

Shariah Governance Framework for Local Banks Operating in Saudi Arabia

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Chapter One: Preliminary Provisions

Article 1: Introduction

Shariah governance has become an important requirement in the Islamic banking industry. Its effectiveness can lead to achieving a number of benefits, the most important of which are:

- Limiting the risk of non-compliance with Shariah principles and rules.
- Supporting the Islamic banking industry stability and economic growth.
- Improving operational efficiency and decision making of the Islamic banking industry.
- Attracting foreign investment in Shariah-compliant assets.
- Increasing efficiency of internal capital management.
- Enhancing trust among key stakeholders.
- Strengthening relations with depositors, investors, and financiers.

In order to implement the effective Shariah governance requirements for banks and ensure that Islamic banking transactions in Saudi Arabia are Shariah compliant, SAMA issued this framework. To establish a robust and effective Shari'ah Governance Framework (SGF) for the banks conducting Shari'ah compliant banking, a minimum set of regulations and guidelines are issued for compliance by the banks. SGF does not contradict the requirements of other regulations rather it compliment already issued regulations and guidelines.

Article 2: Objectives of the Shariah Governance Framework

This framework aims to enhance the environment for compliance with Shariah principles and rules in banks in general. It also aims to define the tasks and responsibilities of the board of directors, executive management, Shariah committee, compliance department, risk management department, and internal audit department in relation to the application of the requirements of this framework.

To achieve this, the board and the executive management of the bank are expected to have a reasonable understanding of Shariah principles and their broad application in Islamic finance. The Shariah committee is expected to have sufficient knowledge of financial and banking aspects in general and Islamic finance in particular so as to be able to understand the Shariah matters presented to it. In addition, the committee is

expected to constantly gain knowledge of Shariah and financial matters and laws, attend relevant training programs, continue to enhance knowledge and understanding, and keep abreast of the latest developments in the field of Islamic finance.

Article 3: Definitions

The following words and phrases, wherever mentioned in this framework, will have the meanings assigned to them unless the context requires otherwise:

SAMA: The Saudi Central Bank.

Bank: Any local bank that is licensed to carry out banking business in Saudi Arabia in accordance with the provisions of the Banking Control Law and that conducts Islamic banking.

Board: The board of directors of the bank.

Management: The bank executive management and senior executives that manage the bank business as well as propose and implement strategic decisions.

Committee: A Shariah committee responsible for supervising compliance with Shariah principles and rules and their application in the bank.

Committee Members: A group of specialists whose knowledge and experience are not limited only to the Shariah and related matters, but also include the jurisprudence of contemporary financial transactions used to form Shariah decisions given to the bank. These Shariah decisions are usually not directed to the public or entities engaging in other activities.

Independent Committee Member: A person who is completely independent in position and decisions and who meets the requirements for independence as stipulated in Paragraph 3 of Article 7 of this framework.

Shariah Compliant: Compliance with Shariah decisions issued by the bank's Shariah committee.

Islamic Window : That part of a conventional bank (which may be a branch or a dedicated unit of that bank) that provides Shariah compliant finance and investment services both for assets and liabilities products.

Investment Account Holders: Bank customers who have Shariah-compliant investment accounts which may be restricted or unrestricted according to their Shariah and accounting status.

Bank Subsidiaries: Any legal entity controlled by the bank by owning more than half of its capital or voting rights or by forming its board of directors, including special-purpose entities.

Relatives:

- Fathers and mothers, grandfathers and grandmothers.
- Offspring and their children.
- Full and half siblings.
- Spouses.

Stakeholders: Any person who has an interest in the bank, such as shareholders, employees, investors, creditors, customers, suppliers and supervisors.

Chapter Two: Composition of the Shariah Governance Framework

Article 4: Composition of the Shariah Governance Framework

The bank shall establish a Shariah governance framework with emphasis on the key functions and elements that ensure effective implementation of this framework and according to the following:

1. The Shariah governance framework shall consist of a set of policies and procedures that describe the structure, roles, responsibilities, and tasks of the relevant departments as well as the communication arrangements among them.
2. These policies and procedures shall define the mechanism that a bank must follow to meet the requirements of this framework, including how committee meetings shall be conducted, how decisions are made and recorded, and how reports shall be prepared and submitted.
3. The bank shall establish formal reporting channels among the key units/departments to ensure effective and timely reporting. In this regard, the committee shall report to the board of directors.
4. The bank must establish a control mechanism to ensure that the objectives and operations of its Islamic banking activities are in compliance with Shariah principles and rules at all times.
5. The composition of the Shariah governance framework shall be supported by pillars that include effective tasks and responsibilities carried out by the board and the management, independence of the committee, and qualification of its members in addition to the effectiveness of the internal control functions which are Shariah compliance, Shariah non-compliance risk management, and Shariah internal audit.
6. Continuous assessment of the bank's compliance with the Shariah principles and rules shall be carried out.

