



# Legal Aspects of Corporate and Shariah Governance of Islamic Financial Institutions in Malaysia

## *Aspek Perundangan Tadbir Urus Korporat dan Syariah Institusi Kewangan Islam di Malaysia*

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### ABSTRACT

The concept of corporate governance, which is based on the principles of accountability, transparency, and fairness, is an essential element in the context of Islamic banking and finance. Compared to its conventional counterpart, Islamic financial institutions are subject to the same guidelines and standards on corporate governance practices in addition to the Shariah governance guidelines issued by the regulators. At the international level, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have issued various standards and guidelines from time to time to complement the corporate governance standards issued by other authorities such as Organisation for Economic Co-operation and Development (OECD) and Basel Committee for Banking Supervision (BCBS). The concept of corporate and Shariah governance have been incorporated into the legal and regulatory framework in Malaysia and it is being updated from time to time. However, issue arises as to whether or not the existing legal framework is adequate in governing the Islamic financial institutions. Thus, the objective of this study is to discuss the legal aspects of corporate and Shariah governance framework of Islamic financial institutions in Malaysia. This legal study applies qualitative research methodology that emphasises on library-based research. References are made to relevant legislations, standards and guidelines to provide insight on the legal aspects of corporate and Shariah governance principles in the Islamic financial institutions in Malaysia. Finding of the study shows that Malaysia has a comprehensive legal and regulatory framework regulating corporate and Shariah governance in Islamic financial institutions that indicates Malaysia's commitment towards promoting good corporate and Shariah governance practices in the Islamic banking and finance industry.

**Keywords:** Islamic Banking and Finance, Corporate Governance, Shariah Governance, Legal, Regulatory





## ABSTRAK

Konsep tadbir urus korporat yang berdasarkan kepada prinsip kebertanggungjawaban, ketelusan dan keadilan merupakan elemen yang penting dalam konteks perbankan dan kewangan Islam. Jika dibandingkan dengan perbankan dan kewangan konvensional, institusi-institusi kewangan Islam adalah tertakluk kepada garis panduan dan standard yang sama berkenaan amalan tadbir urus korporat sebagai tambahan kepada garis panduan tadbir urus Syariah yang dikeluarkan oleh badan pengawalselia. Di peringkat antarabangsa, AAOIFI dan IFSB telah mengeluarkan pelbagai standard dan garis panduan dari semasa ke semasa sebagai pelengkap kepada garis panduan tadbir urus korporat yang dikeluarkan oleh pihak berkuasa lain seperti OECD dan BCBS. Konsep tadbir urus korporat dan Syariah ini telah dirangkumkan ke dalam kerangka perundangan di Malaysia dan ianya sentiasa dikemaskini dari semasa ke semasa. Walau bagaimanapun isunya adalah sama ada kerangka perundangan sedia ada mencukupi dalam mengawalselia institusi-institusi kewangan Islam. Maka, objektif kajian ini adalah untuk membincangkan aspek perundangan tadbir urus korporat dan Syariah bagi institusi-institusi kewangan Islam di Malaysia. Sebagai kajian undang-undang, kajian ini menggunakan kaedah penyelidikan kualitatif yang menumpukan kepada kajian pustaka. Rujukan dibuat kepada undang-undang, standard dan garis panduan berkaitan untuk memberi gambaran tentang aspek perundangan tadbir urus korporat dan Syariah bagi institusi kewangan Islam di Malaysia. Hasil kajian mendapati Malaysia mempunyai kerangka perundangan yang menyeluruh berkenaan tadbir urus korporat dan Syariah dan ini menunjukkan komitmen Malaysia untuk menggalakkan amalan tadbir urus korporat dan Syariah yang baik dalam industri perbankan dan kewangan Islam.

**Kata Kunci:** Perbankan dan Kewangan Islam, Tadbir Urus Korporat, Tadbir Urus Syariah, Perundangan

## INTRODUCTION

Corporate governance refers to the process and structure used to direct and manage the business and affairs of an institution towards enhancing business prosperity and corporate accountability. The ultimate objective of corporate governance is the realization of the long-term shareholder value, whilst taking into account the interests of other stakeholders as a whole (High-Level Finance Committee Report, 1999). The concept of corporate governance in the financial sector has been developed in the context of the conventional financial system. This is explained by the fact that the conventional system has been in existence long before the introduction of the Islamic financial system (ISRA, 2016).

