

*Special Issue, the Second GPDRL College of Law International Conference  
on Legal, Socio-economic Issues and Sustainability*

## Research Article

# THE IMPORTANCE OF SHARIAH GOVERNANCE IN THE BANKING INDUSTRY IN SAUDI ARABIA AND THE CASE OF SHARIAH COMMITTEE MEMBERS AS RELATED PARTIES

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Submitted on 16 Feb 2023 / Revised 04 Mar 2023 / Approved **15 Mar 2023**

Published online: **03 Apr 2023** / Last published: **17 Jun 2023**

**Summary:** 1. Introduction. – 2. Corporate Governance: An Overview on the Main Principles Adopted by Saudi Regulations. – 3. Shariah Governance Application in Saudi. – 4. Shariah Committee Composition. – 5. Shariah Committee Independence Affecting Issues. – 6. Shariah Committee Members as Related Parties. – 7. Shareholder's

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**Corresponding author**, responsible for writing and research. **Competing interests:** Any competing interests should be included here. **Disclaimer:** The authors declares that the opinion and views expressed in this paper are free of any impact of any organizations.

**Funding:** The authors would like to thank Prince Sultan University for supporting this publication. Special acknowledgement is given to the Governance and Policy Design Research Lab (GPDRL) at Prince Sultan University (PSU) for their academic support to conduct this research and publish it in a reputable journal.

**Translation:** The content of this paper was translated with the participation of third parties under the authors' responsibility.

**Managing editor** – Mg Polina Siedova. **English Editor** – Dr Sarah White.

**Guest Editors of the Special Issue:** Dr. Mohammed Albakjaji, Prince Sultan University, and Dr. Maya Khater, Al Yamamah University, Saudi Arabia.

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**How to cite:** W Alsunaidi, M Albakjaji "The Importance of Shariah Governance in the Banking Industry in Saudi Arabia and the Case of Shariah Committee Members as Related Parties" 2023 Special Issue Access to Justice in Eastern Europe 148–162. <https://doi.org/10.33327/AJEE-18-6S012>

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**Competing interests:** Dr. Albakjaji serves as a Guest Editor of the Special Issue, though he was not involved in peer review and was not able to impact decisions; to avoid any bias, the final decision concerning the publication was made by Dr. Maya Khater, who serves as a Guest Editor, and by Editor-in-Chief of the Journal.

Authorisations for Shariah Committee Members' Contracts and Businesses. – 8. Shariah Committee Related Party Transaction Disclosures. – 9. Concluding Remarks.

**Keywords:** Corporate Governance, Shariah Corporate Governance, Related Parties, Shariah Committee Members.

## ABSTRACT

**Background:** Saudi Arabia has become an important economic player in the world. Based on this strategic importance, the banking sector had to keep pace. As a result, the Shariah Governance Framework was put in place in February 2020, as banks in Saudi operate in accordance with the requirements of Islamic laws. Therefore, shariah governance is important in the Islamic banking industry. The Shariah Governance framework was issued to control the growth in financial assets, and the first issuance of such a framework needed comprehensive studies. Therefore, due to the lack of local and international research focused on the Saudi corporate governance infrastructure, specifically related parties, the significance of this paper lies in the academic impact and the impact it has on the field practitioners, as it will try to identify the concept of shariah committee members and their re-addition as related parties and disclosures. This research paper aims to study a key principle in corporate governance, that is, the conflict of interest that can be defined under Related Parties Transactions. Specifically, this study will focus on the Shariah Committee Members as Related Parties in the Banking sector in Saudi Arabia.

**Methods:** The researchers used primary and secondary resources.

**Results:** This paper concludes with some findings related to the Shariah Governance Framework and the narrowed topic of this paper, which is the Shariah committee members as related parties. Although it was an important step to re-add the members, there is a need to improve the current regulatory structure.

## 1 INTRODUCTION

The Islamic banking system in Saudi Arabia is very important. Ten banks are listed on the Saudi stock exchange, and all of them provide products that meet Shariah requirements.<sup>3</sup> Shariah corporate governance is important in the Islamic banking industry because not only is our legal system based on shariah, but our banks also offer products that comply with it.

This means that we need a strong shariah system to control the whole process and make sure it is effective. Additionally, it is important to note that the Basic Law of Governance, which is equivalent to and considered to be the Saudi Constitution, states in its first article that the Holy Quran and the sunnah are the constitution of the Kingdom of Saudi Arabia (KSA) religion, which indicates that shariah is the essence and the foundation for KSA. Therefore, shifting the focus of this paper to shariah governance in Saudi is beneficial to academics, practitioners, and our regulators.

Among dual banking jurisdictions, the Kingdom's Islamic banking industry is the largest globally. Islamic banking assets reached \$544 billion in 2020, making up around 65% of the major components of Islamic finance assets.<sup>4</sup>

3 'Main Market Watch: An overview of activity across Saudi Exchange's Main Market' (Saudi Exchange, 2023) <<https://www.saudiexchange.sa/wps/portal/saudiexchange/ourmarkets/main-market-watch?locale=ar>> accessed 25 January 2023.

