ISLAMIC FINANCIAL SERVICES BOARD

EXPOSURE DRAFT (ED-30)

REVISED GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES (BANKING SEGMENT)

22 March 2023

Comments on this Exposure Draft should be sent to the IFSB Secretariat no later than 20 May 2023 by email to: public_consultation@ifsb.org

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, issuing exposure drafts and organising public hearings/webinars and reviews by the IFBS's Sharīʿah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues and organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ABBREVIATIONS

AAOIFI	:	Accounting and Auditing Organisation for Islamic Financial Institutions
BCBS	:	Basel Committee on Banking Supervision
BCP	:	Business Continuity Plan
CEO	:	Chief executive officer
CFO	:	Chief financial officer
CFR	:	Climate-related financial risk(s)
CIS	:	Collective investment schemes
CPIFR	:	Core principles for Islamic finance regulation
CRO	:	Chief risk officer
DSIBs	:	Domestic Systemically Important Banks
ESG	:	Environmental, social and governance
FSB	:	Financial Stability Board
IA	:	Investment accounts
IAH	:	Investment account holder(s)
IFSB	:	Islamic Financial Services Board
IFSI	:	Islamic financial services industry
IIFS	:	Institution(s) offering Islamic financial services
IRR	:	Investment risk reserve
ISCU	:	Independent *Sharī`ah* Compliance Unit
ISSB	:	International Sustainability Standard Board
IT	:	Information technology
OECD	:	Organisation for Economic Co-operation and Development
PER	:	Profit equalisation reserve
RAS	:	Risk appetite statement
RCG	:	Revised guiding principles on corporate governance
RSAs	:	Regulatory and supervisory authorities
RSGF	:	Revised *Sharī`ah* Governance Framework
SDGs	:	Sustainable development goals
SIBs	:	Systemically important banks
SIFIs	:	Systemically important financial institutions
SSB	:	*Sharī`ah* supervisory board
TCFD	:	Task force on Climate-related Financial Disclosures
WG	:	Working group

Bismillahirrahmanirrahim

Allahumma salli wasallim ‘ala Sayyidina Muhammad wa’ala alihi wasahbihi

1. INTRODUCTION

1.1. Background

1. The importance of corporate governance has been widely recognised, as observed during previous financial crises.[1] Weaknesses in corporate governance arrangements can cause institutions to engage in excessive risk taking, which may result in institutional failures. As banks perform a crucial role in the economy by intermediating funds to support enterprise and help drive economic growth, their safety and soundness are key to financial stability. Failures in a specific financial institution may induce greater risk in the financial system due to increasing interdependencies across entities and sectors, among other factors.

2. Islamic banks, as the major contributor to the Islamic financial services industry (IFSI), play a significant role in determining the robustness and stability of the IFSI and even the economy as a whole; particularly in jurisdictions where Islamic banks are considered as domestic systemically important banks (DSIBs). Therefore, establishing an effective corporate governance framework is imperative to ensure proper functioning of the Islamic banking sector while upholding conformity to *Sharī`ah* rules and principles.

3. The Islamic Financial Services Board (IFSB) firstly issued IFSB-3: *Guiding Principles on Corporate Governance for Institutions offering Islamic Financial Services (excluding Islamic Insurance [Takaful] Institutions and Islamic Mutual Funds)* in 2006. The document was intended to supplement the relevant conventional corporate governance standards by addressing only Islamic finance specificities. Thus, the guiding principles primarily focus on (i) safeguarding the rights of Investment Account Holders (IAH) and (ii) ensuring compliance with *Sharī`ah* principles.[2]

4. Subsequent to that issuance, there have been substantial changes of global regulations especially post-global financial crisis – i.e., BCBS and OECD updated their standard on corporate governance in 2015 – and emerging issues which include cyber risks,

[1] See OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages,* June 2009, [Corporate governance and the financial crisis - OECD.](#)

[2] At the time, IFSB had not issued IFSB-10: *Sharī`ah Governance Framework*, which was issued in 2010.

climate-related financial risks (CFR),[3] and sustainable development goals (SDGs) that need to be addressed.

5. The Revised IFSB Guiding Principles on Corporate Governance for the Banking Segment (hereinafter referred to as "the Guiding Principles") is designed to facilitate institutions offering Islamic financial services (IIFS) in identifying areas where governance structures and processes are required, and to recommend best practices in addressing these issues. The document is not intended to establish a wholly new regulatory framework in contrast to the existing international standards or national regulations; rather, it is intended to complement the prevailing relevant standards/regulations by (i) assisting Regulatory and Supervisory Authorities (RSAs) in assessing and refining the quality of the corporate governance framework respective to the IIFS, and (ii) facilitating IIFS in evaluating the adequacy of its existing corporate governance frameworks and improving any identified deficiencies.

6. This standard builds upon the BCBS Guidelines on "*Corporate Governance Principles for Banks"* (hereinafter referred to as *"BCBS Guidelines"*) released in July 2015 by incorporating common principles of conventional and Islamic finance and amending and further enhancing them to deal with Islamic finance specificities and several emerging issues. The development of the Guiding Principles also benefited immensely from pertinent international standards and/or documents issued by other international standard setters,[4] regulations from RSAs across jurisdictions offering Islamic financial services, relevant IFSB standards[5] (including those that have been issued and ongoing projects/ revisions), the working group's (WG) own deliberations, and the guidance from the IFSB Technical Committee.

7. These Guiding Principle address additional areas of governance compared to IFSB-3, to provide a complete set of guidance that is aligned with BCBS Guidelines. It also places more emphasis on the following subject matters: (i) reinforcement on the collective oversight

[3] BCBS recently published *"Principles for the effective management and supervision of climate-related financial risks"* in June 2022.

[4] Mainly from BCBS, G20/OECD *"Principles of Corporate Governance"* (2015), Financial Stability Board (FSB), Task Force on Climate-related Financial Disclosures (TCFD) on "*Recommendations of the Task Force on Climate-related Financial Disclosures"* (2017), and AAOIFI "Code of Ethics for Islamic Finance Professionals" (2021).

[5] IFSB has published a range of standards that specifically or partially address corporate governance, i.e., IFSB 1: *Guiding Principles of Risk Management for IIFS (Banking Sector)* (2005), IFSB 9: *Guiding Principles on Conduct of Business (Banking)* (2009), IFSB 10: *Guiding Principles on Sharī`ah Governance Systems for IIFS* (2009) and its ongoing revision (RSGF), IFSB 16: *Revised Guidance on Key Elements in the Supervisory Review Process of IIFS (Banking Segment)* (2014), IFSB 17: *Core Principles for Islamic Finance Regulation (Banking Segment)* (2015), and IFSB 22: *Revised Standard on Disclosures to Promote Transparency and Market Discipline for IIFS (Banking Segment)* (2018).

and risk governance responsibilities of the board; (ii) key components of risk governance such as risk culture and risk appetite, and their relationship to a bank's risk capacity; (iii) delineation of the specific roles of the board, board risk committees, *Sharī`ah* Supervisory board (SSB),[6] senior management and the control functions, including the chief risk officer (CRO) and internal audit; (iv) strengthening institutions' overall checks and balances, (v) incorporation of emerging risks such as CFR and cyber risks, and (vi) disclosure on the impact of Islamic social finance and its alignment with the United Nations Sustainable Development Goals (SDGs).

8. Based on these considerations, the 37th IFSB Council Meeting in December 2020 approved the initiative to develop the Guiding Principles. The importance of this work is further confirmed by survey results from both RSAs and market players across jurisdictions; the results of the survey informed the development of this standard.

1.2. Objectives of the Guiding Principles

9. The main objective of corporate governance is to protect the interests of stakeholders, insofar as it is consistent with public interest on a sustainable basis. This is done by ensuring that robust governance mechanisms are in place to minimise agency costs – i.e., prevent excessive risk taking – and thereby to minimise the potential of a crisis and preserve financial stability. Among stakeholders, particularly with respect to retail banks, shareholders' interests would come after depositors' and IAHs' interests respectively.

10. The ultimate objective of the Guiding Principles set out in this standard is to strengthen the integrity and resilience of IIFS by enhancing the effectiveness of the corporate governance framework, i.e., to be at par with international best-practices and, thus, to positively contribute to financial stability and sustainable economic growth.

11. The guiding principles are intended to:

(i) provide guidance on areas where minimum governance structures and processes are required for a sound corporate governance framework, including effective *Sharī`ah* governance mechanisms;

[6] *Sharī`ah* Supervisory Board (SSB) in this document refers to SSB or other committee/group of individuals who possess *Sharī`ah* expertise or qualifications with equivalent functions as SSB. See IFSB-10 definition on *Sharī`ah* Board.

(ii) protect the interests of stakeholders in conformity with the public interest; among stakeholders, primary concern should be given to (a) depositors, (b) unrestricted IAH, (c) restricted IAH, and (d) shareholders respectively;[7]

(iii) strengthen IIFS transparency and accountability to enhance stakeholders' trust and confidence;

(iv) promote financial sustainability by implementing a holistic approach to include financial and non-financial criteria.

1.3. General Considerations for Governance of IIFS

12. The notion of corporate governance with its attached norms and values is naturally in conformance with Islamic teachings that promote good ethics, strong morals, integrity, and honesty.[8] Thus, corporate governance, from an Islamic perspective, incorporates the integration of moral dimensions and ethical values into IIFS business operations and activities. This means that an IIFS decision-making process – from strategic decisions to day-to-day business – has to incorporate moral and ethical values and this should be embedded into the corporate culture of the IIFS.

13. The IIFS, as part of the wider Islamic economy ecosystem, should aim to contribute to the pursuance of *Maqāṣid al-Sharī'ah*, an overarching concept that encompasses the protection of religion/faith, life, intellect, wealth, and progeny. Accordingly, an IIFS, as a corporate body governed by the principles laid out in Islam, must strictly fulfil its obligations to all stakeholders insofar as it operates within the confines of *Sharī`ah* principles.

14. Several tools that are commonly used in corporate governance include:

(i) internal controls;

(ii) risk management;

(iii) compliance;

(iv) accounting and audit;

(v) transparency (e.g., through disclosures);

(vi) *Sharī`ah* governance including *ex-ante* and *ex-post* procedures;

[7] This Standard will put more emphasis on safeguarding the interests of IAH to adequately address Islamic finance specificity, while the remaining stakeholders have been fairly dealt with by conventional standards which are equally applicable to IIFS.

[8] According to IFSB-3, the code of ethics has been set out in the Qur'an as follows: (i) honest fulfilment of all contracts (*Al-Māidah*: 1); (ii) prohibition of betraying any trust (*Al-Anfāl*: 27); (iii) prohibition in deriving income from impermissible acts such as cheating, price manipulation, dishonesty, and fraud (*An-Nisāa*: 29); (iv) prohibition of bribery to derive undue advantage (*Al-Baqarah*: 188); and (v) a concern for minimising problems arising from information asymmetry between contracting parties (*Al-Baqarah*: 282).

(vii) regulation and supervision, primarily by RSAs, and can be extended to involve wider internal and external parties through a whistleblowing mechanism.

The effectiveness of the tools above will be highly dependent on the moral commitment – i.e., integrity and accountability – of each organ or individual operating them.

15. Corporate governance determines the allocation of authority and responsibilities by which the business and affairs of an IIFS are carried out by its board and senior management, including how they:

(i) set the corporate strategy and objectives;
(ii) select and oversee personnel;
(iii) operate IIFS business on a day-to-day basis;
(iv) protect the interests of depositors, accord due rights to IAHs, meet shareholders' obligations, and take into account the interests of other recognised stakeholders;
(v) align corporate culture, corporate activities, and behaviour with the expectation that the IIFS will operate in a safe and sound manner with integrity and in compliance with applicable laws, regulations, and *Sharī`ah* principles;
(vi) establish control functions; and
(vii) establish a robust *Sharī`ah* governance framework.

16. Supervisors have a keen interest in sound corporate governance, as it is an essential element in the safe and sound functioning of an IIFS and may adversely affect the IIFS's risk profile if it is not operating effectively. Well governed IIFS contribute to the maintenance of an efficient and cost-effective supervisory process, as there is less need for supervisory intervention.

17. Sound corporate governance may permit the supervisor to place more reliance on the IIFS's internal processes. In this regard, supervisory experience underscores the importance of having the appropriate levels of authority, responsibility, accountability, and checks and balances within each IIFS, including those of the board of directors, SSB, and senior management, and the risk management, compliance, and internal audit functions.

18. The increased focus on risk and the supporting governance framework includes identifying the responsibilities of different parts of the organisation for addressing and managing risk. Often referred to as the "three lines of defence", each of the three lines has an important role to play. The business line – the first line of defence – has "ownership" of risk, whereby it acknowledges and manages the risk that it incurs in conducting its activities. The risk management function is responsible for further identifying, measuring, monitoring, and reporting risk on an enterprise-wide basis as part of the second line of defence, independently

from the first line of defence. The compliance function is also deemed part of the second line of defence. The internal audit function is charged with the third line of defence, conducting risk-based and general audits and reviews to provide assurance to the board that the overall governance framework, including the risk governance framework, is effective and that policies and processes are in place and consistently applied.

19. Among their other responsibilities, board members and senior management are expected to define conduct risk – and identify possible cases of misconduct – based on the context of IIFS business. The board should set the "tone at the top" and oversee management's role in fostering and maintaining a sound corporate and risk culture.

20. Some specific governance mechanisms are required to properly address Islamic finance specificities, e.g., due to different implications of Islamic finance contracts. Among others, investment accounts, with their profit and loss sharing arrangements,[9] will bring unique implications – in terms of risk, operation, reporting, treatment of IAHs, etc., – and therefore must be dealt with accordingly.

21. Effective implementation of sound corporate governance requires relevant legal, regulatory, and institutional foundations – including appropriate provisions within the legal and regulatory framework to support SSB to effectively carry out its duties and responsibilities. A variety of factors, including the system of business laws, stock exchange rules, and accounting standards, can affect market integrity and systemic stability. Such factors, however, are often outside the scope of banking supervision. RSAs are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so. Where it is not, RSAs may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in promoting or requiring sound corporate governance.

1.4. General Approach of the Standard

22. The Guiding Principles aim to comprehensively capture the overarching aspects of corporate governance as the main framework. *Sharī`ah* governance is an integral part of IIFS corporate governance for which a separate IFSB standard is dedicated to provide more detailed provisions on *Sharī`ah*-related matters, and shall be implemented in conjunction with the Guiding Principles. While an essential feature of IIFS is the requirement to comply with *Sharī`ah* rules and principles, this document only deals with the prudential requirements that

[9] Some contracts that are commonly used are *muḍārabah*, *mushārakah,* and *wakālah*. IFSB recognizes the practice in some jurisdictions where *commodity murābaḥah* is also used in their Islamic financial services offerings.

aim to ensure *Sharī`ah* compliance by IIFS within the framework of corporate governance. It is not to be understood as approving any specific *Sharī`ah* ruling or *fatwā* of any kind.[10]

23. A principle-based approach is used to develop this document as it leaves more room for discretion on the mechanisms and procedures to arrive at the intended outcomes. Accordingly, the guiding principles shall be viewed as current but subject to periodic review as the aim is to promote efficient corporate governance that is goal-driven and goes beyond merely ticking compliance check lists.

24. BCBS Guidelines and IFSB-3 are used as primary documents in developing this standard. It builds on the BCBS Guidelines, and adapts or supplements them only to the extent necessary to deal with the distinct characteristics of Islamic finance and to include some recent issues. In addition, IFSB-10 on *"*Sharī`ah *Governance Systems for IIFS"*[11] serves as the main reference, wherever applicable, for any matters related to *Sharī`ah* governance; mainly to ensure harmony and consistency among IFSB standards.

25. The initial point for developing the Standard is done by taking principles and detailed text from BCBS Guidelines and IFSB-3 as two primary documents. Further developments are conducted in the following actions:

(i) retaining principles and detailed text that are equally applicable for both conventional and Islamic finance;

(ii) amending relevant parts – mostly in the detailed text instead of the principles themselves – to properly address the specificities of Islamic finance;

(iii) adding principles, detailed text, or recommendations on how to implement the principles in ways that are befitting to the distinct characteristics of Islamic finance.

26. This document refers to a governance structure composed of a board of directors (herein referred to as "the board"), senior management, and *Sharī`ah* Supervisory Board (SSB). Senior management is sometimes called the executive committee, the executive board, or the management board. Some countries use a formal two-tier structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board or audit and supervisory board, which has no executive functions. Other countries use

[10] IFSB recognises difference opinions and practices in *Sharī`ah* ruling across jurisdictions. Hence, RSAs should refer to relevant *Sharī`ah* authority in their respective jurisdictions in issuing, implementing, and complying to such rulings.

[11] IFSB jointly with AAOIFI is currently at the final stage of developing the revised standard on *Sharī`ah* Governance Framework (RSGF). The document, once completed and issued, will be the main reference for *Sharī`ah* governance for three sectors of IFSI namely banking, capital markets, and *takāful*. Some measures had been taken to harmonise and align this Standard to the revised RSGF.

a one-tier structure in which the board of directors has a broader role. Still other countries have moved or are moving to a mixed approach that discourages or prohibits executives from serving on the board of directors or limits their number and/or requires the board and board committees to be chaired only by non-executive or independent board members. Some countries also prohibit the chief executive officer (CEO) from serving as chair of the board of directors or even from being part of the board of directors.

27. Owing to these differences, this document does not advocate any specific board or governance structure. The terms "board of directors" and "senior management" are used mainly from the perspective of a one-tier board structure. These terms should be interpreted throughout the document in accordance with the applicable law within each jurisdiction. Recognising that different structural approaches to corporate governance exist across countries and that these structures evolve over time, this document encourages legislators, RSAs, IIFS, and others to frequently review their practices so as to strengthen checks and balances and sound corporate governance under diverse structures.

28. The IFSB also recognises varying *Sharīʻah* governance models employed by different jurisdictions in terms of their unique organs of *Sharīʻah* governance and their responsibilities. More detailed recommendations in this regard are provided in the IFSB Standard on *Sharīʻah* governance for IIFS.

29. The Standard consists of 22 high-level principles, taken from BCBS Guidelines and IFSB-3, followed by further explanation for each principle. Additionally, the guiding principles are equipped with recommended practices,[12] whenever applicable.

1.5. Scope of Application

30. The Guiding Principles primarily aims to serve banking institutions – including digital banks[13] – offering Islamic financial services, referred to in this standard as IIFS. Further application, however, can be extended to any type of IIFS, which includes but is not limited to (i) full-fledged Islamic banks;[14] (ii) Islamic investment banks/companies; (iii) Islamic banking

[12] The IFSB shares the opinion of the OECD and the BCBS that there is no "single model" of corporate governance that can work well in every country. Each country, or even each organisation, should develop its own model that can cater to its specific needs and objectives. Thus, this part only serves as instances for implementation.

[13] As digital banks are generally in their early stage of development, there is insufficient data and reference on this matter. Hence, application of the Guiding Principles to digital banks offering Islamic financial services is at the discretion of RSAs and should be commensurate with the nature, complexity, economic significance, and risk profile, as well as regulatory framework, of the respective jurisdiction.

[14] Including those that act as holding/parent company, stand-alone (no parent nor subsidiary), or subsidiary, either of Islamic or conventional institutions.

branches/divisions/units of conventional banks (hereinafter collectively referred to as "Islamic windows"); and such other financial institutions as may be determined by the respective RSA.[15]

31. The Guiding Principles serve as minimum requirements to be implemented by IIFS with a certain degree of flexibility commensurate to the maturity, size, complexity, structure, economic significance, and risk profile of the IIFS and the group (if any) to which it belongs.[16] RSAs should evaluate the quality of the prevailing corporate governance framework and enhance its provisions by considering country-specific needs and objectives, the level of IFSI development, the RSA's resources and capacity, as well as other relevant circumstances. A balanced approach should be employed to allow flexibility in enabling an innovative environment, while putting proper risk management in place to mitigate the risks.

32. The Guiding Principles recommends the adoption of the "comply or explain" approach by IIFS in relation to disclosures of compliance with this standard to the relevant stakeholders. This approach is practical in terms of accommodating the diverse legal frameworks across the jurisdictions in which IIFS operate. Furthermore, it would facilitate the adoption of a governance framework that is commensurate and proportionate with the size, complexity, and nature of each IIFS.

33. Adoption of this Standard should be accompanied by other applicable international corporate governance standards issued by standard-setting bodies – i.e., BCBS, OECD, and FSB – as well as relevant IFSB standards such as IFSB-1, IFSB-9, IFSB 10, IFSB-16, IFSB-17, and IFSB-22. The application of the Guiding Principles in any jurisdiction is expected to be pursued in a manner consistent with applicable national laws, regulations, codes, and the discretion of the RSA.

1.6. Implementation Date

34. This document is intended to guide the actions of board members, senior managers, control function heads, and supervisors of a diverse range of banks in a number of countries with varying legal and regulatory systems. The IFSB recognises that there are significant differences in the legislative and regulatory frameworks across countries which may restrict the application of certain principles or provisions therein. Each jurisdiction should apply the

[15] See IIFS definition on IFSB-22 paragraph 8.

