Legal Aspects of Islamic Finance

LCA4592

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Contents

- Shari’ah Governance framework
- AAOIFI
- IFSB
Section 3 (5) of the IBA

(5) The Central Bank shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless the Central Bank or the Minister, as the case may be, is satisfied—

(a) that the aims and operations of the banking business which it is desired to carry on will not involve any element which is not approved by the Religion of Islam; and

(b) that there is, in the articles of association of the bank concerned, provision for the establishment of a Syari’ah advisory body, as may be approved by the Central Bank, to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.
Section 13A (1)

13A. (1) An Islamic bank may seek the advice of the Syariah Advisory Council on Syariah matters relating to its banking business and the Islamic bank shall comply with the advice of the Syariah Advisory Council.

(2) In this section, “Syariah Advisory Council” means the Syariah Advisory Council established under subsection 16B(1) of the Central Bank of Malaysia Act 1958.
124. (3) Any licensed institution carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business may, from time to time seek the advice of the Syariah Advisory Council established under subsection (7), on the operations of its business in order to ensure that it does not involve any element which is not approved by the Religion of Islam.
Pre-CBA 2009

- Affin Bank v Zulkifli Abdullah: It is not a question of shariah law. It is the conclusion of this court. There is no necessity to refer the question to another forum.

- Arab Msian Merchant v silver concept: s 16B does not make reference to the sac mandatory. Only binding to the arbitrator.
S 51 (1) The Bank may establish a Shariah Advisory Council on Islamic Finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business

(2) The Shariah Advisory Council may determine its own procedures
S 52 of the CBA

- S 52: *(a)* to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part;

- *(b)* to advise the Bank on any Shariah issue relating to Islamic financial business, the activities or transactions of the Bank;
(c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and

(d) such other functions as may be determined by the Bank
Reference to SAC

- The court or arbitrator shall (a) take into consideration any published rulings of the Shariah Advisory Council; or
- (b) refer such question to the Shariah Advisory Council for its ruling.
- (2) Any request for advice or a ruling of the Shariah Advisory Council under this Act or any other law shall be submitted to the secretariat.
Tan Sri Khalid Ibrahim v Bank Islam Malaysia Berhad [2009] 6 MLJ 416

- *Tan Sri Khalid Ibrahim v Bank Islam Malaysia Berhad*, for the first time in the history of the Malaysian court that the High Court judge made reference to the SAC for confirmation of the *Shari’ah* status of the agreement.

- Bba is recognized form of transaction.
Bimb v lim kok hoe

- The ct will have to assume that the sac and the sc would have discharged their duty to ensure that the operation of islamic banks are complied with the syariah.

- The judge should not have taken upon himself to rule otherwise without having regard the view of the sac.
Effect of Rulings

- **S 57** Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.

- **58.** Where the ruling given by a Shariah body or committee constituted in Malaysia by an Islamic financial institution is different from the ruling given by the Shariah Advisory Council, the ruling of the Shariah Advisory Council shall prevail.
The SGF consists of two parts and one appendix with part I consists of five sections and part II, six sections. Part I provides an overview of Shari’ah governance consisting of objectives, scope of application, legal provision, effective date and compliance deadline and approach. Part II details out the Shari’ah governance arrangements and these include general requirement for Shari’ah governance framework, oversight, accountability and responsibility, independence, competence, confidentiality and consistency and Shari’ah compliance and research functions. All IFIs licensed under the IBA, the BAFIA, the DFIA and the TA are required to comply with the SGF.
Objectives

- (i) sets out the expectations of the Bank on an IFI’s Shariah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Shariah;

- (ii) provides a comprehensive guidance to the board, Shariah Committee and management of the IFI in discharging its duties in matters relating to Shariah; and

- (iii) outlines the functions relating to Shariah review, Shariah audit, Shariah risk management and Shariah research
Framework

(i) the board oversight on Shariah compliance aspects of the IFI’s overall operations.

