

Strengthening Shariah Compliance Risk Culture

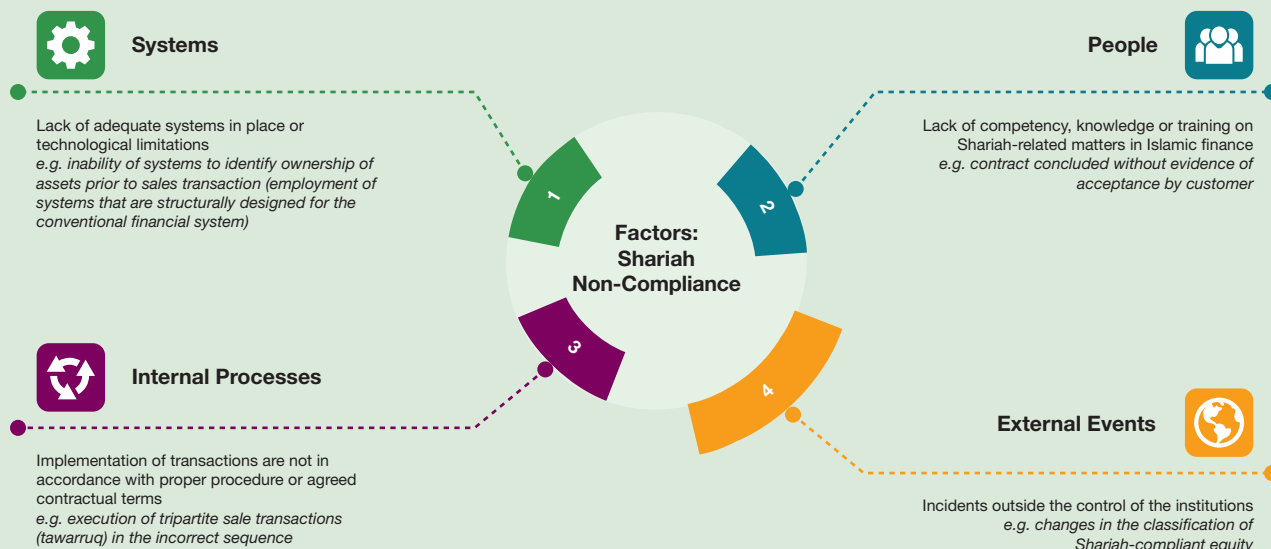
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Introduction

Shariah is the central tenet of Islamic finance. Its principles, which promote fairness and transparency, underpin the conduct of Islamic finance transactions. Failures in fully observing Shariah principles can thus affect the validity and enforceability of Islamic finance transactions, and increase financial and non-financial risks for Islamic financial institutions. For example, it is prohibited for Islamic financial institutions to recognise income derived from transactions that have not fully observed Shariah requirements. This could lead to safety and soundness concerns for an Islamic financial institution. Incidents of non-compliance on a broader scale can, in turn, undermine confidence in the Islamic financial sector and its stability. The effective management of Shariah non-compliance risk is therefore paramount, especially with the growing significance of Islamic finance as a key component of the financial system, domestically and globally. This article highlights the approach by the Bank and the practices of Islamic financial institutions in inculcating an effective Shariah compliance risk culture.

Diagram 1

Factors Contributing to Shariah Non-Compliance



Source: Bank Negara Malaysia

Shariah Compliance in Malaysia

Section 28 of the Islamic Financial Services Act 2013 (IFSA 2013) requires Islamic financial institutions to ensure that their aims and operations, business, affairs and activities are aligned to and in compliance with Shariah principles at all times. In practice, Shariah compliance is supported in Malaysia under a two-tier governance structure that operates at the industry and institutional levels. This is further reinforced through the regulatory framework, supervision and the control functions of Islamic financial institutions.

a) Centralised Shariah Advisory Council

At the industry level, the Shariah Advisory Council of Bank Negara Malaysia (the SAC) is the highest authority in the ascertainment of Islamic law for Islamic financial business conducted by institutions regulated by the Bank. While Islam recognises diversity of *fiqh* interpretations and approaches to implementation, the existence of a central authority is critical in providing certainty and uniformity in Shariah interpretations. The role of the SAC in providing national level Shariah certainty for Islamic finance has enabled the orderly development of the

