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GLOBAL ISLAMIC FINANCIAL SERVICES FIRM

Financial Services for the Future™

Islamic Project Financing Concepts
Global Islamic Financial Services Firm and ABIQ
August 2021

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Content

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Credentials – Mufti Ismail Ebrahim Desai

- **Shariah Advisor:**
- **Ethica Institute of Islamic Finance, UAE (Shariah Education and Advisory)**
- **Infinity Consultants, India (Shariah Stokvel and Investment Vehicle)**
- **Botswana Life Insurance Limited, Botswana (Shariah Compliant Investment Vehicle)**
- **Hejaz Financial Services, Australia (Shariah Home Finance, Investment Vehicle)**
- **HBZ Bank, RSA (Shariah Banking Window)**
- **Centre for Advanced Islamic Economics, Pakistan (Shariah Education and Advisory)**
- **Shariah Review Bureaux, Bahrain (Shariah Advisory)**
- **Lishui Prefecture Municipality, Peoples Republic of China (Shariah Advisory)**
- **Advisor to Governments and Central Banks on Islamic Finance (SADEC, EU, GCC)**
- **Executive Director and Shariah Advisor, Russian Islamic Finance Council (Shariah Advisory and Fatawa)**

Islamic Financial Services Products – Mufti Ismail Ebrahim Desai

1. **Advised and developed several Shariah Compliant Real Estate and Asset Management Funds Worldwide**
2. **Developed first Shariah Compliant Wildlife Fund for South African Market**
3. **Issued hundreds of Fatawa (Islamic Legal Edicts) on Islamic Finance and Economics**
4. **Developed Shariah Wealth Management Products for leading investment bank in South Africa**
5. **Conducted Shariah training for hundreds of bankers and financial professionals in the GCC and beyond**
6. **Advising the Chinese Government on Shariah Compliant Energy Project worth $150 Million**
7. **Advising European Government on Sukuk**
8. **Conducted annual Shariah Compliance review and audit for leading Shariah Compliant Investment Firm in South Africa**

Islamic Financial Services Products

9. Advised Government and central Banks on Shariah Regulations and Guidelines for Islamic Finance

10. Advised and executed Shariah Compliant Trade Finance transactions worth more than $800 Million

11. Advising leading Turkish Bank on setting up Shariah Compliant Window

12. Developed first ever Shariah Compliant asset management company in Eastern Europe

13. Advising major European religious agency on Islamic Finance

Award Winning and Landmark Deals – Global Islamic Financial Services

1. Dubai Municipality Sukuk - 500M USD
2. Al Khabeer REIT Fund – 200M USD
3. Sidra Capital Trade Infrastructure Fund – 500M USD
4. Istithmar Capital REIT Fund – 100M USD
5. Shuaa Capital REIT Fund – 500M USD
6. GLFL Murabaha Syndicated Finance – 200M USD
7. Global Ethical Fund – 200M USD
8. Avani Halal Hotel and Resorts – 300M USD
9. Shariah Currency Trading and Forex – 500 M USD

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Executive Background – Global Islamic Financial Services

Global Islamic Financial Services Firm also holds the honour of delivering the following innovative and award winning transactions and products to the Islamic Finance industry:

World's First: Murabaha stock Leveraging Product – UAE

World's First: Shariah Factoring Product based on Salam – RSA

Africa First: Hybrid Takafol Product - Botswana

Africa First: Baitul Mal - RSA

Africa First: Shariah Compliant Hotel - RSA

Africa First: Shariah Compliant Project Financing Structure - RSA

USA First: Shariah Compliant Asset and Investment Management Structure

Africa First: Shariah Crowdfunding Vehicle - RSA

World's First: Shariah Compliant biological wildlife Vehicle – RSA

Executive Background – Global Islamic Financial Services

Services and Products Offered:

1. **End to End Corporate Shariah Advisory and Shariah Governance**
2. **Shariah Investments and Wealth Management**
3. **Corporate and Investment Banking Solutions**
4. **Wholesale and Business Finance**
5. **Corporate Tax, Audit and Legal Advisory Solutions**

Track Record:

100 percent profitability in all investment portfolios

Zero percent loss in all investment portfolios

4.5 Billion USD Assets Under Management (AUM)

8.2 Billion USD Deal Advisory

Advisor to 53 Global Banks and Financial Institutions

Advisor to 7 Central Banks and Governments in Africa, Europe and Asia

8530 Jobs effectively created through executed deals

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Financial Services for the Future™

Shari’ah Auditing and Advisory Services

- Shariah Product Development
- Fatāwā and Certification.
- Sharīàh Review
- Sharīàh Audit and Assurance
- Shariah Mediation and Arbitration
- Islamic Private Wealth Management
- Shariah Board Development
- Islamic Finance Training and Human Capital Development
- Central Bank Regulatory Assistance
- Sukuk and Islamic Fund Structuring
- Islamic Finance Knowledge and Research

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“Embracing Islamic Finance through Shariah Compliance, achieving new heights in expansion and growth”

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Islamic Infrastructure and Project Funding

Definition of Infrastructure and Project Financing: The financing of an economic unit with the underlying cash flows to service the economic unit in association with collateral.

Shariah Compliant Project and Infrastructure Projects: Oil, mining, gas, PPI, roads, hospitals, etc

Shariah Compliant financing techniques and concepts: Syndication, bridging, securitization, direct financing

Asset classes: fixed income, hybrid and equity

Shariah compliant vehicles: Sukuk funds, Listed and unlisted Infrastructure funds, Infrastructure ETF Funds

Key concepts: Mudarabah, Wakalah, Ijarah, Wakalah, Kafalah, Murabaha and Istisna

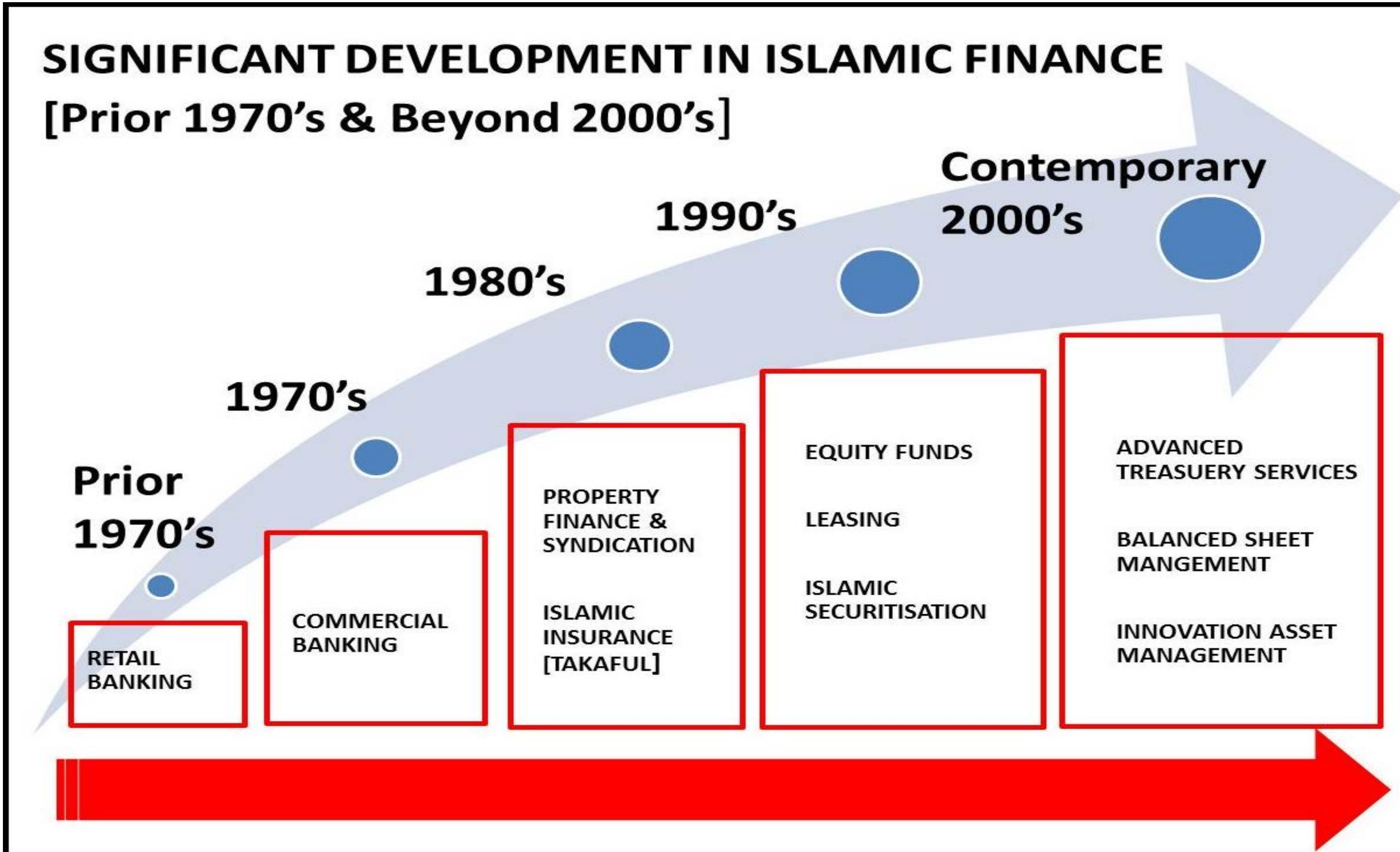
Security: common security pool/kafalah

Key issues: Default, Tax, hedging, inter creditor agreements and Shariah audit

Examples: Aldar Properties, Emirates Airlines, Nigeria Sov Sukuk, Ivory Coast Sov Sukuk and Bangladesh Water Sukuk

Early History of Islamic Finance

1. Establishment during the Prophet's Era
2. Sayarifah, Baitul Mal, Public Sector, Zakaat, Ashabul Suq
3. Dubai Islamic Bank and Islamic Development Bank – 1974/5
4. Sukuk Issued by Ottoman Empire in 1885
5. Islamic Capital Market – 1955 – 1974
6. Mit Ghamr Savings Project – Egypt – Faysal Bank
7. Tabung Haji - Malaysia


SIGNIFICANT DEVELOPMENT IN ISLAMIC FINANCE
[Prior 1970's & Beyond 2000's]
Prior 1970's
1970's
1980's
1990's
Contemporary 2000's
RETAIL BANKING
COMMERCIAL BANKING
PROPERTY FINANCE & SYNDICATION
ISLAMIC INSURANCE [TAKAFUL]
EQUITY FUNDS
LEASING
ISLAMIC SECURITISATION
ADVANCED TREASURERY SERVICES
BALANCED SHEET MANGEMENT
INNOVATION ASSET MANAGEMENT

Sources of Guidance of Islamic Financial Operations

Compliance with Sharia that is derived from three sources :

QURAN (Primary source of Sharia)

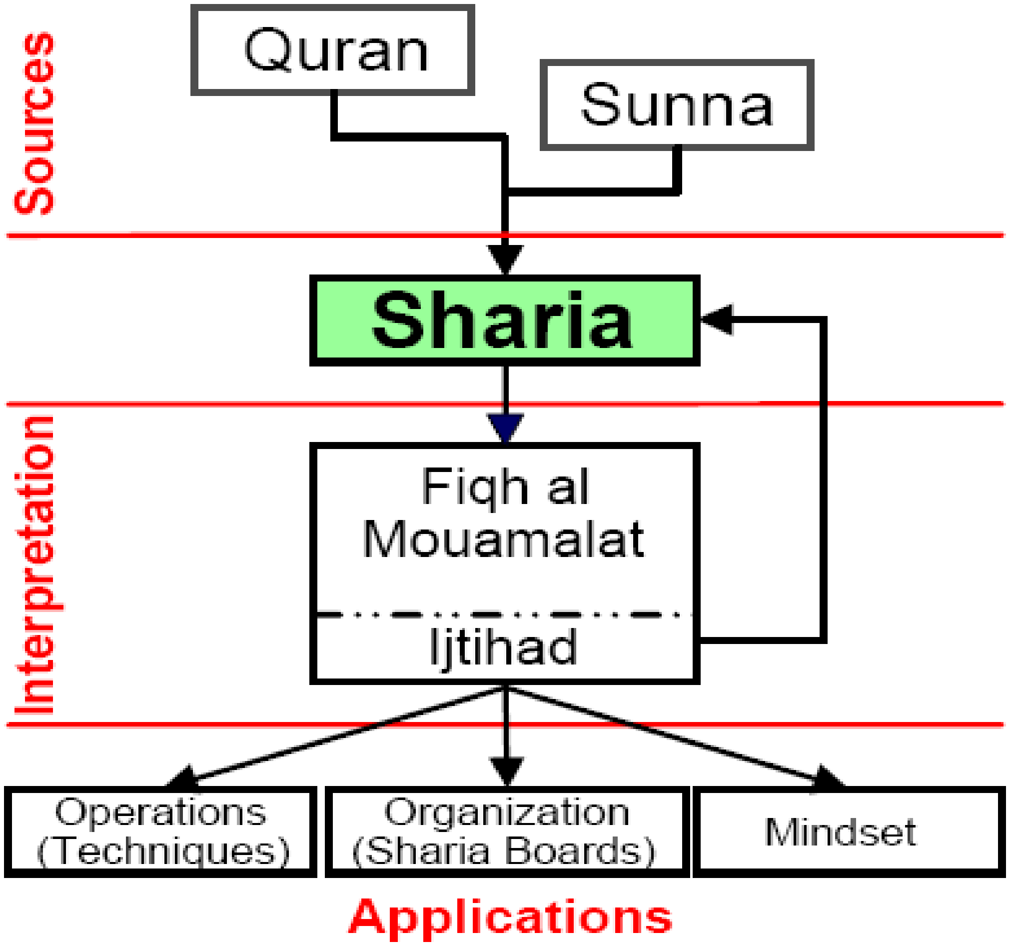
SUNNAH (Practices of the Prophet)

IJMA' (Consensus)

QIYAS (Analogy)

IJTIHAD (reasoning of a group of qualified scholars, which is aimed at adapting Islamic rules to the contemporary world)

Shariah Structure



Islamic Finance and Conventional Finance, Background and Analysis

- Definition: "Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed by the principles and maxims laid down by Classical Islamic Sharia'h Law"

- Islamic Finance is governed by Shari'ah Law and is essentially asset backed financing

- Money has no intrinsic utility, it is a mere medium of exchange
- Market Regulation: Free Market Economy

