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Sharia governance in Islamic financial institutions and the effect of the Central Bank of Malaysia Act 2009

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***J.I.B.L.R. 105 Introduction**

The philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of Sharia compliance. With this aspiration, corporate governance in Islamic financial institutions (IFIs) needs a set of institutional arrangements to oversee the Sharia compliance aspects of their business and operations. In the absence of any model of corporate governance in Islamic literature, IFIs have innovatively introduced the Sharia governance system as part of their corporate governance framework. In this regard, the Sharia governance system is peculiarly exclusive and unique to the corporate governance framework in IFIs, unlike their conventional counterparts.

The Sharia governance system refers to:

“[A] set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of *Shari’ah* compliance over the issuance of relevant *Shari’ah* pronouncements, dissemination of information and an internal *Shari’ah* compliance review.”¹

This definition implies that the institution of a Sharia board is crucial to the Sharia governance system as an authoritative body to ensure Sharia compliance in IFIs. The Accounting and Auditing Organization for IFI (AAOIFI) Governance Standards defines a Sharia board² as:

“[A]n independent body entrusted with the duty of directing, reviewing, supervising the activities of IFIs for a purpose of *Shari’ah* compliance and issuing legal rulings pertaining to Islamic banking and finance.”³

Looking at the different framework and style of Sharia governance in various legal environments and diverse banking models, it is worth examining the regulatory framework of the Sharia governance system in Malaysia by specifically discussing the effect of the recent Central Bank of Malaysia Act 2009 (CBA) which has been passed by the parliament in July this year.

The existing regulations on Sharia governance in IFIs

The Malaysian regulator has initiated a comprehensive Sharia governance framework from regulatory and non-regulatory aspects. Several laws were passed and amended by the parliament such as the Islamic Banking Act 1983, the Takaful Act 1984, the Banking and Financial Institutions Act 1984, and the Securities Commission Act 1993. The amendment to the Central Bank of Malaysia Act 1958 in 2003 enhances the role and functions of the Sharia board where the National Sharia Advisory Council of the Central Bank of Malaysia (SAC) will be the sole Sharia authority and will ***J.I.B.L.R. 106** be referred to by the court or arbitrator in any disputes involving Sharia issues in Islamic banking, finance and takaful cases.

Apart from that, the Central Bank of Malaysia (BNM) issued the Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks (BNM/GPS8-i) as well as the Guidelines on the Governance of Sharia Committee for the IFIs known as the BNM/GPS1. To complement this, the Securities Commission of Malaysia issued the Registration of Sharia Advisers Guidelines 2009 which setting up the criteria for the registration of a Sharia adviser in the capital market sector. In addition, the BNM with the co-operation of the judiciary has agreed to set up a special High Court in the Commercial Division known as the Muamalah bench. According to Practice Direction 1/2003 para.2,

all cases under the code 22A filed in the High Court of Malaya will be registered and heard in the High Court Commercial Division 4 and this special high Court will only hear cases on Islamic banking

Summary of Chapter 1 of Part VII of the CBA

The Malaysian Government took a further step in enhancing the framework of Sharia governance by passing the CBA. This new legislation was passed by the Parliament in July 2009, received royal assent on August 19 2009 and was gazetted on September 3, 2009. The CBA consists of 100 sections divided into 15 parts. Unlike the Central Bank of Malaysia Act 1958, the CBA inserts new provisions into Pt VII which covers provisions pertaining to Islamic financial business. This article hence specifically aims at explaining ss.51-58 of Pt VII of the CBA that exclusively provide framework of Shariah governance for IFIs in Malaysia which can be summarised as follows:

- Section 51: This section grants authority to the BNM to set up National Sharia advisory Council (SAC) that shall be the sole authority in Islamic banking and finance.
- Section 52: The SAC has four main functions and these include ascertaining the Islamic law, issuing Sharias, advising the BNM on any Sharia issue, providing advice on any matters pertaining to Islamic finance and such other functions that the BNM deems necessary.
- Section 53: Interestingly, the appointment of the SAC members will be made by King of Malaysia (the Yang di-Pertuan Agong) on the advice of the Minister of Finance after consultation with the BNM. Only candidates who are qualified in Sharia or who have knowledge or experience in Sharia and in banking, finance, law or such other related disciplines may be appointed as the SAC members. This section also allows the appointment of judge of the civil court and Shariah court as SAC members.
- Section 54: This section provides authority to establish a secretariat and any other committees to assist the SAC in carrying out its functions.
- Section 55: The BNM is obligated to consult the SAC in any matter involving Islamic financial business and for the purpose of carrying out its functions or conducting its business or affairs. On the other hand any IFI may refer the SAC for a ruling and advice in order to ascertain that it does not involve any element which is inconsistent with the Sharia.
- Section 56: This section affirms the authority of the SAC upon the court or arbitrator. Both the court or the arbitrator are required to take into consideration rulings of the SAC or to refer any question or Sharia issues for its ruling.
- Section 57: This section vividly clarifies the legal status of Sharia rulings issued by the SAC to be binding upon the court and arbitrator.
- Section 58: Finally, this last section confirms that the Sharia ruling issued by the SAC prevails over the ruling given by the Shariah Committee at individual IFIs.