7. The bank shall manage the potential Shariah non-compliance risk resulting from Islamic banking which includes identifying the inherent risk and establishing controls to mitigate such risk.
8. A regular and periodic Shariah internal audit shall be conducted to verify the level of compliance of Islamic banking activities and operations with the Shariah principles and rules.
9. The bank shall establish a unit/department responsible for conducting research and studies on Shariah, coordinating between the management and the committee, and disseminating Shariah decisions to stakeholders within the bank in addition to acting as secretariat to the committee.

Chapter Three: Responsibilities of the Board and the Executive Management

Article 5: Responsibilities of the Board of Directors

1. The board is primarily responsible for the overall Shariah governance framework of the bank and the compliance of its Islamic banking activities with the Shariah principles and rules. The board is also responsible for approving the bank's Shariah governance framework, performing continuous oversight over the effective functioning of the framework, and ensuring that the framework is commensurate with the size, complexity, and nature of the bank's business.
2. The board shall approve all Shariah policies of the bank and supervising the effective implementation of these policies.
3. The board shall provide the necessary mechanisms and methodology for risk management to protect the interests of investment account holders through Profit-loss sharing accounts.
4. The board shall supervise the bank's compliance and implementation of the Shariah decisions issued by the committee.
5. The board shall ensure that an effective communication policy among the key functions of the bank is in place to facilitate and allow the escalation of important matters related to compliance of Islamic banking activities with the Shariah principles and rules.
6. The board shall remunerate the Shariah committee members appropriately based on the recommendation of the nomination and remuneration committee of the board. Such remuneration shall be commensurate with the duties and responsibilities of these members and consistent with SAMA's relevant instructions.

7. A formal procedure shall be adopted, as proposed by the nomination and remuneration committee, to assess the performance of the Shariah committee members based on competence, knowledge, contribution and effectiveness.
8. The resume of all the Shariah committee members shall be disclosed so that shareholders and investors can judge the competence and ability of these members to carry out their duties effectively.
9. The mechanism used to supervise the integrity and performance of the committee members shall be disclosed. Moreover, it must be taken into account not to nominate any member who has previously been convicted by a court judgment or of a crime impinging on honor or integrity.

Article 6: Responsibilities of the Executive Management

1. The management shall identify and refer any Shariah issues to the Shariah committee for decisions and provide the committee with the required information and disclosures in a timely manner.
2. The management shall monitor and implement the Shariah decisions issued by the committee.
3. The management shall provide continuous education and training programs to key internal stakeholders, including the board, the Shariah committee, and the employees related to Shariah and finance matters. This is to ensure that all departments/units associated with the Shariah governance framework of the bank are sufficiently exposed to current developments in Shariah related matters.
4. The management shall develop and adopt a holistic culture of Shariah compliance within the bank to comply with the Shariah principles and rules in its overall Islamic banking activities. In addition, all relevant employees are expected to be familiar with the Shariah-compliant products offered by the bank as well as similarities and differences between Shariah-compliant banking products and services and others that are conventional.
5. The management must ensure that Shariah policies and procedures are accessible to employees involved in the implementation of the Shariah governance framework.
6. The management shall ensure that all Islamic banking operations are carried out according to the bank's Shariah policies and procedures and shall constantly review and update the policies and procedures to reflect market practices and developments.

7. If the management becomes aware that certain financial or Islamic banking transactions appear to involve operations that are not Shariah-compliant, the management shall:
- a) Immediately inform the board and the committee.
 - b) Immediately stop providing any banking services or products in that business line related to the Shariah non-compliant operation.

Within (30) business days of becoming aware of such non-compliance, submit a plan to rectify the state of non-compliance with the Shariah principles and rules, to be approved by the board and endorsed by the committee.

Chapter Four: Formation, Appointment, and Membership of the Shariah Committee

Article 7: Formation of the Shariah Committee ¹

The board shall form the Shariah committee and appoint its members, based on the recommendation of the nomination and remuneration committee, after obtaining SAMA's written non-objection. The bank may obtain the approval of the general assembly to appoint the Shariah committee members if such is stated in the bank internal policy. The term of committee membership is three years. The committee shall be formed according to the following:

1. The number of its members must be proportionate with the size and nature of the bank business, provided that it is not less than three and not more than five.
2. The chairperson of the committee shall be an independent member.
3. The number of the independent members must not be less than two-thirds of the committee members. Independence of a committee member shall be invalidated in the following cases:
 - a) If the member owns five percent or more of the stock of the bank or one of its subsidiaries.

