Effective Risk Based Supervision through Sharia Supervisory Board

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Abstract

This paper seeks to provide a framework for addressing supervisory issues which impact operations and institutional development of Islamic banks. We argue against universal supervision or creating separate specialized supervisions, the approach in this paper uses the risk based supervisory framework to highlight the need to supervise Islamic banks and focuses on the issues of supervision that need to be highlighted. The findings show that issues of supervisions still intact: what is supervision, and how it is different from regulation; what supervision seeks to achieve; and the philosophy behinds the supervision. Although, the findings also show that the current approach and framework of supervision is able to produce a sound and stable Islamic banks, but the establishment of SSB produces an additional tool for strengthening supervisory framework.

Keywords: supervisory issues; Islamic banks, SSB; supervisory framework; sharia compliance framework

JEL Classification: D03, G21, G23, G28, P40,
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1. Introduction

Risk based supervision is nothing new. Several jurisdictions across the globe have adopted the risk based approach in their supervisory practices. However, there are some variations in the approaches taken. The degree of success also varies. In a jurisdiction that practices Islamic banking, the question arises as to how to produce an effective supervisory approach especially in the presence of contractual based risk that might affect the Islamic banking business. In this circumstance, Islamic bank should comply the sharia principles. Islamic bank can specify the financial contracts with the consultation of the Sharia Supervisory Board (SSB) and then get the approval from board of directors in ensuring the sharia compliance. Then, aspects such as risk management, governance, transparency and disclosure should be part of the operational standards.

The second merit is about the strengthening of the regulatory framework. The Islamic Financial Services Act (IFSA) 2012 gives the Islamic banks the ability to specify supervisory requirements that promote and parallel with sharia contract based operational frameworks. For example, Islamic bank can specify sharia principles for financial contracts with the consultation of SSB. And an operational standard on sharia matters is issued by Islamic bank in order to make the implementation of sharia standards is effective and in compliance with sharia principles.

However, the growing difficulty in the Islamic financial market place is reflected in changes in the structure of Islamic banking holdings and increasing complexity of products and services that are being offered by the market players. There has been a virtual explosion in the number of market players and the products and services on offer, which has complicated the territory for the supervisors. It is, therefore, pertinent that the supervisors are able to identify the institutions that pose the biggest risk to the supervisory objectives and whose failure would have the maximum impact on Islamic financial stability. To achieve the above objective, it is imperative that the supervisor is able to assess and zero in on the real sources of risks facing individual Islamic banking institution and develop appropriate risk mitigation plans. The ability to conduct a proactive assessment of the major risks and to supervise them based on the probability of the risks growing and the impact the likely failure of the Islamic bank might have on the Islamic financial system, is the hallmark of a risk based approach to supervision. Post crisis, there has been a shift towards Risk Based Supervision (RBS), away from the CAMELS or FIMS approach, which uses a backward looking methodology and transaction testing model. The RBS, on the contrary, is forward looking as it seeks to assess the risk

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build-up in a more dynamic manner. It focuses on the twin objectives of examining whether the supervised entity follows the regulatory prescriptions and whether its internal risk management practices are in line with regulatory expectations.

On the other hand, effective supervisors may exert a negative influence. Governments with powerful supervisory agencies may use this power to benefit favoured constituents, attract campaign donations, and extract bribes. Effective supervisors, according to this view, will be less focused on overcoming market failures and more concerned with carrying political support and implementing their own narrow objectives. According to this so-called ‘grabbing-hand’ view, powerful supervision will be positively related to corruption and will not improve either Islamic bank performance or stability.

In addition, the dynamism of the global economic environment requires more robust tools and skills to mitigate risks arising from the rapid development of the Islamic financial sector. In response to the changing financial landscape, advancement in, and widespread use of information/communications technology, a more effective approach is required. Although effective risk management has always been central to safe and sound Islamic banking activities, it has assumed added importance for two main reasons. Firstly, new technologies, product innovation, size and speed of financial transactions have changed the nature of banking. Secondly, there is need to comply fully with the Islamic Financial Services Board guidelines and to prepare an enabling environment for the implementation of the New Capital Adequacy Standards. The foregoing, amongst others, premised the imperative of the adoption of RBS framework.

