



International Association
of Deposit Insurers

Draft: October 2017

SHARIAH GOVERNANCE FOR ISLAMIC DEPOSIT INSURANCE SYSTEMS

Discussion Paper

**Prepared by the Islamic Deposit Insurance Technical Committee
of the Core Principles and Research Council Committee
of the International Association of Deposit Insurers**

C/O BANK FOR INTERNATIONAL SETTLEMENTS
CENTRALBAHNPLATZ 2, CH-4002 BASEL, SWITZERLAND
TEL: +41 61 280 9933 FAX: + 41 61 280 9554
WWW.IADI.ORG

About the Islamic Deposit Insurance Technical Committee¹

The Islamic Deposit Insurance Technical Committee (IDITC) was established in 2007 under the aegis of the Core Principles and Research Council Committee² of the International Association of Deposit Insurers (IADI). The Committee is responsible for conducting research as well as developing and promoting guidance and core principles to enhance the effectiveness of Islamic deposit insurance systems, for the benefit of countries seeking to establish or improve their Islamic deposit insurance system.

¹ Formerly known as the Islamic Deposit Insurance Group (IDIG).

² Formerly known as the Research and Guidance Committee.

TABLE OF CONTENTS

ACRONYMS	1
DEFINITION OF KEY TERMS	2
EXECUTIVE SUMMARY	4
INTRODUCTION	6
APPROACH AND APPLICABILITY OF THIS DISCUSSION PAPER	7
WHAT IS SHARIAH GOVERNANCE?	8
IMPORTANCE OF SHARIAH GOVERNANCE FOR IDIS	9
IDIS OPERATIONS – AREAS REQUIRING SHARIAH COMPLIANCE	11
SHARIAH GOVERNANCE FOR IMPLEMENTATION OF IDIS	14
1. Identification of Shariah Requirements for IDIS Operations	14
2. Incorporation of Shariah Requirements into Relevant Documents and Dissemination to the BOD and Personnel with Shariah Governance Responsibilities	19
3. Shariah Compliance Review	20
4. Shariah Compliance Audit	22
RESPONSIBILITIES IN RESPECT OF SHARIAH GOVERNANCE	23
RECOMMENDED SHARIAH GOVERNANCE GUIDING PRINCIPLES FOR IDIS	24
CONCLUSION	27
REFERENCES	29

ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BOD	Board of directors
CDIS	Conventional deposit insurance system(s)
DI	Deposit insurer
DIS	Deposit insurance system(s)
DSS	Designated Shariah scholar(s)
HOD	Head(s) of division
IADI	International Association of Deposit Insurers
IDB	Islamic Development Bank
IDIF	Islamic deposit insurance fund(s)
IDITC	Islamic Deposit Insurance Technical Committee
IDIS	Islamic deposit insurance system(s)
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IRTI	Islamic Research and Training Institute

DEFINITION OF KEY TERMS

Deposit insurance is defined as a system established to protect depositors against the loss of their insured deposits in the event that a bank is unable to meet its obligations to the depositors.

Deposit insurer refers to the specific legal entity responsible for providing deposit insurance, deposit guarantees or similar deposit protection arrangements.

Deposit insurance system refers to the deposit insurer and its relationships with the financial safety-net participants that support deposit insurance functions and resolution processes.

Financial safety-net is defined to include the functions of prudential regulation, supervision, resolution, lender of last resort and deposit insurance. In many jurisdictions, a department of government (generally a Ministry of Finance or Treasury responsible for financial sector policy) is included in the financial safety-net.

Integrated deposit insurance system refers to Islamic deposit insurance system and conventional deposit insurance system administered under a single deposit insurer, for the purpose of this paper.

Investment accounts refer to a pool of investment funds placed with an Islamic bank on the basis of *mudarabah* for the purpose of profit-sharing between the Islamic bank and the investors. Where investment accounts are managed under a *wakalah* contract, the relationship between the Islamic bank and the investors is a simple agency relationship, with the Islamic bank earning a flat fee rather than a share of the profits.

Islamic deposit insurance is defined as a system with Shariah-compliant design features, set up to protect depositors against the loss of their insured Islamic deposits in the event that an Islamic bank is unable to meet its obligations to depositors.

Islamic deposit insurance system refers to the deposit insurer and its relationships with the financial safety-net participants that support Islamic deposit insurance functions and resolution processes.

Kafalah refers to a guarantee – for example, when a person guarantees the liability or obligation (especially debt) of another person. *Kafalah bi al-ujr* refers to a guarantee accompanied by a fee.

Mandate of the deposit insurer refers to the set of official instructions describing its roles and responsibilities. There is no single mandate or set of mandates suitable for all deposit insurers. When assigning a mandate to a deposit insurer, jurisdiction-specific circumstances must be taken into account. Mandates can range from narrow “pay box” systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a

variety of combinations in between. These can be broadly divided into four categories:

- a. A “pay box” mandate, where the deposit insurer is only responsible for the reimbursement of insured deposits;
- b. A “pay box plus” mandate, where the deposit insurer has additional responsibilities, such as certain resolution functions (e.g. financial support);
- c. A “loss minimiser” mandate, where the insurer actively engages in a selection from a range of least-cost resolution strategies; and
- d. A “risk minimiser” mandate, where the insurer has comprehensive risk minimisation functions that include risk assessment/management, a full suite of early intervention and resolution powers, and in some cases prudential oversight responsibilities.

Public policy objectives refer to the goals which the deposit insurance system is expected to achieve.

Resolution refers to the disposition plan and process for a non-viable bank. Resolution may include: liquidation and depositor reimbursement, transfer and/or sale of assets and liabilities, the establishment of a temporary bridge institution, and the write-down of debt or conversion to equity. Resolution may also include the application of procedures under insolvency law to parts of an entity in resolution, in conjunction with the exercise of resolution powers.

Shariah refers to the divine law deduced from its primary (the Qur’an and Sunnah) and secondary sources (e.g. consensus (*ijma*), analogy (*qiyas*) and customary practice (*urf*)).

Takaful refers to a mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants’ risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.

EXECUTIVE SUMMARY

In tandem with the growth of the Islamic financial services industry (IFSI), Islamic deposit insurance systems (IDIS) have become a key ingredient for a strong industry. An IDIS helps maintain public confidence in the safety of Islamic deposits and investment accounts held by Islamic banks. It also complements the roles of other safety-net players in promoting the stability of the IFSI.

The key distinction between IDIS and conventional deposit insurance systems is the requirement to adhere to Shariah rules and principles. Among other things, deposit insurers (DI) must adopt permissible modalities, ensure that funding sources are Shariah-compliant, manage Islamic deposit insurance funds (IDIF) separately from conventional funds, and invest IDIF in Shariah-compliant instruments. Hence, it is crucial to have Shariah governance for IDIS.

Shariah governance structures and processes may vary from one jurisdiction to another, depending on what the DI deems appropriate for its IDIS. The design of Shariah governance for IDIS operations may be influenced by, among other things, the complexity of the operations that require Shariah compliance and the institutional setup of the DI, which is a non-profit-making entity.

Under Shariah governance for IDIS, the DI should identify Shariah requirements, incorporate such requirements into relevant documents and disseminate them, conduct Shariah compliance reviews and perform Shariah audits. Shariah rulings should be sought from Shariah scholars who are designated to provide rulings on IDIS operations. The Shariah requirements should be incorporated into relevant documents, e.g. legislation and policy documents, and disseminated to boards of directors (BOD) and personnel with Shariah governance responsibilities, in order to facilitate compliance. The Shariah requirements should also be communicated to heads of division (HODs), to ensure proper incorporation into relevant documents and compliance by operating personnel.