The global wave of corporate governance can be seen from the initiatives taken by various organisations, which have resulted in the publication of committee reports including the Cadbury Committee Report, the Greenburg Report, the Hampel Committee Report, the OECD Principles of Corporate Governance and the Principles for Corporate Governance in the Commonwealth. These reports collectively suggested



for reforms and reapplication of the universally accepted principles of good governance such as fairness, transparency, accountability and responsibility (Abidin & Hashim, 2010).

As far as Malaysia is concerned, the concept of corporate and Shariah governance have been incorporated into the existing legal and regulatory framework and consistently being updated from time to time. Despite the development of this systematic structure, issue arises as to whether or not the existing laws and regulations are adequate to govern the Shariah governance aspect of the IFIs in Malaysia.

This study aims to discuss the legal aspects of corporate and Shariah governance framework of the Islamic banking and finance industry in Malaysia. Being a legal research, this study applies qualitative research methodology that is mainly library research. Reference is made to relevant legislations, standards and guidelines to provide insight on the legal aspects of corporate and Shariah governance practices in the Islamic financial institutions in Malaysia. This paper is divided into four sections: Section one provides the introduction of the study. Section two reviews the available literature on the topic. Section three defines the concept of corporate and Shariah governance according to the international organisations i.e. Organisation for Economic Co-operation and Development (OECD), Basel Committee of Banking Service (BCBS), Islamic Financial Services Board (IFSB) and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Section four analyses relevant legislations, guidelines and code regulating the application of corporate and Shariah governance of IFIs in Malaysia. Section five concludes the paper.

## **LITERATURE REVIEW**

Corporate governance is one of the contemporary focus of the corporate world since its establishment over the last two decades. Corporate governance is a vital aspect of the management of an institution. It assists the company to achieve its objectives and enable the company to run smoothly (Muneeza & Hassan, 2014).

From the academic perspective, there are numerous studies on corporate governance, including the Islamic perspective of corporate governance have been made where this area is now being associated with economics, finance, laws, politics and others. One of the studies found that conventional corporate governance and Islamic corporate governance do not have significant differences in basic theory and compliance to Shariah principles is what differentiates corporate governance from Islamic corporate governance (Nopica, Ahmad, Ismail, & Hassan, 2016). This similarity is because both systems are based on capitalism with some priorities of wealth maximisation for investors and rest of the stakeholders. They are provided with opportunities to contribute in corporate decision making by promoting fair, just and honest business dealings. Both systems aim for similar objectives that is to establish the sound system of corporate governance through efficient, effective management, corporate reporting and disclosure for a long-term corporate stability which should not only be beneficial to investors but to the rest of the stakeholders as well (Hafeez, 2013).



The concept of Shariah governance started to emerge in the nineteenth century after the introduction of Islamic banking and Islamic finance. This development is backed by the increase in the number of Shariah-compliant companies, which leads to the formulation of corporate governance rules that are in line with the Islamic law. The earlier literatures mostly focus on the concept of Shariah governance in comparison with the established concept of corporate governance. This can be explained by the fact that corporate governance has been in practice before the introduction of Shariah governance that arises following the introduction of Islamic banking in the 80s. However, academic writings on Shariah governance remain limited as compared to its counterparts (Kasim, NuHtay, & Salman, 2013) and discussions on Shariah governance are mostly in relation to conventional corporate governance (Abdullah, Alnasser, & Jorih Muhammed, 2012) & (Kasri, 2009).

A considerable amount of research has also been conducted on the Shariah governance of Islamic financial institutions such as the Islamic banks (Garas & Pierce, 2010). Hassan et al., (2013) has discussed the salient features of the Shariah governance framework, its component and the current practices in the Islamic financial industry. The existence of sound Shariah governance is crucial to enhance the potential role of Islamic finance in contributing towards corporate reform and to mitigate certain types of risk exclusive to IFIs namely Shariah non-compliance risk (Ahmed & Khatun, 2013), which refers to the risk of non-compliance resulting from a failure of an IFI to comply with Shariah rules and principles determined by the Shariah board of the IFI to the relevant bodies in the jurisdiction in which the IFI operates (IFSB, 2005). The importance of Shariah governance, therefore, lies on the need to earn the trust and confidence of stakeholders of Islamic banks that would impact the stability of the institution and enhances their capacity to function as financial intermediaries in the Islamic financial system (Ginena, 2015).