(ii) a Shariah Committee with qualified members

(iii) effective management responsibilities in providing adequate resources and capable manpower

(iv) an internal Shariah review

(v) a regular Shariah audit, at least on an annual basis,

(vi) a Shariah risk management process

(vii) an internal Shariah research team

(viii) issuance and dissemination of Shariah decisions
In terms of appointment of the Shari’ah board, section 3.8 mentions that the BOD of IFIs upon recommendation of its Nomination Committee should appoint the members of the SHC and subject to the approval of the BNM and the SAC. Appendix 2 on qualification requires the Shari’ah board members to at least either have qualifications or possess the necessary knowledge, expertise or experience in Islamic jurisprudence or Islamic commercial law.

To ensure that the SHC is able to function effectively, the SHC should consist of a minimum of five members and its activities and functions will be coordinated by the Shari’ah secretariat of the respective IFIs (section 2.3).
With the purpose of mitigating the risk of potential of conflict of interest and confidentiality issues, IFIs are not allowed to appoint any member of the SC in another IFI of the same industry (section 5.4).

Appendix 2 on disqualification provides that an SHC member may be disqualified if he fails to satisfy that he is fit for the position, fails to attend 75% of meetings in a year without reasonable excuse, has been declared bankrupt, or a petition under bankruptcy laws is filed against him, was found guilty for any serious criminal offence or any other offence punishable with imprisonment of one year or more, or is subject to any order of detention, supervision, restricted residence or banishment.
Appendix 4 of the SGF provides the clear duties and responsibilities of the SHC and these include: to advise the BOD on Shari’ah matters in its business operations; to endorse Shari’ah compliance manuals; to endorse and validate relevant documentations; to assist related parties on Shari’ah matters for advice upon request; to advise on matters to be referred to the SAC; to provide written Shari’ah opinions; and to assist the SAC on reference for advice.
The SHC is legally required to produce a *Shari’ah report* expressing their observations on IFIs’ compliance with *Shari’ah principles* as illustrated in Appendix 3 of the SGF. In this aspect, the BNM/GP8-i specifies the minimum requirements of the *Shari’ah report*. The BNM/GP8-i requires content of the *Shari’ah report* to be at least, declaration of *Shari’ah compliance* endorsed by the *Shari’ah committee* members.

In terms of reporting structure, the SHC will report functionally to the BOD as this reflects the status of the SHC as an independent body of the IFIs. The BOD is bound by any decision of the SHC and they have to consider their views on certain issues related to operational matters, policy or business transactions.
# Guidelines on CG for IFIs

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<thead>
<tr>
<th>IFSB</th>
<th>AAOIFI</th>
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<tr>
<td>- 10 prudential standards for IFIs, 2 for capital adequacy requirements, 1 for risk management and 7 for governance, disclosure and supervisory review process</td>
<td>- 81 standards and guidelines which include 25 accounting standards, 6 auditing standards, 7 governance standards, 41 <em>Shari’ah</em> standards and 2 codes of ethics.</td>
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<td>- Guiding Principles on CG for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (<em>Takaful</em>) Institutions and Islamic Mutual Funds)</td>
<td>- Shari’a Supervisory Board: Appointment, Composition and Report;</td>
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<td>- Guiding Principles on Governance for Islamic Collective Investment Schemes,</td>
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<td>- Guiding Principles on Governance for <em>Takaful</em> (Islamic Insurance) Undertakings</td>
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<td>- Guiding Principles on Governance for Takaful Operations</td>
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<td>- Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services</td>
<td>- Independence of Shari’a Board</td>
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<td>- Guiding Principles on <em>SG</em> System for Institutions offering Islamic Financial Services</td>
<td>- Statement on Governance Principles for IFIs</td>
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<td>- Corporate Social Responsibility</td>
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(i) Governance Standard for IFIs No. 1: Sharī'ah Supervisory Board: Appointment, Composition and Report

It consists of eight parts, namely introduction, definition, appointment, composition, selection and dismissal, basic elements of report, publication of the report, publication of Sharī'ah rulings and guidelines, and the effective date. Section 2 represents the most important provision in Governance Standard No.1. It has three elements which define the term ‘Sharī'ah board’. Firstly, a Sharī'ah board is an independent body of specialized jurists in fiqh al mu'amalāt. This section allows the appointment of Sharī'ah board members who are not specialized in fiqh al mu'amalāt but who are expert in the field of Islamic finance. Secondly, it elaborates the role of the Sharī'ah board to ensure compliance with Sharī'ah principles by having the authority to direct, review and supervise the activities of IFIs. Thirdly, it indicates the binding authority of the Sharī'ah board upon the IFIs.
Governance Standard for IFIs No. 2: *Sharī ah* Review

It consists of eight parts with eighteen sections. Section 3 explains the *Sharī ah* review as an examination of the extent of the IFIs’ *Sharī ah* compliance. Section 5 puts the responsibility for compliance upon the management.