[16] Reasonable adjustments shall be made, where appropriate, for banks with lower risk profiles, being alert to the higher risks that may accompany more complex and publicly listed institutions. Systemically Important Financial Institutions (SIFIs) are expected to have in place the corporate governance structure and practices commensurate with their role in and potential impact on national and global financial stability.

provisions as the national authorities see fit. In some cases, this may involve legal change. In other cases, a principle may require slight modification in order to be implemented.

35. In order to ensure the IIFS governance framework has been aligned with the international best-practices, supervisory authorities are recommended to adopt this standard in their respective jurisdictions effective from 1 January 2025.

2. THE GUIDING PRINCIPLES

2.1. Board's Overall Responsibilities

Principle 1: The board has overall responsibility for the IIFS, including approving and overseeing management's implementation of the IIFS's strategic objectives, governance framework, and corporate culture.

2.1.1. Responsibilities of the board

36. The board has ultimate responsibility for the IIFS's business strategy and financial soundness, key personnel decisions, internal organisation, governance structure and practices, and risk management and compliance obligations. The term "compliance" as referred to in this standard includes adherence with *Sharī`ah* rules and principles, unless otherwise stated. The board may delegate some of its functions, though not its responsibilities, to board committees where appropriate.

37. The board has a fiduciary duty towards its stakeholders, particularly customers, depositors, IAHs/investors, and shareholders, that the products and services offered[17] and its overall business operations have been conducted in accordance with *Sharī`ah* rules and principles. Therefore, the responsibility of the IIFS's board includes ensuring that an effective *Sharī`ah* governance framework has been put in place and the necessary procedures and mechanisms have been observed and thoroughly carried out at all times.[18]

38. The board should establish and be satisfied with the IIFS's governance policy framework and organisational structure. This will enable the main governance's organs – the board, SSB, and senior management – to carry out their responsibilities and facilitate effective decision-making and good governance. This includes clearly laying out the key responsibilities and authorities of each governance organ and of those responsible for the risk management and control functions.

39. The board must clearly define the strategic roles, authorities, and responsibilities of (i) the board of directors, including its committees; (ii) SSB; (iii) senior management; and (iv) other organs of governance, e.g., control functions such as risk management, compliance, and internal audit. The board should keep in mind, while designing the corporate governance

[17] Including external or third-party products sold through IIFS's channels.
[18] See IFSB Standard on *Sharī`ah* Governance Framework for more detailed provisions on the board's responsibilities with regards to *Sharī`ah* governance.

framework, the importance of checks and balances and mechanisms of balancing accountabilities of each organ to various stakeholders.

40. The members of the board should exercise their "duty of care" and "duty of loyalty" to the IIFS under applicable national laws, supervisory standards, and *Sharī`ah* rulings issued by its SSB and a central/national *Sharī`ah* authority (where present)[19] as determined by RSA in the respective jurisdiction.

41. Accordingly, the board should:[20]

(i) actively oversee the affairs of the IIFS and keep up with material changes in the IIFS's business and the external environment as well as act in a timely manner to protect the long-term interests of the IIFS;

(ii) oversee[21] the development of and approve the IIFS's business objectives and strategy and monitor their implementation;

(iii) play a lead role in establishing the IIFS's corporate culture and values whose foundation is based on *Sharī`ah*;

(iv) oversee implementation of the IIFS's governance framework and periodically review its continued appropriateness in light of material changes to the IIFS's size, complexity, geographical footprint, business strategy, markets, and regulatory requirements;

(v) establish, along with senior management and the CRO, the IIFS's risk appetite, taking into account the competitive and regulatory landscape and the IIFS's long-term interests, risk exposure, and ability to manage risk effectively;

(vi) oversee the IIFS's adherence to the risk appetite statement (RAS), risk policy, and risk limits;

(vii) approve the approach and oversee the implementation of key policies pertaining to the IIFS's capital adequacy assessment process, capital and liquidity plans, investment and financing policies, compliance policies and obligations, internal control system, *Sharī`ah* governance, human resource policies, etc.;

[19] In the case where an IIFS is located in a jurisdiction with the absence of a central/national *Sharī`ah* authority or legal provision, the board shall take adequate measures to ensure the conduct of IIFS is consistent with *Sharī`ah* rules and principles issued by the SSB or qualified *Sharī`ah* scholars/individuals, whichever applicable.

[20] The IFSB recognises that in some jurisdictions, standards derived from general corporate law govern these matters and that national supervisory authorities take appropriate account of these standards while implementing the principles therein.

[21] In the context of board responsibilities, the term "oversee" should be understood to mean "oversee and be satisfied with".

(viii) require that the IIFS maintain a robust finance function responsible for accounting and financial data in accordance with internationally recognised accounting standards that are applicable to IIFS and recognised by the RSA of the country;

(ix) approve the annual financial statements and require a periodic independent review of critical areas;

(x) approve the selection and oversee the performance of SSB members (if applicable), the CEO, key members of senior management, and heads of the control functions;

(xi) oversee the IIFS's approach to compensation, including monitoring and reviewing executive and SSB (if applicable) compensation, and assessing whether it is aligned with the IIFS's risk culture and risk appetite;

(xii) establish a robust *Sharī`ah* governance encompassing *ex-ante* and ex-*post* procedures to ensure adherence to *Sharī`ah* principles;

(xiii) oversee and evaluate the implementation of *Sharī`ah* governance including but not limited to (a) select and oversee the performance of qualified personnel for *Sharī`ah* control functions,[22] (b) ensure the independence of SSB and *Sharī`ah*-related control functions, and (c) properly treat and disclose any *Sharī`ah* non-compliance income/activities;

(xiv) oversee the integrity, independence, and effectiveness of the IIFS's policies and procedures for whistleblowing.

42. The board should ensure that transactions with related parties (including internal group transactions) are reviewed to assess risk and are subject to appropriate restrictions (e.g., by requiring that such transactions be conducted on arm's length terms) and that corporate or business resources of the IIFS are not misappropriated or misapplied.

43. In discharging these responsibilities, the board should take into account the legitimate interests of depositors, IAHs, shareholders, and other relevant stakeholders. It should also ensure that the IIFS maintains an effective relationship with its RSA.

2.1.2. Corporate culture and values

44. A fundamental component of good governance is a corporate culture of reinforcing appropriate norms for responsible and ethical behaviour. These norms are especially critical in terms of an IIFS's risk awareness, risk-taking behaviour, and risk management (i.e., the IIFS's "risk culture").

[22] Compliance, risk management, and internal and external *Sharī`ah* audit.

45. In order to promote a sound corporate culture, the board should reinforce the "tone at the top" by:

(i) setting and adhering to corporate values, which are founded on Islamic ethical values,[23] that create expectations that all business should be conducted in a legal, ethical, and *Sharī`ah*-compliant manner, and overseeing the adherence to such values by board members,[24] SSB, senior management, and other employees;

(ii) establishing a code of conduct[25] and code of ethics[26] that reflect Islamic ethical values, for board members, SSB, senior management, and all employees;

(iii) promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that senior management and all employees are responsible for helping the IIFS operate within the established risk appetite and risk limits;

(iv) confirming that appropriate steps have been or are being taken to communicate throughout the IIFS the corporate values, professional standards, or codes of conduct it sets, together with supporting policies; and

(v) confirming that board members, SSB, and employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions.

46. An IIFS's code of conduct or code of ethics, or comparable policy, should define acceptable and unacceptable behaviours.

(i) The code of conduct or code of ethics should be tailored to suit the roles, responsibilities, and authorities of board members, SSB, senior management, and employees respectively.

(ii) It should explicitly disallow illegal activity, such as financial misreporting and misconduct; economic crime including fraud, breach of sanctions, money laundering, anti-competitive practices, bribery, and corruption; or the violation of depositors' and IAHs' rights.

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[23] Interpretation of Islamic ethical values is at the discretion of RSAs and/or IIFS, with consultation to relevant *Sharī`ah* authority/scholars (if necessary), by considering ethical values derived from the primary sources of Islam (Al-Qur'an and As-Sunnah), relevant international standards, and universal ethical values accepted in the respective jurisdiction, e.g., local tradition or custom (*'urf*).

[24] It can particularly be done through an Ethics Committee specifically designed to exercise self-oversight function – for fellow board members – as well as for senior management and other employees.

[25] See IFSB-9: *Guiding Principles on Conduct of Business for IIFS (Banking)* (2009).

[26] See AAOIFI standard on *Code of Ethics for Islamic Finance Professionals* (2021).

(iii) It should require senior management and employees to act consistently within the bounds of *Sharī`ah* compliance in discharging their responsibilities,[27] including in developing, promoting, and marketing products and services.

(iv) It should make clear that employees are expected to conduct themselves ethically and perform their job with skill and due care and diligence in addition to complying with laws, regulations, *Sharī`ah* rulings, and company policies.

(v) It should require board members and senior management to be mindful of *Sharī`ah* considerations – and *Maqasid Al-Sharī`ah* in a broader sense – in making decisions relating to their roles in the company.

47. The Guiding Principles recommend that the board of IIFS integrate environmental, social, and governance (ESG) principles in formulating its organisational structures, corporate values, strategic decision-making processes, key policies, and other relevant organisation-wide arrangements, as these principles are aligned with the pursuit of IIFS sustainability and overall *Maqāṣid al-Sharī'ah.*

48. The IIFS's corporate values should recognise the critical importance of timely and frank discussion and escalation of problems to higher levels within the organisation.

- Employees should be encouraged and able to communicate, confidentially and without the risk of reprisal, legitimate concerns about illegal, *Sharī`ah* non-compliant, unethical, or questionable practices. This can be facilitated through a well communicated policy and adequate procedures and processes, consistent with national law, which allow employees to communicate material and *bona fide* concerns and observations of any violations in a confidential manner (e.g., whistle-blowing policy). This includes communicating material concerns to the IIFS's supervisor.
- The board should have oversight of the whistleblowing policy mechanism and ensure that senior management addresses legitimate issues that are raised. The board should take responsibility for ensuring that staff who raise concerns are protected from detrimental treatment or reprisals.
- The board should oversee and approve how and by whom legitimate material concerns shall be investigated and addressed by an objective independent internal or external body, senior management, and/or the board itself.

[27] According to IFSB-9, observance of the code of ethics and/or code of conduct – comprising universal principles of good business conduct – are applied to all senior management and employees irrespective of their religious beliefs. It should be understood in relation to their professional duties and responsibilities in managing IIFS's affairs.

2.1.3. Risk appetite, management, and control

49. As part of the overall corporate governance framework, the board is responsible for overseeing a strong risk governance framework. An effective risk governance framework includes a strong risk culture, a well-developed risk appetite articulated through the RAS, and well-defined responsibilities for risk management in particular and control functions in general.

50. Developing and conveying the IIFS's risk appetite is essential to reinforcing a strong risk culture. The risk governance framework should outline actions to be taken when stated risk limits are breached, including disciplinary actions for excessive risk-taking, escalation procedures, and board notification.

51. The board should take an active role in defining the risk appetite and ensuring its alignment with the IIFS's strategic, capital, and financial plans and compensation practices. The IIFS's risk appetite should be clearly conveyed through an RAS that can be easily understood by all relevant parties: the board itself, senior management, IIFS employees, and the RSA.

52. The board – together with senior management – should allocate time and resources to assess the impact of new and emerging risks (if any) to IIFS business performance and sustainability in the short, medium, and long term by considering the change of structure in the regulatory environment and economy; and decide whether these emerging risks should be integrated into the IIFS's risk governance framework and overall IIFS business strategies.

53. The IIFS's RAS should:

(i) include both quantitative and qualitative considerations, including reputational risk stemming from *Sharī`ah* non-compliance business conducts;

(ii) establish the individual and aggregate level and types of risk that the IIFS is willing to assume in advance of and in order to achieve its business activities within its risk capacity;

(iii) define the boundaries and business considerations in accordance with which the IIFS is expected to operate when pursuing the business strategy; and

(iv) communicate the board's risk appetite effectively throughout the IIFS, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the IIFS.

54. The development of an effective RAS should be driven by both top-down board leadership and bottom-up management involvement. While the definition of risk appetite may be initiated by senior management, successful implementation depends upon effective

interactions between the board, senior management, risk management, and operating businesses, including the chief financial officer (CFO).

55. A risk governance framework should include well-defined organisational responsibilities for risk management, typically referred to as the three lines of defence:

(i) the business line;

(ii) a risk management function and a compliance function independent from the first line of defence; and

(iii) an internal audit function independent from the first and second lines of defence.[28]

56. Depending on the IIFS's nature, size and complexity, and the risk profile of its activities, the specifics of how these three lines of defence are structured can vary. Regardless of the structure, responsibilities for each line of defence should be well defined and communicated.

57. Business units are the first line of defence. They take risks and are responsible and accountable for the ongoing management of such risks. This includes identifying, assessing, and reporting such exposures, taking into account the IIFS's risk appetite and its policies, procedures, and controls. The manner in which the business line executes its responsibilities should reflect the IIFS's existing risk culture. The board should promote a strong culture of adhering to limits and managing risk exposures.

58. The second line of defence includes an independent risk management function. The risk management function complements the business line's risk activities through its monitoring and reporting responsibilities. Among other things, it is responsible for overseeing the IIFS's risk-taking activities and assessing risks and issues independently from the business line. The function should promote the importance of senior management and business line managers in identifying and assessing risks critically rather than relying only on surveillance conducted by the risk management function. Among other things, the finance function plays a critical role in ensuring that business performance and profit and loss results are accurately captured and reported to the board, management, and business lines that will use such information as a key input to risk and business decisions.

59. The second line of defence also includes an independent and effective compliance function. The compliance function should, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, and applicable *Sharī`ah* rulings, codes, and

[28] See BCBS, Principles for sound operational risk management, www.bis.org/publ/bcbs195.pdf, and the internal audit function in banks, www.bis.org/publ/bcbs223.pdf.

policies that the IIFS is subject to. The board should approve compliance policies that are communicated to all staff. The compliance function should assess the extent to which policies are observed and report to senior management and, as appropriate, to the board on how the IIFS is managing its compliance risk, including *Sharī`ah* non-compliance risk. The function should also have sufficient authority, stature, independence, resources, and access to the board.

60. Within the overall compliance control function, the IIFS shall have an internal *Sharī`ah* compliance unit/department (ISCU), or at least a *Sharī`ah* compliance officer who is part of the IIFS compliance team. In this respect, the IIFS shall:

(i) ensure the ISCU is equipped with staff who are competent, empowered, and adequately resourced to discharge its duties.

(ii) ensure that the ISCU is separate and independent from the business units and departments.

61. The third line of defence consists of an independent and effective internal audit function inclusive of internal *Sharī`ah audit*. Among other things, it provides independent review and objective assurance on the quality and effectiveness of the IIFS's internal control system, the first and second lines of defence and the risk and *Sharī`ah* governance framework including links to organisational culture, as well as strategic and business planning, compensation, and decision-making processes. Internal auditors must be competent and appropriately trained and not involved in developing, implementing, or operating the risk management function or other first or second line of defence functions (see Principle 12).

62. The board should ensure that the risk management, compliance, and internal audit functions including *Sharī`ah* governance requirements are properly positioned, staffed, and resourced and carry out their responsibilities independently, objectively, and effectively. In the board's oversight of the risk and *Sharī`ah* governance framework, the board should regularly review key policies and controls with senior management and with the heads of the risk management, compliance, and internal audit functions to identify and address significant risks and issues as well as determine areas that need improvement.

2.1.4. Oversight of senior management

63. The board should select the CEO and may select other key personnel, including members of senior management.

64. The board should provide oversight of senior management. It should hold members of senior management accountable for their actions and enumerate the possible consequences (including dismissal) if those actions are not aligned with the board's performance expectations. This includes adhering to the IIFS's values, *Sharī`ah* principles, risk appetite, and risk culture, under all circumstances. In doing so, the board should:

(i) monitor that senior management's actions are consistent with the strategy and policies approved by the board, including the risk appetite;
(ii) meet regularly with senior management;
(iii) question and critically review explanations and information provided by senior management;
(iv) set appropriate performance and remuneration standards for senior management consistent with the long-term strategic objectives and the financial soundness of the IIFS, also taking into consideration emerging risks that possibly raise long-term uncertainties with material impacts, such as CFR;
(v) assess whether senior management's collective knowledge and expertise remain appropriate given the nature of the business and the IIFS's risk profile; and
(vi) be actively engaged in succession plans for the CEO and other key positions, as appropriate, and ensure that appropriate succession plans are in place for senior management positions.

2.1.5. Relationship with Sharī`ah *Supervisory Board (SSB)*

65. Since ensuring *Sharī`ah* compliance is one of the board's utmost responsibilities, it is imperative for the board members to satisfy themselves that:

(i) SSB members should be and remain qualified through a "fit-and-proper" test,[29] individually and collectively, for their positions. This means that SSB should keep abreast in the updates and development of IFSI, particularly related to technology advancements utilised by IIFS.
(ii) The SSB is properly positioned, authorised, and resourced and carry out its responsibilities independently, objectively, and effectively.
(iii) The SSB's comments and suggestions have been taken into account and appropriately addressed in establishing and/or reviewing *Sharī`ah* Governance Framework of the IIFS.

[29] The RSAs are required to conduct "fit-and-proper" tests according to predetermined criteria to ensure the SSB members are qualified for the position..

66. The board should maintain regular and effective communication with the SSB for the purpose mentioned in paragraph 65. Further details on the interaction between the board and SSB may refer to IFSB Standard on *Sharī`ah* Governance Framework for IIFS.

2.2. Board Qualifications and Composition

Principle 2: Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance roles and be able to exercise sound, objective judgment about the affairs of the IIFS.

2.2.1. Board composition

67. The board must be suitable to carry out its responsibilities and have a composition that facilitates effective oversight. For that purpose, the board should be comprised of a sufficient number of independent directors.

68. The board should be comprised of individuals with a balance of skills, diversity,[30] and expertise, who collectively possess the necessary qualifications commensurate with the size, complexity, and risk profile of the IIFS.

69. The board members should continuously develop and strengthen their knowledge and understanding of Islamic finance and collectively possess reasonable understanding and knowledge of the distinctive characteristics of Islamic finance – i.e., the implications of *Sharī`ah* principles on IIFS products, services, and business activities – to allow effective oversight of the overall IIFS operations.

70. In assessing the collective suitability of the board, the following should be taken into account:

(i) the board should have a range of knowledge and experience in relevant areas and have varied backgrounds to promote a diversity of views. Relevant areas of competence may include, but are not limited to Islamic finance, capital markets, financial analysis, financial stability issues, financial reporting, information technology, strategic planning, risk management, compensation, regulation, corporate governance, sustainability, and management skills;

[30] In determining a proper balance and composition of the board, appropriate consideration should be given to various factors resulting in the board's diversity. It should consider all relevant factors such as diversity in skills and competencies, professional and/or educational background, gender, etc.

(ii) the board collectively should have a reasonable understanding of local, regional, and, if appropriate, global economic and market forces and of the legal and regulatory environment. International experience, where relevant, should also be considered; and
(iii) the individual board member's attitude should facilitate communication, collaboration, and critical debate in the decision-making process.

2.2.2. Board member selection and qualifications

71. Boards should have a clear and rigorous process for identifying, assessing, and selecting board candidates. Unless required otherwise by law, the board (not management) nominates[31] candidates and promotes appropriate succession planning of board members.

72. As IIFS offer a different value proposition compared to conventional banking, the board who sets the "tone at the top" should consist of individuals who display an appropriate level of understanding[32] as well as individual characters that are consistent with Islamic ethical values, in the hope that this qualification may minimise the occurrence of *Sharī`ah* non-compliance and reputational risks.

73. The selection process should include reviewing whether board candidates: (i) possess the knowledge, skills, experience, and, particularly in the case of non-executive directors, independence of mind given their responsibilities on the board and in the light of the IIFS's business and risk profile; (ii) have a record of integrity and good repute; (iii) demonstrate reasonable interest and good intent to develop the IFSI by upholding *Sharī`ah* principles; (iv) have sufficient time to fully carry out their responsibilities; and (v) have the ability to promote a smooth interaction between board members.

74. Board candidates should not have any conflicts of interest that may impede their ability to perform their duties independently and objectively and subject them to undue influence from:
(i) other persons (such as management or other shareholders);
(ii) past or present positions held;
(iii) personal, professional, or other economic relationships with other members of the board or management (or with other entities within the group); or

[31] IFSB shares the opinion of BCBS that in some jurisdictions shareholders or other stakeholders have the right to nominate board members and/or to approve their selection. In such cases, the board should still do whatever is within its power to ensure that members selected for the board are qualified.

[32] Interpretation of the minimum level of understanding for board members are left to the RSAs and IIFS to determine by considering the stage of development, availability of qualified candidates, nature and complexity of IIFS, etc. For instance, board members are required to understand the basic prohibitions in Islamic finance. Additionally, RSAs may integrate these expectations to the "fit and proper" test process for board members. From IIFS side, Islamic finance topics should be included to board members' induction programmes and regular trainings.

