

13- SHARIAH SUPERVISORY BOARD

- A) Rules and Conditions for the Appointment and Responsibilities of the Shariah Supervisory Board in Islamic Banks.
- B) Circular No. (2/IBS/369/2016) to all Kuwaiti Islamic Banks Concerning Shariah Supervisory Governance in Kuwaiti Islamic Banks.
- C) Circular Issued to Kuwaiti Islamic Banks Concerning the Application of the Requirements of the External Shariah Audit as of 1/1/2020, and Obtaining CBK Prior Approval on the appointed External Shariah Auditing Office.

**Instructions No. (2/BSA/100/2003) Concerning the Rules
and Conditions for the Appointment and Responsibilities
of the Shariah Supervisory Board in Islamic Banks⁽¹⁾**

Based on the rules of articles (93 and 97) of Law No. 32/1968 and its amendments, and given the prime importance of the supervisory role of Shariah supervisory Board in Islamic Banks, particularly in relation to preserving the reputation of those banks and the confidence of their customers, as well as with regard to compliance of Islamic banks with their articles of association through observing the rules and principles of Islamic Shariah in their business and operations, the Central Bank Board of Directors resolved, at its meeting of 15.6.2003, to set-up the following regulations and conditions that regulate the appointment and responsibilities of the Shariah Supervisory Boards in Islamic banks. These regulations and conditions are intended to ensure the efficiency required for the members of the Shariah Supervisory Board in order to discharge their functions in the appropriate manner. The instructions establish the framework for performing those duties, while providing independence for the members of the Shariah Supervisory Board in expressing their opinions, and defining the role of the external auditor in relation to the bank's compliance with the rules and principles of the Islamic Shariah.

First: The board of directors of each bank shall nominate the members of the Shariah Supervisory Board for the approval of their appointment by the bank shareholders general meeting. Those members should be Islamic Shariah scholars of recognized efficiency and experience, especially in the area of transactions jurisprudence.

Second*: The number of the Shariah Supervisory Board members should not be less than three. This board may not have among its members any of the members of the board of directors or the executive management of the bank, nor any shareholder of effective influence, where a shareholder of effective influence shall mean a shareholder who owns 5% or more of the capital of the bank.

For the Shariah Supervisory Board meetings to be duly held, all of its members must be present in the meeting, if the number of its members does not exceed three.

The Shariah Supervisory Board may ask the bank management to establish a secretariat for this board to be provided with the appropriate staff for facilitating the work of this board.

⁽¹⁾ Instructions dated 20/12/2016 concerning Shariah Supervisory Governance in Kuwaiti Islamic Banks under Item (B) of this Chapter have replaced these Instructions.

* Item (Second) was amended by a resolution issued by the Board of Directors of the Central Bank of Kuwait on 19/06/2003.

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- Third:** The services of the Shariah Supervisory Board member shall end with his resignation or by a justified recommendation from the bank board of directors to be approved by the general meeting, or by the resolution of the general meeting
- Fourth:** The Shariah Supervisory Board shall be responsible for providing opinion on the bank's compliance with the Shariah rules in all of its operations. To do so, the Shariah Supervisory Board shall inspect all contracts, agreements, policies and transactions of the bank with the other parties. This board has the right to unconditionally review all the records and transactions of the bank to ascertain its compliance with the rules of the Islamic Shariah. The bank management must provide this board with all data and information requested for performing its functions.
- Fifth:** Taking into account the fact that the responsibility of complying with the Islamic Shariah rules rests with the management of the bank, the management must present all the contracts, operations and transactions to the Shariah Supervisory Board for providing its Shariah opinion in their regard, and must comply with the implementation of all Fatwa (Shariah legal opinion), resolutions and guidelines issued by the Shariah Supervisory Board in this connection.
- Sixth:** The annual report of the Shariah Supervisory Board required under the rule of Article (93) of the said law, must include the following elements:
- The title of the report and the addressee (the shareholders).
 - The scope of the Shariah Supervisory Board work, which includes: A description of the nature of work performed, including the assurance that this board has performed the appropriate examinations and procedures, and has monitored the work in the proper manner, such as inspecting the documentation and the procedures adopted in the bank through testing each type of transactions. The report shows the extent to which the board was provided with all the information and explanations deemed necessary for passing its opinion as to the consistency of the bank's transaction with the rules of Islamic Shariah.
 - The Shariah Supervisory Board's opinion whether the contracts, documents and transactions executed by the bank are compliant with the rules and principles of the Islamic Shariah. In the event this board finds that the management of the bank has breached the rules and principles of the Islamic Shariah, or the Fatwa, resolutions and directives passed by this board, it must be so stated in its report.

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Seventh: Within the framework of verifying the compliance of the bank management with its responsibilities in relation to implementing the rules and principles of the Islamic Shariah, the task of the external auditor must include the necessary examinations to ascertain the following:

- All the procedures followed by the bank in launching its new financial products or in modifying its existing products, include the proper steps for ensuring complete compliance with the rules and principles of the Islamic Shariah, including the review of such procedures by the bank management and the Shariah Supervisory Board.
- All the products of the bank have been examined by the Shariah Supervisory Board who has confirmed that these products are compliant with the rules and principles of the Islamic Shariah.

In its report, the external auditor must indicate the extent of the bank management's compliance with the Fatwa (Shariah legal opinion), resolutions and directives of the Shariah Supervisory Board in the transactions executed.

Eighth: The Islamic bank shall publish the Fatawa (Shariah legal opinion) and resolutions passed by the Shariah Supervisory Board through printing booklets or bulletins including those Fatawa and resolutions and making them available to those who desire to read.

Ninth: These instructions shall be implemented from the date of notification.

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THE GOVERNOR

*Rabi' Al-Awwal 21, 1438 H
December 20, 2016*

The Chairman of the Board of Directors,

**Circular No. (2/IBS/369/2016) to all Kuwaiti Islamic Banks
Subject: Shariah Governance in Kuwaiti Islamic Banks**

Within the framework of the efforts exerted by the Central Bank of Kuwait “CBK” to promote Islamic banking business activities in the State of Kuwait, including the development of Shariah supervision instructions at Islamic banks, and in line with best practices in this regard, CBK decided at the meeting on 20/12/2016 to issue the attached Instructions concerning “**Shariah Supervisory Governance in Kuwaiti Islamic Banks**”. The new instructions will replace the CBK instructions issued on 15 & 19 June 2003 concerning the rules and terms of reference of the Shariah Supervisory Boards in Islamic Banks. The new instructions will be complementary to the Corporate Governance Rules and Regulations for Kuwaiti Banks, issued in July 2012. You find attached herewith a CD containing these Instructions.⁽¹⁾

The promulgation of these Instructions comes in light of the considerable growth in the Islamic financing sector, and the developments witnessed in the banking sector in Kuwait in terms of the volume and type of its operations since the issuance of the said CBK instructions in May 2003. The matter necessitated development of these Instructions to enhance customer confidence in Islamic banks and help these banks apply corporate governance principles and standards in conformity with Islamic Shariah provisions and objectives.

In addition to the above, the application by the Islamic Kuwaiti banks of these Instructions as a part of the sound governance standards is deemed one of the factors for enhancing confidence in the domestic banking sector as a whole on the local and international arenas. The outgrowth is the improvement of the operating environment at Kuwaiti Islamic banks and the local financial and banking sector, as well as enhancement of the macro-economy in general. Hence, the role assumed by the new Instructions on Shariah Supervisory Governance and the raising concern of Kuwaiti Islamic banks in Shariah supervision emerge to enhance the standing and competence of the Shariah audit as well as enforcement of its pioneer position on the local, regional and world levels. Kuwaiti Islamic banks concern in the various aspects of Shariah supervision as signified by these new Instructions with regard to Shariah Supervisory Governance will give room to increasing the remunerative job opportunities to Kuwaiti youth at Islamic financial and banking sector.

⁽¹⁾ Instructions attached herewith from Page 8 hereof.

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Yet, the most notable challenges that face Islamic financial industry is the necessity to render further concern to the process of realizing compliance with Islamic Shariah provisions, or the so-called “Shariah Audit”, which is deemed an integral part of Shariah supervision regulation and its corporate governance at an Islamic bank. Therefore, the attached new instructions include clear-cut and definite professional frameworks for the roles and responsibilities of both Shariah supervisory boards and the internal and external Shariah audit.

The new instructions contain a set of main chapters for Shariah Governance starting with definitions, the general requirements of the Shariah supervisory corporate governance, the principles of Shariah supervisory corporate governance; in terms of the **supervision, responsibility, accountability**, and roles undertaken by each of the Board of Directors, the executive management, and Shariah Supervisory Board in the framework of Shariah supervisory corporate governance, and **independence** of members of the Shariah Supervisory Board, standards of efficiency and fitness with regard to academic qualifications and expertise of those members, and requirements of **confidentiality** of information that should be satisfied by members of the Shariah Supervisory Board, along with the congruity between members of the Shariah Supervisory Board and their agreement in rendering the opinions and *Shariah Fatawa to the Bank*. These Instructions cover also the two pillars of internal and external Shariah audit⁽¹⁾, the scope and objectives of the Shariah audit as well as the terms and conditions and the necessary qualifications for Shariah auditors to carry out the process of Shariah auditing.

