THE ISLAMIC FINANCIAL SERVICES ACT, 2013
Malaysia's Model Framework for Shariah-compliance and Stability

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Abstract: Malaysia is said to have created legal history by introducing the world's first comprehensive legal framework for its Islamic Finance Industry through the pro-active approach of its central regulator (Central Bank of Malaysia, or the CBM) and government-driven Economic Transformation (ETP) Policy. This piece of legislation was crafted by regulators, policy makers and legal drafters to enforce Shariah compliance in a move towards greater financial stability. Factors such as changing demographics and increased growth of Shariah-conscious consumers worldwide, the increasing complexity of financial products, enlightened public policy goals to alleviate poverty, improve equity and enhance growth, as well as increasing global interconnectivity, have driven the regulators to beef up Shariah compliance surveillance. Punitive measures provided under this Act are designed to act as a deterrent to would-be Shariah non-compliance offenders; and at the stroke of a pen the new law has created a new breed of corporate criminals. The recently gazetted Islamic Financial Services Act 2013 (and its conventional counterpart the Financial Services Act 2013) is regarded by many as a "landmark law" for the multifaceted regulatory objectives it has to fulfil to ensure financial stability. This paper embarks on an impact analysis of the IFSA 2013 from the Shariah-compliance and governance-perspective to examine whether the new law has overcome the constraints or limitations of the Malaysian Shariah Governance Framework (SGF 2011) to ensure effective Shariah governance, as highlighted by the author's earlier studies on Shariah audit[1] and her critical appraisal of the Bank's Shariah governance framework, the SGF 2011.[2] Reference is made to the specific section, Part IV, on "Shariah Requirements" of the IFSA 2013, to see whether the prevailing concerns regarding the accountability, independence and objectivity of the SC have been given due consideration. It will also assess the adequacy of protection accorded to consumers through the expanded avenues for consumer redress as provided under this Act to strengthen the level of confidence in the Islamic financial system.

Introduction

The Islamic Finance Industry in Malaysia is "government-driven", where regulators are described as being backed by political will; it is centrally regulated and adopts a proactive approach in its supervisory and oversight role. The most prominent feature in its Shariah governance set-up is the Shariah Advisory Council (SAC). Positioned in the hierarchy of Shariah supervision and oversight, the SAC as the main accessory for the two central regulatory bodies (the Central

Bank of Malaysia and the Securities Commission of Malaysia) is given the mandate to standardise[3] Shariah practices within their jurisdictions. It also acts as the final arbiter of any disputes on points of law or Islamic jurisprudence and is by mandate resorted to by the civil courts of Malaysia before they come to a decision on Islamic Finance issues.

