

SHARIAH COMPLIANCE IN ALL MATTERS. THE PRIORITY OF A ROBUST ISLAMIC FINANCE ECOSYSTEM.

Malaysia's proactive approach to developing a holistic Islamic finance ecosystem has emphasised Shariah compliance in all aspects of legal, prudential, operational and governance matters.

Malaysia's regulators and the Malaysian finance industry have worked continuously and collaboratively for over 30 years to develop policies, guidelines and frameworks with an emphasis on robust shariah compliance, including the recently gazetted Islamic Financial Services Act 2013, regarded by many as a "landmark law" for its multifaceted regulatory objectives and its contribution towards the sector's financial stability.

27 February 2014

Malaysia continues to set precedence in establishing a holistic Shariah-driven ecosystem for the Islamic finance industry in tandem with the overall industry developments

Given the critical significance of Shariah compliance in the Islamic finance business, Malaysia strives towards achieving best practices standards by incorporating Shariah principles in all aspects of the Islamic system frameworks including operational, reporting, business conduct, risk management and oversight functions.

Islamic finance has rapidly evolved as an important facet of the Malaysian financial industry since the formal inception of the sector three decades ago. As at end-2013, Malaysia's Islamic banking sector holds over USD130bn¹ in assets and the country has the largest and most liquid sukuk market with amounts outstanding over USD158bn (this represents over 58% of the global sukuk outstanding). Furthermore, Malaysia also has the largest Islamic funds sector (in terms of number of funds domiciled) with over USD16.3bn of assets under management while it has the second largest takaful market with total gross contributions estimated at over USD2.2bn². In tandem with market developments, the Malaysian regulatory authorities have been at the forefront in supporting the industry's growth with robust regulatory frameworks, legislations and Shariah guidelines in order to preserve the sanctity of the Shariah-compliant transactions and boost the public's confidence in the sector.

The industry has significantly progressed to emerge as a valuable sector catering to the diverse financial and investment needs of various stakeholders. Among those utilising Shariah-compliant financial solutions include corporate entities for their working capital, trade financing, re-financing and capital expenditure needs as well as the household and retail sector that avail Islamic financing products to meet their asset financing (for e.g. home financing or car financing), personal

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financing and other retail liquidity needs (for e.g. Shariah-compliant credit cards). In addition, Government and government-related entities have been actively tapping into the Islamic finance sector to raise funds for supporting their fiscal, revenue and infrastructure expenditures. The Malaysian Islamic finance sector also provides lucrative investment opportunities to investors globally seeking healthy and ethical returns and over the years, the sector has attracted substantial inflows of funds from global investors, particularly from the Middle East.

¹ Excluding Islamic finance assets in Developing Financial Institutions (DFIs)

² KFH Research Limited

Shariah as the Pinnacle of the Islamic Finance Industry in Malaysia

The fundamental distinction between Islamic finance and conventional finance is in the former's adherence to principles of Shariah that advocate a close link between financial transactions and the real economy. Islamic finance draws its core value propositions from the Shariah and the industry achieves Shariah compliance in products and services through the application of a diverse spectrum of contracts in financial transactions including among others Mudarabah (profit-sharing), Musharakah (profit and loss sharing), Murabahah (cost-plus-profit sale), Ijarah

“In developing the Islamic finance ecosystem in Malaysia, Shariah compliance and governance have been the utmost priority and consideration since the onset of the industry during the 1980s and 1990s.”

(lease), Wadiah (contract of safekeeping) and Istisna (contract of manufacturing). Given the critical significance of Shariah compliance in the Islamic finance business, it is essential for a robust and well-functioning Islamic finance market to enlist legal and regulatory frameworks that provide guidance to Islamic Financial Institutions (IFIs) in complying with the principles of Shariah.