Islamic financial system, mitigating variations and conflicting Shariah interpretations that may undermine public confidence and create gaps in market practices.

b) Shariah committees of individual Islamic financial institutions

At the institutional level, each Islamic financial institution has a Shariah committee responsible for advising the management and board on matters relating to Shariah in all aspects of the institution's business, affairs, practices and activities. While the SAC typically deliberates on industry-wide implications of applying a particular Shariah principle, the institutional level Shariah committee focuses on Shariah issues that are specific to the institution. These include those relating to the development of bespoke products and services, as well as business operations. Currently, there are more than 150 qualified Shariah scholars – local and international – who are appointed as Shariah committee members at 55 Islamic financial institutions.

c) Shariah risk management, Shariah review and Shariah audit functions

The role of the Shariah committee is supported by designated control functions within Islamic financial institutions, namely the Shariah risk management, Shariah review and Shariah audit functions. These functions are independent of the business lines and responsible to provide an objective assessment and assurance of the effectiveness of an Islamic financial institution's compliance with Shariah and management of Shariah non-compliance risks. The establishment of these control functions and the strengthening of their capacity over time have been instrumental in promoting a strong Shariah compliance risk culture within Islamic financial institutions.

d) Regulatory framework

Since 2012, the Bank has issued 14 Shariah Standards and Operational Requirements which give effect to rulings by the SAC and serve to promote the effective management of risks in Islamic financial business. This has led to enhanced internal policies and processes of Islamic financial institutions to effectively manage Shariah non-compliance risks in their business undertakings. In particular, the regulatory standards have had an important role in reducing legal and operational risks associated with people and system in the operationalisation and innovation of Islamic financial products and services.

The upcoming revision to the Shariah Governance Framework will further strengthen Shariah governance implementation within institutions. The framework outlines specific expectations for Shariah considerations to be more closely integrated with the business and risk strategies of Islamic financial institutions. It further clarifies the roles, responsibilities and accountabilities of the board, Shariah committee and key organs involved in instituting a robust Shariah compliance risk culture. An increased emphasis is also placed on elevating the professional competence of individuals who helm these roles in respect of their Shariah knowledge and its applications to Islamic finance. Expectations on the independence and quality of control functions to ensure effective management of Shariah non-compliance risks will also be strengthened under the framework.

Observations on Shariah Compliance

Shariah applications have wide implications for how an institution operates – encompassing its business practices and processes to the behaviours of senior management and employees. In this section, an overview of Shariah organisational practices observed in Islamic financial institutions is provided.

- At the apex, the board and senior management set the tone for the organisational culture and desired behavioural norms that promote Shariah compliance. Increasingly, more Islamic financial institutions are formally adopting a set of common values and purpose which reflect Shariah principles and underpin the institutions' business strategy and risk appetite.
- Responsibilities for Shariah compliance and risk management are increasingly devolved to business units and employees, reflecting an increasing emphasis on the first line of defence in mitigating Shariah non-compliance risks.

This has been accompanied by greater empowerment and accountability accorded to business units, with greater involvement in the design of business processes and controls to manage Shariah non-compliance risks.

- Considerations of conduct that impact an Islamic financial institution's Shariah compliance have become a more prominent feature of incentive frameworks. Most Islamic financial institutions adopt penalty and reward systems that relate performance measures to Shariah expectations. These strategies serve to reinforce a collective focus of the organisation on ensuring Shariah-compliant practices in all aspects of an Islamic financial institution's business, and building a strong risk culture among employees.
- Greater emphasis has been directed by Islamic financial institutions at building strong foundations in Shariah knowledge and applications within the workforce. Strengthened recruitment practices and higher investment in training and development have been observed. This has been motivated both by an increased focus of Islamic financial institutions on the sound management of Shariah non-compliance risks, as well as the desire to drive greater innovation in the offering of Shariah-compliant financial solutions. Increased accountability of the Shariah committees has also encouraged the upskilling of scholars that are appointed to the committees, especially in areas relating to business operations and industry practices.