Despite these development/contrasting views, the whole process of risk based supervision needs to be revisit and done, both at the Islamic bank (supervised institutions) level and at the supervisory authority bank level. It is in the face of these challenges that this paper tries to suggest that SSB can improve the RBS in a phased manner.

Therefore, the aim of this chapter is to produce effective supervision. There are several elements to consider. Among these elements are: the philosophy and objectives of supervision; the adopted supervisory framework, here we also discuss the risk-based supervisory approach and framework. Then, it is followed by an insight into RBS approach and SSB as effective tool RBS.

2. Supervision in Perspective

Having discussed the motivation of this paper, this section will step back and highlight on some of the fundamental issues that need to be understood and appreciated not only by the supervised institutions but also the regulatory and supervisory authority, for ensuring a vibrant Islamic banking system.

First issue: what is supervision and how is it different from regulation?

Regulation and supervision are quite interchangeably used in many literature, for example Grünbichler and Darlap (2003), Quintyn and Taylor (2002) and Barth, Caprio, and Levine (2013). The reason is due to that they seek to serve the same objectives – protecting depositors and promoting financial stability. However, there is a wide difference between the their roles. Regulation is synonymous with laying down the rules and norms for doing business by all the players and, therefore, is uniformly applicable to all participants. Supervision, on the other hand, is the process through which the rules and norms are enforced at individual entity level. Thus, on a very broad level, the difference between the two is that while regulation is applicable to the system as a whole, supervision is entity-specific, with the intensity of supervision being proportional to the perceived risk levels. It shows that supervision is more contextual rather than being general. Here, we would like to emphasize that it is essential to have clarity on the demarcation of the roles and remits of regulation and supervision. Therefore, country like Malaysia and Sudan, both roles are placed
under the same regulator. But, country like Indonesia, both are separated. In the absence of this, both regulation and supervision are likely to get diluted and weakened, which would have an adverse impact on the strength and resilience of the Islamic financial sector.

Second issue: what supervision seeks to achieve?

As discussed in the first issue, the basic function of the supervisor is to enforce the rules and norms laid down by the regulator. There is a clear difference between merely monitoring whether the institutions are adhering to the regulations and actually making sure that the regulated institutions adhere to them in practice. The job of the supervisor is to ensure that the institutions necessarily comply with whatever mitigation plan is given to them. The supervisor should ask questions of the supervised institutions which seem to be good, furthermore during bad times. But, this is not only question that the supervisors should ask, but also they have to effectively intervene. They also need to ensure that there is an appropriate internal mechanism which makes certain that the directions given by the Board are properly implemented down the line.

Third issue: what is the philosophy behind the supervision?

It is necessary that the supervisory approaches should also consider the philosophical foundation of supervisory practices. In order to provide the highest quality of bank supervision, the central bank should adopt a philosophy and approach known as "value-added banking supervision" (i.e., preservation and growth of human well-being and also wealth are part of maqasid shariah). Its intent is to supervise Islamic banks in a more thoughtful and purposeful manner. The primary focus of value-added banking supervision is to be responsive to the needs and concerns of the banking community and to educate bankers about the regulatory environment in which they operate.

In addition, the underlying philosophy governing bank supervision is that Islamic banks should be free to allocate financing according to market forces and should be entitled to set terms and conditions for their operations in an environment of competition. However, strict supervisory rules should be set for Islamic bank behaviour in order to protect depositors and entrepreneurs and the Islamic financial system as a whole.

3. An Insight into Risk-based Supervision Approach

The current approach to banking supervision in many countries, which is transaction and compliance based, is largely reactive, narrow in scope and uniformly applied to all supervised institutions. It is largely on-site driven, but complemented by offsite monitoring. The average cycle of inspection, of once a year, is the same for all institutions regardless of their perceived risks. It does not provide clear yardsticks for risk assessment and allocation of resources in the supervisory processes.