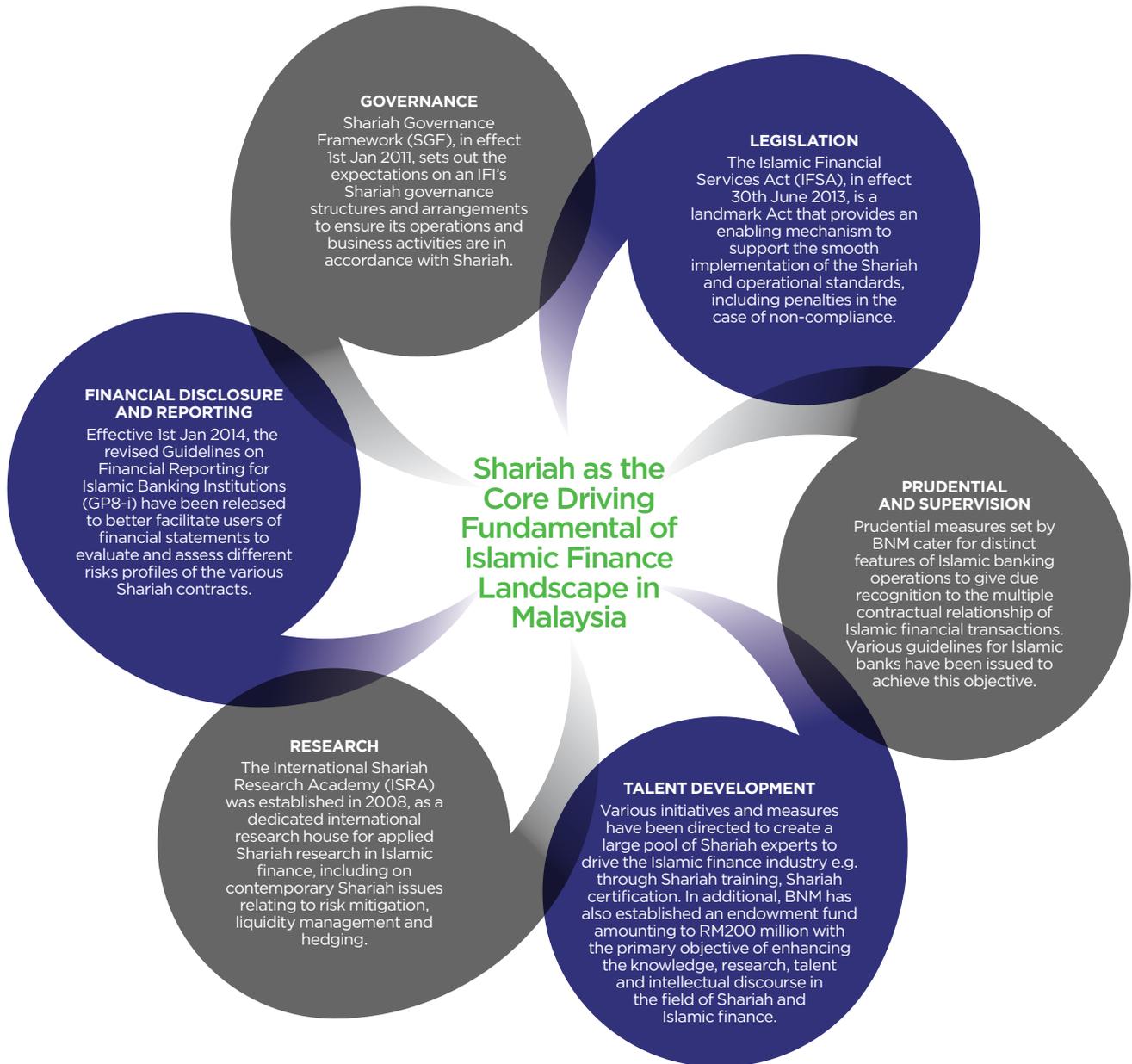
In developing the Islamic finance ecosystem in Malaysia, Shariah compliance and governance have been the utmost priority and consideration since the onset of the industry during the 1980s and 1990s. Prior to the introduction of IFSA, Islamic banks are required under the Islamic Banking Act 1983 and Takaful Act 1984 to establish Shariah advisory body within the institutions to ensure full compliance with Shariah. The introduction of Islamic windows by conventional banks

also mandate similar requirement as well as whereby sufficient regulatory and Shariah firewalls must be instituted to ensure funds between the conventional operations and Islamic banking windows were not co-mingled and the Islamic banking operations remained in compliance with Shariah principles. However, a significant landmark was the establishment of the Shariah Advisory Council (SAC), a centralised Shariah body in 1997 to oversee uniform implementation of Shariah rules in Islamic financial transactions in the country. The Central Bank Act 2009 does not only reinforces the authority of the SAC on Shariah matters relating to Islamic banking and takaful, but also the requirements by the court and arbitrators to observe the decision of the SAC when they are referred to. Building from these foundations and in line with market developments, the ecosystem has evolved in responding to the need for clear guidelines and policies on Shariah aspects in all areas of Islamic finance including legal, operational and prudential frameworks.