4 Islamic Financial Services Board and Saudi Central Bank, *Excellence and Leadership: Saudi Arabic Islamic Finance Report* (SAMA 2021) 9 <[https://www.sama.gov.sa/ar-sa/Documents/Saudi\\_IF\\_Report\\_2021\\_Final\\_DIGITAL\\_v3.pdf](https://www.sama.gov.sa/ar-sa/Documents/Saudi_IF_Report_2021_Final_DIGITAL_v3.pdf)> accessed 7 February 2023.

As part of Saudi legislative infrastructure initiatives, the Shariah Governance Framework was put in place in February 2020 by the Saudi Central Bank.<sup>5</sup> This was due to the enthusiasm of the Saudi Central Bank to issue regulations for Islamic financial institutions in the banking sector, and IFSB10 was used as a benchmark for these regulations,<sup>6</sup> which shows that the Saudi government wants to make shariah governance a requirement and make the Islamic banking industry more mature and effective. Further, and to summarise the regulatory changes that are related to this paper, in January 2023, the Saudi Central Bank regulated and mandated the composition and classification of shariah committee members, the updated related parties rules for banks were issued, and the shariah committee members were re-added as related parties.<sup>7</sup>

This paper seeks to provide insight into shariah corporate governance regulations and the re-addition of shariah committee members as RPs. We will explore the above regulations and how they ensure the independence of the shariah committee members from conflict of interests and identify shariah committee members as related parties and the impact of this.

The current paper aims to answer the following questions:

1. What are the regulations that had the function of identifying shariah committee members as related parties?
2. How effective are the shariah corporate governance regulations and the re-addition of shariah committee members in providing a good level of governance?
3. What are the contradictions between regulations identifying related parties and regulations identifying the independency criteria for shariah members?
4. Could these regulations ensure the independence of the shariah committee members from conflicts of interest?

To answer these questions, the researchers divided this paper into core ideas. The paper will discuss shariah governance applications in Saudi Arabia, shariah committee members as related parties, shareholder's authorisations for shariah committee members' contracts and businesses, and shariah committee related party transaction disclosures. Finally, a conclusion and list of findings and recommendations will be provided.

## 2 CORPORATE GOVERNANCE: AN OVERVIEW OF THE MAIN PRINCIPLES ADOPTED BY SAUDI REGULATIONS

The Saudi Capital Markey Authority has defined corporate governance as 'The framework that determines the rights and responsibilities among various parties, such as the manager, board of directors, shareholders and other stakeholders in the company'.<sup>8</sup>

The Saudi Central Bank did not issue its definition of corporate governance but did nevertheless define some main principles for an effective governance system: the importance

5 SAMA Circular No 41042498 of 18/06/1441H.

For information about the SAMA Circulars, visit [www.sama.gov.sa/en-us](http://www.sama.gov.sa/en-us).

6 Saudi Central Bank, *57th Annual Report 2021* (SAMA 2021) <[https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/ANNUAL\\_Report\\_57th\\_2021.pdf](https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/ANNUAL_Report_57th_2021.pdf)> accessed 7 February 2023.

7 SAMA Circular No 43095743 of 17/11/1443H.

8 Capital Market Authority, 'Corporate Governance Regulations: Pursuant to Resolution No 8-16-2017 of 16/5/1438H (corresponding to 13/2/2017G)' (*Capital Market Authority*, 2017) pt 1 <<https://cma.org.sa/en/RulesRegulations/Regulations/Documents/CorporateGovernanceRegulations.pdf>> accessed 7 February 2023.

of having independence and separation between the chairman of the Board of Directors positions and the CEO (this requires clear powers and responsibilities among stakeholders), as well as effective organisational and administrative structures, in addition to establishing an effective internal control system by having a risk management framework, internal audit, compliance division, internal control procedures, and an external auditor.<sup>9</sup>

The Economic Co-operation and Development Organization has set out six main rules for corporate governance. First, to lay the groundwork for a strong and stable corporate governance structure. Second, all shareholders should be treated equally and fairly, no matter how much they own, and all shareholders should be able to use their rights, even if they are foreign shareholders. The third principle is that all shareholders should be treated the same. Insider trading should be illegal, and transactions by board members and top executives should be limited and stopped during the blackout period.<sup>10</sup> The fourth principle is the roles and responsibilities of stakeholders within the corporate governance concept. This means that rights set out by lawmakers and regulations must be recognised and respected, and the owner of those rights must be able to freely exercise them. It also means that protections for those rights and punishments for violations must be set out, and stakeholders' participation and contributions to the governance process must be recognised and rewarded. The fifth principle, which relates to our main focus in this research, is transparency and disclosure. Effective corporate governance should ensure full, accurate, clear, and non-misleading disclosure. Companies are required to disclose any transactions between their board of directors, one of their top executives, or other related parties. This is to make sure that all shareholder rights are respected. The last principle is that the organisation's corporate governance framework should set out the duties of the board of directors.<sup>11</sup> The most important principle that should be followed by the board is 'noses in and fingers out',<sup>12</sup> which means that the board shall oversee and monitor company operations and strategic initiatives, and "nose in" by asking the right and insightful questions directed to the management to provide guidance, however, the directors shall "fingers out" by not interfering in the operations of the company and making decisions on behalf of the executive management and provide them with the necessary powers and authorities and allowing the management to make the business decisions.

