

TOWARDS ENHANCING CORPORATE AND SHARI'AH GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA: A LEGAL ANALYSIS

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Abstract

The concept of corporate governance which is based on the principles of accountability, transparency, responsibility and fairness is an essential element in the context of Islamic banking and finance. Compared to its conventional counterpart, the Islamic financial institutions are subject to the same guidelines and standards on corporate governance practices in addition to the Shari'ah governance guidelines issued by the regulators. At the international level, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have issued various standards and guidelines to complement the corporate governance standards issued by other authorities such as Organisation for Economic Co-operation and Development (OECD) and Basel Committee for Banking Supervision (BCBS). Malaysia has incorporated the concept of Shari'ah governance into the existing legal and regulatory framework to enhance the application of Shari'ah governance in the Islamic finance and banking industry. Thus, the objective of this study is to discuss the application of corporate and Shari'ah governance framework in the Islamic banking and finance industry in Malaysia. Being a legal research, this study applies qualitative research methodology which is mainly library research. Reference is made to relevant legislations, standards and guidelines to provide insight on the application of corporate and Shari'ah governance principles in the Islamic financial institutions in Malaysia.

Keywords: *Islamic banking and finance, Corporate Governance, Shari'ah governance, Legal, Regulatory*

1.0 Introduction

Corporate governance refers to the process and structure used to direct and manage the business and affairs of the institution towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interests of other stakeholders (High Level Finance Committee Report, 1999). The concept of corporate governance in the financial sector has been developed in the context of conventional financial system. This can be explained from the fact that the conventional system has been in existence long before the introduction of the Islamic financial system (ISRA, 2016).

The global wave of corporate governance can be seen from the initiatives taken by various organisations which has resulted in the publication of committee reports including the Cadbury Committee Report, the Greenbury Report, the Hampel Committee Report, the

OECD Principles of Corporate Governance and the Principles for Corporate Governance in the Commonwealth. The reports collectively suggested for reforms and reapplication of the universally accepted principles of good governance such as fairness, transparency, accountability and responsibility (Abidin & Hashim, 2010).

History has witnessed numerous high profile corporate collapses and corporate malpractices caused by weak and inefficient corporate governance practices as in the case of Bank of Credit and Commerce International (BCCI), Barring (ISRA, 2016), Enron and WorldCom. (Abidin & Hashim, 2010). As far as Islamic banking and finance industry is concerned, instances of corporate governance issues can be referred to the cases of Ihlas Finance in Turkey, Islamic Bank of South Africa (IBSA), Islamic Investment Companies of Egypt (IICE), Dubai Islamic Bank (DIB), Bank Islam Malaysia Berhad (BIMB) and Tamweel in the Middle East. (ISRA, 2016) The financial scandals underscored the need for better practices of corporate governance, not only in the developing countries but also worldwide. (Abidin & Hashim, 2010)

The concept of corporate governance which is based on the principles of accountability, transparency, responsibility and fairness is an essential element in the context of Islamic banking and finance. Compared to its conventional counterpart, the Islamic financial institutions are subject to the same guidelines and standards on corporate governance practices in addition to the Shari'ah governance guidelines issued by the regulators.

This paper aims to discuss the application of corporate and Shari'ah governance framework in the Islamic banking and finance industry in Malaysia. Being a legal research, this study applies qualitative research methodology which is mainly library research. Reference is made by making reference to relevant legislations, standards and guidelines to provide insight on the application of corporate and Shari'ah governance principles in the Islamic financial institutions in Malaysia. This paper is structured as follows: Section 2 reviews the available literature on corporate and Shari'ah governance of Islamic financial institutions. Section 3 defines the concept of corporate and Shari'ah governance according to the international organisations i.e. OECD, BCBS, IFSB and AAOIFI. Section 4 analyses relevant legislations, guidelines and code regulating the application of corporate and Shari'ah governance in Islamic financial institutions in Malaysia. Section 5 concludes the paper.

