards to implement CSR in all aspects of the Islamic Financial Institution's (IFI) activities and provide guidance on disclosure of CSR information to the IFI's stakeholders.

Definition of Corporate Social Responsibility for Islamic Financial Institutions

Corporate Social Responsibility (CSR) for IFIs refers to all activities carried out by an IFI to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions.

Religious responsibility refers to the overarching obligation of IFIs to obey the laws of Islam in all its dealings and operations. Economic responsibility refers to the obligation for Islamic banks to be financially viable, profitable and efficient. Legal responsibility refers to the obligation of IFIs to respect and obey the laws and regulations of the country of operation. Ethical responsibility refers to the obligation of the IFIS to respect the mass of societal, religious and customary norms which are not codified in law.

Discretionary responsibility refers to the expectation from the stakeholders that IFIs will perform a social role in implementing Islamic ideals over and above the religious, economic, legal and ethical responsibilities.

This standard does not focus on economic or legal responsibilities of IFIs as it is assumed that the management/accounting structure and other accounting and governance standards are designed to fulfill economic responsibilities, while legal responsibilities are codified and enforced by the state and its functions.