Implementing good corporate governance in banks and striving to meet the standards required by regulatory entities like the capital market authority or the Saudi central bank and seasoning it with the best practices that are supported by recognised organisations will eventually increase the confidence and trust of investors and shareholders, minimise the potential risks that banks may be exposed to, and increase their competitiveness not only in the Saudi market but globally as well.

'Shariah governance' is not a commonly used term these days compared to corporate governance, but in our Islamic region, it is considered a widely used term, as the Islamic banking system is in continuous development and enhancements. There is a recognised international body that shifts all of its focus to improve the Islamic financial system, which

9 Saudi Central Bank, *Key Principles of Governance in Financial Institutions under the Control and Supervision of the Saudi Central Bank* (3rd edn, SAMA 2021) ch 2 <[https://www.sama.gov.sa/en-US/RulesInstructions/BankingRules/Key\\_Principles\\_of\\_Governance\\_in\\_Financial\\_Institutions-En.pdf](https://www.sama.gov.sa/en-US/RulesInstructions/BankingRules/Key_Principles_of_Governance_in_Financial_Institutions-En.pdf)> accessed 7 February 2023.

10 OECD, *G20/OECD Principles of Corporate Governance* (OECD Publishing 2015) doi: 10.1787/9789264236882-en.

11 *ibid.*

12 Julie Garland-McLellan, 'Nose in, Fingers Out?' (*Australian Institute of Company Directors*, 1 December 2015) <<https://www.aicd.com.au/board-of-directors/performance/structure/nose-in-fingers-out.html>> accessed 7 February 2023.

is the Islamic Financial Services Board (IFSB),<sup>13</sup> which is an important international organisation that we can benefit from its directions to lead and guide us towards the best practices in shariah governance, all of their attempted efforts are aimed to accomplish financial system stability, the organisation issued standards in shariah governance which is IFSB-10 in December 2009, to help stakeholders better understand sharia governance concerns and how to ensure that a suitable and efficient sharia governance framework is in place.<sup>14</sup>

Moreover, IFSB has the term ‘shariah governance system,’ a definition which is ‘it is the set of institutional and organisational arrangements through which an institution – other than insurance institutions – offering only Islamic financial services ensures that there is effective independence oversight of shariah compliance over certain processes.’<sup>15</sup>

The IFSB is aware that the market is expanding and subject to continuous growth, and all of its issued standards are deemed fit and subject to updates and changes to meet the market demands. In accordance with IFSB-10, the shariah governance structure that is adopted by the financial institution that provides financial services and products shall be relevant to the complexity and nature of the institution.<sup>16</sup>

Furthermore, each institution shall establish its own shariah committee or, as some call it, shariah board, with clearly defined roles and competencies in its charter, which is similar to the Saudi provisions that we shall examine in the next section. This committee may be connected via a reporting line with the board and/or the shareholders to create more independence and ensure that there is a code of conduct to manage appropriate behaviour within the committee.<sup>17</sup> The shariah committee members must fulfil certain membership conditions to be able to do the required roles and must possess leadership skills and certain academic qualifications, not be convicted of any criminal offence, especially if it is related to fraud or any financial crime, and they must acquire the required competencies and capability to ensure the effectiveness of shariah governance and supervision.<sup>18</sup>

### 3 SHARIAH GOVERNANCE APPLICATION IN SAUDI

Firstly, it is important to state that the first entity within Saudi that issued a provision regulating shariah governance is the Saudi Central Bank ‘SAMA’, under the aforementioned government entity fall several sectors which are banks, insurance companies, finance companies, fintech companies, and all financial companies.

The Saudi Central Bank issued the ‘Shariah Governance Framework for Local Banks Operating in Saudi Arabia’ in February 2020<sup>19</sup> (hereinafter the framework), which contains articles that are mandatory and for guidance application. It is an important step

13 ‘Islamic Financial Services Board (IFSB)’ (*Islamic Financial Services Board*, 2023) <<https://www.ifsb.org/background.php>> accessed 7 February 2023.

14 ‘The IFSB Publishes French Version of Standards on Shari’ah Governance (IFSB-10) and Supervisory Review Process (IFSB-16)’ (*Islamic Financial Services Board*, 5 April 2015) <[https://ifsb.org/press\\_full.php?id=425&submit=more](https://ifsb.org/press_full.php?id=425&submit=more)> accessed 25 January 2023.

15 Islamic Financial Services Board, *Guiding Principles on Shariah Governance System for Institutions offering Islamic Financial Services (Shariah Governance System (IFSB-10))* (IFSB December 2009) 2 <<https://www.ifsb.org/download.php?id=4366&lang=English&>> accessed 7 February 2023.

16 *ibid* 5, 7.

17 *ibid* 9-10.

18 *ibid* 11-12.