2.0 Literature Review

The term corporate governance is reasonably new as it became the focus of corporate world within the last two decades (Muneeza & Hasan, 2011). Corporate governance has been defined in various manners. Malekian and Daryaei (2010), for instance, defines corporate governance as "the way in which the boards oversee the running of a company by its managers, and how board members are, in turn, accountable to shareholders, stakeholders and the company." Corporate governance is a vital aspect in the management of a company. It assists the company to achieve its objectives and enable the company to run smoothly. This is the main reason why the companies need to have good corporate governance practice which consists of three major components; which are transparency, disclosure and accountability (Muneeza & Hasan, 2011).

Academic discussions on corporate governance from the Islamic perspective are relatively new as compared to the well-established conventional corporate governance (Alnasser & Muhammed, 2012). The concept of corporate governance in Islam refers to a set

of organisational arrangements on how a corporation is directed, managed, governed and controlled with the aim to protect the interest of the stakeholders, to achieve the objectives of the organisation in compliance with the Shari'ah rules and principles (ISRA, 2016)

The requirements of Shari'ah compliance have introduced a new dimension of governance which falls under the corporate governance framework which is unique to the Islamic system of financial management, that is Shari'ah governance (Kassim, Htay & Salman, 2013). The concept of Shari'ah governance started to emerge in the nineteenth century after the introduction of Islamic banking and Islamic finance. This development is backed by the increase in the number of Shari'ah compliant companies which led to the formulation of corporate governance rules which are in line with the Islamic law (Muneeza & Hassan, 2013). The earlier literatures mostly focus on the concept of Shari'ah governance in comparison with the established concept of corporate governance. This can be explained from the fact that corporate governance has been in practice before the introduction of Shari'ah governance that arise following the introduction of Islamic banking in the 80s. So far, however, academic writings on Shari'ah governance remains limited (Kassim, Htay & Salman, 2013) and discussions on Shari'ah governance are mostly in relation to corporate governance (Kasri, 2009; Abdullah & Muhammed, 2012; Choudhury & Alam, 2013)

A considerable amount of research has also been carried out that focusing on Shari'ah governance of Islamic financial institutions such as the Islamic banks including Hamza (2013), Hasan (2011), Muneeza (2014), Garas & Pierce (2010) and Hassan et al (2013) that discuss the salien features of the Shari'ah governance framework, its component and the current practices. The existence of sound Shari'ah governance is crucial for the enhancement of the potential role of Islamic finance in contributing towards corporate reform and to mitigate certain types of risk exclusive to IFIs (Hasan, 2011). Shari'ah governance is essential to deal with Shari'ah compliance risk, which refers to the risk of non-compliance resulting from a failure of an Islamic bank's internal systems and personnel (Archer & Haron, 2013).

As far as Islamic banking is concerned, the importance of Shari'ah governance lies on the need to earn the trust and confidence of stakeholders of Islamic banks that would directly impact the stability of the institution and enhances their capacity to function as financial intermediaries in the Islamic financial system (Ginena and Hamid, 2015).

3.0 The Concept Of Corporate And Shariah Governance

3.1 Definition of corporate governance

The definition of corporate governance can be found in the corporate governance standards issued by a number of international organisations such as the Organisation for Economic Co-operation and Development (OECD), the Bank for International Settlements (BIS), the World Bank Group (WBG), the International Organisations of Securities Commission (IOSCO), the European Commission, the International Accounting Standard Board, the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

The OECD defines corporate governance in its G20/OECD Principles of Corporate Governance as a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those

objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy (OECD, 2015).

According to BCBS, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they set corporate objectives; operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders; align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors (BCBS, 2006).

The IFSB defines corporate governance its Guiding Principles on Corporate Governance (IFSB-3) as a defined set of relationships between a company's management, its board of directors, its shareholders and other stakeholders, which provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined. (IFSB, 2006). The IFSB-3 further describes corporate governance in the context of the IFIs as a set of organisational arrangement whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interests of its stakeholders, provisions of proper incentives for the organs of governance such as the board of directors, the Shari'ah supervisory board and management to pursue objectives that are in the interests of stakeholders and facilitate effective monitoring, thereby encouraging IFIs to use resources more efficiently, and to comply with the Shari'ah rules and principles (IFSB, 2006).