The efforts of Malaysian regulators to provide a holistic Islamic finance ecosystem that emphasizes Shariah compliance in all aspects of legal, prudential, operational and governance matters is evident based on the number of policies, guidelines and frameworks in place. Among the notable ones include the Shariah Governance Framework (SGF) for IFIs which has been in effect from 1st January 2011 and is a one-of-its-kind framework to be introduced by a unilateral regulatory body. The SGF is designed to set out the expectations on an IFI's Shariah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Shariah. The framework also provides comprehensive guidance to the Board of Directors, Shariah Committee and management of an IFI in performing their duties on matters related to Shariah. Furthermore, Section III of the SGF also mandates Shariah scholars to have independence in performing their duties

**Shariah-driven Frameworks for Islamic Finance in Malaysia:
The Holistic and Dynamic Approach**

Source: KFH Research Limited



and requires the Board of Directors of IFIs to recognise the independence of the Shariah Committee at all times in order to provide a feasible environment for the Committee to exercise their duties and make objective and informed judgments.

Another noteworthy acclaim is the Islamic Financial Services Act 2013 (IFSA 2013), a comprehensive Islamic finance legislation pertaining to all sectors of the Malaysian Islamic finance industry including Shariah and which went into effect 30th June 2013. Specifically,

IFSA 2013 provides the foundation for the shift towards a contract-based regulatory framework by providing legal recognition to the contractual requirements in accordance with the Shariah, thus ensuring alignment in terms of legal and regulatory treatment of Islamic financial transactions with the underlying Shariah contractual principles. This Act has been hailed as a landmark act, setting a global benchmark, that could be use to develop more comprehensive regulatory frameworks globally that promote greater legal and operational certainty in Islamic finance. The IFSA 2013 also clarifies regulatory expectations on Board of Directors, management team and Shariah

committee to ensure Shariah requirements are observed in conducting Islamic financial business and operation. Thus, all transactions undertaken by Islamic banks are aligned with the prudential and business requirements of distinctive elements of the respective Shariah contracts.

Pursuant to IFSA 2013, BNM and the Islamic finance industry stakeholders in Malaysia are currently developing a new set of Shariah standards that aim to facilitate the execution of contract-based regulatory framework by providing principle-based guidance on Islamic financial contracts.

Contract-based Shariah Regulatory Framework in Malaysia

Islamic finance:

Islamic banks conduct financial intermediation functions using Shariah contracts
Distinct risk and reward profiles based on Shariah contracts

End-to-end Shariah compliance under the Islamic Financial Services Act 2013

<p>Shariah Standards Compliance with fundamental requirements of respective Shariah contracts</p>	<p>Operational Standards Strengthened risk management, governance, transparency and disclosure, market conduct and other operational aspects of applying Shariah standards</p>	<p>Oversight Functions Codification of the role of the Shariah committee and board of directors of financial institutions in ensuring Shariah compliance</p>	<p>Resolution Priority of payment reflective of underlying Shariah contracts</p>
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Shariah Contracts applied in Islamic financial business

ASSETS			LIABILITIES		
<p>Sale Based</p> <ul style="list-style-type: none"> • Murabahah • Istisna' • Ijarah • Tawarruq 	<p>Equity Based</p> <ul style="list-style-type: none"> • Mudarabah • Musharakah 	<p>Fee Based</p> <ul style="list-style-type: none"> • Wakalah • Kafalah • Rahnu 	<p>Islamic Deposits</p> <ul style="list-style-type: none"> • Wadi'ah • Qard • Tawarruq 	<p>Investment Accounts (Equity)</p> <ul style="list-style-type: none"> • Mudarabah • Musharakah 	<p>Investment Accounts (Other)</p> <ul style="list-style-type: none"> • Wakalah

Source: Financial Stability Report and Payments System, BNM (2012)

An integrated and holistic Shariah operating framework is critical for providing cohesiveness and clarity to industry players to ensure Shariah compliance in their operations while the industry benefits from a boost in perception and reputation leading to further growth in business transactions. Shariah standards that are currently being formulated in Malaysia aim to provide reference on Shariah rulings associated with various Islamic finance contracts. Key operational requirements with regards to the implementation of the concerned contracts are also set out to promote end-to-end compliance with Shariah requirements as well as to ensure sound banking practices and consumer protection.

