

# The Sharia Governance Framework for Local Banks and Banks Operating in the Kingdom

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Chapter One

Preliminary Provisions

Article One: Introduction

Sharia governance has become an important prerequisite in the Islamic banking industry, and effective Sharia governance achieves some benefits, the most important of which are:

Reducing the risk of non-compliance with the Sharia provisions and principles.

Supporting the stability of the Islamic banking industry and economic growth.

Improving the operational efficiency and decision-making of the Islamic banking industry and activity.

Attracting foreign investment in Sharia provisions and principles-compliant assets.

Efficient internal capital management.

Improving trust among key stakeholders.

Strengthening the relationship with depositors, investors and financiers.

To implement effective Sharia governance requirements for banks and work on conformity of Islamic banking transactions in the Kingdom with the provisions and principles of Sharia, the Saudi Arabian Monetary Agency issued this framework as a minimum of supervisory and control requirements concerning Sharia governance practices. And in a manner that does not conflict with the regulatory regulations and other relevant supervisory requirements issued by the Agency.

#### Article Two: Objectives of the Sharia Governance Framework

This framework aims to enhance the environment for compliance with the provisions and principles of Sharia in banks in general, and to define the tasks and responsibilities of the Board of Directors, the Executive Management, the Sharia Committee, the Compliance Department, the Risk Management, and the Internal Audit Department, concerning the implementation of this Framework requirements.

To achieve this, the board and executive management of the bank are expected to have a reasonable understanding of Sharia principles and their broad application in Islamic finance. It is also expected that the Sharia committee will have sufficient knowledge of the financial and banking aspects in general, and Islamic finance in particular, to enable it to understand the Sharia issues presented to it. In addition, the committee is expected to continuously enriched with knowledge of Sharia and financial issues and regulations, attend relevant training programs, continue to enhance knowledge and understanding, and keep abreast of the latest developments in the field of Islamic finance.

#### Article Three: Definitions

The following terms and phrases - wherever they appear in this framework - have the meanings adjacent to them, unless the context requires otherwise.

Agency: Saudi Arabian Monetary Agency (SAMA)

**Bank:** Banks and local banks licensed to engage in banking business in the Kingdom following the provisions of the Law on Supervising Banks Practicing Islamic Banking Activity.

**Board:** The bank's board of directors.

**Administration:** The executive management of the bank and senior executives responsible for managing the bank's business, proposing strategic decisions and implementing them.

**Committee:** A specialized Sharia committee to undertake the tasks of supervising compliance with the provisions and principles of Sharia and their applications in the bank.

**Committee members:** A group of specialists whose scientific background is not limited to familiarity with Sharia sciences and other areas of knowledge only, but their knowledge and experience includes familiarity with the jurisprudence of contemporary financial transactions that are employed in the form of Sharia decisions directed to the bank, not to the public or entities operating in other fields.

**Independent Committee Member:** A person who enjoys complete independence in his position and decisions, and none of the independence impediments stipulated in Paragraph 3 of Article Seven of this Framework apply on him.

**Compliant with the provisions and principles of Sharia:** compliance with the Sharia decisions issued by the Sharia committee of the bank.

**Islamic window operations:** It is a separate part of conventional bank operations (it may be a branch of the bank or a specialized unit affiliated to it) that provides financing and investment services that are compatible with the provisions and principles of Sharia in the asset and liability sides.

**Investment account holders:** bank clients who have investment accounts that are compatible with the provisions and principles of Sharia. These accounts may be absolute or restricted, depending on their Sharia and accounting status

**Entities affiliated to the bank:** any legal entity controlled by the bank by owning more than half of its capital or voting rights, or by controlling the formation of its board of directors, including special purpose companies.

Kinship:

Fathers, mothers, grandparents, and grandmothers.

Boys, and their children.

Brothers and sisters, brothers and sisters in law.

Husbands and wives.