On this point, the IFSB has issued a number of standards relating to corporate governance for IFIs as shown in Table 1.

Table 1: List of IFSB Governance Standards

No.	Standards
IFSB-1	Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering only Islamic Financial Services
IFSB-2	Capital Adequacy Standard for Institutions (Other Than Insurance Institutions) Offering only Islamic Financial Services
IFSB-3	Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Fund)
IFSB-4	Disclosure to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
IFSB-5	Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (<i>TakāFul</i>) Institutions and Islamic Mutual Funds)
IFSB-10	Guiding Principles on Shariah Governance System for Islamic Institutions offering Islamic Financial Services
IFSB-17	Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR)

On the same note, AAOIFI has also taken the steps to introduce basic guidelines for governance framework in its governance standards. Table 2 provides the list of governance standards issued by AAOIFI.

Table 2: List of AAOIFI Governance Standards

GS No.	Standards
GS No.1	Shariah Supervisory Board: Appointment, Composition and Report
GS No. 2	Shariah Review
GS No. 3	Internal Shariah Review
GS No. 4	Audit and Governance Committee for Islamic Financial Institutions
GS No. 5	Independence of Shariah Supervisory Board
GS No. 6	Statement on Governance Principles and Disclosure for Islamic Financial Institutions
GS No. 7	Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions

3.2 Definition of Shari'ah Governance

The concept of corporate governance from the Islamic perspective requires an additional layer of governance to deal with the issue of Shari'ah compliance. Therefore, the Shari'ah governance system was introduced to complement the existing corporate governance framework in the IFIs to deal with the Shari'ah compliance-related issues (ISRA, 2016).

Shari'ah governance refers to the set of institutional and organizational arrangements, policies, processes, procedures rules, regulations and laws which leads the organisation towards Shari'ah compliance (Minhas, 2012). Shari'ah compliance requirement allows the IFI to consolidate their differentiation factor compared to conventional financial institutions and support their reputation and credibility (Hamza, 2013). The existing framework of Islamic finance in various jurisdictions around the world demonstrates diverse practices and models of Shari'ah governance system. This can be explained from the fact that some jurisdictions prefer greater involvement of regulatory authorities and some countries, on the other hand, favor different views (Hasan, 2010).

The IFSB via IFSB-10 defines Shari'ah governance system as a set of institutional and organisational arrangements through which IFIs ensure that there is an effective independent oversight of Shari'ah compliance over the issuance of relevant Shari'ah pronouncements; dissemination of information on such Shariah pronouncements to the operative personnel of the institution who monitor the day-to-day compliance; an internal Shari'ah compliance review or audit to verify that Shari'ah compliance has been satisfied, during which any incident of non-compliance will be recorded, reported, addressed and rectified; and an annual Shari'ah compliance review or audit to verify that the internal Shari'ah compliance review or audit has been appropriately carried out and its findings have been communicated and duly noted by the Shari'ah Supervisory Board (IFSB, 2009).

Table 3 illustrates how Shari'ah governance complements the existing corporate governance framework in the IFIs.

Table 3: Shari'ah governance vis-a-vis corporate governance framework

Function	Conventional Financial Institutions	Additional to IFIs
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Governance	BOD	Shariah Board
Control	Internal Audit, external audit	Internal Shariah review, Shariah audit
Compliance	Regulatory and financial compliance officers, unit or department	Internal Shariah compliance officer, unit or department
Risk management	Risk management department (credit, market and operational risk)	Shariah compliance risk

Source: Adapted from IFSB-10 (2009)

4.0 The Application Of Corporate And Shariah Governance In Islamic Financial Institutions In Malaysia: A Legal Analysis

4.1 Central Bank of Malaysia Act 2009 (CBMA 2009)

The CBMA 2009 is an updated version of the legislation which has the effect of repealing the Central Bank of Malaysia Act 1958. This Act was passed on July 2009 and has come into force in November 2009 with improvement and added provisions as compared to its previous Act. The provisions relating to corporate and Shari'ah governance can be referred to Part VII of the Act, ranging from Section 51 until 58. The sections provide the coverage of Islamic financial business in terms of laws and regulation through the supervision of the Shariah Advisory Council (SAC) under the BNM.