19 SAMA Circular No 41042498 of 18/06/1441H.

for the banking industry as our constitution is shariah, and recently, the CMA issued the Instructions for Shariah Governance in Capital Market Institutions, although this does not apply to banks, only financial institutions.<sup>20</sup>

As a result of the researcher meeting with the Saudi Central Bank team, SAMA's motive to issue this framework was mainly due to the large growth of Islamic banking activities and Islamic banking assets. In accordance with SAMA's fifty-third annual report, in 2015, the total Islamic banking assets reached USD 1.5 trillion, and 19% of the total assets were in Saudi,<sup>21</sup> and it grew to reach USD 2.1 trillion of total Islamic banking assets, of which 20.4% was in Saudi in 2017.<sup>22</sup> Further, in 2018, the total Islamic banking asset was USD 2.2 trillion, with Saudi's acquisition of 20.2%.<sup>23</sup>

### 3.1 The Shariah Governance Framework

The framework has focused on developing an important standard in shariah within the Islamic banking industry and ensuring that we have a robust and effective shariah governance system in banks that issues shariah-compliant products. The framework has been determined to regulate the following: the formation and composition of the shariah committee; membership conditions of the shariah committee; shariah committee meetings and their roles and responsibilities; the board of directors' responsibilities; executive management's responsibilities; internal control provisions; shariah products.<sup>24</sup>

As we said above, Saudi has ten listed banks in the Saudi exchange, all of them issue shariah-compliant products and services, and all of them have established a shariah committee. Moreover, in accordance with the shariah framework, all banks must establish their own shariah governance framework, which must include, among other requirements, the structure of all business lines that are involved in the process, the mechanism to ensure that all products and services are appropriately accredited and in line with the internal policies and the regulatory instructions.

Each bank shall have a formal reporting line and channels among the relevant functions to ensure that the reporting is effective. In due course, as banking activities are associated with a lot of risks, it is critical to have strong control systems to achieve the objectives of Islamic banking along with the role of the compliance function, which shall conduct a continuous assessment of the bank's compliance with the shariah principle to manage and identify the potential non-compliance and risks issues. Even the audit has a role in this process, as it is part of the three lines defence that they must verify the level of compliance

20 Capital Market Authority 'Instructions for Sharia Governance in Capital Market Institutions: Pursuant to Resolution No 3-77-2022 of 23/11/1443 H (corresponding to 22/6/2022 G)' (*Capital Market Authority*, 2022) <[https://cma.org.sa/en/RulesRegulations/Regulations/Documents/The\\_Instructions\\_for\\_Shariah\\_Governance\\_in\\_Capital\\_Market\\_InstitutionsEN.pdf](https://cma.org.sa/en/RulesRegulations/Regulations/Documents/The_Instructions_for_Shariah_Governance_in_Capital_Market_InstitutionsEN.pdf)> accessed 7 February 2023.

21 Saudi Arabian Monetary Authority, *53<sup>rd</sup> Annual Report 2017* (SAMA 2017) <<https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Fifty%20Third%20Annual%20Report.pdf>> accessed 7 February 2023.

22 Saudi Arabian Monetary Authority, *54<sup>th</sup> Annual Report 2018* (SAMA 2018) <<https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Fifty%20Fourth%20Annual%20Report.pdf>> accessed 7 February 2023.

23 Saudi Arabian Monetary Authority, *55<sup>th</sup> Annual Report 2019* (SAMA 2019) <[https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Annual\\_Report\\_55th-EN.pdf](https://www.sama.gov.sa/en-US/EconomicReports/AnnualReport/Annual_Report_55th-EN.pdf)> accessed 7 February 2023.

24 Saudi Arabian Monetary Authority, 'Shariah Governance Framework for Local Banks Operating in Saudi Arabic' (*Saudi Central Bank*, February 2020) <<https://www.sama.gov.sa/ar-sa/RulesInstructions/BankingRules/Banking-KSA.pdf>> accessed 7 February 2023.

with the shariah instructions and make sure that the bank's activities and operations are well in place.<sup>25</sup>

The board holds the primary responsibilities for the overall shariah governance framework, which shall:

- Make sure that the shariah governance framework matches and fits with the bank's size, complexity, operations, and business
- Ensure compliance with the shariah rules and continuously oversee the effectiveness of the shariah structure and the implementation
- Approve all policies that the bank is determined to issue and that are related to shariah to enable the board to do its work effectively if the senior executives do not cooperate sufficiently, and that eventually may and will affect the work of the board.<sup>26</sup>

Banks in Saudi are determined and committed to providing their shareholders with true value in investment and products over the long term to achieve sustainable growth through the formulation of strategic objectives and translation of them into an appropriate implementation step. One of the listed banks in Saudi is Bank Albilad. Since it was established, they have been keen to apply Islamic principles in all of their transactions as part of the bank strategy. These are implemented through a well-built structure where the board holds the overall and monitoring responsibilities, and the shariah committee, which started working in 2004, performs the issuance of the decisions related to shariah compliance, related policies and procedures, and the Islamic banking collaboration with other business lines, focusing on the role the bank that is playing among other banks in the Islamic services sector and its growth.<sup>27</sup>

The structure of the shariah committee is one of the subjects that is regulated by SAMA. Further, one of the board of directors' roles is to have a nomination and rumination committee. One of this committee's responsibilities is to recommend to the board of directors the members that should be appointed to the shariah committee. They also consider how the number of appointed members should fit the size of the bank and its nature. In order for SAMA to conduct its due diligence and ensure appropriateness, all members must obtain a no-objection from Saudi Central Bank before becoming a member.<sup>28</sup>

The framework suggested as a guiding article that the shareholders shall approve the appointment of shariah committee members, which shall enhance the independence level of responsibility performance. It also touched on the independence of the committee members, which shall not be less than two-thirds of the appointed committee members.<sup>29</sup> Only recently most shariah committee members are members in more than one committee, which could eventually create tremendous cases of conflict of interest because if you are a member, for example, of bank A and a member of bank C, and you approve a certain Islamic product or services, but the bank did not announce as they still need to obtain SAMA's approval, that might affect their independence and the business of the bank, which is very critical, and the competitiveness of the banks between and, most importantly, the loyalty and honesty with which the committee member must act. The cause of misrepresentation

25 *ibid*, ch 2.