Malaysia is not the only country that is concerned about greater compliance with Shariah and effective governance and the pressing need to have Shariah-compliant legal and regulatory mechanisms to ensure that IFIs comply with Shariah. Other countries are still drawing from the experiences of their counterparts, tweaking existing models before developing their own unique model in their persistent effort to manage risks of non-compliance with Shariah. In comparison with Malaysia's GCC neighbours,[4] the Shariah governance model of Bahrain, Kuwait, UAE, Qatar and Oman is based on a "minimalist approach", in which the regulatory authorities expect IFIs to have a proper Shariah governance system without specifying the requirements in detail.[5] Oman as a new entrant in the Islamic Finance Industry is reported[6] to be opting for the decentralised approach rather than the centralised Malaysian model to ensure Shariah compliance. In this Sultanate, there will be no single, commonly accepted Shariah board overseeing the industry and no creation of a centralised Shariah supervisory board like the SAC of Malaysia.[7] The Central Bank of Oman requires that each bank establish its own Shariah board and stricter rules will be imposed on the choice of Islamic financial modes to manage liquidity and other facilitative transactions, as well as on the "fit and proper" qualifications of their Shariah supervisory board, where the competency and maturity of Shariah scholars are measured by how well-grounded they are in Shariah and finance and how committed they are in performing their role through regular attendance at meetings. The minimum years of experience was set at ten years before Shariah scholars can serve on any Shariah supervisory board in Oman. Dubai has recently switched over to a centralised Shariah board after seeing the benefits of legal and regulatory clarity offered by centralised governance. The Malaysian Shariah governance model, although displaying some semblance of uniformity, is still in need of fine tuning, "as no system can be perfect" (Sheila Ainon Yussof and Abdullah Masoud Alharthy, 2013). Saudi Arabia is the only GCC country that adopts a "passive approach" where the existing Shariah governance system as practiced by IFIs is not with any legal and supervisory requirements but rather is a voluntary initiative with indirect influence from the market.[8] Generally, in all these countries the AAOIFI[9] standards will be used for effective management of Shariah compliance. AAOIFI, a standard setting body focusing on accounting and auditing, is based in Bahrain and GCC central bankers and regulators--particularly within Bahrain--have naturally endorsed their support for AAOIFI standards, although in many cases, there has been a resistance to making the standards mandatory across borders (several countries' regulators require compliance with AAOIFI standards, but others do not).[10] Other governance standards are offered by international standard setters like the Malaysian-based Islamic Financial Service Boards (IFSB), which provide guidelines on effective governance and consumer protection in the Takaful industry under the IAIS-IFSB[11] collaborative effort (the Insurance Core Principles). Recently, there has been a shift towards making the IFSB standards mandatory which may mark the failure by AAOIFI to broaden its mandate beyond accounting and auditing standards (primarily adopting the international standards for Islamic financial institutions). AAOIFI was considering expanding its role to include investigating breaches of Shariah-compliance by member institutions, but the effort appears to have "fizzled out", overshadowed to a certain extent by the IFSA 2013 and IFSB standards[12].

There is greater awareness now (with numerous examples given in the GCC of failed transactions or Sukuk-securitisation which circumvented Shariah for commercial pursuits) that to ignore the implications or risks of non-compliance with Shariah is to be exposed to other contagions such as operational and systemic risks which make the industry vulnerable to financial instability. To ensure the continued safety and soundness of financial institutions and to promote overall financial and payment systems stability, the Bank as a central regulator has to undertake a yearly assessment of risks and challenges faced by the financial system and to review the strength of its regulatory and supervisory measures. Malaysia undergoes this annual assessment under the Financial Sector Assessment Program (FSAP) conducted by the International Monetary Fund and World Bank. And as a result of the Financial Stability and Payment Systems Report 2012, "the Islamic Financial Services Act (IFSA) 2013 and its conventional counterpart the Financial Services Act (FSA) 2013 were enacted to reinforce the Bank's mandate to safeguard financial stability and strengthen the foundations for a regulatory and supervisory framework that is effective, transparent and that can contribute towards an efficient financial system that is resilient to future stresses. The new laws also strengthen the oversight on the market conduct of financial service providers, promote effective oversight of payment systems and payment instruments, and support preconditions for the development of the financial sector."

The IFSA 2013

The Islamic Financial Services Act 2013 was enacted to reinforce the CBM's mandate to safeguard financial stability as well as to statutorily monitor and enforce Shariah compliance. The Bank is given the locus standi to initiate civil actions in court against financial institutions. The Act empowers the Bank with wider responsibilities to expand its early intervention role in addressing emerging problems in financial institutions. It represents a modernisation of Malaysia's financial sector laws to make it financially inclusive with international financial systems. Rifaat Abdel Karim, a former IFSB secretary general, gives a glowing commendation to the new legislation, that "when it comes into force, it will be a landmark law, and perhaps the only omnibus Islamic finance legislation in the world."[13] Other positive comments about the Act are that it has elevated the country's status to become the world's most important Islamic finance centre, internationally known for its continued and resolute focus on developing Islamic financial services and products, a sound regulatory infrastructure with strong global integration, and skilled talent in managing and innovating Shariah compliant products. A contrary opinion is however held by a former central banker who was CBM's Project Advisor for IFSA 2013, that the new legislation has not made dramatic changes to the Shariah governance system within Malaysia (Gopal Sundram, 2013). What it does is to formalise the Shariah regulatory system for Shariah compliance within the overall regulatory system in relation to oversight on the process of determining Shariah compliance, and specifically to oversight of the operational details associated with products. This raises the question why it was not steered towards the changes as expected when the project advisor was charged with the responsibility to make a difference? Could it be that the Bank will leave it to the Shariah scholars and Shariah Committee members to determine the arrangements through a separate body, or as recommended by the present author in another study, a council to govern the role and responsibilities of the Shariah board like the Bar Council for the legal profession, as an independent body, which cannot and should not therefore be created by statute?

