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Islamic Financial Services Act (IFSA) 2013 and the Sharīʿah-compliance requirement of the Islamic finance industry in Malaysia

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Abstract

Purpose – This paper aims to observe the development of the Sharīʿah governance framework (SGF) and practice in Islamic financial institutions (IFIs) in Malaysia.

Design/methodology/approach – The study is a qualitative-based research. It uses various documents and content analysis approach to understand and analyze the structure, process and practice of SGF in IFIs in Malaysia.

Findings – It is found that the Central Bank of Malaysia, Bank Negara Malaysia, has attempted to develop a comprehensive framework of Sharīʿah governance for IFIs in Malaysia. The framework governs the practice of the industry, covers stakeholders' scope of duties and responsibilities and provides details on processes and procedures in the operations of IFIs to achieve the objective of Sharīʿah compliance. To maintain the relevance of the SGF to the needs of the industry, the framework has also been updated recently in 2017. The amendments aim to strengthen the effectiveness of Sharīʿah governance implementation within the Islamic finance industry.

Originality/value – This study attempts to comprehensively examine the evolution of the SGF Sharīʿah governance framework for IFIs in Malaysia. The Malaysian model of the SGF is unique and could be emulated by other countries in developing the Islamic finance industry in their respective jurisdictions.

Keywords Malaysia, Islamic finance, Sharīʿah governance, Sharīʿah compliance, Sharīʿah standards

Paper type Conceptual paper

Introduction

Malaysia, as one of the leading countries in the Islamic finance industry, believes that a consistent and systemic Sharīʿah governance framework (SGF) is the cornerstone for

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effective corporate governance of Islamic financial institutions (IFIs). Since the inception of the Islamic finance industry, a framework of Sharīʿah governance that IFIs have to adhere to has been developed in Malaysia. A sound and robust SGF is reflected in a clear governance structure and process that would ensure total commitment to Sharīʿah (Islamic law) compliance.

This paper attempts to observe the development of Sharīʿah governance requirements in the Malaysian Islamic finance industry from its inception until recently. It adopts the content analysis approach to examine the evolution of the SGF in Malaysia. It also describes the dynamic development of regulation and guidelines on Sharīʿah governance, which has progressed in line with the latest requirements and expectations of the SGF.

The evolution of the Sharīʿah governance framework in Malaysia

To make Sharīʿah governance enforceable, Malaysia adopted an integrative approach whereby Sharīʿah governance is part of the national legal framework governing the country's Islamic banking and finance system (Hasan, 2010). In the early phase, the aspiration for Sharīʿah compliance commitment in IFIs' practices was developed in the Act legislated for the Islamic finance industry. The Islamic Banking Act (IBA) (1983) was the first regulatory act that required the licensing and regulation of full-fledged Islamic banks in Malaysia to undertake Sharīʿah-compliant business and establish a Sharīʿah advisory board to advise on the banks' operations (Ibrahim, 1997).

For *takāful* operators, the requirement for establishment of Sharīʿah advisors is provided in Section 8(3)(a) of the Takaful Act (1984). The provision states that:

> A Religious Supervisory Council, whose members would be made up of Muslim religious scholars in the country, shall be established to advise the Company on the operations of its takaful business in order to ensure that they do not involve any element which is not approved by the religion of Islam.

In 1989, the Banking and Financial Institutions Act (BAFIA) (1989) authorized any licensed institution (conventional banks and financial institutions) to carry out Islamic banking business or any Islamic banking financial business in Malaysia. Sections 124(3) and (7) of BAFIA provide a similar requirement for the operation of Islamic banking and finance business – that it must be conducted in a Sharīʿah-compliant manner and that a Sharīʿah committee is to be appointed to ensure the Sharīʿah compliance aspect of the bank's operations.

In 2005, the first systematic effort to develop an SGF was undertaken by Bank Negara Malaysia (BNM). It issued the *Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions* (also known as BNM/GPS 1) which defines SGF in three dimensions, namely:

(1) the rules, regulations and procedures in the establishment of a Sharīʿah committee in every IFI;

(2) the role, scope of duties and responsibilities of a Sharīʿah committee; and

(3) the relationship and working arrangement between a Sharīʿah committee and the Sharīʿah Advisory Council (SAC) of BNM.