The new enhanced Shariah standards critically encompass guidelines on mandatory and optional features of the Shariah contracts of which IFIs must comply along with guidelines on operational parameters to provide clear guiding principles on effective risk management, governance, legal, disclosure and market conduct. This is vital to better facilitate the operationalisation aspects of the Shariah contracts as well as to encourage product innovations and developments. These Shariah standards are expected to enable uniformity of Shariah rulings across institutions while enhancing certainty and public confidence in the Islamic financial transactions.

To date, BNM has issued the new and enhanced Shariah standards for the contract of Murabahah in December 2013. Shariah standards are likely to be issued soon for the other five key Islamic contracts of Mudarabah, Musharakah, Ijarah, Wadiah and Istisna in the first half of 2014. Other contracts that are awaiting feedback from the public and industry on the exposure drafts of the Shariah requirements and optional practices include: Hibah, Bai Inah, Kafalah; Wakalah; Wadi'ah; Wa'd; and Tawarruq.

Standards Development in Malaysia: An inclusive and transparent process

In developing the new cohesive Shariah standards, the SAC of BNM adopts a proactive approach by engaging in an inclusive process with relevant stakeholders before releasing guidelines and standards on Islamic finance business. The Shariah standards in Malaysia are also developed in a practical sense, keeping in mind the dynamic needs of the industry players. Consisting of prominent Shariah scholars, jurists and market practitioners, members of the SAC are qualified individuals and have vast experience in banking, finance, economics, law and application of Shariah, particularly in the areas of Islamic economics and finance.

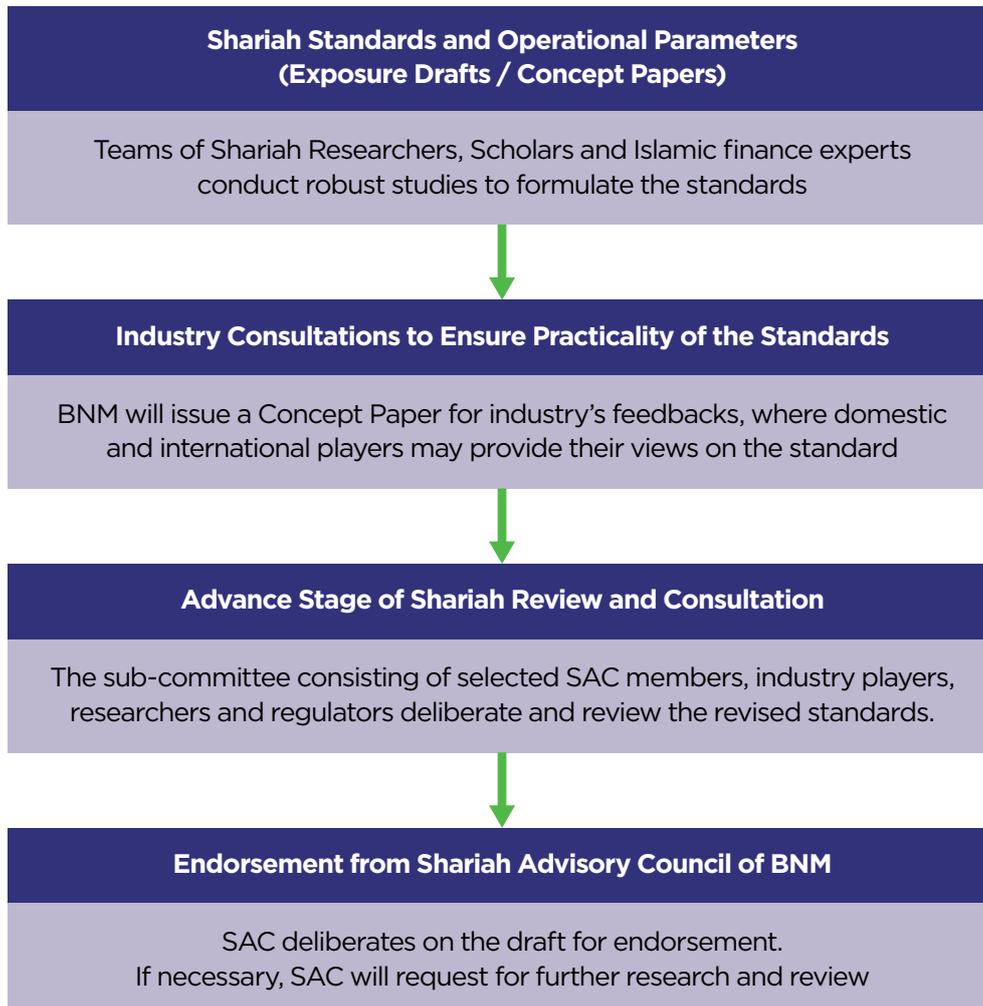
“Malaysia’s decision to formulate new Shariah standards is an excellent move that would align the practices of Islamic financial institutions and instruments with the underlying Shariah contractual principles. Furthermore, these new standards would be comprehensive enough to cover the needs of different jurisdictions and become global benchmarks”