Islamic Finance Principles – Rationale

Sharia Compliant Transaction

Requirements	
Asset backed	Transactions must be backed by tangible assets
Prohibition of payment/receipt of Riba	Prohibition of interest as incremental of debt
Prohibition of activities	Considered harmful to the society (e.g. alcohol, pork, weapons, drugs, pornography business, etc…)
Prohibition of Gharar (uncertainty) and Maysir (gambling)	Subject of contract must exist, must be specifiable and measurable. Speculative trading in financial instruments is prohibited
Profit/Loss Sharing	The bank act as an agent/partner with the depositor who is entitled to share the gains/loss of the investment

The parameters and fundamental principles of Islamic banking and Economics are defined as follows:

- Prohibition of interest (Riba): the giving and taking of interest. Example: Overdraft Facility, Interest bearing loans
- Prohibition of Gharar (speculative behaviour): Involvement in speculative and uncertain transactions. Example: Life Insurance
- Prohibition of Qimaar (Gambling): Involvement in gambling transactions. Example: Lotto
- Prohibition of investing in unlawful and prohibited activities: Islamic classical Law prohibits transactions in Wine, drugs, Pornography, pork related products, conventional finance, etc. Example: Porn shop
- Risk Sharing: Risk must be shared between at least two parties so that the entrepreneur and capital provider share the loss based on capital contribution. Based on the Islamic Principle "No return without risk"
- Major Difference between Islamic Finance and Conventional Finance
- Conventional finance and banking transactions are interest based transactions and not backed up by assets
- Islamic Finance and Banking is backed up by real assets or services

The parameters and fundamental principles of Islamic banking and Economics are defined as follows: (continued)

- Interest creates an artificial money supply which is non-asset based resulting in inflation, volatility and the concentration of wealth in the hands of the rich
- The essential maxim in Islamic Finance is “No profit without risk”. This means that one would only have the right to profits if there is risk. If there is no risk, then there is no right to profits.
- Conventional banking is almost risk free. Risk mitigation is an important component of Conventional banking. Depositors have no risk of losing money since their assets and equities are guaranteed.
- Islamic Finance allows for free trade and the maximization of profit governed by Shari’ah Law
- Conventional banking practice allows for unbridled and unregulated free trade and the maximization of profit without any regulations and restrictions

General Shariah Guidelines

1. **All transactions must conform with Islamic Law (Shari’ah)**

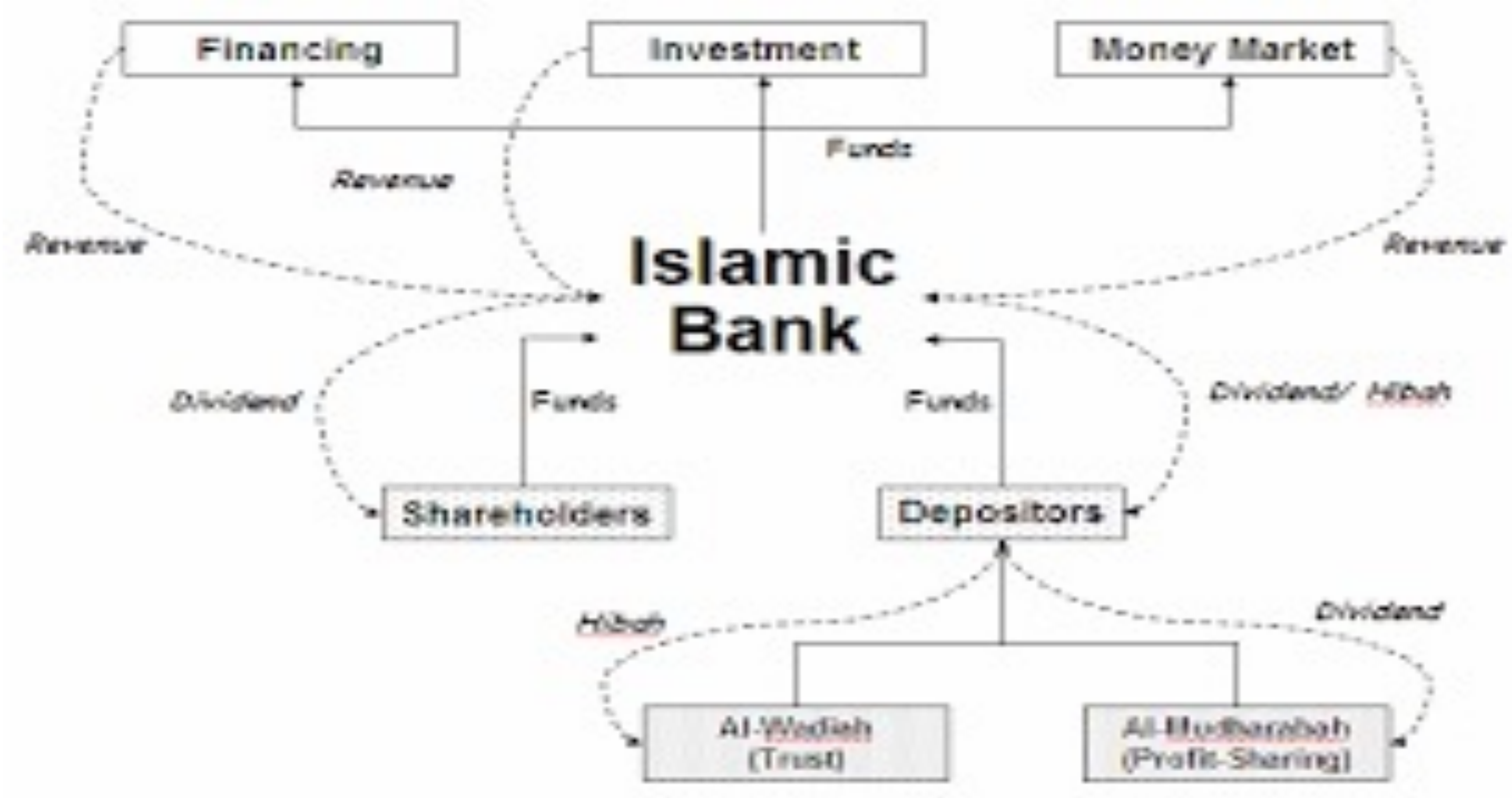
2. **Prohibition of interest (riba) but trading between parties is acceptable**

3. **Prohibition of speculation (maysir)**

4. **Avoidance of uncertain or excessively risky transactions (gharar)**

5. **Prohibition of investment in unlawful goods and services (e.g. pork, alcohol, gambling)**

6. **Sharing of risk between parties**

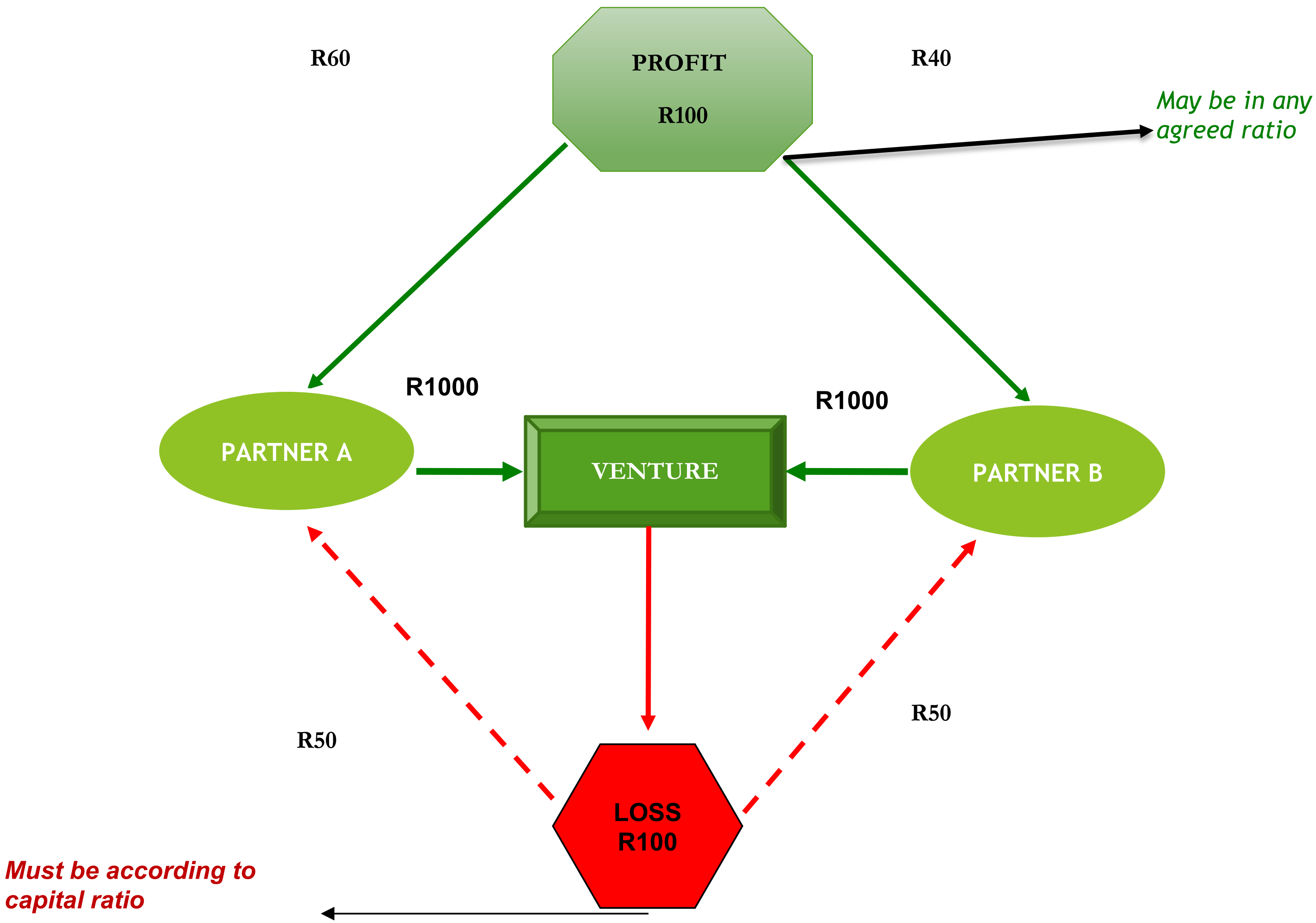

Financing
Investment
Money Market
Funds
Revenue
Revenue
Revenue
Islamic
Bank
Dividend
Funds
Funds
Dividend/ Hibah
Shareholders
Depositors
Hibah
Dividend
Al-Wadiah
(Trust)
Al-Mudharabah
(Profit-Sharing)

Islamic Finance, Fundamental Concepts and Mechanisms

Islamic Finance products are essentially categorized into three broad categories:

- **Equity based – Mudaraba – Musharakah**
- **Trading – Salam – Istisna – Murabaha**
- **Lease based – Ijarah – Ijarah Muntahiya Bi Tamleek**

Musharakah


R60
PROFIT
R100
R40
May be in any agreed ratio
R1000
R1000
PARTNER A
VENTURE
PARTNER B
R50
R50
LOSS
R100
Must be according to capital ratio

Musharakah: Modern Application

Islamic Banks offer Musharakah Financing Facilities for clients. By opening funding lines via current accounts. Profit rations, segregation of duties and mandate terms agreed upon before execution.

Common Products:

1. **Diminishing Musharakah**
2. **Project Financing**
3. **Import Financing**
4. **Working Capital Financing**
5. **Securitization**
6. **Islamic Current/Running Facility/ Account**

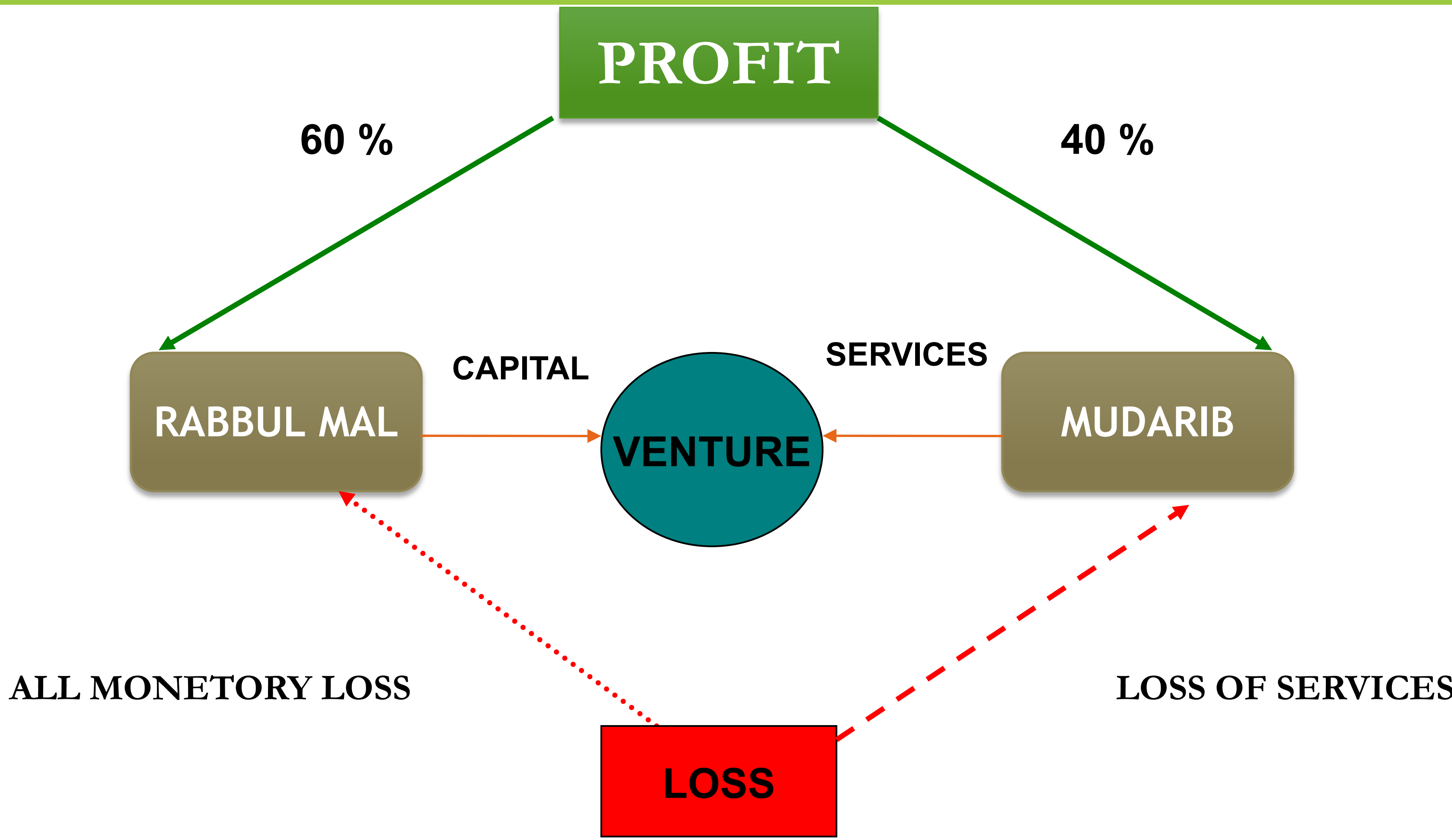
Modern Islamic Banking Products – Diminishing Musharakah

Mudarabah (Islamic Investment Partnership)

Nature: Equity based

- **One partner contributes capital investment while the other partner contributes investment management expertise**
- **Two types: Restricted and Un-Restricted**
- **Pre-Agreed percentage ratio**
- **Loss is borne by capital investor only, the working partner loses his services in managing the Mudarabah portfolio**
- **The Mudarib has the sole right to manage the Mudarabah portfolio**
- **Duration: Fixed or Purpose based**

Mudarabah


PROFIT
60 %
40 %
RABBUL MAL
CAPITAL
VENTURE
SERVICES
MUDARIB
ALL MONETORY LOSS
LOSS OF SERVICES
LOSS

Mudarabah: Modern Application

Islamic Banks offer Certificates of Deposit (CD's) and Deposit Account Facilities (MDAF) on the basis of Mudarabah. ROI and profit rates are indicative and not fixed.