Section 51 defines the SAC as the body of authority which ascertains the principles of Islamic law in relation to the Islamic financial business. It is statutorily authorised to set its procedures as to how to carry out their duties in supervising and ensuring that the practice by the Islamic financial institutions is in line with the Islamic principles (Oseni and Ahmad, 2015). This, however, should not be confused with the Shari'ah Committee which exists in every Islamic banking section despite the sharing similar task in supervising the products under the Islamic finance (Wan Zainal, Kasim, Zakaria, and Mohamed, 2015). Section 52 provides for the functions of the SAC, which among them are, to issue a ruling as well as to advise the BNM and other Islamic financial institutions on any Shariah issue relating to Islamic financial activities.

The members of the SAC are appointed among the persons who possess the expertise and experience in multidiscipline including banking, Islamic finance law and other related fields. Under Section 53, the appointment of such members is made by the Yang di-Pertuan Agong on the advice of the Minister of Finance, upon recommendation list by the BNM. The list of SAC members for the 2016-2019 term is provided in Table 4.

Table 4: List of SAC members for 2016-2019

No.	Name of SAC members
1.	Tan Sri Sheikh Ghazali Abdul Rahman
2.	Datuk Dr Zulkifli Mohamad Al-Bakri
3.	Datuk Dr Mohd Daud Bakar
4.	Datuk A. Aziz. A. Rahim
5.	Prof. Dr Mohamad Akram Laldin
6.	Prof. Dr Engku Rabiah Adawiah Engku Ali
7.	Prof Dr Ashraf Md. Hashim
8.	Assoc. Prof Dr Asmadi Mohamed Naim
9.	Dr. Shamsiah Mohamad
10.	Burhanuddin Lukman

The SAC ascertains the application of Shari'ah law and principle of the Islamic finance practice in Malaysia. This includes the role to analyse and to evaluate Shari'ah aspects of new products or schemes under banking institutions (Hussain, Hassan and Hasan, 2015). Section 55 stipulates that the BNM shall consult the SAC on any matter relating to Islamic financial business; and for the purpose of carrying out its functions or conducting its business or affairs under this Act or any other written law in accordance with the Shari'ah, which requires the ascertainment of Islamic law by the SAC.

In executing its duties and responsibilities, the SAC shall examine and endorse the validity of the application of Shari'ah in Islamic financial products which are submitted by Islamic financial institutions under the supervision of the BNM. Section 55(2) also provides that any Islamic financial institution in respect of its Islamic financial business, may refer for a ruling; or seek the advice, of the SAC on the operations of its business to ascertain that it does not involve any element which is inconsistent with the Shari'ah.

Apart from the Islamic financial institution, the SAC is also being referred to by other institutions including courts. The requirement for reference to SAC for ruling from court or arbitrator is expressly provided in Section 56 (1) which states that:

“Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be, shall
(a) take into consideration any published rulings of the Shariah Advisory Council; or
(b) refer such question to the Shariah Advisory Council for its ruling.”

It is a requirement under the CBMA 2009 that the judge or arbitrator who is presiding over any dispute arising from Islamic financial business to refer to the rulings of the SAC or to request for advice from the SAC in determining any issue concerning Shari'ah matters. This provision applies to the civil courts as the matters pertaining to banking and Islamic finance falls under the jurisdiction of the civil courts (Manaf, et al., 2014). In relation to this, any request for advice or ruling of the SAC under the CBMA 2009 or any other law shall be submitted to the secretariat which is stated under Section 54.