Shariah compliance reviews should be conducted independently, either by the DI's Shariah personnel or by qualified personnel within the compliance division, whose responsibilities should be expanded to cover the Shariah compliance review function. Shariah compliance audits should be performed by the DI's internal auditors, who should be adequately trained for the purpose. Alternatively, the DI may use qualified external auditors.

Following a discussion of Shariah governance structures and processes for IDIS, this paper presents a set of recommended guiding principles including, but not limited to, the following:

1. The DI should establish adequate Shariah governance framework for IDIS operations;
2. Shariah governance processes and structures for IDIS should be commensurate with the nature and complexity of their operations;
3. Any person bearing the responsibilities outlined in the Shariah governance framework for IDIS operations should possess the necessary skills;

4. There should be an adequate process to facilitate the effective deliberation of issues by the designated Shariah scholars (DSS), with a view to obtaining Shariah rulings;
5. The DSS should ensure that internal information obtained in the course of their duties is kept confidential;
6. The independence of the Shariah compliance review and audit functions should be preserved, so that they can carry out their responsibilities unhindered;
7. The DI should provide adequate disclosures to their stakeholders on how Shariah governance is being practised by the organisation.

INTRODUCTION

Islamic deposit insurance systems (IDIS) have become a key ingredient for a strong Islamic financial services industry (IFSI). This is due to the growth of the industry globally, which warrants the creation of IDIS to complement other safety-net players in promoting the stability of the IFSI. The challenge of the IFSI includes maintaining public confidence in the safety of deposits and investment accounts held by Islamic banks in the event of distress.

In May 2015, the Islamic Financial Services Board (IFSB) published a report³ that contains an assessment on the IFSI. The report states that the Islamic banking sector has achieved systemic importance in at least ten jurisdictions⁴ and some countries are deemed to be markets where Islamic finance may gain systemic importance. This is attributed mainly to the remarkable growth of the industry over the previous years. It was also reported that Islamic banking assets formed the bulk of the industry's total assets.⁵

In promoting the stability of the IFSI, the IFSB, in another report⁶ published in April 2010, stressed the need for financial safety-net arrangements for the industry. This report identifies eight building blocks aimed at further strengthening the IFSI, of which IDIS is one. Therefore, it is no longer a question of whether protection for Islamic deposits and investment accounts is necessary, but rather of how the system should be implemented in accordance with Islamic teachings.

An IDIS is designed to provide protection for Islamic deposits and investment accounts in the event that an Islamic bank which is a member of the system is wound up. Additionally, as stated above, it is aimed at promoting the stability of the IFSI.

In pursuing these objectives, an IDIS differs from conventional deposit insurance systems in that it is required to adhere to the principles and rules of Shariah (hereinafter Shariah requirements). Under Shariah requirements, deposit insurers (the party responsible for administering IDIS) must, among other things, ensure that IDIS are free from elements that Islam prohibits, such as interest (*riba*) and uncertainty (*gharar*). Deposit insurers (DIs) also need to promote fairness in the system.

IDIS activities are not confined to providing protection for Islamic deposits and investment accounts and seeking rulings from Shariah scholars. The DI also needs to ensure compliance with such rulings. This may be facilitated by the institutionalisation of Shariah governance for IDIS operations.

³ *Islamic Financial Services Industry Stability Report 2015*.

⁴ The criteria for Islamic banking systemic importance are as follows: when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets, or at least 5% of global Islamic banking assets. The ten jurisdictions are Brunei, Bangladesh, Iran, Kuwait, Malaysia, Qatar, Saudi Arabia, Sudan, the United Arab Emirates (UAE) and Yemen.

⁵ Islamic banking accounts for almost 80% of the industry; as of 1H 2014, assets in full-fledged Islamic banks, subsidiaries and windows amounted to approximately USD 1.48 trillion.

⁶ Joint IFSB-IRTI-IDB report: *Islamic Finance and Global Financial Stability*.

The Islamic Deposit Insurance Technical Committee (IDITC or the Committee) of the International Association of Deposit Insurers (IADI) regards Shariah governance as key for IDIS. Compliance with Shariah will not only help the DI to realise what an IDIS should be, i.e. a Shariah-compliant system, but will also enable the DI to implement an effective IDIS. Against this backdrop, IDITC has developed this paper to, among other things, discuss the following:

- (a) Shariah governance in the context of IDIS, particularly the required processes and structures; and
- (b) Proposed guiding principles on Shariah governance for IDIS.

IDITC is aware that concerns might arise that the introduction of Shariah governance may unnecessarily bind the DI, especially when the DI is a government agency. However, IDITC believes that Shariah governance should be regarded as a best practice rather than a compliance tool, in the spirit of good corporate governance.

APPROACH AND APPLICABILITY OF THIS DISCUSSION PAPER

Shariah governance is already widely discussed in the IFSI. Thus, for the purpose of this paper, IDITC has reviewed relevant literature on Shariah governance and corporate governance for Islamic banks, with established Shariah governance standards of international standard setting bodies and selected regulators as the main sources of reference. IDITC is of the view that the extensive contents of these standards are adequate to facilitate the Committee in assessing and discussing Shariah governance in the context of IDIS. Where appropriate, other literature was also taken into account.

It is not IDITC's intention to cover every aspect of Shariah governance for IDIS in this paper. The selection of areas for discussion is based on what IDITC views as appropriate and adequate in the context of IDIS. IDITC has also taken note of the various current practices and possible other practices of Shariah governance for DIs. Hence, IDITC is of the view that it is appropriate to recommend some guiding principles.

In terms of the applicability of Shariah governance discussed in this paper, the aim is to cover IDIS, defined as systems in which all design features and every aspect of the operations are in compliance with Shariah. Operations of IDIS are elaborated in the section "IDIS Operations" below.

Currently, a few jurisdictions such as Nigeria and Malaysia implement a dual deposit insurance system, where a DI administers an IDIS and a conventional deposit insurance system separately but within the same organisation. For the purpose of clarity, Shariah governance for the dual system is applicable only to aspects of IDIS business relating to, among others, sources and uses of funds, reimbursement of depositors and resolution of failed Islamic banks. It is not applicable to matters related to the DI's conventional deposit insurance business. In the case of a full-fledged IDIS like Sudan, where conventional banking is prohibited, a comprehensive Shariah governance framework is required to govern its business and operations.

Similarly, for the sake of clarity, Shariah governance does not apply to DIs that provide protection for Islamic deposits and investment accounts under a conventional deposit insurance system. Under such a system, premiums paid by the Islamic banks are commingled with premiums collected from conventional banks, and there are no Shariah compliance requirements on the management and utilisation of the premiums collected from the Islamic banks.

IDIS can be administered by organisations such as government agencies and private entities or by the central bank (by a unit set up to administer protection for Islamic deposits and investment accounts).⁷ Shariah governance as discussed in this paper is applicable to the various setups, although there could be variations in governance structures. Additionally, the discussion also applies to DIs under any mandate i.e. pay box, pay box plus, loss minimiser or risk minimiser.⁸

WHAT IS SHARIAH GOVERNANCE?

Shariah governance is commonly regarded as the structures and processes adopted by an organisation to ensure compliance with Shariah. It complements the corporate governance of an organisation.

