

Sharī'ah Governance Framework Model for Malaysian Islamic Banking and Finance: A Critical Analysis

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Abstract: *The models of Sharī'ah supervisory governance differ from one country to another. In some countries, there is central Sharī'ah Supervisory Boards at Central Bank level such as Malaysia. Whereas, in other countries, there are the Sharī'ah Supervisory Boards at bank level only, such as Bahrain. Therefore, this paper discussed the model of Sharī'ah governance for Islamic banking and finance in Malaysia. It explained the establishment of Sharī'ah Boards for Islamic bank and finance in Malaysia as well as the process of appointing Sharī'ah governance board for IFIs in Malaysia. Moreover, the Sharī'ah governance in Islamic bank in Malaysia and legal framework was analysed. The study concluded by identifying Malaysia as a strong proponent of regulation-based model.*

Keywords: *Sharī'ah Governance, Framework, Model, Malaysian, Islamic Banking and Finance, Critical Analysis*

I. Introduction

The issue of Sharī'ah Governance in Islamic finance is given the attention when the Islamic finance industry arose. Moreover, Islamic finance industry has been widely progressing not only in Muslim countries but also in non-Muslim countries. Due to the emergence of the Islamic finance industry, there is a need for the Sharī'ah governance guidelines to mode the Islamic financing practices. However, it has been well known that conventional financial system is based on the interest, uncertainty and gambling which are prohibited in Islam. As an alternative, Islamic finance system has been proposed by the Muslim scholars and its growth is tremendous since it has first been introduced.

Besides, since the emergence of the Islamic finance industry is to implement Sharī'ah compliance, the role of Sharī'ah governance play a significant role in the industry to ensure that it meets the objective of the Islamic financial industry and the tools that can be used to meet the unique needs of Islamic finance. Sharī'ah governance principles and codes in Islamic banks have been developed in different countries, although, there is no single recognised best model of Sharī'ah governance. Therefore, model of Sharī'ah governance in Malaysia will be analysed in this paper in order to examine whether there is any significant difference their practices.

II. Establishment of Sharī'ah Boards for Islamic Bank and Finance in Malaysia

Malaysia has a very unique legislative framework consisting of mixed jurisdictions and mixed legal systems namely common law and the Sharī'ah. The common law principles were applied in the civil court in almost matter of jurisdiction. Islamic law in contrast is practised in the Sharī'ah court and only pertaining to the family matters and law of inheritance. The Federal Constitution puts Islamic banking matter under the jurisdiction of the civil court. This is due to the fact that Islamic banking is considered as under the item 'finance' in the Federal Constitution. As a matter of fact, Central Bank of Malaysia with a cooperation of judicial body has agreed to set up a special High Court in the Commercial Division known as the *Mu'amalah* bench. According to Practice Direction No.1/2003, paragraph 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.¹

The development of Islamic banking industry in Malaysia involved several phases whereby Phase 1 started in 1983 until 1993 and Second Phase began in 1994. Malaysia has liberalised its policy on the implementation of Islamic finance by allowing foreign entities to set up Islamic banks in the local market. These staggered developments are facilitated and supported by legal infrastructure through several legislations and directives namely the Islamic Banking Act 1983 (IBA), the Takaful Act 1984, both now replaced by IFSA 2013, the Banking and Financial Institutions Act 1989 (BAFIA) which has been replaced by FSA 2013. The Central Bank of Malaysia Act 2009 and the Securities Commission Act 1993.² On 30 July 1981, a 20-member National

¹ The implementation of this *Mu'amalah* bench shows a positive result on the increasing numbers of viewed cases. From the statistic, it shows that more than 81% out of 3185 cases has been viewed by the court from year 2003 to 2009. See, Hakimah, Y. Analysis of Legal Disputes in Islamic Finance and the Way Forward: With Special Reference to a Study Conducted at *Mu'amalah* Court, Kuala Lumpur, Malaysia. ISRA, 2011), at. 9.

² Hasan Z. Regulatory Framework of Sharī'ah Governance System in Malaysia, GCC Countries and the UK, 2010, at 85.

Steering Committee of Islamic Banks was established. The Committee proposed recommendations to the Government on 5 July 1982: These are:

1. An Islamic bank should operate under *Sharī'ah* principles;
2. An Islamic bank should be incorporated as a limited company under the Companies Act 1965;
3. The Central Bank should monitor and supervise the Islamic bank; and
4. An Islamic bank should have a Religious Supervisory Council to ensure that the bank's operations are in accordance with the *Sharī'ah*.

Following these recommendations, the Islamic Banking Act 1983 was promulgated. Under this Act, it was compulsory for Islamic banks to have their own Religious Supervisory Council with a minimum of three and a maximum of seven Muslim religious scholars. The Council's role was to advise the Islamic bank on its operations and transactions.³ The first *Sharī'ah* Board that has been set up was in 1983 by Bank Islam Malaysia Berhad. After 10 years, on 4 March 1993, BNM introduced an interest-free Banking Scheme in which conventional banks may offer Islamic banking products through its windows. With that policy, many conventional banks set up their Islamic windows and at the same time they appoint selected Muslim scholars to be members of the *Sharī'ah* Board. As part of the effort to streamline and harmonise the *Sharī'ah* interpretations amongst banks and Takaful companies, the *Sharī'ah* Advisory Council was established on 1st May 1997 under the BAFIA where it is considered as the highest *Sharī'ah* authority pertaining to Islamic banking, finance and takaful in Malaysia.⁴

The term *Sharī'ah* Committee or *Sharī'ah* Supervisory Council or *Sharī'ah* Advisory Council has been used interchangeably in Malaysia. The S.5 of former IBA refers the *Sharī'ah* Board as SAB and the old BAFIA as *Sharī'ah* Advisory Council. With the issuance of the BNM/GPS1 in 2004, all *Sharī'ah* Board of IFIs and Takaful operators are recognised as *Sharī'ah* Committee (SC) and the SAC is used as a reference to *Sharī'ah* Board of the BNM. The establishment of the SC is a statutory requirement to all banks which offer Islamic banking products pursuant to section 30 (3) of the IFSA 2013 for Islamic banks and section 15 (7) (b) of the FSA 2013 for Islamic banking scheme bank. The main objective of the establishment of the SC is to advise the Islamic financial institutions on any *Sharī'ah* matter and to ensure compliance with the *Sharī'ah* tenets and requirements.⁵

