

Response to feedback received Shariah Governance

Introduction

The Bank issued today the policy document on *Shariah Governance* for Islamic financial institutions. This policy document has incorporated, where appropriate, the feedback and proposals received during the consultation period.

Key comments received and the Bank's responses are set out in this document. Other comments and suggestions have also been incorporated in the policy document for further clarity.

**Bank Negara Malaysia
20 September 2019**

1 Shariah governance structure and disclosure template

Feedback received

Respondents proposed to maintain the illustration on Shariah governance structure and disclosure template for Shariah committee in the annual report, as provided in the Shariah Governance Framework 2011.

The Bank's view

- 1.1 The Bank does not intend to maintain the illustrations as provided in the Shariah Governance Framework 2011, given that the minimum requirements and expectations relating to the reporting arrangement and disclosure have been incorporated in the policy document.
- 1.2 In relation to reporting arrangement, the Bank would like to emphasise that an Islamic financial institution (IFI) must organise its key organs under Shariah governance in a manner that allows communication or reporting on Shariah matters and Shariah non-compliance risk to be managed effectively, taking into account the size, complexity and nature of IFI's business. Such requirement is clarified in paragraph 15.1(a) where IFIs must establish management structure and reporting arrangement in accordance to the roles expected of each key organ.
- 1.3 In relation to disclosures, this policy document has specified heightened expectations for the Shariah committee to enhance its disclosure, as reflected in paragraphs 22.4 to 22.10. Some of these expectations are beyond those specified in the Shariah Governance Framework 2011.
- 1.4 On the adoption of the materiality concept in disclosing the state of an IFI's compliance with Shariah, IFIs are encouraged to clearly define the scope of "material Shariah non-compliance" internally. The Bank accepts that there is potential for differences in assessing the materiality of Shariah non-compliance across the industry. However, the Bank does not tolerate any practices of abuse or misuses of the materiality concept. In this case, IFIs are expected to consult their respective Shariah committee in setting the interpretation and magnitude of material Shariah non-compliances.

2 Appointment of Islamic finance practitioner

Feedback received

Respondents raised concerns on the mandatory appointment of the Islamic finance practitioner. As the Shariah committees have access to advice from third party experts, the mandatory appointment of Islamic finance practitioner in the Shariah committee can serve as a guidance.

The Bank's view

- 2.1 The Bank has considered industry's feedback and has removed the mandatory requirement on the appointment of Islamic finance practitioner in the Shariah committee in the final standard.
- 2.2 This does not preclude an IFI to appoint expert(s) with relevant background and expertise other than Shariah (e.g. finance, accounting, law etc) as Shariah committee members. The revised expectation is reflected in paragraph 12.1(c)(ii).

3 Tenure limit for appointment of Shariah committee member

Feedback received

Respondents proposed for a maximum tenure be imposed on the appointment of Shariah committee members. This is to address concerns on long-serving Shariah committee members who may induce complacency and affect professional objectivity of the Shariah committee.

The Bank's view

- 3.1 The Bank shares the industry's concerns on the familiarity threat of long-serving members of the Shariah committee. A renewed composition of the Shariah committee can contribute towards providing fresh perspectives and enrich Shariah deliberation and overall competence of the Shariah committee. Therefore, the policy document stipulates a nine-year tenure limit for the appointment of a Shariah committee member, as prescribed in paragraph 12.5. This is consistent with the criteria applied for independent director in the Corporate Governance policy document.
- 3.2 To minimise operational challenges, the Bank has granted a three-year transitional arrangement, as stated in paragraph 4.2 to allow sufficient time for IFIs to reconstitute its Shariah committee.

4 Single Shariah committee within financial group

Feedback received

Respondents requested clarity on the expectations for the establishment of a single Shariah committee within a financial group, especially in terms of the reporting arrangement and interaction between the board and Shariah committee.

The Bank's view

- 4.1 Establishment of a single Shariah committee at group level shall not compromise compliance with the requirements of the policy document at the entity level, especially on responsibilities of the Shariah committee and interaction between the board and Shariah committee. Therefore, the board of each IFI must establish effective communication with the Shariah committee (includes reporting arrangement) to enable both the board and Shariah committee to discharge their respective responsibilities effectively.

5 Officers performing control functions

Feedback received

Respondents sought further understanding on the rationale of having different expectations on the level of expertise for officers who perform the control functions, i.e. Shariah risk management, Shariah review and Shariah audit functions.

The Bank's view

- 5.1 Officers who perform Shariah risk management, Shariah review and Shariah audit functions must primarily have the relevant expertise and experience on the respective subject matter i.e. risk management, compliance and internal audit. This is important as strong knowledge and experience in performing the responsibilities will improve the quality and implementation of the control functions.
- 5.2 Nevertheless, these officers must also have understanding on relevant Shariah matters applicable to Islamic financial business to ensure that the control functions are performed effectively.
- 5.3 Officers with Shariah qualification, those holding at minimum, a bachelor's degree in Shariah, which includes study in *Usul Fiqh* (principles of Islamic jurisprudence) or *Fiqh Muamalat* (Islamic transaction/commercial law), may also perform the control functions, provided that they are trained on the respective subject matter.
- 5.4 Although it is no longer a requirement for the Shariah review function to be performed by officers with Shariah qualification, heightened expectations are imposed for the Shariah review to be part of the IFI's overall compliance responsibilities. This requires improvement in the quality of Shariah review implementation through sound understanding of Shariah to manage Shariah non-compliance risks effectively.

6 Shariah research function

Feedback received

Respondents sought further clarification on the status of Shariah research function, as required in the Shariah Governance Framework 2011. The Shariah research function was not mentioned in the exposure draft.

The Bank's view

- 6.1 Given the emphasis of the policy document is to ensure effective management of Shariah non-compliance risk through the control functions, the Bank has removed the requirement to establish Shariah research function in the final standard.
- 6.2 However, it does not mean that the Bank is diluting the focus on the development of Shariah research. The expectation to perform in-depth research and studies on Shariah issues is already incorporated under paragraph 14.1(b), as part of the roles of the secretariat to serve the Shariah committee. The IFI may expand the scope of the Shariah research function and structure it accordingly, in line with its business strategy and direction.