The ruling by the SAC takes precedence over others in the Islamic finance field (Muhammed, Ramli, Aziz, and Yaakub, 2014). In case of conflict or inconsistency between the ruling issued by a Shari'ah Committee of Islamic financial institutions and the ruling issued by the SAC, the ruling of the SAC shall prevail and be applicable. Hence, Section 57 is essential in this case to ensure that any deliberation of the SAC will also bind the courts and not only the financial institutions and the arbitrators. This Section provides that any ruling made by the SAC pursuant to a reference made under Chapter VII shall be binding on the Islamic financial institutions under Section 55 and the court or arbitrator making a reference under Section 56.

From one perspective, the provision provides excellent assistance to the dispute settlement institutions such as courts and arbitrators in addressing the related matters. From another perspective, the SAC serves as the mainstay for the legitimisation of Islamic laws and principle in the Islamic financial service in Malaysia which requires to be observed by related institutions including the courts and arbitrators (Jan and Marimuthu, 2015).

The CBMA 2009 not only serves as an improvement of the previous version of the Act but it is also intended to resolve the issues which have arisen before the coming into effect of the Act primarily the legal effect of the rulings issued by the SAC. The setting up of the SAC

marks the development of Islamic financial industry Malaysia. The step taken by the law-maker is essential as the growth in such industry should come together with an adequate supervision to ensure that the overall course is in line with the Shari'ah principle.

4.2 *Islamic Financial Services Act 2013 (IFSA 2013)*

The law relating to Shari'ah governance in Islamic finance in Malaysia is statutorily provided under the Islamic Financial Services Act 2013 (IFSA 2013). The IFSA 2013 is one of the recent editions of legislation being introduced related to the Islamic financial industry in Malaysia. The Act which came into effect on 30 June 2013 emphasises on the development of Shari'ah-compliant regulatory framework through the updated provisions in catering the needs for the conduct of Islamic financial operation in Malaysia (Hassan, 2014). Several Acts were repealed with the coming into force of this legislation namely the Islamic Banking Act 1983, the Takaful Act 1983, Payment Systems Act 2003 and Exchange Control Act 1953. This implies the extensiveness of the IFSA 2013 as it covers the area of the repealed acts together with the latest and up-to-date provisions. It is interesting to note that prior to 30 June 2013, the legal framework relating to Shari'ah governance in Islamic finance was not statutorily provided.

This paper emphasises on the provisions relating to the rules of Shari'ah governance which are provided under Part IV of the IFSA 2013 from Section 28 until Section 38. Section 28 (1) of the IFSA 2013 requires an IFI to ensure that its aims and operations, business, affairs and activities are in compliance with Shari'ah at all times. The provision further requires that compliance with Shari'ah in respect of its aims and operation, business affairs or activities as required under the provision refers to compliance with any ruling of the SAC made pursuant to the powers vested upon them by virtue of Section 51 of the CBMA 2009.

Section 28 (3) of the IFSA 2013 deals with the situation where there has been a non-compliance with Shari'ah on part of the IFI, and where an IFI becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shari'ah or the advice of its Shariah Committee or the advice or ruling of the SAC. Consequently, the IFI shall immediately notify the BNM and its Shariah Committee of the fact; immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affairs or activities; and within thirty days of becoming aware of such non-compliance or such further period as may be specified by the BNM, submit to the BNM a plan on the rectification of the non-compliance. Failure to comply with this requirement is an offence under Section 28 (5) and any person who contravenes this provision, shall on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.

Section 29 of the IFSA 2013 empowers the BNM to specify standards on Shari'ah matters, in accordance with the advice or ruling of the SAC, on Shari'ah matters in respect of the carrying on of business, affairs or activities by an institution which requires the ascertainment of Islamic law by the SAC; and to give effect to the advice or rulings of the SAC. The provision further empowers the BNM to issue standards relating to Shariah governance including functions and duties of the board of directors, senior officers and members of the Shari'ah Committee of an IFI in relation to compliance with Shari'ah; fit and proper requirements or disqualifications of a member of a Shari'ah Committee; and internal

Shari'ah compliance functions; and any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shari'ah.

