Shariah governance framework in Bahrain's Islamic banks

After four decades since the inception of the first fully-fledged Islamic bank in 1975, Islamic banks have now matured and are in a position to finalize the Shariah governance framework as their governance structure. AHMED ABDULRAHIM AL MAHMOOD explores.

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Shariah governance is interpreted as a system or a framework which Islamic banks can adopt to ensure that their activity are compliant with Shariah principles. All stakeholders must implement and enhance the Shariah governance framework for Islamic financial institutions.

The objectives of the Shariah governance framework are:

1. To provide a structure and system that govern the business activities of Islamic banks to ensure Shariah compliance at all levels and at all times.
2. To assist Islamic banks to be seen to be compliant with Shariah principles by all stakeholders including the general public.

The Shariah governance framework initially had the requirement of a single Shariah advisor whose responsibility was to look after Shariah compliance and audit and was provided with limited authority. It then evolved into the formation of a Shari'ah supervisory board (SSB) consisting of three Shariah scholars or more and its responsibility was to issue Shariah resolutions (Fatwas) for the day-to-day activities of the institution and also to review all submissions made by the management.

The SSB at this stage could direct to audit some transactions to ensure that a Fatwa was implemented correctly. Subsequently, the Shariah compliance department was set up within the organizational structure of Islamic banks, and played a critical role: it acted as the eyes and the ears of the SSB.

In August 2017, the Central Bank of Bahrain (CBB) issued the Shariah Governance Module (SG-Module) to enhance the Shariah governance framework in financial institutions in Bahrain. The purpose of this SG-Module is to develop principles for best practices of Shariah governance in financial institutions in Bahrain and to ensure the protection of investors and related parties in Islamic banks by adhering to these principles.

The SG-Module enhanced the framework of Shariah governance through a comprehensive structure with the following:

1. SSB.
2. Shari'ah Coordination and Implementation Department (SCID).
3. Internal Shariah Audit Department (ISAD).
4. Independent external Shariah compliance auditor (IESCA).

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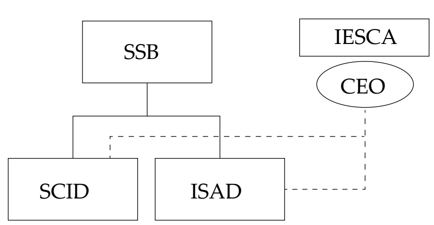
This new governance structure is reportedly adopted by Bahrain, Kuwait, Oman, Malaysia and Pakistan. More countries are expected to adopt it in the near future.

Diagram 1: The new Shariah governance structure



Source: Author's own

Each function is detailed briefly in the following:

1. The SSB is an independent body consisting of three or more Shariah scholars specializing in Shariah principles who are appointed by shareholders during an annual general meeting and subject to CBB approval. The SSB's main role is to direct, review and supervise all transactions processed by the Islamic bank to ensure Shariah compliance. All the Fatwas issued by the SSB are considered to be binding on the Islamic bank. At the end of each year, the SSB will issue a Shariah annual report about the Islamic bank's compliance to Shariah principles.
2. The SCID is a department within an Islamic bank appointed by the executive management and subject to the approval of the SSB and the CBB. The SCID reports directly to the SSB and administratively to the CEO to ensure independence. Its main role is to review and evaluate Shariah compliance (before any product or service is offered to clients) of the transaction which includes, but is not limited to, the agreement, fees, polices, procedures, advertisement material, product manual and any other matter which could potentially influence the perception of its Shariah compliance. The SCID submits the results of its evaluation along with all supporting documents to the SSB for

its final review and approval.

3. The ISAD is a department within an Islamic bank appointed by the executive management and subject to the approval of the SSB and the CBB. The ISAD reports directly to the SSB and administratively to the CEO to ensure independence. Its main role is to review and examine the adequacy and effectiveness of the Islamic bank's Shariah compliance system. The ISAD submits a periodic report to the SSB, based on an approved audit plan, for appropriate action. A copy of the report must also be presented to the audit committee and the CEO.
4. The IESCA is an independent body appointed by an Islamic bank's board of directors in consultation with the SSB which must be approved by the CBB. The IESCA must conduct an independent Shariah audit on an annual basis and issue its report before issuing the annual Shariah report of the SSB. The report must be addressed to the audit committee and subsequently to the SSB and executive management. Its role is similar to an external auditor but with a focus only on Shariah matters.

It is important to shed light on Shariah non-compliance risk in Islamic banks. It is a significant risk for an Islamic bank on two perspectives:

1. It impacts the **reputation** of the Islamic financial institution and deteriorates the confidence of depositors, investors, customers and other stakeholders in the long term, and
2. It impacts the **revenue** as well, because in case of an identified Shariah non-compliance, the income arising from such transaction is to be given to charity.

Those risks categorized in the findings in the internal Shariah audit report are as follow:

1. High risk: a finding which significantly affects the transaction from a Shariah perspective, in a way that it cannot be rectified, and the profits of the transaction may be transferred to the charity account.
2. Medium risk: a finding which affects the transaction from a Shariah perspective, in a way that can be rectified by certain procedures.
3. Low risk: refers to a mistake or error which does not have a direct influence on the transaction from a Shariah perspective and does not entail a rectification.