The IFSA 2013 has consolidated the Islamic Banking Act 1983 and the Takaful Act 1984. The new Act was gazetted on 22 March 2013. At first glance, the new Act provides a comprehensive regulation and supervision of Islamic financial institutions, payment systems and other relevant entities. It also covers the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shariah. Some of the key features[14] of the new legislation referred to in this paper include:

- Greater transparency and accountability of the CBM in carrying out its principal object to safeguard financial stability through a more risk-focused and integrated approach to the regulation of financial institutions;
- A comprehensive or end-to-end Shariah-compliant legal framework with respect to regulation and supervision (from licensing to winding-up);

- Strengthened business conduct and consumer protection requirements to promote consumer confidence in the use of financial services and products;
- Strengthened provisions for effective enforcement and supervisory intervention through imposition of higher penalties to act as a credible deterrent; locus standi given to CBM to initiate civil actions in court against financial institutions. CBM can also issue directions of compliance or accept legally enforceable undertakings that commit financial institutions to take specific actions to address identified risks.

Past Research on Constraints to Effective Shariah Governance

It was only recently in 2011 that the CBM introduced the Shariah Governance Framework to ensure effective Shariah governance for Islamic Banking and Takaful industries. The principle-based directives given by CBM were viewed, however, to be inadequate to deter IFIs from committing consistent acts of Shariah non-compliances, which were either the result of a greater focus given to commercial viability by IFIs in order to remain competitive or the limited understanding of the macro socio-economic impact of Shariah non-compliances.

Various research projects undertaken by academicians and research analysts have exposed the areas where IFIs have failed to undertake end-to-end compliance to the Shariah throughout its operations. This was due mainly to weak internal controls and inadequate or ineffective audit at the implementation stage by IFIs (Abdul Rahim, 2008), or, from a risk-focused approach, the scant attention given to the level of risks that Islamic financial institutions, markets and products pose to the overall financial system (Zeti Akhtar Aziz, 2012). The dangers of Shariah non-compliances were also highlighted as a risk that can have contagion effects such as systemic risks which can lead to financial instability. There were rampant practices of form over substance compliance by IFIs due to the replication of conventional products, which exhibited the Shariah features only in form, but in substance only mimicked conventional practices, rather than reflecting Shariah objectives, or *maqasid al-Shariah*.

Strengthened Provisions for Effective Enforcement and Supervisory Intervention under the IFSA 2013

Effective enforcement is achieved mainly through enactment of civil and criminal penalties for Islamic Financial Institutions for non-compliance to Shariah. It is shown in this section that the new Act has provisions for both civil and criminal penalties for Shariah non-compliance by an Islamic financial institution. Under the new legal framework, Islamic financial institutions will be deterred from committing statutory offenses, as the punishment (if convicted), will be imprisonment for a term not exceeding eight (8) years or being liable to a fine not exceeding RM25 million ringgit or to both [Clause 28(5) IFSA 2013].

Legislating punitive measures was recommended in an earlier paper to deter unethical practices and persistent violations of Islamic laws and regulations by IFIs in Malaysia (Sheila Ainon Yussof & Abdullah Masoud Alharthy, 2013). The issue raised here is the severity of the punishment. The regulators and legal drafters of the IFSA have viewed non-compliances not to the same degree as suggested by the above study, where it should be *persistent* non-compliances and not *first-time* offenders, as the classical rule for any crime is that the punishment must fit the crime. It is suggested here that the regulator rely on two consecutive Shariah audit reports showing consistent deviations by IFIs before meting out severe punishment.