Section 3 (5) (b) of old IBA provides that the BNM shall not recommend the grant of a license, and the Minister shall not grant a license, unless he is satisfied that there is, in the Articles of Association of the bank concerned, provision for the establishment of SAB. The prime task of the SC is, in fact to further define, expand and in some cases to limit the scope of Section 2 of the IBA which is left opened for interpretation. In responding to the positive demands of the conventional banks to open Islamic counters, Section 124 (7) of the BAFIA was then introduced which provides for the establishment of the SAC to advise the bank relating to Islamic banking business or Islamic financial business. As for Takaful, section 8 of the former Takaful Act 1984 provides that the Director General shall also refuse to register an applicant unless he is satisfied:

(a) that the aims and operations of the Takaful business which it is desired to carry on will not involve any element which is not approved by the *Sharī'ah*; and

(b) that there is in the Articles of Association of the Takaful operator concerned provision for the establishment of a *Sharī'ah* advisory body, as may be approved by the Director General, to advise an operator on the operations of its Takaful business in order to ensure that it does not involve in any element which is not approved by the *Sharī'ah*.

In 2003, section 13A was added to the IBA which provides for reference by the Islamic banks to the SAC on *Sharī'ah* matters. It further provides that they shall comply with the advice of the SAC. Section 13A further defines "*Sharī'ah* Advisory Council" to mean the *Sharī'ah* Advisory Council established under Section 16B (1) of the Central Bank of Malaysia Act 1958. Section 13A of the IBA must therefore be read together with Section 16(B)(1) of the CBMA 1958.⁶ Under Section 16B, the SAC has been conferred with a statutory function that it shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, among others, based on *Sharī'ah* principles and advisory powers to the SAC over the Islamic banks, creates a common understanding between the *Sharī'ah* advisory bodies and the SAC.⁷

³Shanmugam B. Governance Issues and Islamic Banking. In Corporate Governance: An Islamic Paradigm, Volume 3, Issue 37 retrieved from <http://www.eurekahedge.com/news/06_dec_IFN_Governance_Issues_and_Islamic_banking.asp> accessed on 14/1/2014.

⁴Section 124 (7) of the BAFIA.

⁵Chapter 1 of Part VII, sections 52(B) CBMA, 2009.

⁶Section 16(B) (1) was introduced by the Central Bank of Malaysia (Amendment) Act 2003 which came into force on 1 January 2004.

⁷Norhashimah M.Y. The Legal Issues Related to the *Sharī'ah* Advisory Council of Central Bank of Malaysia (BNM). Paper presented at the International Conference of Law and Society 1 (ICLAS 1) co-organised by Faculty of Law, Universitas Muhammadiyah Yogyakarta and Hurun M. Hashim Law Central, AIKOL, IIUM on the 16th February 2013, Yogyakarta, Indonesia, at 3. In Cases and Materials on Islamic Banking Compiled. (IIUM n.p, n.d)

Generally, the amendment to the Central Bank of Malaysia Act 1958 in 2003 - 2009 enhances the role of the SAC. Now, the SAC is accorded to be the sole authoritative body on *Sharī'ah* matters pertaining to Islamic finance. The amendment provides that the BNM may establish an advisory council which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, Takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on principles and is supervised and regulated by the BNM. Due to several controversial court cases involving IFIs, with the initiative of the BNM, the CBMA was passed in July 2009. Chapter VII section 51-58 specifies the *Sharī'ah* governance framework of the SAC. This new Act confirms the status of the SAC as the highest authority in matters pertaining to Islamic banking, finance and Takaful. In addition, it clarifies the position of the *Sharī'ah* pronouncement and the SAC's deliberation to be binding upon the court as well as arbitration.⁸ The case of *Tan Sri Abdul Khalid Ibrahim v. Bank Islam Malaysia Bhd & Another*⁹ can illustrate on this, when the court referred to the earlier decisions that it is clear that the SAC was established as the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, takaful business and Islamic financial business. Also, decision of Court of Appeal in the case of *Bank Islam Malaysia Bhd v. Lim Kok Hoe & Anor & Other Appeals*.¹⁰

III. The Process Of Appointing *Sharī'ah* Governance Board For IB In Malaysia

The *Sharī'ah* governance board process represents the instrumental function of the *Sharī'ah* Board as part of the institution of corporate governance of IFIs. In actual practice, numerous IFIs appoint members of their *Sharī'ah* Committee through their BODs, as in the case of Malaysia part 2 section 1 of the BNM/RH/GL_012_3 places the power of appointment in the hands of the IFIs upon recommendation of its nomination committee and by obtaining prior written of BNM. The power of appointment of *Sharī'ah* Board members at the central bank level is vested in the government. The *Sharī'ah* board of BNM is appointed by the Yang di-Pertuan Agong (King), on the recommendation of the finance minister pursuant to the Central Bank of Malaysia Act 2009.¹¹ Moreover, by and large, most IFIs appoint between three and six members for the SC. The SCs comprises less than 20 members who are appointed by the Board of Trustees for a four-year term from among *Sharī'ah* scholars, as section 2 of the BNM/RH/GL_012_3 puts a condition of a minimum of three members and further requires the IFIs to set up a *Sharī'ah* secretariat to ensure the effective function of the *Sharī'ah*.¹²

