Survey on Implementation of Internal Shariah Compliance Function in Malaysian Islamic Banks and Takaful Companies

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Abstract: The Central Bank of Malaysia has issued Shariah Governance Framework for Islamic Financial Institutions (hereinafter referred to as “SGF”) which was effective starting from January 2011 brought a new dimension and evolution phase in Malaysian Islamic Banking. The issuance of SGF shows the commitment of regulator in enhancing Shariah governance of Malaysian Islamic financial institutions. One of the requirements stipulated in SGF is the requirement for Islamic Financial Institution (hereinafter referred to as “IFI”) to have a robust Shariah compliance function which encompasses Shariah Secretariat, Shariah Review and Shariah Audit, Shariah Risk Management and Shariah Research functions. This study is intended to examine the approaches conducted by the Malaysian Islamic banks in implementing those functions. The finding of this study contributes towards establishing the effective mechanism in implementing Shariah Compliance function which in return beneficial to the industry.

Key-Words: Islamic banking, takaful, Islamic financial institutions, shariah governance, shariah compliance

1 Introduction

Shariah compliance is the most significant feature for any Islamic bank which differentiates Islamic banks with those which are not. At early stage of Islamic banking industry in Malaysia, in order to ensure Shariah compliance of the bank, generally focus was more given towards the establishment of Shariah Committee for each Islamic bank. The establishment of Shariah Committee is a statutory requirement to all banks and takaful operators which offer Islamic banking and takaful products. However, with the coming of SGF 2010, the emphasis is also put on the internal Shariah compliance function that must be established in the IFIs.

The SGF which was introduced in October 2010 was circulated to all Islamic Banks and Takaful Institutions in Malaysia and shall take effect 1st January 2011. It is the duty of the IFI to adopt the framework and to improve their Shariah governance structures accordingly. The objectives of the SGF, as stated in the Guideline, are to establish a robust Shariah governance structures of IFIs; to provide a comprehensive guidance to the board, Shariah Committee and management of the IFI in discharging its duties in matters relating to Shariah; and to outline the functions relating to Shariah review, Shariah audit, Shariah risk management and Shariah research.

Shariah compliance function is one of the instrumental aspects in Shariah governance of Malaysian Islamic banks. The function as explained in SGF comprised of Shariah Review and Audit functions, supported by Shariah Risk Management...
control process. It is stated in SGF Principle 7: ‘‘There shall be a robust Shariah compliance function, comprising review and audit functions, supported by risk management control process and internal research capacity’’. The main focus of this proviso is that the IFIs should have established four main internal Shariah compliance functions that are shariah review, shariah audit, shariah risk management and shariah research in order to ensure good shariah governance practice in the institutions. The brief explanation on those functions are as follows:

(a) Shariah Review function refers to regular assessment on Shariah compliance in the activities and operations of the IFI by qualified Shariah officer(s), with the objective of ensuring that the activities and operations carried out by the IFI do not contravene with the Shariah.

(b) Shariah Audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance.

(c) Shariah Risk Management is a function to systematically identify, measure, monitor and control of Shariah non-compliance risks to mitigate any possible of non-compliance events.

(d) Shariah Research refers to the conduct of performing in-depth research and studies on Shariah issues, including providing day-to-day Shariah advice and consultancy to relevant parties, including those involved in the product development process(es).

The objectives of the study are to examine the internal Shariah Compliance functions practises in Malaysian Islamic banks and Takaful companies. This study is carried out through the collection of data to obtain the percentage from a sample. The target groups of this study are Shariah Committee (34.5%), Management (35.6%) and Shariah Officer (20.9%) from Islamic banks (79.5%) and Takaful companies (20.5%).

The respondents’ perception on the above issues was measured using 5 point Likert scale (1=strongly disagree to 5=strongly agree). The level of agreement was measured by the percentage of each level of agreement. scores 1 (strongly disagree) to 5 (strongly agree). The data were collected and analyzed using the Statistical Package for Social Sciences (SPSS) software version 16.0 and Microsoft Excel. Descriptive analysis is used to determine the number of frequencies and percentages. In addition, researchers also use multiple response analysis for the related questions.

2 Number of Shariah Officers Performing Shariah Compliance Functions and Their Qualifications

The provisions in SGF provide for the requirement of the effective Shariah compliance functions but does not provide any specific or minimum number of shariah officers performing the shariah compliance functions. The respondents were asked on the numbers respondents were asked as to the number of Shariah officers performing Shariah related function and whether the officers have Shariah qualifications. The response is 35.2% of the IFIs have between 4 to 6 (35.2%) shariah officers, 25.0% have between 1 to 3 shariah officers and 20.0% of the IFIs have between 7 to 10 shariah officers performing shariah related functions. Only few of them (18.2%) have more than 11 people and 1.1% did not respond (Fig.1). The numbers of officers performing Shariah related function which have Shariah qualification can be seen at Fig.2. From the figure, overall 81 – 100% officers that performing Shariah related function which also have Shariah qualification that varies from Diploma, Bachelor degree, masters and professional courses that is shown in Table 1.