Yet, the Central Bank of Kuwait on 18 July 2016 surveyed the opinions of Islamic banks with regard to these Instructions. Their comments were received by virtue of the Kuwait Banking Association’s letter dated 13 October and appropriate issues of these comments have been taken into consideration upon issuance of these attached Instructions.

In this regard, all Kuwaiti Islamic banks shall have to commence taking the necessary measures towards satisfaction of the requirements for application of these Instructions since the date of their issuance, provided that these measures shall be completed latest by 31 December 2017 for these Instructions to entirely take force effective from the first of January 2018. Each Islamic Kuwaiti bank shall have to provide the Central Bank of Kuwait with a quarterly report that include the policies, procedures and the steps taken by the bank for the purpose of satisfaction of the requirements for application of these Instructions at that bank. Such report shall be signed by the Chairman within a maximum period of ten business days from the end of the reporting period, for reporting process to start effective from the end of March 2017. Needless to say, these reports shall

(1) Circular dated 6/1/2020 Concerning the Application of the Requirements of the External Shariah Audit as of 1/1/2020, and Obtaining CBK Prior Approval on the Appointed External Shariah Auditing Office.

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have to show developments and tangible steps towards entire compliance with application of these Instructions during the referred to period.

The Central Bank of Kuwait hopes that these Instructions will help develop Shariah supervisory governance in Islamic Kuwaiti banks and improve the domestic Islamic banking practices for the benefit of the domestic banking and financial sector and the Kuwaiti economy.

With my best wishes,

The Governor
Dr. Mohammad Y. Al-Hashel



Instructions Concerning Shariah Supervisory Governance in the Kuwaiti Islamic Banks

20/12/2016

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Introduction

Shariah supervision constitutes an essential factor in Islamic financial industry. With the advancement of this industry, the term “Shariah Audit” emerged to existence, which is an art, having its principles, standards, policies, and procedures to be applied.

Undoubtedly, among the most significant conditions for Islamic banking and financial business success is the existence of independent and active Shariah supervisory boards which contribute to assisting Islamic financial institutions to strictly comply in their operations and products with the Islamic Shariah provisions and render them the solutions in conformity with Islamic Shariah provisions and objectives.

At recent times, several regulatory authorities in a number of Arab and Islamic countries, and international standards organizations, such as the “Islamic Financial Services Board” (“IFSB”), interested in Islamic financial banks and institutions, paid their concerns of **“Shariah Supervisory Corporate Governance”** or **“Shariah Control”** in Islamic banks, owing to the significance of this issue to enhance confidence of counterparties with banks and help Islamic banks comply in their operations and transactions with the Islamic Shariah provisions and objectives.

Furthermore, Islamic banks’ failure to abide by Islamic Shariah render them liable to serious risks that may lead in the worst scenarios to the entire collapse of the bank due to customers loss of confidence in the bank. This may extend to other Islamic banks, and consequently customers may withdraw their funds from these banks. As such, the banking sector as a whole may be rendered to adverse repercussions and regulatory risks. Therefore, Shariah governance is of high importance for each Islamic bank and the banking sector as a whole, and effective Shariah governance is one of the significant pillars of financial stability.

In 2003, the Central Bank of Kuwait issued its instructions concerning the rules and regulations as well as the terms of reference of Shariah supervisory boards in Islamic banks. These rules handled nomination by the board of directors Shariah supervisory boards members to obtain approval of the general assembly of the bank, the number of the members of the Shariah supervisory board, its meetings, jurisdictions, expiry of members membership, the board of directors responsibility of compliance with Shariah, and the contents of the annual Shariah report issued by the Shariah Supervisory Board, in addition to the responsibility of the accounts auditor to verify bank management’s compliance of its responsibility in implementing Islamic Shariah provisions.

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Should we take into consideration the considerable growth in Islamic financing sector in the world markets, we find out that some estimates indicate that total Islamic Shariah compliant assets at present exceeded US\$ 5 trillion. This is deemed a tremendous jump compared to US\$ 121 billion in the mid-nineties. In Kuwait, Islamic banking sector during the past period witnessed considerable development since the promulgation of the law No. 30 of 2003 concerning Islamic banks, whereby Islamic banking sector at present dominates 39% of the banking sector. The number of Kuwaiti Islamic banks now reaches five banks, against five conventional banks, in addition to a branch of an Islamic foreign bank (Al-Rajhi Bank). Therefore, it was necessary to develop the Central Bank of Kuwait's instructions relevant to Shariah supervision in order to strengthen Shariah supervisory controls and their governance.

Yet, in the framework of keeping pace with the developments in world and regional Shariah supervisory corporate governance guidelines and controls, aimed at enhancing banks and financial institutions observance of Islamic Shariah provisions and objectives, the Central Bank of Kuwait issues these Instructions on “**Shariah Supervisory Corporate Governance in Islamic Banks**”, to replace the instructions issued in 2003. These Instructions shall be deemed complementary to the Instructions on Corporate Governance Rules & Regulations on Kuwaiti banks issued in June 2012, with regard to Islamic banks. These present Instructions have been guided by the Guidelines issued by the Islamic Financial Services Board (IFSB) titled, “Guiding Principles of Shariah Controls for Institutions Rendering Islamic Financial Services”, issued in December 2009, and the Corporate Governance Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the instructions issued by some central banks in Arab and Islamic countries in this regard.

These Instructions embodied a set of main chapters on Shariah supervisory corporate governance starting with the general requirements for the Shariah supervisory corporate governance, and extending to the five principles of Shariah supervisory corporate governance in terms of the **oversight, responsibility and accountability**, the roles undertaken by the Board of Directors, the executive management and the Shariah Supervisory Board in the framework of Shariah supervisory corporate governance, and **independence** of the members of the Shariah Supervisory Board, standards of **efficiency and fitness** with regard to academic qualifications and expertise for those members. The Instructions goes on to handle the **confidentiality** of information that should be observed by members of the Shariah Supervisory Board, in addition to the congruity between members of the Shariah Supervisory Board and the consistency in submission of the opinions and *fatawa* to the Bank.

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Hence, while Shariah audit process is deemed to be an integral part of the Shariah supervisory regulation and its corporate governance in the Bank as a whole, these Instructions encompass the pillars of internal and external Shariah audit, the scope and objectives of the Shariah audit, in addition to the terms and conditions and qualifications of Shariah auditors necessary to carry out Shariah audit function.

The Central Bank of Kuwait hopes that these Instructions will help contribute enhancing Islamic banking course of action on strong basis, and enhancing the confidence of counterparties in Islamic banks, in the framework of strengthening the financial stability in the State of Kuwait.

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Instructions on Shariah Supervisory Governance in Kuwaiti Islamic Banks

Chapter One: Definitions

- Islamic Banks (“Banks”)** : are those banks entered in the Islamic banks register, which exercise their banking business profession, as provided by the Commercial Law, or as stipulated by customary rules deemed among banking businesses, in accordance with the Islamic Shariah provisions, and in conformity with the provisions of article (86) of the law No. 32 of 1968 concerning currency, the Central Bank of Kuwait and regulation of banking business and its amendments.
- Banks Corporate Governance** : It is the approach by which banks businesses and affairs are regulated by their boards of directors and the executive managements. It also identifies the sound approaches in laying down objectives and strategies of banks and their daily operations, and realizes the principle of accountability towards shareholders, and taking into consideration relevant parties rights, and the rules and guidelines issued by the regulatory authority and protection of depositors rights, and the necessary development of robust risk management systems.
- Islamic Shariah Provisions** : The set of orders and faith-based and practical judgments which Islamic Shariah obligates their implementation to realize Islam reform objectives in society.
- Islamic Shariah Objectives** : Objectives ordained by Islamic Shariah to be realized for the interest of mankind.
- Shariah Supervision** : It is the examination of the bank’s compliance with Islamic Shariah provisions in all its activities and businesses.
- Shariah Supervisory Board** : It is an independent body of scholars (*fuqha’a*) specialized in Islamic transactions jurisprudence (*fiqh almua’malat*). They oversight the Bank’s transactions, activities and products and ensure their compliance with Islamic Shariah provisions and objectives.
- Shariah Supervisory Board Secretariat** : It is full time technical and administrative dedicated employee to assist the Shariah Supervisory Board in realizing its objectives and performing its functions.