¹ The article is for guidance and will be enforced starting from 01/01/2023.

- b) If the member is a representative of a corporate person who owns five percent or more of the stock of the bank or one of its subsidiaries.
- c) If the member is a relative of any of the board members or senior executives in the bank or in one of its subsidiaries.
- d) If the nominated member is a board member in one of the bank's subsidiaries.
- e) If the member is currently an employee, or used to be an employee during the past two years, of the bank, of a party that deals with the bank, or of a subsidiary, e.g. an accounting auditor or a main supplier, or held a controlling interest in any of these parties during the past two years.
- f) If the member has a direct or indirect interest in the business and contracts executed for the bank.
- g) If the member receives financial consideration from the bank in addition to the remuneration for their membership in the committee.
- h) If the member has a credit relationship with the bank (credit cards, credit facilities, guarantees, etc.), under his name or the name of a relative, in excess of three hundred thousand Saudi riyals.
- i) If the member engages in a business that would compete with the bank or conducts businesses in any of the bank's sub-activities.
- j) If the member served for more than six consecutive years or nine nonconsecutive years as a member of the committee.
- k) The business and contracts that serve a personal interest of a committee member, which requires a license from the ordinary general assembly, shall not be considered as interest invalidating independence of that committee member if such business and contracts are carried out according to the same terms and conditions adopted by the bank with all contractors and customers and are part of the bank's usual activities unless the nomination and remuneration committee of the board deems otherwise.

If independence of any member is invalidated for any reason, the bank shall notify SAMA within five business days.

4. The bank shall not appoint any member of its committee from a Shariah Committee of another bank operating in Saudi Arabia. This is to ensure that the committee member would be more focused, avoiding conflict of interest, and maintaining the confidentiality of information.
5. The bank shall include a confidentiality clause in the contract or terms of appointment of the committee members to maintain the confidentiality and secrecy of the bank's information.

6. Upon resignation/expiry of the term of membership of any committee member for any reason, the bank must notify SAMA in writing within five business days. The resigning member shall submit his resignation, along with his reasons, to the board with a copy to SAMA. Membership of a committee member may not be terminated before the expiry of its term except with an acceptable justification.

Article 8: Membership of the Shariah Committee

The committee members shall be properly qualified to carry out the duties assigned to them. They shall have a clear understanding of their tasks and responsibilities and be able to exercise sound judgment with objectivity. These members shall also possess various professional, practical and administrative skills as well as experience in Shariah and financial matters. They shall have appropriate personal qualities, especially honesty and commitment in addition to a high degree of good reputation, competence and responsibility. The effectiveness of the committee depends on the experience and ability of its members to judge comprehensively as well as their participation in the committee's discussions and familiarity with the topics raised before making any related decision. Moreover, a member's qualifications should include the following:

- **Leadership:** A Committee member should have leadership skills and be able to grant powers that lead to stimulating performance, applying best practices in the field of effective management, and adhering to professional values and ethics.
- **Independence:** It is the ability of a committee member to be impartial and objective in making a decision without any influence from the management or from other external entities.
- **Competence:** This is reflected by the level of education, training, skills, and the desire to continue learning as well as the diversified experience of at least five years in various fields, including Islamic banking, compliance, and Shariah audit of financial transactions.
- **Shariah and financial knowledge:** A member should have adequate Shariah knowledge in addition to the ability to read and understand financial statements and reports.

Article 9: Shariah Committee Meetings

1. The committee shall hold meetings on a regular basis, and whenever the need arises, to exercise its duties effectively and to ensure that the bank's operations are not adversely affected by the difficulty in obtaining the committee's decisions on Shariah matters that are referred to it.

2. The committee meetings shall be held periodically, at least once every three months.
3. For a committee meeting to be valid, it shall be attended by the majority of the members. The resolutions shall be adopted by the majority of votes of the attending members. In the case of a tie, the vote of the committee's chairperson shall prevail.
4. A committee member is expected to contribute to meetings and allocate sufficient time and effort to discharge their duties effectively. The member must attend at least (75) percent of the committee meetings held during the fiscal year.
5. The meetings shall be documented and minutes of meetings shall be prepared, including the discussions and deliberations. The committee's decisions and voting results shall be documented and kept in a special and organized record. Names of the attending members shall be stated along with their objections (if any) and their reasons. All attending members shall sign the minutes of meetings.