Table 4.1

Two-Tier *Sharī'ah* Governance Framework Infrastructures

<i>Sharī'ah</i> Advisory Council , National Level (BNM)	<i>Sharī'ah</i> Committee, Industrial Level (IFIs)
<ul style="list-style-type: none"> ➢ Centralised <i>Sharī'ah</i> Advisory Council at BNM ➢ Established under Sec 51 of CBMA 2009 ➢ Apex authority for determination of Islamic law in Islamic Financial business ➢ Mandates : <ul style="list-style-type: none"> ✓ ascertain the Islamic law on any financial matter & issue a ruling upon reference made to it ✓ Advise BNM & IFI on any <i>Sharī'ah</i> issue relating to Islamic financial business operations, activities or transactions 	<ul style="list-style-type: none"> ➢ <i>Sharī'ah</i> Advisors at the respective IFIs ➢ Appointed by BOD of IFI ➢ Have an active role in: <ul style="list-style-type: none"> ✓ Advising the IFIs on <i>Sharī'ah</i> matters ✓ Monitoring activities & operations of the IFIs ✓ Developing products ✓ Providing training & awareness programme ✓ Representing the IFIs in forums etc ✓ Conducting <i>Sharī'ah</i> audit exercise for the IFIs

Relationship between *Sharī'ah* Advisory Council (SAC) of Bank Negara Malaysia and *Sharī'ah* Committees of the IFIs

The *Sharī'ah* committees are independent bodies which report directly to the Board of directors of the respective bank. The Board of Directors must ensure that the *Sharī'ah* committee of the IFI's can operate independently. The board of directors will be ultimately responsible to ensure that the *Sharī'ah* governance

⁸SAC.SAC Streamlines Registration of *Sharī'ah* Advisers, (2009). Retrieved from <<http://www.sc.com.my/main.asp?pageid=379&linkid=2256&yearno=2009&mod=paper>>. Accessed on 26th January, 2014.

⁹[2010] 4 CLJ 388 (HC).

¹⁰[2009] 6 CLJ 22.

¹¹BNM/RH/GL_012_3.*Sharī'ah* Governance Framework for Islamic Financial Institutions.(Islamic Banking and Takaful Department, 2010), at. 10-13.

¹²Dasuk A.W, et, al., (Ed). Islamic Financial System Principle & Operations (2012), at. 714-15.

structure is implemented and that the operations and products of the IFI are *Sharī'ah*compliant.¹³ In ensuring the *Sharī'ah*compliance of the operations and products of the IFI, the BODs relies on its *Sharī'ah*Committee. Therefore, the appointed *Sharī'ah*committee of the respective financial institution shall be responsible for its decisions, views and opinions related to *Sharī'ah*matters. The BODs appoints the members of *Sharī'ah*committee on the prior recommendation of its Nomination Committee.

The management of the Islamic financial institution is obliged to refer any *Sharī'ah*issues to the *Sharī'ah*committee and the rulings by the *Sharī'ah*committee as well as SAC of BNM are to be followed and implemented by the management of the IFI.¹⁴ The harmonious relationship between the *Sharī'ah*committees of the IFIs and SAC of the BNM is expected. Nevertheless, in the event that the rulings in relation to the *Sharī'ah*aspect of the financial matters given by the *Sharī'ah*committee of the IFIs differs from the ruling issued by the SAC of BNM, S. 58 of the CBMA provides that the SAC's ruling shall prevail and shall bind the *Sharī'ah*committee of the IFIs.¹⁵ In this manner, the harmonisation in the IFIs would be achieved at the state level.

IV. *Sharī'ah*governance In Islamic Bank In Malaysia And Legal Framework

From the foregoing studies, it is observed that there is a need to analyse the effect of Banking Acts on *Sharī'ah*Advisory Council for Islamic bank and finance which are the main legal constraint and which could be said to resolve the legal system of Malaysia where Islamic banking is being operated. Therefore, this part will examine effects of CBMA 1958 (Act 509) Pre 2009, Post 2009 (Act 701) and IFSA 2013.

***Sharī'ah*Advisory Council and the CBMA 1958 Pre-2009 (Act 509)**

The CBMA was amended in 2003 to insert section 16(B) which provides for the establishment of an Advisory Council which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking, takaful, Islamic financial and Islamic development financial business, or any other business which is based on the *Sharī'ah*principles and is supervised and regulated by the Central Bank of Malaysia. For example, in the subsequent development, by virtue of the decisions of the Court of Appeal in the case of *Bank Islam Malaysia Berhad v Lim Kok Hoe and Anor and Other Appeals*,¹⁶ and the earlier decisions of *Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Bhd & Another case*,¹⁷ when the resolutions of SAC have been restored and that it ought to be referred to by the judges. The 2003 amendment was meant to provide a better position on the National *Sharī'ah*Advisory Council whereby it uplifts the position of Islamic banking and finance in the country. For instance, in the case of *Glencore International AG v Metro Trading International Inc*¹⁸ in which the English Judge, Moore-Bick J, was willing to examine the issue at hand from the viewpoint of *Sharī'ah*with the assistance of experts.

The provision further provides that where in any proceedings relating to Islamic banking business and Islamic financial business which is based on *Sharī'ah*principles before any court or arbitrator any questions arises concerning a *Sharī'ah*matter, the court or the arbitrator may refer such question to the *Sharī'ah*Advisory Council for its ruling. Any ruling made by the *Sharī'ah*Advisory Council pursuant to a reference by a court, will be taken into consideration by the court and if the reference was made by an arbitrator, it will be binding on the arbitrator.¹⁹

***Sharī'ah*Advisory Council and the CBMA Post-2009 (Act 701)**

The Act 701 was passed to provide for the continued existence of the Central Bank of Malaysia and for the administration, objects, functions and powers of the Bank, for consequential or incidental matters. The most significant provision of the newly passed legislation is Part VII under the heading "Islamic financial business".

Part VII is divided into 2 chapters i.e. Chapter 1 *Sharī'ah*Advisory Council (Section 51 to 58)²⁰ and Chapter 2 (Section 59 -60) Powers of the Bank.²¹ Part VII directly provides for the Islamic financial business which is defined under section 2 as any financial business in ringgit or other currency which is subject to the

¹³*Sharī'ah* Governance Framework for Islamic Financial Institutions' issued by BNM. BNM/RH/GL_012_3, at. 21.