In its standards,⁹ the IFSB defines Shariah governance as a set of institutional and organisational arrangements through which an Islamic bank ensures that there is effective independent oversight of Shariah compliance for each of the following structures and processes:

1. Issuance of relevant Shariah pronouncements or rulings

“Shariah pronouncements or rulings” refer to a legal opinion on any matter pertaining to Shariah issues in Islamic finance, given by the appropriately mandated Shariah board¹⁰. Once it is decided that a Shariah pronouncement

⁷ Regardless of the DI setup, the International Association of Deposit Insurers, in its Core Principles for Effective Deposit Insurance Systems (IADI CPs), recommends that the DI should be operationally independent, so that it is able to fulfil its mandate and use its powers without interference from external parties.

⁸ Based on the IADI CPs, mandates of deposit insurers can range from narrow “pay box” systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a variety of combinations in between. These can be broadly classified into four categories:

- (a) A “pay box” mandate, where the deposit insurer is only responsible for the reimbursement of insured deposits;
- (b) A “pay box plus” mandate, where the deposit insurer has additional responsibilities, such as certain resolution functions (e.g. financial support);
- (c) A “loss minimiser” mandate, where the insurer actively engages in a selection from a range of least-cost resolution strategies; and
- (d) A “risk minimiser” mandate, where the insurer has comprehensive risk minimisation functions that include risk assessment/management, a full suite of early intervention and resolution powers, and in some cases prudential oversight responsibilities.

⁹ Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services.

¹⁰ The IFSB defines a Shariah board as a panel of Shariah scholars who are special advisers to the Islamic banks. It may alternatively be called a Shariah committee or Shariah supervisory board.

or ruling should be implemented, it becomes a Shariah ruling with full legal effect that binds the Islamic bank

2. Dissemination of Shariah pronouncements or rulings to the operating personnel

Shariah pronouncements or rulings should be disseminated to the Islamic banks operating personnel who monitor day-to-day compliance of every level of operations and each transaction with the Shariah pronouncements or rulings.

3. Internal Shariah compliance review or audit

Shariah pronouncements or rulings issued by the Shariah boards should be strictly adhered to. Internal Shariah compliance reviews or audits verify that Shariah compliance has been satisfied. Any incident of non-compliance is recorded and reported, and as far as possible, addressed and rectified.

4. An annual Shariah compliance review or audit

The annual Shariah compliance review or audit is performed to verify that the internal Shariah compliance review or audit has been appropriately carried out and its findings have been duly noted by the Shariah board.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) does not provide definitions on Shariah governance. Its standards provide guidance on matters relating to Shariah supervisory boards, Shariah reviews, internal Shariah reviews, and audit and governance committees for Islamic financial institutions.¹¹

According to the AAOIFI's standards, the Shariah supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of Islamic financial institutions in order to ensure that they comply with Shariah. A Shariah review is conducted to assess compliance.

As regards internal Shariah reviews, the AAOIFI's standards require this to be carried out by an independent division or department, or part of the internal audit department. The function is designed to examine and evaluate the extent of compliance with Shariah, as well as ensure that the institution's management discharge its responsibilities in relation to implementation of rulings determined by the Shariah supervisory board.

IMPORTANCE OF SHARIAH GOVERNANCE FOR IDIS

From the Shariah perspective, an IDIS is permissible as its objective is to protect the interests of the people and promote the stability of the IFSI. Nevertheless, the DI is still required to ensure that IDIS operations are in compliance with Shariah, which is the overarching requirement for IDIS. Such compliance requirement justifies the importance of Shariah governance.

¹¹ *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, 2015.

Among the key goals of Shariah governance for IDIS are:

1. Ensure the legitimacy of adopted modalities¹²

Different modalities result in different design features of IDIS, i.e. some areas of operations under the *takaful* model are different from those under the *kafalah* model. Hence, Shariah governance helps the DI to ensure that design features are aligned with the Shariah arrangements which have been adopted. The DI needs to make clear to the Islamic banks the underlying Shariah arrangement of the IDIS.

2. Build and sustain confidence of relevant stakeholders

Some IDIS stakeholders are concerned about the manner in which the system is implemented. They emphasise that the DI should implement the system in accordance with Shariah.

For instance, Islamic banks are concerned about how their contributions or the premiums that they pay to the DI to fund the system are utilised and managed. The Islamic banks conduct banking business that is Shariah-compliant, and they therefore expect the contributions or premiums to be invested in instruments that are likewise Shariah-compliant.

In certain jurisdictions, contributions or premiums for the protection of investment accounts are paid by investment account holders themselves. Investment account holders make placements with the Islamic banks for Shariah-compliant investments. Hence, it is appropriate for them to demand that the portion taken from their funds by the Islamic banks to pay contributions or premiums be utilised for permissible activities.

3. Facilitate effective implementation of the System

An IDIS is effective when, among other things, mandatory membership is imposed on the Islamic banks.¹³ However, if the system is not Shariah-compliant, Islamic banks may be reluctant to join the system and may challenge the membership requirement. Moreover, it is unfair to impose mandatory membership on Islamic banks under deposit insurance systems that are not Shariah-compliant.

Another aspect in the effective implementation of an IDIS is the adequacy of legal powers to carry out the mandate of providing deposit insurance and resolving failed Islamic banks. Hence, it is paramount that provisions of law are based on rulings of Shariah scholars in which the uniqueness of Islamic banks' operations is appropriately dealt with.

4. Assist in mitigating the consequences of Shariah non-compliance risk

¹² This may have legal implications, depending on how the modalities are applied as well as the underlying Shariah arrangements. It may just be limited to a religious issue that implementation of the IDIS is not aligned with Islamic teachings.

¹³ This is stated in IADI Core Principle 7 (Membership).

Incidences of Shariah non-compliance may expose the DI to certain risks, namely reputational, legal and financial.

- Reputational risk – Non-compliance with Shariah rulings may damage the image of a DI which claims to have implemented an IDIS but in actual fact does not comply with Shariah requirements. Reputational risk also results in governance risk as this involves an unfavourable perception of the BOD, since it is responsible for ensuring that the DI complies with Shariah. Reputational risk is not confined to the DI; it may spill over at the country level as deposit insurance is a national initiative by governments.
- Legal risk – This might arise when Shariah rulings or Islamic finance specificities are not taken into account in the legal documentation (laws, regulations, etc.) defining the mandate to provide deposit insurance. As a result, the DI does not have adequate powers to deal with protection for Islamic deposits and investment accounts, or to resolve an Islamic bank (see the above explanation of how Shariah governance can facilitate the implementation of an effective IDIS).
- Financial risk – The DI is exposed to the risk of financial losses when investments are not made in Shariah-compliant instruments. As a result, income or returns from such investments are not recognised and must be channelled to charitable bodies. Likewise, in cases where the DI has the power to provide financing to Islamic banks in distress and where a going-concern approach is an appropriate resolution option, profits achieved using non-permissible instruments are not supposed to be recognised. Although DIs are not profit-making entities, it is still appropriate for the DI to consider this risk, as profit that can be recognised will be an additional source of funding for IDIS operations.

IDIS OPERATIONS – AREAS REQUIRING SHARIAH COMPLIANCE

Before discussing Shariah governance for IDIS, it is essential to understand IDIS operations so as to identify areas that require Shariah compliance. Identification of these areas can help the DI to form a view of the complexity of complying with Shariah, and thus the extent of Shariah governance required.

