SUSTAINING FINANCIAL STABILITY THROUGH SHARIAH GOVERNANCE FRAMEWORK

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The Outline

- Islamic Finance: A Recap
- The Regulatory Aspects
- The Shariah Governance Framework
Shariah principles are the foundation for the practice of Islamic finance through the observance of the tenets, conditions and principles espoused by Shariah.
Islamic Finance Features

Product development and innovation guided by principles of Shari`ah, fiqh and ijtihad.

Documentation requirement of Islamic products that reflect “islamicity” of its terms & conditions.

Departure from conventional practice in product, legal requirement, tax and accounting.

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The Shariah Framework of Islamic Finance

Islamic Finance is to **adopt** Shariah principles

Islamic Finance is to **reflect** Shariah components or aspects in all its activities

Islamic Finance is commercial transactions based on **prescribed** principles of *Fiqh al-Muamalat*

Islamic Finance is to **uphold** the objectives of Shariah (*Maqasid al-Syariah*)
Islamic Finance in Contemporary Operating Environment – The Challenges

Dual-Banking / Financial System

Conventional Banking/Financial System Framework

Leveraging on Conventional Banking/Financial Business Model

Operating Environment of Islamic Finance

Debt-based, Collateral Based & Risk Averse

Fractional Reserve Banking

Fiat Monetary System

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Islamic Finance in Contemporary Environment – What Need To Be Done

How is Shariah Compliance being translated in the Contemporary Operating Environment of IBF?

- Application of Shariah compliant contracts eg: Murabahah, Musharakah, Ijarah etc
- Offer Shariah compliant products & services which satisfy form & legal technicalities
- Finance & invest in Shariah compliant business portfolio
- Apply/use majority of conventional banking rules & products which are consistent with Shariah
Fitting-in Conventional banking/finance features has resulted the following:

**Product Pricing:**
- Benchmarking against interest rate

**Profit Maximization**
- Credit evaluation from one-dimensional financial angle

**Replication of Conventional Products**
- Debt based (debt-ridden features)
- Risk Averse (risks transfer to customers)
- Loss Averse (Losses borne by customers)

**THUS …**

Expose IFIs to Shariah Non-Compliance Risk &

**THE NEED** for Shariah Compliance and Governance Framework
Islamic Finance: The Regulatory Aspects

The growth and development of Islamic finance industry are supported through good governance and its comprehensive legal frameworks.
Malaysian Islamic Finance: Development & Progress

1980
Introduction & market familiarization

- Development of markets, players & products
- “Pilot project”:
  - BIMB – IBA 1983
  - STMB – TA 1984
- Limited products:
  - BBA, Ijarah – financing
  - Mudarabah, Wadiah – deposits

1990
Accelerated growth in market size & players

- Islamic windows (1993) - BAFIA
- Accelerated growth in market size & players
- Additional products features:
  - BBA, Murabahah, Ijarah, Wadiah, Mudarabah
- Intro of Islamic Capital Market:
  - Equity, bonds, money market

2000
Broader & deeper market especially sukuk

- Introduction to sukuk
  - Guthrie Sukuk al Ijarah (2001)
  - 1st Malaysian Global Sukuk al Ijarah (2002)
- Experimenting new product structures:
  - BBA, Murabahah, Ijarah, Istimna’, Mudarabah, Musharakah
- More facilitative legal/tax regime – exemptions etc.

2005
Maturing & globalization

- Rule on full fledged Islamic subsidiaries
- Islamic bank licenses to foreigners (2005):
  - KFH, Al Rajhi, QIB, etc
- Moving towards globally accepted products:
  - Ijarah, Istimna’, Mudarabah, Musharakah

2010
Strengthening regulatory framework

- 2009: Enactment of Central Bank of Malaysia Act 2009 (CBMA)
- 2010: Shari’ah Governance Framework (SGF)
- 2012: Enforcement of the Takaful Operational Framework (TOF)
- 2013: Islamic Financial Services Act 2013
Implementation of Islamic Finance is to be supported by effective regulatory framework to ensure Shariah compliance aspects of the overall operations.

Central Bank of Malaysia Act 2009

“Any financial business in ringgit or other currency which is subject to the laws enforced by the Bank and consistent with Shariah”

Islamic Financial Services Act 2013

“An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with Shariah”

Activities based on the principles of Islamic transactions contracts (*fiqh al-muamalat*)
# IFSA 2013:
Towards Ensuring End-to-End Shariah Compliance

## Birth of IFSA

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<tr>
<th>Royal Assent</th>
<th>Gazetted</th>
<th>Effective Date</th>
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<td>18 March 2013</td>
<td>22 March 2013</td>
<td>30 June 2013</td>
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## Sec 6 IFSA:

“The principal regulatory objectives of this Act are to promote financial stability and compliance with Shariah”
Regulatory Requirements On Shariah Compliance

IFSA 2013
Enhances shariah governance aspects of IFIs by codifying the shariah compliance requirements and enforcement of penalties for non-compliance.