Although numerous studies have focused on corporate and Shariah governance of Islamic financial institutions, little analytic attention has been paid to the legal aspect of corporate and Shariah governance of IFIs in Malaysia. For instance, (Hussain, Hassan, & Hasan, 2015; OECD, 2015) has pointed out on the development of laws governing Shariah Advisory Council in Malaysia by highlighting relevant provisions of the Central Bank of Malaysia Act 2009 in comparison with the repealed Central Bank of Malaysia Act 1958 without making any reference to other legislations relating to corporate and Shariah governance practices in Malaysia.

Legal issues relating to the appointment of Shariah Advisory Council (SAC) members have been discussed by Hussain et al. (2017) whereby the study found that several loopholes exist in the current statutory requirements which need to be addressed by the relevant authoritative bodies in order to avoid any legal conflict in the future. One of the issues involved is the absence of provision that specifies the number of members in the composition of SAC as well as the Shariah committee of IFIs. Similarly, this study is focused on the Central Bank of Malaysia Act 2009 (CBMA) and Islamic Financial Services Act 2013 (IFSA) without making any reference to other legislations.



## **THE CONCEPT OF CORPORATE AND SHARIAH GOVERNANCE**

### **Definition of Corporate Governance**

The definition of corporate governance can be found in the corporate governance standards issued by a number of international organisations such as the Organisation for Economic Co-operation and Development (OECD), Basel Committee of Banking Service (BCBS), the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

The OECD defines corporate governance in its G20/OECD Principles of Corporate Governance as a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring of the operation of the company. The presence of an effective corporate governance system, within an individual company and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy (OECD, 2015).

On the other hand, corporate governance according to BCBS involves the manner in which the business and affairs of banks are governed by the boards of directors and senior management that affects how they set corporate objectives; operate the bank's business on a daily basis; meet the obligation of accountability to the shareholders and take into account the interests of other recognised stakeholders; align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors (BCBS, 2006).

The IFSB describes corporate governance in its Guiding Principles on Corporate Governance (IFSB-3) as a defined set of relationships between a company's management, its board of directors, its shareholders and other stakeholders, which provides the structure through which the objectives of the company are set and the means of achieving those objectives and monitoring performance are determined (IFSB, 2006). The IFSB-3 further describes corporate governance in the context of the IFIs as a set of organisational arrangement whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interests of its stakeholders, provisions of proper incentives for the organs of governance such as the board of directors, the Shariah supervisory board and management to pursue objectives that are in the interests of stakeholders and facilitate effective monitoring, thereby encouraging IFIs to use the resources more efficiently while complying to the Shariah rules and principles (IFSB, 2006).



### Definition of Shariah Governance

The concept of corporate governance from the Islamic perspective requires an additional layer of governance to deal with the issue of Shariah compliance. Therefore, the Shariah governance system was introduced to complement the existing corporate governance framework of the IFIs to deal with the Shariah compliance-related issues (ISRA, 2016). The concept of corporate governance that emphasizes on the principles of accountability, transparency, responsibility and fairness is an essential feature in the context of Islamic banking and finance. The Islamic financial institutions are subject to the same guidelines and standards on corporate governance practices similar to its conventional counterpart, in addition to the Shariah governance guidelines issued by the regulators. The concept of corporate governance in Islam refers to a set of organisational arrangements on how a corporation is directed, managed, governed and controlled with the aim to protect the interest of the stakeholders, and to achieve the objectives of the organisation in compliance with the Shariah rules and principles (ISRA, 2016).

Shariah governance in its contextual definition refers to the set of institutional and organizational arrangements, policies, processes, procedures rules, regulations and laws which leads the organisation towards Shariah compliance (Minhas, 2012). Shariah compliance requirement allows the IFIs to consolidate their differentiation factor compared to conventional financial institutions and to support their reputation and credibility (Hamza, 2013). The existing framework of Islamic finance in various jurisdictions around the world demonstrates the diverse practices and models of Shariah governance system. This can be explained by the fact that some jurisdictions prefer greater involvement of regulatory authorities and some countries, on the other hand, favour different views (Hasan, 2011).