(iv) other factors or conditions that may impair the fair judgment and objectivity of the concerned board member in carrying out fiduciary duties and responsibilities due to a conflicting interest.

75. Board members should commit themselves to continuous professional development held regularly, which includes Islamic finance education, training, workshops, or similar activities, to keep them abreast in the development of IFSI. The board should dedicate sufficient time, budget, and other resources for this purpose, and draw on external expertise as needed.

76. If a board member ceases to be qualified or is failing to fulfil his or her responsibilities, the board should take appropriate actions as permitted by law, which may include notifying the member's banking supervisor.

77. The IIFS should have in place a nomination committee or similar body, composed of a sufficient number of independent board members, which identifies and nominates candidates after having taken into account the criteria described above. Further details about the nomination committee and other board committees are discussed in paragraph 114.

78. Where there are shareholders with power to appoint board members, the board should ensure that such individuals understand their duties. Board members have responsibilities to the IIFS's overall interests, regardless of who appoints them. In cases where board members are selected by a controlling shareholder, the board may wish to set out specific procedures or conduct periodic reviews to facilitate the appropriate discharge of responsibility by all board members.

2.3. Board's Own Structure and Practices

Principle 3: The board should define appropriate governance structures and practices for its own work and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

2.3.1. Organisation and assessment of the board

79. The board should structure itself in terms of leadership, size, and the use of committees so as to effectively carry out its oversight role and other responsibilities. This includes ensuring that the board has the time and means to cover all necessary subjects in sufficient depth and have a robust discussion of issues.

80. The board should maintain and periodically update organisational rules, by-laws, or other similar documents setting out its organisation, rights, responsibilities, and key activities.

81. To support its own performance, the board should carry out regular assessments – alone or with the assistance of external experts – of the board as a whole, its committees, and its individual board members. The board should:

(i) periodically review its structure, size, and composition as well as committees' structures and coordination;

(ii) assess the ongoing suitability of each board member periodically (at least annually), also taking into account the member's performance on the board;

(iii) either separately or as part of these assessments, periodically review the effectiveness of its own governance practices and procedures, determine where improvements may be needed, and make any necessary changes; and

(iv) use the results of these assessments as part of the ongoing improvement efforts of the board and, where required by the supervisor, share results with the supervisor.

82. The board should maintain appropriate records (e.g., meeting minutes or summaries of matters reviewed, recommendations made, decisions taken and dissenting opinions) of its deliberations and decisions. These should be made available to the supervisor when required.

2.3.2. Role of the chair

83. The chair of the board plays a crucial role in the proper functioning of the board. The chair provides leadership to the board and is responsible for its effective overall functioning, including maintaining a relationship of trust with board members. The chair should possess the requisite experience, competencies, and personal qualities to fulfil these responsibilities. The chair should ensure that board decisions are taken on a sound and well-informed basis. The chair should encourage and promote critical discussion and ensure that dissenting views can be freely expressed and discussed within the decision-making process. The chair should dedicate sufficient time to the exercise of his or her responsibilities.

84. To promote checks and balances, the chair of the board should be an independent or non-executive board member. In jurisdictions where the chair is permitted to assume executive duties, the IIFS should have measures in place to mitigate any adverse impact on the IIFS's checks and balances, e.g., by designating a lead board member, a senior independent board member, or a similar position and having a larger number of non-executives on the board.

2.3.3. Board committees

85. To increase efficiency and allow deeper focus in specific areas, a board may establish certain specialised board committees. The committees should be created and mandated by the full board. The number and nature of committees depend on many factors, including the size of the IIFS and its board, the nature of its business areas, and its risk profile.

86. Each committee should have a charter or other instrument that sets out its mandate, scope, and working procedures. This includes how the committee will report to the full board, what is expected of committee members, and any tenure limits for serving on the committee. The board should consider the occasional rotation of members and of the chair of such committees, as this can help avoid undue concentration of power and promote fresh perspectives.

87. In the interest of greater transparency and accountability, a board should disclose the committees it has established, their mandates, and their composition (including members who are considered to be independent).

88. Committees should maintain appropriate records of their deliberations and decisions (e.g., meeting minutes or summaries of matters reviewed, recommendations made, and decisions taken). Such records should document the committees' fulfilment of their responsibilities and help the supervisor or those responsible to assess the effectiveness of these committees.

89. A committee chair should be an independent, non-executive board member.

Recommended best practices for structuring board committees:

90. BCBS Guidelines encouraged the formation of at least three board committees – i.e., an audit committee, risk committee, and compensation committee – which are required for systemically important banks (SIBs).

91. In addition, the Guiding Principles recommends the establishment of a governance committee whose main mandate is to oversee the implementation and effectiveness of the overall governance framework and safeguard the interest of stakeholders other than the shareholders, with particular attention to IAH. The governance committee should be required for IIFS that offer investment accounts as a product or service.

92. The establishment of a specific board committee should consider the need of IIFS in responding to internal and/or external opportunities and challenges, e.g., the changes in business and regulatory environments. In today's context, this will include the rapid changes

stemming from (i) IT advancements which inevitably bring cyber risks into prominence, e.g., cyber security and data protection, and (ii) sustainability issues such as climate-related financial risks (CFR). Additionally, the board may wish to set up a specific new board committee to address a particular issue or to simply integrate such issues into relevant board committee(s), such as a risk committee. The decision should take into account long-term interests of IIFS (e.g., corporate strategy), size, risk profile, and the competencies of IIFS/ board members, as well as the issue's urgency, necessity, and its economic significance.

93. Due to CFR material impacts and uncertainty of occurrence, the board should consider addressing CFR by assigning a specific board committee – either by establishing a new committee or extending the responsibility of an existing board committee, such as the risk committee – to be in charge of overseeing and monitoring the management of CFR. This additional responsibility should be clearly stated in the charter. The assignment of CFR into board committees will demonstrate its significance to senior management and all employees.

94. Another crucial topic in governance relates to the intensive use of digital technology in IIFS operations which may increase the potential risk of cyberattacks and other cyber risks. Hence moving forward, IIFS should aim to build strong cyber resilience.[33] The board is encouraged to assign someone with adequate skills, knowledge, experiences, or qualifications for IT expertise into the position. For a digital bank, cyber resilience may be one of the major factors for sustaining the overall business operations; and therefore, the position becomes highly important.

95. In relation to paragraphs 93 and 94, the board and senior management should further identify responsibilities for climate-related risk and cyber risk management throughout the organisational structure.

2.3.3.1. Audit committee

96. An audit committee in an IIFS should be responsible for both a financial audit and a *Sharī`ah* audit. This responsibility should be reflected in the composition of its members to ensure that collectively they are qualified and suitable to effectively discharge these duties.

97. An audit committee should:[34]

(i) be required for systemically important banks and is strongly recommended for other banks based on an organisation's size, risk profile, or complexity;

[33] The FSB published a final report on "*Effective practices for cyber incident: response and recovery*" in October 2020.

[34] See BCBS, External audits of banks, 2014, available at www.bis.org/publ/bcbs280.pdf.

(ii) be distinct from other committees;
(iii) have a chair who is independent and is not the chair of the board or of any other committee;
(iv) be made up entirely of independent or non-executive board members; and
(v) include members who have experience or expertise in:
- audit practices, financial reporting, and accounting;
- *Sharī`ah*-compliance audit, including internal/external *Sharī`ah* audit (preferably well-versed in *fiqh al-mua'amalat* and *usul al fiqh*).

98. The audit committee is, in particular, responsible for:
(i) framing policy on internal audit, internal *Sharī`ah* audit, and financial reporting, among other things;
(ii) overseeing the financial reporting process;
(iii) ensuring that the IIFS undertakes periodic *Sharī`ah* compliance review and/or audit, performed by the internal and/or external *Sharī`ah* audit function by persons having the required knowledge and expertise for the purpose;
(iv) providing oversight of and interacting with the IIFS's internal and external auditors;
(v) providing oversight of and interacting with IIFS's internal and/or external *Sharī`ah* auditors, along with the SSB;
(vi) approving, or recommending to the board or shareholders for their approval, the appointment,[35] remuneration, and dismissal of external auditors;
(vii) reviewing and approving the audit scope and frequency;
(viii) receiving key audit reports and ensuring that senior management is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors and other control functions;
(ix) overseeing the establishment of accounting policies and practices by IIFS;
(x) reviewing that the IIFS's policies are in compliance with *Sharī`ah* rules and principles; and
(xi) reviewing the third-party opinions on the design and effectiveness of the overall risk governance framework and internal control system.

99. At a minimum, the audit committee as a whole should possess a collective balance of skills and expert knowledge – commensurate with the complexity of the IIFS organisation and the duties to be performed – and should have relevant experience in internal/ external *Sharī`ah*

[35] In some jurisdictions, external auditors are appointed directly by shareholders, with the board only making a recommendation.

audit, financial reporting, accounting, and auditing. Where needed, the audit committee has access to external expert advice.

100. The audit committee shall communicate and coordinate with both the SSB and Governance Committee to ensure that information on compliance with Islamic *Sharīʾah* rules and principles by the IIFS is reported in a timely and adequate manner.

101. This section should be read in conjunction with Principle 9 on independent external *Sharīʾah* audit in IFSB Standards on *Sharīʾah* Governance Framework for IIFS.

2.3.3.2. Risk committee

102. A risk committee should:

(i) be required for systemically important banks and is strongly recommended for other banks based on a bank's size, risk profile, or complexity;
(ii) be distinct from the audit committee, but may have other related tasks, such as finance;
(iii) have a chair who is an independent director and not the chair of the board or of any other committee;
(iv) include a majority of members who are independent;
(v) include members who have experience in risk management issues and practices;
(vi) discuss all risk strategies on both an aggregated basis and by type of risk and make recommendations to the board thereon, and on the risk appetite;
(vii) be required to review the IIFS's risk policies at least annually; and
(viii) oversee that management has in place processes to promote the IIFS's adherence to the approved risk policies.

103. The risk committee of the board is responsible for advising the board on the IIFS's overall current and future risk appetite, overseeing senior management's implementation of the RAS, reporting on the state of risk culture in the bank, and interacting with and overseeing the CRO.

104. The committee's work includes oversight of the strategies for capital and liquidity management as well as for all relevant risks of the IIFS, such as credit, market, operational, and reputational risks, to ensure they are consistent with the stated risk appetite.

105. The committee should receive regular reporting and communication from the CRO and other relevant functions about the IIFS's current risk profile, current state of the risk culture, utilisation against the established risk appetite, and limits, limit breaches, and mitigation plans (see Principle 7).

106. There should be effective communication and coordination between the audit committee and the risk committee to facilitate the exchange of information and effective coverage of all risks, including emerging risks, and any needed adjustments to the risk governance framework of the IIFS.

2.3.3.3. Compensation committee

107. A compensation committee is required for systemically important banks. It should support the board in overseeing the remuneration system's design and operation and in ensuring that remuneration is appropriate and consistent with the IIFS's culture, long-term business, risk appetite, performance, and control environment (see Principle 12) as well as with any legal or regulatory requirements. The compensation committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives they create. The compensation committee works closely with the IIFS's risk committee in evaluating the incentives created by the remuneration system. The risk committee should, without prejudice to the tasks of the compensation committee, examine whether incentives provided by the remuneration system take into consideration risk, capital, liquidity, and the likelihood and timing of earnings.

2.3.3.4. Governance committee

108. A governance committee is required for IIFS offering investment account products. The board of directors shall set up a governance committee to coordinate and integrate the implementation of the governance policy framework. The governance committee shall be empowered to:

(i) oversee and monitor the implementation of the governance policy framework by working together with the senior management, audit committee, and the SSB; and
(ii) provide the board with reports and recommendations based on its findings.

109. The roles and functions of the governance committee shall not duplicate or overlap with the roles and functions of the audit committee.[36] The roles of the governance committee shall complement those of the audit committee in some of the governance functions, taking into account that:

(i) the audit committee already has a very demanding mandate and could be over-burdened by its own primary responsibilities;
(ii) there could be some perceived conflicts of interest between shareholders and the IAH,

[36] See paragraphs 97 and 98.

especially where the funds are commingled, which could be difficult for the audit committee to deal with. If the audit committee monitors primarily from the standpoint of the shareholders' interests and the governance committee monitors primarily from the standpoint of the IAH's interests, the scope of their duties and responsibilities would be clearer and more focused; and

(iii) the governance committee shall focus on the specificities of IIFS.

110. The primary objective of the governance committee is to protect the interests of stakeholders other than the shareholders. The governance committee shall not be treated as just another board committee. Instead, the governance committee shall be accorded special attention by RSAs.[37] In the event that there are differences between the governance committee and the audit committee, the board should have the ultimate responsibility for reconciling those differences.

111. The governance committee shall ensure that IAH interests have been safeguarded, and should:

(i) oversee key policies with regards to investment accounts, including policies on *Sharī`ah* compliance, sound investment strategies, risk management, fair[38] profit computation and distribution, building up and drawing on reserves such as PER and IRR,[39] and disclosure;
(ii) monitor procedures to ensure that IAH have been well-informed of the terms and conditions of the investment account products offered, including their risks and legal and economic implications;
(iii) review IIFS's marketing strategy[40] and monitor how it has been executed;
(iv) ensure that an IIFS has set out mechanisms to fairly compute and distribute returns of investment from investment account funds;
(v) monitor financial performance of investment accounts including computation and distribution of return;
(vi) assess whether the determination of the profit-sharing ratio and distribution of the return of investment accounts between IAH and the IIFS are conducted in a fair and ethical manner in accordance with the contract signed by the *Rabbulmal* (IAH) and *Muḍārib* (IIFS);

[37] This is in line with the BCBS Paper, which requires that banking organisations shall have in place adequate policies to identify, prevent, or manage potential conflicts of interest arising from their various business activities.
[38] It also includes fairness with respect to the profit-sharing ratio between the contracted parties (IIFS and depositor/investment account holder) as per contractual terms.
[39] To ensure that the utilisation of the PER is appropriate, the governance committee shall be mandated to scrutinise its utilisation and to make appropriate recommendations to the board.
[40] In the case where IIFS uses digital marketing, the governance committee should be well-informed of any algorithm used to promote the products to ensure fairness, inclusivity, and transparency of the product offerings.

(vii) monitor the use of restricted investment account funds in order to ensure that the expenses and profits are distributed according to the agreement between the IIFS and the IAH as per the SSB guidance;

(viii) regularly review contracts, performance, and key policies pertaining to investment accounts; and

(ix) protect the IAHs' rights related to PER and IRR especially during the liquidation of the IIFS. This requires that the IIFS develop a proper mechanism to allow the interaction between the governance committee and the IAH.

Recommended best practices relating to the governance committee:

112. The governance committee shall comprise at least three members, for example:

(i) a member of the audit committee;

(ii) a member with appropriate *Sharī`ah* expertise; and

(iii) a non-executive director (selected based on the director's experience and ability to contribute to the process).

Any increase of membership in the governance committee should preferably be filled by independent non-executive directors rather than non-independent directors.

113. In appointing members of the governance committee, the board should ensure that each member is capable of making a valuable contribution to the committee. A diversity of outlooks and experience among members is desirable since a uniform point of view could lead to overemphasis in one direction. Therefore, the Guiding Principles support the view that:

(i) it would be preferable for an independent non-executive director to chair the governance committee. The Chair of the governance committee should not only possess the relevant skills, such as the ability to read and understand financial statements, but should also be able to coordinate and link the complementary roles and functions of the governance committee and the audit committee;

(ii) it is necessary to include a *Sharī`ah* scholar for the purpose of leading the governance committee on *Sharī`ah*-related governance issues (if any); and

(iii) the third member of the governance committee should preferably be an independent non-executive director who can offer different skills to the committee, such as legal expertise and business proficiency, which are considered particularly relevant by the board for cultivating a good corporate governance culture and deemed "fit and proper" by the RSAs.[41]

2.3.3.5. Other board committees

114. Other specialised committees that are recommended include:

(i) *Nomination/human resources/governance committee*[42]: provides recommendations to the board for new board members and members of senior management. The nomination committee should analyse the role and responsibilities of the board member and the knowledge, experience, and competence that the role requires. Where a supervisory board or board of directors is formally separate from a management board, objectivity and independence still need to be ensured by appropriate selection of board members. The nomination committee should strive to ensure that the board is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the IIFS as a whole. It may be involved in assessment of board and senior management effectiveness and may be involved in overseeing the IIFS's personnel or human resource policies (see Principle 2).

(ii) *Ethics and compliance committee*: ensures that the IIFS has the appropriate means for promoting proper decision-making, due consideration of the risks to the IIFS's reputation and compliance with the relevant *Sharīʿah* rules and principles, laws, regulations, and internal rules.

(iii) *Sustainability committee*: ensures that IIFS have given due consideration and taken adequate and timely measures to address sustainability issues, including emerging risks, i.e., climate-related risks. The committee shall promote awareness, understanding, and integration of the sustainability agenda[43] into the IIFS's strategic decision-making process and implement it throughout the organisation.

115. The board should appoint members to specialised committees with the goal of achieving an appropriate mix of skills and experience that, in combination, allow the

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[41] In a best-case scenario, each board committee should have a different chair; hence, if possible, the chair of the governance committee should not be chair of another board committee. However, it should be sufficient for a representative of the audit committee also to sit on the governance committee. This would allow the required understanding of financial issues to be addressed. Additionally, and preferably, the third member of the governance committee should not be a member of the audit committee. Adopting such a recommendation allows the widest range of views to be expressed within the governance committee.

[42] The "governance committee" recommended in this paragraph holds the same function as mentioned in paragraph 91 and point 2.3.3.4. In general, a governance committee is required for IIFS with IA products. In the case where IIFS does not offer IA products, IIFS are not required – but still recommended – to establish a governance committee which may be consolidated with other responsibilities such as nomination or human resources.

[43] The sustainability concept constitutes environment, social, and governance principles (ESG) to be considered in the decision-making process of a corporation.

committees to fully understand, objectively evaluate, and bring fresh thinking to the relevant issues.

116. In jurisdictions permitting or requiring executive members on the board, the board of an IIFS should work to ensure the needed objectivity in each committee, e.g., by having only non-executives and, to the extent possible, a majority of independent members.

Recommended best practices for other board committees

117. When the ethics and compliance committee is established, at least one member should have expertise in *Sharī`ah*, as *Sharī`ah* non-compliance risk is an important aspect to be monitored and managed.

2.3.4. Conflicts of interest

118. Conflicts of interest may arise as a result of the various activities and roles of the IIFS, or between the interests of the IIFS or its customers and those of the IIFS's board members, SSB, or senior managers (e.g., if the IIFS enters into a business relationship with an entity that one of the IIFS or SSB board members has a financial interest in).

119. Conflicts of interest may also arise when an IIFS is part of a broader group. For example, where the IIFS is part of a group, reporting lines and information flows between the IIFS, its parent company, and/or other subsidiaries can lead to the emergence of conflicts of interest (e.g., sharing of potential proprietary and/or confidential or otherwise sensitive information from different entities, or pressure to conduct business on a non-arm's length basis).

120. The board should oversee the implementation and operation of policies to identify potential conflicts of interest. Where these conflicts cannot be prevented, they should be properly managed, based on the permissibility of relationships or transactions under sound corporate policies consistent with national law and supervisory standards.

121. The board should have a formal written conflicts-of-interest policy and an objective compliance process for implementing the policy. The policy should include:

- (i) a member's duty to avoid, to the extent possible, activities that could create conflicts of interest or the appearance of conflicts of interest;
- (ii) examples of where conflicts can arise when serving as a board member;
- (iii) a rigorous review and approval process for members to follow before they engage in certain activities (such as serving on another board) so as to ensure that such activity will not create a conflict of interest;

(iv) a member's duty to promptly disclose any matter that may result, or has already resulted, in a conflict of interest;
(v) a member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfil duties to the IIFS may be otherwise compromised;
(vi) adequate procedures for transactions with related parties so that they are made on an arm's length basis; and
(vii) the way in which the board will deal with any non-compliance with the policy.

122. The board should oversee and be satisfied with the process by which appropriate public disclosure is made, and/or information is provided to RSAs, relating to the IIFS's policies on conflicts of interest and potential material conflicts of interest.

123. This should include information on the IIFS approach to disclosing and managing material conflicts of interest that are not consistent with such policies, and conflicts that could arise because of the IIFS's affiliation or transactions with other entities within the group.

124. There is a potential conflict of interest where an IIFS is both owned by the state and subject to banking supervision of the state. If such conflicts of interest exist, there should be full administrative separation of the ownership and banking supervision functions in order to minimise political interference in the supervision of the IIFS.

2.4. *Sharī`ah* Governance Framework

Principle 4: RSA shall require an IIFS to have in place a comprehensive *Sharī`ah* Governance Framework which encompasses a set of institutional and/or system-wide arrangements for the effective and independent oversight of *Sharī`ah* compliance of its products/ services, systems, processes, and business operations.

