

***Shariah* Governance for Islamic Financial Institutions in Malaysia on the Independency of *Shariah* Committee and Efficiency of Its *Shariah* Decisions**

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Abstract: *Shariah* governance for Islamic Financial Institutions (IFIs) in Malaysia is governed by the *Shariah* Governance Framework for the Islamic Financial Institutions 2010 (SGF 2010) that was developed and introduced by Central Bank of Malaysia (CBM) [1]. SGF 2010 provides that *Shariah* Committee as an internal *Shariah* advisory body formed in each respective Islamic financial institution (IFI) is important to ensure the overall Islamic financial practices of such institution operate in accordance with the *Shariah* principles. Similarly, SGF 2010 provides a comprehensive guidance to the *Shariah* Committee in discharging its duties and responsibilities in matters relating to *Shariah*. To ensure that all of its duties and responsibilities are carried out accordingly, *Shariah* Committee must be independent. Its independency shall be observed at all times while exercising its duties and responsibilities. To ensure *Shariah* Committee independency, the Board of Directors (Board) needs to be notified on the minutes of *Shariah* Committee meetings. The *Shariah* Committee shall also have access to accurate, timely and complete information from the management. Its independency requires the findings of *Shariah* audit and *Shariah* review to be tabled before the *Shariah* Committee members for their comments and endorsements. In a situation where the *Shariah* Committee has reasons to believe that the IFI has been carrying on *Shariah* non-compliant activities, the *Shariah* Committee shall inform the Board and recommend suitable measures to rectify the situation. Independency of *Shariah* Committee leads to the efficiency of *Shariah* Committee decisions made during the *Shariah* Committee meetings. In order to facilitate the *Shariah* Committee members' decisions, they shall be given the necessary access to files, records, draft materials and conversations, including those categorised as confidential, so long as the information is related to the work undertaken by the Committee. This means that *Shariah* Committee needs to be given sufficient information, and full disclosure and transparency on all issues during meetings. Not only that, to facilitate and reach good decisions, *Shariah* research needs to be carried out by the *Shariah* research officers of the IFI to facilitate *Shariah* decisions and research conducted by the *Shariah* research officers would assist the *Shariah* Committee to reach good decisions.

Key-Words: Shariah Committee, Board, Shariah decisions, Shariah officers, independency, efficiency

1 Introduction

Central Bank of Malaysia (CBM) has introduced a two-tier *Shariah* governance infrastructure comprising of two vital components, i) *Shariah* Advisory Council (SAC) which is a centralised *Shariah* advisory body at CBM and ii) *Shariah* Committee which is an internal *Shariah* advisory body formed in each respective Islamic financial institution (IFI). This is important in ensuring the overall Islamic financial system in Malaysia operates in accordance with the *Shariah* principles.

For IFI, CBM has developed, introduced and issued the *Shariah* Governance Framework for the Islamic Financial Institutions (SGF 2010) with the primary objective of enhancing the role of the Board of Directors (Board), the *Shariah* Committee and the management in relation to *Shariah* matters, including enhancing the relevant key organs having the responsibility to execute the *Shariah* compliance and research functions aimed at the attainment of a *Shariah* based operating environment. The introduction of SGF 2010 is at the same time to cope with new developments of the Islamic finance as well as higher expectation of the key stakeholders of the IFI pertaining to the *Shariah* compliance process.

Thus, this article investigates the independency of the *Shariah* Committee and the efficiency of its *Shariah* decisions. This is done through the collection of data and information by distributing the questionnaire to the respondents who are involved in IFIs' industries such as the management of the IFIs, be it Islamic banks and Takaful institutions, *Shariah* Committee and *Shariah* Officers. Likert scale is used to measure the level of approval for the resources effectiveness and manpower efficiency on the implementation of SGF 2010. These factors are assessed according to the Likert scale scores 1 (strongly disagree) to 5 (strongly agree). Most of the data in this study were collected and analyzed using the Statistical Package for Social Sciences (SPSS) software version 16.0 and Microsoft Excel. Additional the descriptive analysis is used to determine the number of frequencies and percentages.