Table 1 illustrates how Shariah governance complements the existing corporate governance framework in the IFIs.

Table 1: Shariah Governance Vis-A-Vis Corporate Governance Framework

Function	Conventional Financial Institutions	Additional to IFIs
Governance	BOD	Shariah Board
Control	Internal Audit, external audit	Internal Shariah review, Shariah audit
Compliance	Regulatory and financial compliance officers, unit or department	Internal Shariah compliance officer, unit or department
Risk management	Risk management department (credit, market and operational risk)	Shariah compliance risk

(Source: Adapted from IFSB, 2009)

The IFSB via IFSB-10 defines Shariah governance system as a set of institutional and organisational arrangements through which IFIs ensure that there is an effective



independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements; dissemination of information on such Shariah pronouncements to the operative personnel of the institution who monitor the day-to-day compliance; an internal Shariah compliance review or audit to verify that Shariah compliance has been satisfied, during which any incident of non-compliance will be recorded, reported, addressed and rectified; and an annual Shariah compliance review or audit to verify that the internal Shariah compliance review or audit has been appropriately carried out and its findings have been communicated and duly noted by the Shariah Supervisory Board (IFSB, 2009).

## **LEGAL ASPECTS OF CORPORATE AND SHARIAH GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS**

### **Part 1: Corporate Governance**

Discussion on the legal aspects of the corporate governance of IFIs in Malaysia includes the laws and regulations:

- (1) Companies Act 2016 and Companies Regulations 2017
- (2) Islamic Financial Services Act 2013
- (3) Malaysian Code on Corporate Governance
- (4) Guidelines on Corporate Governance of Licensed Islamic Banks

### ***Companies Act 2016 and Companies Regulations 2017***

The Companies Act 2016 and Companies Regulations 2017 came into effect on 31 January 2017 that have the effect of repealing the Companies Act 1965 and Companies Regulations 1966. The new Act was enacted to strengthen corporate governance and ensure the interests of directors, shareholders and creditors are protected. It is generally applicable to all companies incorporated under the Act and its previous corresponding laws including IFIs.

While the new Act makes it easier to do business and allows the Malaysian company law to be more viable and flexible, this also means that directors will be held to higher expectations and will have to shoulder more responsibility to ensure that companies are properly managed. Among its key provisions include requirements that directors' remuneration to be approved at general meetings, the introduction of solvency statements by directors, director indemnification and insurance as well as increased sanctions for breach of directors' duties.

For instance, section 114 of the Act renders the directors liable for offences regarding the issuance of solvency statement without having reasonable grounds for the opinion and shall, on conviction, be liable to imprisonment for a term not exceeding five years or a fine not exceeding five hundred thousand ringgit or both.

In relation to director's fees, section 230 of the Act requires that director's fees and any benefits payable to the directors must be approved at the general meeting of the



company. This requirement is applicable to public companies and their subsidiaries. For private companies, the director's remuneration may be approved by the board of directors, but mandatory record and shareholder notification are required. It is further provided under section 233 that qualifying shareholders have the right to inspect the contract of service of the directors. The contract can be inspected upon request by members holding at least 5% of total paid-up capital for a public company with share capital while for the public company with no share capital, the requirement is 5% of members.

Section 289 provides for stricter requirements for director indemnification and insurance. The provision stipulates that indemnification is not allowed and insurance cannot be effected on directors who have breached their duties to the company under the Act.

The Act also imposes heavier fines and longer terms of imprisonment on directors for breaches under the Act. For instance, Section 218 provides that the improper use of property and position by a director to gain a benefit for himself or to cause detriment to the company can result in up to a 5-year imprisonment or up to three million ringgit fine, or both upon conviction. The three million ringgit fine is a 100-fold increase from the fine of thirty thousand ringgit under the repealed Act and this is intended to serve as a stronger deterrent against improper behaviour and practices by directors.

### ***Islamic Financial Services Act 2013 (IFSA 2013)***

Division 2 of IFSA 2013 that deals specifically with corporate governance aspect of IFIs consists of 10 provisions ranging from section 62-71. Section 63 requires that the chairman, director and chief executive officer of an IFI can only be appointed through written approval from the Bank Negara Malaysia (BNM). IFI is further required to inform the BNM of any appointment, reappointment, election or re-election of the three positions within seven days or such other period as may be determined by BNM.