26 *ibid*, ch 3.

27 'Shariah Committee in Bank Albilad' (*Albilad Bank*, 2023) <<https://www.bankalbilad.com/ar/about/sharia/Pages/role.aspx>> accessed 7 February 2023.

28 Shariah Governance Framework (n 24) ch 4.

29 *ibid*.

and repetition in the banks' shariah committee membership is discussed in Section 4 of this paper.

Moreover, SAMA has added different parameters to the independency of the members, such as:

- If the member owns a certain percentage of the bank's shares
- When the member is a legal representative of a company that owns a certain percentage in the banks, and this criteria still applies to the shariah committees members, even with the Saudi new Companies Law that was published on 22 July 2022, effective from 19 January 2023, which requires that all members must be natural persons, as it does not apply to shariah members
- When the member has a relative of a defined degree in the board of directors or the senior management
- If the nominated member is a board member in one of the bank's subsidiaries, which by this point means that if the member becomes a member in one of the bank subsidiaries after becoming a member not at the election duration, it shall not affect his/her independence because of the language used
- If the member has direct or indirect business or transactions that are executed for the bank – this point is related to our paper and will be analysed in depth in Section 5; SAMA has defined eleven issues that might affect the independence of the shariah member, but it was a guiding article, which was enforced starting from 1 January 2023, as it is crucial for the member to be able to make decisions with objectivity and without being influenced by other persons or entities.

In ensuring the independency and confidentiality of floating information, the framework has dedicated a whole section to that subject, where it is the board of director's responsibility to verify the independence of the shariah committee members and their freedom from any influence that might affect their performance of their duties. Additionally, to help the board to execute their work, the committee should be committed to reporting to the board of directors periodically and updating them with their work and achievements along with any obstacles they are facing.

The internal control subject in banks is vital and critical, as banks hold a lot of responsibilities to their shareholders, society, government, regulatory authorities, and other stakeholders. Thus, the shariah committee members' transactions should be captured properly.

## 4 SHARIAH COMMITTEE COMPOSITION

There was a study that concluded a definition for the shariah supervisory board, which is equivalent to the shariah committee in Saudi:

[A] comprehensive organ whose functions include review, investigation, and evaluation of all products, transactions, activities and businesses conducted by the Islamic Financial Institutions to ensure Shariah compliance; and this responsibility is performed by qualified experts and Shariah scholars who possess appropriate tools and vested knowledge.<sup>30</sup>

The shariah committee was defined under the framework as well as the body in charge of ensuring that the laws and regulations of Islam are followed in Saudi banks, and the

30 Abdulrahman Alnofli and Engku Rabiah Adawiah Engku Ali, 'The Role of Key Functions of Shariah Governance in Islamic Financial Institutions (IFIs)' (2020) 4 (1) *International Journal of Fiqh and Usul Al-Fiqh Studies* 98, doi: 10.31436/ijfus.v4i1.173.

framework has dedicated a full chapter for the shariah committee regulating its composition, formation, appointment, and membership qualification, but with no adequate provision of the termination of membership.

Notwithstanding the issuance of the framework in 2020, in accordance with SAMA's circular, it issued a new instruction on 9 October 2017 for the banks' new products. In light of these instructions, in order for SAMA to issue its no-objection on one of the shariah-compliant products, it must be approved by the shariah committee of the bank; hence, all banks that issue such products must form this committee, and it can be understood from these instructions that obtaining an opinion from an external party/entity is not allowed, as it is a condition to obtain an approval from the committee be formed within the bank. Therefore, starting in 2017, banks must form a shariah committee, and such formation is not regulated in terms of compositions, characteristics, responsibilities, and liabilities until the issuance of the framework. As a result of this gap, the members of most of the shariah committees in all banks were the same, which created conflicts of interest. This can be attributed to many reasons, but the main one is that there were no regulations for banks to follow and a limited number of available individuals with the requisite knowledge of Islamic laws and Islamic banking transactions.

Additionally, and with respect to the above, the following two paragraphs will demonstrate some of the gaps that the Shariah Governance Framework for Local Banks Operating in Saudi Arabia covers and regulates. According to the framework, it states that the bank board of directors holds the primary responsibility for the overall shariah governance systems and the compliance of the bank's Islamic banking activities. The composition of shariah committee members shall be determined and appointed by the bank board of directors based on the nomination and remuneration committee recommendations or as an optional method to obtain approval on the appointment by the shareholder, and this is as per the framework.

As for the article that governed the formation of the committee and its compositions, which is the focus of this section, all members must obtain SAMA's no-objection before appointing and must not pursue the role of a member before approval from SAMA. The composition was a guiding article and was enforced starting from 1 January 2023. As for the number of members, the shariah committee (hereinafter – SC) should not be less than two and not more than five members. However, it must be suitable for the size and nature of the banking business and activities.