¹⁴*Ibid.*

¹⁵Section 58 of the CBMA 2009.

¹⁶ [2008] 9 CLJ 522; see also the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya SdnBhd & Ors; Koperasi Seri Kota Bukit CherakaBhd (Third Party) And Other Cases* [2009] 1 CLJ 449.

¹⁷[2010] 4 CLJ 388 (HC).

¹⁸[2000] EWHC 199 (Comm), [2001] 1 All ER (Comm) 103.

¹⁹Miskam, S., & Nasrul, M.A. *Sharī'ah* Governance In Islamic Finance: The Effects of The Islamic Financial Services Act 2013 paper presented at World Conference on Integration of Knowledge, WCIK 2013. 25-26 November 2013, Langkawi, Malaysia at 457. Available at <http://worldconferences.net/proceedings/wcik2013/toc/papers_wcik2013/WCIK%20112%20SURIANOM_read_shahrul.pdf> accessed on 31/1/2014.

²⁰ Section 51-58 of CBMA 2009.

²¹ Section 59-60 of CBMA 2009.

laws enforced by the Bank and consistent with the *Sharī'ah*.²² The *Sharī'ah* Advisory Council on Islamic Finance shall be established by the Central Bank of Malaysia by virtue of section 51 and the Council shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business. The Council is given authority to determine its own procedures in carrying out their duties under the Act. The functions of the SAC²³ are listed under section 52 and it includes the following:

- (a) to ascertain the Islamic law on any financial matters and issues a ruling upon reference made to it in accordance with Part VII of the Act;
- (b) to advise the Bank on any *Sharī'ah* issues 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 in force in Malaysia; and
- (d) such other functions as may be determined by the Bank.

The members of the *Sharī'ah* Advisory Council shall be appointed from amongst persons who are qualified in the *Sharī'ah* or who have knowledge or experience in the *Sharī'ah* and in banking, finance, law or such other related disciplines and the appointment shall be made by the Yang di-Pertuan Agong on the advice of the Minister of Finance after consultation with the Central Bank as provided by section 53(1). Section 55 further stipulates that the Bank shall consult the *Sharī'ah* Advisory Council on any matter relating to Islamic financial business; and for the purpose of carrying out its functions or conducting its business or affairs under this Act or any other written law in accordance with the *Sharī'ah*, which requires the ascertainment of Islamic law by the *Sharī'ah* Advisory Council.

In executing its duties and responsibilities, the *Sharī'ah* Advisory Council shall examine and endorse the validity of application of *Sharī'ah* in Islamic financial products which are submitted by Islamic financial institutions under the supervision of the Central Bank of Malaysia. Section 55 (2) also provides that any Islamic financial institution in respect of its Islamic financial business, may refer for a ruling; or seek the advice, of the *Sharī'ah* Advisory Council on the operations of its business in order to ascertain that it does not involve any element which is inconsistent with the *Sharī'ah*. The requirement for reference to *Sharī'ah* Advisory Council for ruling from court or arbitrator is expressly provided in section 56 (1) which states that:

“Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a *Sharī'ah* matter, the court or the arbitrator, as the case may be, shall

- (a) take into consideration any published rulings of the *Sharī'ah* Advisory Council; or
- (b) refer such question to the *Sharī'ah* Advisory Council for its ruling.”²⁴

The provision requires the judge or arbitrator who is presiding over any dispute arising from Islamic financial business to refer to the published rulings of the *Sharī'ah* Advisory Council or to request for advice from the Council to determine any issue concerning a *Sharī'ah* matter before them. Any request for advice or ruling of the *Sharī'ah* Advisory Council under this Act or any other law shall be submitted to the secretariat which is established under section 54. In case of conflict between ruling issued by a *Sharī'ah* committee of an Islamic financial institutions and ruling issued by the *Sharī'ah* Advisory Council, the ruling of the *Sharī'ah* Advisory Council shall prevail and be applicable. In order to ensure that any deliberation of the *Sharī'ah* Advisory Council will bind the courts and not only the financial institutions and the arbitrator as provided under the repealed Act, section 57 comes into play. It provides that any ruling made by the *Sharī'ah* Advisory Council pursuant to a reference made under Chapter VII shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.²⁵

For instance, in the case of *Majlis Amanah Rakyat v. Bass Bin Lai*,²⁶ Hamid Sultan J explained the above issue as follows:

“There is a common notion in Malaysia that it is in the hands of Islamic jurists and or *Sharī'ah* advisory Boards to be the sole arbiter to determine whether a *Sharī'ah* financial instrument is *Sharī'ah* compliant. Such a notion is flawed, and support for the proposition can be found in Justice Khan’s report in *Shamil Bank Bahrain v. Beximo Pharmaceuticals Limited & Ors*²⁷ case where it was stated in no uncertain terms, that in *Sharī'ah* there is no option of any person, body or jurist which binds a court in deciding a *Sharī'ah* issue. Further, the court is the supreme body under the Federal Constitution to decide what is right and what is wrong in a given

²²Id., 46.

²³ Unlike in the repealed CBMA 1958 where the functions were left to be determined by Bank Negara as provided for under Section 16(B)(4) which states “The *Sharī'ah* Advisory Council shall have such function as may be determined by the Bank (CBM) and shall determine its own procedure”.

²⁴Section 56(1) of CBMA 2009.

²⁵Dasuk A.W, et. al., (Ed). *Islamic Financial System Principle & Operations* (2012), at. 458.

²⁶[2009] 2 CLJ 433.