The proposed chairman, director and chief executive officer must fulfil the qualification requirements imposed by section 64 that requires such person must be an individual, is not disqualified under section 68 (1) and has complied with the fit and proper requirements under section 69.

The duties and responsibilities of the board of directors (BOD) are stipulated under section 65 to include:

- (a) setting and overseeing the implementation of business and risk objectives and strategies while having regard to the long-term viability of the IFI and reasonable standards of fair dealings.
- (b) ensuring and oversee the effective design and implementation of sound internal controls, compliance and risk management systems commensurate with the nature, scale and complexity of the business and structure of the IFI.
- (c) overseeing the performance of the senior management in managing the business and affairs of the IFI;



- (d) ensuring that there is a reliable and transparent financial reporting process within the institutions;
- (e) promoting timely and effective communications between the IFI and the BNM on matters affecting or that may affect the safety and soundness of the IFI; and
- (f) having due regard to any decision of the SC on any Shariah issue relating to the carrying on of business, affairs or activities of the IFI.

Sections 66 requires that a director of an IFI shall at all times act in good faith and in the best interest of the IFI; exercise reasonable care, skill and diligence with the knowledge, skill and experience which may reasonably be expected of a director and exercise of sound and independent judgement in compliance with the standards specified by the BNM. Failure to comply is an offence, which is punishable with imprisonment for a term not exceeding eight years or to a fine not exceeding twenty five million ringgit or both.

### **Malaysia Code on Corporate Governance**

The application of the concept of corporate governance in Malaysia can also be found in the Malaysian Code on Corporate Governance (MCCG). The MCCG, which was introduced in 2000, reflects global principles and internationally recognised practices of corporate governance that are above and beyond the minimum required by statute, regulations or those prescribed by Bursa Malaysia.

The MCCG was reviewed in 2007 and 2012 to ensure that it remains relevant and is in line with the global recognised practices and standards. In 2017, the MCCG, which supersedes its earlier edition, introduced a new approach with the objective to promote greater internalisation of corporate governance culture among companies in Malaysia including Islamic financial institutions. The MCCG 2017 is based on three key principles of good corporate governance, which are board leadership and effectiveness; effective audit and risk management and integrity in corporate reporting as well as meaningful relationship with stakeholders (MCCG, 2017).

In relation to board leadership, among its key outcomes are every company is headed by a board that has the responsibility for the company's leadership and is collectively responsible for achieving the objectives and goals of the company. It is also intended that there must be a demarcation of responsibility between the board, board committees and management.

In order to have an effective audit and risk management, the company must have an effective and independent audit committee whose findings and recommendations can be reviewed objectively by the board. The existence of an effective governance, risk management and internal control framework will enable stakeholders to assess the effectiveness of the framework.

To ensure integrity in corporate reporting and meaningful relationship with stakeholder, continuous communication between the company and stakeholders is required to facilitate a mutual understanding of each other's objectives and expectations. This will



enable the stakeholders to make informed decisions with respect to the business of the company, its policies on governance, the environment and social responsibility.

### ***Guidelines on Corporate Governance for Licensed Islamic Banks***

The IFIs in Malaysia are also governed by the Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i) issued by the BNM in 2013. The Guidelines outline the provisions to promote best practice and good corporate governance for financial institutions in Malaysia and to support the adoption of effective and high standards of corporate governance practices by IFIs i.e. Islamic banks and its financial holding companies. The Guidelines also contain broad principles dealing with board matters, management oversight, accountability and audit, and transparency.

For Islamic bank holding companies, among the requirements under the Guidelines are the requirement to establish a Nominating and Remuneration Committee and, independent directors and the appointment of directors, Chairman and Chief Executive Officer are subjected to approval from BNM.

### **Part II: Shariah Governance**

Discussion on Shariah governance of IFIs covers the following laws and legislations:

- (1) Central Bank of Malaysia Act 2009
- (2) Islamic Financial Services Act 2013
- (3) Shariah Governance Framework for Islamic Financial Institutions
- (4) Financial Reporting for Islamic Banking Institutions 2016

### ***Central Bank of Malaysia Act 2009 (CBMA 2009)***

The CBMA 2009, which came into effect in July 2009, is an updated version of the Central Bank of Malaysia Act 1958. The provisions relating to Shariah governance are stated under Part VII of the Act, ranging from Section 51 to 58. These sections govern the Islamic financial business through the supervision of the Shariah Advisory Council (SAC) under the BNM.