Chapter Five: Responsibilities and Duties of the Shariah Committee

Article 10: Responsibilities of the Shariah Committee

The committee shall be responsible for all its decisions related to Shariah matters. The board must rely on the committee for issuing Shariah decisions related to engaging in Islamic banking activities. The committee shall perform the following tasks:

1. It shall supervise the compliance of Islamic banking transactions with the Shariah principles and rules. Shariah compliance reports and internal Shariah audit observations should enable the committee to identify issues that require attention and, where appropriate, propose corrective measures.
2. It shall issue decisions on Shariah matters so that the bank can comply with the Shariah principles and rules.
3. It shall ensure that the Shariah policies and procedures developed by the bank are consistent with the Shariah principles and rules.
4. To ensure that Islamic banking products are Shariah compliant, the committee shall approve the following:
 - a) The terms and conditions contained in the forms, contracts, agreements and other legal documents used in executing the transactions.
 - b) The product manual, marketing advertisements, illustrative pamphlets and brochures used to describe the product.
5. The committee shall assess the compliance and internal Shariah audit work to ensure compliance with the Shariah aspects. Such assessment is part of the tasks related to submitting the reports on assessment of Shariah compliance.

6. The related parties of the bank such as its legal consultant, external auditors, or consultant entities may seek advice from the Shariah committee on Shariah matters related to the bank operations, and the committee shall provide the necessary assistance in this regard.
7. It shall inform the board, and recommend appropriate corrective actions, if it is proven to the committee that the bank has engaged in Islamic banking activities that are not Shariah compliant.
8. The committee shall inform SAMA of cases in which Shariah non-compliant activities are not effectively or adequately addressed or no corrective actions are made by the bank.
9. It shall prepare an annual report on the compliance of the banking Islamic activities of the bank with the Shariah principles and rules and submit it to the board.

Article 11: Responsibilities and Duties of the Chairperson

Without prejudice to the functions of the committee, the chairperson shall lead the committee, supervise the progress of its work, and effectively perform its duties, which are:

1. Ensuring that the committee members receive complete, clear, correct and not misleading information on a timely manner.
2. Verifying that the committee has discussed all Shariah matters submitted to it effectively and on a timely manner.
3. Encouraging the committee members to carry out their tasks effectively.

Article 12: Responsibilities and Duties of the Shariah Committee Members

1. Attending committee meetings and providing a legitimate excuse when absent after notifying the chairperson in advance.
2. Knowing clearly the duties and responsibilities arising from membership in the committee.
3. Dedicating sufficient time to carry out their responsibilities and to prepare for and participate in committee meetings effectively.
4. Enabling other committee members to express their views freely, encouraging the deliberation of certain topics, and taking opinions of specialists from the relevant department and others if the need arises.
5. Informing the board immediately and fully about any direct or indirect interest in the business and contracts executed for the bank, or the direct or indirect engagement in any business that would compete with the bank.
6. Refraining from disclosing any confidential information obtained through their membership in the committee.

Chapter Six: Independence and Confidentiality of Information

Article 13: Independence

The independence of the Shariah committee in performing its duties to issue objective and reliable Shariah decisions shall be observed continuously as follows:

1. The board shall recognize the independence of the committee and ensure its freedom from any influence that would hamper the committee from issuing objective Shariah decisions when deliberating issues presented to the committee.
2. The committee shall report to the board directly.
3. The Shariah decisions issued by the committee should not be modified or set aside without its approval.
4. The Shariah committee shall have accurate and complete information from the management. If the information provided is insufficient, the committee has the right to request additional information which shall be provided by the management.
5. If the committee is not provided with the required information, the board shall be informed of the fact and an appropriate action shall be taken to rectify the situation.

Article 14: Confidentiality of Information

1. Internal information obtained by the committee members in the course of their duties shall be kept confidential and shall not be misused. Confidential or sensitive information obtained by any member of the committee while performing his duties shall not be used in any manner that could be detrimental to the bank.
2. Notwithstanding the above, the committee will not be regarded as breaching the confidentiality code if the information was disclosed to SAMA when reporting serious breaches of Shariah Principles and Rules by the bank.

Article 15: Maintaining Professional Ethics, Judgment, and Consistency to Ensure Compliance with Shariah Principles and Rules

In ensuring the quality and consistency of the Shariah decisions, the committee shall develop a structured procedures for arriving at Shariah decisions to be documented, approved and maintained in order to ensure the credibility of decision making and protect the committee from undue influences. In this regard, please check the development process of Shariah-compliant products described in Chapter Nine of this framework.