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Shariah Supervisory Corporate Governance	: It is the regulations through which any Islamic banking and financial institution endeavors for its activities to be exercised based on Islamic Shariah provisions and objectives, through the professional, effective and independent Shariah oversight.
Internal Shariah Audit	: A periodic process represented in examination and assessment of the adequacy and effectiveness of Shariah Supervisory System, for the purpose of identifying whether the existing system and the compliance thereto provides a reasonable assurance that the Bank's management has discharged its responsibilities towards ensuring the implementation of Islamic Shariah provisions and objectives or not, as stipulated by Shariah Supervisory Board in the Bank.
External Shariah Audit	: It is an annual process represented in compilation and assessment of evidences on the Bank's activities and transactions to ensure their compliance with the resolutions and Shariah opinions (<i>fatawa</i>) of the Shariah Supervisory Board in the Bank.
First Degree Kinship	: The father, mother, husband, spouse and children.
Board of Directors	: Chairman and members of the Board of Directors of the Bank, unless otherwise defined.
Stakeholders	: Any person or entity having relation with the Bank, such as depositors, shareholders, employees, creditors, customers, and other relevant entities.
Related Parties	: For the definition of related parties, the instructions of concentration controls in financing in Islamic banks and the amendments thereto, shall be considered.
IFSB	: Islamic Financial Services Board.
AAOIFI	: The Accounting and Auditing Organization for Islamic Financial Institutions.
CIBAFI	: General Council for Islamic Banks And Financial Institutions.

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Chapter Two: General Requirements of the Shariah Governance Framework

1. An Islamic bank shall ensure that the aims and operations of its business are carried out in compliance with Shariah principles at all times. An end-to-end Shariah compliant control mechanism shall be established in all aspects of its business operations to ensure that all activities are Shariah compliant, in accordance with the resolutions passed by the Shariah Supervisory Board in the bank.
2. A sound and robust Shariah governance framework is reflected by effective, independent, responsible and competent Shariah Supervisory Board, supported by a strong internal Shariah research capacity, along with Shariah internal and external audit, and Shariah diligent risk management process.
3. The Shariah governance framework shall, at minimum, comprise the following:
 - a. The board of directors' oversight on Shariah compliance aspects of the Bank's operations in general. The Board of Directors is the ultimate responsible body for the establishment of an appropriate Shariah governance framework. In setting up the Shariah governance framework, the Board of Directors is expected to understand the Shariah non-compliance risks associated with the Bank's businesses and issues relating to such risks, as well as their potential implications on the Bank specifically and the banking sector in general.
 - b. Formation of qualified Shariah Board capable to deliberate issues presented to it and thence to take the sound Shariah resolutions. In this regard, the Bank shall have to establish a Shariah supervisory board, composed of persons holding adequate expertise and background in Islamic Shariah and transactions jurisprudence (*fiqh almua'malat*), and its resolutions shall be binding on the executive management.
 - c. The responsibility of the effective executive management is reflected in providing adequate and competent resources capable of supporting manpower in each function taking part in implementing the Shariah Supervisory Governance and ensuring that business is implemented in accordance with Islamic Shariah provisions.
 - d. Periodic **internal** Shariah audit to ensure that operations and products are performed in compliance with Islamic Shariah as resolved by the Shariah Supervisory Board in the Bank.
 - e. An annual **external** Shariah audit to ensure that the Bank's operations are performed in accordance with Islamic Shariah provisions as resolved by Shariah Supervisory Board.

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- f. Prudent management for Shariah risks to identify risks resulting from non-compliance with Shariah and taking the required remedial actions for risk mitigation.
 - g. Issuance and dissemination of the Shariah Supervisory Board's resolutions.
4. The Bank's Shariah governance framework shall be implemented through a set of policies and procedures that further explains the structure, roles, responsibilities, accountabilities, and the scope of duties of the various functions within the bank. The Bank's policies and procedures shall also describe the communication arrangements among various functions.
5. The bank shall establish reporting channels among the key functions to ensure that the reporting on Shariah matters is carried out effectively and on timely manner. In this regard, Shariah Supervisory Board shall submit its reports to the general assembly to ensure implementation of the resolutions it passes on businesses and activities of the executive management. Internal Shariah Audit Department shall submit its reports also to the Shariah Supervisory Board and the Bank Audit Committee.

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Chapter Three: Principles and Requirements of Shariah Supervisory Governance

Principle One: Oversight, Accountability & Responsibility

This Principle shows the roles of the Board of Directors, the executive management and Shariah Supervisory Board, in the framework of principles of Shariah supervisory corporate governance. These roles are signified in the following pillars:

Pillar One: Role of the Board of Director and its Committees

A. Board of Directors

1. The Board of Directors assumes the ultimate responsibility for Shariah supervisory corporate governance framework and the Bank's compliance with the Islamic Shariah provisions, by means of setting up appropriate processes for satisfaction of the said responsibilities. The Board of Directors is expected to be keen to perform effective supervision on the efficiency of the framework of Shariah supervisory corporate governance in the Bank, and to ensure that the framework approved by the Bank is tailored with the volume and nature of its business and the degree of complexity.
2. The Board of Directors shall approve all policies relevant to application of Islamic Shariah, following the approval of the Shariah Supervisory Board. The Board of Directors is expected to ensure that these policies are effectively applied.
3. Members of the Shariah Supervisory Board shall be appointed by the general assembly upon Board of Directors' recommendation. The number of appointed Shariah Supervisory Board shall not be less than three members of scholars in Islamic jurisprudence (*fiqh*) who satisfy the conditions mentioned hereunder. The Board of Directors shall have to ensure that members of the Shariah Supervisory Board are acquainted with the functions and responsibilities entrusted to them.
4. The Board of Directors shall have to ensure that a policy is laid down for effective communication between the main divisions in the Bank, in order to raise significant Shariah related issues to the Board of Directors. Such policy shall have to ensure that the Bank staff are entirely aware of the necessity to satisfy the Shariah requirements at all times.

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5. The Board of Directors shall have to remunerate members of the Shariah Supervisory Board with appropriate remuneration upon proposal of the Remunerations & Nominating Committee, following approval of the Bank's general assembly, or the general assembly authorization to the Board of Directors to determine their remunerations. Such remuneration shall commensurate with the responsibilities and functions of Shariah Supervisory Board.
6. Members of the Board of Directors shall have to develop their expertise and knowledge in Islamic banking business, through attending ad-hoc training courses, as well as taking part in conferences, seminars or symposiums in Islamic banking related business and issues.

B. Committees Emanating from the Board of Directors^(*)

In addition to the objectives of formation and terms of reference of the committees mentioned in the instructions promulgated in June 2012 concerning corporate governance rules and regulations in Kuwaiti banks, Islamic banks shall have to take into consideration the following upon formation of the committees emanating from the Board of Directors:

1.B Remunerations & Nominating Committee

1) Within the Objectives of this Committee

Monitor and ensure the transparency of appointment and re-appointment of Shariah Supervisory Board's members and evaluate the effectiveness of the Shariah Board as a whole and efficiency of each member independently, as well as to ensure the transparency of laying down the policies, remunerations and compensations of the Shariah Supervisory Board's members tailored with their functions and responsibilities.

2) Within the Terms of Reference of this Committee

- Recommend to the Board of Directors the nomination and re-nomination to the membership of the Shariah Supervisory Board and cancellation of membership.
- Propose to the Board of Directors the remunerations and compensations of members of Shariah Supervisory Board to endorse them to arrange for such remunerations and compensations to be ratified by the general assembly.

^(*) In case of merging the Nominating Committee with the Remuneration Committee in accordance with the permissions allowed by the referred to Instructions issued in June 2012. In case of non-merge, each committee shall have jurisdiction in the functions entrusted to it.

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2.B Risk Committee

1) Within the Terms of Reference and functions of this Committee

Monitor the scope of the Risk Management's compliance with the standards issued by the Islamic Financial Services Board concerning risk management including Shariahh risks and the standards laid down by Basel Committee with regard to credit risk, market risk, operational risk, without prejudice to the provisions of Islamic Shariah principles, in accordance with the Shariah Board's resolutions and the relevant instructions issued by the Central Bank of Kuwait.

2) As for banks applying transactions based on Musharaka and Mudharaba, or any form of transactions approved by the Shariah Supervisory Board, the committee's responsibilities shall extend to include ensuring the following:

- Carrying out a periodic review of assets performance in these transactions.
- Laying down strategies for these transactions.
- Keeping the Board of Directors informed on regular basis of any material development in these transactions.

3.B Audit Committee

1) Within the Formation of this Committee

The Internal Shariah Audit Department Manager shall take part in meetings of this committee to discuss the subjects related to Shariah audit, without having the right to vote on resolutions of the committee.