2 Appointment and Roles of *Shariah* Committee

SGF 2010 has mentioned clearly that the *Shariah* Committee members shall be appointed by the board upon the recommendation of its Nomination Committee. The number of *Shariah* Committee members to be appointed must not be less than five. The following Chart 1 shows the existing number of *Shariah* Committee members amongst the IFIs in Malaysia.

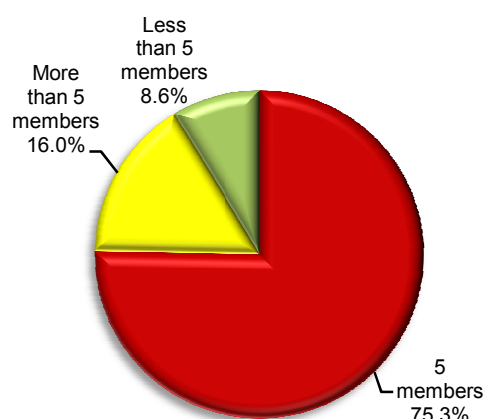


Chart 1. Respondents' distribution based on number of *Shariah* Committee members

From Chart 1, it indicates that most of the institutions have 5 members of *Shariah* Committee. 75.3% of the respondents mention that they have 5 members, 16.0% of the respondents have more than 5 members while only 8.6% of respondents have less than 5 members. This is a very good indication as about 92.4% of the institutions have achieved the required numbers of the *Shariah* Committee members.

It is also the requirement of SGF 2010 that the majority of *Shariah* Committee members must possess strong knowledge in *Shariah* and backed by the appropriate qualifications in that area. In this regard, every IFI is required to establish a *Shariah* Committee of which the majority shall comprise persons with appropriate qualifications and experience in *Shariah*. The competency and credibility of the *Shariah* Committee members provide the assurance that the IFI's operations are being monitored by a credible and competent committee. The numbers of *Shariah* Committee that possess *Shariah* qualification are shown in Table 1.

Table 1. Respondents' distribution based on their responses on number of *Shariah* Committee possess *Shariah* qualification

Number of <i>Shariah</i> Committee possess <i>Shariah</i> qualification						Total
No.	1	3	4	5	6	
5	0	9	24	26	0	59
%	0.0%	11.4%	30.4%	32.9%	0.0%	74.7%
More than 5	0	0	2	4	7	13
%	0.0%	0.0%	2.5%	5.1%	8.9%	16.5%
Less than 5	2	3	2	0	0	7
%	2.5%	3.8%	2.5%	0.0%	0.0%	8.9%
No.	2	12	28	30	7	79
%	2.5%	15.2%	35.4%	38.0%	8.9%	100.0%

Based on the above Table 1, the requirement that each of the IFI must have majority of *Shariah* Committee possess *Shariah* qualification is fulfilled accordingly especially the IFIs that have five *Shariah* Committee members.

Moreover, SGF 2010 provides a comprehensive guidance to the *Shariah* Committee members in discharging their duties and responsibilities for matters relating to *Shariah*. Their main duties and responsibilities are as follows,

- To be responsible and accountable for all *Shariah* decisions, opinions and views provided by them.
- To advise the board and provide input to the IFI on *Shariah* matters in order for the IFI to comply with *Shariah* principles at all times.
- To endorse *Shariah* policies and procedures prepared by the IFI and to ensure that the contents do not contain any elements which are not in line with *Shariah*.
- To endorse and validate relevant documentations including the terms and conditions contained in the forms, contracts, agreements or other legal documentations used in executing the transactions; and the product manual, marketing advertisements, sales illustrations and brochures used to describe the product comply with *Shariah* principles.

e) To assess the works carried out by *Shariah* review and *Shariah* audit are in order and compliance with *Shariah* matters which form part of their duties in providing their assessment of *Shariah* compliance and assurance information in the annual report.