The classification of members as per the framework is divided into three: the independent members, the non-executive members, and lastly, the executive members. Notwithstanding the classifications, the framework only had a definition and requirements for independent members and was silent on the other classifications, in which banks, as a practice, could appoint an executive member to the committee.

One of AAOIF's 2005 recommendations was that the SC should not work independently from the board of directors and should be allowed to freely discuss and voice their concerns relating to shariah matters in board meetings.<sup>31</sup> AAOIFI GS-1 also states that the SC must include at least three shariah scholars.<sup>32</sup> The framework was silent on the scholars' qualifications and only required that the members should have adequate shariah knowledge in addition to experience in shariah. As to the relationship between the SC and the board of directors, the framework states the opposite, where the SC is independent in the performance of its duties, and the board of directors recognise the independence of the committee and ensures its freedom from any

31 Nazrul Hazizi Noordin and Salina Kassim, 'Does Shariah Committee Composition Influence Shariah Governance Disclosure? Evidence from Malaysian Islamic Banks' (2019) 10 (2) *Journal of Islamic Accounting and Business Research* 158, doi: 10.1108/JIABR-04-2016-0047.

32 Alnofli and Engku Ali (n 30).

influence that would hamper the committee when issuing their decisions. Here, there seems to be no difference, as the framework did not prohibit the committee from contacting the board. On the contrary, its reporting line is connected to the board, and the board shall approve its decisions. That said, the decisions that are issued by the committee should not be modified or set aside without the committee's consent and approval.

Further to the connection between the board of directors and SC members, one of the studies recommended that one way to fill the gap between the SC and the board of directors is to appoint one of the shariah committee members to the board of directors.<sup>33</sup> This suggestion seems very sensible and relevant in Saudi for banks that only conduct Islamic activities. As per Saudi exchange public information, as of 11 December 2022, none of the Islamic banks in Saudi has SC members that serve on the board of directors of the bank. The shariah framework is silent on this matter, neither permitting nor prohibiting the possession of these two memberships. That said, banks might encounter issues with SAMA's no-objection, but if there is no membership conflict, the member can serve on the board of directors and the SC.

Now, regarding the independency classification of shariah members, in the Saudi system, the chairman has to be classified as an independent member, and no less than two-thirds of the committee members should be independent, as per the framework.

Regarding the mechanism on how the SC members, including the chairman, must be classified as independent if none of the issues affecting the independency has accrued to the member, the issues that are invalidating the independency will be analysed in depth in Section 5 of this paper.

The framework did not regulate one critical subject, which is remuneration, for which there is no cap for the shariah members, and it can reach and exceed the remuneration cap for the board and board sub-committees – excluding audit committee members – which is 500,000 SAR.<sup>34</sup> It seems that the SC is considered to be among the board sub-committees, and the same restriction should be applied, but the authors do not believe this is the case given the following:

1. The nature of the SC's activities, roles, and responsibilities
2. Its fully independent decision-making authority and the nature of its fatwa decisions
3. Banks are obliged to disclose the remuneration of the board sub-committees, but no banks disclose the remuneration of their shariah committee members.

Additionally, when the framework is read, after each mention of one of the board committees in the Key Governance principles, it is always followed by 'board sub-committee', and there is a definition for the committee in the framework. There is nothing that indicates that the SC is considered to be a board sub-committee, only that it shall report to the board. Considering all of the above factors and the nature of the members in the board sub-committees, as most of the committee members are board members, we can conclude that it is not a board sub-committee and their remuneration is not regulated, and this might create risk for the banking industry.

33 Mohammad Azam Hussain, Rusni Hassan and Alias Azhar, 'The Procedures of Appointment and Cessation of the Shariah Committee Member of the Islamic Banks and Takaful Companies in Malaysia: Legal Analysis' (2016) 6 (S7) *International Journal of Economics and Financial Issues* 266.

34 SAMA Circular No 38100006370 of 14/06/1438H.

## 5 SHARIAH COMMITTEE INDEPENDENCE AFFECTING ISSUES

Art. 7 point 3 of the framework, which was effective from 1 January 2023, has regulated the issues affecting independence, which are as follows:

- If the member holds at least five per cent of the bank's or one of its subsidiaries' equity
- If the member is a representative of a corporation that holds at least five per cent of the bank's or one of its subsidiaries' equity
- If the member is related to any of the bank's board members or senior executives or any of the bank's subsidiaries
- If the proposed member serves on the board of directors of one of the banks' subsidiaries
- If the member is a current or former employee of the bank, a party that does business with the bank, or a subsidiary, such as an accounting auditor or a major supplier, or owned a controlling stake in any of these parties over the preceding two years
- If the member has a direct or indirect financial interest in the bank's operations and contracts – if an SC member has either direct or indirect transactions with the bank, it will be affecting his/her independence
- If the member receives additional compensation from the bank in addition to their compensation for committee participation
- If the member has a credit connection with the bank in excess of three hundred thousand Saudi riyals under his/her name or the name of a family member
- If the member participates in a business that competes with the bank or engages in any of the bank's sub-activities
- If the member serves on the committee for more than six consecutive years or nine non-consecutive years.