²⁷ [2003] EWHC 2118

circumstances. The Federal Constitution does not permit the courts to abdicate its role by submitting to decisions of the lesser bodies or tribunals such as the instant case to *Sharī'ah* supervisory board or fatwas or any purported legislation, rules etc. made thereunder. Having said that, courts will at all times listen respectfully to the views and opinions expressed by these bodies but the final decision maker under the Federal Constitution is none other than the courts. In essence, whether a contract or Islamic product, based on *murābahah* or *al-inah* or *muḍārahah* etc. principle is valid must be decided by the courts. As long as it does not breach the Qur'an prohibition of *ribā* or *gharar* etc., the courts will have no hesitation in upholding the same. It all depends on the terms of the contract and not the concept per se, because, the court is concerned with the terms and not the concept".²⁸

Further to the above, the current position of the SAC is that it is the highest authority for the ascertainment of the Islamic law in relation to the Islamic financial business. It is thus, immune from any attack'.²⁹ The provision clearly states that any ruling made by the Council will be binding on the civil court and the arbitrator which means the court and the arbitrator must follow the ruling to arrive at their decision and the ruling shall form part of the judgment of the court in Islamic banking and finance cases.³⁰ The new legislation is intended to resolve the issues which have arisen before the coming into effect of the Act especially the legal effect of the rulings issued by the *Sharī'ah* Advisory Council. However, there still exist certain issues which need to be addressed such as the issue of reasonability and equality and most importantly, public perception towards Islamic banking products and Islamic financial system itself.³¹

***Sharī'ah* Advisory Council and the IFSA 2013**

Provision relating to SAC was made available under the Central Bank of Malaysia Act 2009 and the repealed Islamic Banking Act 1983 with a general information as the status and overviews which were regarded as rather generic and in need for a better enlightenment. The newly enforced Islamic Financial Services Act (IFSA) 2013 seeks to redress this matter by providing a more significant authority towards SAC which at the same time regulates the Islamic financial institutions throughout Malaysia with the latest provisions within its respective jurisdiction. If study is to compare between the previous and current authorities of SAC, reference to the Central Bank Act 2009 needs to be made whereby section 52(1) mentioned that, the SAC shall have the following functions which includes, to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it, to advise the Central Bank on any *Sharī'ah* issue relating to Islamic financial business, as well as to provide advice to any Islamic financial institutions.³²

V. Guidelines Of The *Sharī'ah* Governance And Committees For Islamic Financial Institutions in Malaysia

In 2004, the GPS-1 prepared the *Sharī'ah* Governance Framework on the Governance of *Sharī'ah* Committee for the Islamic Financial Institutions that regulates the governance of *Sharī'ah* Committee of an Islamic financial institution. These guidelines are applicable to all Islamic financial institutions regulated and supervised by Malaysia Central Bank including the Islamic bank licensed under the Islamic Banking Act 1983 (IBA); financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) which participates in the Islamic Banking Scheme (BAFIA IBS bank); development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) which carries on Islamic Banking Scheme; and takaful operator registered under the Takaful Act 1984 (TA).³³

The objectives of *Sharī'ah* governance framework issued by Bank Negara Malaysia (BNM) in December 2004 were to set out the expectations of the bank on an IFI's *Sharī'ah* governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with *Sharī'ah*, to provide a comprehensive guidance to the Boards, *Sharī'ah* committee and management of the IFI in discharging its duties in matters relating to *Sharī'ah* and outline the functions relating to *Sharī'ah* review, *Sharī'ah* audit, *Sharī'ah* risk management and *Sharī'ah* research. The Guideline has now been superseded by the *Sharī'ah* Governance Framework for the Islamic Financial Institutions which was issued by the Central Bank in

²⁸[2009] 2 CLJ 433. See also, Trakic, A., & Ashgar A.A.M. Islamic Banking Business in Malaysia: The Regulatory Aspects, in Trakic, A., & Hanifah H.A.T. (Ed). Islamic Banking & Finance Principles, Instruments & Operations. (Kuala Lumpur: CLJ, 2012), at. 274-75.

²⁹MdDohlan, N.H., and Syed Abdul Kader Aljunid, S.Z. *Sharī'ah* and Legal Issues in the Bay' Bithaman Al-Ajil (BBA): A Viewpoint', [2010] 6 MLJ Ixxv.

³⁰*Id.*, 57.

³¹*Ibid.*, at. 459.

³²Syafira, M. Time Cannot Destroy This Memory: IFSA 2013. Retrieved from <<http://syafi-ct.blogspot.com/2013/05/ifsa-2012.html>> accessed on 1/2/2014.

³³Miskam, S., & Nasrul, M.A. *Sharī'ah* Governance in Islamic Finance: The Effects of The Islamic Financial Services Act 2013. 25-26 November 2013, Langkawi, Malaysia, at. 459.

January 2011 requiring all Islamic financial institutions to comply with the framework within six month period from the date of its issuance.³⁴

Generally, the SGF is discussed in six sections that are related to the general requirement, oversight, accountability and responsibility, independence, competency, confidentiality and *Sharī'ah* compliance and research function. According to the general requirement of *Sharī'ah* governance framework, the essential key functions of key organs in *Sharī'ah* governance framework are the board, *Sharī'ah* committee, management and *Sharī'ah* compliance and research functions. According to BNM *Sharī'ah* governance framework, IFIs are responsible to establish a sound and comprehensive *Sharī'ah* governance framework with an emphasis placed on the roles of key functionalities in ensuring effective implementation of the *Sharī'ah* governance framework.³⁵

Regarding to the oversight, accountability and responsibility, IFIs shall set out the accountability and responsibility of every key functionary involved in the implementation of *Sharī'ah* governance framework. To safeguard the independence of the *Sharī'ah* committee, IFIs shall ensure the sound *Sharī'ah* decision-making and emphasis on the role of the board of directors in recognising the independence of the *Sharī'ah* committee. Furthermore, independence of the *Sharī'ah* committee shall observe at all times in exercising their duties to make an objective and informed judgment. Any person bearing responsibilities outlined in the *Sharī'ah* governance framework for an IFI shall possess the necessary competency and continuously enhance their knowledge and understanding on the *Sharī'ah* as well as keep abreast of the latest developments in Islamic finance. Internal and privileged information obtained by the *Sharī'ah* committee members in the course of their duties shall be kept confidential at all times and shall not be misused.³⁶

