SHARIAH GOVERNANCE IN ISLAMIC FINANCE: THE EFFECTS OF THE ISLAMIC FINANCIAL SERVICES ACT 2013

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ABSTRACT

The coming into force of the Islamic Financial Services Act 2013 on 30 June 2013 was intended to pave way for the development of an end-to-end Shariah compliant regulatory framework for the conduct of Islamic financial operation in Malaysia. The new Act provides a comprehensive legal framework that is in full compliance with Shariah in all aspects of regulation and supervision, from licensing to the winding up of the Islamic financial institutions. The legislation specifically provides for the enforcement of Shariah non-compliance risk and imposes statutory duty upon the Islamic financial institutions to ensure that their aims, operations, affairs, businesses and activities are in compliance with Shariah rules. The Islamic Financial Services Act 2013 has the effect of repealing the Islamic Banking Act 1983, the Takaful Act 1984, the Payment System Act 2003 and the Exchange Control Act 1953. Prior to 30 June 2013, the legal framework relating to Shariah governance in Islamic finance was not statutorily provided. The objective of this paper is to examine the relevant provisions of the Act relating to Shariah governance of the Islamic financial institutions and its legal effect on all parties involved in the Islamic financial business. Discussion will also include reference to the Central Bank of Malaysia Act 2009 which provides for the establishment of the Shariah Advisory Council which plays essential role in the governance of Islamic financial institutions and forms part of the principal component of the Shariah governance framework in Malaysia.

Field of Research: Shariah Governance, Islamic Finance, regulatory framework.

1. Introduction

The Islamic Financial Services Act 2013 (IFSA) which came into effect from 30 June 2013 was intended to pave way for the development of an end-to-end Shariah compliant regulatory framework for the conduct of Islamic financial operation in Malaysia. With the coming into force of this legislation, several separate legislations namely the Islamic Banking Act 1983, the Takaful Act 1983, Payment Systems Act 2003 and Exchange Control Act 1953 were repealed on the same date. Prior to 30 June 2013, the legal framework relating to Shariah governance in Islamic finance was not statutorily provided.

Among the salient features of this comprehensive legislation is the provision relating the enforcement of Shariah non-compliance risk and imposes statutory duty upon the Islamic financial
institutions to ensure that their aims, operations, affairs, businesses and activities are in compliance with Shariah principles as part of Shariah governance implementation in the Islamic financial system in Malaysia.

The Shariah non-compliance risk arises from failure on part of the Islamic financial institution to comply with the Shariah rules and principles determined by the Shariah committee of the respective Islamic financial institutions or the Shariah supervisory board at the Central Bank level. Shariah non-compliance risk can have effect on the asset values of the Islamic financial institutions with possible loss of investment or reinvestment income with may result in fund withdrawals and cancellation of investment contracts thus causing a decline in profits and performance of the Islamic financial institution which will further affect public confidence in Islamic finance system. (Hamza, 2013)

2. Shariah Governance in Islamic Finance

Islamic financial institutions have the duty to ensure the compliance with Shariah principles in all aspects of their products, instruments, operations, practices and management which will be achieved by the establishment of a proper Shariah governance framework. Thus Shariah supervision plays an essential role in the governance of Islamic financial institution and forms part of the principal component of the Shariah governance framework (Hamza, 2013). One of the roles of the Shariah supervisory board is to advise the Islamic financial institutions on Shariah matters to ensure conformity with Shariah rules in its operations at all time, endorsing and validating relevant documentations pertaining to the products and services of the Islamic financial institutions. The ideal role of Shariah supervision involve ex ante and ex post aspects of Shariah governance and these include Shariah pronouncement, supervision and review. (Zulkifli Hasan, 2011)

In this aspect, the Shariah governance framework in Malaysia is based on the centralised model as compared to the decentralized being practiced in the GCC countries (Hamza, 2013). The centralised model is formed on the basis that the Central Bank itself has its own Shariah supervisory board called the Shariah Advisory Board by virtue of section 51 of the Central Bank of Malaysia Act 2009 and all Islamic financial institutions are required to form their own Shariah committee which must comply with the rules set by the Shariah Advisory Board of the Central Bank.