IDIS are designed to provide protection for Islamic deposits and investment accounts in the Islamic banks. Such protection will come into effect when there is an Islamic bank failure. In providing such protection, an IDIS is funded by periodical contributions or premium payments. Regarding the protection for Islamic deposits, the contributions or premiums are paid by the Islamic banks. As regards funding of protection for investment accounts, practice varies, with funding being sourced either from investment account holders or from the Islamic banks.

The DI ensures that the contributions or premiums received are managed and utilised for permissible activities. In a dual deposit insurance system, where the DI operates an IDIS alongside a conventional deposit insurance system, collections for the respective systems are maintained separately in an Islamic deposit insurance fund (IDIF) and a conventional deposit insurance fund, so that

the Shariah-compliant status of contributions or premiums for the IDIS can be maintained.

In the normal course of their operations, the DIs mainly utilise the IDIF for expenditures and invest surpluses in approved instruments. These are in accordance with Shariah.

In the case of an Islamic bank failure, if the institution is wound up, the IDIF are utilised for reimbursing the failed Islamic bank's insured depositors and investment account holders. Where the DI has a wider mandate such as resolution of a failed Islamic bank, the IDIF are used for appropriate resolution options, e.g. bridge institutions, purchase and assumption, etc.

Where the DI need additional funds to carry out their mandates, they must source the funds using Shariah-compliant instruments. Funds can be obtained from, inter alia, the government or other entities, including private institutions through the issuance of *sukuk*.

To sum up, the IDIS operations that are subject to Shariah compliance include:

- (a) Contributions or premiums received from the Islamic banks are correctly channelled and maintained by the DI in the IDIF. Where contributions or premiums for the protection of investment accounts are maintained separately from those received for the protection of deposits, the DI ensures the segregation of contributions or premiums;
- (b) Only permissible expenditures are charged to the IDIF;
- (c) Investments are made in Shariah-compliant instruments only;
- (d) Investment returns that are generated from non-Shariah-compliant instruments are treated appropriately based on the DSS' rulings e.g. distributions to charitable bodies;
- (e) Payments to insured depositors and investment account holders are made from appropriate funds, i.e. the IDIF;
- (f) Sources of external funds (if any) are Shariah-compliant. For instance, if the DI borrows from the government, the agreement between the DI and the government does not contain an interest (*riba*) element; and
- (g) Resolutions of failed Islamic banks take into account the unique characteristics of the institutions and retain the Shariah-compliant status of the business.

DIs will need to address different items on this list, depending on their mandate. In the case of DIs with the pay box model, their operations are relatively less complex than the other models i.e. pay box plus, loss minimiser and risk minimiser, particularly with the exclusion of item (g). However, the operations of the DI under the pay box model can be more complex if, for instance, the DI is rigorous in its investment activities and external funding (with a wide array of instruments), which will require adequate screening of structures and documentation of investment and funding instruments.

For the other three models, the areas that warrant Shariah compliance arise from the additional mandate to resolve failed Islamic banks. The Islamic businesses of the Islamic banks can be complicated and the options to resolve them are varied. Understanding the complexity of IDIS operations may provide

the DI with an insight into the extent of Shariah governance practices required for these operations.

Additionally, the level of compliance with Shariah principles would also depend on the institutional set-up of the DI. A full-fledged IDIS like Sudan, where conventional banking is prohibited, needs to have in place a comprehensive Shariah governance framework to govern its business and operations.

However, for a DI that implements an integrated deposit insurance system i.e. IDIS and conventional deposit insurance system (CDIS) administered under a single DI such as Nigeria and Malaysia, the implementation of Shariah principles is applicable only to the IDIS operations. The following table depicts the applicability of Shariah governance to the DI that implements a full-fledged IDIS and an integrated DIS.

Table 1: Applicability of Shariah governance to a full-fledged IDIS and an integrated DIS

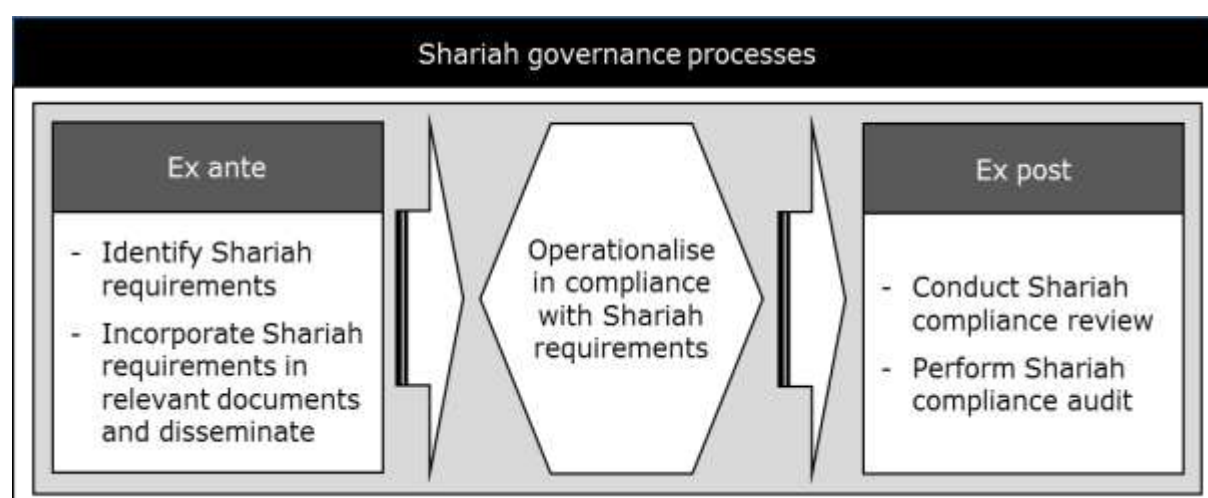
Operational aspects	Full-fledged IDIS	Integrated DIS	
		IDIS	CDIS
<u>Sources and uses of funds</u>			
(i) Premiums received from the Islamic bank are maintained separately in IDIF.	Yes	Yes	No
(ii) Only permissible expenditures are charged to IDIF.	Yes	Yes	No
(iii) Investments are made in Shariah compliant instruments.	Yes	Yes	No
(iv) Investment returns that are generated from non-Shariah compliant instruments are treated appropriately based on the Shariah scholar's rulings. For example, distributions to charitable bodies.	Yes	Yes	No
(v) Sources of external funds (if any) are Shariah compliant. For instance, if the DI borrows from the government, the agreement between the DI and the government does not contain interest (riba) element.	Yes	Yes	No
<u>Failure resolution</u>			
Resolutions of failed Islamic bank take into account unique characteristics of the institutions and retain Shariah compliant status of the business.	Yes	Yes	No

Operational aspects	Full-fledged IDIS	Integrated DIS	
<u>Reimbursing depositors</u>			
Payments to insured depositors and IAH are made from IDIF.	Yes	Yes	No
Priority of payments to the depositors and IAH, whether IAH are ranked pari passu or below depositors.	Yes	Yes	No

SHARIAH GOVERNANCE FOR IMPLEMENTATION OF IDIS

Shariah governance for IDIS refers to processes and structures adopted by DIs to ensure compliance with Shariah requirements. They should be commensurate with and proportionate to the nature and complexity of IDIS operations. This section discusses the processes and structures that can be adopted by DIs to ensure that they are in compliance with Shariah in relation to IDIS operations.

Diagram 1: Shariah governance processes for IDIS operations



1. Identification of Shariah Requirements for IDIS Operations

To implement a deposit insurance system that is Shariah-compliant, the identification of Shariah requirements for IDIS operations is critical. Otherwise, the DI would not know which specific operations are subject to Shariah requirements, and the initiative to put in place the required Shariah governance processes and structures would be blunted.