Section 51 defines the SAC as the body of authority that ascertains the principles of Islamic law in relation to the Islamic financial business. The SAC is statutorily authorised to set its own procedures as to how to carry out their duties in supervising and ensuring that the practice by the Islamic financial institutions is in line with the Islamic principles (Oseni & Ahmad, 2015). Section 52 provides for the functions of the SAC, which among them are, to issue a ruling as well as to advise the BNM and other Islamic financial institutions on any Shariah issue relating to Islamic financial activities.

The members of the SAC are appointed among the persons who possess the expertise and experience in multidiscipline including banking, Islamic finance law and other related fields. Under Section 53, the appointment of such members is made by the



Yang di-Pertuan Agong on the advice of the Minister of Finance, upon recommendation list by the BNM.

The SAC ascertains the application of Shariah law and principle of the Islamic finance practice in Malaysia (Hussain et al., 2015). Section 55 stipulates that the BNM shall consult the SAC 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 SAC.

information to the Shariah committee in exercising its tasks and duties.

In executing its duties and responsibilities, the SAC shall examine and endorse the validity of the application of Shariah in Islamic financial products, which are submitted by Islamic financial institutions under the supervision of the BNM. 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 SAC on the operations of its business to ascertain that it does not involve any element, which is inconsistent with the Shariah.

Apart from the Islamic financial institutions, the SAC is also being referred to by other institutions including courts and arbitrators. The requirement for reference to SAC for ruling from courts or arbitrators is expressly provided in Section 56 (1) which stipulates that the judge or arbitrator who is presiding over any dispute arising from Islamic financial business to refer to the rulings of the SAC or to request for advice from the SAC in determining any issue concerning Shariah matters. This provision is applicable to the civil courts as the matters pertaining to banking and Islamic finance in Malaysia fall under the jurisdiction of the civil courts. In relation to this, any request for advice or ruling of the SAC under the CBMA 2009 or any other law shall be submitted to the secretariat which is provided under Section 54.

In case of conflict or inconsistency between the ruling issued by a Shariah Committee of Islamic financial institutions and the ruling issued by the SAC, the ruling of the SAC shall prevail. Hence, Section 57 is essential in this case to ensure that any deliberation of the SAC will also bind the courts and not only the financial institutions and the arbitrators. This provision states that any ruling made by the SAC pursuant to a reference made under Chapter VII shall be binding on the Islamic financial institutions by virtue of Section 55 and on the courts or arbitrators as stated in Section 56.

The CBMA 2009 not only serves as an improvement of the previous version of the Act but it is also intended to resolve-issues which have arisen before the coming into effect of the Act primarily on the legal effect of the rulings issued by the SAC. The setting up of the SAC marks the development of the Islamic financial industry in Malaysia. The step taken by the lawmaker is essential, as the growth in such industry should come together with an adequate supervision to ensure that the overall course is in line with the Shariah principle.



### ***Islamic Financial Services Act 2013 (IFSA 2013)***

IFSA 2013 that came into effect on 30 June 2013 emphasises on the development of Shariah-compliant regulatory framework through the updated provisions in catering the needs for the conduct of Islamic financial operation in Malaysia (Hassan, 2014). Several Acts were repealed with the coming into force of this legislation namely the Islamic Banking Act 1983, the Takaful Act 1983, the Payment Systems Act 2003 and Exchange Control Act 1953. This implies the extensiveness of the IFSA 2013 as it covers the area of the repealed acts together with the latest and up-to-date provisions. It is interesting to note that prior to 30 June 2013, the legal framework relating to Shariah governance in Islamic finance was not statutorily provided.

The provisions relating to the rules of Shariah governance are provided under Part IV of the IFSA 2013 from Section 28 until Section 38. Section 28 (1) of the IFSA 2013 requires an IFI to ensure that its aims and operations, business, affairs and activities comply with Shariah at all times. The provision further requires that compliance with Shariah in respect of its aims and operation, business affairs or activities as required under the provision refers to compliance with any ruling of the SAC made pursuant to the powers vested upon them by virtue of Section 51 of the CBMA 2009.