125. *Sharī`ah* governance is of paramount importance to IIFS as compliance with *Sharī`ah* rules and principles is mandatory for IIFS. Therefore, the board should establish and satisfy themselves on the *Sharī`ah* Governance system within IIFS to provide reasonable assurance on the adherence towards *Sharī`ah* rules and principles on all of IIFS products, services, systems, processes, and business activities.

126. IIFS must clearly define the roles and responsibilities of its board of directors, senior management, SSB, and other organs towards upholding *Sharīʻah* compliance in its activities and operations.

127. The *Sharīʻah* governance framework must include arrangements to incorporate effective and independent oversight of *Sharī`ah* compliance for the products offered by the IIFS. This entails, among other things, having in place effective procedures to design, structure, and market these products while ensuring *Sharīʻah* compliance at all times. Besides products, *Sharīʻah* governance extends to systems and processes as well as people. Other important aspects include training the relevant staff and creating an overall culture of *Sharīʻah* compliance. Where an IIFS offers *Sharī`ah*-compliant products of a third-party entity (e.g., *takaful* providers), such products must be subject to all of the *Sharī`ah* governance processes of the IIFS as well as the relevant *Sharī`ah*-related disclosures applicable to the *Sharī`ah*-compliance of the product. In the case where the IIFS relies on the *Sharī`ah* pronouncements of the third party's SSB, this should also be clearly disclosed to customers and potential customers, along with relevant information on the third party's SSB that approved the product (including the *Sharī`ah* pronouncements and its rationale, etc.).

128. IIFS should ensure that its *Sharīʻah* Governance Framework includes, at a minimum, these organs of governance:

(i) *Sharīʻah* Supervisory Board (SSB);
(ii) *Sharīʻah* compliance function;
(iii) internal *Sharīʻah* audit function;
(iv) independent external *Sharīʻah* audit (IESA).[44]

129. IIFS must have in place a competent, independent, empowered, and adequately resourced SSB, *Sharī`ah* compliance function, and internal *Sharī`ah* audit function. To achieve this purpose, several governance issues should be properly addressed:

(i) competence: relates to composition and qualification, continuous development, and assessment;
(ii) independence: including prevention and management of conflicts of interest;
(iii) confidentiality; and
(iv) compensation.

130. A *Sharī`ah* governance system entails *ex-ante* and *ex-post* processes in ensuring adherence to Sharī`ah rules and principles. *Ex-ante* considerations should take place at the product design/development stage before it is launched and offered to the customers which involves (i) the issuance of Sharī`ah pronouncements by the SSB, and (ii) a *Sharī`ah*

[44] The implementation of IESA is at RSA's discretion, subject to the readiness of the industry as well as the regulatory and legal environment, by considering the level of development, size, nature, and economic significance of IFSI within its respective jurisdiction..

compliance function. On the other hand, *ex-post* processes should be conducted at the product offering stage and when transactions have been carried out which relates to internal *Sharī`ah* review/audit and *Sharī`ah* governance reporting.

131. IIFS shall be transparent in its *Sharī'ah* governance to its shareholders, customers, other relevant stakeholders, and market participants. This is done by providing adequate, proper, and timely disclosures pertaining to material *Sharī`ah*-related activities and processes including but not limited to the following:

(i) SSB report as part of the annual report, which must include disclosures related to the *Sharī`ah* compliance of the IIFS;
(ii) *Sharī`ah* rulings/pronouncements issued by the SSB should be made easily accessible to customers and the general public;
(iii) the IIFS shall follow any *Sharī`ah* rulings prescribed by its SSB, consistent with rulings/ *fatwā* issued by the national/central *Sharī`ah* authority (if any). In the event of any incidents of *Sharī`ah* non-compliance, disclosures should be made on the number and nature of *Sharī'ah* non-compliance events and how these were resolved including control measures to avoid recurrence of such events.[45]

132. The IFSB acknowledges that the *Sharī`ah* governance system may vary across jurisdictions and there is no "one-size fits all" approach in designing a *Sharī`ah* governance framework. Thus, supervisory authorities may tailor the *Sharī`ah* governance system adopted by IIFS in their respective jurisdictions to suit market realities and the stage of development of their IFSI.

133. This Principle and the detailed provisions herein are applicable to the types of IIFS referred to in paragraph 30 of this standard.

134. More detailed provisions on the *Sharī`ah* governance framework are set out in a separate IFSB Standard[46] and shall be considered as an integral part in adopting this Guiding Principles.

2.5. Senior Management

Principle 5: Under the direction and oversight of the board, senior management should carry out and manage the IIFS's activities in a manner consistent with *Sharī`ah*

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[46] IFSB-10 on *Sharī`ah* governance is currently being revised. Both documents will be made available here.

principles, business strategy, risk appetite, remuneration, and other policies approved by the board.

135. Senior management consists of a core group of individuals responsible and accountable to the board for the sound and prudent day-to-day management of the IIFS.

136. Senior management's organisation, procedures, and decision-making processes should be clear, transparent, and designed to promote effective management of the IIFS. This includes clarity on the role, authority, and responsibility of the various positions within senior management, including the CEO. A check-and-balance mechanism in the decision-making process is also important, particularly in strategic and material decisions, to prevent over-concentration of power to a certain position.

137. Members of senior management should have the necessary experience, competencies, and integrity to manage the businesses and people under their supervision. Due to the pivotal roles of senior management in determining the direction of IIFS, senior management should consist of individuals who demonstrate an appropriate level of understanding of Islamic finance[47] – along with its implications for IIFS products, services, and operations – as well as individual characters that are consistent with Islamic ethical values and leadership.[48] This is expected to help minimise the occurrence of *Sharī`ah* non-compliance and reputational risk.

138. Senior management members are required to have Islamic finance qualifications – which can be obtained through formal education, professional certification, formal training, or workshops – as determined or recognised by the respective RSA. Senior management should receive access to regular training to maintain and enhance their competencies and stay up to date on developments relevant to their areas of responsibility. Sufficient time, budget, and other resources must be dedicated for this purpose.

139. Members of senior management should be selected through an appropriate promotion or recruitment process that takes into account the qualifications required for the position in question. For those senior management positions for which the board of directors is required to review or select candidates through an interview process, senior management should provide sufficient information to the board.

[47] The necessary understanding may differ among members of senior management proportionate to their respective roles and responsibilities. For instance, a senior manager who is responsible for financing would require more understanding than the one dealing with human resource or information technology. The RSAs should take this into account in designing a "fit and proper" test for senior management members.

[48] These values should be reflected on the code of conduct/code of ethics for senior management as prescribed in paragraphs 45 and 46.

140. The selection process should include reviewing whether senior management candidates: (i) possess the knowledge, skills, experience, and qualification to discharge their duties and responsibilities; (ii) have a record of integrity and good repute consistent with Islamic ethical values; and (iii) demonstrate interest and good faith in developing IFSI by upholding *Sharī`ah* principles.

141. Senior management is responsible to ensure that all employees within the respective IIFS, particularly middle management and control functions, have the necessary skills, knowledge, experience, and qualifications in Islamic finance. Regular trainings should be made accessible to keep them abreast of developments in the IFSI.

142. Senior management contributes substantially to an IIFS's sound corporate governance through personal conduct (e.g., by helping to establish the "tone at the top" along with the board). Members of senior management should provide adequate oversight of those they manage and ensure that the IIFS's activities are consistent with the business strategy, risk appetite, and the policies approved by the board.

143. Senior management is responsible for delegating duties to staff and should establish a management structure that promotes accountability and transparency throughout the IIFS.

144. Consistent with the direction given by the board, senior management should implement business strategies, *Sharī`ah* governance, risk management systems, risk culture, and processes and controls for managing the risks – both financial and non-financial –which the IIFS is exposed to and concerning which it is responsible for complying with *Sharī`ah* rules and principles, laws, regulations, and internal policies. This includes comprehensive and independent risk management, compliance, and audit functions as well as an effective overall system of internal controls. Senior management should recognise and respect the independent duties of the SSB, risk management, compliance, and internal audit functions and should not interfere in their exercise of such duties.

145. Senior management should provide the board with the information it needs to carry out its responsibilities, supervise senior management, and assess the quality of senior management's performance. In this regard, senior management should keep the board regularly and adequately informed of material matters, including:

(i) changes in business strategy, *Sharī`ah* governance, risk strategy, or risk appetite;
(ii) the IIFS's performance and financial condition;
(iii) breaches of risk limits or compliance rules;
(iv) instances of *Sharī`ah* non-compliance, disclosing the reason, its resolution, and control measures;

(v) internal control failures;

(vi) *Sharī`ah*, legal or regulatory concerns; and

(vii) issues raised as a result of the IIFS's whistleblowing procedures.

146. In order to promote effective implementation of risk management policies across the IIFS, the senior management shall ensure that important organs within an IIFS, such as an SSB, a governance committee, the *Sharī`ah* compliance function, and the internal *Sharī`ah* audit function, where applicable, are adequately resourced to provide input to the implementation of the IIFS's risk management framework.

147. Management should develop a written code of ethics or a code of conduct (which will be approved by the board). Either code is intended to foster a culture that reflects Islamic ethical values, primarily emphasising integrity and accountability, to protect the interest of its stakeholders.

2.5.1. Senior management's responsibility for managing Islamic windows

148. Senior management in this section refers to senior management of the conventional bank offering Islamic windows.

149. Senior management shall identify positions in Islamic windows that hold key control functions in managing Islamic windows and ensure they are adequately positioned, qualified, authorised, and resourced to effectively discharge their duties and responsibilities.

150. Senior management should appoint a specific senior executive to be responsible for monitoring and managing the overall operations of Islamic windows. Accordingly, a clear and well-defined line of reporting with regards to Islamic windows shall be set out throughout the organisation.

151. The head of Islamic windows, along with other key control functions, should be responsible for managing IIFS operations in a manner consistent with *Sharī`ah* principles, business strategy, risk appetite, remuneration, and other policies approved by the board and senior management.

Recommended best practices for managing Islamic windows

152. In assigning a particular senior executive to be responsible for Islamic windows. As mentioned in paragraph 150, senior management should consider the size, complexity, economic significance, and risk profile of the Islamic window. The Guiding Principles strongly recommends that the designated senior executive should only be responsible for Islamic

windows.[49] This would allow a more effective representation of Islamic windows' interests at the senior management level of the institution offering the Islamic window and provide better focus on strategic planning and management of the respective Islamic window. Institutions offering Islamic windows should also have a business strategy for short-, medium-, and long-term development of the Islamic windows. The SSB shall be apprised of relevant *Sharī'ah*-related matters of the strategy, prior to approval of the board.

153. The designated senior executive, as mentioned in paragraph 150, shall be properly positioned, authorised, resourced, and have a direct report line to the CEO.

2.6. Governance of Group Structures

Principle 6: In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business, and risks of the group and its entities.[50] The board and senior management should know and understand the IIFS group's organisational structure and the risks that it poses.

2.6.1. Parent company boards

154. In operating within a group structure, the board of the parent company should be aware of the material risks and issues that might affect both the bank as a whole and its subsidiaries. It should exercise adequate oversight over subsidiaries while respecting the independent legal and governance responsibilities that might apply to subsidiary boards.

155. When the parent company is a *Sharī`ah*-compliant entity, the parent company board – together with the subsidiary's board – is responsible to ensure the adherence to *Sharī`ah* principles by putting in place a robust *Sharī`ah* Governance System within the subsidiary.

156. In order to fulfil its responsibilities, the board of the parent company should:

(i) establish a group structure (including the legal entity and business structure) and a corporate governance framework with clearly defined roles and responsibilities, including those at the parent company level and at the subsidiary level as may be appropriate based on the complexity and significance of the subsidiary;

[49] Conventional banks offering Islamic windows in some jurisdictions design a specific position, e.g., Islamic window director, to exclusively manage the operations of the Islamic window(s).
[50] IIFS that are part of a conglomerate should also take into account the Joint Forum's Principles for the supervision of financial conglomerates (September 2012, available at www.bis.org/publ/joint29.htm). For the purposes of the corporate governance principles herein, the terms "parent company" and "group" signify a financial group.

(ii) define an appropriate subsidiary board and management structure which takes into account the material risks to which the group, its businesses, and its subsidiaries are exposed;

(iii) assess whether the group's corporate governance framework includes adequate policies, processes, and controls and whether the framework addresses risk management across the businesses and legal entity structures;

(iv) ensure that the group's corporate governance framework includes appropriate processes and controls to identify and address potential intragroup conflicts of interest, such as those arising from intragroup transactions;

(v) approve policies and clear strategies for establishing new structures and legal entities, and ensure that they are consistent with the *Sharī`ah* principles, policies, and interests of the group;

(vi) assess whether there are effective systems in place to facilitate the exchange of information among the various entities, to manage the risks of the separate subsidiaries or group entities as well as of the group as a whole, and to ensure effective supervision of the group;

(vii) have sufficient resources to monitor the compliance of subsidiaries with all applicable *Sharī`ah* rulings as well as legal, regulatory, and governance requirements;

(viii) ensure consistency in *Sharī`ah* compliance within the group across all products, services, and activities, particularly in activities that involve cross-selling;[51]

(ix) maintain an effective relationship with both the home regulator and, through the subsidiary board or direct contact, with the regulators of all subsidiaries;

(x) establish an effective internal audit and internal *Sharī`ah* audit function that ensures audits are being performed within or for all subsidiaries and part of the group and group itself;[52] and

(xi) ensure that the group's corporate governance framework includes appropriate processes and controls to identify and address potential intragroup conflicts of interest, such as those arising from intragroup transactions, in appropriate recognition of the interest of the group.

2.6.2. Subsidiary boards

157. Subsidiary boards and senior management remain responsible for developing effective risk management processes for their entities. The methods and procedures applied by

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[51] Cross-selling in this paragraph entails cross-selling activities across financial products or entities within the group itself and/or with or through other external third-party products or channels. For instance, bancassurance will involve selling the *takāful* product through IIFS channels.

[52] See the BCBS's *Internal audit function in banks* at www.bis.org/publ/bcbs223.pdf.

subsidiaries should support the effectiveness of risk management at a group level. While parent companies should conduct strategic, group-wide risk management and prescribe corporate risk policies, subsidiary management and boards should have appropriate input to their local or regional application and to the assessment of local risks. Parent companies should ensure that adequate tools and authorities are available to the subsidiary and that the subsidiary understands the reporting obligations it has to the head office. It is the responsibility of subsidiary boards to assess the compatibility of group policy with local legal, regulatory requirements and, where appropriate, amend those policies.

158. While the strategic objectives, *Sharīʿah* governance framework, risk governance framework, corporate values, and corporate governance principles of the subsidiary should align with that of the parent company (referred to here as "group policies"), the subsidiary board should make necessary adjustments where a group policy conflicts with an applicable *Sharīʿah* ruling[53], legal or regulatory provision, or prudential rule, or would be detrimental to the sound and prudent management of the subsidiary.

159. Given the presence of potentially different *Sharīʿah* rulings within the group, due to various factors including but not limited to:

(i) their legal presence in different jurisdictions, e.g., different *Sharīʿah* rulings between the parent company and its subsidiary, when the parent company is a *Sharīʿah*-compliant entity;

(ii) different types of IIFS within a financial group, e.g., a group comprising banking entities and *takāful* entities with different SSB in each entity; or

(iii) different SSB in each IIFS (banking);

internal documentation should be made through the subsidiary's *Sharīʿah* compliance function and should be shared with the SSB of the parent company through the parent's *Sharīʿah* compliance function.[54]

[53] For instance, where a difference in *Sharīʿah* rulings exists between the group company and subsidiary's jurisdictions, or across subsidiaries.

[54] See also paragraph 149. The rationale behind this is that the board, SSB, and management of the parent company are responsible to take sufficient measures in ensuring *Sharīʿah* compliance across the group. Thus, it will be beneficial for the SSB of the parent to be apprised of the issue. For instance, in the case where the subsidiary interacts with the parent company, e.g., for liquidity, capital support or business collaboration.

160. The SSB of the Islamic subsidiary should be independent in its *Shari'ah* opinion from the conventional parent, to ensure that there is no undue influence of the conventional parent on the Islamic subsidiary.

161. In the case of a significant regulated subsidiary (due to its risk profile, systemic importance, or its size relative to the parent company), the board of the significant subsidiary should take such further steps as are necessary to help the subsidiary meet its own corporate governance responsibilities and the legal, *Sharī`ah,* and regulatory requirements that apply to it.

162. In order to avoid conflicts of interest, the conventional parent's representatives on the Islamic subsidiary/affiliate's board should not vote on any issue which is – or is reasonably perceived to be – benefitting the conventional parent at the cost of the interests of the stakeholders of the Islamic subsidiary/affiliate.

2.6.3. Complex or opaque structures

163. IIFS create structures for legal, regulatory, and tax purposes. Structures can take the form of units, branches, subsidiaries, or other legal entities that can considerably increase the complexity of the organisation. The number of legal entities, and in particular the interconnections and intragroup transactions among such entities, can lead to challenges in identifying and managing the risks of the organisation as a whole.

164. Operating through complex or non-transparent structures may pose financial, legal, reputational, and other risks – including *Sharī`ah* non-compliance risk – to the IIFS. It may impede the ability of the board and senior management to conduct appropriate business oversight and could hinder effective banking supervision.[55]

165. Senior management – and the board, as appropriate – should be cognisant of these challenges and take action to avoid or mitigate them by:

(i) avoiding the construction of complicated structures that lack economic substance or business purpose;

(ii) continually maintaining and reviewing appropriate policies, procedures, and processes governing the approval and maintenance of those structures or activities, including fully

[55] In addition, the IIFS may also be indirectly exposed to risk when it performs certain services or establishes structures on behalf of customers. See BCBS, *Customer due diligence for banks*, October 2001.

vetting the purpose, the associated risks and the IIFS's ability to manage those risks prior to setting up new structures and initiating associated activities;

(iii) having a centralised process for approving the creation of new legal entities and subsidiaries based on established criteria, including the ability to monitor and fulfil each entity's regulatory, tax, financial reporting, governance, *Sharī`ah*, and other requirements and for the dissolution of dormant subsidiaries;

(iv) establishing adequate procedures and processes to identify and manage all material risks arising from these structures, including lack of management transparency, operational risks introduced by interconnected and complex funding structures, intragroup exposures, trapped collateral, and counterparty risk. The IIFS should only approve structures if the material risks can be properly identified, assessed, and managed; and

(v) ensuring that the activities and structure are subject to regular internal and external audit reviews, including that of *Sharī`ah* audit both internal and/or external.

166. The board of the parent company can enhance the effectiveness of the above efforts by requiring a periodic independent formal review of the structures and their controls and activities, as well as of their consistency with board-approved strategy.

167. The board should be prepared to discuss with, and as necessary report to, the IIFS's supervisor and the host country supervisors the policies and strategies adopted regarding the establishment and maintenance of these structures and activities.

2.7. Risk Management Function

Principle 7: IIFS should have an effective independent risk management function, under the direction of a chief risk officer (CRO), with sufficient stature, independence, resources, and access to the board.

168. The independent risk management function is a key component of the IIFS's second line of defence. This function is responsible for overseeing risk-taking activities across the enterprise and should have authority within the organisation to do so. Key activities of the risk management function should include:

(i) identifying material individual, aggregate, and emerging risks;

(ii) assessing these risks and measuring the IIFS's exposure to them;

(iii) subject to the review and approval of the board, developing and implementing the enterprise-wide risk governance framework, which includes the IIFS's risk culture, risk appetite, and risk limits;

(iv) ongoing monitoring of the risk-taking activities and risk exposures in line with the board-approved risk appetite, risk limits, and corresponding capital or liquidity needs (i.e., capital planning);

(v) establishing an early warning or trigger system for breaches of the IIFS's risk appetite or limits;

(vi) influencing and, when necessary, challenging decisions that give rise to material risk; and

(vii) reporting to senior management and the board or risk committee on all these items, including but not limited to proposing appropriate risk-mitigating actions.

169. While it is common for risk managers to work closely with individual business units, the risk management function should be sufficiently independent of the business units and should not be involved in revenue generation. Such independence is an essential component of an effective risk management function, as is having access to all business lines that have the potential to generate material risk to the IIFS as well as to relevant risk-bearing subsidiaries and affiliates.

170. The risk management function should have a sufficient number of employees who possess the requisite experience and qualifications, including market and product knowledge as well as command of risk disciplines.[56] Staff should have the ability and willingness to effectively challenge business operations regarding all aspects of risk arising from the IIFS's activities. Staff should have access to regular training.

171. The risk management function must consider *Sharī`ah* non-compliance risk, by considering Islamic finance specificities and in collaboration with relevant control functions, in carrying out its key activities (as mentioned in paragraph 168).

[56] BCBS argued that some banks have found it to be a sound practice to encourage or require staff to gain experience in both business line and risk management roles on a rotational basis. Such an approach can have several benefits, including giving risk management stature within the IIFS commensurate with business lines and other functions, promoting bank-wide dialogue regarding risk, and ensuring that business lines understand the importance of risk management and that risk managers understand how business lines operate. However, to avoid conflicts of interest, risk managers should not be charged with overseeing activities for which they previously held line responsibility or participated in business decision-making or the approval process.