In identifying Shariah requirements for IDIS operations, the DI should understand or seek Shariah rulings – pronouncements or decisions provided by Shariah scholars. Shariah rulings form the basis of IDIS policy objectives and

design features, which should be binding¹⁴ upon the DI. The requirement to have and adhere to the rulings distinguishes IDIS from conventional deposit insurance systems.

When obtaining Shariah rulings, the areas of IDIS operations that require such rulings should be comprehensively identified. Based on the discussion provided in the previous section on "IDIS Operations", Shariah rulings on IDIS should be sought for, inter alia, the following:

(a) Modalities of IDIS

IDIS are permissible in Islam, on the basis that they are designed to protect people's assets in the form of Islamic deposits and investment accounts placed with the Islamic banks. Nevertheless, it is necessary that, while such a system is permissible, it is also implemented in accordance with Shariah.

Among the areas of concern is the manner or mechanism used by the DI to provide protection; for example, major uncertainty (*gharar*) or an interest (*riba*) element must not be present. The DI may address this concern through the adoption of structures based on underlying Shariah concepts (referred to in this paper as modalities). Currently, the Shariah concepts that have been adopted for IDIS are *takaful* and *kafalah*.¹⁵

It is paramount that Shariah scholars provide opinions on what modalities should be adopted for IDIS, with consideration given to the implications of the adopted concepts for the design features and effectiveness of the system.

(b) Types of deposits or investment accounts that can be covered

In one of its discussion papers,¹⁶ IDITC concluded that Shariah allows Islamic deposits and investment accounts to be protected under IDIS, where protection for the latter can be provided under a third-party guarantee. Hence, the decision not to protect certain deposits or investment accounts is driven by the public policy objectives of individual jurisdictions. Nevertheless, it is still appropriate for the DI to seek the opinions or decisions of Shariah scholars as regards protection for these products, in view of the continuing widespread divergence in Shariah interpretations by Shariah scholars.

(c) Funding of coverage

With respect to the protection of Islamic deposits, funds are sourced from the Islamic banks. However, for the protection of investment accounts,

¹⁴ Shariah rulings become binding when, for example, the DI incorporates them into documentation such as laws and regulations, or when the policies have been approved by the DI's board of directors.

¹⁵ These modalities are not detailed in this paper as the information can be found in IDITC's discussion paper, *Shariah Approaches for the Implementation of Islamic Deposit Insurance Systems*.

¹⁶ IDITC discussion paper, *Insurability of Islamic Deposit and Investment Accounts*.

rulings should be sought on the sourcing of funds for such protection. The current practice appears to be that funds for the protection of investment accounts are sourced either from the investment account holders themselves or from the Islamic banks.

(d) Management and utilisation of contributions or premiums

The DI should ensure that the IDIF is managed separately from the conventional deposit insurance fund, and that the IDIF is not used for non-permissible activities. With regard to utilisation of contributions or premiums, rulings may be sought on, among other things, the basis for allocating expenditures under a dual deposit insurance system (where the IDIS operates alongside a conventional deposit insurance system) and the treatment of income from non-permissible investments.

(e) Arrangements or instruments for additional funding

When winding up an Islamic bank, the DI reimburses insured depositors and investment account holders up to the coverage limit. However, in the event of a shortfall in the IDIF, rulings may be sought from Shariah scholars as to whether borrowing from the conventional fund (in the case of a DI that administers a dual deposit insurance system and segregates the IDIF from the conventional deposit insurance fund) is allowed, with consideration given to the need for the DI to have immediate access to funds for prompt reimbursement.

In cases where DIs source additional funds externally to meet their liquidity needs, the instruments should be structured according to Shariah requirements.

(f) Resolution of failed Islamic banks

Where an Islamic bank is liquidated, the place of Islamic deposits and investment accounts in the priority of payment claims should be determined, among other things.

In cases where the DI's mandate is wider than just a pay box model, rulings should be sought on how resolution approaches (e.g. bridge institution, purchase and assumption, assumption of control and receivership) should be implemented to, inter alia, preserve the interests of the affected stakeholders in light of, among other things, the various Shariah contracts that were used to structure the products and services offered by the failed Islamic banks.

Shariah rulings on IDIS matters should be obtained from Shariah scholars, who are qualified in areas such as Usul Fiqh (principles of Islamic law) and Fiqh Muamalat (Islamic commercial law). The responsibilities of Shariah scholars are not confined to providing rulings, but also include other Shariah expertise such as reviewing compliance. For the purpose of this paper, the scholars are referred to as "designated Shariah scholars" (DSS).

The DI can use three types of DSS when seeking rulings on IDIS matters. Based on the current structures in the Islamic finance industry, these types are:

- (a) A national or centralised Shariah board;
- (b) External Shariah consultants; and
- (c) Shariah personnel of the DI.

The national or centralised Shariah board¹⁷ can be regarded as the highest authority providing rulings on Islamic finance in a given jurisdiction. This structure has been set up for the IFSI in several jurisdictions.¹⁸ Hence, it provides an avenue for the DI to leverage on such board to obtain rulings on IDIS, since IDIS falls under the ambit of Islamic finance.

The DI may also engage external Shariah consultants to provide rulings on IDIS. External Shariah consultants are qualified scholars outside the entity, engaged by the DI to provide the required expertise. Again, depending on the need, they can be a group of people, e.g. a committee or a firm's scholars, or an individual.

Alternatively, qualified persons may be hired by the DI as personnel with responsibility for identifying Shariah requirements for IDIS operations. Shariah personnel of the DI can be mandated to provide rulings in cases where the DI does not refer to a national or centralised Shariah board for rulings, either because there is no such structure in the jurisdiction concerned, or because there is such board but the DI chooses not to consult it for whatever reason.

The decision to consult a DSS structure may be guided by the acceptability of a particular structure in a jurisdiction, especially because the DI is responsible for a national initiative, in which Shariah rulings have an impact on many stakeholders. This may be a concern if the DI relies solely on its Shariah personnel rather than on external Shariah consultants or the national or centralised Shariah board, although all three forms of DSS are subject to an independence requirement. To address such concerns, the DI may need to provide for the adoption of a particular DSS structure in the legislation. If the DI does not address this through legislation, the DI may face challenges over whether any Shariah rulings provided by the DSS are legally binding. If there is no such issue, it would be flexible for the DI to use the structure that is more appropriate or practicable for it.

Shariah rulings should be issued only through appropriate due process. The matters for Shariah consideration should be identified by the DSS and their deliberation should be rigorous.

The necessity to involve the DSS in identifying matters for Shariah consideration is critical to ensure that concerns are genuine and deliberations are effective and efficient (e.g. from a timing perspective). If there is no such involvement, there is a risk that the DI may not be aware of, or may overlook, certain operations that are not compliant with Shariah requirements.

¹⁷ In the IFSI, they are known as the National Shariah Advisory Council, National Fatwa Council, and High Shariah Board etc.

¹⁸ National or centralised Shariah boards have been set up in jurisdictions like Indonesia, Kuwait, Malaysia, Pakistan, Sudan and the UAE.

The DI may use different types of DSS when seeking Shariah rulings and identifying matters for Shariah consideration. For instance, if the DI wishes to seek a ruling from the national or centralised Shariah board, its own Shariah personnel or external Shariah scholars can assist it in identifying the matters to be deliberated.