f) To assist related parties of the IFI such as its legal counsel, auditor or consultant who seeks advice on *Shariah* matters from the *Shariah* Committee.

g) To advise on *Shariah* matters to be referred to the SAC that could not be resolved.

h) To provide written *Shariah* opinions in circumstances where the IFI make reference to the SAC for further deliberation, or where the IFI submits applications to the BNM for new product approval

3 Independency of *Shariah* Committee

To ensure that all the abovementioned duties and responsibilities are carried out accordingly, *Shariah* Committee must be independency. Its independency is clearly mentioned in the SGF 2010 that provides, "Independence of the *Shariah* Committee shall be observed at all times in exercising its duties to make objective and informed judgment. The Board shall recognise the independence of the *Shariah* Committee and ensure that the Committee is free from any undue influence that would hamper the *Shariah* Committee from exercising objective judgment in deliberating issues brought before them. Correspondingly, the *Shariah* Committee is expected to make sound decisions on *Shariah* matters in an independent and objective manner."

The agreement amongst the respondents as regard to the independency of *Shariah* Committee is mentioned by Chart 2.

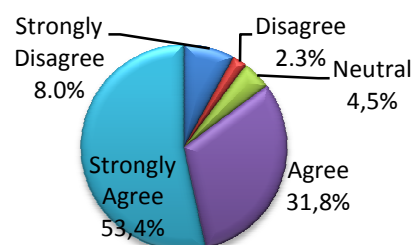


Chart 2. Respondents' distribution on *Shariah* Committee has independence in making *Shariah* decision without any influence from the management

Chart 2 shows that it is strongly agreed by the respondents that *Shariah* committee has independence in making *Shariah* decision without any influence from the management.

To ensure *Shariah* Committee independency, the Board of Directors needs to be notified about the minutes of *Shariah* Committee meetings. Chart 3 shows clearly about it.

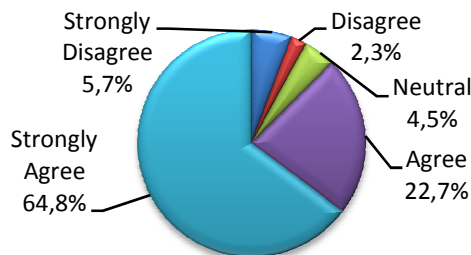


Chart 3. Respondents' distribution notification of *Shariah* Committee meeting minutes to the Board

Chart 3 shows that 87.5% of the respondents agree (64.8% strongly agree and 22.7% agree) that minutes of *Shariah* Committee meetings need to be notified to the Board.

Similarly, the *Shariah* Committee shall report directly to the Board and regularly inform the Board on relevant *Shariah* matters. The Board at the same time shall ensure that decisions made by the *Shariah* Committee are duly observed and implemented by the IFI and should not be set aside or modified without *Shariah* Committee's consent.

Its independency requires the findings of *Shariah* auditor and *Shariah* review have to be tabled before the *Shariah* Committee for comments and endorsements. This is indicated by Chart 4 and Chart 5 respectively.

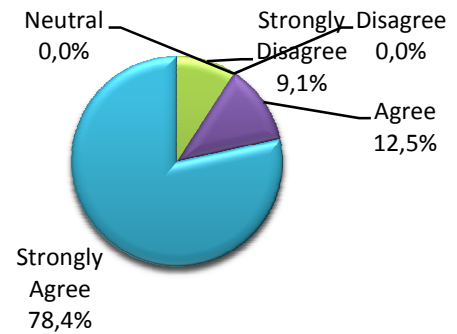


Chart 4. Respondents' distribution on communication of *Shariah* audit to *Shariah* Committee

Chart 4 indicates that out of 78.4% of the respondents strongly agree that the findings of the *Shariah* audit must be communicated to the *Shariah* Committee. Similarly, as shown in Chart 5 they are strongly agreed (75.0% of the respondents) that the findings of the *Shariah* review must be communicated to the *Shariah* Committee.

