

Contract-Based Regulatory Framework for Islamic Finance

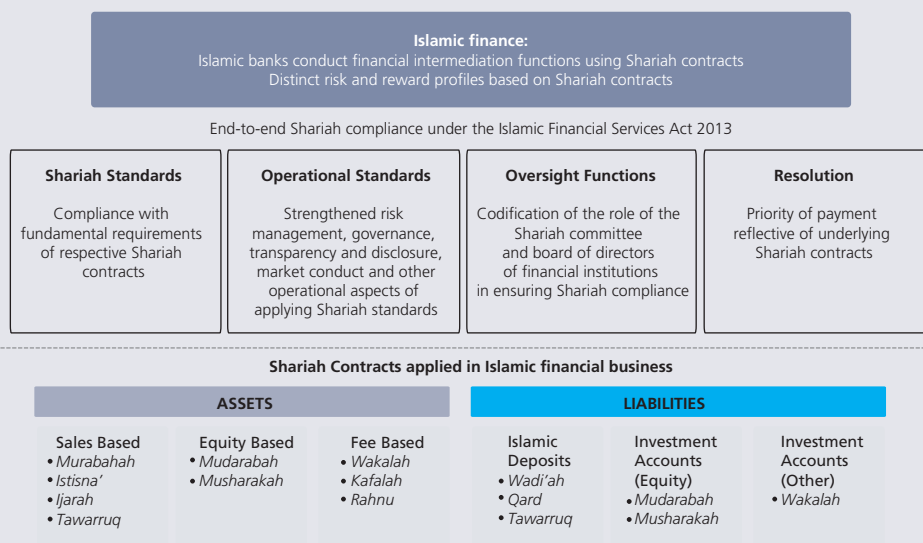
Islamic finance draws its value propositions from the application of a diverse spectrum of Shariah contracts in financial transactions that provide for different risk and return profiles. The strict adherence by Islamic financial institutions to Shariah principles under such distinct contracts preserves the sanctity and validity of Islamic financial transactions. This article highlights the main initiatives undertaken in Malaysia to put in place a comprehensive contract-based regulatory framework for Islamic finance.

Providing a Strong Legal Foundation

The foundations for end-to-end Shariah governance and compliance for the Islamic finance sector have been further strengthened by the Islamic Financial Services Act 2013 (IFSA). The Act provides the legal premise for a comprehensive regulatory framework for Islamic finance in Malaysia that reflects the specificities of the various types of Shariah financial contracts, and supports 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 Islamic financial institution (Diagram 1). This represents a significant step forward in aligning legal and regulatory principles with Shariah precepts, and can serve as a useful benchmark for evolving more comprehensive regulatory frameworks globally that promote greater legal and operational certainty in Islamic finance.

Diagram 1

Contract-Based Regulatory Framework



In terms of achieving greater alignment with Shariah, three elements of the new legislation are noteworthy:

- **The Act clearly defines the scope of assets and liabilities in Islamic banking business based on the underlying contractual features.** On the liability side, the use of principal-guaranteed Shariah contracts such as *qard*, *wadi'ah* and *tawarruq* in deposit-taking is clearly distinguished from principal non-guaranteed Shariah contracts for investment such as *mudarabah* and *wakalah*. On the asset side, the scope of financing activities similarly draws on the distinctive features of Islamic contracts to include equity and partnership financing contracts such as *musharakah mutanaqisah*, lease-based financing contracts such as *ijarah muntahia bittamleek*, and fee-based activities under *wakalah* contracts.

- **Provisions governing takaful business clearly account for the nature of Shariah contracts that underpin the takaful operational framework.** The new legislation gives legal effect to the segregation of ownership of funds between the takaful participants and the shareholders of a takaful operator in accordance with Shariah. This is reinforced through regulatory requirements that emphasise the fiduciary relationship between takaful operators and takaful participants as stipulated in *mudarabah* or *wakalah* contracts employed in takaful business by requiring takaful funds to be managed on behalf and in the best interests of the takaful participants.
- **The legislation brings the legal framework for the resolution of Islamic financial institutions in line with distinctive elements of the relevant Islamic contracts (Diagram 2).** Assets that are managed by Islamic banks on behalf of investors are legally ring-fenced from the assets of the Islamic banks to reflect the prohibition of any co-mingling of profits and losses attributed to the investment account with other funds. A similar separation is applicable to Islamic windows within licensed commercial banks and investment banks, where Islamic assets and funds are ring-fenced from the conventional banking business. In the event of the resolution of an Islamic financial institution, payments to Islamic depositors are prioritised in a manner that is consistent with the guaranteed nature of contracts employed in Islamic deposit products. Similarly for takaful business, assets of takaful funds and shareholder funds are separated and utilised to meet the respective liabilities in the event of a winding-up of a takaful operator. These obligations differ in priority based on the specific contracts underlying the takaful business model.