Professional ethics, judgment and consistency shall be maintained in ensuring *Sharī'ah* compliance. In the case of *Sharī'ah* compliance and research function, the framework suggests having a comprehensive *Sharī'ah* compliance function, comprising review and audit functions, supported by risk management control process and internal research capacity. The function of *Sharī'ah* review is to make assessment regularly on *Sharī'ah* compliance in the activities and operations of the IFIs by qualified *Sharī'ah* officers. The review process shall cover the planning of the review programme itself including the objectives, scope, reporting and follow-up actions. It also includes the documentation process involved in the review, communicating the outcome of review to *Sharī'ah* committee and management.³⁷

Lastly, rectifying any instances of non-compliance with the *Sharī'ah* to prevent such events from recurring is compulsory. The *Sharī'ah* audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to assess its value and improve the degree of compliance in relation to the IFI's business operation. The scope of *Sharī'ah* audit shall cover all aspects of the IFI's business operations and activities, including audit of financial statement of the IFIs, compliance audit on organisational structure, people, process and information technology application system, as well as review of adequacy of the *Sharī'ah* governance process. With regard to *Sharī'ah* risk management, it is recommended to have a function to systematically identify, measure, monitor and control of *Sharī'ah* non-compliance risks to mitigate any possible of non-compliance events. However, apart from the departments above, there shall be an internal unit comprising the qualified *Sharī'ah* officers to conduct pre-product approval process, research, vetting of issues for submission and undertake administrative and secretarial matters relating to the *Sharī'ah* committee.³⁸

VI. Regulation Of Islamic Banking In Malaysia

Malaysia adopts a model which is usually termed as a dual banking system. This is a model in which the Islamic banking operates side by side with the conventional banking and is regulated under the authority of a Central bank. In this context, Bank Negara Malaysia (BNM), as the Central Bank of Malaysia, holds authority to control and regulate the banking operations in the country.³⁹ Islamic banks, as well as Malaysian conventional banks, are under the supervision and regulation of the Central Bank of Malaysia. The Central Bank is an authoritative body vested with a comprehensive legal power to regulate and supervise the financial system in Malaysia. Hence, the main regulation in the financial system is in the Central Bank of Malaysia Act 1958, now repealed by CBMA 2009.

Islamic banks, together with other banks and financial institutions carrying out Islamic banking business, are under the authority and supervision of the BNM. The legal basis for the operation of the Islamic banking business in Malaysia primarily comprises of two Acts, which are the IBA 1983 which has been

³⁴Shafie, Z., Zainal Abidin, A., Salleh, S., Jusoff, K. & Kasim, N. Research in Contemporary Islamic Finance and Wealth Management. Middle- East Journal of Scientific Research 13, 2013), at. 7-11.

³⁵Nawal K., Sheila N.N & Syed A.S. Comparative Analysis on AAOIFI, IFSB and BNM *Sharī'ah* Governance Guidelines, at. 225.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Ibid.

³⁹YakcopNor Mohamed. Teori, AmalandanProspek System Kewangan Islam di Malaysia.(Kuala Lumpur: Ustusan Publications &DisributionsSdnBhd, 1996), at. 70-71.

replaced by IFSA 2013, and the BAFIA 1989, which was replaced by FSA 2013. Although these two Acts are similar in terms of regulating banking business, they have different jurisdictions. The IBA 1983 specifically governs the Islamic banks in which Islamic tenets are applicable in their products and operations. The Act does not contain any provisions pertaining to any banking business, or even Islamic banking business conducted by conventional banks. Historically, the enactment of this Act also paved the way for the establishment of the Islamic banks in Malaysia.⁴⁰

The Ambiguous of Islamic Banking Act (IBA) 1983

The IBA mainly provides for the licensing and regulation of Islamic banks and Islamic banking business in Malaysia. Subsequently, the IBA was amended in 2003, and became the Islamic Banking (Amendment) Act 2003. An analysis of the provisions in the IBA shows that the Act is regulatory in nature and does not provide for the basic law for Islamic banking. There have not been specific thoughts of meeting the requirements and expectation of the *Shari'ah* since the clauses used are mainly derived from the conventional banking practices and the existing banking laws. Moreover, the main legislative framework for Islamic banking in Malaysia is actually based on civil laws and falls within the jurisdiction of the civil courts.⁴¹

There are also ambiguities in the Islamic Banking Act 1983. For example, there is no definition of banking business in the IBA. By way of comparison, BAFIA provides a definition of banking business in section 2(1), which provides:

- “(a) the business of —
(i) receiving deposits...;
(ii) paying or collecting cheques;
(iii) provision of finance...”⁴²

In addition, the term “Religion of Islam” has not been defined. This may give rise to ambiguity as to the position of the Islamic legal schools (*madhhab*) in the interpretation of the catch-all phrase “approved by the Religion of Islam” used in IBA. For instance, in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya SdnBhd&Ors*⁴³ and case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Other Appeals*⁴⁴ as court accept that a BBA agreement does not involve any element which is not approved under any of the recognised *Madhhab*. This difficulty is somewhat mitigated by the existence of a *Shari'ah* advisory body (SAB) for the Islamic bank as required by the IBA, essentially to safeguard and ensure *Shari'ah* compliance. The general rule to be observed in IBF is to ensure that there is no contravention of any *Shari'ah* principles in the transactions; for example, all transactions must be free from the elements of usury, dubiousness and gambling.⁴⁵ A new section was also added to the IBA in the 2003 amendment. Section 13A provides:

- “(1) An Islamic bank may seek the advice of the *Shari'ah* Advisory Council on *Shari'ah* matters relating to its banking business and the Islamic bank shall comply with the advice of the *Shari'ah* Advisory Council.
(2) In this section, “*Shari'ah* Advisory Council” means the *Shari'ah* Advisory Council established under subsection 16B (1) of the Central Bank of Malaysia Act 1958”.⁴⁶

