LEGAL FRAMEWORK & GOVERNANCE FOR ISLAMIC FINANCIAL SERVICES

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<table>
<thead>
<tr>
<th>Legal &amp; Regulatory Framework</th>
<th>Description</th>
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<tbody>
<tr>
<td>Totally conventional – e.g. Japan, US, China</td>
<td>Conventional framework with special law / regulation for IFS – e.g. Malaysia, Brunei, Indonesia</td>
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<td>Generally Islamic law – e.g. Saudi Arabia, Sudan</td>
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OVERVIEW OF ISLAMIC FINANCIAL SERVICES IN MALAYSIA & THEIR REGULATORY FRAMEWORK

Islamic Banking
- Financing
  - Deposit & Investment
    - Bank Negara
      - CBMA 2009
      - IBA 1983 – Islamic Bank
      - BAFIA 1989 – Islamic Windows
      - DFIA 2002

Takaful
- Takaful
- Retakaful
  - Bank Negara
    - Takaful Act 1984

Islamic Capital Market
- Equity Market
- Sukuk Market
  - Various Funds & Investments
    - Securities Commission
      - CMSA 2007
      - SCA 1993
      - CA 1965
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

<table>
<thead>
<tr>
<th>Shariah Advisory Council (BNM)</th>
<th>Shariah Committee (IFI)</th>
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<tbody>
<tr>
<td>• Centralised Shariah advisory body at BNM</td>
<td>• Shariah Advisors at the respective IFIs</td>
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<tr>
<td>• Established under Sec 51 of CBMA 2009</td>
<td>• Appointed by BOD of IFI</td>
</tr>
<tr>
<td>• Apex authority for determination of Islamic law in Islamic Financial business</td>
<td>• Have an active role in:</td>
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<tr>
<td>• Mandates:</td>
<td>– Advising the IFIs on Shariah matters</td>
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<tr>
<td>– ascertain the Islamic law on any financial matter &amp; issue a ruling upon reference made to it</td>
<td>– Monitoring activities &amp; operations of the IFIs</td>
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<tr>
<td>– Advise BNM &amp; IFI on any Shariah issue relating to Islamic financial business operations, activities or transactions</td>
<td>– Developing products</td>
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<td></td>
<td>– Providing training &amp; awareness programme</td>
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<td>– Representing the IFIs in forums etc</td>
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<td>– Conducting Shariah audit exercise for the IFIs</td>
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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

<table>
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<th>General Requirements</th>
<th>IFI must establish a sound &amp; robust Shariah governance structure with emphasis on roles of key functionalities</th>
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<td>Oversight, Accountability &amp; Responsibility</td>
<td>IFI shall set out the accountability and responsibility of every key functionary (BOD, SC, Mgt) involved in the implementation of SGF</td>
</tr>
<tr>
<td>Independence</td>
<td>Independence of the Shariah Committee shall be observed at all times in exercising their duties to make objective and informed judgment</td>
</tr>
<tr>
<td>Competency</td>
<td>Any person bearing responsibilities in SGF shall possess the necessary competency and continuously enhance their knowledge</td>
</tr>
</tbody>
</table>
| Confidentiality & Consistency | • 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

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<th>Shariah Review</th>
<th>Shariah Audit</th>
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<td><strong>Meaning</strong>: regular assessment on Shariah compliance in the activities &amp; operations of IFIs by qualified Shariah officer(s)</td>
<td><strong>Meaning</strong>: periodical independent assessment of the IFI to ensure sound and effective internal control system for Shariah compliance</td>
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<tr>
<td><strong>Function</strong>: examination &amp; evaluation of the IFI’s level of Shariah compliance, remedial rectification measures and control mechanism</td>
<td><strong>Function</strong>: shall be performed by internal auditors with adequate Shariah related knowledge and training</td>
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<td><strong>Scope</strong>: overall business operations of IFIs, starting from product structuring to product offering</td>
<td><strong>Scope</strong>: all aspects of IFI’s business operations &amp; activities (eg: financial statement; organisational structure, adequacy of Shariah governance process)</td>
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<td><strong>Process</strong>: planning - documentation; - communicating the outcome (report) - rectification</td>
<td><strong>Process</strong>: understanding the business of IFI – develop audit program – obtain relevant sources – conduct audit exercise – communicating result — recommendation, rectification, follow-up</td>
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KLFF 2012 - Kuala Lumpur
Shariah as overarching principle in Islamic finance

**Board Risk Management Committee**
- Board Risk Management Committee

**Board**
- Overall oversight on Shariah governance structure & Shariah compliance

**Shariah Committee**
- Oversight accountability on Shariah related matters

**Management**
- Ensure executions of business & operations are in accordance with Shariah principles
- Provide necessary support to the Shariah Committee

**Shariah Risk Management Control Function**
- Identify, measure, monitor, report & control Shariah non-compliance risk

**Shariah Review Function**
- Review business operations on regular basis to ensure Shariah compliance

**Shariah Research Function**
- Conduct in-depth Shariah research prior to submission to the Shariah Committee

**Board Audit Committee**
- Shariah Audit Function
  - Provide independent assessment & objective assurance designed to value add & improve IFI’s compliance with Shariah

**Shariah Compliance and Research Functions**
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 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