Dr Mohamad Akram Laldin
(Executive Director International
Shari’ah Research Academy)

The formulation of Shariah standards in Malaysia is not restricted in following any one particular Fiqh (legal jurisprudence) and the Shariah team takes into account various credible Fatwas (Islamic opinions)

from other schools of thought including those issued by global standards setting bodies (for e.g. the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)), international fatwa councils (for e.g. International Islamic Fiqh Academy of Organisation of Islamic Cooperation (OIC)) and also those of renowned contemporary scholars. The Shariah team would amalgamate the various fatwas and then deliberate upon the issue at hand in the light of the primary and secondary sources of Shariah. Based on this international benchmarking process, Shariah standards are issued to highlight the mandatory and optional features of the Shariah contracts of which IFIs must comply.

The fundamental thought process behind Shariah standards development in Malaysia is to achieve a holistic Shariah framework that upholds the sanctity of Shariah compliance in Islamic finance business while encompassing feedback from industry stakeholders to ensure its relevance and feasibility to support growth of the Islamic finance industry. The standards development follows a transparent structured process with the aim of achieving uniform standards that also take into account religious opinions from other Fiqh's (Islamic schools of thoughts) and hence are comparable to other international standards set by non-Malaysian regulatory bodies. A typical Shariah standard development process entails the following steps as indicated below:



Source: BNM

The Malaysian Islamic finance ecosystem also includes guidelines on disclosures and financial reporting. Recently, Guidelines on Financial Reporting for Islamic Banking Institutions (GP8-i) has been revised to better facilitate users of financial statements to evaluate and assess different risks profiles and characteristics associated with the various Shariah contracts. In addition to that, it is also to ensure its compatibility with the Malaysian Financial Reporting Standards (MFRS). The guideline is effective from 1st January 2014 and is expected to promote greater transparency, quality and relevance of Islamic banking.

“Since the inception of the Islamic finance industry in Malaysia three decades ago, the country has successfully embarked on a number of strategies and initiatives to develop its Islamic finance industry.”

Malaysia is also keen to develop a pool of Shariah experts conversant in both Islamic law of contracts and business aspects of Islamic finance operations. In this regard, the International Shariah Research Academy (ISRA) was established, as a dedicated international research house for applied Shariah research in Islamic finance, including on contemporary Shariah issues relating to risk mitigation, liquidity management and hedging. ISRA also provides a number of scholarships to talented individuals with a Shariah background in order to develop skills required for providing services to the Islamic finance industry.

Conclusion

Malaysia has developed a comprehensive legal infrastructure and regulatory framework which promotes effective enforceability of Shariah contracts beyond financial services laws and regulations. Through the proactiveness of its regulatory bodies, a number of meritorious and comprehensive legislations have been

introduced which contribute towards greater confidence in the country’s Islamic finance industry. The recently gazetted Islamic Financial Services Act 2013 is regarded by many as a “landmark law” for the multifaceted regulatory objectives it has to fulfil while also contributing towards the sector’s financial stability. Punitive measures provided under this Act are designed to act as a deterrent to potential non-Shariah compliance to reflect the high degree of importance to uphold Shariah principles.

