

Ref. 1117/6504/MH
9th November 2017

Dr. Hamed Hassan Merah
Secretary General
Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI)
Al Nakheel Tower
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Building 1074
Road 3622
Manama
Kingdom of Bahrain

Dear Dr. Merah,

السلام عليكم ورحمة الله وبركاته،،

**CIBAFI Comments on the AAOIFI Exposure Draft on Governance Standard No. 9
“Shariah Compliance Function”**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) presents its compliments to the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and takes this opportunity to express its appreciation of the work that the AAOIFI does to promote and enhance the Islamic financial services industry (IFSI).

CIBAFI is the official umbrella for all Islamic financial institutions, whose services and products comply with the Shariah rules and principles. CIBAFI acts as the voice of the Islamic finance industry, and our members comprise more than 120 Islamic banks and non-bank financial institutions, both large and small, from 32 countries and jurisdictions.

We noted the request for comments on the AAOIFI Exposure Draft on Governance Standard No. 9 “Shariah Compliance Function”, and welcome this opportunity to offer

our comments and recommendations. The comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. We are also attaching more detailed comments in the Appendix to this letter for AAOIFI's kind consideration.

Firstly, we note that the ED attempts to define the internal Shariah compliance system within Islamic financial institutions (IFIs) which include banks, Takaful operators, capital market institutions and other similar institutions. Although the standard claims to be applicable to all IFIs, much of the text pertains to institutions of larger sizes, which are able to sustain a number of internal units. It is therefore likely to be more applicable to banks and Takaful operators than to capital market firms and other similar institutions (or indeed Islamic microfinance institutions). It would be helpful if the Standard could give guidance on how it could be applied in smaller institutions, for example by combining or outsourcing functions.

Secondly, members have noted that, although this is a Standard for the Shariah compliance function, the ED at some points strays into other matters, for example the Secretariat of the Shariah Supervisory Board (SSB) (paras 53-56), which properly belongs in a Standard for the SSB, and more general matters of culture and human resources policy (paras 11-12 and 31-35). We suggest these be removed from the current Standard, to focus it strictly on the Shariah compliance function. If it is considered necessary, the material can be incorporated in other standards in the future.

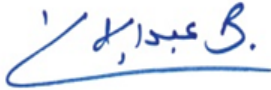
Thirdly, the ED states in para 42 that the Shariah Compliance Department (SCD) is principally a part of management and accountable to senior management. The issue of reporting lines led to a great deal of comment from our members, who were keen that the standard should preserve the operational independence of the SCD. We recognize that the SCD needs to have day to day administrative reporting to senior management, but it also needs direct access to the Shariah Supervisory Board (SSB); this is expressed in one jurisdiction as reporting technically to the SSB and administratively to senior management, and some similar formulation may be appropriate in this Standard.

We offer some more detailed comments on the text in the Appendix to this letter.

We would like to express our thanks to the AAOIFI for its great effort and commitment with respect to developing standards that accommodate the interest of the global Islamic finance industry.

We remain at your disposal should you need any further clarifications on the above or on the attached Appendix.

Yours sincerely,



Abdelilah Belatik
Secretary General

Appendix
Comments on Exposure Draft of the AAOIFI Exposure Draft on Governance
Standard No. 9 “Shariah Compliance Function”

CIBAFI’s analysis has identified the following comments with regards to the specificities in the Exposure Draft.

- **IFI’s financial arrangements**

We notice that the term “IFI’s financial arrangements” is used (in para 3.a. and at various points thereafter) to define the scope of the Shariah compliance function, without a clear definition of its own meaning. This can open the door for different interpretations in practice. Therefore we recommend adding to the standard a definition of “IFI’s financial arrangements”.

- **Hierarchy of Shariah principles and rules**

The ED defines the applicable hierarchy in definitions (para 3.k), that Shariah principles and rules defined by the following hierarchy, as appropriate:

1. The Shariah standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI);
2. The regulations issued by the respective jurisdiction’s regulator insofar as these entail the regulatory Shariah requirements;
3. The rulings of the Central Shariah Board for the respective jurisdiction;
4. The requirements of the applicable Financial Accounting Standards as issued by AAOIFI insofar as these entail Shariah related requirements; and
5. The approvals and rulings given by the Shariah Supervisory Board (SSB) of the IFI.

This hierarchy might not be applicable in many jurisdictions some of which may, for example, give primacy to the rulings of their own Central Shariah Boards. In addition, the hierarchy is silent on the role and position of the rulings of other Shariah bodies such as the International Islamic Fiqh Academy. We consider that a standard dealing with the Shariah compliance function is not the right place in which to try to establish a hierarchy of this kind.

- **The pillars of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)**

Some CIBAFI members note that COSO’s pillars are defined in a purely secular context. If they are to be cited, therefore, and in order to educate the SSB members and those in charged with governance about their application to the Shariah compliance function, the standard should elaborate more on linking the COSO components to Shariah requirements.

- **Organizational independence of SCD and reporting lines**

We have already noted, in relation to para 42, the issue of the independence and reporting lines of the SCD. We note also that different language is used at different points to describe how this is to work. Para 42 says that “SCD is principally a part of management and shall report to, be accountable to, and be evaluated and appraised for performance by, the senior management in consultation with the SSB”. On many occasions, the ED uses the expression, “using powers vested in it by the SSB”. Moreover, the ED mentions (para 50) that “In order to ensure effective Shariah compliance mechanism, it is imperative that the SCD works in close collaboration with, and under the active supervision of, the SSB”. In para 52 the ED says that “the SCD shall be a part of management in an IFI. It shall, however, remain independent from business operations to maintain segregation of duties, neutrality of views and performance, and preserve work ethics. It shall particularly be independent of the following functions: a. managerial decision making; b. finance-related functions; c. legal – with regard to documentation and product related legal functions; d. marketing and sales; and e. product development (except for providing inputs and reviews)”. It is not clear that all this language is consistent, and that the same concepts are being expressed throughout; there are also elements of repetition. A thorough review in this area would be desirable.

- **Shariah compliance, Shariah audit and SSB Secretariat**

The definitions distinguish clearly between the Shariah compliance function, internal Shariah review and external Shariah audit. However, some CIBAFI members found that this distinction was not preserved throughout the ED, and that at some points the roles were not clearly separated. This was exacerbated by the fact that some of the functions of the SSB Secretariat

were also being described; as we have already indicated, this material should be in a standard dealing with the operations of the SSB itself.

- **Shariah non-compliance risk rating**

The ED indicates in para 71 that “SCD may introduce Shariah non-compliance risk rating in its report. A quantitative Shariah non-compliance risk assessment will enable the senior management to assess the Shariah compliance status of the IFI and to take corrective actions.” While we recognize that this is put forward as an option rather than a requirement, some of our members would appreciate more elaboration on the application of rating mechanisms and quantitative assessment to Shariah non-compliance. We recognize, however, that this may be work for a future standard.