

The New Shariah Governance Framework

The importance of Shariah governance

The principles of Islamic finance place great emphasis on strong corporate governance values and structure, transparency, disclosure of information and strict adherence to Shariah principles. The Shariah governance framework is a set of organisational arrangements through which Islamic financial institutions ensure effective oversight, responsibility and accountability of the board of directors, management and Shariah committee. The framework serves as a guide towards ensuring an operating environment that is compliant with Shariah principles at all times. Shariah principles provide the foundation for the practise of Islamic finance through the observance of the tenets, conditions and principles propagated by Islam. Comprehensive compliance with Shariah principles would bring confidence to the general public and the financial markets on the credibility of Islamic finance operations.

In Malaysia, the Bank has established the necessary mechanism for the Islamic financial system to operate in a manner consistent with Shariah *muamalah* principles, with a clearly defined institutional arrangement within Islamic financial institutions regulated by the Bank. A two-tiered Shariah governance structure has been established, comprising an apex Shariah advisory body at the Bank and a supervisory Shariah committee formed at the respective Islamic financial institutions.

Central Shariah advisory council

The Shariah Advisory Council of Bank Negara Malaysia (SAC) was established in 1997 as the ultimate authority to decide on all Shariah matters pertaining to the Islamic banking and takaful industry. It serves as the final arbiter in the interpretation of Shariah principles on Islamic banking and takaful matters and practices, and promotes the harmonisation of Shariah interpretations among the Shariah committees residing in the individual Islamic financial institutions. The mandates of the SAC as provided under section 52 of the Central Bank of Malaysia Act 2009 (the Act) are as follows:

- ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it;
- advise the Bank on any Shariah issues relating to Islamic financial business, the activities or transactions of the Bank; and
- provide advice to any Islamic financial institution or any other person as may be provided under any written law.

To reflect the critical role of the SAC, its members are appointed by the Yang di-Pertuan Agong from amongst persons who are qualified in Shariah, or who have knowledge or experience in Shariah, banking, finance, law or other related disciplines.

An important development under the Act is the requirement for the court and arbitrator to take into account the published rulings of the SAC and to refer any Shariah issues to the SAC for its ruling. All SAC rulings in such cases are binding on the Islamic financial institutions, courts and arbitrators. This represents an important step forward as previously the rulings bind the arbitrator, but not the courts. This further enhances the consistency in application of Shariah rulings, thus securing certainty and finality on Shariah issues relating to Islamic finance applications and practices.

Establishment of individual Shariah committee at Islamic financial institutions

The Islamic Banking Act 1983 and Takaful Act 1984 require the establishment of an independent Shariah committee within each Islamic financial institution. In 2004, the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (the Guidelines) was issued outlining the role, duties and responsibilities of Shariah committee and its members and the relationship and working arrangement between the Shariah committee at individual institutions and the SAC at the national level. The Guidelines, among others, prohibit individuals from sitting in more than one committee within the same industry. While the underlying rationale for the prohibition is to avoid a conflict of interest, the rule served as a catalyst in expanding the pool of Shariah talent within the Islamic financial industry and, at

the same time, increasing its diversity in terms of the experience and expertise of Shariah experts. Today, the total number of Shariah experts has increased to more than 100 individuals from a small number of scholars when the Guidelines was first issued in December 2004.

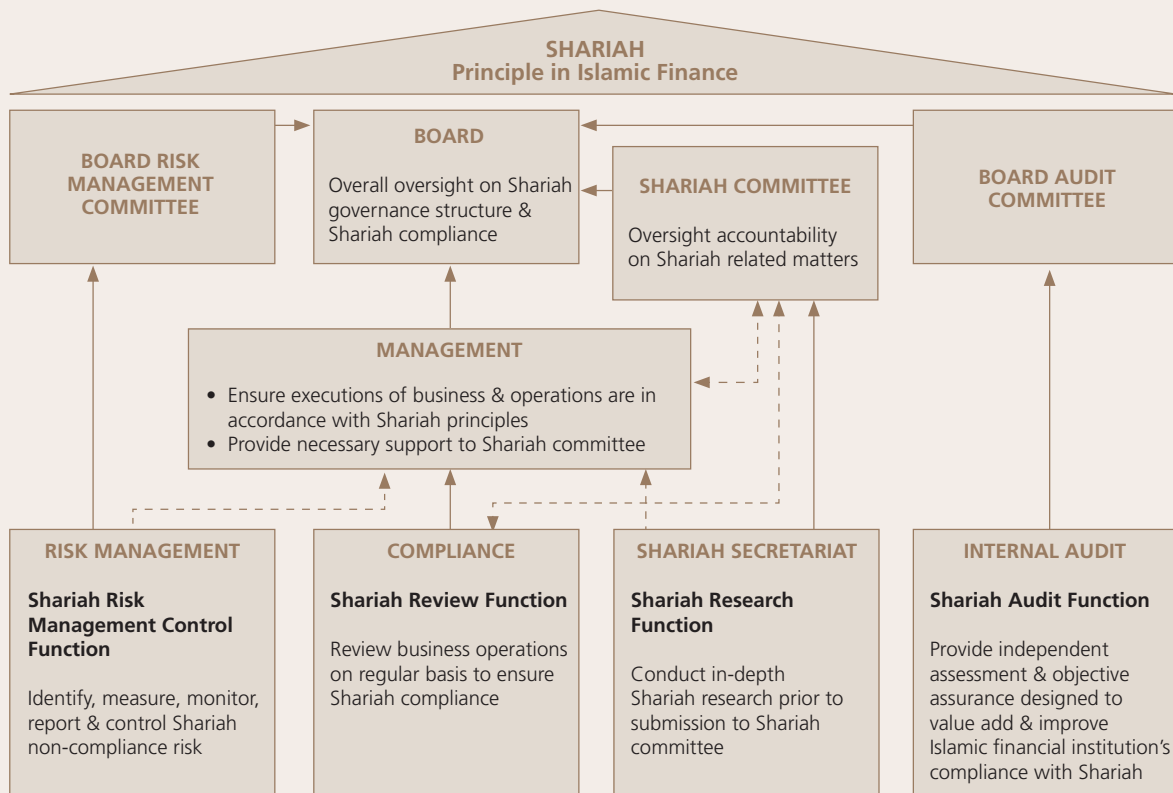
Although the current Shariah governance structure has increased the prominence of the role of the Shariah committee within the Islamic financial industry, the further enhancements to the Guidelines are needed to take into account the rapid developments in Islamic finance in this recent few years. These include, the enhancements relating to the governance arrangements of the board and management in respect to the Shariah compliance process, the independence and accountability of the Shariah committee in the decision making process, the strengthening of internal research capacity, compliance and the risk management processes.

A new Shariah framework

To further strengthen the Shariah governance structure, the Bank will be issuing a new Shariah governance framework for the Islamic financial institutions under the Bank’s purview with the following objectives:

- to set out the expectations on an Islamic financial institution’s Shariah governance structures, processes and arrangements with the goal of ensuring that all operations and business activities are consistent with Shariah principles at all times;
- to provide comprehensive guidance to the board, Shariah committee and management of Islamic financial institutions in discharging its duties on matters relating to Shariah; and
- to ensure proper functioning of Shariah compliance through effective Shariah review and Shariah audit functions.

**Chart 1
Shariah Governance Framework Model for Islamic Financial Institutions**



In developing the framework, the Bank has taken into account the Islamic Financial Services Board's (IFSB) Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services issued in December 2009 and also relevant practices observed in jurisdictions that have a substantial Islamic banking and finance sector.

The framework aims essentially to strengthen the Shariah governance process, decision making, accountability and independence. To reinforce the Shariah compliance functions, internal Shariah review and audit requirements will be introduced, supported by an appropriate risk management process and research capability. It is envisaged that the implementation of the framework will contribute towards evolving a more robust and sound Shariah governance framework within Islamic financial institutions which, in turn, will promote Shariah compliance throughout the organisation.

Under the framework, the board will be responsible for the overall Shariah oversight of Islamic financial institutions and the effective functioning of the Shariah governance structure, policies and processes. However, the board must recognise the independence of the Shariah committee and uphold the committee's decisions on Shariah aspects of the institution's business operations. While the framework does not specifically require an Islamic financial institution to appoint a Shariah expert among its board members, the board is encouraged to consider co-opting members on the board who have strong Shariah knowledge in order to serve as a 'bridge' between the board and the Shariah committee. The board shall also reasonably remunerate the Shariah committee members, to commensurate and reflect the accountability, duties and responsibilities of the Shariah committee.

The role and function of the Shariah committee has been expanded further from merely advisory in nature to assume a higher degree of accountability. The Shariah committee will now be accountable for the implementation of decisions and opinions throughout the Islamic financial institution. Consistent with its stature, the Shariah committee shall have direct access to the board. The Shariah committee shall also report directly to the Bank where the committee believes that non-compliances on Shariah matters in the Islamic financial institution have not been effectively and adequately addressed by the Islamic financial institution.

In supporting the board and the Shariah committee, the senior management of an Islamic financial institution is responsible to promote a strong culture of Shariah awareness and compliance within the organisation, including implementing best practices in Shariah governance in all aspects of the institution's operations. The senior management is also responsible for ensuring that all submissions to the Shariah committee are adequately researched and supported by a thorough study on the Shariah issues, product structuring and documentation. This would entail the development of internal Shariah research capabilities which are supported by adequate knowledge and resources to provide and undertake research effectively.

Islamic financial institutions are also expected to establish three functions that provide a system of checks and balances within the organisation, which include the following:

- a Shariah risk management control function that is able to identify all possible risk of Shariah non-compliance and, where appropriate, remedial measures to manage this risk;
- a Shariah review function that continuously assesses Shariah compliance of all activities and operations. Where instances of non-compliances are identified, the institution is expected to take prompt rectification measures and put in place the necessary mechanisms to avoid such recurrences; and
- a Shariah audit function that performs annual audits to provide an independent assessment of the adequacy and compliance of the Islamic financial institution with established policies and procedures, and the adequacy of the Shariah governance process.

Conclusion

With the rapid expansion of Islamic finance in Malaysia, the establishment of a comprehensive and holistic governance structures and processes is being continually enhanced to remain dynamic and relevant at all times. The Shariah governance framework in Malaysia has evolved with the changing market conditions, whereby the governance structure at both the overall Islamic financial system and the individual Islamic financial institutions have been enhanced and strengthened to ensure the observance of Shariah. The effective implementation of the new Shariah governance framework will further promote stakeholders' confidence and the integrity of the Islamic financial industry thereby reducing Shariah non-compliance risks and, over the medium term, contribute towards maintaining financial stability.