2) Within the Terms of Reference and functions of this Committee

- Monitor the scope of compliance with Islamic Shariah principles and provisions.
- Monitor the use of restricted investment account funds and ensure that expenses and profits have been allocated as per the agreement between the Bank and the account holders in accordance with Islamic Shariah provisions and the regulations ratified by the Shariah Supervisory Board.
- Study the effectiveness of the Bank charters to monitor compliance with Islamic Shariah provisions and principles, certified by Shariah Supervisory Board.

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- Assess the efficiency and adequacy of the Internal Shariah Audit Function and the range of its contribution in ensuring compliance with Islamic Shariah provisions and principles (and determination of *fatawa* and resolutions issued by the Shariah Supervisory Board). The responsibility of this Committee covers the following:
 - (1) Assess the effectiveness and adequacy of the scope and programs of the internal Shariah audit.
 - (2) Peruse the reports prepared by the Internal Shariah Audit Department to ensure that the necessary measures related thereto have been taken.
 - (3) Streamline the functions of the Internal Shariah Audit Department.
 - (4) Review and ratify the revision and audit plan proposed by the Internal Shariah Auditor.
- Revision of the scope, outcomes and the adequacy of the functions of the external Shariah auditor; the responsibilities of the committee in this regard cover the following:
 - (1) Streamline the function of the external Shariah audit.
 - (2) Recommend to the Board of Directors concerning appointment and removal of the external Shariah auditor, determining his fees and assessing his performance.
 - (3) Revision and acceptance of the engagement letter.
 - (4) Peruse the reports prepared by the external Shariah auditor to ensure that the necessary measures have been taken therewith by the executive management.
 - (5) Communicate and coordinate with the external Shariah auditor and the Corporate Governance Committee to ensure that reports are made on the standard of compliance with the Islamic Shariah provisions and principles.
 - (6) Hold periodic meetings with the External Shariah Auditor at least once a year, and with the Internal Shariah Auditor at least twice a year. The Internal Shariah Auditor and the External Shariah Auditor may request holding a meeting with the committee when necessary to the Bank's business.

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4.B Corporate Governance Committee

1) Within the Formation of this Committee

The Internal Shariah Audit Department Manager takes part in meetings of this Committee to discuss the Shariah supervision related subjects, without having the right to vote on resolutions passed by the Committee. The Committee may hire external Shariah expertise upon approval of the Board of Directors.

2) Within the Terms of Reference and functions of this Committee

- a) Coordinate with the Shariah Supervisory Board and the Audit Committee to ensure compliance with the Shariah Audit Manual.
- b) Concentrate on the privacy of Islamic banking business and protection of the interests of investment account holders as provided for by the contracts signed with them.
- c) Ensure the ratification and application of the investment strategy laid down for the investment accounts holders.
- d) Ensure the appropriate and timely disclosure to the investment accounts holders.

Pillar Two: The Executive Management

1. The Executive Management is responsible for overseeing and implementing the Shariah resolutions passed by the Shariah Supervisory Board in the Bank, and shall be responsible also for determination and referral of any Shariah issues to the Shariah Supervisory Board to have its opinion thereon.
2. Since the accountability in the Shariah resolutions is laid down on the part of the Shariah Supervisory Board, the executive management shall have to provide the Shariah Supervisory Board in due course with all information necessary. Further, the executive management's relationship with Shariah Supervisory Board should be characterized with transparency to enable it perform its duties effectively.
3. Among the responsibilities of the executive management is allocation of the sufficient resources and manpower in support of the Shariah Supervisory Corporate Governance, tailored with the volume and nature of the Bank business and their complexities. This should include, among other things, allocation of the sufficient budgets and the necessary reference and research materials.

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4. The executive management is responsible for providing the continued educational and training programs to the main internal stakeholders in the Bank, including the Board of Directors and the employees concerned with the Shariah issues with relevance to the Bank's business. This is to ensure also that all departments in the framework of the Shariah supervision corporate governance are well aware of the latest developments in the relevant Shariah matters.
5. The executive management shall have to ensure the possibility of obtaining the relevant policies and procedures at all times for each staff member who assumes a role in implementing the Shariah supervisory corporate governance.
6. Also among the responsibilities of the executive management is to ensure that transactions are implemented in accordance with the policies and procedures approved by the Shariah Supervisory Board, and shall have to review and update such policies and procedures on an ongoing basis to reflect the prevailing practices and developments in the market.
7. The executive management shall have to implant the culture of compliance with Islamic Shariah inside the Bank, through the appropriate policies and programs in this regard.

Pillar Three: Shariah Supervisory Board

1. Shariah Supervisory Board is responsible for all its resolutions and opinions relevant to Shariah issues. While the Board of Directors assumes the ultimate responsibility and the entire accountability in all aspects of corporate governance in the Bank, the Board of Directors is expected to rely upon the Shariah Supervisory Board in all Shariah resolutions and opinions associated with the Bank's business. Therefore, Shariah Supervisory Board shall have to ensure that its resolutions are the outgrowth of clear-cut deliberations.
2. Shariah Supervisory Board shall have to assume the role of oversight over Shariah issues related to the Bank's activities and transactions. This can be realized through the internal Shariah Audit personnel. The internal Shariah audit reports and remarks should be periodically submitted to the Shariah Supervisory Board so that it can determine the issues that require its concern and propose remedial actions, if necessary.
3. Shariah Supervisory Board is required to disclose adequate information on the scope of the Bank's compliance with the Islamic Shariah provisions in the annual financial report of the Bank.

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For this purpose, Islamic banks shall have to comply with the rules and conditions of setting up the following terms of reference for Shariah Supervisory Board [Items from First to Eleven]:

First: The general assembly of the Bank shall appoint Shariah Supervisory Board upon nomination from the Board of Directors.

Second: A member of the Shariah Supervisory Board shall not take part in the membership of Shariah Supervisory Boards for more than three Islamic banks in the State of Kuwait.

Third: Shariah Supervisory Board shall be composed of three members at least of scholars well known of expertise and efficiency, especially in the transactions jurisprudence. The task of the Shariah Supervisory Board shall be to give Shariah opinion on the Bank's activities and its transactions, and verify the Bank's compliance with the Islamic Shariah provisions and principles.

Fourth: Shariah Supervisory Board's membership may not include any member of the Board of Directors or the executive management of the Bank, or shareholders having effective influence. Effective influential shareholder means a shareholder who owns 5% or more of the Bank capital share.

Fifth: Shariah Supervisory Board Functions

1. Examine the Bank's memorandum and articles of association, and the applicable charters and policies in the Bank business, and ensure their conformance with the Islamic Shariah provisions.
2. Give the Shariah opinion of the Shariah Supervisory Board on the Bank transactions, and on the issues referred to the Shariah Board from the executive management, the Bank divisions, or from the Shariah Internal Audit Department.
3. Review and ratify forms of contracts, agreements and operations of all Bank transactions with shareholders, customers, investors, and others, and take part in amendment and development of the mentioned forms, when necessary. It shall also revise contracts created by the Bank for the purpose of ensuring that such contracts are clear of any Shariah restrictions and to verify that transactions concluded are for products approved by Shariah Supervisory Board.
4. Provide and propose possible Shariah solutions to problems of financial transactions which do not comply with the principles and provisions of Islamic Shariah, and contribute to finding out Shariah alternatives to Shariah non-compliant products, if any.

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5. Ensure to set apart the gains realized from sources or by ways in breach of Islamic Shariah provisions and their disbursement in charity channels.
6. Ensure appropriation of expenses, profits and charging losses in accordance with Islamic Shariah provisions and the approved regulations for the same.
7. Ensure that Zakat account is managed in accordance with Islamic Shariah provisions in cases that require the same in accordance with the Bank's articles of association.
8. Supervise compilation of the opinions (*Fatawa*) of Shariah Supervisory Board and ratify the ones published therefrom, on consideration that they would be taken as Shariah reference and official documents that should be observed.
9. Record the transactions in breach of Shariah – if any – in the Bank's activities, and request their correction or ceasing. Objection of such transactions on Shariah incompliant transactions shall be made in writing and submitted to the Chief Executive Officer.
10. Study the reports of the Shariah Internal Audit Department concerning auditing the Bank's transactions executed and their compliance with Islamic Shariah provisions.
11. Shariah Supervisory Board, or one of its members at least, shall attend meetings of the general assembly to answer the questions of the general assembly members (if any).
12. Shariah Supervisory Board shall submit an annual report, within the Bank's annual report, which will be presented to the general assembly and in which Shariah Supervisory Board shall present its opinions on the transactions carried out by the Bank and the scope of the management's observance of the opinions (*fatawa*) and resolutions passed by the Shariah Supervisory Board.
13. Shariah Supervisory Board shall be responsible for the *fatawa* it passes on the issues presented to it before the Board of Directors and the general assembly.
14. A member of the Shariah Supervisory Board shall not be entitled to issue *fatawa* or research in the name of his membership, or to give any press release to the media and means of information in the name of the Shariah Supervisory Board unless with permission of the Shariah Supervisory Board and approval of the Chairman of the Board of Directors.