The importance of Shariah supervision is derived from five different resources namely religious, social, economic, legal and governance. The religious position is derived from the ability of Shariah scholars in understanding and interpreting Shariah principles to others. The social power of the Shariah supervision provides confidence to the stakeholders about the legitimacy of the transactions and activities of the Islamic financial institutions. The economic power of the Shariah supervision can be seen from the fact that the profitability of an Islamic financial institution is dependent on the performance of Shariah scholars. As far as legal power is concerned it is derived from a variety of sources including regulators of the respective countries. The hierarchical position of Shariah supervision under the shareholders of the Islamic financial institutions emphasizes its supremacy over other governance organs thus giving them authority to set their internal policy including task, responsibilities and relations with other governance organs in the Islamic financial institutions. (Garas and Pierce, 2010)

The Shariah governance which refers to all the elements about the active role of the Shariah board and compliance with Shariah is fundamental to Islamic banks in particular and the implementation of Shariah governance is encouraged by international institutions of regulations like Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) and Islamic Financial Services Board (IFSB) (Hamza, 2013).
The independence of the supervisory board in the mission of supervision and the consistency of Shariah ruling can contribute to an efficient Shariah governance framework. The confidence on part of the stakeholders in the product of the Islamic financial institutions generally and the Islamic bank in particular will be enhanced with the existence of an efficient Shariah governance framework. (Hamza, 2013).

3. The legal framework in Malaysia

3.1 The Central Bank of Malaysia Act 2009


The repealed Act was amended in 2003 to insert section 16B 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 business, takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on Shariah principles and is supervised and regulated by the Central Bank of Malaysia. The 2003 amendment was meant to provide a better position on the National Shariah Advisory Council whereby it uplifts the position of Islamic banking and finance in the country.

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

_The Central Bank of Malaysia Act 2009 (Act 701)_

The Act 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 Syariah Advisory Council (Section 51 to 58) and Chapter 2 (Section 59 -60) Powers of the Bank. 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 laws enforced by the Bank and consistent with the Shariah.

The Shariah 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 Shariah Advisory Council are listed under section 52 and it includes the following:

(a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with Part VII of the Act.
(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 in force in Malaysia; and
(d) such other functions as may be determined by the Bank.
The members of the Syariah Advisory Council shall be appointed from amongst persons who are qualified in the Shariah or who have knowledge or experience in the Shariah 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.

Section 55 further stipulates that the Bank shall consult the Shariah 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 Shariah, which requires the ascertainment of Islamic law by the Shariah Advisory Council. In executing its duties and responsibilities, the Shariah Advisory Council shall examine and endorse the validity of application of Shariah 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 Shariah Advisory Council on the operations of its business in order to ascertain that it does not involve any element which is inconsistent with the Shariah.

The requirement for reference to Shariah 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 Shariah matter, the court or the arbitrator, as the case may be, 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.”

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 Shariah Advisory Council or to request for advice from the Council to determine any issue concerning a Shariah matter before them.

Any request for advice or ruling of the Shariah 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 Syariah committee of an Islamic financial institutions and ruling issued by the Shariah Advisory Council, the ruling of the Shariah Advisory Council shall prevail and be applicable.

In order to ensure that any deliberation of the Shariah 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 Shariah 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. (Ahmad Suhaimi Yahya, 2009). 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. (Tengku Dato’ Hasmuddin Tengku Othman, 2009)

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 Shariah Advisory Council. However, there still exist certain issues which need to be addressed such as the issue of reasonability and equality and most important, public perception towards Islamic banking products and Islamic financial system itself. (Engku Rabiah Adawiyyah, 2009).
In 2005, the Central Bank has prepared the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions that regulates the governance of Shariah Committee of an Islamic financial institution. These Guidelines shall be 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). The guidelines set the role, scope of duties and responsibilities of the Shariah Committee and its members and the relationship between the Shariah Committee of the respective Islamic financial institutions and the Shariah Advisory Board of the Central Bank.