In providing their Shariah rulings, the DSS should have an adequate knowledge and understanding of IDIS operations, especially the matters being raised for their deliberation. While the three types of DSS must possess Shariah qualifications, it is not envisaged that the national or centralised Shariah board and external Shariah consultants (collectively referred to as external DSS) who are engaged to provide rulings must understand IDIS operations in great details. They are outside the organisation and only engaged by the DI when the need arises and for specific matters.

Thus, in ascertaining the adequacy of their knowledge and understanding of IDIS operations, the DSS (particularly the external DSS) should be assisted by the management through the provision of timely and adequate information. Where relevant, the external DSS should be subject to appropriate confidentiality requirements. It is also helpful that the HODs or operating personnel who are well versed in the operations are present at the DSS deliberations. Where necessary, research may also be conducted to provide perspective and opinions or suggestions on the matters being raised.

As regards Shariah personnel of the DI, they should possess a sound understanding of IDIS operations, as a result of day-to-day involvement or exposure and continuous training. The DI's use of Shariah personnel as its DSS may provide an advantage in ensuring appropriate rulings on IDIS operations.

Shariah rulings should be obtained prior to putting the IDIS into operation. However, there may be instances in which, for whatever reason, certain matters for Shariah consideration are only identified once operations are up and running. These matters should be brought before the DSS for rulings as and when they are identified.

It is critical to note that, most importantly, DIs are guided by Shariah rulings when developing policies for an IDIS and when implementing the system. Obtaining rulings from the DSS is just one way to achieve this. It is not necessary that all matters under consideration are rigorously deliberated by the DSS. Shariah rulings that are relevant to IDIS may also be available from rulings that have been sought for other areas of Islamic finance. Hence, available and relevant rulings should be examined prior to deciding whether there is a need for rigorous deliberation. For instance, it is acceptable that rulings on Islamic banking business, stating that Islamic banks are prohibited from investing in non-Shariah-compliant instruments, be adopted for IDIS, and that the DI should be subject to the same requirements in respect of the IDIF.

Shariah rulings provided for IDIS and other Islamic finance areas are available from other jurisdictions or from academic literature. However, it is best practice that rulings are sought from the DSS to ensure that they are applicable in

appropriate contexts, taking into account the local environment and latest developments.

2. Incorporation of Shariah Requirements into Relevant Documents and Dissemination to the BOD and Personnel with Shariah Governance Responsibilities

Having identified Shariah requirements for IDIS operations, the DI should then incorporate the requirements into relevant documents such as legislation, policies, guidelines etc, and disseminate such requirements, where relevant, to the BOD and the personnel with Shariah governance responsibilities (the management as well as those involved in Shariah compliance review and audit functions).

The main objectives of incorporating Shariah requirements into relevant documents include:

- (a) Transform Shariah rulings into binding or enforceable requirements;
- (b) Serve as a reference for the BOD and the personnel with Shariah governance responsibilities; and
- (c) Provide guidance to the HODs and operating personnel on how operations that are subject to Shariah requirements should be conducted.

For instance, Shariah requirements on investing IDIF should be provided for in the legislation or specified in internal policy documents. In addition, the DI's powers to resolve a failed Islamic bank in compliance with Shariah should be provided for in the legislation.

Shariah requirements should be communicated to the personnel in charge of incorporating the requirements into relevant documents, such as the head of the legal division and the HODs who are responsible for operations that are subject to Shariah requirements. These HODs are responsible for ensuring that Shariah requirements are properly incorporated into their documents. In that process, assistance can be sought from the DSS to avoid misinterpretation of the Shariah requirements.

Shariah requirements should also be disseminated to the BOD and the personnel with Shariah governance responsibilities, through appropriate mediums or means. The HODs and operating personnel should also be made aware of the Shariah requirements in relation to specific operations under their responsibility. The knowledge and awareness of Shariah requirements by all these parties is critical to ensure the orderly implementation of Shariah governance.

Once the Shariah requirements have been disseminated to the operating personnel, it is the responsibility of the heads of operating divisions to ensure that they are complied with. For instance, the head of the finance division must ensure compliance with regard to the separate management of the IDIF and the conventional deposit insurance fund. The HOD responsible for investment activities must ensure Shariah compliance with regard to the investment of IDIF surpluses. In the course of operations, HODs can be assisted by the DSS (i.e.

Shariah personnel or external Shariah consultants) through provision of day-to-day Shariah advisory services.

To ensure that the operating divisions are in compliance with Shariah requirements, the DI should institute ex post processes and appropriate structures that provide for verification, assessment or examination of such compliance. This is done through the Shariah compliance review and audit functions. Without such follow-up, the DI would not be able to monitor the consistency of its Shariah compliance and effectively manage any Shariah non-compliance risk that may arise over time.

3. Shariah Compliance Review

The IFSB defines a Shariah compliance review as a process of verifying that Shariah compliance has been satisfied, during which any incident of non-compliance is recorded and reported, and as far as possible, addressed and rectified.

The AAOIFI defines a Shariah review as the examination of the extent of an Islamic institution's compliance, in all its activities, with Shariah. This examination includes contracts, agreements, policies, products, transactions, memoranda and articles of association, financial statements, reports, circulars, etc. The objective of the review is to ensure that activities carried out by the institution do not contravene Shariah.

In the context of IDIS, "Shariah compliance review function" refers to the regular independent assessment, by qualified officers, of Shariah compliance in the activities and operations of the DI, with the objective of ensuring that such activities and operations do not contravene Shariah.¹⁹ It involves the examination and evaluation of the DI's level of compliance with Shariah requirements, remedial measures to resolve non-compliance and control mechanisms to avoid recurrences. The scope covers the DI's overall operations, including the end-to-end collection of premiums, utilisation of contributions for expenditures, investments, and intervention and failure resolution of an Islamic bank.

The responsibilities of the Shariah compliance review function include, but are not limited to, the following:

1. Assess the appropriateness of the DI's compliance procedures and guidelines, promptly follow up any identified deficiencies and, where necessary, formulate proposals for amendments;
2. Review relevant documentation of transactions entered into by the DI;
3. Identify, document and assess Shariah compliance risks associated with IDIS operations;
4. Monitor and test Shariah compliance by performing sufficient and representative compliance testing;

¹⁹ This definition is adopted from Bank Negara Malaysia's Shariah Governance Framework for Islamic Financial Institutions.

5. Institute remedial measures to resolve Shariah non-compliance and control mechanisms to avoid recurrences;
6. Report on a regular basis to the management on Shariah compliance matters.
7. Incorporate or help to incorporate Shariah rulings into relevant documents such as laws, regulations, policies and procedures;
8. Seek rulings from the DSS on identified areas; and
9. Educate personnel on Shariah requirements and compliance issues, and act as a contact point within the DI for compliance queries from personnel.

The “qualified officers” conducting Shariah compliance reviews are the Shariah personnel of the DI. In addition to the provision of rulings, the Shariah personnel will facilitate the effective conduct of a review on the basis that they are well versed in Shariah requirements, and they understand the IDIS operations as a result of day-to-day involvement or exposure and continuous training. Where a DI does not have Shariah personnel but has a separate division, e.g. compliance division, to perform compliance activities for the organisation, the DI may include the Shariah compliance function as part of the responsibilities of the division (with the exception of compliance with Shariah requirements provided for in the legislation).

The setting-up of an independent Shariah compliance review function offers several advantages to the management in ensuring effective Shariah compliance, namely:

- (a) It provides another independent layer of verification besides the audit function;
- (b) Because it is performed continuously, it allows the management to rectify issues before they are brought to the attention of the BOD by the audit function; and
- (c) Because it is carried out continuously, it allows for timely identification and rectification of issues, and thus helps prevent the DI from being exposed to larger issues or consequences due to late rectifications.

