Regulatory Framework of Shariah Governance

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  - IBA 1983
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Since establishment of first Islamic bank in 1983, Shariah governance has developed gradually to strengthen Shariah compliance

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<td>2010</td>
<td>Shariah Governance Framework for Islamic Financial Institutions</td>
<td>Shariah Compliance and Shariah Governance provisions specifically covered under Section 27 to Section 38 of the Act.</td>
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<td>2009</td>
<td>Central Bank of Malaysia Act 2009</td>
<td>Set out the expectation of BNM on Shariah governance structures, processes and arrangements, duties and responsibilities of Board, management and Shariah committee as well as Shariah compliance functions to ensure Shariah compliance.</td>
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<td>2004</td>
<td>Guidelines on the Governance of the Shariah Committee for Islamic Financial Institution</td>
<td>Provides specific clauses on Shariah Advisory Council in the Sections 51 to 58 as well as the power of BNM to issue guidelines on Shariah matters in Section 59.</td>
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<td>1983</td>
<td>Islamic Banking Act 1983</td>
<td>Provides the duties and responsibilities of the internal Shariah Committee in advising the respective IFIs on Shariah matters (superseded by the Shariah Governance Framework for Islamic Financial Institutions)</td>
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</table>
BNM Shariah Governance Framework (2011) proposed the model of Shariah governance framework for IFI operating in Malaysia.
Section 3 (5) of the IBA (No longer relevant)

(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) (No longer relevant)

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.
Sec 124 of the BAFIA (no longer relevant)

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.
“Shariah Advisory Council” means the Shariah Advisory Council on Islamic finance established under section 51 of the Central Bank of Malaysia Act 2009;

“Shariah committee” means the Shariah committee of an institution established pursuant to section 30;
Part IV Shari’ah Requirements of the IFSA

S28. (1) An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah.

(2) For the purposes of this Act, a compliance with any ruling of the Shariah Advisory Council in respect of any particular aim and operation, business, affair or activity shall be deemed to be a compliance with Shariah in respect of that aims and operations, business, affair or activity.
S 29 of the IFSA

(a) Shariah governance including—

(i) functions and duties of the board of directors, senior officers and members of the Shariah committee of an institution in relation to compliance with Shariah;

(ii) fit and proper requirements or disqualifications of a member of a Shariah committee; and

(iii) internal Shariah compliance functions; and

(b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shariah.
30. (1) A licensed person shall establish a Shariah committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Shariah.

31. No person shall be appointed, reappointed or accept any appointment as a member of a Shariah committee unless such person meets the requirements as set out in any standards as may be specified by the Bank under subparagraph 29(2)(a)(ii) and has obtained the prior written approval of the Bank.
To ensure strict adherence to the Shariah, IFSA 2013 imposed severe punishment on non-compliance to the Act.

**Financial**
- Shariah non-compliant income due to invalidation of contract (‘aqad)
- Capital adequacy ratio (CAR) impact

**Non-Financial**
- Against the commands of Allah SWT
- Impediment of Allah’s SWT blessing or barakah
- Jeopardize business reputation

**Contravention of the Islamic Financial Services Act 2013:**

Section 28(5) of the Act provides
- Imprisonment for a term not exceeding **eight years**; or
- Fine not exceeding **twenty-five million ringgit**; or both.
Section 28 (3) of Islamic Financial Services Act 2013:

Where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah or the advice of its Shariah Committee or the advice or ruling of the Shariah Advisory Council, the institution shall:

(a) Immediately notify the Bank and its Shariah Committee of the fact;

(b) Immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and

(c) Within thirty days of becoming aware of such non-compliance or such further period as may be specified by the Bank, submit to the Bank a plan on the rectification of the non-compliance.
Accountability of Board, SC and Management in Non-Shariah Compliant event

Actual Shariah Non-Compliance (SNC) Event

1. Report on actual SNC shall be submitted to BNM on an “immediate” basis as and when necessary.

2. Within the 14 days required to obtain the confirmation from the SSC.

3. The Bank is required to submit to BNM the rectification plan (approved by the Board and SSC) within 30 days after the confirmation by SSC.

4. In the event that no Board meeting will be held within such 30 days, the Bank is required to exhaust other means to obtain the Board’s approval on the rectification plan prior to submission to BNM.

*Note: “Immediate” is defined as within 14 working days upon realization of the event*
Pre-CBA 2009

- **Affin Bank Berhad v Zulkifli Abdullah** [2006] 3 MLJ 67:
  - 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 Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd** [2005] 5 MLJ 210:
  - s 16B does not make reference to the SAC mandatory.
  - Only binding to the arbitrator.
Central Bank of Malaysia Act 2009

SAC

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;
S 52 of the CBA

- (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.
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.
The court 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.
(Mohd Zawawi J):

- It is settled law that ss 56 and 57 of the Act are valid federal laws enacted by Parliament and as such were not in contravention of the FC.