However, if one takes the position of the regulators, it is submitted here that the strict provision under Section 28 is designed to support the principal regulatory objectives of the Act, which is aimed at promoting financial stability and compliance with Shariah. It requires IFIs to ensure *at all times* that their aims, operations, business, affairs and activities are in compliance with Shariah [Clause 28 (1) of the IFSA]. The term "institution" in this section refers to an authorized person (directors, controllers or officers) or operator of a designated payment system. The severity of the punishment is an indication of the regulator's seriousness in managing Shariah non-compliance risk as it can lead to systemic risk and financial instability.

The present writer however views this as an onerous duty which could create a backlash and hamper the growth and development of the Islamic Finance Industry as potential entrants to the industry may fear being made a criminal. The law as it is now states that any person, including a financial institution or its directors, controllers or officers, is considered to have committed a criminal offence if he contravenes the requirements under Clause 28 of IFSA, and this may reduce the number of experts wanting to serve the Islamic Finance Industry as directors, chief executive officers and auditors.

The other area that needs further clarification is related to the procedural mechanism under Section 28 (3), where in the event that an institution *becomes aware* that it has failed to abide by this statutory requirement of complying with the Shariah or the advice of its Shariah Committee (SC) or ruling of the Shariah Advisory Council (SAC), the institution shall do the following:

- Immediately notify the Bank (CBM) and its SC of the fact of non-compliance;
- Immediately cease continuing with the business activity which is the cause of the non-compliance, and
- Submit a plan for rectification of the non-compliance to the regulator (CBM) within 30 days.

The circumstances in which an institution *becomes aware* of the offending situations are not outlined here. How does an institution discover the fact of non-compliances? Will it be through the Shariah Committee or internal audit reports? Will the discovery of non-compliances be fully reported? Are there governance arrangements and mechanisms within the IFIs that can erode the independence and objectivity of internal control reports and the SC reports? Can the new legal framework accommodate the role of whistleblower? Can information on non-compliances be suppressed by IFIs since the SC members are remunerated by the IFIs and not by a public or professional body?

It is not intended here to cast aspersions on the role of Shariah scholars, but under principles of good governance, there must be a separation of powers between IFIs and the Shariah Committee to prevent conflict of interest. This would require that the SC members be remunerated by a public body and not by IFIs. Furthermore if it is the Shariah body that has designed the Shariah-compliant manual and the oversight procedures, it must not at the same time review its efficacy or compliancy; otherwise it amounts to "self-review" and the erosion of independence.

As Section 28 (3) requires the institution to immediately notify CBM of not complying with the Shariah, the advice of its SC, or the ruling of the SAC, perhaps it is time to consider the setting up of a Central Compensation Fund where it is the CBM who will remunerate the SC and SAC members directly.

There is a need to overhaul the Shariah governance system relating to Shariah advisory, so that independence can be further strengthened through a separate professional body to govern Shariah advisors or SC members similar to the Bar Council that governs the legal profession. It can be called the Governing Council for Shariah Advisors, to be made a public body under the supervision of the Central Bank (Sheila Ainon Yussof & Abdullah Masoud Alharthy, 2013); or as an independent regulatory body for the SC (not governed by the CBM) known as an "Association of Shariah Advisors", where the Central Bank and IFIs can seek their services (Akram Laldin, 2012).

Civil and Criminal Penalties for SC Members for not complying with Shariah Standards set by CBM

The questions that were posed in an earlier research (Sheila Ainon Yussof & Abdullah Masoud Alharthy, 2013) requires further reflection here: Can the SC be sued for not reasonably foreseeing harm to customers when it approves based on the legality of transactions for commercial reasons and not on the basis of applying the objectives of the Shariah which requires protection of consumers or looking after their welfare for social reasons or the public good? Or will they be immune from liability suits based on the justification that Shariah advisors individually, or Shariah Committee members collectively, cannot be sued if they made the wrong decisions on Shariah compliance because they have religious immunity in exercising collective *ijtihad*?