Section 28 (3) of the IFSA 2013 deals with the situation where there has been a non-compliance with Shariah on part of the IFI, and where an IFI becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shariah or the advice of its Shariah Committee or the advice or ruling of the SAC. Consequently, the IFI shall immediately notify the BNM and its Shariah Committee of the fact; immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affairs or activities; and within thirty days of becoming aware of such non-compliance or such further period as may be specified by the BNM, submit to the BNM a plan on the rectification of the non-compliance. Failure to comply with this requirement is an offence under Section 28 (5) and any person who contravenes this provision, shall on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.

Section 29 of the IFSA 2013 empowers the BNM to specify standards on Shariah matters, in accordance with the advice or ruling of the SAC, on Shariah matters in respect of the carrying on of business, affairs or activities by an institution which requires the ascertainment of Islamic law by the SAC; and to give effect to the advice or rulings of the SAC. The provision further empowers the BNM to issue standards relating to Shariah governance including functions and duties of the board of directors, senior officers and members of the Shariah Committee of an IFI in relation to compliance with Shariah; fit and proper requirements or disqualifications of a member of a Shariah Committee; and internal Shariah compliance functions; and any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shariah.



The subsequent provisions of the IFSA 2013, generally, highlights the intention of the lawmaker in focusing on the matters pertaining to the appointment and qualification of the Shariah Committees members in Islamic financial institution. This further complements the provisions from the CBMA 2009, which merely touched on the surface of the matter by highlighting the general requirement for the financial institution to have a Shariah committee. This can be seen under Section 30 of the IFSA 2013, which requires an institution to apply directly to the BNM for the establishment of Shariah Committee. Through this provision, the BNM will be able to secure a direct information as to the members of the Shariah Committee in an Islamic financial institution, which at the same time, ensure a proper supervision towards the activities conducted.

Another key improvement of the Shariah governance legal provision is the insertion of criteria of the members of Shariah Committee where a clear standard of requirement pertaining to the appointment of such committee is highlighted under Section 31. This provision which is crossed-referred to Section 29 (2) (a) states only those who are fit and qualified may be appointed as the members of the Shariah Committee.

Section 32 of IFSA 2013 further exerts the significance of Shariah Committees through the introduction of the Shariah governance, which not only set out the duties of the Shariah Committee in the institution but also blends the Shariah Committee 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, it can be concluded that Shariah governance is now being regarded as one of the integral parts of an institution and the committee is no longer be treated as a minor part or division of a company. The clause regarding the cessation of members under Section 33 and 34 of IFSA 2013 enables the BNM to continuously being updated by the institution of its Shariah Committee members. The provision sets out the clause relating to the cessation of the members including situations that would disqualify any member from becoming Shariah Committee members in order to maintain its aim in ensuring that only those who are qualified could be appointed as members. Moreover, the management in charge of the company is now duty-bound under Section 35 of the IFSA 2013 to provide information to the Shariah committee in exercising its tasks and duties.

While the Act does 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 to the Shariah Committee to hold any information including confidential information provided such information is not being relayed to any other persons. While maintaining the duty of confidentiality, the Shariah committees are also vested with the protection under the qualified privilege that prevents them from being sued in a legal action by the Islamic financial institution, if it can be proven that such duties were conducted in good faith.

In order to ensure Shariah compliance by the IFI, the BNM is empowered by Section 37 (1) to require the IFI to appoint any person, subject to approval by the BNM, to carry out



an audit on Shariah compliance. The appointed person shall have the duties and functions as prescribed by the BNM and is required to submit a report to the BNM pertaining to the carried-out audit.

The updated provision as to the Shariah Committee and the newly introduced clause on Shariah governance are among the major features being introduced under the IFSA 2013 which contributes to the boost of authorities as to the roles of the Shariah Committee. This would ensure the activities of the Islamic financial institution are in accordance with Shariah and thus, maintaining a sound and comprehensive Shariah governance framework for Islamic financial industry in Malaysia.

### ***Shariah Governance Framework for Islamic Financial Institutions***

The effort to strengthen the overall control over Shariah compliance matters in the Islamic finance industry was made as early as 2005 where the BNM has prepared the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (Shamser & Sori, 2016). The guideline sets the roles, 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 SAC of the BNM.