The Sharīʿah committee, as described by BNM/GPS 1, was expected to deliver the following responsibilities:

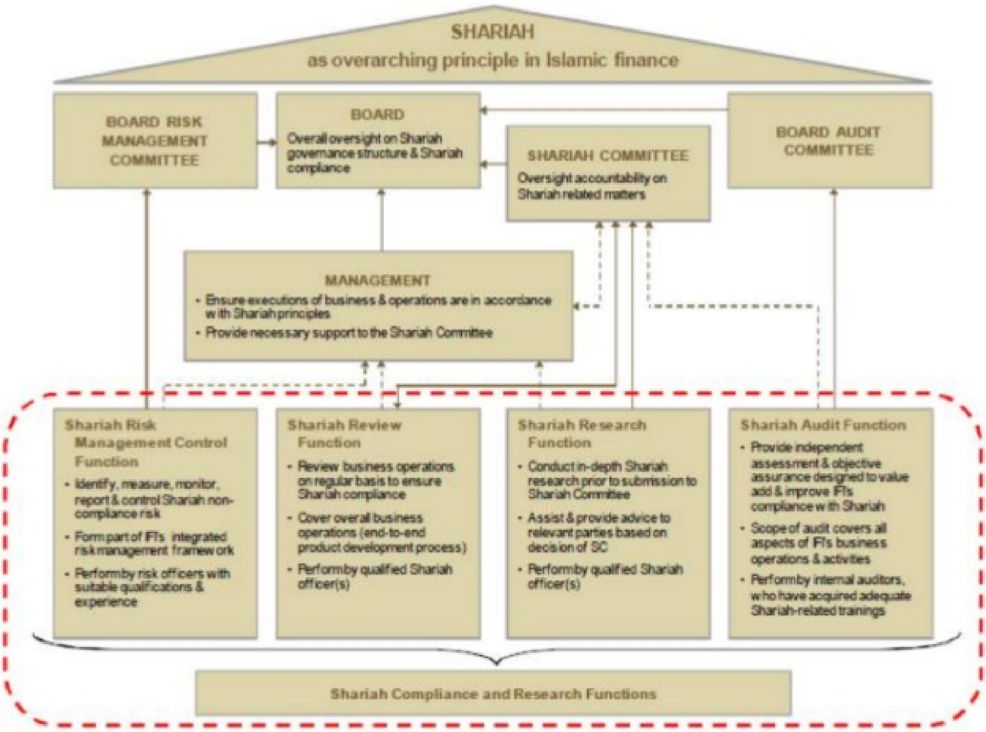
- to advise the board on Sharīʿah matters in its business operation;
- to endorse Sharīʿah compliance manuals;

- to endorse and validate relevant documentations in the products of IFIs such as the terms and conditions, contracts, agreements, product manuals, marketing advertisements, sales illustrations and brochures used to describe the products;
- to advise related parties on Sharīʿah matters upon their request;
- to advise on matters to be referred to the SAC of BNM; and
- to provide written Sharīʿah opinions.

In 2009, a new act, The Central Bank of Malaysia Act (2009), was introduced. The Act provided for the continued existence of the Central Bank of Malaysia and for its administration, objectives, functions and powers, and for consequential or incidental matters. The Act also envisaged the significant role of the SAC as the highest authority in Sharīʿah matters in Islamic finance.

One year later, in 2010, BNM issued a comprehensive SGF to raise the standards of Sharīʿah governance. The SGF specifically describes the roles of key functionalities in an IFI to ensure effective implementation of the Sharīʿah governance process in the operations, arrangements and business activities of IFIs. An IFI is required to establish a sound and robust SGF with emphasis placed on the accountability and responsibility of every key functionary involved in the implementation of SGF (Hasan *et al.*, 2013). Figure 1 illustrates a model structure of roles, functions and reporting relationships of key organs in an IFI's SGF.

IFIs are also expected to establish three functions that provide a system of checks and balances within the organization, which include the following:



Source: Bank Negara Malaysia (2010)

Figure 1.
Key organs in an IFI's Sharīʿah governance framework

- *Sharīʿah risk management control function*: It identifies all possible risk of Sharīʿah non-compliance and, where appropriate, proposes remedial measures to manage this risk.
- *Sharīʿah review function*: It continuously assesses the Sharīʿah compliance of all activities and operations. Where instances of non-compliance are identified, the IFI is expected to take prompt rectification measures and put in place the necessary mechanisms to avoid such recurrences.
- *Sharīʿah audit function*: It performs annual audits to provide an independent assessment of the adequacy and compliance of the IFI with established policies and procedures and the adequacy of the Sharīʿah governance process.

In 2017, the SGF 2010 was revised to enhance the existing regulatory requirements and expectations on Sharīʿah governance for IFIs. Revisions to SGF 2010 were also made in view of the growing scale and complexity of Islamic financial business, as well as recent policy developments in the area of governance, compliance and risk management. BNM is currently inviting feedback on the proposed SGF to be released in 2018.

