

LEGAL FRAMEWORK & GOVERNANCE FOR ISLAMIC FINANCIAL SERVICES

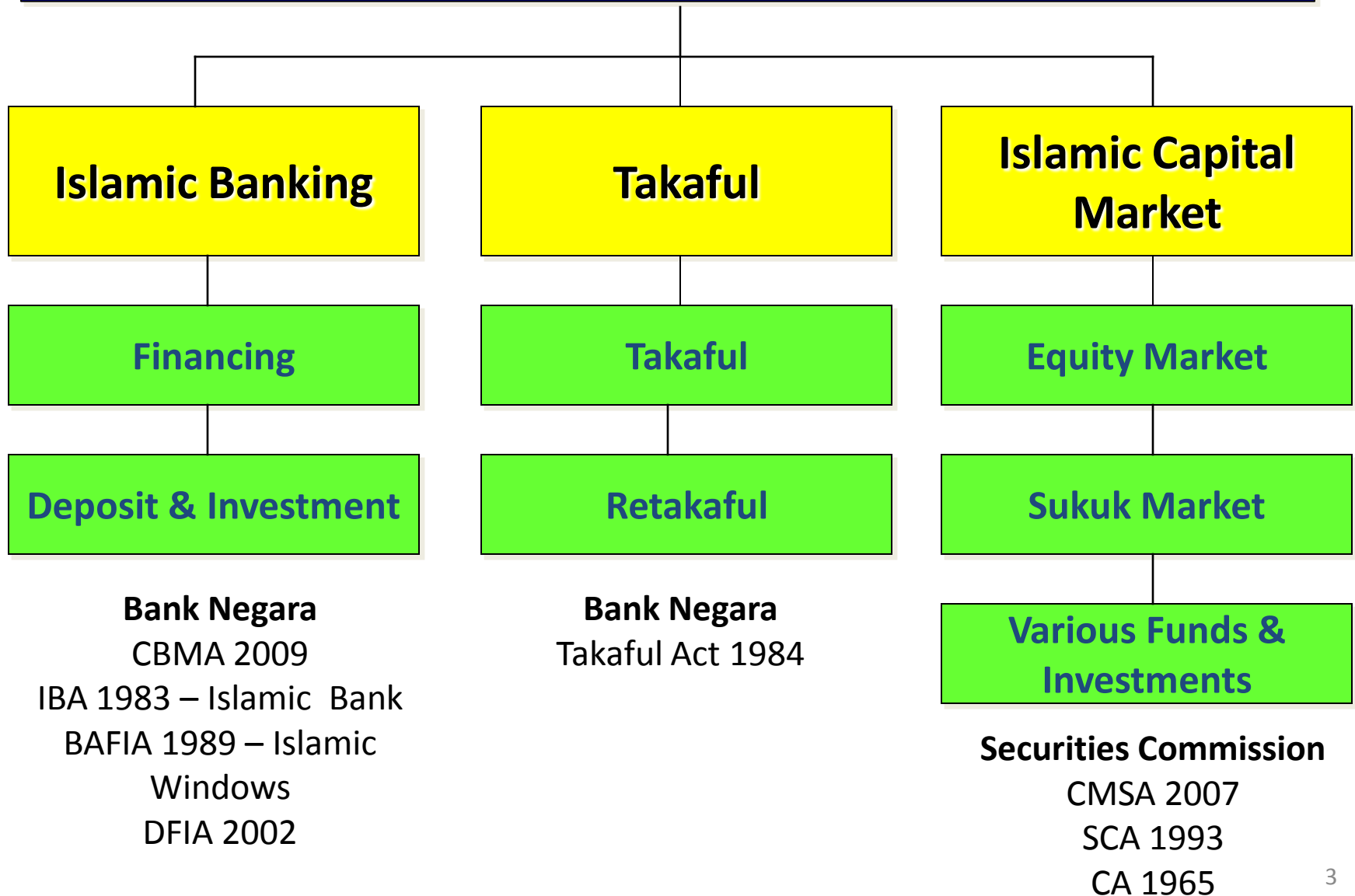
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LEGAL & REGULATORY FRAMEWORK FOR IFS: A BROAD CLASSIFICATION

Legal & Regulatory Framework	Totally conventional – e.g. Japan, US, China
	Conventional framework with special law / regulation for IFS – e.g. Malaysia, Brunei, Indonesia
	Generally Islamic law – e.g. Saudi Arabia, Sudan

OVERVIEW OF ISLAMIC FINANCIAL SERVICES IN MALAYSIA & THEIR REGULATORY FRAMEWORK



SHARI`AH COMPLIANCE GOVERNANCE IN MALAYSIAN BANKING STATUTES

Specific Islamic Banking Laws – requires Syariah compliance & mandates Syariah governance

Sect. 2 IBA 1983

“Islamic banking business” means banking business whose **aims and operations do not involve any element which is not approved by Religion of Islam**”

Sect. 3 (5) IBA 1983

The Central Bank shall not recommend the grant of a licence, unless...