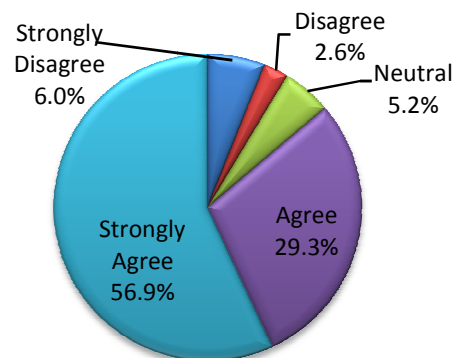


Chart 5. Respondents' distribution on communication of *Shariah* review to *Shariah* Committee

Its independency is also based on the fact that the *Shariah* Committee shall have access to accurate, timely and complete information from the management. If the information provided is insufficient, the *Shariah* Committee may request for additional information which shall be duly provided by the management.

In the event where the *Shariah* Committee is not provided with the required information, the Board shall be informed of the fact and appropriate action

shall be taken to rectify the situation. Where appropriate, the Board shall consider taking the necessary punitive measures against parties who intentionally failed to extend the required information.

In a situation where the *Shariah* Committee has reason to believe that the IFI has been carrying on *Shariah* non-compliant activities, the *Shariah* Committee shall inform the Board and recommend suitable measures to rectify the situation. In cases where *Shariah* non-compliant activities are not effectively or adequately addressed or no rectification measures are made by the IFI, the *Shariah* Committee shall inform the CBM on the fact.

Furthermore, the independency of the *Shariah* Committee may be implied from the restrictions mentioned in the SGF 2010 itself. It provides, “The *Shariah* Committee member shall not have any relationship that could interfere or be reasonably perceived to interfere with the exercise of independent judgment, with the following persons:

- i) an immediate family member such as spouse, children or siblings who are, or who were during the last financial year, employed by the IFI or any of its related companies as a chief executive officer (CEO) or non-independent board members; and
- ii) a substantial shareholder of, or a partner in (with a stake of 5% or more), or an executive officer of, or a director of any for-profit business organisation to which the IFI or any of its subsidiaries made, or from which the IFI or any of its subsidiaries received, significant payments in the current or immediate past financial year.”

4 Efficiency of *Shariah* Committee Decisions

Independency of *Shariah* Committee leads to the efficiency of *Shariah* Committee decisions made during the *Shariah* Committee meetings. It is a mandatory requirement of the SGF 2010 for the *Shariah* Committee meetings to be held regularly at least once in every two months. The *Shariah* Committee member must attend at least 75% of the *Shariah* Committee meetings held in each financial year. The number of *Shariah* Committee meetings held in the year, as well as the attendance of every *Shariah* Committee member shall be disclosed in the IFI’s annual report.

The participation of the *Shariah* Committee can be facilitated by means of video or telephone conferencing when necessary. This is to ensure that the *Shariah* Committee is kept sufficiently in touch with the business of the IFI and the operations of the IFI are not adversely affected because of the difficulty in securing the *Shariah* Committee’s approval for policy and decision.

The frequency of the *Shariah* Committee meeting is shown in Chart 6. Chart 6 shows that 44.3% respondents said they meet every month, 29.5% respondents said that they have the meeting once in the month and 12.5% respondents is more than once in the month. This shows that the requirement of SGF 2010 for the *Shariah* Committee meeting to be held once in two months has been fulfilled and observed by the majority of the IFIs.

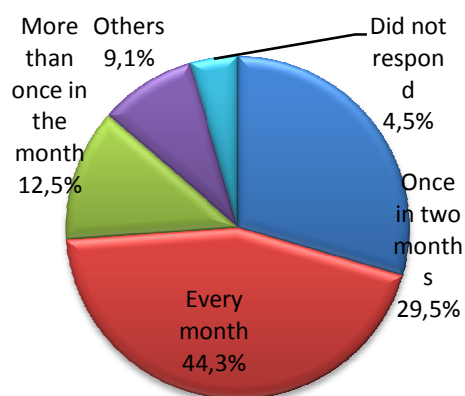


Chart 6 Respondents’ distribution based on the frequencies of *Shariah* Committee meeting

For *Shariah* Committee decisions, usually there are made in the formal *Shariah* Committee meetings. This is shown in Chart 7.