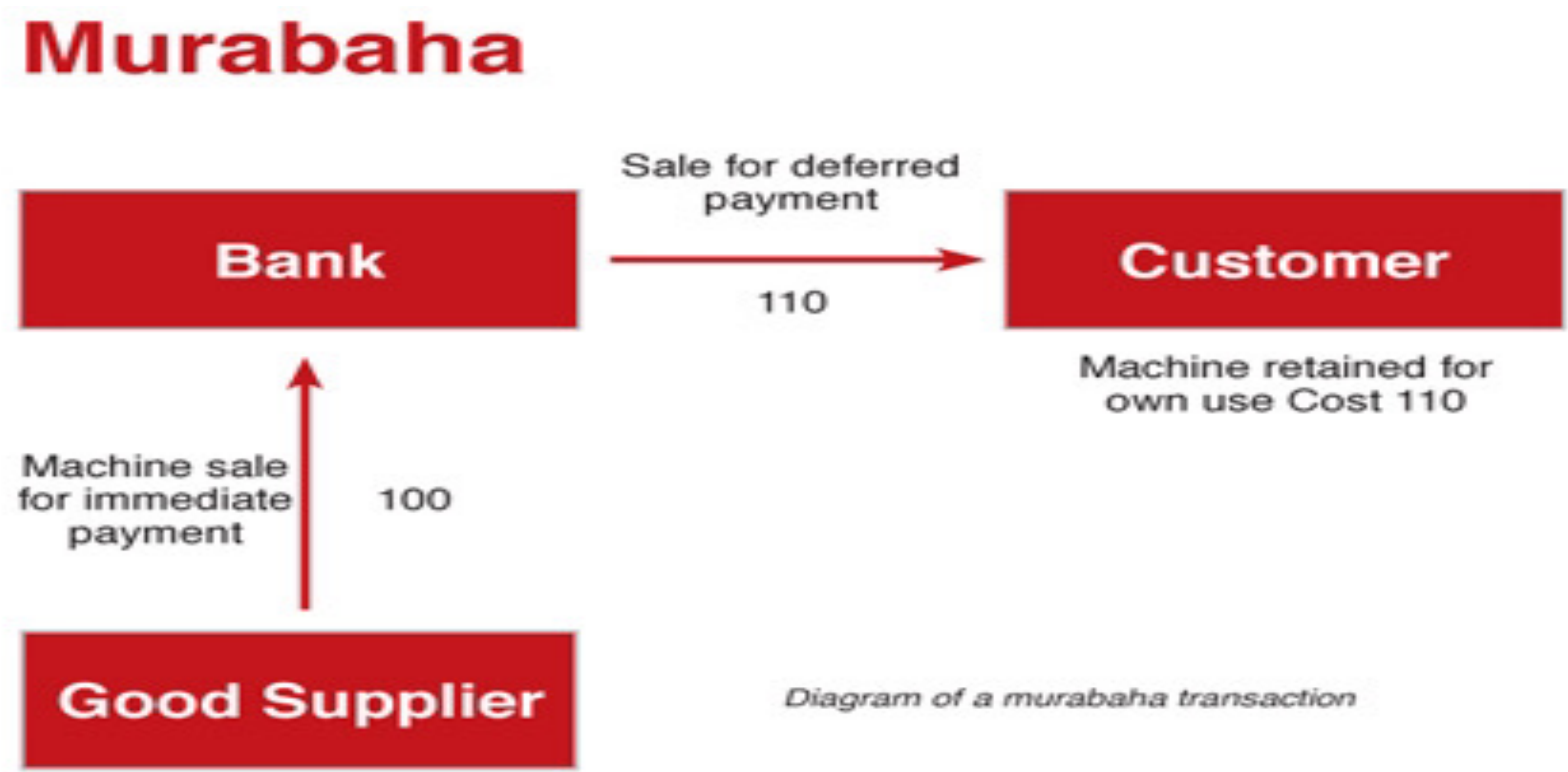
Combined Musharakaha and Mudarabah/Parrallel Mudarabah

Common Products:

1. **Private Equity Fund**
2. **Deposit Accounts**
3. **Project Financing**
4. **Import Financing**
5. **Export Financing**
6. **MDAF – Mudaraba Deposit Account Facility – Islamic Term Account/Deposit/Cheque**

Mudarabah Roles: Ameen, Wakeel, Shareek, Dhamin, Ajeer

Islamic Trade Finance – Illustrative Diagram



Murabaha – Financial Model

1. The customer approaches the bank to finance 100 tonnes of wheat.

2. The bank conducts full and complete due-diligence on the customer including credit and risk checks. The bank seeks Shariah Approval from the Shariah Advisor.

3. The bank approves the facility for the customer.

4. The supplier invoices the bank and receives cash payment

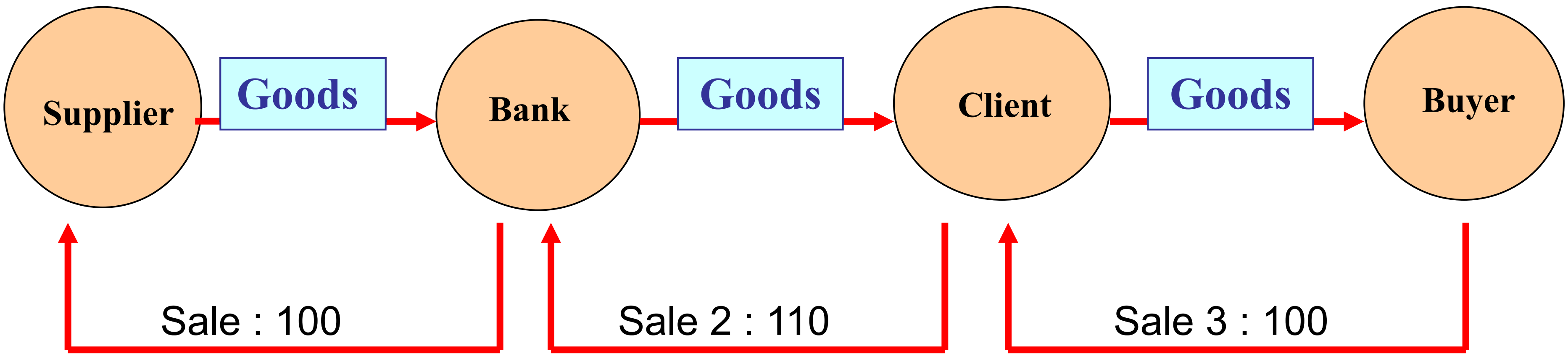
5. The bank appoints an agent to receive the goods on behalf of the bank

6. The bank receives the goods via the agent and re-sells to the customer on deferred payment basis with a fixed tenure and price

7. The bank is allowed to charge all incurred costs to the client based on mutual agreement

Murabaha - Diagram

Islamic Finance

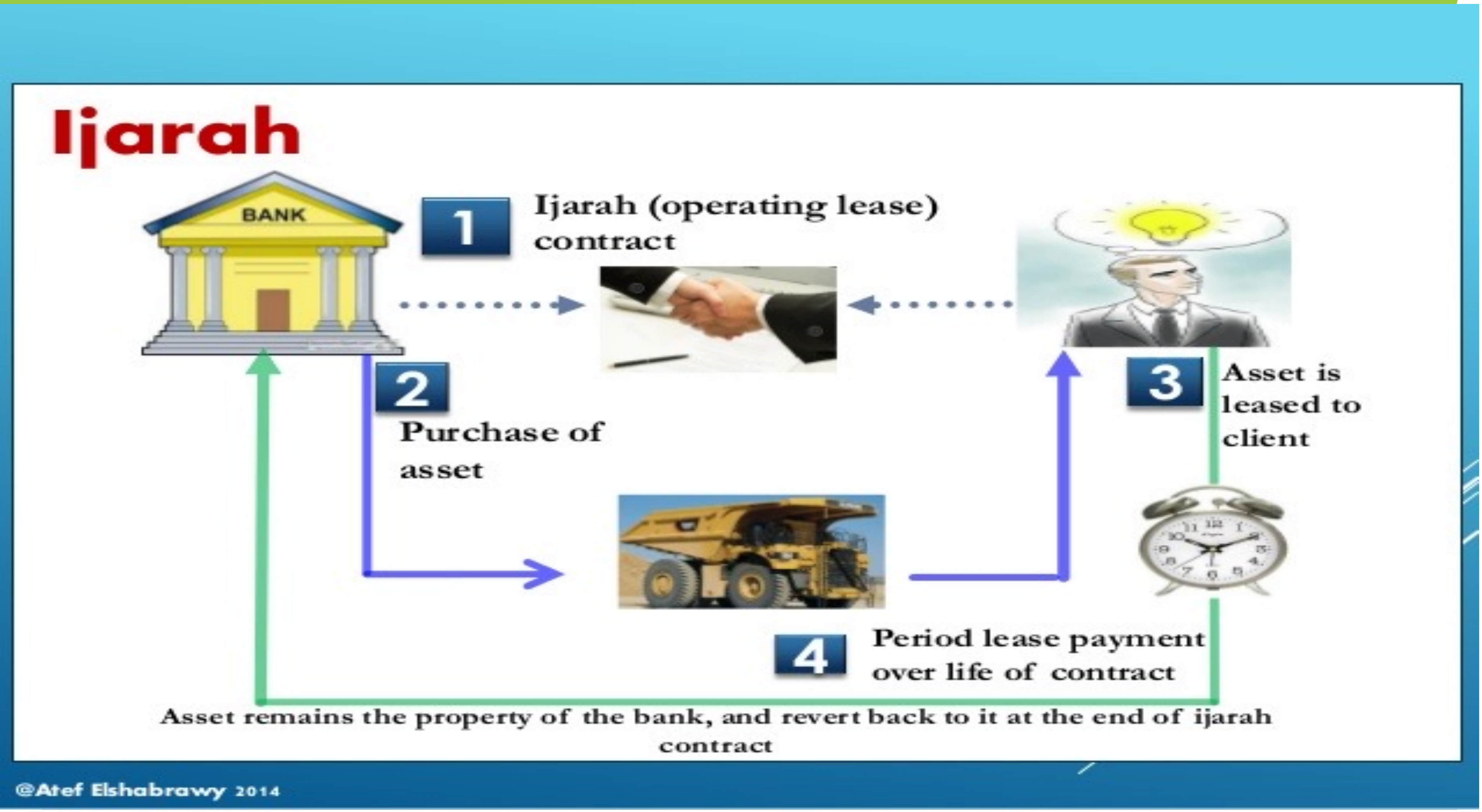


⇨ Credit sale or Murabaha

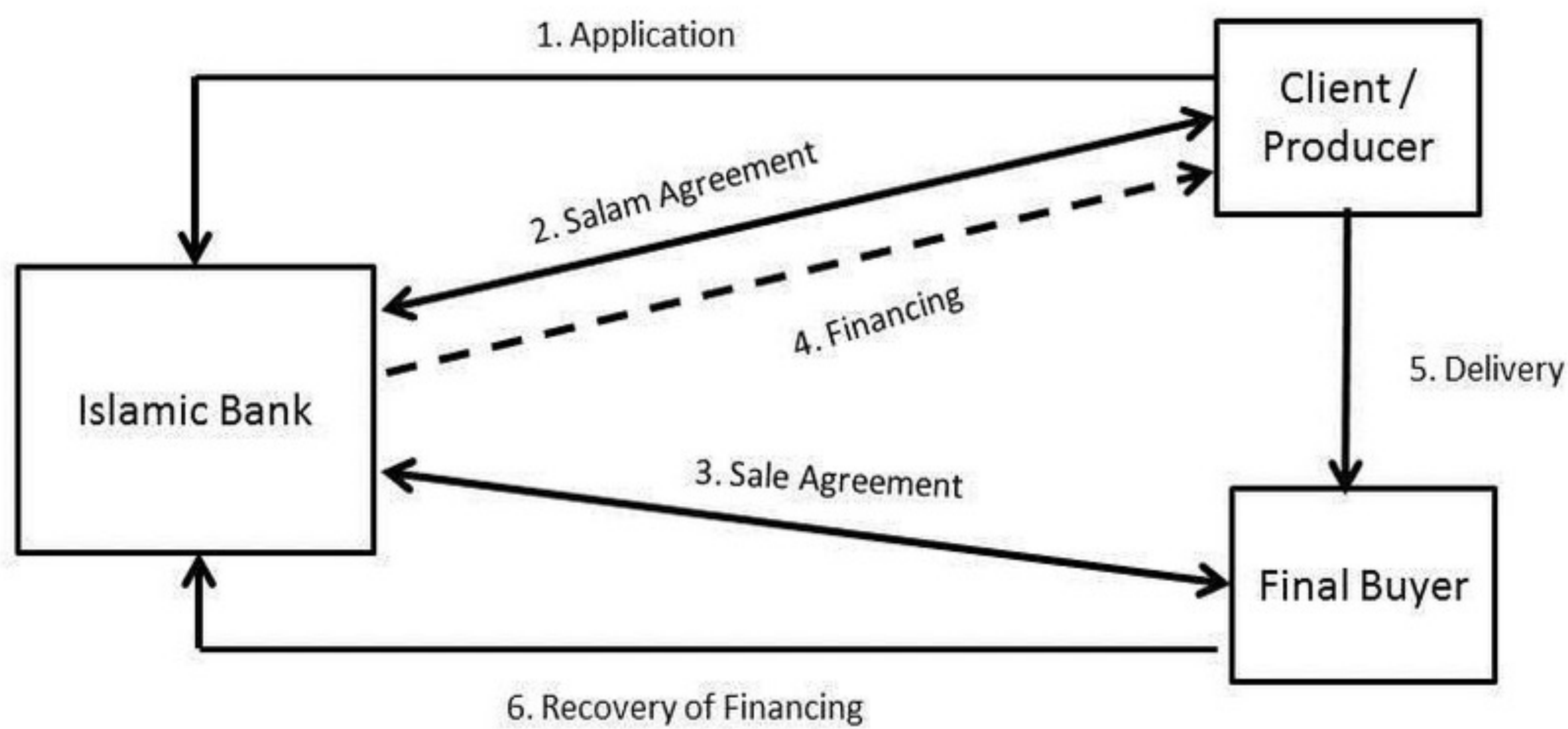
Conventional Vs Islamic

Conventional Banking (CB)		Islamic Banking (IB)	
Amount Financed :	10,000.00	Purchase Price:	10,000.00
Interest Rate:	10% p.a.		
[Monthly rest at ____% + BLR]*			
Tenor	3 years	Tenor	3 years
Installment	322.70	Installment	322.70
Total Installment	11,617.20 ??	Selling Price	11,617.20
[322.70 x 36]		[322.70 x 36]	
* variable rates	FIXED PRICE	* the profit rate is quoted internally & fixed throughout the financing period.	