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

(Chapter Two)

Create a Sharia governance framework

Article Four: Establishing the Sharia Governance Framework

The bank must establish a Sharia governance framework that focuses on the main functions and elements that ensure the effective implementation of this framework, as follows:

1. The Sharia governance framework for the bank should consist of a set of policies and procedures that explain the structure, roles, responsibilities, and functions of the relevant departments and the communication mechanism between them.
2. These policies and their procedures must define the mechanism that the bank must follow to implement the requirements of this framework, and this includes determining how to hold committee meetings, the mechanism for making and documenting decisions, and the mechanism for preparing and submitting its reports.
3. The bank should establish formal channels for reporting between its main units/departments to ensure effective and timely reporting. In this regard, the organizational link of the committee is to the board.
4. The bank must put in place supervisory controls to ensure that the objectives and operations of its Islamic banking activities are consistent with the provisions and principles of Sharia in all cases.

5- one of the pillars of the Sharia governance framework, is the effectiveness of the board and management in carrying out their tasks and responsibilities, the independence of the committee and the qualification of its members, in addition to the effectiveness of the internal control functions, which are represented in Sharia compliance, managing the risks of non-compliance with the provisions and principles of Sharia, and internal Sharia auditing.

6. Continuous evaluation of the bank's level of compliance with the provisions and principles of Sharia.

7. Managing the potential risks of non-compliance with the provisions and principles of Sharia resulting from practicing Islamic banking activity, which includes identifying the inherent risks and setting up the corrective measures that must be taken to mitigate those risks.

8. An internal Sharia audit regularly to verify bank's activities and Islamic banking transactions compliance with the provisions and principles of Sharia.

9- To form a unit/department concerned with conducting Sharia research and studies, coordinating between the management and the committee, distributing Sharia decisions to stakeholders within the bank, in addition to carrying out secretarial duties for the committee.

(Chapter Three)

Responsibilities of the Board of Directors and Executive Management

Article 5: Responsibilities of the Board of Directors

1. The Board is primarily responsible for the Sharia governance framework of the bank in general, and compliance of its Islamic banking activities with the provisions and principles of Sharia. The Board is also, responsible for adopting the framework of the Sharia governance of the bank and continuous supervision of the effective performance of the framework, as well as ensuring that the framework is commensurate with the size of the bank's business and its nature and complexity.

2. The Board approves all the Sharia policies of the bank and supervises the effective implementation of these policies.

3. Providing the necessary mechanisms and methodology to manage risks to protect the interests of the investment account holders and depositors through accounts based on profit and loss sharing.
4. Supervising the bank's compliance and its implementation of the Sharia decisions issued by the committee.
5. Ensuring the existence of an effective communication policy between the bank's main units that facilitates and enables the reporting of important issues related to the compliance of the bank's Islamic banking activities with the provisions and principles of Sharia.
6. Establish appropriate compensation and wages for members of the committee based on the recommendation of the Board Nominations and Remuneration subcommittee. And in proportion to the size of their duties and responsibilities and in consistent with the instructions of the relevant institution.
7. Establishing a formal procedure - based on the proposal of the Nomination and Remuneration subcommittee - to evaluate the performance of committee members based on an indicator of competence, knowledge, contribution and effectiveness.
8. Disclosing the CVs of all committee members so that the shareholders and investors can judge their competence and ability to carry out their tasks effectively.
9. Disclosure of the mechanism used to oversee the integrity and performance of the members of the committee, taking into account not to nominate any member who have been previously convicted by a court ruling of an offence prejudicial to honor and integrity.

#### Article Six: Responsibilities of the Executive Management

1. Identify the Sharia issues and refer them to the committee to solicit its decision and provide it with the necessary information and disclosures promptly.
2. Follow-up and implementation of the Sharia decisions issued by the committee.
3. Providing continuous education and training programs for the main internal stakeholders, including the board, the committee, and employees related to Sharia and financial matters, and the purpose of this is to ensure that all

departments/units associated with the Sharia governance framework of the bank are adequately informed of developments in matters related to Sharia.

4. Spreading an inclusive culture of adherence to the provisions and principles of Sharia and adopting them within the bank in all its Islamic banking activities. Moreover, all relevant employees are expected to be familiar with the bank's products that are compatible with the provisions and principles of Sharia, and their knowledge of the similarities and differences between banking products and services that are compatible with the provisions and principles of Sharia and conventional ones.