- a. the aims and operations of the banking business which it is desired to carry on **will not involve any element which is not approved by the Religion of Islam**; and
- b. that there is in the articles of association of the bank concerned, provision for the **establishment of a Syariah advisory body**, as may be approved by the Central Bank, to advise the bank on the operations of its banking business in order **to ensure that they do not involve any element which is not approved by the Religion of Islam**

Sect. 124 BAFIA 1989

“Islamic Financial Business – any financial business the **aims and operations of which do not involve any element which is not approved by the Religion of Islam**”

Note: Shari`ah non-compliance is a legal risk!

SHARI`AH GOVERNANCE

One of the main aims of SG is to ensure Shari`ah compliance:

- In actuality
- In the perception of the outsiders – reputation / public confidence

Good Shari`ah compliance governance requires:

- Independence of judgment
- Integrity & accountability
- Competency & professionalism
- Research function & support

Good Shari`ah Governance prevents unnecessary operational risks:

- Legal risk
- Loss of income – non-compliant income that cannot be earned
- Reputational risk

THE DYNAMICS OF SYARIAH COMPLIANCE GOVERNANCE

- Not just a one-off thing – nor a mere rubber stamp at the end of everything...
- On-going: pre-present-post:
 - Inception & conceptualization
 - Structuring
 - Documentation
 - Execution & implementation
 - Audit & review
 - Restructuring (if needed)
 - Recovery mechanisms & dispute resolution

SHARI`AH AUDIT – INTERNAL & EXTERNAL

- Shari`ah Audit – essential check & balance (hisbah); enhance accountability
- Regulation of Shari`ah audit – essential – to ensure independence & integrity:
 - Appointment
 - Process & procedure
 - Reporting
 - Implementation of the reports & recommendations
- An important indicator of good Shari`ah governance
- Generate Shari`ah compliance culture
- Enhance public & stakeholders' confidence

SHARIAH GOVERNANCE FRAMEWORK FOR IFI (Malaysia - Effective January 2011)

Two-tier Shariah Governance Infrastructure

Shariah Advisory Council (BNM)	Shariah Committee (IFI)
<ul style="list-style-type: none">• Centralised Shariah advisory body 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 Shariah issue relating to Islamic financial business operations, activities or transactions	<ul style="list-style-type: none">• Shariah 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 Shariah matters– Monitoring activities & operations of the IFIs– Developing products– Providing training & awareness programme– Representing the IFIs in forums etc– Conducting Shariah audit exercise for the IFIs

SHARIAH GOVERNANCE FRAMEWORK FOR IFI (Effective January 2011)

OBJECTIVES



1

- Sets out the expectations of BNM on an IFI's Shariah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Shariah;

2

- Provides a comprehensive guidance to the board, Shariah Committee and management of the IFI in discharging its duties in matters relating to Shariah

3

- Outlines the functions relating to Shariah review, Shariah audit, Shariah risk management and Shariah research

Shariah Governance Framework & its Principles

General Requirements	IFI must establish a sound & robust Shariah governance structure with emphasis on roles of key functionalities
Oversight, Accountability & Responsibility	IFI shall set out the accountability and responsibility of every key functionary (BOD, SC, Mgt) involved in the implementation of SGF
Independence	Independence of the Shariah Committee shall be observed at all times in exercising their duties to make objective and informed judgment
Competency	Any person bearing responsibilities in SGF shall possess the necessary competency and continuously enhance their knowledge
Confidentiality & Consistency	<ul style="list-style-type: none">• Internal & privileged information obtained by the SC in the course of their duties shall be kept confidential at all times• Professional ethics, judgment and consistency shall be maintained in ensuring Shariah compliance
Shariah Compliance & Research Functions	Robust Shariah compliance functions comprising: Shariah review; Shariah audit; Shariah risk management and Shariah research