Ijarah Financing - Diagram



Salam Financing - Diagram



Global Takafol Industry

More than 40 takaful operators worlwide.

It is estimated that the combined total assets of the operators stand at around USD1 billion.

The contributions (premium) of the operators stand at around USD500 million.

Possesses high potential to expand because the insurance and takaful penetration in Muslims countries is less than 1% of GDP.

In Malaysia, the insurance penetration rate is around 30% of GDP.

Takafol (Islamic Mutual Indemnification)

Takaful literally means "guaranteeing each other"

Sharia compliant alternative to conventional insurance

Can be thought of as a mutual insurer within a shareholder wrapper i.e. the shareholders operate the company on behalf of the policyholder and any insurance surplus is distributed back to the policyholders

Based on solidarity, co-operation & mutuality

Products are broadly similar to conventional insurance

Free of uncertainty ('gharar'), gambling ('maisir') and interest ('riba')

Investments must be Sharia compliant (Sukuk bonds, collective investment schemes etc)

In theory and in practice in the more mature Islamic Finance economies, it is price competitive with equivalent conventional products

Insurance deficit will be financed with Qard Hassan (interest free loan)

The interest free loan will be paid as soon as surpluses arise

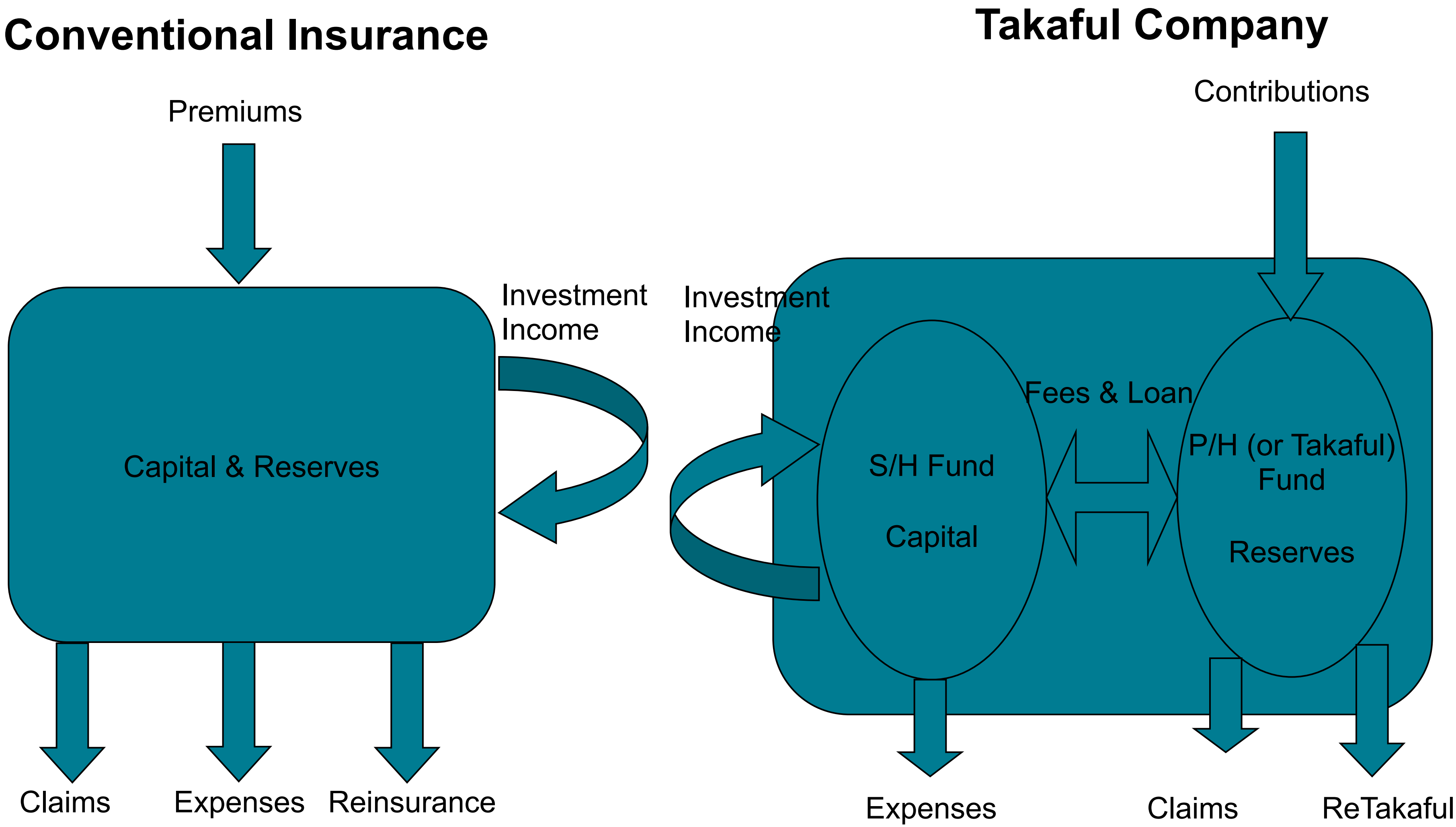
Conventional Insurance Prohibition

Involves the elements of excessive uncertainty (gharar);

Gambling (maysir) as the consequences of the presence of excessive uncertainty that rely on future outcomes;

Interest (riba) in the investment activities of the conventional insurance companies;

Takafol Diagram



Introduction to Sukuk

- **Sukuk are certificated Shariah Compliant financial instruments.**

- **Sukuk always linked to underlying assets representing partial ownership in the asset.**

- **Usually translated as “Islamic bond” and is the most active Islamic debt market instrument.**

- **Derived from the Arabic word Sakk (Plural: Sukuk)**

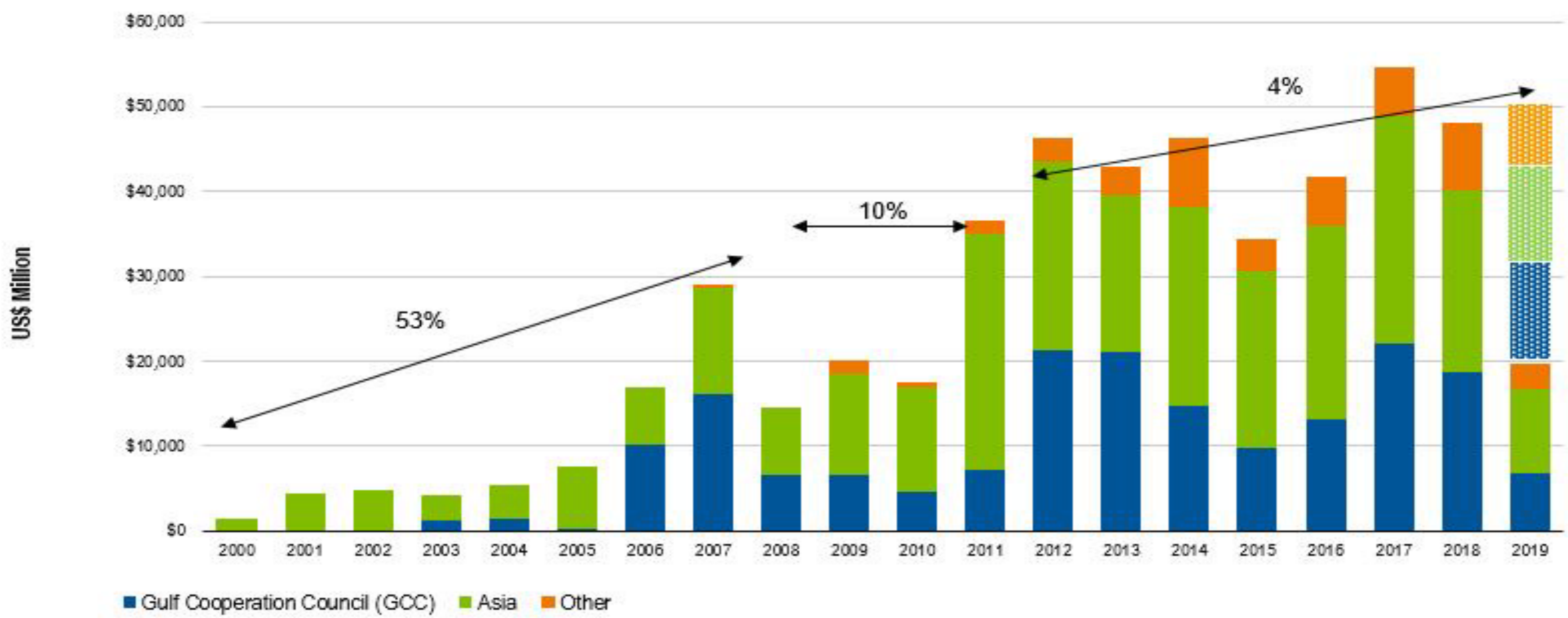
- **Islamic Financial Services Board (IFSB-2) definition:**
- **“Certificates that represent the holder’s proportionate ownership in an undivided part of the underlying asset, where the holder assumes all rights and obligations to such asset.”**

- **Benefits and objectives of Sukuk: Expansion of investor base, liquidity for secondary capital market, raising Shariah Compliant funding, Shariah Compliant investment opportunities, Shariah balance sheet management and tradability**
- **Sukuk Holders are exposed to asset level risks and the Sukuk income is based on asset ownership and not revenue rights**

Global Sukuk Issuances Are Growing

Over US$477 Billion to Date

As of December 31, 2018



Source: Bloomberg as of December 31, 2018. Data excludes short-term issuance. Important data provider notices and terms available at www.franklintempletondatasources.com.

Specific Sukuk Shariah Guidelines

1. Funds raised must be used for Shariah compliant activities.

2. All funds raised may be used to finance tangible assets. Specificity of assets is important, since Sukuk unlike conventional bonds cannot be used for general financial needs of the issuer. Non-tangible assets may be used based on Urf and Aaadah subject to Shariah Board approval.

3. Income received by sukuk holders (investors) must be derived from the direct cash flows generated by the underlying assets.

4. Sukuk holders have a right to the ownership of the underlying asset and its cash-flows.

5. Clear and transparent specification of rights and obligations of all parties to the transaction, in particular the originator (customer) and sukuk holders.

6. No fixity in returns and no financial guarantees.

7. Generic Shariah Compliant screening.

Specific Sukuk Shariah Guidelines

8. All the rules of original contract on the basis of which Sukuk are created should be applied.

9. The issuer cannot guarantee the face value of the certificate for the holder except in case of negligence/misconduct.

10. In Sukuk based on sale and lease back, the issuer can unilaterally undertake that he will purchase the asset after one year for a pre-agreed price.

11. Different types of reserves (e.g. profit equalization reserve) or takaful pool can be created.

12. Only those Sukuk can be traded that represent proportionate ownership of tangible assets, usufructs or services.

13. In Sukuk of Musharakah/Mudarabah, the issuer can redeem the certificates on the market price. Purchase undertaking is allowed however the purchase price should be market value of the underlying assets.