The *Sharī ah* board is only responsible for forming and expressing opinions on the extent of *Sharī ah* compliance. Sections 7–13 detail the *Sharī ah* review procedures, which involve planning, designing, executing, preparing and reviewing. The *Sharī ah* review report should be submitted to the AGM.
Governance Standard for IFIs No. 3: Internal Ḫarīthah Review

It consists of eleven parts and thirty sections which complement Governance Standard No. 2. Standard No. 3 aims at establishing standards and guidance on the internal Ḫarīthah review.

As the management of IFIs is responsible for the extent of Ḫarīthah compliance, it is incumbent upon them to have a proper mechanism of internal Ḫarīthah review. While the AAOIFI requires IFIs to carry out an internal Ḫarīthah review, it does not specify the requirement of establishing a separate internal Ḫarīthah audit department.

The internal Ḫarīthah review can be carried out by either an independent department or part of the internal audit division.
Governance Standard for IFIs No. 4: Audit and Governance Committee

To complement the corporate governance framework for IFIs, the AAOIFI strongly recommends the establishment of an Audit and Governance Committee (AGC) at the board level.

The AGC should consist of a minimum of three members, appointed by the BOD from its non-executive and independent board members, who are knowledgeable about the affairs of the institution and applicable regulations and laws, including Sharī'ah rules and principles.
Governance Standard for IFIs No. 5: Independence of *Sharīʿah* Board

- guidelines for its independence and mechanisms to resolve issues of independence.
- The state of independence of the *Sharīʿah* board is of the essence in enhancing public confidence on the aspect of *Sharīʿah* compliance. Section 3 restricts the *Sharīʿah* board to subordinating their judgment on *Sharīʿah* supervision to third parties. The *Sharīʿah* board is not recommended to consist of employees of the same IFIs or be involved in managerial decisions and operational responsibilities. The *Sharīʿah* board is required to conduct continuous assessment of the IFIs and do anything necessary to resolve any issues of independence impairment.
SG:
The set of institutional and organizational arrangements: This refers to the \textit{Shar	extipa{\textae}h} board and its related institutions, such as an internal audit department and \textit{Shar	extipa{\textae}h} division.

Effective independent oversight of \textit{Shar	extipa{\textae}h} compliance: This indicates the aims and objectives of the \textit{Shar	extipa{\textae}h} governance system to provide efficient mechanisms for the purpose of \textit{Shar	extipa{\textae}h} compliance.

\textit{Shar	extipa{\textae}h} pronouncements, dissemination of information and an internal \textit{Shar	extipa{\textae}h} compliance review: This involves the overall \textit{Shar	extipa{\textae}h} governance processes that cover both \textit{ex ante} and \textit{ex post} aspects of the \textit{Shar	extipa{\textae}h} compliance framework.
### Key Elements

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<th>Principle</th>
<th>Operational Framework</th>
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<td><strong>Competence</strong></td>
<td>Fit and proper criteria</td>
<td><em>Ex ante</em>: Screening process &lt;br&gt; <em>Ex post</em>: Review and assessment</td>
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<td>Professional training</td>
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<td>Formal assessment</td>
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<td><strong>Independence</strong></td>
<td>Adequate capability to exercise objective judgment</td>
<td><em>Ex ante</em>: Appointment, disclosure and full mandate &lt;br&gt; <em>Ex post</em>: Review and assessment</td>
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<td>Complete, adequate and timely information</td>
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<td><strong>Confidentiality</strong></td>
<td>Strictly observe the confidentiality</td>
<td><em>Ex ante</em>: Undertaking secrecy &lt;br&gt; <em>Ex post</em>: Review and assessment</td>
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<td><strong>Consistency</strong></td>
<td>Fully understand the legal and regulatory framework strictly observes the said framework</td>
<td>There must be consistency in all <em>ex ante</em> and <em>ex post</em> Sharīah governance processes</td>
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Thank You

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