IFIs shall at all times ensure Shariah compliance

Shariah compliance refer to compliance to rulings of SAC

Procedure for Sharian non-compliant activities

(a) notified to SC  (b) cease the activities  (c) report to BNM within 30 days

Penalty for non-compliant with the above

liable to imprisonment not exceeding 8 yrs or fine not exceeding RM25 mil or both
Bank Negara Malaysia places great importance in ensuring that the overall Islamic financial system operates in accordance with Shariah principles. This is to be achieved through the two-tier Shariah governance infrastructure comprising two (2) vital components, which are a centralised Shariah advisory body at the BNM and an internal Shariah Committee formed in each respective Islamic financial institution (IFI).
Shariah Governance for IFIs

“Shariah Governance system is a set of institutional and organisational arrangements through which Islamic financial institutions ensure that there is an effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review.”

IFSB-10 Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services

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Aims Of Shariah Governance

- SG aims to ensure Shariah compliance in actuality i.e. Shariah legitimacy of products and/or Shariah compliant operations of IFIs

- SG is essential to gain confidence and trust of stakeholders i.e. perception of the outsiders and reputation/public confidence

Shariah Compliance aspects are to be observed throughout the process in developing/constructing the products/framework and to be supported by proper Shariah governance functions.
Principles Of Shariah Governance Framework

- Shariah Compliant Functions
- Oversight, Accountability & Responsibility
- Sound and Robust Shariah Governance Structure
- Independence
- Competency
- Confidentiality & Consistency
- Professionalism
Constituents of Shariah Governance

- BODs
- Shariah Committees
- Management
- Employees

PEOPLE

PROCESS

- Effective communication
- Rigorous & efficient process;
- Disclosure
Roles of Key Functionaries To Ensure Shariah Compliance

- **BOD**
  - Oversight role in ensuring Shariah compliance & due regards to SC’s decision

- **Actuary**
  - Oversight role to assist BOD & senior management for prudent management of TO by ensuring/safeguarding interest of takaful participants

- **SC**
  - Oversight & advisory role on Shariah matters to ensure Shariah compliance

- **Auditors**
  - Enhanced statutory reporting obligations (Audit & Shariah Audit)

- **CEO**
  - Ensure business operations meet Shariah requirements & Reporting obligations to BNM & SC

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The Shariah governance structure shall be robust & supportive to the IFIs internal infrastructure to ensure effective overall Shariah compliant process.
Shariah Governance Framework: The Centralised Approach

Two layer of Shariah Advisory Board to ensure Shariah Compliance and harmonisation of Shariah decision

- Shariah Advisory Council at the Central level (BNM) established under Sec 51 of CBMA 2009
- Highest authority to decide Shariah matters in Islamic Finance in Malaysia
- Shariah Committee at the respective IFIs
- Appointed by Board of Director
- Upon recommendation/approval of BNM

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Establishment of Shariah Advisory Council

Sec 51 (1) of CBMA

“\textit{The Bank may establish a Shariah Advisory Council on Islamic Finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic financial business}”.

Functions of SAC

- To ascertain the Islamic law on any financial matter & issue a ruling upon reference made to it

Reference of BNM to SAC

- BNM shall consult SAC on any matter relating to Islamic financial business for the purpose of carrying out its functions or conducting its business or affairs in accordance with Shariah

Effect of SAC decision

- Any ruling made by SAC shall be binding on IFI, Court and/or arbitrator
Establishment of Shariah Committee  
(*Sec 30 IFSA*)

- A licensed person shall establish a Shariah committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Shariah.

Functions of SC

- Accountable & responsible for Shariah decisions
- Ensure Shariah compliant operations of IFIs

Effect of SC decision

- BoD shall give due regards to SC decision
SG & Financial Stability

- SG ensure end-to-end Shariah compliant aspects which is the essence of IF
- SG ensure consistent market practices in view of differences of views of scholars
- SG supports Corporate Governance principles
- SG enhance accountability of stakeholders
- SG ensure the public expectations are met

- IFIs which do not comply with Shariah requirement shall be subject to:
  - imprisonment for a term not more than eight years, or
  - a fine not exceeding twenty-five million ringgit, or
  - both.

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Conclusion & The Way Forward

- Shariah governance framework as mechanism to ensure Shariah compliance of Islamic Finance
- Effective enforcement of Shariah governance
- Transparent deals - disclosure, accounting & auditing
- Good Shariah governance practice for global acceptance and recognition
Wasaalamualaikum warahmatullahi wabarakatuh

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THANK YOU