- Difference of opinion on Shariah issues relating to Islamic banking should be resolved within the SAC. It is advisable and practical that a special body like the SAC should ascertain the Islamic law most applicable to the Islamic banking industry in Malaysia.
Counsel for the bank contended that in a BBA contract the Bank has a legal right to claim for the full sale price as stipulated in the Property Sale Agreement, as.

The HC observed that in specifying the amount due, the issue which confronts a BBA contract is the agreement is silent on:

Since the tenure of the contract has not completed, normally the bank will further deduct as ibrar (a term used in Islamic banking for rebate) what it refers to as ‘unearned profit‘, i.e. the amount which has yet to be earned by the bank, based on an Amortization table.

when a BBA contract is prematurely terminated upon default by the borrower, the court cannot allow the bank to enforce the payment of the full sale price in a premature termination:
The plaintiff must know of the imposition of Ta’widh so that consent could be given freely. Obviously, the plaintiff in this case did not know the imposition of Ta’widh on the financing facility granted to it.

At the time the agreements were entered into Ta’widh was not practised by the IFI. Ta’widh was only introduced after the SAC’s Resolution in 1998. The said resolution was to take effect only on 1 January 1999 to existing and new agreements. Therefore, Ta’widh shall be applicable only on or after 1 January 1999.
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.
Shariah Governance Framework

Set of process, guidelines, standards or rules outline by BNM that defines the activity/operation/grant power or performance to be undertaken by Islamic Financial Institutions in relation to its Islamic financing activities.

To regulate the practices and operation of Islamic FIs in relation and ensures Shariah compliance.
Nevertheless, where the Shariah governance framework and the standards are not adopted, the following concerns of the industry is still persistent. Apart from that, in many jurisdictions, various concerns on legal risks are not addressed too.
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 IFIs 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.
### IFSB

- 10 prudential standards for IFIs, 2 for capital adequacy requirements, 1 for risk management and 7 for governance, disclosure and supervisory review process
- Guiding Principles on CG for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
- Guiding Principles on Governance for Islamic Collective Investment Schemes,
- Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings
- Guiding Principles on Governance for Takaful Operations
- Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services
- Guiding Principles on SG System for Institutions offering Islamic Financial Services

### AAOIFI

- 81 standards and guidelines which include 25 accounting standards, 6 auditing standards, 7 governance standards, 41 Shari’ah standards and 2 codes of ethics.
- Shari’ah Supervisory Board: Appointment, Composition and Report;
- Shari’ah Review
- Internal Shari’ah Review
- Audit and Governance Committee
- Independence of Shari’ah Board
- Statement on Governance Principles for IFIs
- Corporate Social Responsibility
■ (i) Governance Standard for IFIs No. 1: Sharīʻah 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 Sharīʻah 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 ‘Sharīʻah board’. Firstly, a Sharīʻah board is an independent body of specialized jurists in fiqh al muāmalāt. This section allows the appointment of Sharīʻah board members who are not specialized in fiqh al muāmalāt but who are expert in the field of Islamic finance. Secondly, it elaborates the role of the Sharīʻah board to ensure compliance with Sharīʻah principles by having the authority to direct, review and supervise the activities of IFIs. Thirdly, it indicates the binding authority of the Sharīʻah board upon the IFIs.
Governance Standard for IFIs No. 2: *Sharīʿah* Review

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

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

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

The internal Sharī‘ah 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 Shariah rules and principles.
Governance Standard for IFIs No. 5: Independence of Sharī‘ah Board

- guidelines for its independence and mechanisms to resolve issues of independence.

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

Effective independent oversight of Sharī‘ah compliance: This indicates the aims and objectives of the Sharī‘ah governance system to provide efficient mechanisms for the purpose of Sharī‘ah compliance.

Sharī‘ah pronouncements, dissemination of information and an internal Sharī‘ah compliance review: This involves the overall Sharī‘ah governance processes that cover both ex ante and ex post aspects of the Sharī‘ah compliance framework.
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<td>Formal assessment</td>
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<td>Independence</td>
<td>Adequate capability to exercise objective judgment</td>
<td><em>Ex ante:</em> Appointment, disclosure and full mandate</td>
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<td><em>Ex post:</em> Review and assessment</td>
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<td>Complete, adequate and timely information</td>
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<td>Confidentiality</td>
<td>Strictly observe the confidentiality</td>
<td><em>Ex ante:</em> Undertaking secrecy</td>
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<td><em>Ex post:</em> Review and assessment</td>
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<td>Consistency</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> <em>Sharīah</em> governance processes</td>
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