The guideline has now been superseded by the Shariah Governance Framework for the Islamic Financial Institutions which was issued by the Central Bank in January 2011 which requires all Islamic financial institutions to comply with the framework within six month period from the date of its issuance. (Zurina Shafie, 2013). The guidelines provides for the establishment of two-tier Shariah governance infrastructure comprising two vital components namely the Shariah Advisory Council at the Central Bank and an internal Shariah Committee formed in each respective Islamic financial institution (BNM, 2011).

The framework is divided into six sectors:
Section I: General requirements of the Shariah governance framework
Section II: Oversight, accountability and responsibility
Section III: Independence
Section IV: Competency
Section V: Confidentiality and consistency
Section VI: Shariah compliance and research functions.

The Framework requires that that the Shariah governance framework of an Islamic financial institution shall consist of the board oversight on Shariah compliance aspects of the the Islamic financial institution's overall operation, a Shariah Committee, effective management responsibilities in providing adequate resources in the implementation of Shariah governance, an internal Shariah review, a regular Shariah audit, a Shariah risk management process to identify all possible Shariah non-compliance risks, an internal Shariah research team as well as issuance and dissemination of Shariah decisions to the relevant stakeholders.

It is therefore important to point out that an Islamic financial institution is required to set out the accountability and responsibility of every key functionary involved in the implementation of Shariah governance framework. In this aspect the Board of Directors is ultimately responsible on the overall Shariah governance framework and Shariah compliance of the Islamic financial institutions and the board is expected to perform diligent oversight over the effective functioning of the Shariah governance framework. The Shariah Committee shall be responsible and accountable for all its decisions, views and opinions related to Shariah matters and the Board is expected to rely on the Shariah Committee on all Shariah decisions, views and opinions relating to the business of the Islamic financial institution. The Shariah Committee is expected to disclose sufficient information in the Islamic financial institution’s annual financial report on the state of compliance of the institution. At the same time the management is entrusted with the responsibility for observing and implementing Shariah rulings and decisions made by the Shariah Advisory Council and the Shariah Committee. The management is under the duty to develop and adopt a holistic culture of Shariah compliance within the organisation (BNM, 2011).
3.2 The Islamic Financial Services Act 2013

The rule relating to Shariah governance is provided under section 30 until section 36 of IFSA 2013 whereby the existence of these provisions highlighted the intention of the law maker, in focusing to the matters pertaining to appointment and qualification of the Shariah Committees members in Islamic financial institution. Unlike the Central Bank of Malaysia Act 2009 which merely touched the surface of the matter by highlighting the general requirement for financial institution to have a Shariah committee, the current provision provides a more specific requirement under section 30 of IFSA 2013 which requires an institution to apply directly to the Central Bank for the establishment of Shariah Committee. This will enable the Central Bank to have direct information as to the members of the Shariah Committee in an Islamic financial institution, which at the same time, to ensure a proper supervision towards the activities conducted.

Another major point being made available under the new Shariah governance legal provision is the criteria of the members of Shariah Committee. A clear standard of requirement pertaining to the appointment of such committee is highlighted under section 31 which is to be crossed referred with section 29 (2) (a) which states only those who is really fit and qualified may be appointed as the Shariah Committee members. This leads to the notion that members of Shariah Committees in every financial institution must be chaired by those who met the requirements as stated by the Central Bank. Availability of such clause would be vital in ensuring the products and services introduced by the Islamic financial institution complied with the Shariah principles via the supervision of competent members.

Section 32 of IFSA 2013 contributes to the significance of Shariah Committees in every institution through the introduction of the Shariah governance which not only set out the duties of the Shariah committees in the institution, but rather blend into the structure of the company itself. By extending the powers of Shariah governance into certain aspects in a company such as matters involving the board of directors and internal Shariah compliance, we can understand that Shariah governance would be one of the integral parts in an institution up to the point that Shariah committee may no longer be treated as a minor part or division of a company, what more against the idea of abandoning such governance rules.

The introduction of under section 33 and 34 of IFSA, on the other hand, enables the Central Bank to continuously be updated by the institution of its Shariah Committee members. In order to maintain its aim of ensuring that only those who really qualifies entitled to be the members, the provision set out the clause relating to the cessation of the members including situations which would disqualifies from becoming Shariah committee members.