However, the dynamism of the global economic environment requires more robust tools and skills to mitigate risks arising from the rapid development of the Islamic financial sector. In response to the changing financial landscape, advancement in, and widespread use of information/communications technology, a more effective approach is required. Although effective risk management has always been central to safe and sound Islamic banking activities, it has assumed added importance for two main reasons. Firstly, new technologies, product innovation, size and speed of financial transactions have changed the nature of Islamic banking. Secondly, there is need to comply fully with the Islamic Financial Services Board guideline and to prepare an enabling environment for the
implementation of the New Capital Adequacy Standard. The foregoing, amongst others, premised the imperative of the adoption of Risk-Based Supervision (RBS) Framework.²

The Approach

Supervision by risk requires supervisors to determine how certain existing or emerging issues facing an Islamic bank or the Islamic banking industry affect the nature and extent of risks in that institution. Based on that risk evaluation, supervisors then structure supervisory plans and actions. Supervision by risk builds upon the risk-based supervisory philosophy historically used by many supervisory authority. This enhancement provides consistent definitions of risk, a structure for assessing these risks, and a more integrated use of risk assessment in the supervisory process.

The supervisor recognizes that Islamic banking is a business of taking risk in order to earn profits. However, risk levels must be appropriately managed and controlled. Islamic banking risks must also be evaluated in terms of their significance. These assessments should be ongoing. Supervision by risk leaves the responsibility for controlling risks with the Islamic bank management. The supervisor assesses how well an Islamic bank manages this risk over time, rather than only assessing the condition at a single point in time. With supervision by risk, the supervisor functions in more of an oversight than an audit role. Supervision by risk allows the supervisor to supervise by concentrating on systemic risks and institutions or areas that pose the greatest risk to the system.

For the whole industry, the supervisor’s supervision by risk identifies areas that, in aggregate, pose the potential for presenting an unacceptable level of risk to the Islamic banking system and the deposit insurance fund. For those high-risk activities or activities that have become particularly risky because of market conditions, the supervisor’s goal is to communicate with, and influence, the industry through direct supervision, policy, and regulation. In situations where an individual Islamic bank is not properly managing its risks, the supervisor’s goal is to use appropriate means to influence the Islamic bank management to adjust its practices to conform to sound fundamental banking principles.

Some risks are inherent to Islamic banking. A wide body of knowledge exists within the industry on how to identify, measure, control, and monitor these inherent risks. Supervision by risk acknowledges those inherent risks and performs limited testing in examinations directed at confirming whether adequate controls are in place. Other risks in the industry are more diverse and complex. These more sophisticated risks require enhanced controls and monitoring by both the supervised entities and the supervisor. The supervisor is committed to directing significant resources to these complex and evolving risks, especially where they present material, actual, or potential risks to the Islamic banking system.

Risks that large Islamic banks assume are generally diverse and complex and warrant a risk-oriented supervisory approach. Under this approach, supervisors do not attempt to prohibit appropriate risk-taking, but rather ensure that Islamic banks understand and control the levels and types of risks they assume. In situations where risk is not properly managed, the supervisor tries to direct the Islamic bank management to take corrective action so that the Islamic bank is managed in a safe and sound manner. In all cases, the supervisor’s supervisory focus is to ensure that the Islamic bank management identifies, measures, controls, and monitors risks to ensure sufficient capital is present in light of the risks involved.

Risks that small Islamic banks assume are generally less diverse and complex than those of larger Islamic banks. Under this approach, supervisors verify the existence of adequate controls and risk management systems by testing transactions. Supervisors will focus attention on the risk management systems and the methods the

² The RBS has been practiced in three jurisdictions, namely, the Federal Reserve System of America (FRS), the Office of the Superintendent of Financial Institutions (OSFI) Canada and the Financial Services Authority (FSA) UK.
management uses to identify, measure, control, and monitor risks in those small Islamic banks or in areas that are more diverse and complex. Supervision by risk allocates greater resources to those areas with higher risks.

The supervisor accomplishes this by: (i) identifying risks using common definitions. This set of risks forms the basis for supervisory assessments and actions; (ii) measuring risk based on common evaluation factors. Risk measurement is not always quantified in ringgit terms; it is sometimes a relative assessment of exposure. For example, numerous internal control deficiencies may indicate an Islamic bank has an excessive amount of transaction risk; (iii) evaluating risk management to determine if Islamic banking systems adequately manage and control the identified risk levels. The sophistication of the systems will vary based on the level of risks present and the size and/or complexity of the institution; (iv) assigning greater resources to areas of higher or increasing risk, both within an individual institution and among banks in general. This is done through the supervisory strategy; and (v) performing examinations based on the risks, reaching conclusions on risk profiles and conditions, and following up on areas of concern.

To accomplish the above tasks, supervisors should discuss preliminary conclusions of this risk-based supervisory strategy with the Islamic bank management and adjust conclusions and strategies based on these discussions, if appropriate. The supervisor can then focus supervisory efforts on significant risks, i.e., the areas of highest risk within an Islamic bank and within the Islamic banking system. Supervisors must focus on the consolidated company risk profile to fully implement supervision by risk. This consolidated approach recognizes that risks at individual institutions may be mitigated or increased on a companywide basis. However, individual Islamic bank risk profiles must be determined for the lead Islamic bank and significant country bank affiliates for the supervisor to fully evaluate the consolidated risk profile.

In summary, the supervision by risk approach provides the supervisor and the Islamic banking industry with: a high level of consistency in supervision because it sets and uses minimum core procedures; an allocation of resources based on risk; sufficient flexibility to allow supervisors to tailor the supervisory effort to the risks present; less supervisory intervention in areas of low risk; and help in determining the sufficiency of each Islamic bank’s capital and risk management systems.

The Framework

To ensure effective supervision by risk, the supervisory authority normally requires a common framework to document decisions about risk. This section will present the RBS framework. These risks may threaten the Islamic banks and we will outline the supervisory tools to mitigate them. In the following discussion, we will introduce a series of structured stages that are designed to: (i) focus the supervisor’s attention on the risks that threaten the achievement of supervisory objectives; and (ii) enable the supervisor to devise a risk mitigation programme to address those risks.

The framework is based on the four main supervisory objectives, that is, promoting stability and soundness of the Islamic banking system; ensuring consumer protection; reducing financial crimes and achieving the maqasid sharia.

The framework involves six stages:

Stage 1: Full Scope Examination of Islamic Banks
This stage involves the identification of risk elements that covers the full range of risks in an Islamic bank. This stage will be a one-off event, as subsequent examinations will depend on the supervisors’ assessment and perception of the risks of individual Islamic banks.

Stage 2: Impact Assessment of Islamic Banks

The first step at this stage is to determine the potential impact of an Islamic bank, in the event of distress, on the entire financial system by appraising quantitatively, balance sheet items such as total assets and deposits against defined impact thresholds. This will indicate the scale and significance of the problem if it is to occur.

Stage 3: Risk Assessment of Islamic Banks

At this stage, the focus is to assess the likelihood of various Islamic bank-specific risks crystallizing. The aim of risk assessment of Islamic banks is to provide a concise method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern (measured as aggregate or composite risk), and the direction of risk.

In achieving this, the first step is to identify the risk elements that threaten the achievement of the supervisory objectives. Islamic banks are assessed based on a risk map, which takes into account external events or threats and Islamic bank-specific risk issues and scores each of these risks in a common way. The next step will be to determine the overall risk.

Stage 4: Development of a Risk Mitigation Programme

The risk mitigation programmes (RMP) are regulatory actions designed to address the issues identified at the risk assessment stage. The programme will address the nature of the risk, intended outcome, actions to be taken by the supervisor and/or the Islamic bank and the timeframe within which to implement the programme. This will involve the selection of regulatory tools (Table 1), based on the severity and nature of the risk and the expected outcome.
### Table 1: Supervisory Tools

<table>
<thead>
<tr>
<th>Diagnostic</th>
<th>Monitoring</th>
<th>Preventive</th>
<th>Remedial</th>
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</thead>
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<tr>
<td>On-site examinations</td>
<td>Off-site surveillance</td>
<td>Disclosure</td>
<td>Compensation schemes</td>
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<tr>
<td>Investigations</td>
<td>On-site visits</td>
<td>Consumer education</td>
<td>Complaints resolution</td>
</tr>
<tr>
<td>Sector-wide projects</td>
<td>External auditors</td>
<td>Public statements</td>
<td>Holding actions</td>
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<tr>
<td>Risk assessments</td>
<td></td>
<td>Regulatory standards</td>
<td>Disciplinary actions</td>
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<td>Authorizations</td>
<td>Interventions</td>
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<td>Institution-specific standards</td>
<td>Restitution</td>
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<td>Contingency planning</td>
<td>Penalties</td>
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<td>Self-Regulatory Organizations (SRO)</td>
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<td>Memoranda of Understanding (MOU)</td>
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### Stage 5: Evaluation and Validation

Having completed the risk assessment and the risk mitigation programme, the next stage entails conducting an internal evaluation and validation, before the results are adopted for implementation. The validation and testing process is expected to provide quality control and ensure consistency. A committee whose members will be independent of the risk assessment of a particular bank will conduct it. The process will cover the items listed in Table 2.

### Table 2: Evaluation and Validation Procedure

<table>
<thead>
<tr>
<th>Type of Review</th>
<th>Reviewer</th>
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<tbody>
<tr>
<td>A review of the risk assessment for completeness and appropriateness of the</td>
<td>Committee of Group Heads of relevant supervisory departments.</td>
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<td>scores assigned.</td>
<td></td>
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<tr>
<td>A review of any business and control risk overrides.</td>
<td>Central Bank Management (CBM)/DIS (Deposit Insurance Scheme) Executive</td>
</tr>
<tr>
<td></td>
<td>Committee on Supervision.</td>
</tr>
<tr>
<td>A review of the risk mitigation programme, for completeness, adequacy,</td>
<td>The Director of the relevant supervisory department.</td>
</tr>
<tr>
<td>proportionality and optimal allocation of resources.</td>
<td></td>
</tr>
</tbody>
</table>
Stage 6: Communicating the Results of the Assessment and Risk Mitigation Programme to the Islamic Bank

The results of the risk assessment, and the threat it poses to achieving supervisory objectives, the on-site examination report and the risk mitigation programme, will be formally communicated to the Islamic bank. The Islamic bank will be required to respond formally to the results confirming that it will follow the prescribed RMP. If the Islamic bank declines to carry out the actions in the RMP, the supervisor will consider the use of other supervisory tools. The supervisor will also consider whether the Islamic bank has breached any rule, principle or threshold condition and whether other formal actions, consistent with the provisions of IFSA as well as the Contingency Planning Framework for Systemic Distress and Crisis, should be taken.

Stage 7: Implementation of Risk Mitigation Programme, On-Going Assessment and Response to Risk Escalation

Where an Islamic bank’s supervisory period exceeds certain prescribed months or as an example - say 12 months, an interim review will be carried out before the expiration of the regulatory period to determine whether the earlier risk assessment and risk mitigation programmes are still applicable to the Islamic bank. The review will also determine whether there has been an escalation of the risks and the appropriateness of the risk mitigation programmes. The review will be an off-site assessment, covering all the risk factors, issues and the supervisory tools deployed.

4. Pre-Conditions for the Effective of Risk Based Supervision

This section details steps in off-site surveillance and on-site examination under the RBS framework. The new framework, based essentially on risk profiling of Islamic banks, would be largely carried out through baseline monitoring. Through analyses of information rendered by the Islamic bank, the supervisor would monitor, identify and deal with Islamic bank-specific risks, and provide an insight into industry developments. Since supervisory action would be risk driven, routine monitoring visits will not be a dominant feature of the new framework.

In line with the framework, off-site supervisory activity will involve risk identification and assessment; implementing and monitoring on-going corrective actions; providing statistical reports to operators; discussions with management and/or external auditors; collaboration with on-site examiners and identification of high risk areas for on-site examination.

There are several conditions that are needed for effective off-site surveillance; among others are data integrity, legal protection for compliance officers, and legal protection for whistle blowers, independent directors, fit and proper persons tests, and supervisory team formation.
Data Integrity

The efficacy of RBS relies heavily on integrity of data upon which informed and accurate analysis of risks are based. Where information and data are either false or unreliable, assessment from the analysis conducted on such data would also be unreliable and faulty. The need for zero tolerance for data and information unreliability is a *sin qua non* for effective risk based supervision. In order to further ensure the quality of data received from Islamic banks, proper validation tests should be carried out with adequate links to examination reports. For comparable purposes, data that use the same standard may benefit the users. For example, in the preparation of the financial statements, the financial reporting of Islamic bank should comply with FRS and the central bank Guidelines on Classification and Impairment Provisions for Loans/Financing.

Legal Protection for Compliance Officers

The Compliance Officers (such as internal auditors, external auditors and sharia control function officer) of the reporting Islamic banks will play a very significant role under a risk-based supervision regime. Accordingly, there should be adequate legal protection for them. They are to ensure that returns comply with rules and regulations before appending their signatures. They should be made to operate within minimum operating standards.

Legal Protection for Whistle Blowers

The supervisor needs to be alerted on happenings in the Islamic banking institutions being supervised that constitute threat to the supervisory objectives. One source of such information are the insiders of the Islamic banking institutions and others whose information could be relied upon. To assure adequate protection for those providing the information, appropriate legal backing will be necessary.

Independent Directors

In constituting the board of directors of Islamic banks, provision should be made for independent directors so as to promote transparency and reliability of information from the Islamic banks. Such persons must be of high integrity, have no equity interest in the Islamic bank and should be professionals in their own fields. The Islamic banks should ensure that they are appointed as members of the major committees of the board.

Fit and Proper Persons Test

The process of carrying out the fit and proper persons test should be reviewed to make it more effective. The Boards of banks should have proper combination of Executive and Non-Executive Directors (which comprise one of the Sharia Supervisory Board). The Chairman of the Board should not serve as the Chairman of Board Committees while the posts of Board Chairman and Managing Director/Chief Executive Officer should not be vested in one person.

Supervisory Team Formation

Risk-Based Supervision requires full collaboration between on-site and off-site supervision. In that regard, the roles of on-site examination and the off-site supervision teams need to be harmonized. This would entail the assignment of a group of Islamic banks to a particular on-site examination team with its equivalent off-site. This arrangement
would facilitate continuous exchange of information, regular meetings, continuity, and specialization amongst supervisory personnel.

5. Role of the Sharia Supervisory Board – An Independent Monitoring

In the previous discussion, the supervisory role should be given to supervisory authority like central bank or financial services authorities. The monitoring effort by private agent is very costly. Other organizations can also indirectly supervise on different capacity like the external or internal auditors on standard compliant basis. But, this paper will suggest the Sharia Supervisory Board as an additional supervisory body that can strengthen the risk based supervisory approach. Some may argue that the role of SSB is only confined to sharia matters. We argue that sharia matters should be above all.

Reason 1: SSB plays the role as supervisor and monitor

The name of this body tells us that the members of SSB have a role as sharia supervisor. In a wider perspectives, their duties and responsibilities (as provided under the Islamic Financial Services Act, IFSA) are to review, appraise (can be summarised as monitoring role) and advise the board on the operations of the Islamic bank’s business. This is done to ensure that they do not involve in elements, which are not approved by Islam. Hence, the Islamic bank will not be exposed to non-compliant sharia risks. The roles of SSB in monitoring the Islamic bank’s activities can be performed as follow: first, review the products and services to ensure conformity with sharia requirements. SSB has the authority to scrutinize and approve documents used by Islamic banks. Nevertheless, although all transactions including products and services offered have to be first approved by SSB in order to ensure that they do not involve non-Islamic elements, it is open to any interested party to challenge such transactions as being contrary to Islamic law as there is nothing in the IFSA which states that, once an operation has been approved by National Sharia Advisory Council, it may not be called into question or reviewed by any court of justice.

Second, SSB would deliberate on sharia issues pertaining to the day-to-day operations of the Islamic bank and provide advice accordingly. Third, SSB form opinions on the operations of the Islamic bank on whether they are sharia compliant. Fourth, they provide training and education on transactions based on sharia principles.

Reason 2: SSB as an independent body

Sharia Supervisory Board is an independent body - one of the SSB members should be appointed as independent board member and the board, under sharia governance framework, would consult SSB in relation to policies and procedures related to sharia matters. This recognises the independence of the SSB and ensures that it is free from any undue influence. This would allow the SSB to make sound decisions on sharia matters in an independent and objective manner.

Reason 3: Qualification of SSB Team

Guidelines on the Governance of Sharia Committee for the Islamic Financial Institutions suggest that the proposed member of the sharia committee shall at least hold a degree in sharia, which includes study in the origin of Islamic law and Islamic transaction or commercial law. The sharia committee also has a relevant background in economics, and finance and law. This is considered as the attributes of a good supervisor.
Reason 4: Sharia Management Control – Part of Supervisory Framework

Basically, sharia principles are the foundation for the practice of Islamic bank through the observance of the tenets, conditions and principles espoused by sharia. Hence, non-compliance with sharia principles may bring about financial and legal disrepute that could affect the reputation of the Islamic banking institution and the industry generally. In this perspective, SSB can perform an oversight role on sharia matters related to the Islamic bank’s business operations and activities. This can be achieved through the sharia management control via sharia review process and sharia audit functions.

This control could be considered as part of the Islamic bank integrated risk management framework. Their functions are to identify, assess, monitor and control the sharia risks through a systematic approach to mitigate any possible non-compliance events.

Reason 5: Reporting

Regular sharia review reports and the sharia audit observations would enable the sharia committee to identify issues that require its attention and where appropriate, to propose remedial measures. They should be reported in the annual financial report on the state of compliance of the Islamic bank, as required by the Guidelines on Financial Reporting for Licensed Islamic Banks (GP8-i). However, in the case of certain operations which are found to be carrying business which is not in compliance with the sharia, or against the advice of SSB or the rulings of the National Sharia Advisory Council, SSB can inform the board and to recommend suitable measures to rectify the situation. Under the IFSA, if the sharia non-compliant activities are not adequately addressed, the SSB can inform the supervisory authority. The supervisory authority may ask the Islamic bank to: immediately cease to take on any new businesses related to the sharia non-compliance business. Furthermore, under the Islamic Financial Services Act, the Minister of Finance may, on the recommendation of the Central Bank, revoke the license issued to the bank if it is pursuing aims or carrying on operations involving non-Islamic elements.

6. Conclusion

The aim of this paper is to produce effective supervision. There are several elements to achieving such a level. Among these elements are: the philosophy and objectives of supervision; the adopted supervisory framework, here we also discussed the risk-based supervisory approach and framework. Then, it was followed by the supervisory process in performing the supervisory task. The supervision by risk approach provides the supervisor and the Islamic banking industry with: a high level of consistency in supervision because it sets and uses minimum core procedures; an allocation of resources based on risk; sufficient flexibility to allow supervisors to tailor the supervisory effort to the risks present. In this paper, we also suggest that the Sharia Supervisory Board can be used as an additional supervisory body that can strengthen the risk based supervisory approach.
References