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15. The Chairman of the Board may invite the Chairperson of the Shariah Supervisory Board or any member thereof to attend meetings of the Board of Directors to answer any Shariah-related queries. Chairperson of the Shariah Supervisory Board or his deputy may request to attend meetings of the Board of Directors to present any subject related to the Shariah issues in the bank businesses, without exercising the right to vote on the board's resolutions in these cases.

Sixth: The Shariah Supervisory Board shall convene four meetings per year at least on regular basis in the Bank's premises. It may also convene its meetings outside the Bank's premises

1. Members of the Shariah Supervisory Board shall elect one of them in the first meeting of the Shariah Board to assume the designation of the Chairperson.
2. Meeting of the Shariah Supervisory Board shall be convened with presence of the majority of its members. Should the Shariah Board be composed of three members, all its members shall have to attend the meeting. The Shariah Supervisory Board shall pass its resolutions with the majority of the attending members. In case of tie of votes, the side in which the Chairperson cast his vote shall prevail. The member who objects the Shariah Board's resolutions may establish his opinion in the minutes of meeting justifying such objection.
3. Shariah Supervisory Board may invite to its meetings whomever it deems necessary of the Bank managers, staff, experts or counsels to identify data and information it needs on the issues presented to it, but they shall not be entitled to vote in these meetings.
4. Attendance of a member of the Shariah Supervisory Board to its meetings shall not be less than 75% during the year. A member may attend through state-of-the-art means of communications (Video Call-Voice Call) – if necessary – provided the same shall be recorded in the minutes of meeting.
5. Shariah Supervisory Board may elect an executive member among its members, and may identify his functions as decided by the Shariah Supervisory Board in order to decide upon the urgent matters, provided his decisions shall be presented to the Shariah Supervisory Board at its first meeting.

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6. Resolutions of the Shariah Supervisory Board may be passed by circulation in the urgent issues, provided that all members shall consent such resolutions. The resolution shall be established in the minutes of the first meeting convened. In case of disagreement, a meeting shall be arranged to be convened at the earliest possible chance.
7. Resolutions of the Shariah Supervisory Board are binding and the Bank's management shall adhere to such resolutions.
8. Members of the Shariah Supervisory Board shall consider the economic and social aspects, and other aspects, for the products and services under discussion, in order to reach Shariah *fatawa* that consider the objectives of Islamic Shariah provisions.
9. Resolutions of the Shariah Supervisory Board shall have to be issued in a procedural approach – as possible – to ensure their correct implementation.

Seventh: The Management's Responsibility Towards the Shariah Supervisory Board is represented in the following:

1. Provide all information which will assist the Shariah Supervisory Board to formulate the Shariah opinion on the transactions exercised by the Bank.
2. The Bank divisions and departments shall check with the Shariah Supervisory Board before issuing any form or contract. This requires circulation of the condition of obtaining Shariah approval before enforcement of any new form or contract.
3. Any contract or form on which Shariah Board has given notes shall not be used unless after being amended or replaced and newly ratified by the Shariah Supervisory Board.
4. All documents, contracts and agreements delivered to the Bank shall be presented to the Shariah Supervisory Board before the Bank becomes a party therein.
5. In event the executive management in the Bank falls in breach of the *fatawa* and resolutions passed by Shariah Supervisory Board, the Shariah Supervisory Board shall warn the executive management in writing of the occurrence of such breach, and with the way of its correction. In case the executive management does not make the required correction, the Shariah Supervisory Board shall have to establish the incident in the annual report submitted to the general assembly.

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Eighth: A Secretariat shall be formed for the Shariah Supervisory Board to streamline performance of its functions. Functions of the Shariah Supervisory Board's Secretariat shall cover the following:

1. Prepare the agenda of the Shariah Supervisory Board and complete the information, data and documents necessary for the functions of the Shariah Supervisory Board.
2. Indexing and follow up the businesses presented to the Shariah Supervisory Board.
3. Forward invitations to attend the Shariah Board's periodic meetings, and prepare the minutes of meeting, follow up all necessary matters until such minutes are ratified by the Shariah Supervisory Board.
4. Receive all questions, queries and communications delivered by the Bank management to be presented to the Shariah Supervisory Board.
5. Report the Shariah Supervisory Board to the executive management and the concerned departments in the Bank.

Ninth:

- A) Membership of Shariah Supervisory Board shall be terminated in the following cases:
 - 1) Resignation of the Shariah Supervisory Board's member, his disability, death or absence of three consecutive meetings of the Shariah Supervisory Board without excuse or absence of 75% of the Shariah Board's meetings during one year.
 - 2) The member's incapacitation or in case of a final judicial order is passed on his disqualification, or if indicted in a freedom restricting punishment.
- B) If the position of the member / members of the Shariah Supervisory Board becomes vacant during the membership terms for whatsoever reason, thereby making the number of the members less than the minimum number legally stipulated, the Board of Directors shall nominate a replacement to such member / members to be presented to the general assembly to consider his / their appointment.
- C) In all cases, a member of the Shariah Supervisory Board shall not be removed from his office or fired unless after having the Shariah Supervisory Board's opinion, together with giving the reasons for the same. This matter shall be presented to shareholders in the general assembly to decide thereupon and elect another member (if necessary).

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Tenth: The annual report of the Shariah Supervisory Board, which will be presented to the Bank's general assembly shall contain the following main elements:

- Title of the report and the entity to which the report is directed (shareholders).
- Scope of the function of the Shariah Supervisory Board. This scope shall have to include the description of the nature of the business carried out. This shall have to include also that Shariah Supervisory Board has carried out the examinations and the appropriate measures and monitored the business with the appropriate means, including examination of deeds and the applicable measures in the Bank, on test basis of each type of these transactions, along with the range of obtaining all information and interpretations deemed necessary by the Shariah Board to issue its opinion on the scope of businesses compliance with Islamic Shariah provisions.
- The Shariah Supervisory Board's opinion on whether the contracts, deeds and transactions carried out by the Bank conform with Islamic Shariah provisions and principles or not. In case violations by the Bank's management of Islamic Shariah provisions and principles, or the *fatawa*, resolutions and guidelines issued by the Shariah Board, are evidenced to the Shariah Board, it shall have to establish the same in the report.
- The number of meetings convened by the Shariah Supervisory Board during the year and the number of meetings attended by members of the Shariah Board, each independently, in the annual report of the Bank.
- Date of the report.
- Signature of the members of the Shariah Supervisory Board.

Eleventh: Shariah Supervisory Board shall lay down a charter which will identify the details and mechanisms of taking the resolutions and the means of their implementation, as well as laying down the appropriate means for realizing its functions in conformity with the terms and conditions of these instructions.

Principle Two: Independence

In the context of these instructions, independence is meant to pave the area for Shariah Supervisory Board in the Bank to issue *fatawa* and Shariah judgments in accordance with and as necessitated by the independent judgment controls and conditions for giving *fatawa* (opinions) without influence on the members of the Shariah Supervisory Board, and to ensure enhancing shareholders confidence and stakeholders in the soundness of transactions in term of the Shariah consideration.

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Hereunder are the minimum controls and guidelines to be considered to ensure independence of members of the Shariah Supervisory Board:

1. A member of the Shariah Supervisory Board shall not have first-degree kinship relation with any person of the Bank officials who may have interference in the independence of the Shariah Supervisory Board with regard to issuing a judgment that serves the interests of the Islamic bank in which the member works.
2. A member of the Shariah Supervisory Board shall not be a full-time employee at the Islamic bank or any of its affiliates during the current financial year or the last financial year.
3. None of the Shariah Supervisory Board members shall have direct kinship relation – such as the husband, boys, girls or brothers – with senior executives of the present or the ex-staff (during the last financial year) in the Islamic bank or any of its affiliates.
4. Any member of the Shariah Supervisory Board shall not accept any remuneration from the bank or its subsidiaries, except for the remuneration paid against his service in the Shariah Supervisory Board. As for extending funding to the member, it must be extended to him on an arm's length basis without preference terms, and funding amounts which each member of the Shariah Supervisory Board receives shall have to be disclosed in the Bank's annual report.
5. The Shariah Supervisory Board member, or the related parties thereto, shall not own a material equity, or be a partner (having an equity of 5% or more), or be an executive officer or manager in any commercial company, to which the Islamic bank or any of its subsidiaries, has paid, or received from it a significant payment in the current or the ended financial year.
6. Shariah supervision services shall not be offered or presented to the Bank according to an arrangement that stipulates that fees shall not be claimed unless a certain outcome is realized, or to link the fees with the results of these services (conditioned fees).