By setting out a more precise rules and features of the Shariah committee members, the IFSA 2013 under section 35 has made it compulsory for management in charge of the company to provide information to the Shariah committee in exercising its task and duties. While the Act did not mention the type and degree of information required, it can be assumed that the Shariah Committee is authorised to obtain regardless of any kind, if such information would assist them in carrying out their duties.

In addition, section 36 marks the trust which has been given by the legislation over the Shariah Committee to hold any type of information including the confidential ones provided such information is not being relayed to the other persons. While maintaining the duty of confidentiality, the Shariah committees are also vested with the protection under the qualified privilege which prevents them from being taken a legal action by the Islamic financial institution, if it can be proven that such duties was conducted in good faith.
The provision clauses as to the Shariah governance is one of the major features being introduced under the IFSA 2013 which contributes to the boost of authorities as well as roles of the Shariah Committee, thus ensuring the activities of the Islamic financial institution to be under Shariah compliance thus maintaining a sound and robust Shariah governance framework in Islamic financial industry in Malaysia.

4. The Effect of the Islamic Financial Services Act 2013

The development of Islamic banking in Malaysia gave rise to the establishment of Shariah Advisory Council of Bank Negara Malaysia as the highest authoritative body in ascertaining the Shariah matters relating to Islamic finance in Malaysia. The Shariah Advisory Council has been given the mandate to ascertain the Shariah compliance relating to matters which include Islamic banking, Takaful, Islamic financial business or any other business that are based on Shariah principles. In addition, the Shariah Advisory Council advises the Central Bank of Malaysia and the Islamic financial institutions on any Shariah issues pertaining to Islamic financial business. Provision related to Shariah Advisory Council 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 Shariah Advisory Council which at the same time regulates the Islamic financial institutions throughout Malaysia with the latest provisions within its respective jurisdiction.

If we are to compare between the previous and current authorities of Shariah Advisory Council, reference to the Central Bank of Act 2009 needs to be made whereby section 52(1) mentioned that, The Shariah Advisory Council 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 Shariah issue relating to Islamic financial business, as well as to provide advice to any Islamic financial institutions. However, the IFSA 2013 has reinforced the matter by introducing new provision pertaining to Shariah 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 Shariah. Any irregularities or non-compliance with the Shariah requires the institution to inform the Shariah Advisory Council 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. Compare to the provision under section 46 of the Islamic Banking Act 1983 which only set penalties on directors and managers of an Islamic bank who fails 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, this is a clear cut display of the regulator’s intention in addressing the matter in a more serious manner. In the other words, the new Act highlights the duty of institution to ensure stricter Shariah compliance and imposed a more severe punishment under the law for the financial institutions who infringes it.

Additionally, introduction on power of the Central Bank to specify standards on Shariah matters is being made available under section 29 of the IFSA 2013 which states that, Islamic financial institution is required to comply with Shariah standards issued by the Central Bank in accordance with the advice of the Shariah Advisory Council. The requirement to abide by the standards issued by the Central Bank is also imposed on the directors of the financial institutions, the chief executive officer, senior officers and members of the Shariah Committee of the financial institutions. 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.

Shariah compliance and Shariah governance provisions under the Shariah Advisory Council is among the latest features being made available under the IFSA 2013 which empower the authorities of Shariah Advisory Council 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.

5. Conclusion

Compliance to Shariah is essential to enhance the confidence of the stakeholders of Islamic financial institutions. In this regard, the IFSA provides a comprehensive legal framework that is in full compliance with Shariah in all aspects of regulation and supervision of the Islamic financial institutions in Malaysia, from licensing to the winding up of the Islamic financial institutions. The legislation specifically provides for the enforcement of Shariah non-compliance risk and imposes statutory duty upon the Islamic financial institutions to ensure that their aims, operations, affairs, businesses and activities are in compliance with Shariah rules at all times. This is one of the key areas in the evolution of the legal framework for Islamic finance in Malaysia which aims is to provide greater certainty and predictability to the Islamic financial institutions in order to build public confidence in the system.

This is fundamental to enable the Islamic financial system in Malaysia to meet the new challenges and demands for financing associated with Malaysia's economic transformation programme in the future and the increasing integration of the Malaysian economy with the region and the world.

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