172. In the case where a new or emerging risk arises and is considered to be materially impactful to the IIFS's sustainability, with the recommendation of the CRO (or senior executive with similar function), a particular member of senior management should be assigned to address the issue. This assignment should be clearly reflected in the duty and responsibilities of his or her position.

Recommended best practices for the risk management function

173. As climate-related financial risks have become apparent and increasingly important,[57] the board and senior management should clearly assign climate-related responsibilities to members and/or committees and exercise effective oversight of climate-related financial risks. Further, the board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure.

174. The provision in paragraph 173 is equally applicable to building cyber resilience as an IIFS's business operations are highly dependent on information technology systems. The board and senior management should take this issue into their deliberations and clearly assign members and/or committees with sufficient skills, knowledge, experience, and/or expertise in information technology to be responsible for enhancing the IIFS's cyber resilience.

175. The member of senior management – when it is not the CRO – or board committees who are assigned to the task (as mentioned in paragraphs 173 and 174) should have an effective communication and collaboration with the CRO.

2.7.1. Role of the CRO

176. Large, complex, and internationally active IIFS, and other IIFS, based on their risk profile and local governance requirements, should have a senior manager (CRO or equivalent) with overall responsibility for the IIFS's risk management function. In banking groups, there should be a group CRO in addition to subsidiary-level risk officers. Because some banks may have an officer who fulfils the function of a CRO under a different title, reference in this document to the CRO is intended to incorporate equivalent positions, provided they meet the independence and other requirements set out herein.

177. The CRO has primary responsibility for overseeing the development and implementation of the IIFS's risk management function. This includes the ongoing strengthening of staff skills and enhancements to risk management systems, policies,

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[57] To the very least, due to physical risks – particularly in affected regions – and transitional risks emerging from the social, economic, and regulatory shift to reduce carbon emissions.

processes, quantitative models and reports as necessary to ensure that the IIFS's risk management capabilities are sufficiently robust and effective to fully support its strategic objectives and all of its risk-taking activities. The CRO is responsible for supporting the board in its engagement with and oversight of the development of the IIFS's risk appetite and RAS, and for translating the risk appetite into a risk limits structure. The CRO, together with management, should be actively engaged in monitoring performance relative to risk taking and risk-limit adherence. The CRO's responsibilities also include managing and participating in key decision-making processes (e.g., strategic planning, capital and liquidity planning, new products and services, compensation design, and operation).

178. The CRO shall keep abreast of the current developments that may affect the IIFS's business operations, remain alert to include any potential emerging risks – e.g., climate-related financial risks and cyber risks in today's context – and maintain readiness to identify, monitor, and control the risks. With the support of relevant control functions, the CRO is responsible to notify the other members of senior management and the board in the event a new risk emerges and needs to be integrated into the strategic decision-making process and overall governance procedures.

179. The CRO should have the organisational stature, authority, and necessary skills to oversee the IIFS's risk management activities. The CRO should be independent and have duties distinct from other executive functions. This requires the CRO to have access to any information necessary to perform his or her duties. The CRO, however, should not have management or financial responsibility related to any operational business lines or revenue-generating functions, and there should be no "dual hatting" (i.e., the chief operating officer, CFO, chief auditor, or other senior manager should in principle not also serve as the CRO).[58] While formal reporting lines may vary across IIFS, the CRO should report and have direct access to the board or its risk committee without impediment. The CRO should have the ability to interpret and articulate risk in a clear and understandable manner and to effectively engage the board and management in constructive dialogue on key risk issues. Interaction between the CRO and the board and/or risk committee should occur regularly, and the CRO should have the ability to meet with the board or risk committee without executive directors being present.[59]

[58] Where such "dual hatting" is unavoidable (e.g., in smaller institutions where resource constraints may make overlapping responsibilities necessary), these roles should be compatible – for example, the CRO may also have lead responsibility for a particular risk area – and should not weaken checks and balances within the IIFS.

[59] In some cases, the CRO sits on the IIFS's credit committee, which is responsible for approving credit exposures. While CRO participation may benefit the decision-making process and also benefit the CRO by providing information on potential exposures (and underwriting practices) which should be captured in the credit monitoring process, it can place the CRO in a conflicted position if faced with flagging or criticising the exposure in the future.

180. Appointment, dismissal, and other changes to the CRO position should be approved by the board or its risk committee. If the CRO is removed from his or her position, this should be disclosed publicly. The IIFS should also discuss the reasons for such removal with its supervisor. The CRO's performance, compensation, and budget should be reviewed and approved by the risk committee or the board.

2.8. Risk Identification, Monitoring, and Control

Principle 8: Risks should be identified, monitored, and controlled on an ongoing bank-wide and individual-entity basis. The sophistication of the IIFS's risk management and internal control infrastructure should keep pace with changes to the IIFS's risk profile, to the external risk landscape and in industry practice.

181. The IIFS's risk governance framework should include policies, supported by appropriate control procedures and processes, designed to ensure that the IIFS's risk identification, aggregation, mitigation, and monitoring capabilities are commensurate with the IIFS's size, complexity, and risk profile.

182. Risk identification should encompass all material risks to the IIFS, on- and off-balance sheet and on a group-wide, portfolio-wise and business-line level. In order to perform effective risk assessments, the board and senior management, including the CRO, should, regularly and on an ad hoc basis, evaluate the risks faced by the IIFS and its overall risk profile. The risk assessment process should include ongoing analysis of existing risks as well as the identification of new or emerging risks. Risks should be captured from all organisational units. Concentrations associated with material risks should likewise be factored into the risk assessment.

183. Risk identification and measurement should include both quantitative and qualitative elements. Risk measurements should also include qualitative, bank-wide views of risk relative to the IIFS's external operating environment. IIFS should also consider and evaluate harder-to-quantify risks, such as reputational risk specifically stemming from *Sharī`ah* non-compliance.

184. With regards to identification of emerging risks, IIFS should develop and implement a sound process for understanding and assessing the potential impacts of climate-related risk drivers on their businesses and on the environments in which they operate. IIFS should

Some institutions have found it a better practice to provide the CRO with veto authority only (as opposed to approval authority) in such situations.

consider material CFR that could materialise over various time horizons and incorporate these risks into their overall business strategies and risk management frameworks.

185. Additionally, IIFS should identify, assess, implement, and monitor and have in place the necessary controls to address cyber risks as part of operational risk management. The board and senior management – through the CRO or an equivalently senior executive – should ensure that IIFS has a strong cyber resilience framework, including a recovery plan, to ensure its ability to deliver critical operations through disruption.

186. Internal controls are designed, among other things, to ensure that each key risk has a policy, process, or other measure, as well as a control to ensure that such policy, process, or other measure is being applied and works as intended. As such, internal controls help ensure process integrity, compliance, and effectiveness. Internal controls provide reasonable assurance that financial and management information is reliable, timely, and complete and that the IIFS is in compliance with its various policies and applicable *Sharī`ah* rulings, laws, and regulations.

187. In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion. Even in smaller IIFS, for example, key management decisions should be taken by more than one person. Internal reviews should also determine the extent of an IIFS's compliance with company policies and procedures as well as with *Sharī`ah* rulings, legal, and regulatory policies. Adequate escalation procedures are a key element of the internal control system.

188. The degree of sophistication of the IIFS's risk management infrastructure – including, in particular, a sufficiently robust data infrastructure, data architecture, and information technology infrastructure – should keep pace with developments such as balance sheet and revenue growth; increasing complexity of the IIFS's business, risk configuration or operating structure; geographical expansion; mergers and acquisitions; or the introduction of new products or business lines.

189. IIFS should have accurate internal and external data to be able to identify, assess, and mitigate risk, make strategic business decisions, and determine capital and liquidity adequacy. The board and senior management should give special attention to the quality, completeness, and accuracy of the data used to make risk decisions.[60] While tools such as external credit

[60] See BCBS, *Principles for effective risk data aggregation and risk reporting*, January 2013, including its progress report of January 2015.

ratings or externally purchased risk models and data can be useful as inputs into a more comprehensive assessment, the IIFS are ultimately responsible for the assessment of its risks.

190. Risk measurement and modelling techniques should be used in addition to, but should not replace, qualitative risk analysis and monitoring. The risk management function should keep the board and senior management apprised of the assumptions used in and potential shortcomings of the IIFS's risk models and analyses. This would ensure better understanding of risks and exposures and may allow quicker action to address and mitigate risks.

191. As part of its quantitative and qualitative analysis, the IIFS should utilise stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances:[61]

(i) internal stress tests (whether bottom-up or top-down) should cover a range of scenarios based on reasonable assumptions regarding dependencies and correlations. Senior management should define and approve and, as applicable, the board should review and provide effective challenge to the scenarios that are used in the IIFS's risk analyses;
(ii) reverse stress testing could provide additional insight into the risk position of the IIFS as well as potential future management actions;
(iii) stress test programme results should be periodically reviewed with the board or its risk committee. Test results should be incorporated into the reviews of the risk appetite, the capital adequacy assessment process, the capital and liquidity planning processes, and budgets. They should also be linked to recovery and resolution planning. The risk management function should suggest if and what action is required based on results; and
(iv) the results of stress tests and scenario analyses should also be communicated to, and given appropriate consideration by, relevant business lines and individuals within the IIFS.

192. IIFS should regularly compare actual performance against risk estimates (i.e., back-testing) to assist in judging the accuracy and effectiveness of the risk management process and making necessary adjustments.

193. In addition to identifying and measuring risk exposures, the risk management function should evaluate possible ways to mitigate these exposures in a *Sharī`ah*-compliant manner.

[61] See BCBS, *Principles for sound stress testing practices and supervision*, May 2009, available at www.bis.org/publ/bcbs155.htm.

In some cases, the risk management function may direct that risk be reduced or hedged to limit exposure. In other cases, such as when there is a decision to accept or take risk that is beyond risk limits (i.e., on a temporary basis) or take risk that cannot be hedged or mitigated, the risk management function should report material exemptions to the board and monitor the positions to ensure that they remain within the IIFS's framework of limits and controls or within exception approval. Either approach may be appropriate depending on the issue at hand, provided that the independence of the risk management function is not compromised.

194. IIFS should have risk management and approval processes for new or expanded products or services, lines of business, and markets, as well as for large and complex transactions that require significant use of resources or have hard-to-quantify risks. IIFS should also have review and approval processes for outsourcing IIFS functions.[62] The risk management function should provide input on risks as part of such processes and on the outsourcer's ability to manage risks and comply with legal and regulatory obligations. Such processes should entail the following:

(i) a full and frank assessment of risks under a variety of scenarios as well as an assessment of potential shortcomings in the ability of the IIFS's risk management and internal controls to effectively manage associated risks; and

(ii) an assessment of the extent to which the IIFS's risk management, legal and regulatory compliance, *Sharī`ah* compliance, information technology, business line, and internal control functions have adequate tools and the expertise necessary to measure and manage related risks.

If adequate risk management processes are not in place, a new product, service, business line or third-party relationship, or major transaction should be delayed until the IIFS is able to appropriately address the activity. There should also be a process to assess risk and performance relative to initial projections and to adapt the risk management treatment accordingly as the business matures.

195. Risk management processes shall take into account *Sharī`ah* requirements for the IIFS's products/services, business operations, and activities that potentially lead to the emergence of specific risks to be addressed. Following identification of pertinent risks, the IIFS should undertake the necessary measures to manage and control the risks through *Sharī`ah*-compliant risk management tools.

[62] See the Joint Forum's *Outsourcing in financial services* at www.bis.org/publ/joint12.pdf.

196. Mergers and acquisitions, divestitures, and other changes to an IIFS's organisational structure can pose special risk management challenges to the IIFS. In particular, risks can arise from conducting due diligence that fails to identify post-merger risks or activities conflicting with the IIFS's strategic objectives or risk appetite. The risk management function should be actively involved in assessing risks that could arise from mergers and acquisitions and inform the board and senior management of its findings.

Principle 9: IIFS shall have in place a comprehensive risk management and reporting process which sufficiently caters to the specificities of Islamic finance, with appropriate oversight from the board and CRO.

197. IFSB-1 requires IIFS to have a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report, and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall consider appropriate steps to comply with *Sharī`ah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority. It further elaborates, in detail, the required risk management processes to address these six risks:

(i) credit risk;
(ii) equity investment risk;
(iii) market risk;
(iv) liquidity risk;
(v) rate of return risk; and
(vi) operational risk.

198. Operational risks also include reputational risk to IIFS, arising from failures in governance, business strategy, and process. Negative publicity about the IIFS's business practices, particularly relating to *Sharī`ah* non-compliance in their products and services, could have an impact on their market position, profitability, and liquidity.

199. Detailed provisions on risk management for IIFS are set out in IFSB-1: *Risk Management for IIFS*.

2.9. Risk Communication

Principle 10: An effective risk governance framework requires robust communication within the IIFS about risk, both across the organisation and through reporting to the board and senior management, and the SSB for matters related to *Sharī`ah*.

200. Ongoing communication about risk issues, including the IIFS's risk strategy, throughout the institution is a key tenet of a strong risk culture. A strong risk culture should promote risk awareness and encourage open communication and challenge about risk-taking across the organisation as well as vertically to and from the board, SSB as pertains to *Sharī`ah* non-compliance risk, and senior management. Senior management should actively communicate and consult with the control functions on management's major plans and activities so that the control functions can effectively discharge their responsibilities.

201. Information should be communicated to the board, SSB, and senior management in a timely, accurate, and understandable manner so that they are equipped to take informed decisions. While ensuring that the board, SSB, and senior management are sufficiently informed, management and those responsible for the risk management function should avoid voluminous information that can make it difficult to identify key issues. Rather, information should be prioritised and presented in a concise, fully contextualised manner. The board should assess the relevance and the process for maintaining the accuracy of the information it receives and determine if additional or less information is needed.

202. The board, SSB, and senior management should communicate to all employees, specifically frontliners and those who actively interact with customers, investors, shareholders, or other external parties, and underline the importance of understanding reputation risk, particularly that arising from a lack of understanding of *Sharī`ah* requirements and *Sharī`ah* non-compliant business conduct.

203. Material risk-related ad hoc information that requires immediate decisions or reactions should be promptly presented to senior management and, as appropriate, the board, the responsible officers and, where applicable, the heads of control functions so that suitable measures and activities can be initiated at an early stage.

204. Any affairs, such as in paragraph 203, that may raise *Sharī`ah* concern must be presented to SSB to obtain a *Sharī`ah* ruling or opinion in this regard.

205. Risk reporting to the board requires careful design in order to convey bank-wide, individual portfolio, and other risks in a concise and meaningful manner. Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses and should provoke a robust discussion of, for example, the IIFS's current and prospective exposures (particularly under stressed scenarios), risk/return relationships, and risk appetite and limits. Reporting should also include information about the external environment to identify market conditions and trends that may have an impact on the IIFS's current or future risk profile.

206. Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions. Risk monitoring and reporting should not only occur at the disaggregated level (including material risk residing in subsidiaries) but should also be aggregated to allow for a bank-wide or integrated perspective of risk exposures. Risk reporting systems should be clear about any deficiencies or limitations in risk estimates, as well as any significant embedded assumptions (e.g., regarding risk dependencies or correlations).

207. IIFS should avoid organisational "silos" that can impede effective sharing of information across an organisation and can result in decisions being taken in isolation from the rest of the IIFS.[63] Overcoming these information-sharing obstacles may require the board, senior management, SSB, and control functions to re-evaluate established practices in order to encourage greater communication.

208. As part of risk culture, a business continuity plan (BCP) or recovery plan or similar document should be prepared, communicated, and regularly simulated to create organisation-wide awareness and understanding. It aims to build resilience of IIFS in time of crisis by getting familiar with multiple crises scenarios, whereby each relevant personnel will be able to recognise the early warning indicators and undertake appropriate steps to limit, mitigate, control, and/or recover from the downside risks.

209. The risk management function, approved by the CRO, should define communication channels to update and enhance risk awareness across the organisation, specifically pertaining to emerging risks such as CFR and cyber risks, i.e., cybersecurity risk, data security risk, etc.

2.10. Compliance

Principle 11: The IIFS's board of directors is responsible for overseeing the management of the IIFS's compliance risk, including *Sharī`ah* non-compliance risk. The board should establish a compliance function and approve the IIFS's policies and processes for identifying, assessing, monitoring, reporting, and advising on compliance risk.

210. An independent compliance function[64] is a key component of the IIFS's second line of defence. This function is responsible for, among other things, ensuring that the

[63] Organisational silos can be characterised by business lines, legal entities, and/or geographical units being run in isolation from each other, with limited information shared and, in some cases, competition across silos.
[64] See BCBS, *Compliance and the compliance function in banks*, 2005, available at www.bis.org/publ/bcbs113.pdf.

IIFS operates with integrity and in compliance with applicable *Sharī`ah* rules, principles, laws, regulations, and internal policies.

211. The IIFS's senior management is responsible for establishing a compliance policy that contains the basic principles to be approved by the board and explains the main processes by which compliance risks are to be identified and managed through all levels of the organisation.

212. Compliance policy, as required in paragraph 211, must include *Sharī`ah* compliance to be approved by SSB, in addition to the board's approval. SSB should provide the necessary inputs to be incorporated into the policy.

213. While the board, senior management and SSB are accountable for the IIFS' compliance[65], the compliance function has an important role in supporting corporate values, policies and processes that help ensure that the IIFS acts responsibly and fulfils all applicable obligations.

214. The compliance function should advise the board, SSB, and senior management on the IIFS's compliance with applicable laws, rules, and standards and keep them informed of developments in the area. It should also help educate staff about compliance issues, act as a contact point within the IIFS for compliance queries from staff members, and provide guidance to staff on the appropriate implementation of applicable laws, rules, and standards in the form of policies and procedures and other documents such as compliance manuals, internal codes of conduct, and practice guidelines.

215. The compliance function is independent from management to avoid undue influence or obstacles as that function performs its duties. The compliance function should directly report to the board, as appropriate, on the IIFS's efforts in these areas and on how the IIFS is managing its compliance risk.

216. To be effective, the compliance function must have sufficient authority, stature, independence, resources, and access to the board. Management should respect the independent duties of the compliance function and not interfere with their fulfilment. As previously noted, there should be no "dual hatting" by the head of the compliance function.

217. All of the provisions set out in this section are equally applicable to IIFS and therefore, the term "compliance" should include *Sharī`ah* compliance. Accordingly, "compliance function" will also cover the *Sharī`ah* compliance function as a part of the holistic IIFS compliance

[65] The board and senior management are responsible for overall compliance, including *Sharī'ah* compliance. The SSB is only accountable for ensuring adherence to applicable *Sharī'ah* rulings and opinions.

function. Further provisions to address specificities in the *Sharī`ah* compliance function refer to IFSB Standard on *Sharī`ah* Governance Framework.

2.11. Internal Audit

Principle 12: The internal audit function should provide independent assurance to the board and should support the board, SSB, and senior management in promoting an effective governance process and the long-term soundness of the IIFS.

218. An effective and efficient internal audit function constitutes the third line of defence in the system of internal control. It provides an independent assurance to the board, SSB, and senior management on the quality and effectiveness of an IIFS's internal control, risk management, and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation.[66]

219. The internal audit function should have a clear mandate, be accountable to the board and be independent of the audited activities. It should have sufficient standing, skills, resources, and authority within the IIFS to enable the auditors to carry out their assignments effectively and objectively.

220. The mandate of internal audit function in IIFS should be extended to include the internal *Sharī`ah* audit function. Further provisions to address Islamic finance specificities in the internal *Sharī`ah* audit function can be seen in the IFSB Standard on *Sharī`ah* Governance Framework for IIFS.

221. There should be no "dual hatting" by the heads of these functions.

222. The board, SSB, and senior management contribute to the effectiveness of the internal audit function by:

(i) providing the function with full and unconditional access to any records, file data, and physical properties of the IIFS, including access to management information systems and records and the minutes of all consultative and decision-making bodies;
(ii) requiring the function to independently assess the effectiveness and efficiency of the internal control, risk management, and governance systems and processes;
(iii) requiring internal auditors and internal *Sharī`ah* auditors to adhere to national and international professional standards applicable for them, respectively;
(iv) requiring that audit staff and *Sharī`ah* audit staff have or can access knowledge, skills, and resources commensurate with business activities and risks of the IIFS;

[66] See BCBS, *The internal audit function in banks*, 2012, available at www.bis.org/publ/bcbs223.pdf.

(v) requiring timely and effective correction of audit issues by senior management; and

(vi) requiring the function to perform a periodic assessment of the IIFS's overall risk governance framework – *Sharī`ah* governance should be viewed as an integral part of this – including but not limited to an assessment of:

- the effectiveness of the risk management and compliance functions;
- the quality of risk reporting to the board and senior management; and
- the effectiveness of the IIFS's system of internal controls.