The above cases shall be taken as examples with regard to independence of members of the Shariah Supervisory Board. Should the Bank desires to deem any member of the Shariah Supervisory Board independent, notwithstanding the existence of a relation/relations of the ones mentioned above; then the banks shall have to transparently disclose the nature of such relation and the Bank shall also be held responsible to identify the reasons of considering certain members of the Shariah Supervisory Board independent.

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Further to the above, as long as unavoidable conflict of interest cases arise, members of the Shariah Supervisory Board shall have to report the same in writing to the Bank management. They shall have to disclose any conflict of interest cases relevant to members of their families, their business partners, or companies in which they have interest. In case of existence of such conflict of interest towards another party; thence, they shall have to abstain taking part in the resolution or the measure with relevance to the Bank's account. When any conflict of interests case is reported, such reporting shall have to be recorded and noted down in the concerned records.

Principle Three: Efficiency & Fitness (Fit & proper)

Efficiency and fitness means the academic qualifications, practical experience, well reputation, good history of the members of the Shariah Supervisory Board.

With regard to **academic qualifications, expertise and efficiency**, a member of the Shariah Supervisory Board must be a bachelor of Islamic Shariah, specifically in Islamic commercial jurisprudence (*fiqh almua'malat*) from a university certified by the Ministry of Higher Education in Kuwait or the National Bureau for Academic Accreditation and Education Quality Assurance (NBAQ) for foreign universities outside Kuwait or be one of the scholars well known of their efficiency and expertise in transactions jurisprudence. A member should also have adequate knowledge of financing in general and Islamic financing in particular. It is necessary that members of the Shariah Supervisory Board shall have the following:

- High skills in *fiqh and fiqh* principles. A member of the Shariah Supervisory Board shall have to be well acquainted with the *fiqh* approaches to derive the Shariah opinions (*fatawa*), and knowledge with the Islamic Shariah provisions and objectives applicable to the Bank's activities.
- Practical experience of not less than five years in the area of Shariah supervision.
- Adequate knowledge of the legal and regulatory frameworks of the Central Bank of Kuwait related to the functions entrusted to him.
- Good knowledge in Arabic language, whereby he must be well informed of the basic Shariah sources. It is preferable that the member of the Shariah Supervisory Board would be able to speak English language, because such facility will help him improve communication between him and the stakeholders.
- Grasp technical aspects and economic impacts of the Islamic financial services and products in the framework of Islamic Shariah objectives.

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In order to maintain the efficiency and appropriateness of the members of the Shariah Supervisory Board, the Bank Management shall perform the following:

- Carry out annual performance appraisal to the members of the Shariah Supervisory Board using a joint form between the Board of Directors – through the Nomination & Remuneration Committee – and members of the Shariah Supervisory Board. The appraisal of the members to each other in terms of Shariah and scientific aspect shall be weighted by 65%, and the appraisal by the Board of Directors in terms of administrative and organizational aspect shall be weighted by 35%. The Bank – through the Nomination & Remuneration Committee shall prepare the appraisal form to appropriately assess the performance of the members of Shariah Supervisory Board. Such appraisal shall be confidential (attached is the appraisal form in this regard).
- Members of the Shariah Supervisory Board shall be advised with the elements of the performance appraisal upon their appointment, so that they shall have clear perception on the functions they are expected to carry out. Such elements may be changed or developed by participation or in consultation with the Shariah Supervisory Board.

Principle Four: Confidentiality

Members of the Shariah Supervisory Board may have access to, upon carrying out their duties, files, documents, drafts, and deliberations with secret nature according to the internal procedures in the Bank and in accordance with the applicable market practices. **Confidential information** is meant to be the information which members of Shariah Supervisory Board obtain while such information is unavailable to the public and is not permitted to be published. Such information includes such information which bears stamp or marked by the Bank to the effect of its confidentiality, or that it is related to deliberations carried out in the Bank. Examples of the confidential information are the following:

- Information related to new products and services which the Bank plans to launch or take part therein.
- Internal memos prepared, in the form of drafts or in their final form, related to issues submitted, or that shall be submitted to members of the Shariah Supervisory Board.
- The time of a certain resolution, or the position of a trade transaction, including transactions which have not yet been completed, excluding transactions permitted by the Board of Directors in accordance with the internal procedures in the Bank.
- Viewpoints of several parties during discussions on a certain issue before the Shariah Supervisory Board.

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Members of the Shariah Supervisory Board in the Bank shall maintain the confidentiality of the referred to above information or any information deemed secret by the Bank, and shall be keen not to disclose the secrets related to transactions and products of the Bank.

Principle Five: Consistency

Consistency is meant to be concordance of the members of the Shariah Supervisory Board in rendering their opinions and *fatawa* submitted to the Bank, and keenness, as much as possible, to render the resolutions in consensus, and not to resort to voting by majority, unless they fail within a reasonable time to reach consensus. Consistency is linked with efficiency and independence, which falls also within the issues of ethics of the profession.

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Chapter Four: Shariah Audit

Pillar One: Internal Shariah Audit:

Internal Shariah Audit is deemed to be an integral part of the Shariah Supervisory System in the Bank as a whole. In the framework of enhancing Islamic banks compliance in all their operations, products and services with Islamic Shariah provisions, banks shall have to comply with the following:

- First.** The establishment of an internal department (body/division) independent of the executive management to be in charge of the Internal Shariah Audit.
- Second.** The Department Manager shall be accountable of technical issues before the Shariah Supervisory Board, and shall be accountable of administrative issues before the Chairman of the Board via the Audit Committee (such as appraisal, promotions, allowances, bonus and rewards). The Executive Management shall present the names nominated to the post of the Internal Shariah Audit Department Manager, and such names shall be presented to the Shariah Supervisory Board to obtain its opinion. Appointment shall be made by a resolution from the Chairman of the Board of Directors while, and appointment of Shariah auditors shall be made following approval of the Internal Shariah Audit Department Manager.
- Third.** The Department shall be in such an organizational position that achieves the highest degree of Independence and Objectivity⁽¹⁾ in its functions, whereas the technical reporting line of the Department shall be to the Shariah Supervisory Board and the administrative reporting line shall be to the Chairman of the Board through the Audit Committee. It shall submit its reports to the Shariah Supervisory Board and the Audit Committee (quarterly and annual reports). Contribution to independence and objectivity shall be realized by the Bank's compliance with the following:
- The Internal Shariah Audit Department and the person in-charge of it shall be reporting to the highest possible organizational level.

⁽¹⁾ **Objectivity** is meant to be an independent mental satisfaction and can be realized through building conclusions on supporting evidences and indifference to the personal or emotional aspects, individual or corporate relations, or to reach conclusions that cannot be supported by evidences or based on third parties' satisfaction.

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- The Internal Shariah Audit Department Manager and the staff working with him shall not be subject in their promotions, allowances, performance appraisal and removal from office, to resolutions of the Executive Management, which they oversight its functions, but their reporting line shall be to the Chairman of the Board through the Audit Committee, in consultation with the Shariah Supervisory Board.
- Shariah auditors shall not assume any executive functions or any functions that may become subject to their audit at subsequent time.
- Internal Shariah audit function shall not be subject to any type of restriction, either with regard to narrowing its scope or in terms of determining the communication with various administrative levels or prevention of access to certain reports or documents.
- Internal Shariah Audit Department shall have business procedures applied to all departments subject to the audit.
- Appraisal of performance of the Internal Shariah Audit Department Manager shall be made by the Audit Committee in consultation with the Shariah Supervisory Board.
- In all cases, the Executive Management in the bank shall not be entitled to remove the Internal Shariah Audit Department Manager, or any of the staff reporting to him, from his / their office, and their removal from office shall be vested in the Board of Directors following obtaining the Shariah Supervisory Board's opinion, based on giving reasons of the same.

Fourth. Objectives of the Internal Shariah Audit Department:

- A) Ensure that the Bank' management has discharged its responsibility towards implementation of the provisions and principles of Islamic Shariah, based on the issues ratified by the Shariah Supervisory Board.
- B) Ensure the appropriateness of the internal Shariah audit system, its adequacy and effectiveness in realizing the objective of internal Shariah supervision, and that it guarantees compliance with Islamic Shariah in all the Bank's transactions, and the immediate disclosure of any deviations and reporting the same to the Management for taking the necessary remedial measures and ensuring non-recurrence of the same.