Despite these advantages, the setting-up of an independent Shariah compliance review function warrants a management assessment of the need for such function (e.g. depending on the risk appetite). The function may be critical if certain operations are significant to the DI (e.g. in terms of the size of IDIS operations or major Shariah non-compliance risk to which the DI is exposed), or there have been major or recurring Shariah non-compliance incidences.

As regards compliance with Shariah requirements incorporated into the legislation, the legal division should be responsible for managing compliance with such requirements. If responsibilities with respect to Shariah compliance are split between divisions, the allocation of responsibilities to each division should be formally and clearly specified.

The resources to be provided for the review function should be both sufficient and appropriate to ensure that Shariah compliance within the DI is managed effectively. In particular, the Shariah compliance review personnel should have the necessary knowledge and experience of IDIS operations, keep abreast of developments in Islamic finance, and have an adequate understanding of

Shariah rulings and their impact on IDIS operations. Hence, personnel should be adequately trained to understand the end-to-end IDIS operations and have a firm grasp of the Shariah requirements to which such operations are subject.

Shariah compliance reviews should be performed on a regular basis. The DI should determine the frequency of review, which may be based on the risk appetite of the DI. To ensure the adequacy and effectiveness of the Shariah compliance review function, it should be subject to periodic and independent review by the Shariah compliance audit function.

4. Shariah Compliance Audit

The definitions for a Shariah compliance audit by the IFSB and AAOIFI are interchangeable with the definitions for a Shariah compliance review. In other sources of reference, a Shariah audit is defined as a periodic assessment conducted to provide an independent assessment and objective assurance, and designed to add value and improve the degree of compliance of the Islamic institution's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance.²⁰

In another definition, a Shariah audit is the examination of an institution's compliance with the Shariah in all its activities, particularly the financial statements and other operational components of the institution that are subject to risk compliance, including but not limited to products, the technology supporting the operations, operational processes, the people involved in key areas of risk, documentation and contracts, policies and procedures and other activities that require adherence to Shariah principles.

As for IDIS, the Shariah compliance audit process should be designed to enable the DI to assess whether a sound and effective internal control system for Shariah compliance has been implemented. It should cover, but should not be limited to, the following:

- (a) Understanding IDIS operations to allow for better scoping of an audit exercise, i.e. auditability and relevance of activities;
- (b) Developing a comprehensive internal audit programme or plan, which should include objectives, scope, personnel assignment, sampling, control and duration, and establishing proper audit processes, policies and procedures for IDIS operations;
- (c) Obtaining and referring to relevant sources, including the DSS' published rulings, guidelines, the Shariah audit results and the internal Shariah checklist;
- (d) Conducting Shariah audits on a regular basis;
- (e) Communicating the results of any assessment or findings arising from the Shariah audit to the BOD; and
- (f) Providing recommendations on remedial measures taken, as well as following up on implementation by the DI.

²⁰ This definition is adopted from Bank Negara Malaysia's Shariah Governance Framework for Islamic Financial Institutions.

The scope of the Shariah audit should cover all aspects of IDIS operations and activities, as follows:

- (a) Audit of financial statements – This involves identifying and testing the internal controls used in drawing up the IDIF’s financial statements, in order to provide reasonable assurance of the accuracy of the financial statements.
- (b) Audit of operational aspects – This involves examining the policies and procedures governing IDIS operations. The completeness of policies should be reviewed, in particular whether they incorporate the relevant Shariah rulings and procedures or processes. The design and operational effectiveness of internal controls will also be reviewed.
- (c) Audit of organisational structure – This is aimed at ascertaining whether the organisational structure and the people involved are suitable to ensure Shariah compliance. Among other things, this audit should show the DI whether the Shariah compliance review function within the compliance division is adequate, or whether the DI should have dedicated Shariah personnel to perform such a review function.
- (d) Audit of IT systems – This involves the evaluation and testing of the controls within the IT systems that support IDIS operations. It will provide an indication of the effectiveness of system configurations, i.e. whether the systems used by the DI facilitate the separate management and reporting of the IDIF.

The audit should be performed by competent internal auditors, who should possess adequate skills, which can be acquired through continuous education and training. In particular, internal auditors should have the necessary knowledge and experience of IDIS operations and an understanding of Shariah requirements and their impact on IDIS operations. The acquisition of such knowledge can be facilitated by the Shariah personnel, if any. Where the internal auditors do not have the required skills, the DI may engage qualified external parties to conduct the audit. A Shariah compliance audit of critical areas should be conducted at least once a year, depending on the risk appetite of the DI.

For a Shariah compliance audit to be credible, the audit function has to be independent, i.e. free from any influence that would compromise the ability of the auditors to exercise sound judgement or perform their duties impartially. While administrative reporting to the management and Shariah personnel (if any) is acceptable, the auditors should report functionally to the BOD or BOD Audit Committee.

RESPONSIBILITIES IN RESPECT OF SHARIAH GOVERNANCE

To facilitate effective Shariah governance, it is critical that the roles of the BOD and the personnel with Shariah governance responsibilities are formally and clearly specified. In the previous section, the responsibilities of the BOD and the personnel are briefly outlined, with the exception of the responsibilities of the

Shariah compliance review and audit functions. In this section, the paper examines the responsibilities of the BOD and the management in more detail. The BOD's additional responsibilities under Shariah governance include:

1. Establish a Shariah governance framework for IDIS;
2. Perform oversight of the effective functioning of Shariah governance;
3. Approve policies by adopting Shariah rulings provided by the DSS; and
4. Ensure that rulings of the DSS are implemented.

The management is responsible for ensuring effective management of Shariah compliance by carrying out, among other things, the following tasks:

1. Provide resources and personnel to the organs of Shariah governance;
2. Identify Shariah issues, provide adequate information to the DSS and seek rulings from the DSS; and
3. Incorporate Shariah rulings into relevant documents and implement Shariah rulings.

While the management itself needs to understand IDIS operations and the Shariah requirements, it is also key that the management facilitates the provision of adequate education and training to the BOD members, the DSS and the personnel with Shariah governance responsibilities. Additionally, management should understand the importance of Shariah governance and how incidences of non-compliance will impact on the organisation.

The BOD's understanding of these matters is key to meeting its responsibilities as regards putting in place adequate and effective Shariah governance structures and processes. It can also facilitate the promotion of Shariah compliance culture within the DI, which can effectively be driven from the top.

To promote stakeholders' confidence that IDIS operations are in compliance with Shariah, it is important that they are provided with adequate disclosures. This may be an additional responsibility of the management. Other than the disclosures regarding the Shariah requirements for IDIS operations and financial management, another disclosure that can be made by the management is with regard to how Shariah governance is being practised by the DI.