3 Dedicated Shariah officer performing Shariah functions

To ensure that the IFIs are effective in ensuring shariah compliance in their operations, the SGF requires that they must have dedicated officers performing the internal Shariah compliance functions. The results of the survey shows that most of the institution dedicated Shariah officer for Shariah secretariat (96.6%), Shariah review (89.7%) and Shariah research (86.2%). Less than half of the respondents dedicated Shariah officer for Shariah audit (49.4%) and Shariah risk management (44.8%). (see Fig.3).
Fig. 1 Respondents’ distribution on the number of Shariah officer performing Shariah related function

Fig. 2 Respondents’ distribution on the number of Shariah officer performing Shariah related function and posses Shariah qualification

Table 1 The numbers of qualification based on the number of Shariah officer that performs Shariah related function

<table>
<thead>
<tr>
<th>No. of Shariah officer</th>
<th>Diploma in Shariah</th>
<th>Shariah Degree</th>
<th>Master in Shariah</th>
<th>Professional Courses</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 3</td>
<td>No. 1</td>
<td>21</td>
<td>2</td>
<td>5</td>
<td>1</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>% 1.14%</td>
<td>23.86%</td>
<td>2.27%</td>
<td>5.68%</td>
<td>1.14%</td>
<td>34.09%</td>
</tr>
<tr>
<td>4 to 6</td>
<td>No. 3</td>
<td>30</td>
<td>15</td>
<td>12</td>
<td>3</td>
<td>63</td>
</tr>
<tr>
<td></td>
<td>% 3.41%</td>
<td>34.09%</td>
<td>17.05%</td>
<td>13.64%</td>
<td>3.41%</td>
<td>71.59%</td>
</tr>
<tr>
<td>7 to 10</td>
<td>No. 0</td>
<td>18</td>
<td>6</td>
<td>11</td>
<td>3</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td>% 0.00%</td>
<td>20.45%</td>
<td>6.82%</td>
<td>12.50%</td>
<td>3.41%</td>
<td>43.18%</td>
</tr>
<tr>
<td>11 to 15</td>
<td>No. 0</td>
<td>8</td>
<td>8</td>
<td>5</td>
<td>1</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td>% 0.00%</td>
<td>9.09%</td>
<td>9.09%</td>
<td>5.68%</td>
<td>1.14%</td>
<td>25.00%</td>
</tr>
<tr>
<td>More than 15</td>
<td>No. 3</td>
<td>8</td>
<td>4</td>
<td>8</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>% 3.41%</td>
<td>9.09%</td>
<td>4.55%</td>
<td>9.09%</td>
<td>2.27%</td>
<td>28.41%</td>
</tr>
</tbody>
</table>
Fig. 3: Respondents’ distribution on the number of Shariah officer performing Shariah related function and possesses Shariah qualification

4 Shariah compliance manual on Internal Shariah Compliance functions

Another significant factor to measure the IFIs commitment on performing the shariah functions is to examine whether the IFIs have Shariah Compliance Manual which incorporated all those functions. It is interesting to note that majority of IFIs in Malaysia have included the related functions in their respective manual, as shown in Figure 4.

Most of them use Shariah compliance manual for product development (83.5%) and Shariah review (85.9%) while 69.4% respondents use it for procedure for fatwa/resolution. 62.4% of the use the Shariah compliance manual for Shariah audit while 56.5% and 58.8% respondents use for Shariah risk and Shariah pronouncement respectively.

5 Shariah Review and Audit

Shariah Review and Audit are significant process to ensure Shariah compliance operations of the IFIs. To ensure that Shariah Review and Audit takes place effectively, the IFIs were asked few questions such as who conduct Shariah review and audit; frequency of the exercise and whether they have proper planning for such an exercise.

Most of the respondents said that the Shariah officer is the staff who conducts the Shariah review (86.0%). Only 26.7% respondents said that the internal auditor while 7.0% external auditor and consultant respectively conduct the review (see Fig.4). The respondents’ distribution on the person who conducted the Shariah audit are shown in Fig.5.

Out of them, 87.5% of respondents have specific planning or schedule for the Shariah review exercise (Fig.6) while the frequencies distribution of the exercise conducted are shown in Fig.7. Similarly, most of the respondents (89.6%) have specific planning or schedule for Shariah audit exercise and the frequencies of exercise conducted can be seen in Fig.8 and Fig.9.
Fig 4 Who conduct Shariah Review and Audit

Fig 5 Respondents distribution based on the person conducted Shariah audit

Fig 6 Respondents distribution based on the specific planning for Shariah review exercise

Fig 7 Respondents distribution based on the frequency of the exercise conducted
6 Shariah Research

The essence of Shariah Research is to ensure that in every decision made by the IFIs, proper research has been conducted to study on the overall shariah principles applicable. The respondents were asked whether their institutions provides sufficient research to facilitate Shariah decision making, whether the research conducted is effective and whether the institutions provides conducive research function. The response on these questions are very positive. Table 2 is the summary of respondents’ responses on these questions. Based on the responses; they strongly agree that there is sufficient Shariah research conducted to facilitate Shariah decision, research conducted by the Shariah research officers effectively assist the Shariah Committee to reach good decisions and that their institution has provided a conducive research function.

Effective research requires that sufficient or adequate research materials have been made accessible to the officers performing that function. The survey finds that IFIs provide adequate research materials and facilities such as Resource Centre (56.8%), AAOIFI standards (82.4%), BNM Shariah resolutions (94.6%), securities commission resolutions (83.8%), compilation of various international and local fatwas (62.2%) and other facilities and materials (14.9%) (see Fig.10).
Table 2 Respondents responses for the statement on effectiveness of Shariah Research function

<table>
<thead>
<tr>
<th>Statement</th>
<th>Median</th>
<th>Mode</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is sufficient Shariah research conducted to facilitate Shariah decision</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Research conducted by the Shariah research officers assist the Shariah Committee to reach good decisions</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Your institution has provided a conducive research function</td>
<td>4</td>
<td>4</td>
</tr>
</tbody>
</table>

Fig.10 Respondents distribution based on the facilities and research materials

7 Conclusion
The survey finds that the IFIs have satisfactorily adopt the SGF requirements as regards to the internal shariah compliance functions. Sufficient adoption of these aspects and overall implementation of the SGF is expected to promote stakeholders’ confidence and the integrity of the Islamic financial institutions besides reducing Shariah non-compliance risks and subsequently contribute towards maintaining financial stability in the country.

References: