

GUIDELINES ON SHARIAH GOVERNANCE FOR LABUAN ISLAMIC FINANCIAL INSTITUTIONS

1.0 Introduction

- 1.1 Shariah governance is the foundation for proper conduct and practice of Islamic finance to adopt Shariah principles and adhere to Shariah rulings and resolutions. Compliance with Shariah principles is indispensable in upholding the sanctity and credibility of Islamic financial business and promoting market confidence in the Islamic financial services industry. The Guidelines on Shariah Governance for Labuan Islamic Financial Institutions (Guidelines) defines Labuan FSA's minimum expectations on the Shariah governance framework that should be implemented by Labuan Islamic Financial Institutions (LIFIs) in ensuring Shariah compliance in all aspects of Islamic financial business operations.
- 1.2 The Guidelines outlines the institutional and organisational arrangements through which LIFIs ensure effective oversight, responsibility and accountability of the Board of Directors (the Board)¹, senior management² and Internal Shariah Advisory Board (ISAB)³ in implementing and enforcing Shariah compliance in their respective institutions.
- 1.3 The Shariah governance framework in LIFIs shall comprise at least four key areas:
- (i) Competent, accountable and independent ISAB;
 - (ii) Effective and responsible Board and Management;
 - (iii) Internal Shariah compliance review and Shariah audit; and
 - (iv) Reporting framework.

¹ In relation to LIFI of a branch status, the Board can refer to the regional office or head office overseeing the management of the branch LIFI.

² Officers who have primary or significant responsibility for the management and performance of the business activities of the LIFI including the Principal Officer.

³ The establishment of ISAB is provided under sections 129 and 130 of LIFSSA.

- 1.4 Given that Shariah compliance is paramount to the LIFIs, Labuan FSA expects that the Board and Principal Officer (PO)⁴ to be responsible in ensuring the appropriate Shariah governance framework is established based on the size, nature of business and complexity of activities. LIFIs should also ensure that the framework is continuously enhanced in line with the changing conditions of their Islamic financial business operations.

2.0 Applicability

2.1 The Guidelines is applicable to the following LIFIs:

- (i) Labuan Islamic banks and Islamic investment banks licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA), excluding Labuan Islamic financial business;
- (ii) Labuan takaful and retakaful operators licensed under Part VII of the LIFSSA, excluding Labuan captive takaful business;
- (iii) Labuan banks and investment banks licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA) that carries on any business or part of its business in compliance with Shariah principles, excluding Labuan financial business;
- (iv) Labuan insurers and reinsurers licensed under Part VII of the LFSSA that carries on any business or part of its business in compliance with Shariah principles, excluding Labuan captive insurance business;
- (v) Fund managers of Islamic public fund licensed under Part III of the LFSSA; and
- (vi) Any other persons or licensed entities that Labuan FSA may specify from time to time.

2.2 For the purpose of this Guidelines, reference to LIFIs shall include:

- (i) Labuan Islamic banks, Islamic investment banks, takaful operators and retakaful operators licensed under LIFSSA; and

⁴ The officer that is ultimately responsible for managing the overall affairs of the LIFI and is equivalent to the role of a Chief Executive Officer (CEO) of an organisation.

- (ii) Labuan banks, investment banks, insurers, reinsurers and fund managers of public funds licensed under LFSSA that carries on any business or part of its business in compliance with Shariah principles in Labuan International Business and Financial Centre.

3.0 Legal Provision

- 3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSSA) to clarify the minimum Shariah governance standards to be observed by LIFIs.
- 3.2 LIFIs which fail to comply with the Guidelines may be liable of an offence punishable by law under Section 36B and 36G of the LFSSA.

4.0 Effective Date

- 4.1 The Guidelines shall come into effect on 1 January 2018 and will remain effective and applicable unless amended or revoked.
- 4.2 The Guidelines shall be adopted together with the following circulars:
 - (i) Directive on Islamic Financial Business in Labuan IBFC dated 6 August 2013; and
 - (ii) Circular on the Appointment of Internal Shariah Advisory Board or Shariah Adviser under Sections 129, 130 and 131 of Labuan Islamic Financial Services and Securities Act 2010 dated 3 January 2014.

5.0 Competent, Accountable and Independent ISAB

- 5.1 The Labuan Islamic Financial Institution (LIFI) must ensure that the ISAB comprises an appropriate number of qualified Muslim individuals that commensurate with the nature, scale and complexity of its business operations.

- 5.2 The LIFI shall appoint qualified persons⁵ to the ISAB. In this regard, **at least one of the qualified persons** shall meet the following criteria:
- (i) holds a bachelor's degree in Shariah or equivalent qualification, including study in Fiqh al-Muamalat (Islamic commercial law) or Usul al-Fiqh (principles in Islamic jurisprudence) from a recognised university; and
 - (ii) has at least three years' experience as a Shariah adviser in the Islamic financial services industry.
- 5.3 The ISAB may comprise experts from relevant backgrounds such as finance and law, which could support the depth and breadth of the Shariah deliberations. However, these members must not constitute the majority of the ISAB.
- 5.4 The ISAB members shall be fit and proper in accordance with the *Guidelines on Fit and Proper Person Requirements* issued by Labuan FSA.
- 5.5 The ISAB members shall be independent in character and judgement, and free from associations or circumstances that may impair the exercise of his independent judgement.
- 5.6 If an ISAB member has multiple Shariah board appointments, he must devote sufficient time and attention to exercise due care and diligence in the affairs of each Islamic financial institution. He must not have competing time commitments that impair his ability to discharge his duties effectively.
- 5.7 If the LIFI appoints a Shariah Advisory Firm (SAF) as ISAB, the LIFI must ensure the following conditions are satisfied:
- (i) at least one individual in the SAF meets the criteria described in paragraphs 5.2 (i), (ii) and 5.4;
 - (ii) the SAF has sufficient expertise and resources to perform its functions and responsibilities effectively; and
 - (iii) the SAF is independent from the LIFI. The SAF and LIFI shall not be related parties such as having common shareholders or common directors.

⁵ Please refer to Section 2 of LIFSSA for the definition of a "qualified person".

5.8 The duties and responsibilities of ISAB shall include at least the following key functions:

- (i) Advise the Board and LIFI on Shariah-related matters. The ISAB shall be responsible and accountable for all its decisions, views and opinions related to Shariah matters. As the Shariah decisions are binding upon the LIFI, the ISAB is expected to rigorously deliberate the issues at hand before arriving at any decision;
- (ii) Endorse and validate relevant documentations used in business transactions including contracts, agreements, prospectus, etc;
- (iii) Put on record, in written form, any opinion that it gives on Shariah-related issues;
- (iv) Observe confidentiality of internal and privileged information obtained in the course of their duties;
- (v) Perform an oversight role on Shariah matters relating to all aspects of LIFI's business operations. This shall be achieved through the internal Shariah compliance review and Shariah audit functions;
- (vi) Adequately address and report Shariah non-compliant activities to the Board and notify Labuan FSA when necessary; and
- (vii) Consider any Shariah pronouncements or resolutions issued by Labuan FSA's Shariah Supervisory Council (SSC) and advise the LIFI to consult the SSC on Shariah matters where necessary.

6.0 Effective and Responsible Board and Management

Board of Directors

6.1 The Board is ultimately accountable and responsible for the establishment of the Shariah governance framework and Shariah compliance of the LIFI. In this regard, the Board must ensure that an adequate Shariah governance framework is in place which commensurate with the size, complexity and nature of the business operations of the LIFI.

6.2 The Board shall ensure the ISAB is vested with appropriate powers and authorities necessary to perform its duties effectively.

- 6.3 The Board shall recognise the independence of the ISAB and ensure that the ISAB can exercise its objective and independent judgement without undue influence or duress.
- 6.4 The Board shall ensure that the decisions made by the ISAB are duly observed and implemented by the LIFI.
- 6.5 The Board shall ensure that the ISAB has access to accurate, timely and complete information from the management. Where appropriate, the Board shall consider taking appropriate measures against parties who intentionally failed to extend the required information to the ISAB.
- 6.6 All appointment, reappointment, resignation and removal of the ISAB members shall be approved by the Board or the shareholders (where appropriate). If the LIFI is leveraging on the ISAB within the LIFI's group, the LIFI's Board shall approve the appointment of the ISAB members.

Management

- 6.7 The Management shall be responsible for establishing systems and controls to comply with Shariah governance requirements.
- 6.8 The Management shall identify and refer any Shariah issues to the ISAB for decisions, views and opinions. In this regard, the Management shall be responsible for observing and implementing the Shariah rulings and decisions made by the ISAB and SSC of Labuan FSA respectively.
- 6.9 The Management must dedicate sufficient resources and provide the required assistance to support the ISAB in performing its duties.
- 6.10 The Management shall give the ISAB right of access to relevant records and information to effectively perform its functions and responsibilities.

7.0 Internal Shariah Compliance Review and Shariah Audit

- 7.1 The internal Shariah compliance review function refers to regular assessment on Shariah compliance in the activities and operations of the LIFI with the objective of ensuring that the activities and operations carried out by the LIFI do not contravene Shariah principles.

- 7.2 The function involves the examination and evaluation of the LIFI's level of compliance to the Shariah, remedial rectification measures to resolve non-compliances and control mechanism to avoid recurrences.
- 7.3 LIFIs are allowed to leverage on their existing compliance function to undertake the Shariah compliance review. Alternatively, LIFIs may also opt to have a dedicated internal Shariah compliance unit to conduct the Shariah compliance review function.
- 7.4 The staff of the LIFI performing the internal Shariah compliance review shall assist the ISAB to identify, monitor and report on Shariah compliance in all business transactions and operations on an ongoing basis.
- 7.5 Shariah audit shall be conducted on critical areas according to the risk level and materiality of the impact of Shariah non-compliance in these areas. The staff of the LIFI performing the Shariah audit shall assist the ISAB to audit the critical areas of the LIFI's operations at least on an annual basis.
- 7.6 LIFIs are allowed to leverage on their existing internal audit function to conduct Shariah audit. Alternatively, LIFIs may also opt to have a dedicated internal Shariah audit unit to conduct the Shariah audit function.
- 7.7 Labuan FSA expects LIFIs to conduct the internal Shariah compliance review and Shariah audit functions in-house. However, if this is not feasible for the LIFI, the LIFI may outsource the internal Shariah compliance review and Shariah audit functions to a third party service provider or a related entity within the LIFI's group. In this regard, the LIFI must obtain prior approval from its ISAB and Labuan FSA as well as adhere to any outsourcing requirements of Labuan FSA. The Board and the PO of the LIFI shall remain responsible for the effectiveness of the LIFI's outsourced internal Shariah compliance review and Shariah audit functions. Notwithstanding this, the LIFI must strive towards building its own capabilities in conducting these functions in-house.
- 7.8 LIFIs shall ensure that the staff performing the internal Shariah compliance review and audit functions are qualified, competent and sufficiently independent to perform these functions.

8.0 Reporting Framework

- 8.1 The report on Shariah compliance shall be included in the following reports outlined in the Guidelines on Compliance Function for Labuan Licensed Entities issued by Labuan FSA on 6 November 2013:
- (i) Compliance Report submitted to the Board on regular basis; and
 - (ii) Annual Compliance Report submitted to Labuan FSA.
- 8.2 Any Shariah non-compliant matter shall be immediately reported to the LIFI's ISAB, senior management and the Board to address and rectify the matter as soon as possible. If the Shariah non-compliant matter is deemed material by the ISAB, it shall be immediately reported to Labuan FSA together with the LIFI's rectification measures.
- 8.3 The report on Shariah audit shall be included in the internal audit report submitted to the Board and Labuan FSA.
- 8.4 In cases where Shariah non-compliant activities are not adequately addressed by the LIFI, the ISAB shall notify Labuan FSA.
- 8.5 LIFIs shall submit the report on Shariah compliance and Shariah audit together with the annual compliance report and internal audit report respectively to Labuan FSA at the following address:

Director
Supervision and Monitoring
Labuan Financial Services Authority (Labuan FSA)
17th Floor, Main Office Tower
Financial Park Complex
Jalan Merdeka
87000 Federal Territory of Labuan, Malaysia

Telephone no: 087 591 200
Facsimile no: 087 453 442/ 413 328
Email: sed@labuanfsa.gov.my

Labuan Financial Services Authority
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