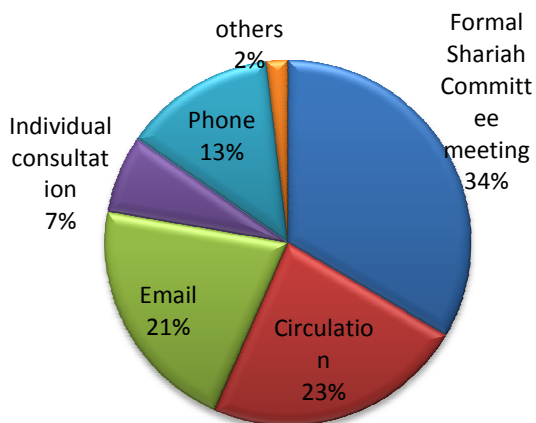


Chart 7. Respondents distribution based on *Shariah* decision made

From Chart 7, the respondents have indicated that the *Shariah* decision makings are made mostly through the formal *Shariah* Committee meeting (100%). The decision also made through circulation (69.0%) and email (63.2%) while only 20.7% made using individual consultant and 40.2% using phone. The rest are using other methods.

In order to facilitate the *Shariah* Committee decisions, they shall be given the necessary access to files, records, draft materials and conversations, including those categorised as confidential, so long as the information is related to the work undertaken by the Committee. This means that *Shariah* Committee are given sufficient information, and full disclosure and transparency on all issues during meetings. Chart 8 and Chart 9 indicate such practice.

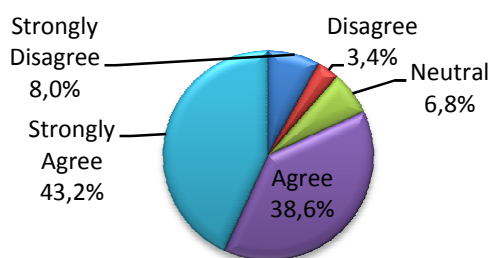


Chart 8. Respondents' distribution on sufficient information to *Shariah* Committee during meetings

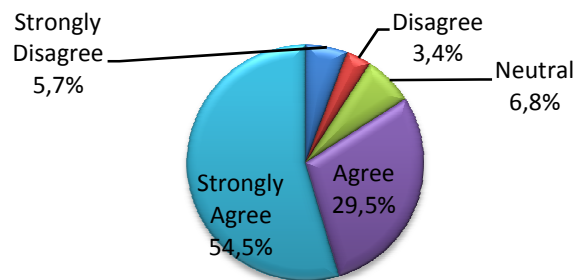


Chart 9. Respondents' distribution on full disclosure and transparency on all issues to *Shariah* Committee during meetings

Chart 8 shows 81.8% of the respondents agree (43.2% strongly agree and 38.6% agree) that *Shariah* Committee members have been given sufficient information about the issues discussed in the meeting. The respondents also agree as shown in Chart 9 that out of 84% (54.5% strongly agree and 29.5% agree) that institution exercises full disclosure and transparency on all issues deliberated in *Shariah* Committee meeting.

The relevant information must be that which is critical for the *Shariah* Committee to form their decisions, views and opinions on matters brought to their attention. In this regard, it is the responsibility of the individual *Shariah* Committee to observe the principle of confidentiality at all times. Confidential or sensitive information obtained by any member of the *Shariah* Committee while serving his or her duties shall not be used in any manner that could be detrimental to the IFI.