The subsequent provisions of the IFSA 2013, generally, highlight the intention of the lawmaker in focusing on the matters pertaining to the appointment and qualification of the Shari'ah Committees members in Islamic financial institution. This further complements the provisions from the CBMA 2009 which merely touched the surface of the matter by highlighting the general requirement for the financial institution to have a Shari'ah committee. This can be seen under Section 30 of the IFSA 2013 which requires an institution to apply directly to the BNM for the establishment of Shari'ah Committee. Through this provision, the BNM will be able to secure a direct information as to the members of the Shari'ah Committee in an Islamic financial institution, which at the same time, ensure a proper supervision towards the activities conducted (Zanganeh, 2015).

Another key improvement of the Shari'ah governance legal provision is the insertion of criteria of the members of Shari'ah Committee where a clear standard of requirement pertaining to the appointment of such committee is highlighted under Section 31. This section which is crossed-referred with Section 29 (2) (a) states only those who are fit and qualified may be appointed as the members of the Shari'ah Committee. This leads to the notion that members of Shari'ah Committees in every financial institution must be appointed from among those who met the requirements as stated by the BNM. Availability of such clause would be vital in ensuring the products and services introduced by the Islamic financial institution complied with the Shari'ah principles via the supervision of competent members (Kunhibava, 2015).

Section 32 of IFSA 2013 further exerts the significance of Shari'ah Committees through the introduction of the Shari'ah governance which not only set out the duties of the Shariah Committees in the institution but rather blends into the structure of the company itself. By extending the powers of Shari'ah governance into certain aspects in a company such as matters involving the board of directors and internal Shari'ah compliance, it can be concluded that Shari'ah governance is now being regarded as one of the integral parts of an institution and the committee is no longer be treated as a minor part or division of a company. The clause regarding the cessation of members under Section 33 and 34 of IFSA 2013 enables the BNM to continuously be updated by the institution of its Shari'ah Committee members. The provision sets out the clause relating to the cessation of the members including situations which would disqualify any member from becoming Shari'ah Committee members in order to maintain its aim in ensuring that only those who are qualified be appointed as members. Moreover, the management in charge of the company is now duty-bound under Section 35 of the IFSA 2013 to provide information to the Shari'ah committee in exercising its task and duties.

While the Act does not mention the type and degree of information required, it can be assumed that the Shari'ah Committee is authorised to obtain regardless of any kind, if such information would assist them in carrying out their duties. In addition, Section 36 marks the trust which has been given by the legislation to the Shari'ah Committee to hold any information including the confidential ones provided such information is not being relayed to the any other persons. While maintaining the duty of confidentiality, the Shari'ah committees are also vested with the protection under the qualified privilege which prevents them from being sued in a legal action by the Islamic financial institution, if it can be proven that such duties were conducted in good faith.

In order to ensure Shari'ah compliance by the IFI, the BNM is empowered by Section 37 (1) to require that an IFI to appoint any person subject to approval by the BNM, to carry out an audit on Shari'ah compliance by the IFI. The person appointed to carry out audit on Shari'ah compliance on the IFI shall have duties and functions as prescribed by the BNM and is required to submit a report to the BNM on the carried out audit.

The updated provision clause as to the Shari'ah Committee and the newly introduced clause on Shari'ah governance are among the major features being introduced under the IFSA 2013 which contributes to the boost of authorities as to the roles of the Shari'ah Committee. This could ensure the activities of the Islamic financial institution to be under Shari'ah compliance thus maintaining a sound and comprehensive Shari'ah governance framework in Islamic financial industry in Malaysia.

4.3 Shari'ah Governance Framework for Islamic Financial Institutions

The effort to strengthen the overall control over Shari'ah compliance matters in the Islamic finance industry was made as early as 2005 where the BNM has prepared the Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions that regulates the governance of Shari'ah Committee of an Islamic financial institution (Shamsher and Muhamad Sori, 2016). The guidelines set the roles, scope of duties and responsibilities of the Shari'ah Committee and its members and the relationship between the Shari'ah Committee of the respective Islamic financial institutions and the SAC of the BNM.