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Fifth. Functions of the Internal Shariah Audit Department:

Internal Shariah Audit Department shall assume the function of reviewing the Bank's operations and all its internal and external banking and investment activities in the framework of the Shariah Supervisory Board resolutions, throughout the following functions:

- Verify that any activity, product, service, or contract applied in the Bank, is allowed by the Shariah Supervisory Board.
- Review all forms, contracts and agreements, and procedures of implementing the operations, to ensure their compliance and congruence with the resolutions passed in connection therewith.
- Ensure that the Bank branches, its internal and external departments and its subsidiaries comply with the Shariah resolutions, in accordance with the forms, contracts, agreements and business procedures approved by the Shariah Supervisory Board.
- Review the business procedures and instructions issued by the Bank departments in light of the Shariah Supervisory Board resolutions.
- Ensure the soundness of the Shariah internal audit system, its effectiveness and evaluation, and ensure Bank's compliance with its Shariah policy.
- Conduct onsite periodic regulatory visits to the Bank departments and its internal and external branches (if any).
- Prepare the Shariah Audit Manual and its periodic update. Such Manual shall clearly identify the following:
 - a) Objectives, functions and jurisdictions.
 - b) Internal Shariah audit plans.
 - c) Internal Shariah audit policies and procedures.
 - d) Standards of selection of internal Shariah auditors.
 - e) Relations with other bodies, specifically the external auditor.
 - f) Programs and sheets necessary for the internal Shariah audit.
 - g) Charter of ethics and rules of professional conduct.
 - h) The responsibility of amending and updating the manual.

Such Manual shall be prepared by the Internal Shariah Audit Department, approved by the Shariah Supervisory Board and issued by the Board of Directors.

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- Prepare the Shariah audit programs and sheets necessary for conducting the examination process and documentary verification of the soundness of operations in light of the Shariah Supervisory Board's resolutions.
- Prepare the annual Shariah audit plan which shall be approved by the Shariah Supervisory Board and the Audit Committee.
- Prepare a periodic report on each regulatory period containing the findings of onsite supervision on activities and operations, and will identify the existing Shariah notes during the period.
- Conduct meetings and deliberations with the various bank departments to discuss the Shariah remarks, and propose the appropriate solutions to avoid such remarks in collaboration with the concerned entities in the bank.
- Take part in the meetings and scientific seminars and symposiums called for by the Bank's Shariah Supervisory Board.
- Review press releases and advertisements on the bank products and operations and approve the same before dissemination;
- Contribute with the Bank management in creation of appropriate environment for Shariah supervision, as follows:
 - Disseminate awareness of Islamic economy inside and outside the Bank.
 - Give due care to queries of the bank staff and customers, and follow up the issues raised by them with regard to the soundness of execution in terms of the Shariah consideration for certain operations inside the bank departments and its branches.
 - Answer the Shariah questions and queries presented by the bank customers and staff in light of the preceding Shariah opinions (*fatawa*) and resolutions.

Sixth. The Internal Shariah Audit Department Manager shall satisfy the following conditions:

- He must be a holder of a university degree in Islamic Shariah in general, and transactions jurisprudence (*fiqh almua'malat*) in particular, from one of the universities certified by the Ministry of Higher Education in the State of Kuwait, or from the National Bureau for Academic Accreditation and Education Quality Assurance (NBAQ) for foreign universities outside Kuwait; Or

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- Obtaining an appropriate university degree in economics, administrative or legal fields with a professional diploma in Shariah audit and Islamic banking from one of the standardized institutions of Islamic financial industry, such as the Islamic Financial Services Board (IFSB) or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- He must have experience of not less than five years in Shariah audit function.
- He has never been subject to a final verdict of mistrust or dishonor crime or has been indicted with a freedom restriction punishment in a crime.

It is preferable that the Shariah Audit Department Manager shall be capable to speak English language, in that such facility shall enable him to have better communication with the bank stakeholders.

Seventh. The Internal Shariah auditor shall satisfy the conditions mentioned in item “Sixth” above, excluding the experience condition, where the Internal Shariah Auditor must have experience not less than two years in the area of Shariah auditing.

Eighth. The Internal Shariah Audit Department manager shall have to establish a training policy to his staff to reach the highest degree of quality and professional perfection in Shariah auditing.

Pillar Two: Outsourced Shariah Audit:

In view of (i) the considerable growth in the Islamic financial industry’s sector, (ii) many members of Shariah supervisory boards can not dedicate full time to fulfill their duties, (iii) their engagement with many local and foreign institutions and (iv) their absence from their daily assignments in banks and institutions thus concentrating their efforts in giving Shariah opinions (*fatawa*) rather than performing Shariah supervision; therefore it has been necessary to engage full time persons (outsourced Shariah Auditors) to carry out Shariah audit function.

Pursuant to the above, Shariah supervisory boards in Islamic banks shall have to engage outsourced Shariah audit firms.

Outsourced Shariah Audit Firm

First. Outsourced Shariah Audit Firm is an independent institution in charge of supervision on all transactions, to ensure their compliance with Islamic Shariah provisions in accordance with the resolutions and

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Shariah opinions (*fatawa*) of the Shariah Supervisory Board. This firm shall be appointed by the general assembly of the bank based on nomination from the Board of Directors. The outsourced Shariah audit firm shall submit its reports in this regard to the general assembly, and a copy thereof to the Shariah Supervisory Board.

Second. The outsourced Shariah audit firm shall satisfy the following conditions in order to carry out its outsourced Shariah audit in Islamic banks:

1. The firm shall have a license from the Ministry of Commerce & Industry to exercise the profession of outsourced Shariah audit.
2. The elapse of five years since the incorporation of the firm and exercising its functions.
3. Shariah auditors at the firm must satisfy the conditions provided for in item “Fifth” of Pillar Two of these Instructions, and that firm shall have the sufficient number of Shariah auditors to perform the function of the Shariah audit on Islamic banks.
4. That firm shall maintain a Shariah audit approach and a manual that identifies the means of carrying out outsourced Shariah audit on Islamic banks.
5. The firm shall have to segregate the Shariah audit team who carry out outsourced Shariah audit functions from the team who renders Shariah consultations.

Third. Outsourced Shariah audit firm shall not be entitled to render any of its services to any entity registered with the Central Bank of Kuwait if it is not licensed from the Ministry of Commerce & Industry and satisfied the above mentioned conditions.

Fourth. The outsourced Shariah audit firm shall be composed of Shariah auditors assisted in their functions by an accountant/accountants and a legal advisor.

Fifth. The Shariah auditor who works at the outsourced Shariah internal firm shall have to meet the following conditions:

- a) He must be a holder of a university degree in Islamic Shariah in general, and transactions jurisprudence (*fiqh almua'malat*) in particular, from one of the universities certified by the Ministry of Higher Education in the State of Kuwait, or from the National Bureau for Academic Accreditation and Education Quality Assurance (NBAQ) for foreign universities; or

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- b) Obtaining an appropriate university degree in economics, administrative or legal fields with a professional diploma in Shariah audit and Islamic banking from one of the training or standard - setting institutions of Islamic financial industry, such as the Islamic Financial Services Board (IFSB) or the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).
- c) He must have experience of not less than two years in Shariah audit function.
- d) He has never been subject to a final verdict of mistrust or dishonor crime or has been indicted with a freedom restricting punishment in a crime.

It is preferable that the outsourced Shariah auditor shall be capable to speak English language, as such facility shall enable him to have better communication with the bank stakeholders and officials.

Sixth. Appointment of the outsourced Shariah audit firm at the bank will be for one year only renewable for four consecutive financial years at most, and shall not be reappointed afterwards unless after the lapse of two financial years at least.

Seventh. Appointment of the outsourced Shariah audit firm shall be made by the general assembly of the bank at its annual meeting.

Eighth. The task of the outsourced Shariah audit firm shall be terminated at the expiry of the period determined for its appointment by the bank's general assembly and such term shall not be renewed.

Ninth. Report of the outsourced Shariah audit firm shall include the following:

1. Contracts and transactions examined and perusal thereof in accordance with the provisions of the resolutions of the Shariah Supervisory Board, all without prejudice to the confidentiality of these transactions.
2. The entities in the bank in charge of carrying out these examined transactions and the phases of their completion.
3. Terms of reference of these transactions and products (financing and investment policies).
4. Breaches – if any – to the resolutions of the Shariah Supervisory Board, either in the contracts or in execution of the transactions, and the means of their remedy, and the period proposed for such remedial actions.
5. Number and dates of onsite visits to the bank and their outcomes.

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Tenth. The outsourced Shariah audit firm's report shall be published within the annual report of the bank.

Eleventh. In order to avoid conflict of interest, a partner in the outsourced Shariah audit firm, or his subordinates, must not occupy the post of chairman, or a member of the board of directors of the bank subject to the audit. This applies to relatives up to the first degree to those who oversight the bank's management or its accounts.

Cases of conflict of interest with the bank shall deemed to have existed if the two parties have joint engagements, as in the case of common equity or common management.

Twelfth. The outsourced Shariah audit firm or any of its members shall not be entitled to render any of the following services to the bank which appointed it:

- Work for pay.
- Shariah consultancies.
- Training, including holding of fairs, seminars or workshops.
- Represent the bank at third parties, specifically membership of the boards of directors of companies in which banks subject to the audit have equities therein.
- Obtain any financial or in-kind benefits other than the benefits approved to them by the general assembly of the concerned banks, whether these benefits are issued from the bank itself or its subsidiary companies.