The above questions have been answered to a certain extent by section 29 (6) of the IFSA: "*Any person* who fails to comply with any standards specified under subsection (1), commits an offence and 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." The persons here include "every institution, its director, chief executive officer, senior officer or *member of a Shariah committee*" (emphasis added). Section 29 (1) gives power to the CBM to specify standards on Shariah matters with consultation of the SAC.

It appears that the institution, its director, chief executive officer, senior officer, can be caught under two IFSA sections: Section 28 (3) for not complying with Shariah, the advice of the SC or the ruling of the SAC; and Section 29 (6) for not complying with the Shariah standards as prescribed by the CBM. The institution and its officers will be walking a tight rope, trying to balance business goals and strict statutory requirements of Shariah compliance. Will this also be reflected in their KPIs (Key Performance Indicators)?

Furthermore, the law as it is described in the Act does not specifically link the potential of jail terms to compliance with the SAC, which may also err in its advice to CBM on the Shariah standards, ultimately affecting the legal positions of the consumers in Islamic financial transactions. Under the new law, any affected customer would have a right of civil redress against the financial institutions. But it is not clear whether the SAC can be accountable for giving wrong advice to the CBM, where the effect of the Shariah approved Islamic financial product was unjust enrichment of the financiers to the detriment of customers.

Contract-Based Regulatory Framework for Islamic Finance under the IFSA

The IFSA has established a strong legal foundation for the evolution of a contract-based regulatory framework (See Diagram 1). The legislation contains provisions that enable CBM to specify regulatory requirements that promote and are consistent with Shariah contract-based operational frameworks. As the principles of Shariah will be enforced within this framework from end–to-end, it will ensure a comprehensive Shariah governance and compliance in the Islamic financial sector and facilitate reducing the legal and operational risks in the conduct of Islamic financial transactions. The holistic governance approach will redress the lopsided or imbalanced monitoring and oversight of Shariah compliance management, at the product development and implementation stages by IFIs, and preclude the form over substance compliance, as highlighted by earlier research.

In this regard, CBM is now empowered under S 29 of IFSA to specify "Shariah Standards" for key Islamic contracts in consultation with the Bank's Shariah Advisory Council. The standards will define the essential features of the contract which will promote certainty and enhance public confidence in Islamic financial transactions. The Shariah standard on *Mudarabah* was issued in October 2012, while Shariah standards on *murabahah*, *musharakah*, *ijarah*, *wadi'ah* and *istisna* are expected to follow in 2013 and 2014. The well-defined Shariah parameters should also incorporate the ethical standards or *maqasid* benchmarks. It should address the possible harm to consumers when Islamic financing modes are viewed from the legality and not the *maqasid* aspects. At this juncture, the Shariah standards are still to be determined by CBM. An earlier study had put forth the recommendation as a public policy requirement that any Shariah decision on product development must take into consideration both the legal and *maqasid* impacts for the public good and a sustainable development of the Islamic Finance Industry in Malaysia.

CBM is also empowered to issue guidance or Operational Standards on Shariah matters to address sound practice principles and the Bank's expectations for effective risk management, governance, disclosures and appropriate legal and accounting treatments for key Islamic contracts that are necessary to ensure compliance with Shariah under different Islamic contracts (See Diagram 1).

Diagram 1 Contract-Based Regulatory Framework [15]

Shariah Standards	**Operational Standards**	**Oversight Functions**	**Resolution**
Compliance with fundamental requirements of respective Shariah contracts	Strengthened risk management, governance, transparency and disclosure, market conduct and other operational aspects of applying Shariah standards	Codification of the role of the Shariah Committee and Board of Directors of financial institutions in ensuring Shariah compliance	Priority of payment reflective of underlying Shariah contracts