This amendment enables Islamic banks to seek the advice of the *Shari'ah* Advisory Council (SAC) of Bank Negara Malaysia (BNM); and it is mandatory for the Islamic banks to comply with the advice given by the SAC pursuant to such request. This indicates that the SAC has advisory powers over the Islamic banks, where liaison and common understanding between the SAB and SAC are expected. This will also ensure that *Shari'ah* compliance is always strictly observed and adhered to by the Islamic bank with the advice of the SAC. The liaison with the SAC can also facilitate a shorter time frame in endorsing any new products in IBF. Nonetheless, nothing in the IBA provides for a minimum qualification of lawyers who are involved in IBF documentation and litigation. There is no specific requirement that lawyers dealing with Islamic banking transactions should have the relevant qualifications in drafting the documents. Generally, this lack of necessary knowledge of the *Shari'ah* could lead to mistakes in drafting and also risks on the legality of the documents, especially for non-compliance with the *Shari'ah* principles.⁴⁷

⁴⁰ Jane Conners, Towards a System of Islamic Finance in Malaysia, in ChibliMallat (Ed) *Islamic Law and Finance* (London: Graham & Trotman, 1988), at. 40-42.

⁴¹ Islamic Banking Malaysia. Legal and Regulatory Framework of Islamic Banking and Finance in Malaysia. Retrieved from <<http://islamicbanking-malaysia.com/legal-regulations/170-legal-and-regulatory-framework-of-islamic-banking-and-finance-in-malaysia>> accessed on 15/2/2014.

⁴² Bank And Financial Institutions Act (BAFIA) 1989, Section 2(1).

⁴³ [2009] 6 CLJ 22

⁴⁴ [2008] 5 MLJ 631.

⁴⁵ Id., 72.

⁴⁶ Section 13A of IBA Amendment 2003.

⁴⁷ Id., 77.

Adequacy and Capability of Islamic Financial Service Act 2013

Malaysia has recently published a new law governing Islamic banking and Takaful, namely the Islamic Financial Services Act 2013 (IFSA). The IFSA replaced two existing Acts: Islamic Banking Act 1983 and Takaful Act 1984. The IFSA aims to introduce a more risk-focused and integrated approach to the regulation and supervision of financial institutions to safeguard financial stability. A dedicated Part on *Sharī'ah* requirements and other specific provisions on *Sharī'ah* compliance throughout the Act provide a comprehensive regulatory framework to ensure an end-to-end *Sharī'ah* compliance by Islamic financial institutions. Regulated persons comprise of Islamic banks, takaful operators, operators of payment systems, issuers of designated Islamic payment instruments, takaful brokers and Islamic financial advisors, as well as conventional institutions approved to carry on its operations according to *Sharī'ah*. The enactment of IFSA brought about regulatory changes in three areas of the Malaysian financial sector, as follows:

1. It imposed more extensive and intrusive regulation in the areas of capital, liquidity, incentive systems, governance, consumers and accounting, and hence enhanced the scope of regulation for systemic institutions.
2. It strengthened institutional arrangements to avoid gaps and clarify accountability by having a more formalised arrangement for coordination and cooperation.
3. It improved the international financial architecture by reforming international institutions to reflect the enhanced role of Islamic finance, to broaden the representation of Muslim countries, and to allow for more diversity in financial matters and their regulation.⁴⁸

The Islamic Financial Service Act (Act 759) and the Islamic Financial Service were published in the Government Gazette on 22nd of March 2013 and came into force on the 1 of July 2013. The Act has 18 parts, 291 provisions and 16 schedules. The IFSA and equipped the Bank with adequate regulatory and supervisory powers. Similarly, it imposes a duty on Islamic financial institutions to ensure compliance with *Sharī'ah* at all times and also empowers the Bank to issue standards on *Sharī'ah* requirements to facilitate institutions in complying with *Sharī'ah*.⁴⁹

Furthermore, the IFSA 2013 has reinforced the matter by introducing new provision pertaining to *Sharī'ah* compliance. According to section 28, an institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with the *Sharī'ah*. Any irregularities or non-compliance with the *Sharī'ah* requires the institution to inform the SAC so that necessary steps can be taken. A rather distinct rule which was introduced is the reinforced penalty clause whereby failure on part of the institution to comply with the above provision shall be liable to imprisonment not exceeding eight years or to a fine not exceeding RM 250 million or both. This can be compared to the provision under section 46 of the Islamic Banking Act 1983 which only sets penalties for directors and managers of an Islamic bank who fail to take all reasonable steps to secure compliance with the requirements of this act as well as section 50 which provides a fine not exceeding fifty thousand ringgit (RM50, 000, 00), this is a clear cut display of the regulator's intention in addressing the matter in a more serious manner.⁵⁰

In the other words, the new IFSA highlights the duty of institution to ensure stricter *Sharī'ah* compliance and impose a more severe punishment under the law for the financial institutions who infringe it. Additionally, introduction on power of the Central Bank to specify standards on *Sharī'ah* matters is being made available under section 29 of the IFSA 2013 which states that, Islamic financial institution is required to comply with *Sharī'ah* standards issued by the BNM⁵¹ in accordance with the advice of the SAC. The requirements must be complied by all Islamic financial institutions including licensed takaful operators.⁵²

⁴⁸IFSB. Prospects and Challenges in the Development of Islamic Finance for Bangladesh (Kuala Lumpur, IFSB, 2014), at. 39.

⁴⁹Frasier-Nelson. E. Bank Islam Malaysia: A Global Leader in Islamic Finance. (International Banker, Summer 2014), at. 97.

⁵⁰Id., 80.

⁵¹The feedback to interview question (Functions of *Sharī'ah* standards and how many have been issued so far) by: Siti Mariam Abdul Mutalib, Manager, Talent Development and Strategic Communication Islamic Banking and Takaful Department Bank Negara Malaysia, explained that the BNM has issued a complete standard of *Murābahah* while four concept paper of 4 Islamic contracts namely *Mudārabah*, *Musharakah*, *Ijārah* and *Istisna'* also has been issued for industry. These standards consist of *Sharī'ah* standards and operational standards, serve to define essential features of the underlying *Sharī'ah* principles that are adopted by Islamic financial institutions while operational standards address sound practice principles and the Bank's expectations for effective risk management, governance, disclosures, and appropriate legal and accounting treatments. These requirements must be complied by all Islamic financial institutions including licensed takaful operators.