The guideline has since been superseded by the Shariah Governance Framework for the Islamic Financial Institutions (SGF). The SGF, which came into effect in January 2011 requires all Islamic financial institutions to comply with the framework within six months' period from the date of its issuance. The SGF provides for the establishment of a two-tier Shariah governance infrastructure comprising two vital components namely the SAC of BNM and an internal Shariah Committee formed in each respective Islamic financial institution and lays down the guidelines for the appointment of Shariah Committee, qualification and roles of the Shariah Committee. The SGF also deals with the duties and roles of the Board of Directors in relation to Shariah compliance process involved in the operations of the IFIs. The SGF further provides the requirement for internal Shariah compliance and research functions with the setting up of Shariah review, Shariah audit, Shariah risk management and Shariah research and secretariat at the IFI level.

In November 2017, BNM has published the exposure draft on Shariah governance which outlines the BNM's proposal to enhance the existing regulatory requirements of Shariah governance for Islamic finance institutions. The objective is to strengthen the effectiveness of Shariah governance implementation within Islamic financial service industry in response to the growing scale and complexity of Islamic financial business and recent developments in the area of governance, compliance and risk management. Among the proposed key enhancement are strengthening board oversight on accountability and responsibilities over Shariah governance, enhanced requirements for the Shariah committee in providing objective and sound advice to IFIs in line with the IFSA 2013, enhanced expectations for the board and senior management to promote a Shariah-compliant culture and further integrate Shariah governance considerations in business and risk strategies, and enhanced regulatory



expectations on the quality of internal control functions to ensure effective management of Shariah non-compliance risk.

### ***Financial Reporting for Islamic Banking Institutions 2016***

The BNM has issued a policy document on Financial Reporting for Islamic Financial Institutions in February 2016 to ensure adequate disclosures by licensed person, i.e. IFI, in the financial statements to improve comparability for users of financial statement and better facilitate the assessment of the financial position, performance and Shariah compliance of Islamic banking activities and operations of the licensed person. The policy document is made in pursuant to Section 29 (1) of the IFSA 2013.

In view of the requirement under the SGF in relation to the state of compliance with Shariah principles, a licensed person is required to disclose the Shariah Committee's Report as part of the Annual Report. The information that must be included in the Report includes identification of the purpose of the Shariah Committee engagement and a clear statement of the management's responsibility in ensuring compliance with Shariah principles and confirmation to the effect that the Shariah Committee has performed the necessary tests, procedures and review work as appropriate. The report must also incorporate opinion of the Shariah Committee on the licensed person's compliance with Shariah with respect of contracts and related documentation used, appropriateness of Shariah basis for the allocation of profit between shareholders and investment account holders, and where appropriate disposal of any earnings from prohibited sources/means to charitable causes, *zakat* computation and any known non-compliance with Shariah and action taken to remedy such non-compliance as reported by the licensed person as specified in the Circular on Shariah Non-Compliance Reporting.

The policy document is applicable to a licensed Islamic bank except for licensed international Islamic banks and a bank licensed under Section 10 of the IFSA 2013 and approved by the BNM to carry on Islamic banking business under Section 15 of the Financial Services Act 2013 (FSA 2013).

### **CONCLUSION**

The existing legal and regulatory framework clearly shows Malaysia's commitment towards promoting corporate and Shariah governance practices among financial institutions, including the Islamic financial institutions in Malaysia. The adoption of sound corporate and Shariah governance standards and practices for the IFIs ensures that IFIs are properly managed by the relevant parties. Effective corporate and Shariah governance practices that enhance corporate accountability are key elements in the working of market discipline and transparency of the IFIs that eventually enhance public confidence on the operation of the Islamic banking and finance industry in Malaysia.



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### **Statutes/Standards/Guidelines**

Central Bank of Malaysia Act 2009

Companies Act 2016

Companies Regulations 2017

Financial Reporting for Islamic Banking Institutions 2016

Guidelines on Corporate Governance for Licensed Islamic Banks 2013

High Level Finance Committee Report 1999

Islamic Financial Services Act 2013

Malaysian Code of Corporate Governance 2017

Shariah Governance Framework for Islamic Financial Institutions 2011