Strengthening the Regulatory Framework

The legislation also contains provisions that enable the Bank to specify regulatory requirements that promote and are consistent with Shariah contract-based operational frameworks. In this regard, the Bank may specify Shariah standards for key Islamic contracts in consultation with the Bank's Shariah Advisory Council. The standards serve to define essential features of the underlying Shariah principles that are adopted by Islamic financial institutions, while enhancing certainty and public confidence in Islamic financial transactions. The Bank issued the Shariah Standard on *Mudarabah* in October 2012, while Shariah standards on *murabahah*, *musharakah*, *ijarah*, *wadi'ah* and *istisna'* are expected to follow in 2013 and 2014.

To support the effective implementation of Shariah standards and ensure compliance by Islamic financial institutions, the Bank also issues guidance or operational standards on Shariah matters. Such guidance and operational standards address sound practice principles and the Bank's expectations for effective risk management, governance, disclosures and appropriate legal and accounting treatments for key Islamic contracts that are necessary to ensure compliance with Shariah under different Islamic contracts. Over the years, the Bank's expectations of the board and management of Islamic financial institutions and their Shariah committees to ensure end-to-end compliance with Shariah have been progressively raised in tandem with the increasing significance of Islamic finance business at the institutional, group and system-wide levels. In 2012, the Guidelines on Financial Reporting for Islamic Banking Institutions were revised to improve the quality of information provided to users of financial statements on the different risk and return profiles and characteristics associated with various Islamic contracts. Enhancements to existing guidance and standards will continue to be developed under a three-year work plan to further strengthen the regulatory framework for application of Shariah contracts.

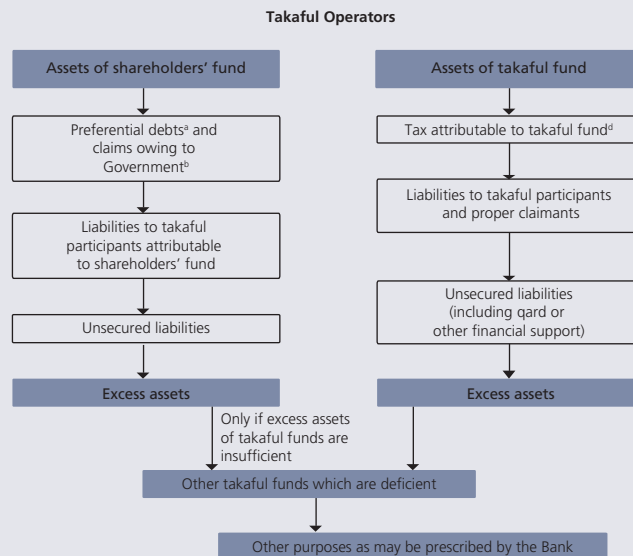
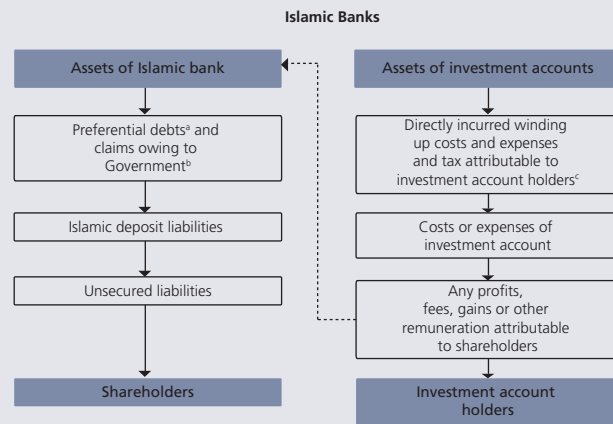
The Bank has wide powers under the law to address non-compliance with Shariah and operational standards. These include the ability to require prompt corrective actions through supervisory intervention as well as a comprehensive penalty framework that provides a credible deterrent.

Promoting a Cohesive National Infrastructure

Malaysia has also developed a comprehensive legal infrastructure and framework that promotes effective enforceability of Shariah contracts beyond financial services laws and regulations. In 2010, the Law Harmonisation Committee was established with a mandate to undertake objective reviews of other relevant laws, recommend appropriate changes to provide legal recognition to Shariah

Diagram 2

Priority of Payment Reflective of Underlying Shariah Contracts

^a Section 292(1) of Companies Act 1965^b Section 10 of Government Proceedings Act 1956^c Section 292(1) (a) & (f) of Companies Act 1965^d Section 292(1) (f) of Companies Act 1965

contractual features, and enhance the legal certainty of financial transactions based on Shariah principles. A current focus of the Committee, working in collaboration with relevant stakeholders, is the development of effective mechanisms to recognise beneficial interests arising from financing under contracts such as *ijarah* and *musharakah mutanaqisah* in the National Land Code 1965 in order to safeguard the interests of contracting parties engaged in Islamic financing. Greater legal certainty is also promoted through the recognition in law of the Bank's Shariah Advisory Council as the reference point for courts and arbitrators on any Shariah matter in relation to Islamic finance business. This has been important to ensure the consistent application of Shariah contractual principles in Islamic financial transactions.

From the taxation perspective, the tax neutrality principle administered by the Tax Neutrality Committee ensures that transactional costs from the application of Shariah contracts in Islamic finance are not structurally higher than conventional financial transactions that produce the same economic impact, thus preserving equivalent tax treatments.