Lastly, the business and contracts mentioned under the sixth point, which serve a personal interest of a committee member and require a license from the ordinary general assembly, shall not be considered as an interest invalidating the 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 normal activities unless the nomination and remuneration committee of the board determines otherwise. This point will be analysed in Section 7 of this paper.

With relation to independence, there was a study in Bahrain that revealed that there are some members in the shariah supervisory boards of Islamic banks in Bahrain who sit on the board of directors for several Islamic banks around the world, which might imply a threat to the independence of the member due to multiple representations.<sup>35</sup> The same scenario is found in Saudi, where SC members serve as members of another SC for another bank, which puts their independence in question, as it might create a conflict of interest and affect the competitiveness between banks. Under the framework, starting from 1 January 2023, members are prohibited from being a member in another SC for another bank working in Saudi.

35 Sutan Emir Hidayat and Ali Khaled Al-Khalifa, 'Sharia Governance Practices at Islamic Banks in Bahrain from Islamic Bankers' Perspective' (2018) 10 (1) *Al-Iqtishad: Jurnal Ilmu Ekonomi Syariah* (Journal of Islamic Economics) 53. doi: 10.15408/aiq.v10i1.5991.

In addition, regarding the ninth point of the above affecting issues, SC members does not have clear competing standards notwithstanding that CMA has mandated listed companies including banks to issue competing standards that shall be approved by the shareholders<sup>36</sup>, however, it shall apply to the board and its committees members, and what is suggested to this point is that banks shall expand the applicability of the competing standards to be applied to SC members as well, and the regulator shall take this into consideration in the next update of the framework, this is to ensure that independency criteria are well governed and clear to apply.

## 6 SHARIAH COMMITTEE MEMBERS AS RELATED PARTIES

Walking through the history of banks' related parties and when and how SC members are added, on 09-01-1441H, SAMA issued the first rules regulating the Related Parties Transactions for banks<sup>37</sup> as separate rules from the large exposures rules, and the SC members were not among the related parties in this version of the rules. However, it was included in the related parties definition in the Large Exposure Rules that was issued on 22/05/1439H<sup>38</sup> and in the Large Exposure Rules issued on 14/10/1439H.<sup>39</sup>

Recently, SAMA issued an update on the Related Party Rules for Banks on 17/11/1443H and re-added the SC members within the definition of related parties, all transactions of which should be captured appropriately. In cases where was a transaction with the bank in which the member has a direct or indirect interest, the member has invalidated one of the independence requirements and will be classified as non-independent to be a non-executive director.

The re-addition of the SC members as a related party was very rational from SAMA, as members have significant influence in the bank and should act with independence and efficiency to ensure the compliance of the bank's products and services with the Islamic rules and principles. Besides, the SC plays a vital role in shariah governance by providing insights and approvals and, issuing decisions, supervising the operations of the bank in accordance with Islamic principles.<sup>40</sup>

## 7 SHAREHOLDER'S AUTHORISATIONS FOR SHARIAH COMMITTEE MEMBERS' CONTRACTS AND BUSINESSES

Section 5 of this paper discussed the issues affecting independence, and one of the points under the framework mentioned that if the member has business or contracts that serve a personal interest of the SC member, which require authorisation from the shareholders, this shall not be considered as interest that invalidates the independency of the member. It was conducted in the same terms and conditions adopted by the banks with all parties and contractors unless the nomination and remuneration committee deems otherwise.

The issue with the above point is its vagueness, as it is the only article and point within the framework that mentions the authorisation of the businesses and contracts of the SC members. However, it was mentioned under the issues that could invalidate independence; therefore, it is not very clear whether banks have to obtain approval from shareholders for

36 *ibid*, (8)

37 SAMA Circular No 67/1607 of 09-01-1441H.

38 SAMA Circular No 391000059150 of 22/05/1439H.

39 SAMA Circular No 41/45201 of 14/10/1439H.

40 Hidayat and Al-Khalifa (n 35).

all related party transactions of the SC members and if it was a specific transaction. This is because, at the beginning of the point, it stated that ‘The business and contracts that serve a personal interest of a committee member, which requires a license from the ordinary general assembly’, which might imply that there is a specific transaction requiring approval, and if that was the case, then what are the transactions that must be approved by the general assembly?

## 8 SHARIAH COMMITTEE RELATED PARTY TRANSACTION DISCLOSURES

An SC with a larger number of members who have extensive knowledge of shariah and relevant experience is effective for overseeing and controlling the disclosures of Islamic banking activities, according to a study that found that the composition of the SC was a significant factor influencing the extent of shariah governance disclosures, for example, non-halal income, charity, and Zakat in Malaysian Islamic banks.<sup>41</sup>

According to the paragraph above and Section 7 of this paper, disclosures are important, and the SC members’ related transactions will be captured and disclosed in accordance with the Related Parties Rules for Banks issued by SAMA and as per IFRS IAS 24 requirements,<sup>42</sup> starting from 1 September 2022 as per SAMA’s instructions and the effectiveness date of the subject rules. However, specific disclosure to the public, particularly within the agenda of the general assembly meetings to acquire the shareholders’ approval, is yet to be clarified by the competent authorities in Saudi.

