

### Shariah Governance Framework for Islamic Financial Institutions

The Financial Sector Masterplan on Islamic banking and takaful emphasised the importance of establishing an effective Shariah framework in the development of Islamic banking and takaful. An effective Shariah framework would serve to ensure uniformity and harmonisation of Shariah interpretations that will strengthen the regulatory framework and governance practices for the Islamic financial industry. Bank Negara Malaysia issued the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions in December 2004, aimed at achieving uniformity of Shariah decisions, in addition to creating and expanding the pool of competent Shariah personnel in Islamic banking and takaful.

Prior to the issuance of the guidelines, various Shariah bodies co-existed and were governed under separate legal framework. An Islamic bank was required under the Islamic Banking Act 1983 to establish a 'Shariah advisory body', while a takaful operator needed to set up a 'Shariah Supervisory Council' as stipulated under the Takaful Act 1984. The Islamic Banking Scheme (IBS) banks under the Banking and Financial Institutions Act 1989 were required to appoint a Shariah consultant, while financial institutions under the Development Financial Institutions Act 2002 appointed Shariah bodies on their own initiatives. These Shariah bodies were not adequately regulated, and were operating independently of one another, and were also independent of the Shariah Advisory Council (SAC) established by Bank Negara Malaysia. Therefore, these Shariah bodies needed to be regulated in order to avoid divergence of Shariah interpretations on similar matters and eliminate confusion among the public. Current practice of allowing similar members in the various Shariah bodies of Islamic financial institutions was also reviewed from the perspective of corporate governance especially in terms of confidentiality and secrecy provisions.

To address these emerging issues, the Bank amended the Central Bank of Malaysia Act 1958 in 2003 to enhance the role and functions of the SAC of Bank Negara Malaysia. The SAC was accorded the sole authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. The jurisdiction covers all financial institutions regulated and supervised by the Bank. An important development is that the Judiciary has agreed to refer to the SAC dispute cases involving Shariah issues on Islamic banking and finance. To preserve its independence, members of the SAC of Bank Negara Malaysia are not allowed to participate in any Shariah committee of financial institutions.

Following the establishment of the SAC at the Bank, the guidelines to strengthen the Shariah committees at the Islamic financial institutions were issued in December 2004. The guidelines, which will take effect on 1 April 2005, set out the rules, regulations and procedures in the establishment of a Shariah Committee (the Committee), the role, scope of duties and responsibilities of a Committee as well as the relationship and working arrangement between the Committee and the SAC of Bank Negara Malaysia. The requirement to establish the Committee covers the Islamic banks, banking institutions that participate in the IBS, takaful operators and development financial institutions that provide Islamic banking facilities. IBS banks may establish a Committee for the banking group, while takaful operators must have their own Committee as required by law.

Among the duties and responsibilities of the Committee are to advise the board of directors on Shariah matters on the bank's business operations to ensure that they comply with Shariah principles at all times, to endorse the Shariah Compliance Manuals, and to endorse and validate relevant documentations. To ensure the proper record for easy reference, the Committee is required to provide written Shariah opinions or decisions.

To ensure the smooth running of the Committee, every Islamic financial institution is responsible to provide the necessary assistance to the Committee in all its undertakings. The Islamic financial institution is required to refer all Shariah issues to the Committee for advice for adoption. It is also required to ensure that product documents containing Shariah matters be endorsed and validated by the Committee, provide access to relevant records, transactions, manuals or other relevant information for the Committee members to enable them to perform their duties, and provide sufficient resources, independent expert consultation, reference materials and training.

An individual person is only allowed to be a member of one Committee for each industry. In other words, if the person sits on the Committee of an Islamic banking institution, he cannot sit on another Committee of an institution of the same industry. However, he is allowed to sit on a Committee of a takaful company. A company or an institution is no longer allowed to be a Committee member as the guidelines restrict the members of the Committee to individuals only. The Committee member must be at least qualified in the field of Islamic jurisprudence (*Usul Fiqh*) or Islamic transaction/commercial law (*Fiqh Mu'amalat*) or possess the necessary knowledge, expertise or experience in the related field.

The composition of the Committee shall be a minimum of three members. In addition to the Shariah Committee, an Islamic financial institution is required to designate at least one officer, preferably with knowledge in Shariah, to serve as the secretariat to the Committee. The Committee will report to the board of directors of the financial institution. This reporting structure reflects the status of the Committee as an independent body of the Islamic financial institution.

The guidelines are expected to improve and strengthen the Shariah governance of the financial institutions and contribute towards creating a larger pool of highly qualified, conversant and experienced Shariah advisors.

- Following the establishment of the Shariah Advisory Council (SAC) at Bank Negara Malaysia under the Central Bank of Malaysia Act 1958, the Malaysian Judiciary and the Regional Centre for Arbitration Kuala Lumpur will use the SAC as the reference point in the event of a dispute that involves Shariah issues on Islamic banking and finance. As the reference body and advisor to Bank Negara Malaysia on Shariah matters, the SAC is also responsible for validating all Islamic banking and takaful products to ensure their compatibility with the Shariah principles.
- The SAC has convened six meetings during 2004. Among the main decisions made by the SAC were as follows:-
  - o Approval on the mechanism of Islamic bond based on *bai' bithaman ajil* to be used by the national mortgage corporation in purchasing the financing assets from the Islamic financial institutions. The new instrument will be an alternative investment instrument offered to the investors and players that prefer fixed and pre-determined return on their investment. The SAC has also approved the bidding methods for this instrument to be based either on price or rate of return. Methods to determine the rate of return to successful investors can also be based either on bid price or bid profit rate or weighted average of bid profit rates.
  - o An Islamic financing that includes cost of coverage as part of its financing package must be covered by takaful. This is to avoid the involvement of Islamic financial institutions in any transaction that is not Shariah compliant. However, the SAC viewed that if the cost of coverage does not form part of the financing package, the Islamic financial institutions should offer takaful as a first choice to the customers.
  - o Approval in principle on the profit rate swap transaction based on sell and buy back arrangement was given to an IBS merchant bank. The proposed profit rate swap is an arrangement where one party exchanges the fixed profit rate obligation of its asset with the variable profit rate obligation of the counterparty's asset, or vice versa. One rationale for this mechanism is for the Islamic financial institutions to match their long-term investment or fixed rate financing with their shorter-term variable funding rates in order to mitigate their market risk exposure.
- The Law Review Committee that was formed in June 2003 by Bank Negara Malaysia focused its task in 2004 in reviewing the relevant tax laws governing the Islamic banking and finance transactions, namely the stamp duty and tax law, and has made some recommendations to the Government. Towards this end, the Government has announced the tax neutrality policy for Islamic banking and finance in the 2005 Budget to create an equitable tax treatment of Islamic banking and financial transactions *vis-à-vis* similar conventional banking transactions. Under the tax neutrality framework, the Inland Revenue Board (IRB) will exempt additional instruments and transactions