Sukuk Vs. Conventional Debt Instruments

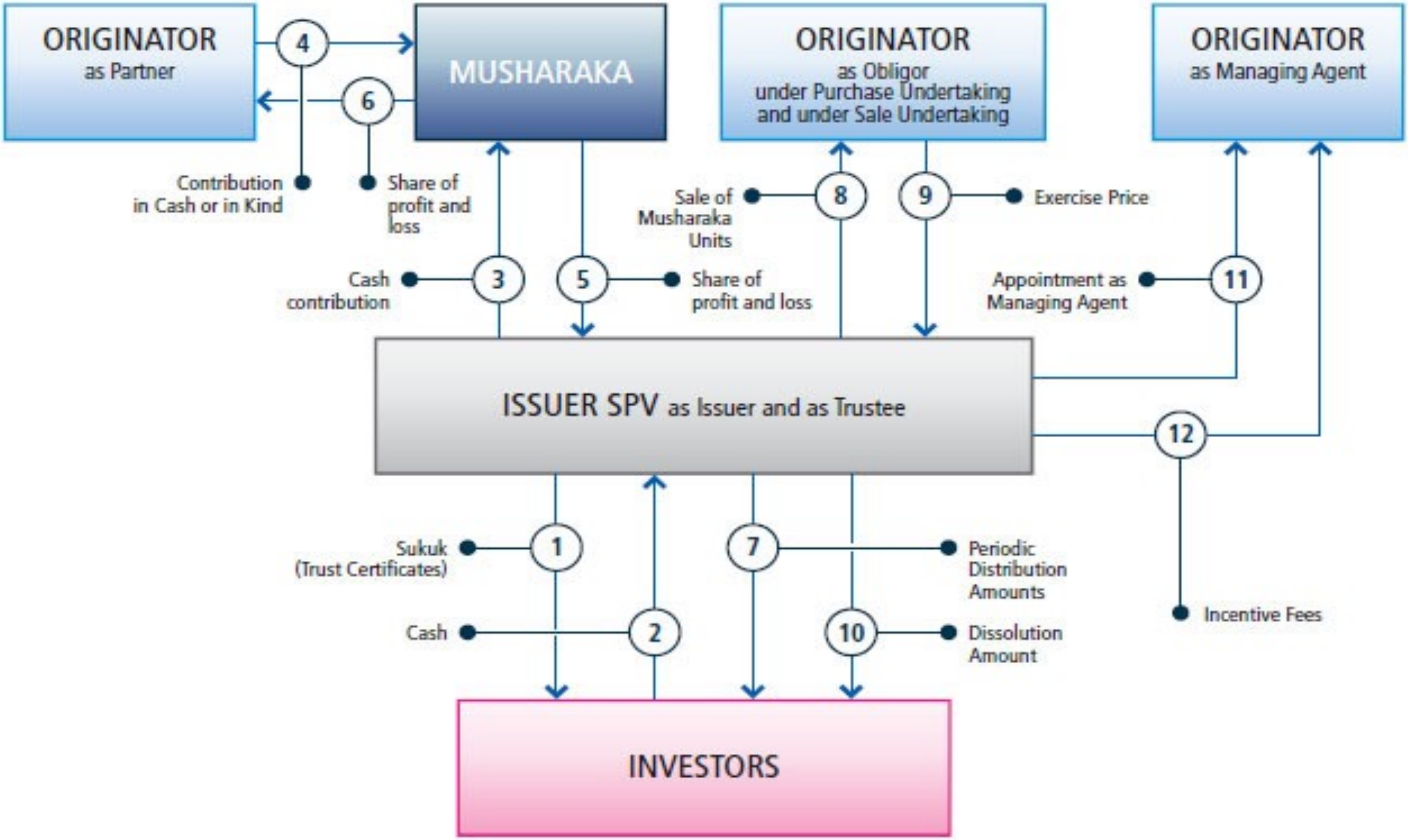
Sukuk:

- Each Sukuk unit represents an ownership of the underlying asset;
- Maturity of the Sukuk corresponds to the term of the underlying project or activity;
- The Sukuk prospectus contains all the Shariah rules related to the issue;
- The underlying asset / project / business has to be Shariah complaint (i.e. not dealing with pork related items, gambling, tobacco, institutions that deal with Riba (interest) etc.); and
- The Sukuk manager is required to abide by Shariah rules
- The Sukuk holders have the rights to profits but also bear losses

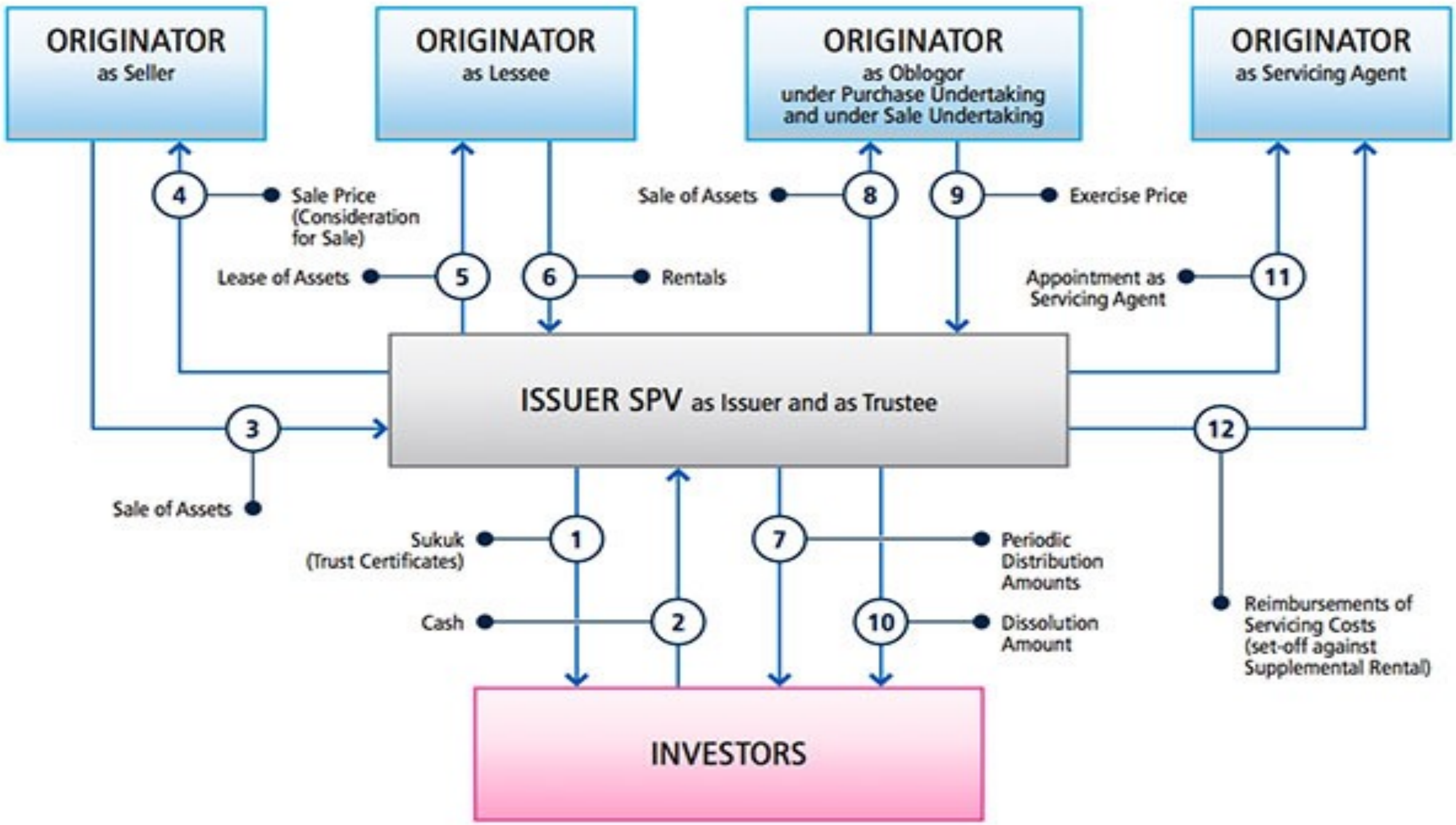
Conventional Debt Instruments:

- Bonds represent pure debt obligations due from the issuer;
- The core relationship is a loan of money, which implies a contract whose subject is purely earning money on money;
- The issue prospectus does not include Shariah constraints; and
- The underlying asset / project / business can belong to any sector / industry
- Can be issued to finance almost any purpose which is legal in its jurisdiction.
- Bond holders are not exposed to losses on the asset although they might bear losses in the event of insolvency by the issuer.

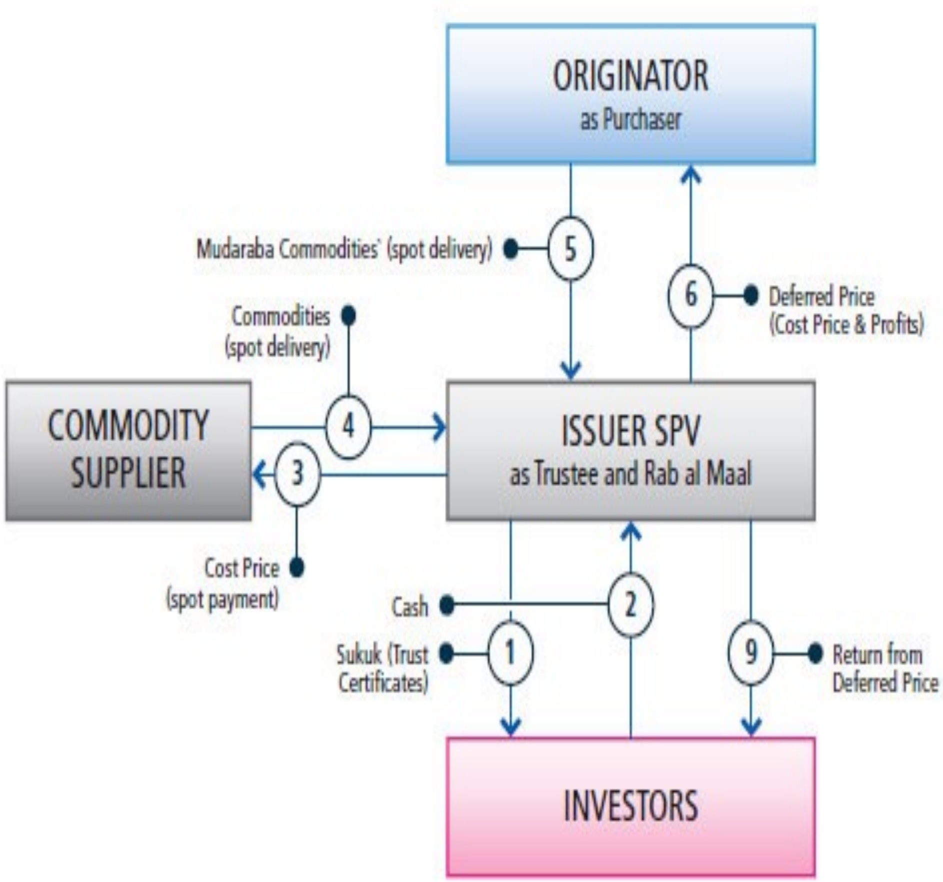
Musharakah Sukuk



Sukuk Ijarah



Sukuk Murabaha



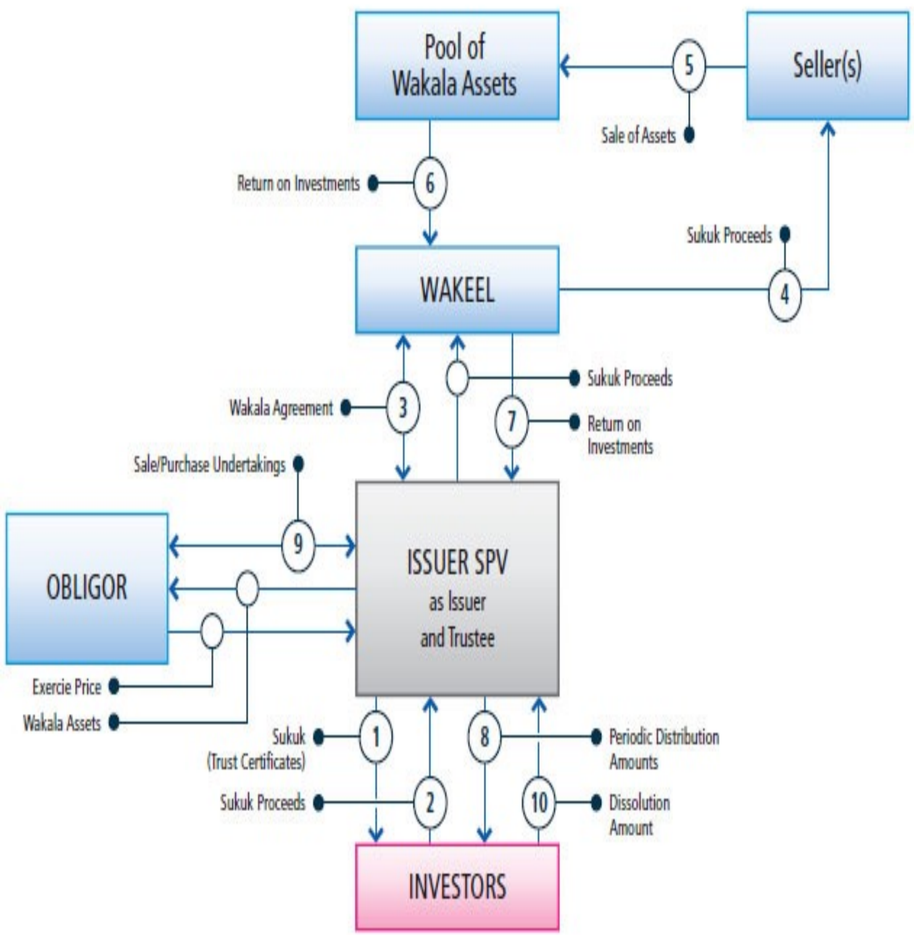
1/2.SPV/Issuer issues Sukuk to raise funds from investors.

3/4.SPV (directly or via company as agent) purchases and acquires the asset from supplier on a fixed spot price.

5/6.SPV sells the asset to company at a mark-up (Murabaha).

9. Company makes periodic payments and SPV distributes payments to investors

Sukuk Wakalah



1/2.SPV/Issuer issues Sukuk to raise funds from investors.

3.SPV enters into a Wakala agreement with the Wakeel.

4/5.The Wakeel on behalf of the issuer will invest in assets.

6. Generation of profit and kept by Wakeel on behalf of the SPV.

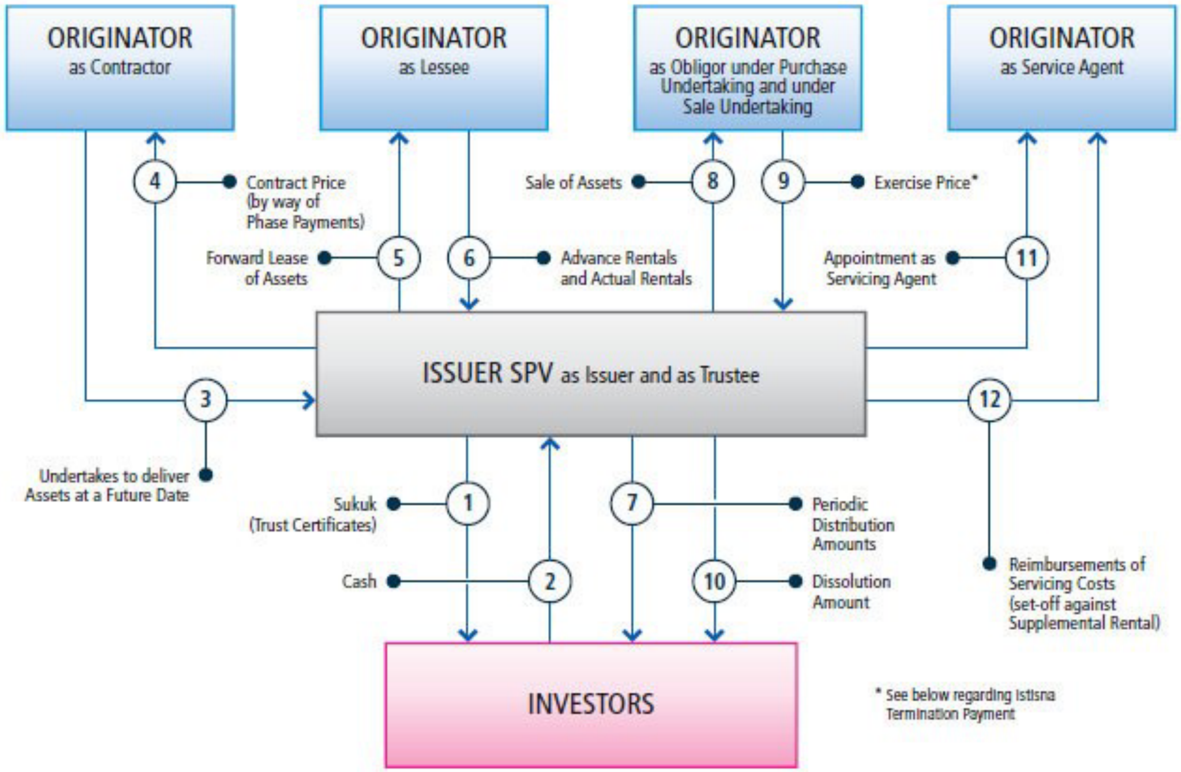
7.Company makes periodic payments.