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Basically, the aim of provisions in Ch.1 of Pt VII is to resolve issues pertinent to Shariah matters as evidenced in several cases involving IFIs in Malaysia such as in the case of *Affin Bank Berhad v Zulkifli Abdullah* (2006) 1 C.L.J. 447 and *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 M.L.J. 631. The Central Bank of Malaysia (Amendment) Act 2003 seems to have failed to resolve the issue since the decision made by the SAC is only binding upon an arbitration and not the court.

Realising this, ss.51-58 of the CBA clarifies and enhances the Sharia governance framework for IFIs in Malaysia in the following aspects:

- It grants authority to the BNM to establish the SAC and to specify its distinctive functions as well as a secretariat to assist the SAC in carrying out its definitive roles. This vividly clarifies the roles and responsibilities of the SAC as the highest and sole authority in Islamic financial matters.
- In parallel with the status of the SAC as the highest authority in matters pertaining to Islamic banking, finance and takaful, the appointment of the SAC members shall be made by the Yang di-Pertuan Agong. The SAC's remuneration and the terms of reference then shall be determined by the BNM.

- It sets the minimum fit and proper criteria of the SAC members. The candidate must at least be knowledgeable and qualified in Sharia or have appropriate knowledge and experience in banking, finance and law. Section 53 of the CBA also allows experts in other related disciplines as well as judges of the civil court and Sharia court to be SAC members. This provision is unique as a combination of mixed expertise amongst the SAC members would potentially contribute towards more solid and sound Sharia rulings.
- The retired s.16B of the Central Bank of Malaysia (Amendment) Act 2003 merely provides that the Sharia rulings issued by the SAC are binding upon the arbitrator. Section 57 of the CBA affirms the legal status of Sharia pronouncement issued by the SAC to be binding upon both the court as well as an arbitration.
- The court or arbitrator is not obligated to refer to the SAC to resolve any Sharia issue in the previous regulation. Section 58 of the CBA on the other hand makes it mandatory for the court or arbitrator to refer to the SAC for deliberation on any Sharia issue and also to take into account its existing Sharia rulings.
- It clarifies the status of Sharia ruling issued by the SAC in the event it contradicts with Sharia pronouncement of the Shariah committees at individual IFIs. The Sharia rulings of the SAC shall prevail and have binding force over the Sharia resolutions of Sharia committees.

Despite the recent legal development, it is worth noting that the CBA has jurisdiction to only in matters falling under the auspices of the BNM, so as to exclude the Sharia board in the Securities Commission. The Securities Commission of Malaysia has its own Sharia board and in August 2009, it issued the Registration of Sharia Advisers Guidelines under s.377 of the Capital Markets and Services Act 2007. This Guideline specifically provides rules and procedures for registration of Sharia advisers in matters regulated and supervised by the Securities Commission.⁴

Conclusion

Sharia governance adds additional values to the existing corporate governance framework in IFIs. With this motivation, Malaysia has extensively facilitated the implementation of Islamic finance by enhancing regulatory framework pertinent to Shariah governance. The Central Bank **J.I.B.L.R. 108* of Malaysia Act 2009 was passed by the parliament to further enhance and improve the Sharia governance framework in IFIs particularly in the aspect of reference for Sharia rulings, functions of the SAC, method of appointment and fit and proper criteria of the SAC members and legal status of the SAC's Sharia pronouncements. It is strongly believed that the CBA would be able to provide a clear and precise governance framework and best practices to facilitate the creation and optimise a healthy and viable environment for the Sharia governance system without impeding further growth of the Islamic finance industry in Malaysia.

J.I.B.L.R. 2010, 25(3), 105-108

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1. IFSB, *Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services* (Kuala Lumpur: IFSB, 2009).
 2. The term Sharia board has been used interchangeably with other names such as Sharia committee, Sharia Advisory Body, Sharia Advisory Council, Sharia Control Board, Sharia Adviser, Sharia Control Committee, Sharia Controller, Sharia Council and Religious Committee. In Malaysia, the term Sharia Committee refers to Sharia board at individual IFI level and Sharia Advisory Council represents the Sharia board at the Central Bank of Malaysia.
 3. AAOIFI, *Governance Standard for IFIs, No.1, Sharia Supervisory Board (SSB): Appointment, Composition and Report* (Bahrain: AAOIFI, 2005).
 4. Securities Commission, *Registration of Sharia Advisers Guidelines* (Kuala Lumpur: Securities Commission, 2009).