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Chapter Five: Closing Provisions

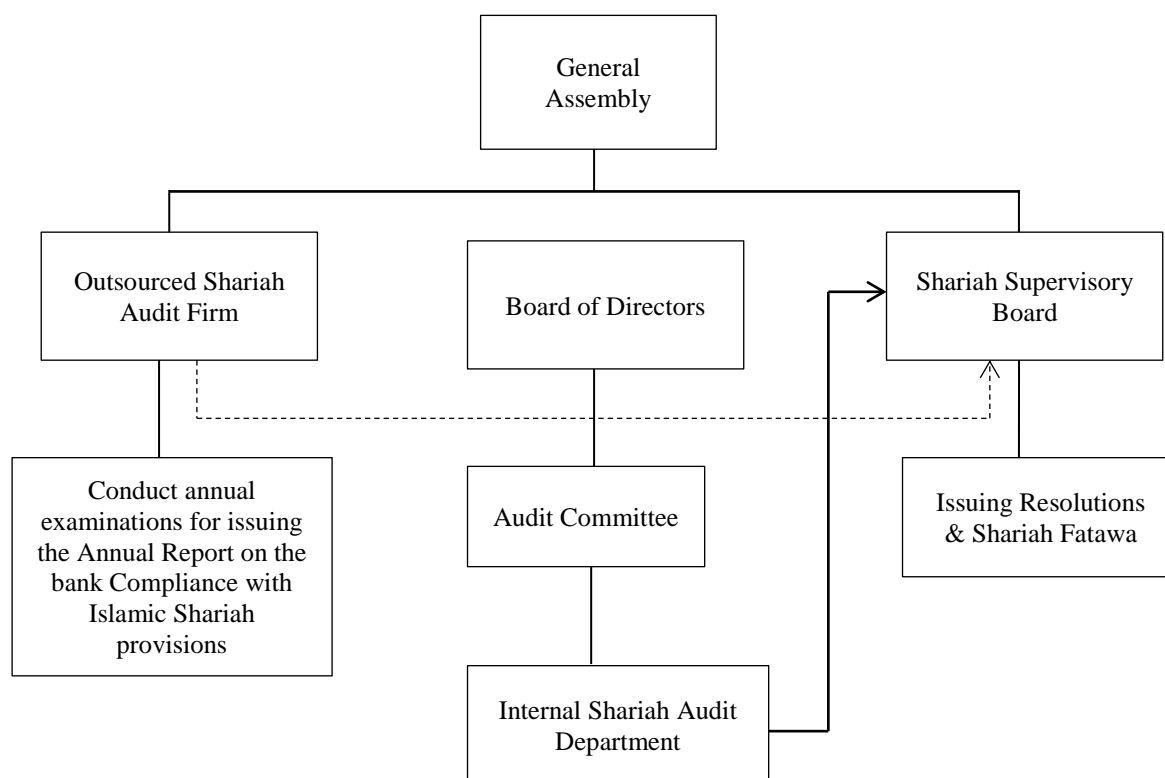
- First.** In view of the recency of the outsourced Shariah audit function in the State of Kuwait, the outsourced Shariah audit mentioned in these instructions shall be applicable effective from 1/1/2020, to allow the outsourced Shariah audit firms to identify Shariah audit requirements on Islamic banks and endeavor to qualify and develop personnel in this area.
- Second.** These instructions shall replace instructions No. (2/IBS/100/2003) concerning the rules and regulations of appointment and jurisdictions of Shariah Supervisory Boards in Islamic banks issued on 15 & 19/6/2003.

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Annex (1)

Organizational Structure of Shariah Audit in an Islamic Bank



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Annex (2)

Performance Appraisal Form of the Shariah Supervisory Board & Its Members

The mechanism of appraisal must be objective and tailored with the essence of Board of Directors responsibility towards the Shariah Supervisory Board, and elements of the appraisal must be known to the members of the Shariah Supervisory Board. It is also necessary to ensure that appraisal measures must be transparent, to prevent their misuse or exorbitance by the Board of Directors for any other purposes that may compromise the independence of members.

Hereunder are the elements of evaluation of the Shariah Supervisory Board members:

1. Did the Shariah Board carry out its functions effectively? (e.g.: Did it reply the questions of the various departments in due time?)
2. Did the Shariah Board communicate its resolutions as required to the concerned persons in the bank, including the Board of Directors, the executive management and Shariah auditors?
3. Did the Shariah Board encourage the bank staff to adhere to good ethics and values emanated from Islamic Shariah?
4. Did the Shariah Board encourage the continued development of the Shariah audit procedures in the bank?
5. Does the Shariah Board maintain good relations, cooperation and continued coordination with all the bank departments?

With regard to a member of the Shariah Board, Does the member:

1. Effectively contribute to enriching the deliberations and discussions carried out in the Shariah Board's meetings? (through perusing the minutes of meetings).
2. Does the member attend meetings of the Shariah Board on regular basis and keen to attend such meetings?
3. Does the member endeavor for continued self-development? (through his attendance of training courses during the year in banking business, Islamic economy or English language, or obtaining scientific degrees, or publish scientific researches in magazines or well-known organizations).

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THE EXECUTIVE DIRECTOR

*Jumada Al-Aula 11, 1441 H
January 06, 2020*

The Chief Executive Officer,

**Circular to All Kuwaiti Islamic Banks
Subject: External Shariah Audit**

With reference to the instructions of the Shariah Supervisory Governance in Kuwaiti Islamic Banks issued on 20/12/2016, stipulating the need to start satisfying the requirements of the external Shariah audit as of 1/1/2020.

It is the responsibility of the Kuwaiti Islamic banks to ensure that the appointed external Shariah auditing offices and their Shariah auditors are fulfilling the conditions stated in the instructions and present evidence proving that. In addition, banks must obtain CBK prior approval on the appointed external Shariah auditing office, taking into account the following:

1. The contract between the bank and the office should include an item requiring the office to fulfill the conditions set forth in the aforementioned instructions.
2. Satisfy the conditions stated in the attached table and provide us with a copy approved by the CEO of your bank.

Best regards,

**The Executive Director of Supervision Sector
Waleed Mahmoud Alawadhi**

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- C) Circular Issued to Kuwaiti Islamic Banks Concerning the Application of the Requirements of the External Shariah Audit as of 1/1/2020, and Obtaining CBK Prior Approval on the Appointed External Shariah Auditing Office.

Prerequisites of the Appointed External Shariah Auditing Office and Its Shariah Auditors

Sr.	Item	Yes	No	Remarks
A. Appointed External Shariah Auditing Office				
1	The office has a license from the Ministry of Commerce and Industry to practice the activity of external Shariah auditing.			
2	The office has been established and practicing its duties for at least 5 years.			
3	The office has a methodology and a Shariah auditing guide that explain the external Shariah auditing on Islamic banks.			
4	The office has a sufficient number of Shariah auditors to perform Shariah auditing on Islamic banks.			
5	The office separates between the Shariah Auditors team who undertakes external Shariah auditing from any team that provides Shariah consultations.			
6	The external Shariah auditing office consists of Shariah auditors who are supported by one or more accountant and a legal advisor.			
B. Shariah Auditors Who Work in an External Shariah Auditing Office				
7	The contract between the bank and the external Shariah auditing office includes an item requiring the office to fulfill the conditions set forth in the aforementioned instructions.			
8	Shariah Auditors have university degrees in the field of Islamic Shariah as a qualification in general, and in the field of Fiqh in financial transactions in particular, from one of the universities accredited/approved by the Ministry of Higher Education in the State of Kuwait or the National Agency for Academic Accreditation for universities outside the State of Kuwait, or a professional university qualification in the fields of Economics, finance, management or legal.			
9	External Shariah Auditors have the “Certified Shariah Auditors” certificate provided by the Institute of Banking Studies, in accordance with the requirements of the Central Bank of Kuwait Circular dated 3/3/2019.			
10	Shariah Auditors have a minimum of 2 years of experience in the field of Shariah Auditing			
11	Have any of the Shariah Auditors been convicted with a final judgment in a crime involving a breach of honor or trust, or have been convicted with punishment restraining his freedom?			
12	Does a partner in an External Shariah Auditing Office or any affiliate thereof occupy the position of Chairman, Member of a Board of Directors of the bank, or supervise the bank’s management, accounts or internal Shariah auditing? This applies to relatives of first of kin who participate in the External Shariah Auditing.			
13	Does the Auditing Office have any cases of conflicts of interest with the bank including, but not be limited to, inter-linkages (collaborative links) such as co-owners or participation in management?			

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- C) Circular Issued to Kuwaiti Islamic Banks Concerning the Application of the Requirements of the External Shariah Audit as of 1/1/2020, and Obtaining CBK Prior Approval on the Appointed External Shariah Auditing Office.