RECOMMENDED SHARIAH GOVERNANCE GUIDING PRINCIPLES FOR IDIS

Based on the discussion of Shariah governance for IDIS in this paper, the recommended guiding principles are as follows:

Principle 1	<p>The DI should establish adequate Shariah governance framework for IDIS operations.</p> <ul style="list-style-type: none"> • The BOD is responsible for establishing a Shariah governance framework to ensure Shariah-compliant control mechanisms for all aspects of IDIS operations.
--------------------	--

	<ul style="list-style-type: none"> • The management is responsible for supporting the BOD in the effective management of Shariah compliance, by providing adequate resources to every function involved in the implementation of Shariah governance. • The Shariah governance framework should comprise the structures and processes required for the DI to ensure that IDIS operations are in compliance with Shariah requirements. • The DI is responsible for seeking Shariah rulings from the DSS and ensuring that the compliance review and audit functions are adequate and effective, to facilitate compliance.
<p>Principle 2</p>	<p>Shariah governance processes and structures for IDIS should be commensurate with the nature and complexity of their operations.</p> <ul style="list-style-type: none"> • The DI should identify all aspects of IDIS operations that are subject to Shariah requirements. The matters or issues identified should be assessed to determine the need for a ruling by the DSS. • Shariah requirements should be incorporated into relevant documents such as legislation, guidelines, policies and procedures, and disseminated to relevant personnel to facilitate compliance. • The BOD is responsible for the effective oversight of Shariah governance, while the management is responsible for its effective implementation. • Adequate Shariah compliance review and audit functions should be set up, and the divisions or personnel responsible for each function should be clearly and formally specified. • The DI should conduct a formal and independent assessment of the adequacy and effectiveness of Shariah governance processes and structures at an appropriate frequency.
<p>Principle 3</p>	<p>Any person bearing the responsibilities outlined in the Shariah governance framework for IDIS operations should possess the necessary skills.</p> <ul style="list-style-type: none"> • The BOD, the management and any personnel with responsibilities related to IDIS operations should possess the necessary skills and have a knowledge of IDIS

	<p>operations, as well as an understanding of how Shariah rulings impact on operations and how non-compliance affects the DI. For example, the BOD is expected to have a reasonable understanding of Shariah requirements for IDIS operations, and the Shariah personnel responsible for the audit function should have an adequate understanding of Shariah requirements for the IDIS operations carried by the various divisions in the DI.</p> <ul style="list-style-type: none"> • The skills required of any personnel with the responsibilities outlined in the Shariah governance framework should be clearly and formally specified, and should be reviewed independently. For example, Shariah scholars must hold qualifications in areas such as <i>Usul Fiqh</i> (principles of Islamic law) and <i>Fiqh Muamalat</i> (Islamic commercial law). • The DI should draw up and provide adequate training and development programmes to the BOD and personnel with Shariah governance responsibilities, to facilitate the continuous enhancement of knowledge and understanding.
Principle 4	<p>There should be an adequate process to facilitate the effective deliberation of issues by DSS with a view to obtaining Shariah rulings.</p> <ul style="list-style-type: none"> • The DI should ensure that adequate processes are in place to identify issues that require Shariah rulings from DSS. • The DI should facilitate the DSS' understanding of IDIS operations and the identified issues that require Shariah rulings. The DI may conduct internal research or engage an external researcher to provide perspectives or suggestions on the issues. • The DI should provide complete, accurate and timely information to DSS, to facilitate the effective deliberation of the identified issues.
Principle 5	<p>The DSS should ensure that internal information obtained in the course of their duties is kept confidential.</p> <ul style="list-style-type: none"> • DSS are responsible for preserving the confidentiality of internal or privileged information at all times. • The DI should implement an information classification, to facilitate DSS in preserving confidential information that is not public in nature and has not been authorised for

	public release.
Principle 6	<p>The independence of the Shariah compliance review and audit functions should be preserved, so that they can carry out their responsibilities unhindered.</p> <ul style="list-style-type: none"> • A Shariah audit of the Shariah compliance review function should be performed, in order to preserve the independence of such function. • The DI should have in place, among other things, the following requirements to preserve the independence of the Shariah audit function: <ul style="list-style-type: none"> - Auditable areas of IDIS operations are clearly and formally specified, and auditing processes and structures are adequately established; and - Shariah audit findings and recommendations for rectifications should be administratively reported to the management and functionally reported to the BOD Audit Committee.
Principle 7	<p>The DI should provide adequate disclosures to its stakeholders on how Shariah governance is being practised by the organisation.</p> <ul style="list-style-type: none"> • The DI should disclose the involvement of DSS in providing rulings for IDIS operations, and may also disclose whether the DSS are involved in ensuring the DI's compliance. • The DI should disclose how it administers the IDIF. Under a dual system, where the DI administers the IDIS separately from the conventional deposit insurance system, the IDIF should be managed separately from the conventional fund and should only be utilised for permissible activities. • The Shariah governance framework should be communicated to the BOD and all personnel responsible for ensuring compliance with Shariah requirements.

CONCLUSION

Shariah governance assists DIs in ensuring Shariah compliance. It helps them to ensure the legitimacy of the modalities they have adopted, to build and maintain stakeholder confidence, to facilitate the effective implementation of IDIS, and to

mitigate certain risks to which DIs are exposed following incidences of non-compliance.

Practices in implementing Shariah governance for IDIS vary, particularly in terms of the functionaries that should be in place and the required processes. Factors influencing the choice of implementation practice include: the complexity of the IDIS operations that require compliance with Shariah; and the institutional setup of the DI, which is a non-profit-making entity.

Despite the varying practices, it is key that the BOD of the DI ensures that adequate and effective Shariah governance is in place. The management supports the BOD in managing Shariah compliance effectively by, among other things, ensuring that adequate resources are allocated. The implementation of Shariah governance can be effective if Shariah compliance in relation to IDIS operations becomes engrained in the culture of the DI.

Given that IDIS are still at an early stage, the discussion on Shariah governance in relation to IDIS is quite limited, compared to deliberations on corporate governance for deposit insurance systems. IADI, in its CPs, included governance in the principles recommended for deposit insurance systems. Thus, this paper could be among the few available papers that deliberate Shariah governance for IDIS operations.

Moving forward, the subject could be discussed further in practical or academic papers, and deliberated at gatherings such as conferences and seminars. These efforts should be directed towards drawing up required principles for Shariah governance of IDIS, which will assist DIs globally in implementing effective IDIS.

REFERENCES

1. Accounting and Auditing Organization for Islamic Financial Institutions. 2015. Accounting, Auditing and Governance Standards for Islamic Financial Institutions.
2. Bank Negara Malaysia. 2010. Shariah Governance Framework for Islamic Financial Institutions.
3. Basel Committee on Banking Supervision. 2005. Compliance and the Compliance Function in Banks.
4. International Association of Deposit Insurers. 2014. IADI Core Principles for Effective Deposit Insurance Systems.
5. International Association of Deposit Insurers. 2014. Insurability of Islamic Deposits and Investment Accounts.
6. International Association of Deposit Insurers. 2014. Shariah Approaches for the Implementation of Islamic Deposit Insurance Systems.
7. International Shariah Research Academy for Islamic Finance. 2016. Islamic Financial System Principles & Operations, 2nd Edition.
8. Karim Ginena and Azhar Hamid. 2015. Foundations of Shariah Governance of Islamic Banks.
9. Islamic Financial Services Board. 2006. Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds).
10. Islamic Financial Services Board. 2009. Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services.
11. Islamic Financial Services Board, Islamic Development Bank and Islamic Research and Training Institute. 2010. Islamic Finance and Global Financial Stability. Strengthening Financial Safety Nets.
12. Islamic Financial Services Board. 2015. Draft Working Paper on Strengthening the Financial Safety Net: The Role and Mechanisms of Shariah-Compliant Deposit Insurance Schemes.
13. Islamic Financial Services Board. 2015. Islamic Financial Services Industry Stability Report 2015.
14. Syed Alwi Mohamed Sultan. 2007. Shariah Audit for Islamic Financial Institutions – A Primer.