8.SPV distributes payments to investors

9.Obligor buys the assets from the Wakeel

10. SPV, in its capacity as Trustee, will pay the Dissolution Amount to investors

Sukuk Istisna



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Shariah Asset and Investment Management

Global Overview:

- **It is estimated that over $500 billion in assets are managed around the world in Shariah-compliant investments**
- **According to Standard & Poor's, Islamic investments have been growing about 10% per year for the past decade**
- **Currently more than 300 Islamic financial institutions are operating in over 75 countries**
- **There are currently 1065 Islamic Funds**
- **80% of funds in the GCC and Malaysia**
- **Islamic Pension Funds - $36 Billion growth projection in the GCC (Thomson Reuters Report, 2014)**

Sharia Compliant Equities

Islamic stocks selection
(Industry Screen)

Conventional Banking and Insurance
Alcohol (including distribution)
Pork (complete supply chain)
Weaponry (complete supply chain)
Gambling (Hotels, casinos)
Adult entertainment (complete supply chain)

Islamic stocks selection
(Financial Screen)

Total Debt / market capitalization < 33%
Interest income / Total revenue < 5%
Account receivables / Total assets < 33%
⇒ Ratios used by GIFS

Understanding Riba

Definition: Any premium that must be paid by the debtor to the creditor with the principle amount as a condition of a loan or for an extension of its maturity.

Riba has been prohibited by the world's major religions including Hinduism, Christianity and Judaism.

1. Veda Scriptures: Rusidin, Sutra Texts and Buddhist Jatakas (600-1000 BC)
2. Juidaism – Neshekh to bite and old testament (Exodus, 22:25, Leviticus, Deuteronomy)
3. Christianity – Roman Church Chagemane in 4th Century AD.

Risk Management for Islamic Banking and Financial Products

Risks are uncertain future events that could influence the achievement of the Bank's objectives, including strategic, operational, financial and compliance objectives. Uncertain future events could be:

- **Failure of a borrower to repay a financing**
- **Fluctuation of foreign exchange rates**
- **Fraud, incomplete security documentations, etc**
- **Non-compliance with shariah law and principles**
- **Other events that may result in a loss to the Bank**

A Bank's business (whether Islamic or Conventional) is to take calculated risks. As such Risk Management is not the minimization of losses but the optimisation of the risk reward equation The competitive advantage of a Bank is dependent on how well it manages risk

Risk management is the process by which various risk exposures are (1) identified, (2) measured/assessed, (3) mitigated and controlled, (4) reported and monitored. Risk reward equation is the competitveness by a bank or financial institution by effectively managing risk.

Risk Management Failures

1. Barings / Nick Leeson (1995)

Barings Singapore reported SIMEX trade losses of GBP850 million brought down the whole bank…

2. National Australia Bank (2004)

FX derivative losses of AUD 360 million…

3. Allied Irish Bank / John Rusnak (2001)

US subsidiary Allfirst reported FX Options trading losses of USD 750 million

4. LTCM, Hedge Fund (1998)

Bond Market losses wiping out capital of USD3.9 billion

Fed and consortium of US Banks bailout

5. Sumitomo / Yasuo Hamanaka (1996)

Commodity (copper) trading losses of USD1.8 billion…

6. Orange County, CA, USA (1994)

Equity losses of USD2 billion

Reverse repos / over-leveraged

7. Societe Generale, France (2008)

Jerome Kerviel traded Euro stock index futures and
concealed losses up to almost EUR 5.0 bio

Generic Banking Risks

1. Credit Risk – The potential that a counterparty fails to meet financial obligations with agreed terms as per contract.
2. Market RISK – The potential impact of adverse price changes such as benchmark rates and equity prices on the economical and financial value of assets.
3. Operational Risk – The potential direct/indirect loss from inadequate or failed systems
4. Liquidity Risk – Inability to meet financial obligations
5. Equity Investment Risk – The risk involved in entering a partnership
6. Rate of Return Risk – Potential impact on returns caused by market volatility
7. Displaced Commercial Risk – The risk that the bank has to pay more than the actual return rate.
8. Shariah Non-Compliance Risk
9. Investory Risk – Risk from holding items in inventory.

Shariah Risk Profiles

MURABAHA MULTI FACTOR RISK MATRIX		
RISK FACTOR	CATEGORY	HEDGING
AGENCY RISK	CREDIT RISK	Direct payment to the vendor and proper pre inspection
OWNSERHSIP TRANSFER/ ASSET RISK	CREDIT RISK	Takaful of goods during transit and induce customers to submit declaration immediately after the purchase of goods
REPAYMENT / DEFAULT RISK	CREDIT RISK	Obtain shariah complaint collaterral and adopt staggered payments
PRICE RISK	MARKET RISK	Secure the collaterral upon executing the promise to purchase with the customer
LIQUIDITY RISK	LIQUIDITY RISK	Make separate pools for different matuirties considering their different maturity dates
PROFITABILITY RISK	OPERATIONAL RISK	A charity may be imposed to discourage a delay in payment of murabaha price
LEGAL RISK	OPERATIONAL RISK	To secure the legal position , the bank shall ensure that the promise to purchase is properly documented and it is legally enforceable .
SHARIAH NON COMPLIANCE RISK	OPERATIONAL RISK	Ensure that the relevant staff has appropriate training and has proper knwoedge of Shariah principles as well.

MUSHARAKAH MULTI FACTOR RISK MATRIX		
RISK FACTOR	CATEGORY	HEDGING
CAPITAL RISK	CREDIT RISK	This can be mitigated by conducting extensive feasibility study prior to entry
ENTERPRENUERAL RISK	BUSINESS RISK	By proper due deligience and feasibility studies
PURCHASE PRICE RISK	MARKET RISK	A partner in musharakah cannot guaraantee the capital of another partner as per islamic law
SHARIAH NON COMPLIANCE RISK	OPERATIONAL RISK	Due attention has to be given to all shariah related aspects during the stages of both pre and post approval
LIQUIDTIY RISK	LIQUIDITY RISK	Only long term or deposits having same maturities will be used for Musharakah arrangements

DIMINISHING MUSHARAKAH

MULTI FACTOR RISK MATRIX

RISK FACTOR	CATEGORY	HEDGING
OWNSERHIP ASSET RISK	CREDIT RISK	This risk can be mitigated through takaful coverage of an asset.
COUNTERPARTY RISK	CREDIT RISK	This risk can be mitigated by the assets value as collaterral
CAPITAL IMPAIRMENT RISK	CREDIT RISK	This risk can be mitigated through takaful of goods through transit
CANCELLATION RISK	MARKET RISK	In order to reduce this risk , the bank must obtain sufficient collaterrals
PURCHASE PRICE RISK	MARKET RISK	In order to reduce this risk , the bank must obtain sufficient collaterrals
LEGAL RISK	LEGAL RISK	This can be executed by proper documentation and timely checking.

SALAM
MULTI RISK FACTOR MATRIX

RISK	CATEGORY	HEDGING
DEFAULT RISK	CREDIT RISK	A security in the form of guaraantee, mortgage or hypothecation can be obtained
QUALITY RISK	CREDIT RISK	Seller is bound to deleiver the goods of exact quality agreed upon , other wise the buyer may refuse to accept its delivery
NON - PERFORMANCE RISK	MARKET RISK	In case of an adverse situtation , to avoid losses , ensure the delivery or promise to purchase from a third party
PRICE RISK	MARKET RISK	This can be mitigated by simply entering into a Parrallel Salam Contract
STORAGE RISK	MARKET RISK	This can be mitigated by simply entering into a Parrallel Salam Contract
OPERATIONAL RISK	OPERATIONAL RISK	Ensure that the relevant staff has checked documentation and have proper knowledge of Shariah principles as well
LIQUIDITY RISK	LIQUIDITY RISK	Accepting partial delivery from the seller / supplier of commodity / asset ; so as to generate cash in order to meet contractual liquidity requirements

	SUKUK	
	MULTI FACTOR RISK MATRIX	
RISK	CATEGORY	HEDGING
RE- INVESTMENT	MARKET RISK	Appropriate interest rate forecasting
RISK		and yeild curve policy formulation
PRICE RISK	MARKET RISK	Calculate modified duration and convexity
ISSUER RISK	CREDIT RISK	Analyze the Short Term credit rating of the issuer
MARKET INABILITY	LIQUIDITY RISK	Monitor the trading activity of Sukuks
RISK		and exchange quotes with brokers
		on frequent basis
REPRICING RISK	MODEL RISK	Using appropraite capital preserving method/s in line with
		the industry standards
SETTLEMENT RISK	CREDIT RISK	Analyze the Long Term credit rating of the issuer
SPV RISK	OPERATIONAL RISK	proper documentation and appropriate legal action
INFLATION RISK	MARKET RISK	Appropriate forecasting of inflation and real returns
ASSET QUALITY RISK	CREDIT AND/ OR MARKET RISK	Proper analysis of the collaterral and developing an insolvency
		activation plan triggered by declaration and / or possibility of downgrade
		in the quality of the asset

ISTISNA
MULTI FACTOR RISK MATRIX

RISK	CATEGORY	HEGDING
DELIVERY RISK	CREDIT RISK	Istisna price can be reduced on daily basis to penalize the borrower
DEFAULT RISK	CREDIT RISK	The bank must obtain sufficient collaterals
NON PERFORMANCE RISK	CREDT RISK	The bank can terminate the Istisna agreement and demand the price back from the manufacturer
QUALITY RISK	CREDIT RISK	Khiyar - e - Aib may be exercised and subcontracters may be penzalied
PRICE RISK	MARKET RISK	Parrallel Istisna or promise to purchase from a third party
ORDER CANCELLATION RISK	CREDIT RISK	The bank must obtain sufficient collaterals
INFLATION RISK	CREDIT RISK	If increased cost of manufacturing due to external diseconomies of scale comes about ;then price of the underlying may be increased with mutual consent
REVENUE RISK	MARKET RISK	Conducting feasibility study of the business before entering into Istinsa contract
STORAGE RISK	CREDIT RISK	Insurance of the goods and immunize the duration between acceptance of delivery and delivery to the ultimate purchaser
NON - PERFORMANCE RISK	CREDIT RISK	A penalty may be imposed to discourage this practise which will further be given to charity
DEFAULT RISK BY ULTIMATE PURCHASER	CREDIT RISK	The delivery against Letter of Confrmation will mitigate default riskonce liability of the beneficiary 's bank will remain there

IJARAH
MULTI FACTOR RISK MATRIX

RISK FACTOR	CATEGORY	HEDGING
REPAYMENT/ DEFAULT RISK	CREDIT RISK	Risk mitigated by the market value of ijarah asset which may be re possessed and collateralized
PRICE RISK	MARKET RISK	Ensure that the promise to Ijarah is properly documented and is legally enforceable
RESIDUAL VALUE RISK	MARKET RISK	Mitigated by the market value of the ijarah asset, which is repossessed .
EARLY TERMINATION RISK	MARKET RISK	Mitigated by taking a profit on sale in case of early termination

Risk of Return for Islamic Banks

Associated with the management of assets and liabilities, Fixed rate long term assets funded by variable rate short term liabilities, Movement in benchmark rates may result in fund providers having expectations of a higher rate of return, Subsequently, it may result in displaced commercial risk where due to market pressure, an Islamic bank needs to pay a return that exceeds the rate that has been earned on its assets. If Islamic bank does not yield to market pressure, they may lose their fund providers which could consequently lead to liquidity risk.

Given the nature of business of an Islamic Bank: short term variable funding and long term (mostly fixed) financing and investing, the GAP of the Bank is usually much larger than in a Conventional Bank, Not many liquid hedging instruments to hedge the gap. No way to sell asset through credit derivative transaction (not Shariah compliant)

How do we match the gap/credit premium mis-match?

Duration matching

Securitization in form of Sukuk certificates

Islamic Profit Rate Swap

However, equity type structures might significantly complicate

accurate assessment of the mismatch Gap.

Equity Investment Risk

Refers to the risk of a decline in the fair value of equity positions held by the IFI in its trading and banking books ”

We classify the following as equity positions:

Ordinary shares; voting or nonvoting (common or preferred)

Convertible Securities

Commitments to buy or sell equity securities

Equity Derivatives

Off-balance sheet items i.e. swaps and options

Underwriting of equities

Equity-type Shariah Contracts:

Mudharabah

Musharakah

Musharakah Mutanaqissah (Diminishing Musharakah)

Guiding Principles of Risk Management

BASEL Committee on Banking Supervision

Islamic Financial Services Board (IFSB)

Bank Negara Malaysia (BNM)

Institute of International Finance (IIF)

1988 Capital Accord (Basel I)

Regulatory based

Set out requirements to calculate capital charge ie the amount of capital to be set aside to absorb potential loss across banks and across countries

One size fits all

1996 Basel I (Amendments)

9 Market Risk was incorporated into Basel I

2004 International Convergence of Capital Measurement and Capital Standards (Basel II)

Aims to make capital requirements more risk sensitive

Includes Operational Risk

Bank shall be subject to 3 mutually reinforcing pillars

2010 Basel III (Response to Financial Crisis)

Enhanced capital ratios, liquidity ratios, leverage ratio

IFSB-1 Guiding Principles of Risk Management

IFSB-2 Capital Adequacy Standard

IFSB-3 Corporate Governance

IFSB-4 Transparency and Market Discipline

IFSB-5 Supervisory Review Process

IFSB-6 Islamic Collective Investment Schemes

IFSB-7 Sukuk, Securitizations and Real Estate

IFSB-8 Takaful

IFSB-9 Conduct of Business

IFSB-10 Shariah Governance Systems

Shariah Risk Governance

Policies for principle risk areas are in place covering areas of credit, market, operational and Shariah compliance

Policies are supported by Guidelines and further supported by operational manuals to ensure policies are implemented properly and effectively

Approving authority

RMF – Board

Policy – Board

Guideline – Board

Manual - Stakeholders

The RMF and all policies are reviewed at a minimum once in 2 years

All Guidelines and Manuals are reviewed annually (at a minimum)

Credit Risk Policy

Credit Risk Policy - The policy addresses the broad credit management framework that covers the objective, strategy, structure and credit processes in order to establish the best practices in the management of credit risk that are in line with the regulatory requirements.