The Guideline has since been superseded by the Shari'ah Governance Framework for the Islamic Financial Institutions (SGF) which came into effect on January 2011 which requires all Islamic financial institutions to comply with the framework within six month period from the date of its issuance. The Guidelines provide for the establishment of two-tier Shari'ah governance infrastructure comprising two vital components namely the SAC of BNM and an internal Shari'ah Committee formed in each respective Islamic financial institution (BNM, 2011). The SGF lays down the guidelines for the appointment of Shari'ah Committee, qualification and roles of the Shari'ah Committee. The SGF also deals with the duties and roles of the Board of Directors in relation to Shari'ah compliance process involved in the operations of the IFIs. The SGF further provides the requirement for internal Shari'ah compliance and research functions with the setting up of Shari'ah review, Shari'ah audit, Shari'ah risk management and Shari'ah research and secretariat at the IFI level.

In the latest development, the BNM has published the exposure draft on Shari'ah governance in November 2017 which outlines the BNM's proposal for enhancement to the existing regulatory requirements on Shari'ah governance for Islamic finance institutions. The objective of the proposal is to strengthen the effectiveness of Shari'ah governance implementation within Islamic financial service industry in response to the growing scale and complexity of Islamic financial business and recent developments in the area of governance, compliance and risk management. Among the key enhancement proposed are strengthen board oversight on accountability and responsibilities over Shari'ah governance; enhanced requirements for the Shari'ah committee in providing objective and sound advice to IFISs, in line with the IFSA 2013; enhanced expectations for the board and senior management to promote a Shari'ah compliant culture and further integrate Shari'ah governance considerations in business and risk strategies; and enhanced regulatory expectations on the quality of internal control functions to ensure effective management of Shari'ah non-compliance risk.

4.4 *Financial Reporting for Islamic Banking Institutions 2016*

The BNM has issued a policy document on Financial Reporting for Islamic Financial Institutions in February 2016 to ensure adequate disclosures by licensed person, i.e. IFI, in the financial statements to improve comparability for users of financial statement and better facilitate the assessment of the financial position, performance and Shari'ah compliance of Islamic banking activities and operations of the licensed person. The policy document is made in pursuant to Section 29 (1) of the IFSA 2013. In view of the requirement under the SGF in relation to the state of compliance with Shariah principles, a licensed person is required to disclose the Shariah Committee's Report as part of the Annual Report. The information that must be included in the Report includes:

- (a) identification of the purpose of the Shariah Committee engagement; and a clear statement of the management's responsibility in ensuring compliance with Shariah principles;
- (b) confirmation to the effect that the Shariah Committee has performed appropriate tests, procedures and review work as appropriate;
- (c) opinion of the Shariah Committee on the licensed person's compliance with Shariah with respect of
 - (i) contracts and related documentation used;
 - (ii) appropriateness of Shariah basis for the allocation of profit between shareholders and investment account holders; and where appropriate
 - (iii) disposal of any earnings from prohibited sources/means to charitable causes; and
 - (iv) *zakat* computation; and
 - (v) any known non-compliance with Shariah and action taken to remedy such non-compliance as reported by the licensed person as specified in the Circular on Shariah Non-Compliance Reporting.

The policy document is applicable to a licensed Islamic bank except for licensed international Islamic banks; and a bank licensed under Section 10 of the IFSA 2013 and approved by the BNM to carry on Islamic banking business under Section 15 of the Financial Services Act 2013 (FSA 2013).

4.5 *Malaysia Code on Corporate Governance*

The application of the concept of corporate governance in Malaysia can be found in the Malaysian Code on Corporate Governance (MCCG). The MCCG, which was introduced in 2000 reflects global principles and internationally recognised practices of corporate governance which are above and beyond the minimum required by statute, regulations or those prescribed by Bursa Malaysia.