Since the inception of the Islamic finance industry in Malaysia three decades ago, the country has successfully embarked on a number of strategies and initiatives to develop its Islamic finance industry. Among these include the robust and sound development of a comprehensive Islamic finance ecosystem that guide the country’s IFIs in effectively managing the Shariah compliance of the operations. These have been critical in substantially attracting Islamic finance business in the country from both domestic and global stakeholders. To date, Malaysia has the world’s most progressive Islamic finance marketplace, leveraging on the country’s long track record of over 30 years of experience in building a successful domestic Islamic financial industry. Malaysia’s Islamic finance continues to grow rapidly placing it among the top Islamic finance jurisdictions across all sectors including banking, sukuk, funds and takaful. Malaysia has also placed a strong emphasis on human capital development alongside the development of the Islamic financial industry to ensure the availability of Islamic finance talent. Rapid liberalisation in the Islamic finance industry, coupled with facilitative business environment has encouraged foreign financial institutions to make Malaysia their destination of choice to conduct Islamic banking business. Moving forward, the Malaysian Islamic finance ecosystem provides a holistic framework that enhances the viability of Islamic finance as a medium of financing that contributes to the overall growth and financial stability.

Appendix: Shariah Compliance Practices in Selected Other Countries

Bahrain:

The Central Bank of Bahrain (CBB) requires all banks to establish an independent Shariah Supervision Committee complying with the Accounting and Auditing Organization for Islamic Financial Institution (AOIFI's) governance standards for IFIs. All banks must comply with all AAOIFI issued accounting standards as well as the Shariah pronouncements issued by the Shariah Board of AAOIFI. National Shariah Board of the Central Bank of Bahrain serves and verifies the Shariah compliance of its own products only. Each bank must have a separate function of Shariah review to verify compliance.

Indonesia:

In Indonesia, National Shariah Board (DSN) formed by Indonesian Council of Ulemas in 1999, is an independent body duly recognized by Bank Indonesia and is responsible to issue Shariah rulings on products of Islamic banks. Bank Indonesia issues regulations for Islamic banking products based on Fatawa issued by DSN. Fatwas concerning Mudarabah and Musharakah contract, Mudarabah and Musharakah contract in Takaful, Wakalah Bil Ujrah contract in Takaful and ReTakaful and fatwa concerning on Tabarru' contract in Takaful and ReTakaful were released by DSN in 2006. The fatwas released by DSN possess the power of positive law. In 2005, Bank Indonesia also issued a regulation on Standard of Contract that is periodically evaluated to keep its relevancy with the Islamic banking industry. So far, the regulations (released in 2006) are concerned with Ijarah, Istisna'a and Salam Contracts. Apart from coordinating with Bank Indonesia, DSN also takes a role in Shariah Supervisory Board selection process.

Pakistan:

In Pakistan, the banks are authorized to offer products based on Islamic modes under the Banking Companies Ordinance, 1962. The Shariah Board of State Bank of Pakistan has approved Essentials of Islamic modes of finance and Model Agreements, which previously issued as guideline to all Islamic banking institutions (IBI) have now been made part of recently issued Instructions for Shariah compliance in IBIs. Each IBI is required to appoint a Shariah Advisor who is responsible to give approval regarding Shariah compliance of all products of IBIs and issue Shariah rulings. The SBP Shariah Board advises State Bank in formulation of regulations on Islamic banking. In case of any difference of opinion between SBP Shariah Board and Shariah Advisor of an Islamic bank, the ruling of SBP Shariah Board is final.

Nigeria:

All non-interest banks and other financial institutions (NIFI) under the purview of the Central Bank of Nigeria (CBN) are required to establish a Shariah Advisory Committee as part of their governance structure and which will be subject to approval of the CBN. The SAC is responsible and accountable for all Shariah decisions, opinions and views provided by them and will advise the NIFI's board and management on Shariah matters so as to ensure the institution's compliance with Shariah principles at all times. In the case of conflict of opinion among members of the SAC concerning a Shariah ruling, the board of directors of the NIFI may refer the matter to the CBN Shariah Council (CSC), which shall have the final authority on the matter.

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