Guidelines:

1. Pricing Matrix Guidelines

2. Acceptance Letter Offer Guideline

3. Negative List Guideline

4. Collaterals Guideline

5. Valuation Guideline

6. Discretionary Power Guideline

7. Sovereign Risk Guideline

8. Consumer Grading Guideline

9. Sectoral Guideline

10. Business Relationship Etiquette Guideline

11. Watchlist Guideline

12. Financing Process Guideline

13.Credit Recovery Guideline

14.Guidelines on Risk Adjusted Pricing for Corporate & Commercial

Market Risk Policy

Market Risk Policy – Describes the Risk Policy and Analytics, Asset and Liability Management (ALM) and Middle Office functions of the Market Risk Department

Trading Book Policy - Addresses market risk factors which include but not limited to profit rate or rate of return, foreign exchange, equity and commodity risks inherent in the Bank's trading and banking books

1. **Market Risk Limits Guideline**
2. **Hedging Guideline**
3. **Mark-to-Market Guideline**
4. **Rate Reasonability Check Guideline**
5. **Value-at-Risk (VaR) Guideline**
6. **Asset and Liability Management Guideline**

Operational Risk Policy

Operational Risk Policy – The policy provides the effective and efficient operational risk management through out the Bank through its strategies in terms of organization structure, process, risk tolerance, risk measurement and analytic model management information system

1. Operational Risk Management Guideline

2. Management Awareness and Self3.

Assessment (MASA) Reporting Guideline

4. Fraud Handling and Reporting Guideline

5. Takaful/Insurance Guideline

6. Key Risk Indicators (KRIs) Guideline

7. Outsourcing Guideline

8. Operational Risk Management Process for Information Security Management System

9. Customer Complaint Guideline

Risk Management Guidelines

1. **Watchlist – Behavioural and Financial Triggers**
2. **Key Risk Indicators (KRI's)**
3. **Regular Stress Testing**
4. **Risk Control Self Assessment (RCSA)**
5. **RAROC - Most Islamic Banks cannot measure economic capital: use regulatory capital as proxy, Need to take expected loss or at least actual provisions into account**
6. **Management Awareness and Self Assessment – MASA**
7. **Fraud Handling and Reporting Guideline**
8. **Customer Complaints Guideline**

Shariah Control for Islamic Banking Products

Shariah Compliance refers to the adherence of the rulings and guidelines of the Shariah in all manners and times. An organization claiming to be Shariah Compliant should be adherent to Shariah Law in all the operations and activities.

Compliance is the state of the business operations of the IFI being in accordance with AAIOFI and the SSB.

Failure to comply leads to the following risks: non-financial risks in loss of Barakah, non-compliance to faith, loss of reputation and financial loss in charity and income.

AAIOFI and IFSB Guidelines

Three Levels of Shariah Compliance: Strategic – Shareholders/Management, Marketing, shariah governance. Tactical Level – Customer Relationship

Operational Level – Ethics/Awareness

External Shariah Compliance – Interbank Relationship – Treasury, regulators, depositors, special structures such as Sukuk, Takafol

Shariah Compliance Levels – Required/Desirable

Internal Shariah Controls:

Operational Control Strategy – Credit Approvals/manuals/protocol/process charts

Structure based on product lines such as Murabaha, Ijarah, Musharakah, Mudarabah, etc

Maintenance: Reviewing contracts/processes to ensure shariah and regulatory compliance

Shariah Audit and Review – Early Origins

- **Hisbah (Auditing) was institutionalized in the early days of Islam, but not focusing on economic and commercial activities only. Instead it was an integral part of a just economy in a just society.**

- **The first muhtasib (Auditor) was Rasulullah (Sallahu Alayhi Wa Sallam). Rasullullah (Sallallahu Alayhi Wa Salaam) once passed by a pile of food (in the market), put his hand in it and felt dampness (although the surface of the pile was dry). He said, "Oh owner of the food, what is this?" The man said, "It was damaged by rain, Oh Messenger of Allah (Sallalahu Alayhi Wa Sallam)." He said, "And you did not put the rain-damaged food on top so that people could see it! Whoever cheats us is not one of us." (Saheeh Muslim)**

- **The First muhtasib appointed after the conquest of Makkah on Makkah markets – Hadhrat Sa'id bin Sa'id bin Al-'As (Radhiyallahu Anhu).**

- **Hadhrat 'Umar (Radhiyallahu Anhu) himself performed the role of muhtasib and he used to tour the market carrying a stick with him warning those who sold goods at exorbitant prices and cheaters.**

Shariah Audit and Review - Introduction

- **Periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the Islamic Financial Institution's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance.**

- **The objective of the Shariah review is to ensure that the activities carried out by an Islamic Financial Institution do not contravene the Shariah. It is the responsibility of SSB to form and express an opinion on the extent of an Islamic Financial Institution's compliance with the Shariah.**

- **The internal Shariah review is an integral part of the organs of governance of the Islamic Financial Institution and operates under the policies established by the Islamic Financial Institution. It shall be carried out by an independent division or part of internal audit department, depending on the size of an IFI. The primary objective of internal Shariah review is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shariah Rules and Principles as determined by the IFI's SSB.**

Shariah Audit and Review: Broad Principles

- **Objective: To enable the Shariah auditor to express an opinion as to whether the business is in accordance with Shariah Rules and Principles.**

- **Principles: The Shariah auditor should comply with Code of Ethics for Professional Accountants**

- **Terms of Engagement: The Shariah auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and the scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports to be provided by the auditor.**

- **Shariah Compliance Testing: When testing for Shariah compliance, the Shariah auditor shall obtain sufficient appropriate audit evidence that provides the auditor with reasonable assurance that the Islamic Financial Institution (IFI) has complied with Islamic Shari'a Rules and Principles (*the Fatwas, Rulings and Guidance issued by Shari'a Supervisory Board (SSB) constitutes Islamic Shariah Rules and Principles).***

Shariah Governance and Audit

1. Structured organizational policies and processes of an Islamic Financial Institution to ensure complete Shariah Compliance.
2. Main Fundamentals: Oversight and Responsibility, Independence and integrity, competency, confidentiality, ethics and procedures and policies.
3. SSB: Shariah Compliance, Zakaat Calculation, Advisory, Policies and Guidelines, Supervision and Monitoring, Fatawa and Public Relations

Shariah Auditor Profile

1. Must be a Muslim adult, of sound mind and just.
2. Must be of the opinion and strict in religion, knowledge-able of the provisions and purposes of the law.
3. Must be of good standing of the Sunnah
4. Sincere in his intention for the sake of Allah and is not flawless hypocrisy.
5. Known that what he says are not contrary to what he did.
6. To be innocent of people's money and refuse to accept gift from employers and industries (auditees).

Shariah Auditor Independence

The integrity of the shari'ah auditor needs to be perceived as independent enough by those stakeholders of Islamic finance. It is a common practice for the shari'ah auditors to rely heavily on or follow the advice of shari'ah advisors or the SSB. This is not acceptable if we want to have fully independent shari'ah auditors. Shari'ah audit in Islamic finance is arguebly as one of the social functions for the benefit of the ummah. The full benefit of the shari'ah audit cannot be realized if they are not wholly or truly independent. Self review threats may occurs because there is no clear line of separation of duties (Kasimet al., 2009). Literature on internal audit independence pinpoints three factors that significantly contribute to the degree of auditor independence, 1) Clarity of definition of the auditor's responsibilities,2) The position of the internal auditor within the institution's organizational structure, and 3)The reporting structure. Haniffa (2010) raises the question of the SSB independence as they are issuing the fatwa and at the same time helping the shari'ah auditors in conducting shari'ah review or shari'ah audit. Clearly there is no clear line on the separation of duties which is essentials for any good internal control practices. The IFIs need to rethink of where they could clearly separate these roles to avoid the misperception of the stakeholders on the SSB and/or shari'ah auditors' independence.

Shar'ee Ruling on Hisbah

Two major views on the Shariah rule on hisbah which is based on the discussion of al-amr bil'ma'ruf wal-nahyu 'an almunkar:

1. Fardh kifayah, but if everyone is ignirant of it, it is fard 'ayn upon the capable – Views of the majority (Shafi'yyah, Hanabilah and Hanafiyyah). They includes Qaadi Abu Bakr al-Jassas and Al-Alusi (Hanafiyyah), Imam al-Ghazzali and Imam Juwayni (Shafi'iyyah) and Syeikhul Islam Ibnu Taimiyyah (Hanabilah)

2. The duty is wajib on everybody – Malikiyyah e.g. Imaam Ibn Abi Zayd al Qayrawaani

Many Quranic verses and ahadith supported the first view. Hence, Shariah auditing should not be accorded as worldly corporate governance practices only, but a religious obligation on the Islamic financial institutions and Shariah auditors (muhtasib/ mudaqqiq syar'ie).

Shariah Audit Implementation

Planning Phase: Understanding the business of the Islamic Financial Institution, Identifying the appropriate techniques, resources, audit scope and developing optimal Shariah Audit plan.

Examination Phase: Fieldwork and identification of proper auditing technique.

Auditing Techniques: Examination of documentation, interviewing, direct observation, benchmarking, surveys, case studies, flowchart, statistical analysis and questionnaires.

Reporting Phase: Review of operational framework to ensure complete Shariah Compliance.

Important Auditing Functions: Shariah Supervisory Board, Internal Shariah Review Team and Audit & Governance Committee (AGC).

Shariah Audit Checklist

1. Sample contracts, terms and conditions
2. Sample marketing material and collateral
3. HR processes and Knowledge awareness
4. IT/Software Systems
5. Cash Flow Management – Mixing of funds
6. Financial Statements and Management Accounts
7. Income Purification
8. Shariah, HR, IT Checklists
9. Policies and Procedures
10. Letters of Appointment

Shariah Rating System

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.

Shariah Auditor - Responsibilities

1. Set Shariah Audit Program with adequate quality control policies and procedures.

2. Perform adhoc survey to gain familiarity with Shari'a risks, compliance postures and Shari'a Review emphasis.

3. Take measures to identify implementation control problems & adequate support compliance.

4. Review & assess the executed transactions to ensure products/services & related activities congruence to their respective Shariah charters.

5. Compile & administer a detailed Shariah Compliance Audit Report with high levels of autonomy and objectivity.

6. Ensure that necessary policies and procedures are in place, for all Shariah approved products, where applicable.

Shariah Audit in Action

1. **Planning Phase:**

Establishing Shariah compliance audit objectives and scope of Work

● Obtaining Shariah Supervisory Board (SSB) fatwas, guidelines, instructions, prior year internal and external Shariah review results and other relevant correspondence with supervisory and regulatory agencies

● Determining the capacity as well as resources to perform the review

● Communicating with relevant parties involved with the review

● Performing feasibility survey and interview on activities, risks and controls to identify areas of emphasis

● Developing Shariah Audit Programs

● Determining mode and timing review results to be communicated

● Obtaining approval of the Shariah audit work plan from concerned authorities including SSB of IFI

2. Examination and Evalution

Shariah Auditors shall collect, analyze, interpret and document information related to Shariah audit objectives to support their Shariah audits results. Types of information are as follows:

● Examination of documents

● Observations

● Analytical reviews

● Inquiries

● Discussion with management

Quality of information should be sufficient, relevant, reliable and useful to provide sound basis for Shariah audit findings and recommendations.

Prepared working papers by the auditor should be complete, organized, reviewed by the head of department and retained.

3. Reporting Phase

Quarterly reporting to the board of directors and copies to SSB and management shall be made. Prior to issuing the report the head shall discuss conclusions and recommendations with the various levels of management. Quality of report should be objective, clear, constructive and timely. The report shall include the following:

- **Purpose**
- **Scope**
- **Findings**
- **Opinion**
- **Recommendations**
- **Corrective actions**
- **Feedback from those reviewed**

Any dispute relating to Shariah interpretation to be resolved with SSB.