The MCCG was reviewed in 2007 and 2012 to ensure that it remains relevant and is aligned with globally recognised best practices and standards. In 2017, the MCCG, which supercedes its earlier edition, introduces a new approach with the objective to promote greater internalisation of corporate governance culture among companies in Malaysia including financial institutions. The MCCG is based on three key principles of good corporate governance, which are board leadership and effectiveness; effective audit and risk

management; and integrity in corporate reporting and meaningful relationship with stakeholders (MCCG, 2017). The principles of MCCG and its intended outcomes are summarised in Table 5.

Table 5: Principles of MCCG2017 and its intended outcomes

Principle		Intended Outcome
Board Leadership and Effectiveness	Board Responsibilities	Every company is headed by a board, which assumes responsibility for the company's leadership and is collectively responsible for meeting the objectives and goals of the company.
		Demarcation of responsibility between the board, board committees and management.
		The board is committed to promoting good business conduct and maintaining a healthy corporate culture that engenders integrity, transparency and fairness.
	Board Composition	Board decisions are made objectively in the best interest of the company taking into account diverse perspectives and insights.
		Stakeholders are able to form an opinion on the overall effectiveness of the board and individual directors.
	Remuneration	The level and composition of remuneration of directors and senior management take into account the company's desire to attract and retain the right talent in the board and senior management to drive the company's long-term objectives. Remuneration policies and decisions are made through a transparent and independent process.
Stakeholders are able to assess whether the remuneration is commensurate with their individual performance, taking into account the company's performance.		
Effective Audit and Risk Management	Audit Committee	Effective and independent Audit Committee. The board is able to review objectively the Audit Committee's findings and recommendations.
	Risk Management and Internal Control Framework	Companies make informed decisions about the level of risk they want to take and implement necessary controls to pursue their objectives.
		Companies have an effective governance, risk management and internal control framework and stakeholders are able to assess the effectiveness of such framework.
Integrity in Corporate Reporting and Meaningful Relationship with Stakeholder	Communication with Stakeholders	Continuous communication between the company and stakeholders to facilitate mutual understanding of each other's objectives and expectations. Stakeholders are able to make informed decisions with respect to the business of the company, its policies on governance, the environment and social responsibility.
	Conduct of General Meetings	Shareholders are able to participate, engage the board and senior management actively and make informed voting decisions at general meeting.

4.6 Guidelines on Corporate Governance for Licensed Islamic Banks

The IFIs are also governed by the Guidelines on Corporate Governance for Licensed Islamic Banks (GP1-i) issued by the BNM in 2013. The Guidelines outline the provisions to promote best practice and good corporate governance for financial institutions in Malaysia. The

Guidelines aim to promote the adoption of effective and high standards of corporate governance practices by IFIs i.e. Islamic banks and its financial holding companies. The Guidelines contain broad principles dealing with Board matters, management oversight, accountability and audit, and transparency. For Islamic bank holding companies among the requirements under the Guidelines are that they are required to establish a Nominating and Remuneration Committee, requirements on independent directors and appointment of directors, Chairman and Chief Executive Officer subject to approval from BNM.

5.0 Conclusion

The adoption of sound corporate and Shari'ah governance standards and practices in the IFIs ensures that IFIs are managed safely by the relevant parties. That means risk taking activities and business operations are appropriately balanced in order to maximise shareholders' return and at the same time to protect the interests of all stakeholders. Effective corporate and Shariah governance practices that enhance corporate accountability are key elements in the working of market discipline and transparency in the IFIs that eventually enhance public confidence on the operation of the Islamic banking and finance industry in Malaysia.

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Statutes/Standards/Guidelines

Central Bank of Malaysia Act 2009

Financial Reporting for Islamic Banking Institutions 2016

Guidelines on Corporate Governance for Licensed Islamic Banks 2013

High Level Finance Committee Report 1999

Islamic Financial Services Act 2013

Malaysian Code of Corporate Governance 2017

Shariah Governance Framework for Islamic Financial Institutions 2011