Shariah Review vs Shariah Audit

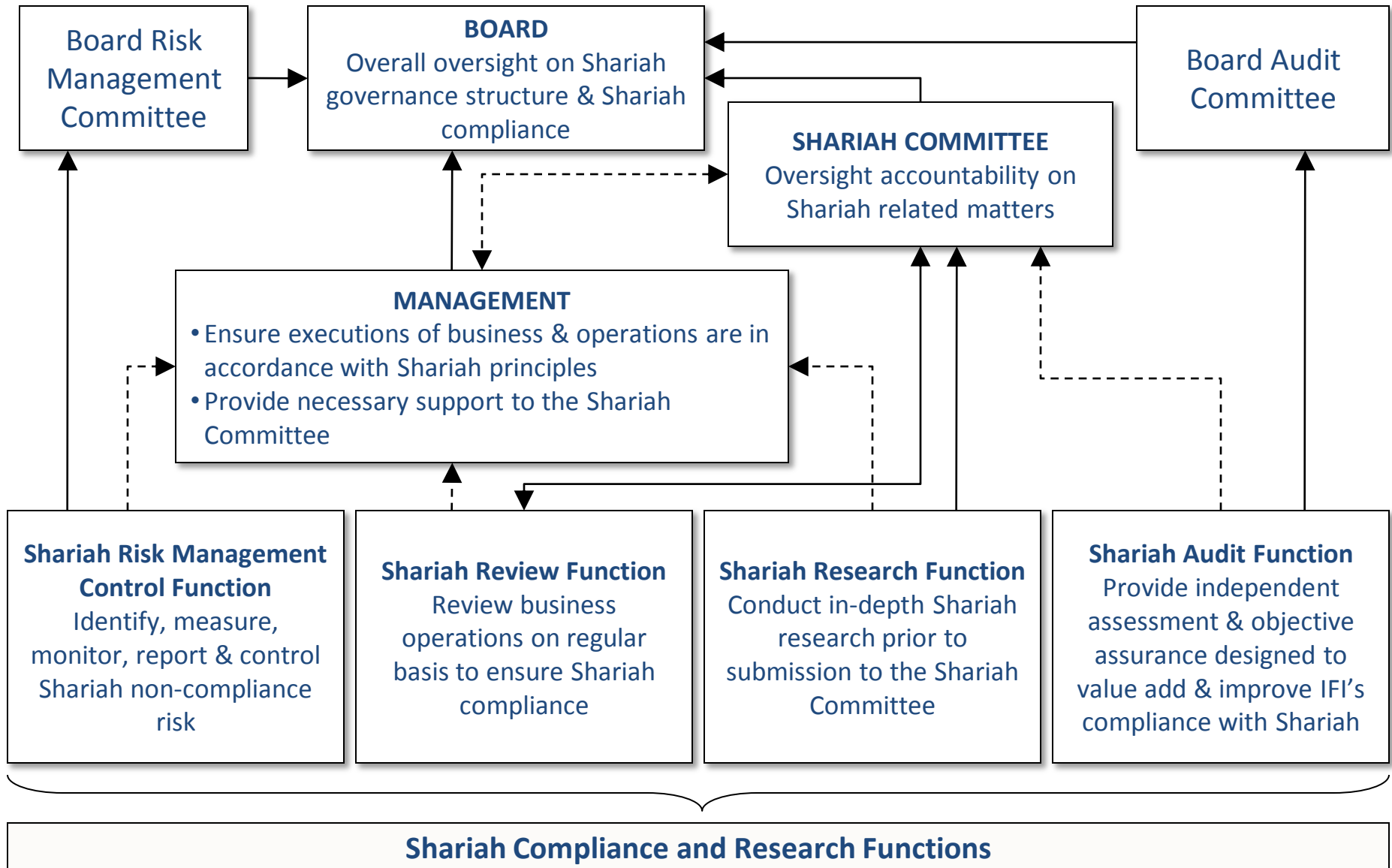
Shariah Review

- **Meaning** : regular assessment on Shariah compliance in the activities & operations of IFIs by qualified Shariah officer(s)
- **Function** : examination & evaluation of the IFI's level of Shariah compliance, remedial rectification measures and control mechanism
- **Scope** : overall business operations of IFIs, starting from product structuring to product offering
- **Process** : planning - documentation; - communicating the outcome (report) - rectification

Shariah Audit

- **Meaning**: periodical independent assessment of the IFI to ensure sound and effective internal control system for Shariah compliance
- **Function** : shall be performed by internal auditors with adequate Shariah related knowledge and training
- **Scope** : all aspects of IFI's business operations & activities (eg: financial statement; organisational structure, adequacy of Shariah governance process)
- **Process** : understanding the business of IFI – develop audit program – obtain relevant sources – conduct audit exercise – communicating result — recommendation, rectification, follow-up

Shariah as overarching principle in Islamic finance



OTHER IMPORTANT GUIDELINES & STANDARDS

AAOIFI – Accounting, Auditing & Governance Standards for IFIs – 2004/05:

- **GSIFI 1 (SSB appointment, composition & report)**
- **GSIFI 2 (Shari`ah Review)**
- **GSIFI 3 (Internal Shari`a Review)**
- **GSIFI 4 (Audit & Governance Committee)**

IFSB Guiding Principles On Corporate Governance For IIFS (2006)

IFSB Guidance On Key Elements in The Supervisory Review Process of IIFS (2007)

IFSB Disclosures To Promote Transparency & Market Discipline For IIFS (2007)

FINAL WORDS

- Shari`ah governance allows for systematic and transparent mechanisms to monitor & ensure Shari`ah compliance in all stages of provision of Islamic financial services
- The real challenge is effective implementation & enforcement of the SGF!
- Requires commitment & correct attitude of all parties involved
- Successful implementation of Shari`ah governance will boost confidence in the integrity of IFS and its Shari`ah compliance; & prevent unnecessary operational risks to the IFIs

Thank you!

Wassalam