⁵²BNM/RH/GL 012-4. The Principles and Practices of *Sharī'ah* in Islamic Finance, *Sharī'ah* Standard on *Mudārabah* issued on 22 October 2012 and effective implementation date is 1 January 2014. Islamic Banking and Takaful Department.

Again, the same penalty clause as the above is enforced for failure to comply with any standards specified, which shall be liable for imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or both. *Shari'ah* compliance and *Shari'ah* governance provisions under the SAC is among the latest features being made available under the IFSA 2013 which empower the authorities of SAC itself as well as posing a more diverse practicality over the main aspects in Islamic financial institution while maintaining the status as the highest supervision power over the Islamic financial institutions in Malaysia.⁵³

In addition, for takaful companies, the requirement for a single licensed takaful business as codified in the Act will ensure that all resources and management of the takaful companies can be focused on enhancing growth of a particular type of business. Takaful operators are given five-year time frame to make feasibility assessment and convert the existing composite licensed into a particular takaful business of their choice. More so, it is envisaged that the separation of license will pave the way for the presence of new niche players while widening the scope of business for the existing general takaful players. The feedback to interview question on functions of IFSA and main contributions to Islamic banking and finance in Malaysia by Siti Mariam Abdul Mutalib,⁵⁴ buttressed the above discussion.

Banking and Financial Institutions Act 1989 (BAFIA)

The BAFIA 1989 that has been replaced by FSA 2013 is promulgated to govern all financial institutions. Thus, this Act deals with conventional banks, including those which operating the Islamic banking business alongside the interest based business. Historically, the Act is an amalgamation of two acts, namely the Financial Companies Act 1969 and Insurance Act 1963.⁵⁵ The BAFIA 1989 provides a legal ground for these financial institutions to carry the Islamic banking business under certain conditions. The only provision of Islamic banking business to be conducted by these conventional banks is stipulated in section 124(1) which states:

“Except as provided in section 33, nothing in this Act or the Islamic Banking Act 1983 shall prohibit or restrict any license institution from carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business, provided that the licensed institution shall consult the bank before it carries on Islamic banking business or any Islamic financial business”.⁵⁶

Thus, in contrast to Islamic banks, conventional banks or other licensed institutions are governed by the Banking and Financial Institutions Act 1989 (BAFIA), instead of the Islamic Banking Act 1983.⁵⁷ The operation of the Islamic banking business is conducted by both the Islamic banks as well as the conventional banks that relates to various aspects which are not covered by the above Acts.

On the other hand, the new FSA 2013 consolidates the previous acts which are the Exchange Control Act 1953, Insurance Act 1996, BAFIA 1989 and Payment Systems Act 2003. More so, it significantly strengthens the foundations for a regulatory and supervisory framework that is effective, transparent and which contributes to an efficient financial system that is resilient to future stresses. The Bank's regulatory priorities continued to be guided by a domestic focus on further raising the standards in governance and risk management practices in keeping with the growing scale and complexity of activities of financial institutions in and outside Malaysia. This included strengthening and updating prudential rules in line with international regulatory reforms.

Under the FSA, the bank will be able to provide an appropriate level of oversight over financial holding companies to ensure that the activities of financial groups do not pose undue risks to the safety and soundness of financial institutions. This will include setting prudential standards for financial holding companies, conducting on-going supervision on a consolidated basis and requiring corrective actions by financial holding companies to address identified risks. Furthermore, the payment and settlement systems in Malaysia had remained resilient and operated reliably without any major disruptions before, whilst with the enactment of the FSA, the Bank's powers in respect of payment systems have been rationalised and strengthened further to ensure effective oversight of payment systems and payment instruments.

VII. Conclusion

The pro-active model is favourable by Malaysian regulatory authority. The proponent of this model has strong faith in regulatory-based approach in strengthening *Shari'ah* governance framework. With this motivation, Malaysian regulators initiate comprehensive *Shari'ah* governance framework from regulatory and non-regulatory aspects. There are several laws passed and amended by the parliament such as the Islamic

⁵³Id., 82.

⁵⁴Siti Mariam Abdul Mutalib, Manager, Talent Development and Strategic Communication Islamic Banking and Takaful Department Bank Negara Malaysia, Jalan Dato' Onn, 50480 Kuala Lumpur: Malaysia.

⁵⁵Hamzah Ismail & Radziah Abdul Latif. Survey & Analysis of Financial Reporting of Islamic Banks Worldwide, (Kuala Lumpur: Arab-Malaysia Banking Group and Malaysia Accountancy Research and Education Foundation, 2001), at. 48.

⁵⁶Banking and Financial Institutions Act (BAFIA) 1989, section 124 (1).

⁵⁷Halsbury's Laws of Malaysia, 14 (Remedies *Shari'ah* Law) (Kuala Lumpur: Malaysia Law Journal, 2002), at. 255.

Banking Act 1983, which has been replaced by Islamic Financial Service Act (2013) (IFSA), the TA 1984, the Banking and Financial Institutions Act 1984 which was replaced by Financial Service Act 2013 and the Securities Commission Act 1993.

The Central Bank of Malaysia Act 2009 confirms the status of National *Shari'ah* Advisory Council (SAC) to be the sole authoritative body in Islamic finance. Furthermore, the Bank Negara Malaysia (BNM) has issued the Guidelines on the Governance of *Shari'ah* Committee for the Islamic Financial Institutions known as the BNM/RH/GL/_012_3. To complement this, the Securities Commission of Malaysia issued the Registration of *Shari'ah* Advisers Guidelines 2009 which set up the criteria for the registration of a *Shari'ah* adviser in the capital market sector. Therefore, the *Shari'ah* governance system in Malaysia can be named as regulated via legal and supervisory requirements. It is also identified as a strong proponent of regulation-based approach.

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