Confidential information is information received by members of the *Shariah* Committee that is not public in nature and has not been authorised to be made public. Confidential information includes, but is not limited to, the following:

- (i) information on the development of new products and services;
- (ii) decisions of the board or management;
- (iii) internal memorandums or reports prepared in connection with matters presented, or to be presented to the *Shariah* Committee;
- (iv) the content or occurrence of conversations among members of the *Shariah* Committee concerning matters deliberated in the meeting and representatives of the IFI;
- (v) the progress status on a business transaction or action that has not been made public;

(vi) views expressed by various parties in the course of discussions on a particular matter deliberated by the *Shariah* Committee; and
 (vii) any subject matter that the IFI has indicated should not be revealed, such as internal policies and procedures.

Notwithstanding the above, the *Shariah* Committee will not be regarded as breaching the confidentiality and secrecy code if the sensitive information were disclosed to the BNM in good faith when reporting serious breaches of *Shariah* by the IFI.

Furthermore, to ensure the *Shariah* Committee decisions are thoroughly discussed and appropriate made, the IFI shall engage other professionals such as lawyers, accountants and economists to provide appropriate assistance and advice to the *Shariah* Committee, especially regarding issues on law and finance.

Not only that, to facilitate and reach good decisions, *Shariah* research needs to be carried out by the *Shariah* research officers of the IFI. The following Chart 10 and Chart 11 have shown this respectively.

Chart 10 Respondents' distribution on sufficient *Shariah* research conducted to facilitate *Shariah* decision

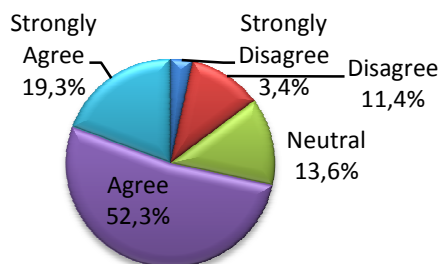


Chart 11 Respondents' distribution on research conducted by the *Shariah* research officers assist the *Shariah* Committee to reach good decisions

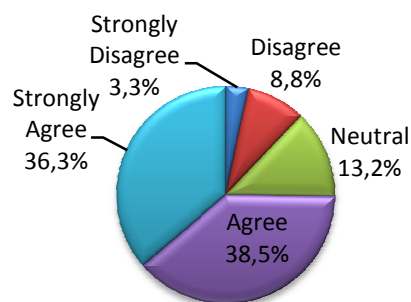


Chart 10 and Chart 11 indicate that 71.6% agree (19.3% strongly agree and 52.3% agree) that there is sufficient *Shariah* research conducted to facilitate *Shariah* decision and 74.8% also agree (36.3% strongly agree and 38.5% agree) that research conducted by the *Shariah* research officers assist the *Shariah* Committee to reach good decisions.

5 Conclusion

All duties and responsibilities in matters relating to *Shariah* are basically discharged by the *Shariah* Committee members. To ensure that they are carried out accordingly, they must be independent. Their independency shall be observed at all times. The Board needs to be notified about the minutes of *Shariah* Committee meetings. They shall have access to accurate, timely and complete information from the management. Their independency requires the findings of *Shariah* audit and *Shariah* review to be tabled before them for their comments and endorsements. In a situation where the *Shariah* Committee members have reasons to believe that the IFI has been carrying on *Shariah* non-compliant activities, they shall inform the Board and recommend suitable measures to rectify the situation.

Independency of *Shariah* Committee leads to the efficiency of *Shariah* Committee decisions made during the *Shariah* Committee meetings. In order to facilitate the *Shariah* Committee decisions, they shall be given the necessary access to files, records, draft materials and conversations, including those categorised as confidential, so long as the information is related to the work undertaken by the Committee. This means that *Shariah* Committee is given sufficient information, and full disclosure and transparency on all issues during meetings. Not only that, to facilitate and reach good decisions, *Shariah*

research needs to be carried by the *Shariah* research officers of the IFI in assisting the *Shariah* Committee.

Reference:

- [1] Bank Negara Malaysia, *Shariah Governance Frame for Islamic Financial Institutions*.2010.