4. Follow Up

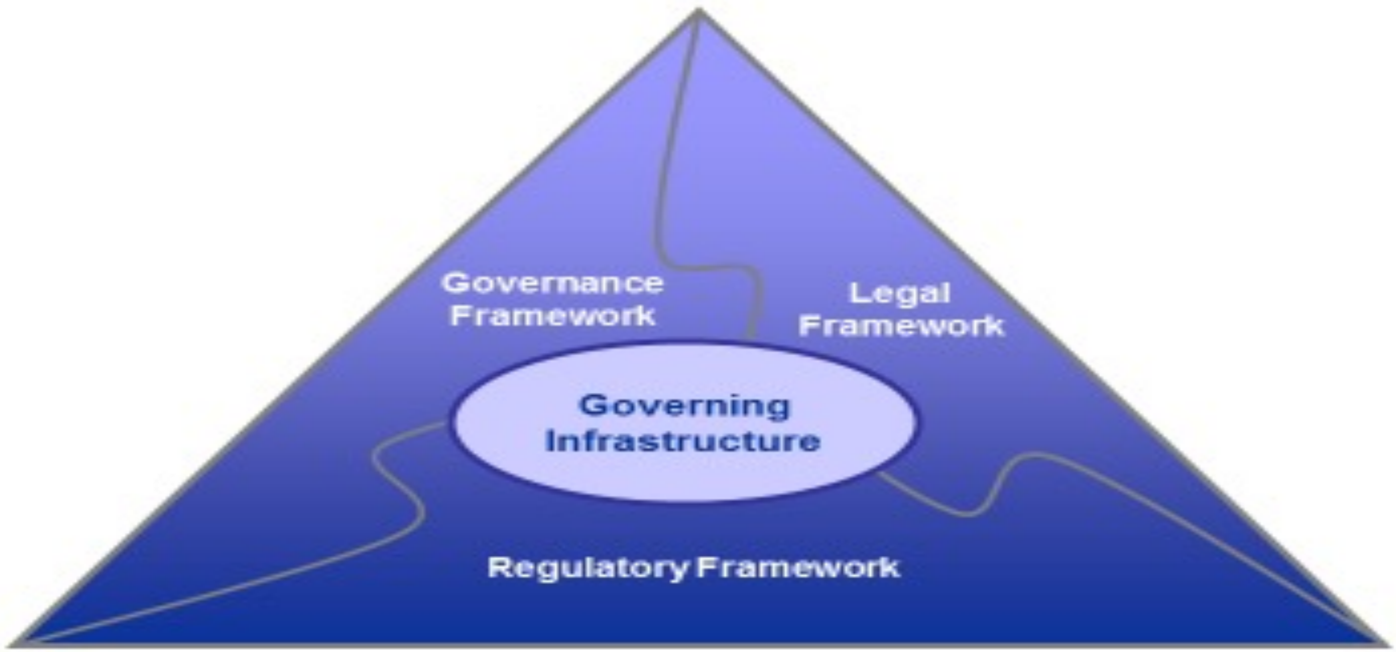
The internal Shariah auditor has a duty to follow up with corrective action and recommendations so as to ensure that the action is rectified and to prevent recurrence of non-compliance.

Shariah Considerations for Banking Products

1. **Trade Finance – Review the process flow, business analysis, offer and acceptance, possession of goods, physical inspection, no by-back, permissible goods, proper invoicing of goods, charity account maintained in order**
2. **LC/Documentary Credits – LC Types VS Shariah Basis such as Kafalah, Mudarabah, Wakalah, Musharakah**
3. **Musharakah/Mudarabah – No fixed return, business analysis**
4. **Ijarah – rental schedule, agreement, no cash financing**

Shariah Audit and Governance

Well developed governance structure is important for safety & soundness of IFIs…



Shariah governance.. an important component of governance framework

IFIs – Islamic financial institutions

...Shariah governance is instrumental in instilling & shaping sound governance practices ....

Importance of Shariah governance

- Ensure full Shariah-compliant
- Instill public confidence
- Promote financial stability

Principles of Islamic finance place great emphasis on strong corporate governance values & structure, transparency, disclosure of information & strict adherence to Shariah principles...

Issues and Challenges in Shariah Audit

1. **Lack of Independence**
2. **Lack of Transparency**
3. **Lack of Accountability**
4. **Lack of Competency**
5. **Role of Shariah Board – Shariah Advisory, R&D, Fatwa, Zakaat, Endorsing Agreements and Contracts**
6. **Regulation**
7. **Segregation of Duties**

Malaysia has experienced five phases of evolution in Shariah governance development...

Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Building foundation of Shariah governance	**Expansion of Shariah advisory role**	**Promoting uniformity & harmonisation of Shariah interpretations**	**Recognition of SAC as an authoritative body & establish governance for SC**	**Positioning SAC as apex authority & codify Shariah governance framework**
▪ **Establishment of SC** at IFIs level under specific laws to provide check & balance, to **ensure Shariah compliance** ▪ Legal provision in dedicated laws to require establishment of SC at IBs	▪ Allow conventional banks with Islamic window to **appoint Shariah advisers** to ensure Shariah compliance ▪ Guided by **specific guidelines** issued by BNM ▪ Created a **small pool of Shariah advisers**	▪ **Instituting dedicated SAC at Central Bank** to address Shariah compliance issues ▪ Providing a **platform for IFIs to seek Shariah advise** through SAC	▪ **Specific provisions** in CBA ▪ Court & arbitrator **to refer to SAC's rulings** in any proceedings related to IF matters ▪ Incorporating **duties of SC** in the industry ▪ **Enlarging pool of Shariah talent** within the Islamic financial industry	▪ **SAC's rulings are binding** on IFIs, courts and arbitrators ▪ Enhancing the roles & functions of the **board, SC & management** in relation to Shariah governance ▪ Formation of **Shariah key functions** within IFIs to ensure Shariah-complaint

SC – Shariah Committee, SAC – Shariah Advisory Council, CBA – Central Bank of Malaysia Act 2009, IBs – Islamic Banks

Why there is a need for Shariah governance framework for IFIs…?

Shariah compliance as the MAIN OBJECTIVE of an IFI

- Business objective of IFI - to conduct financial business in accordance with principles of Shariah
- Responsibility of Shariah compliance not confined to SC but also board, management and staff
- Even more critical to IFIs that leverage on resource-sharing or outsourcing with conventional infrastructure

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Some observations on IFIs Shariah governance…

- IFI that possess strong corporate governance structure, but weak in Shariah governance
- Lack of independence - Strong influence by management on SC
- SC's limited role as advisor, certifying the product approval & validation documentation
- Lack of communication between SC and board
- Lack of resources to ensure Shariah compliance
- Lack of robust Shariah governance infrastructure – Lack of Shariah compliance functions including depth of Shariah research capabilities

Framing the Shariah governance framework…

Guiding Principles

Oversight, Accountability & Responsibility

- Clear demarcations on accountability & responsibility
- Outlines level of accountability and responsibility of board of directors, Shariah committee and management of IFIs

Independence

Aims at safeguarding independence of Shariah Committee in ensuring sound Shariah decision-making, and emphasis on role of board of directors in recognizing independence of Shariah committee

Competency

Highlights requirements and expected competencies to ensure key functions are capable of implementing Shariah governance

Confidentiality & Consistency

Minimum set of rules that emphasizes the importance of observing and preserving confidentiality and improving level of consistency in decision making by Shariah committee

Combining principle-based & rule-based features…

Oversight, accountability & responsibility

- Board overall accountability
- SC accountability on decisions, views & opinions
- Management's responsibility in providing adequate support
- Minimum 5 SC members (at least 3 must be Shariah qualified)
- May appoint SC as BOD

Independence

- Direct reporting & regular engagement between Board & SC
- Recognition by BOD on SC's independence
- Full observance to SC's decision
- Access to necessary info by SC
- Prior written approval BNM & SAC for appointment & removal of SC

Competency

- Comply to fit & proper requirement set by BNM
- Board, mgmt & SC expected to have reasonable understanding on Shariah & Islamic finance respectively
- Continuous training provided to key internal stakeholders
- Succession planning program for SC

Confidentiality & consistency

- SAC's ruling binding on IFIs
- SC should not undermine SAC's rulings
- Whistle blowing by SC to BNM
- Duty to observe confidentiality on sensitive info obtained by SC
- Restriction on SC membership in IFI within same industry

Clarity of responsibilities of key stakeholders on Shariah governance…

Board

- Ultimately accountable & responsible on the overall SGF & Shariah compliance of the IFI
- Approve all policies relating to Shariah matters
- Appoint & remunerate SC
- Ensure effective communication policy

Shariah Committee

- Responsible & accountable for all its decisions, views & opinions related to Shariah matters
- Advise the board & provide input to the IFI on Shariah matters
- Endorse Shariah policies & procedures
- Endorse and validate relevant documentations (e.g. forms, contracts, agreements, legal documentations, product manual, marketing advertisements, brochures, etc)

Management

- Responsible for observing and implementing Shariah rulings & decisions made by the SAC & SC respectively
- Provide complete & accurate information to SC
- Allocate adequate resources & manpower to support the SGF
- Provide continuous learning & training programs to key internal stakeholders
- Develop & adopt holistic culture of Shariah compliance with the IFI
- Ensure Shariah policies & procedures are accessible at all times
- Report on Shariah non-compliance events & rectitfy

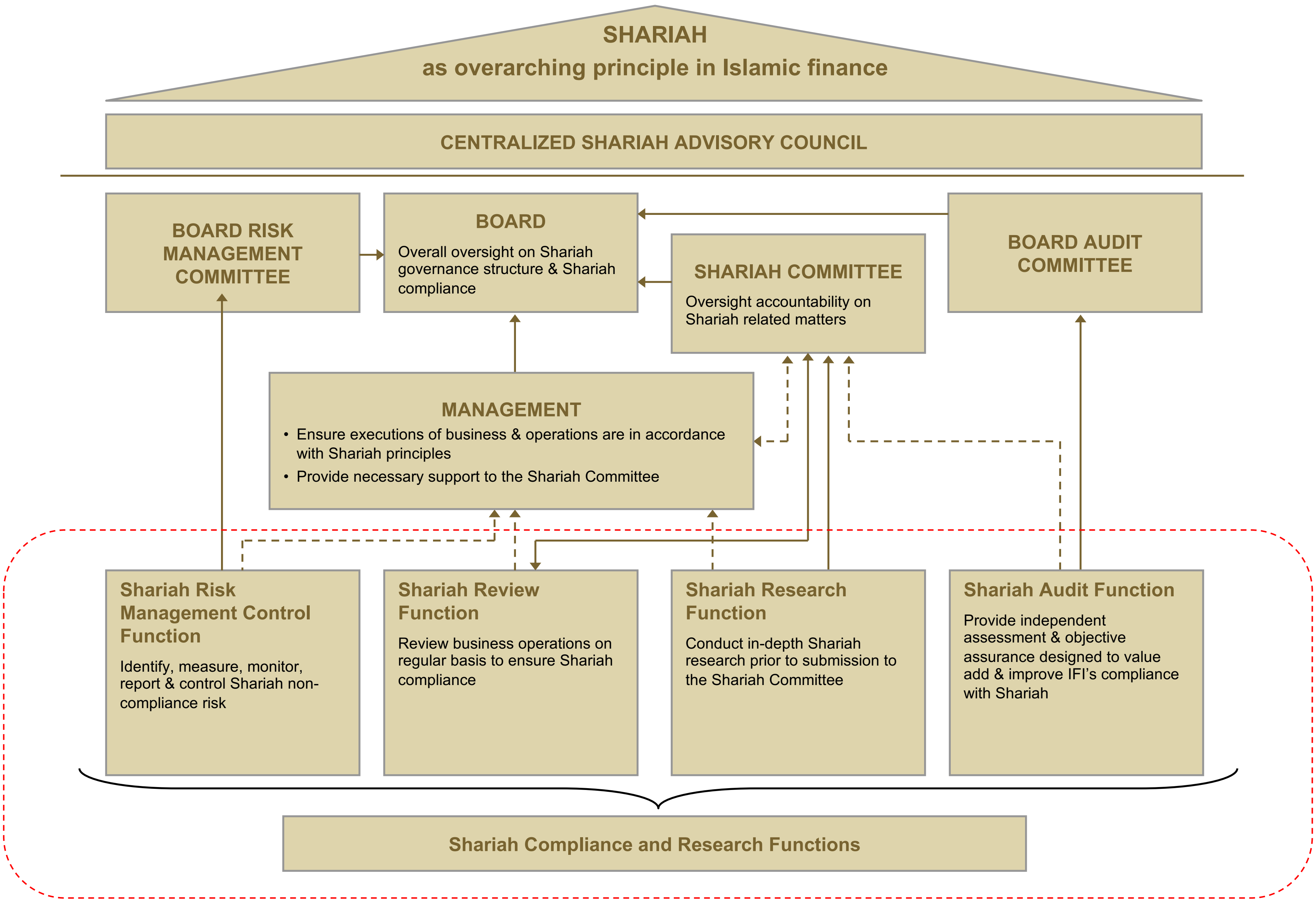
…and supported by comprehensive Shariah compliance & research functions

	Objectives	Scope
Shariah Review	• To ensure that activities and operations carried out by the IFI do not contravene with Shariah	• Overall business operations, including end-to-end product development process (from product structuring to product off

Shariah Audit	• To provide an independent assessment & objective assurance
	• To ensure a sound and effective internal control system for Shariah compliance
		• All aspects of the IFI's business operations & activities, including:
		  • compliance audit on organisational structure, people & information technology application systems; and
		  • review of adequacy of the Shariah governance process.

Shariah Risk Management	• Identification & assessment of Shariah risk would be systematically controlled & monitored	• Form part of IFIs integrated risk management control function
Shariah Research	• Ensure proper deliberation of Shariah related matters	• Perform in-depth research on Shariah including providing day-to-day Shariah advice & consultancy
Shariah Secretariat	• Provide necessary support to Shariah committee & IFI in implementing Shariah governance	• Coordinating meetings, compiling papers, disseminating Shariah decisions • Engaging with relevant parties that need assistance

A snapshot of Shariah governance framework model for IFIs…



Various types of IFIs

Types of entity

1. 'Stand-alone' – Domestic & Foreign-owned
2. Islamic Subsidiary
3. Islamic Window
4. Development Financial Institution / Specialized Institutions

Issues & challenges in Shariah governance…

1. Centralised Shariah body or decentralised at IFIs?
2. Competency of Shariah scholars to understand the complexity of Islamic financial instruments and their professionalism
3. Availability of a pool of Shariah scholars in the required Islamic finance knowledge
4. **Regulatory policy that can accommodate all types of entity**
5. Capability to establish Shariah compliance functions (Shariah review, audit, risk management & research)
6. Can non-Muslims be Shariah scholars?

Developing Shariah Products

- Product / Services Idea and concept.
- Market Research.
- Business Case.
- Fatwa and Structure.
- Stakeholders involvements.
- Compliance.
- Credit Parameters.

Liquidity Management

- Sources of Liquidity: Current Account/Savings/investment deposits/Securitization/Placement Accounts
- Liquidity Tools: Interbank Wadee'ah/Mudarabah/Sukuk/Wakalah
- FX and FEC Contracts

Basic Islamic Banking Products

- Current Accounts
- Home Finance Product
- Treasury Deposit Account
- Savings and Term Deposit Accounts
- Personal Finance Product
- Trade Finance Murabaha Product
- FEC and FX Products
- Vehicle and Asset Finance Products
- LC and Bill of Exchange

Raising Shariah Capital

- Equity/debt funds, banks, family offices, capital markets and multi lateral development banks
- Lawyers, tax advisors, shariah advisors, consultants and banks
- Typical roadmap/process/timeline
- GIFS role in funding projects

What we do today will determine the success of the Islamic Finance Industry in the future.

The sustainability of this industry is our responsibility.

Any Questions?

Kindly Download a free copy of our e-book "Your Brief Guide to Islamic Finance" from our website: www.gifsrv.com

Shukran/Thank You!