For End-to-End Shariah Compliance under the Islamic Financial Services Act 2013

To achieve greater alignment with Shariah, the Act clearly defines the scope of assets and liabilities in Islamic Banking based on the underlying contractual features. For instance, on the liability side, the use of principal-guaranteed Shariah contracts such as *qard*, *wadi'ah* and *tawarruq* in deposit-taking is clearly distinguished from principal non-guaranteed Shariah contracts for investment such as *mudarabah* and *wakalah*. On the asset side, the scope of financing activities similarly draws on the distinctive features of Islamic contracts to include equity and partnership financing contracts such as *musharakah mutanaqisah*, lease-based financing contracts such as *ijarah muntahia bittamleek*, and fee-based activities under *wakalah* contracts. The new legal framework will ensure that the laws are reflective of the "true nature" of Shariah contracts (Zeti Akhtar Aziz, 2012).

Does the "true nature" of Shariah contracts also mean that all Islamic contracts must now reflect both the contractual requirements of an Islamic contract and the *maqasid* of the contracts? Is there now a conscious steering by the regulator to ensure that the Shariah objectives of justice, equity and fair play must be followed to protect consumers and other stakeholders? This is apparent in the significant change made by the IFSA for Takaful industry, in which legal effect is given to the segregation of ownership of funds between the Takaful participants and the shareholders to ensure true conformity with Shariah in Takaful operations; and the greater emphasis on fiduciary relationship between Takaful operators and Takaful participants as stipulated in *mudarabah* or *wakalah* contracts employed in Takaful business where Takaful funds must be managed on behalf of and in the best interests of Takaful participants. But one thing that will be assured by the IFSA is that with greater clarity on the legal and prudential requirements underpinned by Shariah principles in its regulatory architecture, it will enable participants in the Islamic financial system to align their practices and expectations accordingly with Shari 'ah when undertaking Islamic financial business and transactions (Zeti Akhtar Aziz, 2012).[16]

Another significant feature of the IFSA is in the provision of a strong legal foundation for the dissolution of IFIs. Thus under Resolution (Diagram 1), in the event of say, a winding-up or dissolution of an Islamic bank or Takaful operator, the priority of payment should be reflective of underlying Shariah contracts and be in line with distinctive elements of the relevant Islamic contracts: for instance, payments to Islamic depositors are prioritised in a manner that is consistent with the guaranteed nature of contracts employed in Islamic deposit products. Assets managed on behalf of investors (Investment Account Holders) are legally ring-fenced from the assets of the Islamic banks to reflect the prohibition of any co-mingling of profits and losses attributed to the investment account with other funds. Likewise for Takaful business, assets of Takaful funds and shareholder funds are separated and utilised to meet the respective liabilities and these obligations differ in priority based on the specific contracts underlying the Takaful business model.

Now that IFIs are geared by the contract-based regulatory framework toward ensuring authenticity in its Islamic financial products, it should also move IFIs towards a Shariah-based operating environment. Innovations should be contractually engineered on the basis of Islamic contract principles and features, and not as currently practiced, through a financial engineering of Islamic contracts to mimic the nature of conventional instruments. This could mean a new focus for innovation from the fount of Shariah instead of replicating conventional contracts that have caused harm to consumers from the transfer of risk to the latter.

Islamic Finance has a diverse spectrum of Shariah contracts in financial transactions that provide for different risk and return profiles. Complying strictly with the (legal) specificities of the contract will preserve the sanctity and validity of Islamic financial transactions, but what should be further considered are the ethical and social implications of the contract. Islamic contracts and instruments must reflect the true nature of their contractual form and substance to not only distinguish themselves from their conventional counterparts but also to ensure systems and financial stability.

However, with the power given to CBM under the new law to address non-compliance with Shariah and operational standards one would expect greater supervisory intervention to require prompt corrective actions. Enforcement is greatly assisted by a comprehensive penalty framework that provides a credible deterrent.

Market Conduct and Avenues for Consumer Redress

Specific provisions in the IFSA have significantly strengthened the preconditions for an effective regulatory and supervisory regime for business conduct and consumer protection. The CBM has been given wider power to specify standards on business conduct which go toward ethically conscious behaviour.