Chapter Seven: Internal Control

Article 16: Internal Control

First: Shariah Compliance:

The Shariah compliance function refers to the regular assessment of the bank's Islamic activities and operations to ensure that they are Shariah compliant. This function includes:

1. Ensuring of the bank's level of compliance with the Shariah principles and rules, the corrective actions to resolve non-compliances, and the control mechanisms to avoid recurrences.
2. overall Islamic banking operations at the bank, including the development process of Shariah-compliant products, which starts from product structuring to product offering to customers (See Chapter Nine of this framework).

Second: Shariah Non-Compliance Risk Management:

The systematic approach of managing Shariah non-compliance risks will enable the bank to continue its Islamic banking operations and activities effectively without exposing the bank to unacceptable levels of risk. Risk management involves systematically identifying, measuring, monitoring and managing Shariah non-compliance risks to reduce potential cases of non-compliance, taking into account that:

1. The Shariah non-compliance risk management function shall be considered as part of the bank's integrated risk management framework.
2. Due to the technicality and complexity in managing the risk of non-compliance to the Shariah principles and rules, the function shall be performed by risk officers that have suitable qualifications and experience in the subject matter.

Third: Internal Shariah Audit:

The Shariah audit function refers to the independent assessment conducted to provide objective assurance in order to add value and improve the degree of compliance in relation to the bank's Islamic operations and activities, with the aim of ensuring a sound and effective internal control system for Shariah compliance. Additionally, the following should be taken into account:

1. Internal Shariah audit on areas of relative importance shall be conducted at least once a year depending on the risk profile of the bank. Shariah audit may be

conducted as part of the bank’s audit on specialized areas, according to the risk level and materiality of the impact of Shariah non-compliance in these areas.

2. The board audit committee shall determine the deliverables of the internal Shariah audit function after consulting with the Shariah committee. These deliverables shall be in line with accepted auditing standards.
3. The Shariah audit function shall be performed by internal auditors who have acquired adequate Shariah-related knowledge and training. In addition, the internal auditors may engage the expertise of the bank’s Shariah officer in performing the audit, as long as the objectivity of the audit is not compromised.
4. The findings and observations of the internal Shariah audit shall be submitted to both the board audit committee and the Shariah committee.

Chapter Eight: Islamic Window Operations

Article 17: Islamic Window Operations²

When engaging in Islamic banking activity through Islamic window operations, the bank shall ensure that adequate internal control systems and tools are in place to properly separate Shariah-compliant assets and finance sources from those assets and finance sources that are not compliant with the Shariah principles and rules. This is in addition to the other requirements of this framework. Moreover, the bank shall comply with the following requirements:

1. The bank shall keep a separate accounting records for Islamic banking operations and ensure that these records are properly maintained.
2. The bank shall prepare separate financial statements for its Islamic banking operations along with its periodical financial statements at least on a monthly basis.
3. An internal audit is required at least once a year to assess the bank’s compliance with the requirements mentioned in Paragraphs 1 and 2 of this Article.

² The article is for guidance and will be enforced starting from 01/01/2023.

Chapter Nine: The Development Process of Shariah-Compliant Products

Article 18: The Development Process of Shariah-Compliant Products

This development process of Shariah-compliant products should be comprehensive and sufficient to reduce the possibilities of the committee rejecting the products due to non-compliance with the Shariah principles and rules as a result of improper structuring of products, lack of insufficient internal research in understanding the Shariah concepts, or misrepresentation of the product at the issuance or marketing stage. In this regard, the bank shall comply with the following:

1. All Shariah issues related to the product development, design, and process must be referred to the committee. The request for an advice or a decision must be detailed for effective deliberation by the committee. This will include explaining the process involved, documents used, and other necessary information.
2. The committee approval shall be obtained for all Islamic banking products to be presented and for any subsequent amendments. The committee shall make detailed review of legal contracts and other documents related to the products and transactions.
3. Product development includes both pre-product approval (i.e. the process of product structuring and developing prior to introduction to the market) and post-product approval process (i.e. the process after the product has been offered to the customers and transactions have been carried out) as follows:
 - a) **Pre-product Approval:**
 - 1) Pre-product approval process involves the issuance of Shariah decisions, product structuring or design of processes backed by comprehensive Shariah research, and review of contracts and agreements before the product is offered to customers.
 - 2) The pre-product approval process shall include, among other things, a review of the concept, structure, terms and conditions, documentations, policies and procedures, pamphlets, brochures and advertising materials. These documents shall be approved by the committee.
 - b) **Post-product Approval:**
 - 1) Shariah governance shall include the post-product approval process which involves Shariah compliance and internal audit.
 - 2) Areas of potential Shariah non-compliance risks shall be identified, and appropriate relevant actions shall be proposed to the management.