5. Ensuring the availability of Sharia policies and procedures for employees concerned with implementing the Sharia governance framework.

6. Ensuring that all Islamic banking operations are carried out per the Sharia policies and procedures of the bank, and reviewing and updating the policies and procedures constantly to keep pace with market practices and developments.

7. If certain Islamic financial or banking transactions appear to involve transactions that are inconsistent with the provisions and principles of Sharia, the following must be done:

a. Inform the Board and Committee immediately.

b. Immediately stop providing any banking services or products in the area that is inconsistent with the provisions and principles of Sharia.

c. Submit a corrective plan that is approved by the Board and by the committee to correct cases that do not comply with the provisions and principles of Sharia within (30) business days from becoming aware of the incompliant cases.

(Chapter Four)

Formation and appointment of the Sharia committee and its membership

Article Seven: Formation of the Sharia Committee<sup>1</sup>

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<sup>1</sup> This is a guiding article and will be mandatory as of 1/1/2023

The committee is formed and its members are appointed by a decision of the Board based on the recommendation of the Nomination and Remuneration subcommittee, after obtaining in writing SAMA's no objection, and the bank can obtain the approval of the General Assembly to appoint the members of the committee if provided for in its internal policy. The term of membership of the committee is three years. The committee is formed according to the following:

1. The number of its members is proportional to the size and nature of the bank's activity, provided that it is not less than three and not more than five.
2. The chairperson of the committee must be an independent member
3. The number of the independent members shall not be less than two thirds of the committee members. The independence of a committee member is not achieved in the following cases:
  - a. If the member is the owner of five percent or more of the bank's shares or in one of the bank's subsidiaries.
  - b. If he is a representative of a legal person who owns five percent or more of the bank's shares or in one of the bank's subsidiaries.
  - c. If he is related to any of the board members or senior executives in the bank or one of the bank's subsidiaries.
  - d. if he is a member of the board of directors of one of the subsidiaries of the bank to which he is nominated for membership of its Sharia committee.
  - e. To work or have worked as an employee during the past two years for the bank or any party dealing with it or one of the subsidiary companies of the bank as an auditors or major suppliers, or the owner of controlling shares with any of those parties during the past two years.
  - f. If he has a direct or indirect interest in the business and contracts that are made for the bank.
  - g. if he receives money from the bank in addition to the wages or remuneration for his membership in the committee.

h. if he had a credit relationship with the bank (credit cards, credit facilities, guarantees, etc.) in his name or the name of one of his relatives over three hundred thousand Saudi riyals.

i. if he is involved in a business that would compete with the bank, or to trade in one of the branches of the business that the bank engages in.

J. if he spent more than six consecutive years or nine separate years as a member of the committee.

k. The work and contracts that take place with the committee member to satisfy his personal needs are not considered as an interest precluding the independence of the committee member, for which a license must be obtained from the ordinary general assembly, if these works and contracts are carried out in the same terms and conditions that the bank follows with all the contractors and dealers and were within the bank's usual activity Unless the Nominations and Remuneration subcommittee deems otherwise.

The bank shall notify SAMA within (5) working days, if the independence of any member has ceased for any reason.

4. The bank may not appoint any member of the committee who work on a Sharia committee of another bank operating in the Kingdom. This is to ensure the member's focus, and avoid conflicts of interests, and to maintain the confidentiality of information.

5. The bank must include a clause on confidentiality of information in the contract or conditions for appointing a committee member. This is to maintain the confidentiality and privacy of the bank's information.

6. The bank must notify the SAMA in writing when accepting the resignation / expiry of the membership of any member of the committee for any reason whatsoever within (5) working days. The resigning member must also submit his resignation with its justifications to the board and send a copy to SAMA. The membership of the committee may not be terminated before the end of its term except with an acceptable justification.

Article Eight: Membership of the Sharia Committee

Committee members should be qualified to carry out the duties entrusted to them, have a clear understanding of their duties and responsibilities and be able to exercise sound judgment objectively. The members must collectively possess various professional, practical and administrative skills, legal and financial expertise, appropriate personal traits, especially integrity and commitment, and a high degree of good reputation, competence and responsibility.

The effectiveness of the committee depends on the experience of the members and their ability to judge with a comprehensive perspective, in addition to their active participation in the discussions of the committee and familiarity with the topics raised before deciding on them. The member's qualifications should include the following characteristics:

**Leadership:** The member should have leadership skills and the ability to grant powers that lead to stimulating performance to apply best practices in the field of effective management and adhere to professional values and ethics.

**Independence:** It means the member's ability to be impartial and objective in deciding without any influence from management or other external bodies.

**Competence:** This is reflected in the level of education, training, skills and desire to continue learning, and the availability of a variety of experience of no less than five years in various fields, including experience in the field of Islamic banking, compliance and Sharia audit of financial transactions.

**Sharia and financial knowledge:** should have adequate Sharia knowledge in addition to the ability to read and understand financial statements and reports.

#### Article Nine: Meetings of the Sharia Committee

1. The committee holds its meetings regularly, as well as whenever the need arises, to enable the effective exercise of its duties, and to ensure that the bank's operations are not affected by the difficulty in obtaining the committee's decisions on the legal/Sharia issues referred to it.

2. The committee holds its meetings periodically, with no less than one meeting every three months.

3. For the committee's meetings to be valid, the majority of its members must attend, and its decisions are issued by the majority of the votes of those present. And when votes are equal, the casting vote will be of the committee chair.
4. Committee members are expected to contribute to meetings and spend sufficient time and effort to perform their tasks efficiently. The member's attendance rate for committee meetings should not be less than (75) percent of the committee's meetings held during the fiscal year.
5. The committee's meetings must be documented and minutes prepared that include the discussions and deliberations that took place, the committee's decisions and the results of the vote be documented, kept in a special and organized record, the names of the members listed and the reservations that they made - if any - and their reasons and these minutes signed by all the members present.

## (Chapter Five)

### The responsibilities and tasks of the Sharia committee

#### Article Ten: Responsibilities of the Sharia Committee

The committee bears responsibility for all its decisions related to Sharia matters. The board must rely on the committee to issue Sharia decisions regarding the practice of Islamic banking. The committee must perform the following tasks:

1. Supervising the extent of the bank's Islamic banking dealings conform with the provisions and principles of Sharia. Sharia compliance reports and internal Sharia audit notes should assist the committee in identifying issues that require its attention and proposing corrective measures for it, when needed.
2. Issuing decisions on Sharia issues so that the bank can adhere to the provisions and principles of Sharia.
3. Ensure that the Sharia policies and procedures prepared by the bank are consistent with the provisions and principles of Sharia.
4. To ensure that Islamic banking products comply with the provisions and principles of Sharia, the committee must adopt the following:

- a. Terms and conditions contained in the templates, contracts, agreements, and other legal documents used in carrying out transactions.
  - b. Product manuals, marketing ads, brochures, and leaflets used to introduce the product.
5. The committee evaluates the work of compliance and internal Sharia audit to ensure compliance with the Sharia aspects, and this evaluation is part of its tasks when submitting its reports related to assessing compliance with the provisions and principles of Sharia.
  6. The parties concerned with the bank, such as the legal advisor, external auditors, or advisory bodies, may request advice from the committee on Sharia issues related to the bank's operations, and the committee must provide them with the necessary assistance in this regard.
  7. Report to the board and recommend appropriate measures to remedy the situation, if it is proven to the committee that the bank has engaged in Islamic banking activities that are inconsistent with the provisions and principles of Sharia.
  8. Informing SAMA of cases in which the Islamic banking activities that are not in compliance with the provisions and principles of Sharia were not dealt with effectively or adequately, or the bank has not taken any corrective measures in their regard.
  9. Preparing an annual report on the compatibility of the bank's Islamic banking activity with the provisions and principles of Sharia and submitting it to the Board.

#### Article eleven: Duties and terms of reference of the Head of the Sharia Committee

Without prejudice to the functions of the committee, the chairperson of the committee shall assume leadership of the committee, supervise the course of its work and the effective performance of his functions, which are in particular the following:

1. Ensure that committee members receive timely, complete, clear, correct and not misleading information.
2. Ensure that the committee discusses all Sharia issues referred to it in an efficient and timely manner.

3. Encouraging committee members to carry out their duties effectively.

Article Twelve: Duties and responsibilities of the members of the Sharia committee

1. Attending committee meetings and not being absent, except for a legitimate excuse after notifying the committee chairman in advance of his absence.

2. Know the duties and responsibilities of the committee membership.

3. Allocating sufficient time to carry out his responsibilities and to prepare for and participate in committee meetings effectively.

4. Enabling other committee members to express their views freely, urging discussion of issues and taking opinions of specialists from the administration and others if the need arises.

5. Inform the Board immediately and in details of any interest, whether direct or indirect, in the business and contracts that are made for the bank's account, or his participation, directly or indirectly, in any business that would compete with the bank.

6. Not to divulge any secrets that were found through his membership in the committee.

(Chapter Six)

Independence and confidentiality of information

Article Thirteen: Independence

The independence of the committee must always be taken into account in the exercise of its duties to issue objective and reliable Sharia decisions, as follows:

1. The Board's recognition of the independence of the committee and ensuring that it is not exposed to any influence that may hinder it from issuing objective Sharia decisions when discussing the issues presented to it.

2. The committee is reporting directly to the board.

3. Sharia decisions issued by the committee may not be modified or ignored without its approval.

4. The committee must obtain accurate and complete information from management. The committee has the right to request additional information from the management in case the information provided is insufficient.

5. If the committee is not provided with the required information, the board shall be notified of the matter and the board shall take appropriate action to correct the situation.

#### Article Fourteen: Confidentiality of Information

1. The members of the committee are obligated to maintain the confidentiality of the internal information they obtained during the performance of their work and not to misuse it, and it is not permissible to use the confidential or sensitive information obtained by any member of the committee during the performance of his work in any way that may harm the bank.

2. Without prejudice to the aforementioned, disclosure by the committee of information to SAMA to inform it of the bank's committing of grave breaches of the provisions and principles of Sharia is not considered violation of the principle of confidentiality of information

#### Article Fifteen: Preserving ethics, professional rulings, and consistency to ensure compliance with the provisions and principles of Sharia

To ensure the quality and consistency of Sharia decisions, the committee must adopt a structured procedure for taking, documenting, approving and maintaining Sharia decisions to ensure the reliability of the decision-making process and to protect the committee from any unjustified potential impacts. In this regard, it is possible to refer to the procedures for the development of banking products that comply with the provisions and principles of Sharia, as described in Chapter Nine of this framework.

(Chapter Seven)

#### Internal Control

#### Article Sixteen: Internal Control

First; Compliance to Sharia:

The task of Sharia compliance is the regular evaluation of the bank's activities and Islamic banking transactions to ensure that they are consistent with the provisions and principles of Sharia. Sharia compliance tasks include:

1. Ensuring the bank's level of compliance with the provisions and principles of Sharia, the corrective measures to address cases of non-compliance, and the existing control mechanisms to avoid their recurrence.
2. That the scope of Sharia compliance tasks includes all the bank's Islamic banking operations, including developing of banking products that comply with the provisions and principles of Sharia, starting from structuring the product until presenting it to customers as mentioned in Chapter Nine of this framework.

Second: Managing the risks of non-compliance with the provisions and principles of Sharia:

The systematic management of the risks of non-compliance with the provisions and principles of Sharia law allows the bank; to continuing its Islamic banking operations and activities effectively without exposing the bank to unacceptable levels of risk, and the tasks of risk management are to identify, measure, monitor and systematically manage the risks of non-compliance with the provisions and principles of Sharia to reduce potential cases of non-compliance, taking into account the following:

1. Managing risks of non-compliance with the provisions and principles of Sharia shall form part of the bank's integrated risk management framework.
2. That this task be undertaken by a risk officer who has appropriate qualifications and has sufficient experience in this field, due to the technical nature and complexity of the risk management process of non-compliance with the provisions and principles of Sharia.

Third: Internal Sharia Audit:

The Sharia audit is the independent review process to provide objective assurance designed to achieve an added value and improve the level of compliance of the bank's activities and Islamic banking transactions with the provisions and principles of Sharia to ensure the integrity and effectiveness of the internal control system for

compliance with the provisions and principles of Sharia, taking into account the following:

1. Conducting an internal Sharia audit in areas of material importance at least once a year based on the bank's risk log. Sharia audit can be performed as part of the auditing process for the bank in other specialized areas, according to the level of risk and the percentage of the impact of non-compliance in these areas.
2. The Board Audit subcommittee determines the objectives of the internal Sharia audit mission after consulting with the Committee. The targets must be in line with accepted and known standards of internal auditing.
3. The task of internal Sharia auditing must be undertaken by internal auditors who have the necessary knowledge and adequate training in Sharia aspects. Internal auditors may seek the assistance of the expertise of Sharia specialists at the bank in the process of conducting the audit, provided that this does not affect the objectivity of the audit.
4. The findings and observations of the internal Sharia audit should be submitted to both the Board Audit subcommittee and the Committee.

(Chapter Eight)

Islamic window operations

Article Seventeen: Islamic Window Operations<sup>2</sup>

When practicing Islamic banking activity through Islamic window operations, the bank must ensure that adequate internal control systems and tools are in place to properly separate the assets and sources of financing that are compatible with the provisions and principles of Sharia on the one hand, and assets and sources of financing that are not in compliance with the provisions and principles of Sharia on the other. In addition to other requirements of this framework. And when practicing Islamic banking activity through Islamic window operations; the bank must comply with the following requirements:

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<sup>2</sup> This is a guiding article and will be mandatory as of 1/1/2023

1. Maintaining an independent record of accounts for Islamic banking operations as well as ensuring that independent accounting records for Islamic banking operations are adequately maintained.
2. The bank must prepare, at least every month, separate financial statements for its Islamic banking operations in addition to the bank's periodic financial statements.
3. Conduct an internal audit, at least once a year to assess bank's degree of compliance with the requirements mentioned in Paragraph 1 and Paragraph 2 of this Article.

#### (Chapter Nine)

Procedures for the process of developing banking products that are compatible with the provisions and principles of Sharia

Article Eighteen: Procedures for the process of developing banking products that comply with the provisions and principles of Sharia

These procedures aim to ensure that the process of developing the Islamic banking products of the bank is comprehensive and adequate to reduce the possibility of the committee rejecting the Islamic banking products due to their inconsistency with the provisions and principles of Sharia law as a result of improper product structuring or insufficient research efforts of the bank and its failure to understand Sharia concepts or unfair supply of the product at the stage of release or marketing. In this regard, the bank must follow the following procedures:

1. Refer all Sharia issues during the product development process and design procedures to the committee. The subject of the consultation request or the decision requested must be clarified in detail for the committee to study it effectively. This includes an explanation of the relevant processes, documents used, and all other necessary information.
2. The committee must approve all the Islamic banking products to be presented and any subsequent amendments to it, and the committee must review the details of legal contracts and other documents related to the products and operations.

3. That the product development process includes procedures before the product is approved (for example, the process of structuring and developing the product before it is put on the market) and post-approval procedures (after launching the product and presenting it to customers and carrying out operations on it), including the following:

a. Product Pre-approval procedures:

1- the approval before endorsing the product, must include the Sharia decisions, structuring of the product or designing its operations supported by comprehensive Sharia research, and reviewing contracts and agreements before offering it to customers.

2- Ensure that the approval process before endorsing the product must include; in addition to any other aspects, a review of the concepts, structure, terms and conditions document, documents, policies, procedures, brochures, brochures, and advertising materials. These documents must be approved by the committee.

b. Post-product approval procedures:

1- Ensuring that Sharia governance includes post-product approval procedures that include compliance and internal Sharia audit.

2- Identifying potential risks for non-compliance with the provisions and principles of Sharia for the product, and proposing appropriate procedures in this regard to the management.

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