223. The board and senior management should respect and promote the independence of the internal audit and internal *Sharī`ah* audit functions by ensuring that:

(i) internal audit reports are provided to the board or its audit committee without management filtering and that the internal auditors have direct access to the board or the board's audit committee;

(ii) internal *Sharī`ah* audit reports are shared with the SSB for its views and conclusions regarding *Sharī`ah* matters;

(iii) the head of the internal audit function's primary reporting line is to the board (or its audit committee), which is also responsible for the selection, oversight of the performance, and, if necessary, dismissal of the head of this function;

(iv) if the chief audit executive is removed from his or her position, it is disclosed publicly. The IIFS should also discuss the reasons for such removal with its supervisor.

2.12. Compensation

Principle 13: The IIFS's remuneration structure should support sound corporate governance and risk management.

224. Remuneration systems form a key component of the governance and incentive structure through which the board and senior management promote good performance, convey acceptable risk-taking behaviour, and reinforce the IIFS's operating and risk culture. The board (or, by delegation, its compensation committee) is responsible for the overall oversight of management's implementation of the remuneration system for the entire IIFS. In addition, the board or its committee should regularly monitor and review outcomes to assess whether the bank-wide remuneration system is creating the desired incentives for managing

risk, capital, and liquidity.[67] The board or subcommittee should review the remuneration plans, processes, and outcomes at least annually.

225. Systemically important financial institutions should have a board compensation committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation.

226. The FSB principles on compensation are intended to apply to significant financial institutions, but they are especially critical for large, systemically important firms. National jurisdictions may also apply the principles in a proportionate manner to smaller, less complex institutions. IIFS are encouraged to implement the FSB principles, or consistent national provisions based on them.

227. The board, together with its compensation committee where one exists, should approve the compensation of senior executives, including the CEO, CRO, and head of internal audit, and should oversee development and operation of compensation policies, systems, and related control processes.

228. For employees in control functions (e.g., risk, compliance, and internal audit), remuneration should be determined independently of any business line overseen, and performance measures should be based principally on the achievement of their own objectives so as not to compromise their independence.

229. The remuneration structure should be in line with the board's expectations and the business and risk strategy, objectives, values, and long-term interests of the IIFS. It should also incorporate measures to prevent conflicts of interest. Remuneration programmes should encourage a sound risk culture in which risk-taking behaviour is appropriate and which encourages employees to act in the interest of the company as a whole (also taking into account client interests) rather than for themselves or only their business lines. In particular, incentives embedded within remuneration structures should not incentivise staff to take excessive risk.

230. IIFS are encouraged to incorporate environmental, social, and governance (ESG) values in formulating its organisation-wide compensation as it is aligned with the pursuit of IIFS sustainability and overall *Maqāṣid al-Sharīʻah.*

[67] By applying *Implementing the FSB principles for sound compensation practices and their implementation standards – second progress report*, 26 August 2013, p 14.

231. The board or compensation committee should take into account adverse impacts caused by emerging risks such as CFR and cyber risks. Considerable attention should be given to risks that may materialise in a multi-year term, such as CFR, in structuring the compensation of senior management. It should be noted that these risks are high in uncertainty with unforeseeable time horizons or may take longer time to materialise.

232. Remuneration should reflect risk-taking and risk outcomes. Practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain should be carefully evaluated by means of both qualitative and quantitative key indicators. The remuneration framework should provide for variable remuneration to be adjusted to take into account the full range of risks, including breaches of risk appetite limits, internal procedures, or legal requirements.

233. IIFS have to set specific provisions for employees with a significant influence on the overall risk profile, so-called material risk-takers. Remuneration pay out schedules should be sensitive to risk outcomes over a multi-year horizon. For material risk-takers, this is often achieved through arrangements that defer a sufficiently large part of the compensation until risk outcomes become better known. This includes "malus/forfeiture" provisions, where compensation can be reduced or reversed based on realised risks or conduct events before compensation vests, and/or "clawback" provisions, under which compensation can be reduced or reversed after compensation vests if new facts emerge showing that the compensation paid was based on erroneous assumptions, such as misreporting, or if it is discovered that the employee has failed to comply with internal policies or legal requirements. In such cases, the IIFS should take action as soon as practicable to recover forfeitable or recoupable amounts to improve the likelihood of successful recovery. "Golden hellos" or "golden parachutes," under which new or terminated executives or staff receive large pay outs irrespective of performance, are generally not consistent with sound compensation practice.

234. An IIFS should provide adequate qualitative and quantitative disclosures regarding its compensation policies to stakeholders in accordance with the requirements of the respective regulatory and supervisory authority.

235. These above provisions for effective compensation should also be considered when structuring SSB members' compensation, when applicable and in alignment with relevant IFSB standards. Compensation of SSB members should be designed in a manner that will ensure

their objectivity and independence, and in accordance with their respective performance evaluations.[68]

2.13. Investment Account

2.13.1. The Rights of Investment Account Holders

Principle 14: An IIFS shall acknowledge the IAHs' right to monitor the performance of their investments and associated risks and to put into place adequate means to ensure that these rights are observed and exercised.

236. Consistent with IFSB-3: *Corporate Governance for IIFS* and IFSB-23: *Revised Capital Adequacy*,[69] this document will mainly use investment accounts, a pool of investment funds in an IIFS, under *Muḍārabah* contract, as the basis of discussion therein.

237. Conceptually, under *Muḍārabah* contract, the IAH as capital owner and provider (*Rabb al-Māl)* bears the risk of losing the capital invested by the IIFS as *Muḍārib*.[70] Effectively, this means the IAH's investment risk is similar to that of the IIFS shareholders who bear the risk of losing their capital as investors in the IIFS. However, the IIFS, as *Muḍārib*, owe a fiduciary duty to the IAH under the *Muḍārabah* contract, which is parallel with their duty to their shareholders. In this context, the IIFS as *Muḍārib* refer to both their management and their shareholders, not the management alone. Therefore, for the purpose of the Guiding Principles, discussions on the fiduciary duties of the IIFS to the IAH shall always be understood as the fiduciary duties of both the management and shareholders of the IIFS as *Muḍārib* towards the IAH as *Rabb al-Māl*.

238. In this respect, whether the investment mandate is restricted or unrestricted, the IIFS have a fiduciary duty to the IAH to uphold their interests no less than those of the IIFS's own shareholders. In other words, although as investors in the IIFS's assets, the shareholders would rank *pari passu*[71] with the IAH, as a party in the *Muḍārib* side of the *Muḍārabah* contract,

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[68] See also IFSB standard on the Revised *Sharīʻah* Governance Framework.

[69] See IFSB-23: *Revised Capital Adequacy*, 2021, Section 4 on Profit-Sharing Investment Account and IFSB-3: *Corporate Governance for IIFS*, Principles 2 and 4.

[70] IA is tied to the performance of the underlying asset and thus, its characteristics differ with deposit products.

[71] Shareholders and IAH rank *pari passu* as residual claimants in regard to assets financed by funds commingled in the same asset pool. Where current account (unremunerated) funds are also commingled in the same pool, the current account holders rank as creditors in regard to the ***shareholders'*** portion of the assets in the pool, but *not* in regard to the *IAH's* portion. This follows from the nature of the *Sharī`ah*-compliant contract on the basis of which the IAH funds are mobilised.

they also owe a fiduciary duty to the IAH and would have to ensure the protection of the IAH's interests.

239. Hence, it is appropriate that the IIFS put the IAH on an equal footing with the IIFS's own shareholders by duly acknowledging the IAH's right to access all relevant information for their investment accounts. This would assist the IAH in making an informed decision on their selection or choice of the investment accounts in which to place their funds with the IIFS (for example, if the IIFS offer different types of restricted investment accounts). In a situation where the local legal framework is not yet capable of facilitating the exercise of these rights by the IAH, the RSA should play a role in protecting the interests of the IAH vis-à-vis the shareholders of the IIFS with regard to their rights, provided that they are in compliance with *Sharī`ah* rules and principles.

240. The IAH's right to monitor the performance of the investment should not be misconstrued as a right to intervene in the management of the investments by the IIFS. It shall be noted that IIFS shareholders who are entitled to vote in general meetings, to pass resolutions on the appointment of directors and auditors, and to access the documents of the IIFS are also not considered as intervening in the management of the IIFS. Therefore, it is only appropriate that the IIFS disclose its policies and practices for the investment accounts it offers to the IAH.

241. The IFSB recognises the prevailing practices whereby a number of other contracts – such as *mushārakah* and *wakālah* – are also utilised by the IIFS in constructing investment account products; and therefore, the provisions set out in these Guiding Principles could still be of some relevance and are recommended to be adopted where applicable.

242. Where Investment Accounts (IA) are managed under *wakālah,* the relationship between the IIFS and investors becomes that of agency, with the IIFS earning a flat fee – plus, in some cases, performance-based incentives – rather than a share of profit. RSAs should use stringent eligibility criteria for including *wakālah-* or *mushārakah*-based accounts in the definition of investment accounts, according to the features and specificities of investment accounts mentioned in this document.[72]

Recommended best practices

243. An IIFS shall always be aware that with its fiduciary responsibility to the IAH comes accountability. It shall be prepared to be accountable to the IAH in ensuring that the investment

[72] See IFSB-23: *Revised Capital Adequacy for Banking*, 2021, Principle 4 for further reference.

accounts continue to be managed within the parameters of the given mandate. Before opening an investment account with an IIFS, the IAH shall be adequately advised by the IIFS of its contractual rights and the risks of the investment account products, including primary investment and asset allocation strategies and the method of calculating the profit/loss from the investments.

244. Given the nature of investment account contracts, it is only appropriate that an IIFS recognise the IAH's right to monitor the performance of the investment and put in place means for this right to be exercised. The governance committee[73] of the IIFS shall take responsibility for protecting this right of the IAH by ensuring that relevant disclosures to IAH are made in a timely and effective manner, as well as ensuring proper implementation of the investment contracts.

245. For illustrative purposes, the relationship between IAH and IIFS may be compared to that found in collective investment schemes (CIS), in which participants have mandated their fund managers to manage their investments. Both IAH and CIS participants:

(i) entrust their money to be invested and managed by a fund manager (that is, the IIFS in the case of IAH and the CIS operator in the case of CIS participants);

(ii) bear the risk of losing the capital of their investment; and

(iii) have very minimal rights in controlling the conduct of the fund manager; more often they would have to vote with their feet – that is, simply move their investment away if they find the fund manager's performance to be unsatisfactory.

246. Nevertheless, in most cases, at present CIS participants stand in a better position than the IAH, since securities regulation usually ensures that CIS operators meet stringent requirements before they can operate a CIS. CIS participants enjoy more rights; in particular, concerning their access to information.[74] Furthermore, CIS participants often know the net asset value of their investments, which would allow them to dispose of the investments swiftly in a secondary market.

[73] In the case where IIFS do not establish a governance committee, the board must ensure one of its committees is responsible in safeguarding the interests of IAH – if IA are offered by the IIFS.

[74] For example, CIS operators must furnish the CIS participants with a prospectus disclosing relevant information on the CIS before they are allowed to canvas for investments. The International Organisation of Securities Commissions (IOSCO) has also issued principles which specifically require the disclosure of all fees and charges that may be levied by a fund manager under the CIS.

247. The Guiding Principles therefore require that IIFS shall have an internal guideline that sets out:

(i) the eligibility of the IIFS employees who are responsible for managing investment accounts operated by the IIFS;

(ii) the adequate protection of the IAH investments, including the case where the unrestricted IAH's funds are commingled with shareholders' funds;

(iii) the disclosure of relevant and material information to the IAH; and

(iv) a proper and disclosed basis for profit allocation and investment policies to be based on the risk expectations of the IAH.

248. Restricted IAHs shall have the right to obtain at least all the information usually available to participants of a CIS. Unrestricted IAHs shall be allowed access to all the necessary information with respect to their investment accounts; in particular, the calculation and allocation of profits and the investment policies of the IIFS.

249. The IIFS shall inform the IAH from the outset when opening an investment account that particularly in the event of liquidation of the IIFS:

(i) the IAH shall only bear the loss in proportion to the assets funded by their investments;

(ii) the IIFS shall be liable for losses arising from its own negligence, misconduct, or breach of their investment mandate; and

(iii) the restricted IAH shall not be liable for any obligation to other parties arising from the deficiencies of the IIFS or its liquidity unless it is specifically related to the restricted IAH funds. The unrestricted IAH shall only be liable for such obligations in accordance with the proportion of their share in the commingled funds.

250. For a better understanding of the issues and the impacts of their liabilities on IAH, IIFS should refer to the IFSB-23: *Revised Capital Adequacy Standard*. In addition, reference is drawn to Section 4 on "Transparency of Financial Reporting in respect of Investment Accounts" for relevant recommendations.

2.13.2. Management of Investment Account Funds

Principle 15: The IIFS should adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of the IAH (bearing in

mind the distinction between restricted and unrestricted IAH) and be transparent in smoothing any returns.

251. The IIFS shall use its best efforts to implement an investment strategy which is appropriately aligned to the risk and return expectations of the IAH as mutually agreed in the investment account contracts between the IAH and the IIFS, taking into consideration any restrictions that may be imposed by the IAH at the time of concluding the investment contract.

252. Arguably, IAH are generally seeking a low-risk investment with stable returns (employing a “defensive” investment strategy), whereas shareholders may favour a more aggressive and robust investment strategy offering higher returns with more risk. This may lead to a conflict of interest when IAH funds and shareholders’ funds are commingled. Smoothing of the IAH’s returns may mitigate this problem but does not fundamentally affect the underlying risk and may have negative effects on transparency.

253. Dividends paid out to shareholders are likely to differ from, and be more stable than, the profits (earnings) attributable to them, with the differences being added to or released from reserves. Similarly, the amount distributed to an IAH as profit share may differ from its attributable share of the IIFS’s earnings. Many IIFS have adopted the practice of “smoothing the returns” (that is, the profit distributed) for their IAH and shareholders by using a special type of reserve, the profit equalisation reserve (PER). While the Guiding Principles takes note of the fact that this smoothing practice may enable IIFS to pay a competitive rate of return in years when the IAH’s profit rate, based on the attributable share of the IIFS’s earnings, is below the going market rate, there are concerns about the transparency and accountability of this practice. In particular, these concerns are:

(i) the IAH’s attributable share of profit earned and utilisation of reserves, hence the IIFS’s profit performance for its IAH may not be adequately disclosed; and

(ii) such practices may be used to mask the fact that the IIFS has invested IAH funds in assets with more risky returns than an IAH would expect, rather than achieving stable returns for its IAH by adopting an efficient and appropriate asset allocation.

254. As with other types of reserves created for smoothing returns, the PER is also subject to the inter-generational problem. Because the reserves are built up from setting aside a portion of the profits available for distribution to existing IAH and shareholders, it could happen that some IAH who have forgone part of their profit share in years with above-average profits will never receive any benefit from this. This would happen if, throughout the tenure of their investment accounts, the IIFS never releases the funds from the PER to increase the

distribution to those IAH. Instead, if those IAH close their investment accounts today and the IIFS decides to utilise the PER tomorrow for the next profit distribution, new IAH who may never have contributed to the PER at all will get to enjoy “unearned” benefits. The Guiding Principles takes note that in the event that an IIFS has to be liquidated, the PER should be disposed of in accordance with what was agreed upon at the time of establishing the reserves.

255. Therefore, the IIFS shall create practices, procedures, and entitlements that adequately address any undesirable ambiguity in this area, which could be ethically questionable and tantamount to *gharar* with regard to the PER.

256. Smoothing of returns distributed to IAH using the PER is not to compensate for capital loss; for that purpose another special type of reserve, the investment risk reserve (IRR), may be used.[75] Similarly, the inter-generational problem also arises in the case of the IRR, whereby the IAH who actually contributed to building it up may not get any benefit from it, and IAH who may never have contributed to it may be the ones to gain from its existence. It should be noted that in the case of reserves attributable to shareholders, their magnitude is normally reflected in the market value of their shares, so that the inter-generational problem is avoided. There is no such effect on the market value of investment accounts of amounts held in the PER or IRR.

Recommended best practices

257. In developing its investment strategy on behalf of its IAHs, an IIFS shall carefully consider the risk and return expectations of IAHs by:

(i) having an appropriate and systematic know-your-customer mechanism that can effectively reflect the different risk–return profiles of restricted and unrestricted IAHs;

(ii) employing qualified investment managers who fully understand the needs and expectations of IAHs; and

(iii) keeping the governance committee fully informed of the investment strategy adopted by the IIFS, where appropriate.

258. The IIFS shall inform the IAH if the institution practises the smoothing of returns by means of building up and drawing on reserves such as a PER. The IIFS shall also inform the IAH whenever it transfers profits to such reserves or draws on the reserves in order to enhance the profit distribution to IAH. Just as shareholders are entitled to be informed appropriately when a company makes use of reserves to pay dividends to shareholders, the IAH shall have

[75] It should be noted that in the case of a constructive or actual liquidation, both reserves are included in the liquidation process.

the right to know when the returns distributed to them exceed the actual returns earned on investments because of upward smoothing (because investments made on their behalf by the IIFS are not performing adequately).

259. In addition, the IIFS shall clearly distinguish the “distribution rate,” that is, the rate of profit distributed, and the “profit rate,” that is, the actual profit earned from investments made on behalf of the IAH, in disclosing the returns to the IAH. Effectively, the utilisation of PER shall clearly be understood as being for “smoothing the dividend pay out” rather than “smoothing the profits earned” for IAH.

260. Similarly, if the IIFS has created an IRR to cushion any unexpected loss on the part of the IAH, the utilisation of the IRR shall be placed under the scrutiny and subject to the recommendations of the governance committee to the board. Refer to Principle 14 for some disclosure requirements with regard to PER and IRR.

2.14. Disclosure and Transparency

Principle 16: The governance of the IIFS should be adequately transparent to its shareholders, IAHs, depositors, other relevant stakeholders, and market participants.

2.14.1. General guidance to disclosure and transparency

261. Transparency is consistent with sound and effective corporate governance. As emphasised in IFSB-22 on disclosures to promote transparency and market discipline for IIFS, disclosure of meaningful information about key aspects of governance reduces information asymmetry and helps promote market discipline. Provisions on disclosure are made for shareholders, IAHs, depositors, other relevant stakeholders, and market participants to effectively monitor and properly hold the board, SSB, and senior management accountable in governing the IIFS. Above all, the main objective of disclosure is to ensure *Sharī`ah* compliance in all of the IIFS’s products, services, business operations, and activities at all times.

262. Although disclosure may be less detailed for non-listed IIFS, especially those that are wholly owned, these IIFS can nevertheless pose the same types of risk to the financial system as publicly traded IIFS through various activities, including their participation in payment systems and acceptance of retail deposits and investment accounts.

263. All IIFS, even those for whom disclosure requirements may differ because they are non-listed, should disclose relevant and useful information that supports the key areas of corporate governance identified by the BCBS Guidelines. Such disclosure should be

proportionate to the size, complexity, structure, economic significance, and risk profile of the IIFS. At a minimum, IIFS should annually disclose the following information:

(i) the recruitment approach for the selection of members of the board and for ensuring an appropriate diversity of skills, backgrounds, and viewpoints;
(ii) the criteria for and selection of SSB members;
(iii) whether the IIFS has set up board committees and the number of times key standing committees have met;
(iv) the number of SSB meetings and each members' attendance.

264. In general, the IIFS should apply the disclosure and transparency section of the OECD principles.[76] Accordingly, disclosure should include, but not be limited to, material information on the IIFS's objectives, organisational and governance structures and policies (in particular, the content of any corporate governance or remuneration code or policy and the process by which it is implemented), major share ownership and voting rights, and related party transactions. Relevant IIFS should appropriately disclose their incentive and compensation policy following the FSB principles related to compensation. In particular, an annual report on compensation should be disclosed to the public. It should include: the decision-making process used to determine the bank-wide compensation policy; the most important design characteristics of the compensation system, including the criteria used for performance measurement and risk adjustment; and aggregate quantitative information on remuneration. Measures that reflect the longer-term performance of the IIFS should also be presented.

265. The IIFS should also disclose key points concerning its risk exposures and risk management strategies without breaching necessary confidentiality. When involved in material and complex or non-transparent activities, the IIFS should disclose adequate information on their purpose, strategies, structures, and related risks and controls.

266. Disclosure should be accurate, clear, and presented such that shareholders, IAHs, depositors, other relevant stakeholders, and market participants can consult the information easily. Timely public disclosure is desirable on an IIFS's public website, in its annual and periodic financial reports, or by other appropriate means. It is good practice to have an annual corporate governance-specific and comprehensive statement in a clearly identifiable section of the annual report depending on the applicable financial reporting framework. All material

[76] Section V of the OECD principles states: "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company." See OECD (2004), op cit.

developments that arise between regular reports should be disclosed to the IIFS supervisor and relevant stakeholders as required by law without undue delay.

267. In developing this section, the Guiding Principles mainly adopt and expand on the standards below. The detailed disclosures, as set out in these standards, should be considered in implementing this Principle.

(i) IFSB-3 and IFSB-22 for disclosures related to IAH, ESG, and Islamic finance specificities;
(ii) IFSB-10 and its ongoing revision on *Sharī`ah* governance disclosures;
(iii) BCBS Guidelines and other relevant guidelines[77] for climate-related and cyber resilience disclosures; and
(iv) Task Force on Climate-related Financial Disclosures (TCFD) and International Sustainability Standards Board (ISSB) on climate-related disclosures.

268. Regulators should require IIFS to ensure that their reporting for both financial and non-financial information meets the requirements of internationally recognised accounting standards which are consistent with *Sharī`ah* rules and principles and are applicable to the IIFS industry as recognised by the RSA.

269. In order to provide meaningful information for stakeholders to be used in their decision-making process, several key aspects of disclosures should be properly addressed:[78]

- the IIFS shall have a formal disclosure policy;
- disclosures should be clear, comprehensive, and consistent;
- disclosures should be meaningful to users in making decision; and
- disclosures should be comparable across IIFS.

2.14.2. Disclosures on Sharīʻah *Governance*

Principle 17: An IIFS shall be transparent in its *Sharīʻah* governance to its shareholders, customers, other relevant stakeholders, and market participants.

270. A separate IFSB standard on the *Sharīʻah* governance framework has set out more detailed provisions on this topic. Hence, RSAs and/or IIFS shall refer to the that standard. Additionally, Section 7 of IFSB-22 also provides several items of qualitative disclosures that should be made annually by IIFS with regards to *Sharīʻah* governance.

[77] BCBS Guidelines refers to several BCBS guidelines on CFR and cyber risks entitled "*Principles for the effective management and supervision of climate-related financial risks*", June 2022; "*Principles for Operational Resilience*", March 2021; and "*Revisions to the Principles for the Sound Management of Operational Risk*", March 2021.
[78] For detail guidance, see IFSB-22 on disclosures to promote transparency and market discipline for IIFS.

271. Insofar as they are consistent with relevant IFSB standards as mentioned in paragraph 270, disclosures on *Sharī'ah* Governance shall, at minimum, contain the following information:

(i) a statement from SSB stating that the IIFS has conducted its operations in a *Sharī`ah*-compliant manner;
(ii) information on the SSB members, including their professional background and qualifications;
(iii) number of SSB meetings, including regular and extraordinary (if any), and the SSB members' attendance;
(iv) *Sharī`ah* rulings and pronouncements issued by SSB should be easily accessible to the public, containing the background of the issue, *Sharī`ah* legal basis, and justifications;
(v) information on any departure from *Sharī`ah* rulings (if any), reasons for the departure, and how matters are handled; and
(vi) information on the amount and type of activities generating *Sharī`ah* non-compliant income and how it is discharged (if any).

2.14.3. Disclosures on Investment Accounts

Principle 18: The IIFS shall make adequate and timely disclosure to IAHs and the public of material and relevant information on the investment accounts that it manages.

272. In line with the IAHs' right to monitor the performance of their investments, they should be entitled to be informed of the methods of profit calculation, asset allocation, investment strategies, and mechanics of smoothing the returns (if any) for their investment accounts.

273. In addition, the IAH and the public should be entitled to be informed of any related party transactions and treatment of material events by the IIFS. Adequate and timely disclosure of such material information is vital in developing transparency, accountability, and a better risk management culture in IIFS.

274. Inundating IAHs with information does not make the IIFS more transparent. In fact, the opposite can be the case. In order to avoid information overload, the disclosures shall be made in a timely and orderly manner. The aim is not to disclose as much information as possible, but to provide relevant and reliable information that is crucial to the IAH in understanding and properly evaluating how their investment accounts are managed.

275. It is important to ensure that information is readily available in a comparable, understandable, readable, and reliable form, so that it is easily accessible not only by IAHs, but by information intermediaries for consumers such as the media, financial advisers, and

consumer associations. The information intermediaries are likely to use the information to draw attention to good and bad features more effectively than consumers would typically be able to do for themselves. This process would be helped by:

(i) standardisation of terms and language;
(ii) comparable measures of or ways of explaining charges, risks, profit calculation, asset allocation, investment strategies, and the mechanics of smoothing the returns (if any); and
(iii) easy access to such information, for example, through the Internet.

Recommended best practices

276. Information on the basis for profit distribution and allocation shall be provided to the IAH prior to the opening of the investment account, especially since under a *muḍārabah* contract the profit-sharing ratio must be declared in advance. Information that may change from time to time, such as significant changes in the investment strategies, should be included in the investment account statement issued to the IAH whenever there is any change made by the IIFS. Asset allocation shall be duly reported within the IIFS's financial statements.

277. The utilisation of the PER for smoothing the returns to IAHs and shareholders, as well as the use of the IRR for covering losses (if any), is an issue of public interest and shall be publicized in major media organs as well as the IIFS's annual report.

278. An IIFS shall make an adequate and timely public announcement in its annual reports, on its websites, and in mainstream media organs should it make any material changes to its policies in respect of profit calculation, asset allocation, investment strategies, and the mechanics of smoothing the returns (if any) for the investment accounts that it manages.

279. The IIFS is encouraged to publish, in its annual report, a policy statement issued and affirmed by the board for the investment accounts that it offers. In addition, it is recommended that the IIFS make, in a form and medium accessible to IAHs (for example, a public website and annual report), the other disclosures as recommended in IFSB-22. Further guidance and provisions on disclosures for IIFS shall make reference to IFSB-22.

2.14.4. Islamic social finance in supporting a sustainability agenda

Principle 19: An IIFS who offers Islamic social finance products and/or engage in sustainability agenda shall make adequate and timely disclosure of material and relevant information, particularly on the impact of these products/ activities, to relevant stakeholders. The disclosure shall be made available to the public.

280. The concept of sustainability is inherently aligned with Islamic finance principles of risk sharing and restricting financing to ethical activities. IIFS business activities should drive towards the *Maqashid Al-Sharī`ah* that are compatible with SDGs. Notwithstanding its function as commercial institutions, an IIFS is expected to promote financial inclusion as well as wealth distribution through its role in supporting Islamic social finance activities such as collection, management and/or disbursement of *zakāh*, voluntary charity (*sadaqah*) and/or *waqf*, among others.[79]

281. Impact reporting constitutes a number of activities such as measurement, management, and reporting of the IIFS's economic, social, and environmental impact. Hence, well-defined objectives, program targets, scope, and timeframe are critical to the reporting process. The report should focus on how IIFS deliver the business process for Islamic social finance activities starting from utilised resources as the inputs, process, or progress of the program, output, outcome, and ultimately the desired long-term impact.

282. One important process is to analyse the key impact areas and identify significant spheres of the organisation's social and economic influence, which entails the positive impact of the IIFS's activities or reduction in negative consequences arising from the IIFS's business operations.

283. An IIFS engaged in Islamic social finance activity should:

(i) have a comprehensive governance framework incorporating Islamic social finance activities the IIFS is involved in;
(ii) monitor the progress, resources used, and impact of their activities;
(iii) employ risk management processes; and
(iv) disclose any material risks associated with the activities (when applicable).

284. IIFS that offer collection, management, and/or disbursement of Islamic social finance instruments as their services are recommended to disclose these activities with more emphasis placed on the impact of the activities. Section 10 in IFSB-22, which discusses ESG impact disclosures, can be used as a reference for IIFS in preparing the relevant information.

285. In determining the scope of disclosures, the IIFS should take into account the costs and benefits of preparing such information. It is recommended that the IIFS strategise and prioritise a few programs to be reported in a more focused and useful manner.

[79] Based on IFSB survey to develop the Guiding Principles, some jurisdictions opt to exclude IIFS from any Islamic social finance activities, as reflected in the absence of legal and regulatory basis for the said activities. Bearing this in mind, the Guiding Principles encourage IIFS to optimise their corporate social responsibility in the pursuit of *Maqāṣid Al-Sharī`ah,* whenever applicable.

2.14.5. Climate-related financial risks (CFR) disclosures

Principle 20: An IIFS should identify the potential impacts of climate-related risk drivers, assess the materiality of these risks, employ comprehensive risk management, and disclose material and relevant information in an adequate and timely manner.

286. CFR refers to the set of potential risks that may arise from climate change and that could potentially impact the safety and soundness of individual financial institutions and have broader financial stability implications for the banking system. These risks are typically classified as physical and transition risks, which are viewed as two main risk drivers of CFR. Physical risks include the potential economic costs and financial losses resulting from the increasing severity and frequency of extreme climate-change related events, longer-term progressive shifts in the climate and indirect effects of climate change on the loss of ecosystem such as water shortages and degradation in soil quality or marine ecology. Transition risks relate to the process of adjusting to a low-carbon economy.[80]

287. An IIFS should consider the potential impacts of climate-related risk drivers and assess the materiality of these risks. Therefore, the IIFS should manage CFR proportionate to the nature, scale, and complexity of its activities and the overall risk it is willing to absorb.

288. In general, inadequate information about risks can lead to mispricing of assets and misallocation of capital and can potentially give rise to concerns about financial stability since markets can be vulnerable to abrupt corrections. Thus, guidance on disclosures is critical to ensure the quality of information be reliable, consistent, and comparable for decision-making.

289. CFR disclosures are designed to provide forward-looking information on financial impacts for the purpose of decision making. There are at least four aspects of disclosures that are applicable for IIFS in relation to CFR, as detailed below.[81]

(i) **Governance**: An IIFS should disclose the governance used to monitor and manage climate-related risks and opportunities. At the minimum, the IIFS should disclose information on:

- the board’s oversight of climate-related risks and opportunities; and

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[80] See BCBS publication on “*Climate-related risk drivers and their transmission channels*”, April 2021.

[81] See IFRS S-2: *Climate-related Disclosures* for further guidance; available at [Exposure Draft IFRS S2 Climate-related Disclosures]

- management's role in assessing and managing climate-related risks and opportunities.

(ii) **Strategy:** An IIFS should disclose the actual and potential impacts of climate-related risks and opportunities on the IIFS's business model, strategy, and financial planning where such information is material. At the minimum, IIFS should disclose information on:

- the climate-related risks and opportunities the IIFS has identified over the short, medium, and long term;
- the impact of climate-related risks and opportunities on the IIFS's
  (i) operations, including business model and value chain;
  (ii) strategy and decision-making, including its transition plans towards low-carbon emission;
  (iii) financial planning, including financial position, financial performance, cash flows, capability in accessing financial sources and cost of capital over the short, medium and long term; and
- the resilience of the IIFS's strategy to material physical risks and transition risks by taking into consideration different climate-related scenarios.

(iii) **Risk management:** An IIFS should disclose how the organisation identifies, assesses, and manages climate-related risks and opportunities. At the minimum, the IIFS should disclose information on:

- the IIFS's processes for identifying, assessing, and managing climate-related risks; and
- how the IIFS's identification, assessment, and management of climate-related risks are integrated into the IIFS's overall risk management processes.

(iv) **Metrics and target:** An IIFS should disclose the metrics and targets used to measure, monitor, and manage material climate-related risks and opportunities. These disclosures shall allow users to understand how IIFS measures its performance, including progress towards the determined targets. At the minimum, the IIFS should disclose:

- information of the metrics categories used by the IIFS to assess climate-related risks and opportunities in line with its strategy and risk management process;
- information on Scope 1, Scope 2 and, if appropriate, Scope 3[82] greenhouse gas (GHG) emissions and the related risks; and

[82] According to the Corporate Governance Standard issued by Greenhouse Gas Protocol, carbon emission reporting can be classified based on emission sources, i.e., Scope 1 for direct GHG emissions, Scope 2 for

- targets determined by the IIFS to mitigate or adapt to climate-related risks and optimise climate-related opportunities, including its performance against targets.

2.15. The Role of Regulatory and Supervisory Authorities (RSAs)

Principle 21: RSAs should provide guidance for and supervise corporate governance at an IIFS, including through comprehensive evaluations and regular interaction with boards, senior management, and SSB; should require improvement and remedial action as necessary; and should share information on corporate governance with other RSAs.

290. The board and senior management are primarily responsible for the overall governance of the IIFS, while an SSB is responsible mainly for *Sharīʻah* governance of the IIFS. RSAs should assess their performance. This section sets forth several principles that can assist supervisors in assessing corporate governance and fostering good corporate governance in the IIFS.

291. RSAs should put in place reasonable measures to protect the shareholders and investors from fraudulent financial reporting by ensuring IIFS comply with internationally recognised governance mechanisms set out in relation to accounting and audit processes.

292. The effectiveness of corporate governance implementation will be subject to some preconditions as set out in IFSB-17: *Core Principles for Islamic Finance Regulation for Banking Segment (CPIFR)*, particularly in section 2. Additionally, RSAs should lay out the necessary preconditions enabling an effective whistle-blowing mechanism, including protection for the whistle-blower.[83]

2.15.1. Guidance on expectations for sound corporate governance

293. RSAs should establish guidance or rules, consistent with the principles set forth in this document, requiring an IIFS to have robust corporate governance policies and practices. Such guidance is especially important where national laws, regulations, codes, or listing requirements regarding corporate governance are not sufficiently robust to address the unique corporate governance needs of an IIFS. Regulatory guidance should address, among other things, expectations for checks and balances and a clear allocation of responsibilities, accountability, and transparency among the members of the board and senior management

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electricity indirect GHG emissions, and Scope 3 for other indirect GHG emissions including the corporate value chain. For further reference see: [Corporate Standard | Greenhouse Gas Protocol (ghgprotocol.org)]

[83] These preconditions are often outside the scope of banking supervision. RSAs are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so; or make the necessary measures to notify relevant authorities.

and within the IIFS. In addition to guidance or rules, where appropriate, supervisors should also share industry best practices regarding corporate governance with the IIFS they supervise.

2.15.2. Comprehensive evaluations of an IIFS's corporate governance

294. Supervisors should have processes in place to fully evaluate an IIFS's corporate governance. Such evaluations may be conducted through regular reviews of written materials and reports; interviews with board members, SSB, and IIFS personnel; examinations; self-assessments by the IIFS; and other types of on- and off-site monitoring. The evaluations should also include regular communication with an IIFS's board of directors, SSB, senior management, those responsible for the risk, compliance, and internal audit functions, and external auditors.[84]

295. Supervisors should evaluate whether the IIFS has in place effective mechanisms for the board and senior management to execute their respective oversight responsibilities. Supervisors should evaluate whether the board, SSB, and senior management have processes in place for the oversight of the IIFS's strategic objectives, including risk appetite, financial performance, capital adequacy, capital planning, liquidity, risk profile and risk culture, controls, compensation practices, and the selection and evaluation of management. Supervisors should focus particular attention on the oversight of the risk management, compliance, and internal audit functions. This should include assessing the extent to which the board interacts with and meets with representatives of these functions. Supervisors should determine whether internal controls are being adequately assessed and contribute to sound governance throughout the IIFS.

296. Supervisors should evaluate the processes and criteria used by IIFS in the selection of board members, SSB members, and senior management and, as they judge necessary, obtain information about the expertise and character of board members, SSB members, and senior management. The individual and collective suitability of board members and senior management should be subject to ongoing attention by supervisors.

297. Among others, the role of supervisors is to satisfy themselves with the integrity and competence of the board, SSB, and senior management, who should – collectively and/or individually –demonstrate the necessary skills, knowledge, experience, or qualifications pertaining to Islamic finance specificities appropriate for their respective position. RSAs is

[84] External auditors may share information with the supervisor without contravening their duty of confidentiality (see BCBS, *External audits of banks*, 2014, paragraphs 95 and 96).

recommended to set a minimum standard in this regard and it should be reflected in the “fit and proper” test of the board members and senior management of the IIFS.

298. Accordingly, in the case of Islamic windows, supervisors shall assess the suitability of the head of Islamic windows – and can be extended to persons with key control functions – to undertake their roles with respect to the windows.

299. Supervisors shall satisfy themselves that the mechanisms proposed and implemented by IIFS to ensure its governing bodies – i.e., the board, senior management and SSB – remain qualified for their positions by taking reasonable measures to keep abreast in Islamic finance developments.

300. As part of their evaluation of the overall corporate governance in an IIFS, supervisors should also endeavour to assess the governance effectiveness of the board, SSB, and senior management, especially with respect to the risk culture of the IIFS. An assessment of governance effectiveness aims to determine the extent to which the board, SSB, and senior management demonstrate effective behaviours that contribute to good governance. This includes consideration of the behavioural dynamic of the board, SSB, and senior management, such as how the “tone at the top” and the cultural values of the IIFS are communicated and put into practice; how information flows to and from the board, SSB, and senior management; and how potentially serious problems are identified and addressed throughout the organisation. The evaluation of governance effectiveness includes review of any board and management assessments, surveys, and other information often used by IIFS in assessing their internal culture, as well as supervisory interviews, observations, and qualitative judgments. In arriving at such judgments, supervisors need to be particularly mindful of consistent treatment across the IIFS they supervise. Supervisory staff should have the necessary skills to evaluate these issues and arrive at the complex judgments involved in assessing governance effectiveness.

301. In reviewing corporate governance in the context of a group structure, supervisors should take into account the corporate governance responsibilities of both the parent company and subsidiaries, in accordance with Principle 6 of this document.

2.15.3. Regular interaction with directors and senior management

302. Supervisors should interact regularly with boards of directors, individual board members, SSB members, senior managers, and those responsible for the risk management, compliance, and internal audit functions. This should include scheduled meetings and ad hoc exchanges, through a variety of communication vehicles (e.g., e-mail, telephone, in-person

meetings). The purpose of the interactions is to support timely and open dialogue between the IIFS and supervisors on a range of issues, including the IIFS's strategies, business model and risks, the effectiveness of corporate governance, culture, management issues and succession planning, compensation and incentives, and other supervisory findings or expectations that supervisors believe should be particularly important to board members. Supervisors should also provide insights to the IIFS on its operations relative to its peers, market developments and emerging systemic risks such as CFR[85] and cyber risks.[86]

303. The frequency of interactions with the above persons may vary according to the size, complexity, structure, economic significance, and risk profile of the bank. On that basis, supervisors may, for example, meet with the full board of directors annually, but more frequently with the chairman or lead or senior independent director and with key committee chairs. For systemically important banks, interaction should occur more frequently, particularly with members of the board and members of senior management, and those responsible for the risk management, compliance, and internal audit functions.

2.15.4. Requiring improvement and remedial action by an IIFS

304. Supervisors should be empowered with sufficient authority, stature, and resources to effectively enforce the governance regulations set out, and should have access to external experts (e.g., on *Sharīʻah*-related matters, IT, etc.) as needed. In exercising this power, supervisors should keep in mind adherence to applicable *Sharīʻah* rules and principles.

305. Supervisors should have a range of tools at their disposal to address governance improvement needs and governance failures. They should be able to require steps towards improvement and remedial action and ensure accountability for the corporate governance of an IIFS. These tools may include the ability to compel changes in the IIFS's policies and practices, the composition of the board of directors, SSB, or senior management, or other corrective actions. They should also include, where necessary, the authority to impose sanctions or other punitive measures. The choice of tool and the time frame for any remedial action should be proportionate to the level of risk the deficiency poses to the safety and soundness of the IIFS or the relevant financial system(s).

306. When a supervisor requires an IIFS to take remedial action, the supervisor should set a timetable for completion. Supervisors should have escalation procedures in place to require

[85] See Principles 13-18 in BCBS Guidelines on "*Principles for the effective management and supervision of climate-related financial risks",* June 2022.
[86] RSAs – in cooperation with relevant professional/experts association – should encourage sharing of knowledge on the modes of cyberattacks among industry players and/or RSAs, by keeping mindful of confidential information. These would allow industry-wide cyber resilience to be achieved more efficiently.

more stringent or accelerated remedial action in the event that an IIFS does not adequately address the deficiencies identified or the supervisor deems that further action is warranted.

2.15.5. Cooperation and sharing of corporate governance information with other relevant supervisors

307. Cooperation and appropriate information-sharing among relevant public authorities, including bank supervisors and conduct authorities, can significantly contribute to the effectiveness of these authorities in their respective roles. Such information-sharing is particularly important between home and host supervisors of cross-border banking entities.[87] Cooperation can occur on a bilateral basis, in the form of a supervisory college or through periodic meetings among supervisors where corporate governance matters should be discussed.[88] Such communication can help supervisors improve their assessment of the overall governance of a bank and the risks it faces, particularly in a group context, and help other authorities assess the risks posed to the broader financial system. Information shared should be relevant for supervisory purposes and be provided within the constraints of confidentiality and other applicable laws. Special arrangements, such as a memorandum of understanding, may be warranted to govern the sharing of information among supervisors or between supervisors and other authorities.

308. Due to the intensive use of technology in IIFS business operations, the supervisory scope may overlap between more than one supervisory authority as a result of increasing interdependencies across sectors, industries, and jurisdictions. For instance, in addition to financial RSAs, an IIFS may also be subject to other non-financial supervisory authorities, e.g., related to IT such as Ministry of Information and Technology or a customer or data protection authority; as well as cross-border RSAs. Therefore, strong cooperation across RSAs, both inside and outside jurisdictions, is becoming even more prevalent in today's environment.

[87] See IFSB-17: *Core Principles for Islamic Finance Regulation (CPIFR) for Banking Segment*, April 2015, Principle 13 (home-host relationships).

[88] In addition to IFSB-17, see the BCBS's *Principles for effective supervisory colleges* at www.bis.org/publ/bcbs287.pdf.

2.15.6. The Specific Role of RSAs with regards to IIFS

Principle 22: RSAs shall have adequate understanding of *Sharīʻah* non-compliance risks and accordingly ensure that the IIFS has in place an adequate and effective *Sharīʻah* governance framework and reporting mechanism.

309. RSAs must allow *Sharīʻah*-compliant financial services, including Islamic windows, to be offered only by licensed IIFS. The licensed IIFS must put in place a *Sharī`ah* governance framework with minimum requirements, as prescribed in paragraph 128.

310. RSAs shall satisfy themselves that the *Sharī`ah* governance framework proposed and implemented by IIFS will effectively operate and thus, provide reasonable assurance for *Sharī`ah* compliance across an organisation and its group (if applicable).

311. RSAs shall ensure that its staff, who are responsible for developing regulations and supervising IIFS, have adequate skills, knowledge, experience, or professional qualifications in Islamic finance. They should dedicate sufficient time, budget, and resources to ensure that they are and remain suitable for the positions.

312. Further provisions on this regard shall refer to Principle 2 of IFSB Standard on *Sharī`ah* Governance Framework for IIFS.

DEFINITIONS

The following definitions are intended to provide general understanding of the terms used in the standard and are by no means exhaustive.

board of directors, board	The body that supervises management. The structure of the board differs among countries. The use of "board" throughout this paper encompasses the different national models that exist and should be interpreted in accordance with applicable law within each jurisdiction.
control functions	Those functions that have a responsibility independent from management to provide objective assessment, reporting and/or assurance. This includes the risk management function, the compliance function, the internal audit function, the *Sharī`ah* compliance function, and the internal *Sharī`ah* audit function.
corporate governance	A set of relationships between a company's management, its board, its shareholders, and other stakeholders that provides the structure to set the objectives of the company, and the means of attaining those objectives and monitoring performance.[1] It helps define the way authority and responsibility are allocated and how corporate decisions are made. For the purpose of understanding this document, this term includes *Sharīʻah* governance, unless stated otherwise.
cyber resilience	The ability of an organisation to continue to carry out its mission by anticipating and adapting to cyber threats and other relevant changes in the environment and by withstanding, containing, and rapidly recovering from cyber incidents.[2]
duty of care	The duty of board members to decide and act on an informed and prudent basis with respect to the IIFS. Often interpreted as requiring board members to approach the affairs of the company the same way that a "prudent person" would approach his or her own affairs.[1]
duty of loyalty	The duty of board members to act in good faith in the interest of the company. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and shareholders.[1]
executive director	In jurisdictions where this is permitted, a member of the board (e.g., director) who also has management responsibilities

[1] See the glossary of corporate governance-related terms in Organisation for Economic Co-operation and Development (OECD), "Experiences from the Regional Corporate Governance Roundtables", 2003.
[2] See FSB on "Cyber Lexicon", November 2018

	within the bank.[3] A **non-executive director** is a member of the board who does not have management responsibilities within the bank.
governance committee	A committee established by the board of directors that is specifically mandated to protect the interests of investment account holders in IIFS.
independent director	For the purposes of this paper, a non-executive member of the board who does not have any management responsibilities within the bank and is not under any other undue influence, internal or external, political or ownership, that would impede the board member's exercise of objective judgment.[3]
internal control system	A set of rules and controls governing the IIFS's organisational and operational structure, including reporting processes, and functions for risk management, compliance, and internal audit. For the purpose of understanding this document, this term includes internal *Sharīʻah* compliance and internal *Sharīʻah* audit, unless stated otherwise.
investment risk reserve (IRR)	The amount appropriated out of the profit of investment account holders, after allocating the *muḍārib*'s share of profit, in order to cushion against future investment losses for investment account holders.
Islamic window	That part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah*-compliant, with separate funds from the host institution.[4]
maqāṣid al-Sharīʻah	The fundamental principles of *Sharīʻah*, which aim to promote and protect the interests of all human beings and avert all harm that impairs their interests.
profit equalisation reserve (PER)	PER is the amount appropriated by the IIFS out of the *muḍārabah* income, before allocating the *muḍārib*'s share, in order to maintain a certain level of return on investment for IAH and to increase owners' equity.
restricted investment accounts	Accounts whose holders authorise the investment of their funds based on applicable *Sharī`ah-compliant* contracts (e.g., *muḍārabah, mushārakah,* or *wakālah*) contracts with certain restrictions as to where, how, and for what purpose these funds are to be invested.
Risk appetite framework (RAF)	The overall approach, including policies, processes, controls, and systems, through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and

[3] See Financial Stability Board (FSB), *Thematic review on risk governance*, February 2013.

[4] See IFSB-22 paragraph 175.

	responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the bank, as well as to its reputation vis-à-vis policyholders, depositors, investors, and customers. The RAF aligns with the bank's strategy.[5]
risk appetite statement (RAS)	The written articulation of the aggregate level and types of risk that a bank will accept, or avoid, in order to achieve its business objectives. It includes quantitative measures expressed relative to earnings, capital, risk measures, liquidity, and other relevant measures as appropriate. It should also include qualitative statements to address reputation and conduct risks as well as money laundering and unethical practices.
risk appetite	The aggregate level and types of risk a bank is willing to assume, decided in advance and within its risk capacity, to achieve its strategic objectives and business plan.[4]
risk capacity	The maximum amount of risk a bank is able to assume given its capital base, risk management, and control capabilities as well as its regulatory constraints.
risk culture	A bank's norms, attitudes, and behaviours related to risk awareness, risk-taking and risk management, and controls that shape decisions on risks. Risk culture influences the decisions of management and employees during day-to-day activities and has an impact on the risks they assume.
risk governance framework	As part of the overall corporate governance framework, the framework through which the board and management establish and make decisions about the bank's strategy and risk approach; articulate and monitor adherence to risk appetite and risk limits vis-à-vis the bank's strategy; and identify, measure, manage, and control risks.
risk limits	Specific quantitative measures or limits based on, for example, forward-looking assumptions that allocate the bank's aggregate risk to business lines, legal entities as relevant, specific risk categories, concentrations and, as appropriate, other measures.
risk management	The processes established to ensure that all material risks and associated risk concentrations are identified, measured, limited, controlled, mitigated, and reported on a timely and comprehensive basis.
risk profile	Point-in-time assessment of a bank's gross risk exposures (i.e., before the application of any mitigants) or, as appropriate, net risk exposures (i.e., after taking into account mitigants) aggregated within and across each relevant risk category based on current or forward-looking assumptions.

***Sharī`ah* governance system**	The set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight of *Sharī`ah* compliance over each of the following structures and processes[5]: (i) Issuance of relevant *Sharī`ah* pronouncements/ resolutions; (ii) Dissemination of information on such Sharī`ah pronouncements and resolutions to the operative personnel of the IIFS; (iii) Internal *Sharī`ah* compliance review/audit
Sharī`ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (*ijmā'*), analogy (*qiyās*), and other approved sources of the *Sharī'ah*.
Unrestricted investment accounts	Accounts whose holders authorise the investment of their funds based on applicable *Sharī`ah-compliant* contracts (e.g., *muḍārabah, mushārakah,* or *wakālah*) without imposing any restrictions. The institutions can commingle these funds with their own funds and invest them in a pooled portfolio.

[5] See IFSB-10 paragraph 3.

APPENDIX 1

GAP ANALYSIS
THE REVISED GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR IIFS (BANKING SEGMENT)

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
Board's overall responsibilities	• Strengthen the collective oversight and risk governance responsibilities of the board • Board's responsibility in building a strong corporate culture and values, including risk culture • Board's responsibilities extended to protect the interests of all relevant stakeholders • Approve the selection and oversee the performance of the CEO, key members of senior management and heads of the control functions • The board should take an active role in defining the risk appetite and ensuring its alignment with the bank's strategic, capital and financial plans and compensation practices.	Briefly in relation to: • establishment of governance organs (board committees, senior management, SSB, internal and external auditor) • the board's responsibility for steering the establishment of the governance policy framework only as recommended best practices • the board shall set up a governance committee, audit committee • audit committee to coordinate with SSB and governance committee in ensuring *Sharī`ah* compliance	Not addressed	• Lack of emphasis on the board's responsibility to ensure effective corporate governance • The need for the establishment of a code of ethics or code of conduct for board members, senior management and employees which reflects Islamic ethical values	• Strengthen the board's responsibility to safeguard the interests of wider stakeholders; with depositors' and IAH's interests coming before shareholders' interest. • Emphasis on the board's responsibility for overall corporate governance. • Emphasis on the board's fiduciary duty in ensuring *Sharī`ah* compliance by formulating a robust *Sharī`ah* governance framework. • The board's pivotal role in promoting corporate culture and values by incorporating Islamic ethical values; including preparation of a code of ethics and/or code of conduct. • Integrating the *Maqāṣid Al-Sharī`ah* framework into the decision-making process at all levels in the IIFS. • Board's responsibility – together with senior management – to identify, oversee, and ensure necessary measures have been taken to deal with emerging risks, for e.g., CFR and cyber risks. • Provisions on the board's relationship with the SSB.	• Para 9, 11 (ii) and 37 • Principle 1 • Para 37 • Para 41 (iii) and 45 • Para 46 (v) • Para 52, 64 (iv) • Para 65 and 66.

[94] IFSB-10 is currently being revised and is at the final stage of development.

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
Board qualifications and composition	• Adequate details in setting the requirement for the board's qualifications and composition • Boards members should be and remain qualified, individually and collectively	Briefly regarding: • recommendation for RSAs to establish a set of criteria and "fit & proper test" for SSB members • IIFS are encouraged to disclose SSB and board members' qualifications	Not addressed	• Board members' skills/experiences /qualifications in Islamic finance; by setting out baseline requirement on Islamic finance knowledge for board members • Board's overall characters in accordance with Islamic values	• Board qualifications are extended to include the overall characters and professional capabilities in accordance with Islamic values. • Board members are required to take a programme designed specifically to enhance their understanding in Islamic finance principles and practices.	• Para 69, 70 (i) and 75. • Para 72 and 73
Board's own structure and practices	• Role of the board chair • Required committees for SIBs: Audit Committee, Risk Committee, and Compensation Committee; with detail responsibilities for each committee • Requirement for the establishment of Governance Committee for IIFS who offer IA (IFSB-3) • Recommended 2 other committees i.e., "Nomination/ HR/Governance Committee" and "Ethics & Compliance Committee" • Set out how potential conflict of interests should be managed	• Audit Committee and Governance Committee are required • Committees' member composition and criteria	Not addressed	• Emerging risk is not yet specifically addressed in the current board committees	• Designation of a specific board committee to deal with emerging risks. • When ethics and compliance committee is established, RCG recommends that at least one of member should be a *Sharī`ah* scholar considering the importance of *Sharī`ah* non-compliance risk.	• Para 92-94 • Para 117
***Sharī`ah* Governance Framework**	Not addressed	Principle 3 is dedicated to ensuring a proper *Sharī`ah* governance mechanisms are in place to comply with *Sharī`ah*	• Minimum requirement of *Sharī`ah* governance organs i.e.,	N/A	• One principle in RCG is dedicated to the *Sharī`ah* governance framework which entails some key aspects of *Sharī`ah* governance as part of the corporate governance framework.	• Principle 4

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
		rulings and these rulings should be disclosed	*Sharī`ah* Board (SB), *Sharī`ah* compliance, internal *Sharī`ah* audit and external *Sharī`ah* audit. • Detail provisions on SB qualification, composition, independence, confidentiality, and consistency of SB rulings • The need for professional ethics and conduct for SB		• RCG attempts to align and refer to IFSB-10 and its upcoming revision on *Sharī`ah*-related matters. Therefore, RCG will not go into granular details in this regard.	
Senior management	• Qualifications for senior management and ensuring access to regular training • Senior management's role in setting a sound corporate governance within IIFS • Senior management's responsibilities and reporting line to the board	Briefly, whereby IIFS are encouraged to disclose information on senior management (responsibilities, reporting lines, qualifications, and experiences) and management committees in their organisational structure	Not addressed	• Qualification requirement on Islamic finance • Overall characters and attitudes in accordance with Islamic ethical values • Senior management's responsibility to ensure that human resources within the IIFS have the necessary skills and qualifications in Islamic finance • Specific governance in Islamic windows	• RCG requires qualification of Islamic finance and overall characters to align with Islamic ethical values for senior management members. • Senior management shall ensure that all employees are qualified for the positions, including in terms of understanding Islamic finance • Responsibility of senior management to construct code of ethics and/or code of conducts by integrating Islamic ethical values • Responsibility of senior management to appoint one of the executive directors to be accountable for Islamic windows; Islamic finance qualifications for the head of Islamic windows.	• Para 137 and 138 • Para 141 • Para 147 • Para 148 – 151

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
Governance of group structures	• Adopting BCBS 2015 whereby the Board of the parent company has the overall responsibility for the group • Detail responsibilities of the parent company's board and suggestion to take into consideration the complexity of group's structure when exercising its duty to oversee the overall group • Board's relation with the supervisory authority	Not addressed	Not addressed	• If the parent company is an IIFS, the group's board shall be responsible to ensure the adherence to *Sharī`ah* rulings within its subsidiary. • If the parent company is an IIFS, the potential difference in *Sharī`ah* rulings between the parent company and subsidiary is yet to be addressed.	• Address the 1st gap • RCG sets out provision for internal documentation to be made in the case where different rulings exist.	• Para 155 • Para 159
Risk management function	• Emphasis on the importance of CRO and how to ensure its independency which includes its direct access to the board • Establishing early warning system (EWS)	Not particularly addressed, mentioned briefly	Not particularly addressed, mentioned briefly	• Inclusion of *Sharī`ah* non-compliance risk • Assignment of emerging risks – e.g., climate-related financial risks and cybersecurity risks – to particular senior executive	• RCG incorporates the issue related to emerging risk and *Sharī`ah* non-compliance risk to this principle. • The board and management's responsibility in assigning a specific body/individual to monitor and manage emerging issues. • RCG requires CRO to consider emerging risk and ensure IIFS' risk management processes are adequately addressing the issue.	• Para 171 and 172 • Para 173 and 174 • Para 178
Risk identification, monitoring, and controlling	• Dedicated to explain on the risk management process involving identification, monitoring, and controlling • Risk identification should encompass all material risks to the bank, on- and off-balance sheet and on	Not addressed	Not addressed	• Risk management function must consider *Sharī`ah* non-compliance risk • Responding to emerging risks such as climate-related risks and cyber risks.	• RCG addresses these gaps	• Para 183 – 187, 193, 194 (ii), 195 and Principle 9

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
	a group-wide, portfolio- and business-line level. • Risk identification and measurement should include both quantitative and qualitative elements • Internal controls are designed to ensure that each key risk has a policy, process, or other measure • Utilisation of stress-testing and scenario analysis			• Risk management should consider Islamic finance specificities.		
Risk Communication	Adopting BCBS 2015 on how an effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management.	Not addressed	Not addressed	Risk management function, together with CRO or the board, should define communication channels to update and enhance risk awareness across organisations, specifically pertaining to emerging risks such as CFR and cybersecurity risk.	• Minor addition to Principle 9, to include the SSB for *Sharī`ah*-related matters • Addressing reputation risk arising from *Sharī`ah* non-compliance • Adds BCP to be regularly communicated • Enhancing risk communication with regards to emerging risk	• Principle 10, para 200 • Para 202 and 204 • Para 208 • Para 209
Compliance	Adopting BCBS 2015 in which the board is responsible to oversee the IIFS's compliance risk	• Compliance in general is only mentioned briefly regarding the importance of its independence • More extensive discussion on *Sharī`ah* compliance in Part 3 • IIFS to put in place mechanisms for	Only matters related to *Sharī`ah* compliance	-	• The scope of Principle 10 on Compliance to include *Sharī`ah* compliance • RCG requires compliance policy to include *Sharī`ah*-related matters and must be approved by SSB	• Principle 11 • Para 212

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
		obtaining and applying *fatwa* as well as monitoring *Sharī`ah* compliance				
Internal Audit	• Adopting BCBS 2015 which stresses on internal audit function to provide independent assurance to the board and support in promoting effective governance process • The role of the board and senior management to ensure the effectiveness of internal audit function and promote its independence, including disclosure in the case of Chief Audit Executive removal	• Briefly regarding the importance of maintaining internal auditor's independence and its role in monitoring the accounting process • Mentioned briefly on internal *Sharī`ah* audit/review's responsibility and the need for relevant training and skills	Only related to internal *Sharī`ah* audit	Internal *Sharī`ah* compliance review/ audit should also be included in the activities of the internal audit of IIFS. More detailed provisions on Sharī`ah compliance review/audit will refer to IFSB-10 on *Sharī`ah* Governance System and its coming revision.	• Principle 11 to relate internal audit function to SSB since the RCG incorporates internal *Sharī`ah* audit within the function.	• Principle 12, para 220 and 223 (ii).
Compensation	• Emphasis on the importance of structuring an effective compensation and remuneration scheme congruent with the IIFS's objectives in the long run, particularly for senior management • The board responsibility to approve the compensation of senior executives (CEO, CRO, and Head of Internal Audit) • Compensation for control functions should be independent of its supervised business units	Briefly, with regard to senior management compensation should be disclosed	Not particularly addressed, only mentioned in relation to the prevention of conflict of interest	The compensation committee should take into consideration the new emerging risks such as climate-related financial risks in structuring the compensation and remuneration.	RCG integrates ESG principles and emerging risks.	Para 230 and 231

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
	• Remuneration should reflect risk-taking and risk outcomes to mitigate excessive risk-taking behaviour • Disclosure of the compensation and remuneration					
Investment Account	Not addressed	Covered in Part 2 • Recognition of IAH rights and set up of mechanisms to ensure these rights are observed and exercised • IIFS shall adopt a sound investment strategy aligned with expected risk and return of IAH • Only mentions IA with *muḍārabah* contract	Pertaining to the annual *Sharī`ah* compliance report should be made available to IAH, along with RSAs and public	• Enhancement on the contract used (subject to the IFSB *Sharī`ah* Board approval)	• Adopted part 2 of IFSB-3 • Extends the Islamic contracts used in investment accounts to include *mushārakah* and *wakālah;* with a footnote to recognise *commodity murābaḥah* as well (if the characteristics are similar, i.e., the profit & loss sharing agreement). This change will subject to the approval of the IFSB's SSB.	• Principle 14 • Para 241 and 242
Disclosure and Transparency	• The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders, and market participants • Minimum information to be disclosed annually: (i) the recruitment approach for the selection of board members for ensuring an appropriate diversity of skills, backgrounds, and viewpoints, (ii) whether the bank has set up board committees and the number of times key	• Part 3 regarding *Sharī`ah* compliance in which IIFS should make available to the public any decision to adopt or abandon a *fatwā*, detailed opinion on the *fatwā.* • Part 3: Disclosure of *Sharī`ah* rulings to the public • Part 4 is specifically dedicated to addressing disclosure requirements for IA	Disclosure related to potential conflict of interest to ensure independence of SB	• To include disclosure requirements for current issues i.e., (i) sustainability issues, which includes CFR, SDGs and Islamic social finance, and (ii) cyber risks.	• RCG incorporates SSB disclosure into the standard • Disclosures in relation to (i) *Sharī`ah* matters, (ii) investment accounts to safeguard the interests of IAH, (iii) the impact of Islamic social finance services offered by IIFS (if applicable) to reflect alignment between Islamic finance, (iv) SDGs, and (v) CFR.	• Para 267 (ii) and (iv) • Section 2.14.2 until 2.14.5

Issue	BCBS Guidelines (2015)	IFSB Standards		Gap	RCG	Reference
		IFSB-3	IFSB-10[94]			
	standing committees have met • Retain and enhance IFSB-3 guidance on disclosures for IAH • Retain and make reference to IFSB-22 on Disclosures for IIFS section which accommodate social, economic, and environmental impact including carbon footprint activity.					
The role of RSAs	• Adopting BCBS 2015 in which supervisors should guide and supervise IIFS's corporate governance, including through comprehensive evaluations and regular interaction with boards and senior management • Supervisors should have the authority to request for improvement and remedial action by bank; and impose sanctions when appropriate • Cooperation and sharing corporate governance information with other relevant supervisors	Briefly mentioned the role of supervisors	Not particularly addressed, briefly mentioned with regards to its shared responsibility with all stakeholders in ensuring an effective *Sharī`ah* governance system.	Supervisors who are in charge of supervising IFSI should also be equipped with the necessary skills and expertise, i.e., qualifications in Islamic finance through education degree/formal training or workshops done regularly to keep them abreast of the Islamic finance industry	• Extends the role of RSAs to satisfy themselves on the competence of the board, SSB, and senior management of IIFS, including Islamic windows. • RCG specifies CFR and cyber risks as the emerging risks need to be addressed. • RSAs should be adequately empowered to exercise their duties • Strengthen cooperation between RSAs across sectors, including non-financial ones.	• Para 297 – 300 • Para 302 • Para 304 • Para 308 • Principle 22, para 309 – 312.