According to BNM (2017), key enhancements to the new SGF include the following:

- strengthened board oversight on accountability and responsibilities over Sharīʿah governance;
- enhanced requirements for the Sharīʿah committee in providing objective and sound advice to IFIs, in line with IFSA 2013;
- enhanced expectations for the board and senior management to promote a Sharīʿah-compliant culture and further integrate Sharīʿah governance considerations in business and risk strategies; and
- enhanced regulatory expectations on the quality of internal control functions to ensure effective management of Sharīʿah non-compliance risks.

The Islamic Financial Services Act 2013: the next level of Sharīʿah compliance commitment

After three decades of Islamic finance development, Malaysia attempted to further strengthen the Sharīʿah governance and Sharīʿah compliance commitment of the Islamic financial services industry by legislating the Islamic Financial Services Act (IFSA) 2013. The Act represents the culmination efforts of the legal framework of IFIs in Malaysia, in particular in the aspect of Sharīʿah compliance. IFSA 2013 emphasizes a total Sharīʿah compliance effort of the Islamic finance industry through four dimensions, namely:

(1) Sharīʿah governance framework;

(2) Sharīʿah standards for each contract used in Islamic financial transactions;

(3) pre-emptive measures to address issues of concern within IFIs that may affect the interests of depositors and policyholders; and

(4) the effective and efficient functioning of Islamic financial intermediation.

Islamic Finance Services Act 2013 and Sharīʿah compliance requirements

Section 28(1) of IFSA 2013 states that one of the duties of an IFI is to "ensure that its aims and operations, businesses, affairs and activities are in compliance with Sharīʿah". The meaning of Sharīʿah compliance is explained in Section 28(2) as follows:

> 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 Sharīʿah in respect of that aims and operations, business, affair or activity.

In other words, the IFI should comply in all its operations, businesses, affairs and activities with Sharīʿah by:

- complying with the rulings of the SAC of BNM and its Sharīʿah standards;
- ensuring internal policies and procedures are consistent with Sharīʿah requirements; and
- developing a Sharīʿah audit function.

Sharīʿah non-compliance penalty

Section 28(3) of IFSA 2013 also regulates that 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 Sharīʿah or the advice of its Sharīʿah committee or the advice or ruling of the SAC, the institution shall:

- immediately notify BNM and its Sharīʿah committee of the fact;
- immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and
- within 30 days of becoming aware of such non-compliance or such further period as may be specified by BNM, submit to BNM a plan on the rectification of the non-compliance.

Failure to do so, some enforcement will be taken by the Central Bank, namely:

- enforceable undertakings (Section 270), whereby the Minister/BNM may accept a written undertaking from any person in relation to the matter under IFSA 2013 and may be used as an alternative means to address concerns instead of pursuing with other enforcement actions; with regard to the effect of breach, the Minister/BNM may obtain a high court order to enforce and seek specific performance and/or damages;
- removal of director, chief executive officer or senior officer (Section 174) if no longer considered fit and proper in managing the IFI or contributes to the contravention of BNM's direction or breach of enforceable undertaking; and
- removal of non-viable banks (Sections 187-196) by compulsory transfer of business and establishment of bridge institutions for compulsory transfer.

IFSA 2013 (Section 167) also mentions the circumstances for exercising power by BNM if it appears that an institution, its director, chief executive officer or senior officer:

- is carrying or about to carry its business, affairs and activities in a manner which is contrary to Sharīʿah;
- is committing or about to commit an act that is unsafe or failed to act in a manner that is necessary to maintain safety of Islamic banks;
- is conducting business in a manner detrimental to the interests of depositors, policy owners, participants, users, creditors or the public;

- has failed to manage its business in a manner that is consistent with sound risk management and good governance practices; and
- has failed to comply with any standards, notice, condition, specification, requirement, restriction, direction or code specified, issued or made under IFSA.

Administrative actions and civil proceedings (Sections 245-257) could also be taken where it appears to BNM that there is a reasonable likelihood that any person will contravene or has contravened, or will breach or has breached, or is likely to fail to comply with or has failed to comply with any provision of requirements in IFSA 2013, provisions of any regulation made pursuant to the Act, standards, condition, restriction, specification, requirement or code made or issued pursuant to any provision of IFSA.

BNM may seek a court order to impose a monetary penalty (general and for both corporate body and individual), civil penalty of not more than RM 25m, indemnity to seek compensation, injunction order or order to comply, order to remedy breach or mitigate the effect of breach of the above requirements. BNM may also seek court order to impose monetary penalty (for non-criminal offence) of body corporate not exceeding RM 5m, individual not exceeding RM1 million; order to comply with certain act; and order to remedy/mitigate the effect of breach and reprimand – including requiring person in breach to issue a public statement.