Moreover, there is an inconsistency between dates related to the disclosures. SC member transactions are to be captured as related party transactions from 1 September 2022 onwards, and as per the framework Art. 7 point 6, there was a reference to the direct and indirect transactions as one of the issues affecting independence. Therefore, if the SC members are not compliant with the SAMA requirements on composition that will come into effect in 2023, and one of the members has a transaction with the bank that ended on December 2022, will it affect his/her independence or not? Furthermore, according to point 11 from the same article, we must assume that there is a requirement to disclose the transactions that ended in 2022 and obtain the shareholders’ approval.

## 9 CONCLUDING REMARKS

In conclusion, it can be summarised that within this paper, we determined the regulations that identified SC members as related parties, how they were re-added, and where and when they were originally identified. We also analysed the inconsistency between regulations that identified shariah members’ criteria and regulations, which provided conditions for the members’ independence and the related disclosures.

The findings from this paper are based on SAMA’s Shariah Governance Framework and suggest ways we can enhance it and have a better control environment to ensure we have a robust system in place the govern, regulate, and control the Islamic banking system.

The Shariah Governance Framework caused a huge shift and shows that this activity is regulated and controlled, but revision is needed to fill in the gaps.

41 Noordin and Kassim (n 31).

42 ‘IAS 24 Related Party Disclosures’ (IFRS Foundation, 2023) <<https://www.ifrs.org/issued-standards/list-of-standards/ias-24-related-party-disclosures>> accessed 7 February 2023.

The framework was silent on the SC classifications for non-executive and executive members and the composition of these two classifications, but since the composition is constituted by two-thirds of independent members, it leaves a small number of seats to the other classifications, which can be executive and non-executive, and, as such, it is open for banks to choose other classifications, which leads us to the next finding of this paper.

The framework was silent on the requirement of a minimum number of shariah scholars possessing membership in the SC to ensure shariah compliance. This could be seen as positive or negative. The positive point of view is that the SC can have members with professions such as lawyers and economists, with some shariah knowledge, which can enrich the discussions and the decisions of the committee. However, to maintain the SC's independence and not weaken its decisions as those issued by members who are trained for these types of activities, his/her decision shall not be considered in the decision quorum if such a member only brings a business perspective without a deep understanding on the Islamic commercial laws. Lastly, this is as per the standards used by the IFSB.

The framework did not clearly regulate the dismissal and resignation of SC members, as it mentions that membership cannot be terminated except with acceptable justification but does not define acceptable justification – shall it be acceptable for the Bank, SAMA, the board, or the shareholders, if their appointment was approved by the shareholders/

The framework was silent on the possession of membership of both the board of directors and the SC and did not prohibit the possession of these two memberships – it seems sensible in Saudi for banks that only conduct Islamic activities to have SC members that serve on the board of directors of the bank.

The remuneration of the SC members is not regulated, and there is no cap for this committee. Following the new companies law effective from 19 January 2023 and the new corporate governance regulations issued by CMA, there is no cap for the board of directors, but since banks fall under the supervision of SAMA, the cap of 500,000SAR still applies. However, it does not apply to the SC members; therefore, it is suggested to have either a cap or to disclose the remuneration of the SC members for transparency.

The competing standards for SC members are not clear, as SC is not among the board committees, therefore, the board and the board committees competing standards that are mandated by CMA does not apply, but the suggestion here is that banks can expand the applicability of their competing standards that is approved by the shareholders in the General Assembly and include SC members, and the regulator shall take this into consideration in the next update of the framework, this is to ensure that independency criteria are well governed and clear to apply.

Among the recommendations related to the narrowed paper topic are the following.

It is a fact that the board of directors holds the primary responsibility of the shariah governance, but the SC plays a vital role in performing and monitoring with regard to the Islamic operation and activities. Therefore, the re-addition of SC members in the definition of the related parties for banks is a rational step taken by the Saudi Central Bank.

It is important to focus on the independence of the SC members, as the framework is mandating from 1 January 2023 a specific composition of independent members, stating that shariah members cannot be a member in another working bank in Saudi, being silent on international banks or the membership of another SC in another sector that might create a conflict of interest between the two memberships, and putting a cap on the number of memberships to maintain the member's focus. However, considering the limited qualifications of members who acquire shariah knowledge flavoured with the banking industry in Saudi, as the banking industry is associated with numerous risks, this finding

could be implemented in the Saudi jurisdiction after we reach a certain level of maturity where we have proper programs, proper associations, universities who produce experts in shariah in the banking industry.

The vagueness that surrounds Art. 7, point (k) in the framework regarding the requirement of obtaining the shareholders' approval might create confusion between practitioners, and the competent authority within Saudi shall issue a circular or other instruments to clarify what is required by banks in this matter and what banks shall acquire shareholders' approval.

The inconsistency between dates related to the disclosures of SC member transactions in relation to the related parties rules and the shariah governance framework should be clarified by the competent authorities to avoid any misleading or poor implementation by the banks. However, this gap might be a transitional period for banks. That said, considering the maturity of banks and the concept of related parties within banks that started back in 1994 with the "Limits of Credit Exposures to Non-bank Counterparties and banks and financial institutions", we believe that the sector is mature enough and already has a proper understanding of related parties.

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