Collectively, these developments have led to better alignment between business operations, processes and practices with Shariah expectations, thereby mitigating incidents of non-compliance. Further details of practices observed across Islamic financial institutions are elaborated in Diagram 2.

Conclusion

Moving forward, the Bank expects continued progress in evolving a strong Shariah compliance risk culture that is well-integrated and self-reinforcing within Islamic financial institutions. This in turn will provide the critical foundations for further growth and innovation in the Islamic finance industry, while also contributing to domestic financial stability.

Consistent with Shariah principles, the adoption of value-based intermediation (VBI) will further sharpen the focus of Islamic financial institutions in ensuring their products, services and practices deliver a positive and sustainable impact on the economy, community and environment. An increased focus on impact-driven strategies, supported by strong governance, is expected to be embedded within and well-integrated into the risk management practices and product innovation strategies of Islamic financial institutions (the progress of VBI implementation is detailed further in the section on Islamic Finance in Chapter 2). The development of VBI scorecard and disclosure practices will enable stakeholders to better assess the institutions' fulfilment of the basic tenets of Shariah. As such, this ensures that Islamic financial institutions meet the overarching objectives of Shariah (*maqasid* Shariah) – which are to preserve and advance the common interest of society at large, by preventing harm and maximising benefits. This will further strengthen the accountability, transparency and integrity of Islamic financial institutions.

Diagram 2

Increasing Efforts by Islamic Financial Institutions to Strengthen Shariah Compliance Risk Culture

Observed Practices

Tone from the Top



- Internal policies are reflective of Shariah principles, catering to different risks in the implementation of various Shariah contracts
- Shariah consideration integrated within business operationalisation and risk management practices
 - > Integrated IT system ensures execution process of Shariah contracts is systematically observed
 - > Robust risk assessment process to identify and incorporate Shariah non-compliance risk under the ICAAP*, including quantification
- Strengthened high-level deliberation on Shariah and its application in business and risk strategies
 - > Semi-annual dialogue between Board of Directors and Shariah committee enables effective resolutions of strategic issues
 - > Appointment of Shariah scholars as board members in 11 institutions fosters greater understanding among board members on Shariah matters

Accountability and Communication



- Clear roles and responsibilities of all organisational units and employees
 - > Appointment of senior officers responsible for the day-to-day management of Shariah matters
- Regular engagement among employees to enhance awareness on the importance of Shariah compliance
 - > Weekly/monthly dialogue among staff/branch managers to instil awareness on Shariah non-compliance risk
 - > Sharing of good practices or audit findings provides learning opportunities and process improvement

Performance Management



- Driving performance improvement to ensure Shariah compliance
 - > Introduced reward mechanism for achieving zero Shariah non-compliance
 - > Introduced 'Mystery Shopper' as a tool to assess frontliners' competency in handling Shariah matters

Talent Development



- Enhancing the understanding on Shariah and ensuring attainment of technical proficiency
 - > Recruitment practices of prospective board members, senior management or employees, take into consideration a candidate's knowledge and experience in Islamic finance and Shariah
 - > Enhancement of knowledge via structured training programmes

Structured Learning Programmes

109 board members completed the Islamic Finance for Board of Directors (IF4Board) programme – To upscale directors' appreciation on the dynamics of Shariah principles in shaping Islamic finance business

38% Shariah committee members enrolled into Certified Shariah Advisors (CSA) programme in 2018 – To upskill the competency of the Shariah committee in applied knowledge of Shariah and business

More than 2,000 employees across 39 financial institutions pursued specialised qualifications in Islamic finance (AQIF, IQIF and CQIF)** – Three-tier qualification to advance knowledge and competency of Islamic finance practitioners in the areas of Islamic banking, takaful, capital market and wealth management

* ICAAP - Internal Capital Adequacy Assessment Process

** AQIF - Associate Qualification in Islamic Finance; IQIF - Intermediate Qualification in Islamic Finance; and CQIF - Certified Qualification in Islamic Finance

Source: Bank Negara Malaysia