Sharīʿah standards

IFSA 2013 recognizes that Islamic finance draws its value propositions from the application of a diverse spectrum of Sharīʿah contracts in financial transactions that provide different risk and return profiles. The strict adherence by IFIs to Sharīʿah principles under such distinct contracts preserves the sanctity and validity of Islamic financial transactions. Therefore, to ensure that IFIs are able to conduct financial intermediation functions by using various Sharīʿah contracts in a Sharīʿah-compliant manner, IFSA 2013 requires SAC of BNM to develop Sharīʿah standards that explicate fundamental requirements of the respective Sharīʿah contracts to be used in product development.

The Sharīʿah standards would support the effective application of Islamic contracts in the offering of Islamic financial products and services – from the entering into a contract to the resolution of a failed IFI, as can be seen in Table I.

End-to-end Sharīʿah compliance under IFSA 2013

Sharīʿah standards: compliance with fundamental requirements of respective Sharīʿah contracts			*Operational standards*: strengthening risk management, governance, transparency and disclosure, market conduct and other operational aspects of applying Sharīʿah standards		
Sharīʿah contracts applied in Islamic financial business					
Assets			Liabilities		
Sale-based	Equity-based	Fee-based	Islamic deposits	Investment accounts (equity)	Investment accounts (other)
Murābaḥah *Istiṣnāʿ* *Ijārah* *Tawarruq*	*Muḍārabah* *Mushārakah*	*Wakālah* *Kafālah* *Rahn*	*Tawarruq* *Wadīʿah* *Qarḍ*	*Muḍārabah* *Mushārakah*	*Wakālah*

Source: BNM (2013)

Table I. Contract-based regulatory framework in IFSA 2013

Sharīʿah standards serve to define essential features of the underlying Sharīʿah principles that are adopted by IFIs. The standards are intended to:

- promote transparency and consistency of Sharīʿah contract application.
- enhance certainty and strengthen Sharīʿah compliance by IFIs; and
- serve as a key reference to catalyze greater mutual respect of Sharīʿah opinions across jurisdictions.

The process of developing Sharīʿah standards is done through a robust study to develop a conceptual framework until their operationalization by the industry in the following four steps:

(1) A team of Sharīʿah researchers, scholars and Islamic finance experts conducts robust conceptual studies to formulate the exposure drafts/concept papers on Sharīʿah standards and operational parameters.

(2) BNM will issue a concept paper for industry's feedback to ensure practicability of the standards.

(3) The sub-committee comprising selected SAC members, industry players, researchers and regulators deliberates and reviews the revised standards.

(4) The SAC of BNM deliberates on the draft for endorsement.

The issuance of 14 Sharīʿah standards related to the contracts used in the transactions of Islamic finance is a reflection of the ultimate effort to attain uniformity in Islamic financial practices to elevate the industry in the global financial system. It is undeniable that disagreement between *fatwas* (Sharīʿah opinions) is an inevitable phenomenon. However, industry practitioners have long believed that the absence of globally accepted standards in Sharīʿah, accounting, legal, regulations and others are among the factors that impede the realization of the full potential of Islamic finance and hamper the strategic objective of positioning Islamic finance into the mainstream economy.

Conclusion

Sharīʿah compliance of the Islamic finance industry is strengthened through the establishment of a comprehensive SGF. Malaysia, as one of the leaders in the global Islamic finance industry, recognizes this and has attempted to develop a proper SGF through the country's legal and regulatory framework.

The SGF in Malaysia has evolved with changing market conditions, whereby the governance structures of both the overall Islamic financial system and the individual IFIs have been enhanced and strengthened to ensure the observance of Sharīʿah. The latest law, IFSA 2013, provides a comprehensive legal framework that is fully consistent with Sharīʿah in all aspects of regulation and supervision. In addition, the SGF has been recently updated to strengthen the effectiveness of Sharīʿah governance implementation within IFIs in response to the growing scale and complexity of Islamic financial business, as well as recent policy developments in the area of governance, compliance and risk management (Bank Negara Malaysia, 2017).

Moving forward, to get an effective implementation of the SGF, sustained and active collaboration of government, industry players and customers in developing a sound and sustainable Islamic financial system is needed. It is clear that the implementation of an effective SGF will further promote stakeholders' confidence and the integrity of the Islamic finance industry, thereby reducing Sharīʿah non-compliance risks and contributing toward maintaining financial stability. The Malaysian model of the SGF is unique and could be emulated and adapted by other countries when developing the Islamic finance industry in their respective jurisdictions. According to reports, the emulation of the Malaysian SGF model is already under consideration by countries such as Bahrain, Pakistan and the UAE (Parker, 2017). The comprehensiveness and success of the Malaysian SGF could thus serve as a model for strengthening Sharīʿah governance implementation in other countries.

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