To this end the new legislation provides explicit and expanded powers for CBM to set and enforce business conduct standards on Financial Service Providers (FSP) in the following areas:

- Disclosure requirements
- Fairness of contract terms
- Financial promotion
- Provision of advice and complaints handling.

The legislation also identifies prohibited conduct that is inherently unfair to consumers, enhances the legal protection provided to consumers in relation to dealings with Takaful (and insurance) companies and intermediaries and provides for the evolution of avenues for consumer redress.

To complete the end-to-end compliance, and at the dispute settlement stage, there must be a dispute resolution mechanism that can assure customers of the enforceability of Islamic finance contracts in any jurisdiction, as Shariah law must be the governing law to settle disputes that involve Islamic law and ethics (Sheila Ainon Yussof, 2013). Before the Act was introduced, aggrieved customers of IFIs sought justice or redress through civil courts, which referred to the central Shariah advisory (the SAC) for Shariah reference, before making decisions. Under the new law, any affected customer has the right of civil redress against the financial institutions. With the introduction of the IFSA, industry players and investors will find legal certainty when seeking recourse following disputes or disagreements on certain points of law. This will instil more confidence among current and potential investors in Shariah compliant products and services. It will also increase cross-border dealings when there is certainty of the law on dispute settlement and payment systems.

The avenues for consumer redress have now been widened by the IFSA. Thus in addition to litigation and arbitration and financial mediation the CBM is now empowered to approve financial ombudsman schemes, which is another alternative dispute resolution mechanism aimed at ensuring effective and fair handling of complaints and resolution of disputes. Currently there is no specific mechanism for ADR in Islamic Finance. Conventional finance has the Financial Mediation Bureau. A provision now exists in the IFSA for the establishment of a Financial Ombudsman Scheme (FOS) to arbitrate legal and Shariah disputes and to act as an intermediary between disputing parties. It is not yet clear how the FOS is going to be implemented, as the IFSA does not specify its structure or organization (Hashimah Yaacob, 2013).[17] What is certain however is that all Islamic financial institutions operating in Malaysia will be the members of the FOS.

Legislatively providing the FOS avenue or mechanism under the IFSA to arbitrate legal and Shariah disputes in Islamic finance amounts to an ouster clause, which excludes the power of the court as the final arbiter. This means that parties who agree to seek recourse through the FOS instead of the court system will not be able to bring their cases back to the civil court for redress. At this stage, the kind of scheme that the regulator will implement is not elaborated. The issues whether FOS decisions are binding and recognised by the court or not are still being discussed, as some declare that FOS is not like an arbitrator.

Conclusion and Recommendations

Malaysia is one of the few countries where the regulator is given a mandate to promote Shariah compliance among Islamic financial institutions. Glowing commendations have been given to this important legislation crafted by regulators, policy makers and legislators, industry players and scholars, as the only omnibus Islamic Finance legislation any country has hitherto initiated. It is a landmark law development for introducing an Islamic financial system which takes holistic and humanistic approaches towards the governance of IFIs, not forgetting the punitive measures to act as a deterrent for institutions that fail to comply with the Shariah in its goals, operations, business, affairs and activities. These features support the principal regulatory objectives of the IFSA 2013 (Section 6), which is to promote financial stability and compliance with Shariah, wherein the CBM is given a wider mandate to foster the following:

- Safety and soundness of Islamic financial institutions;
- Integrity within and the orderly functioning of the Islamic money market and Islamic foreign exchange market;
- Safe, efficient and reliable payment systems and Islamic payment instruments; and
- Fair, responsible and professional business conduct of Islamic financial institutions.

And most important is the effort made to protect the rights and interests of consumers of Islamic financial services and products.

Some of the shortfalls of the new law were underlined in a remark, as earlier quoted, by a former central banker and CBM's Project Advisor for IFSA 2013, Gopal Sundram, who states that the new legislation has not made dramatic changes to the Shariah governance system within Malaysia. In his view, there is not much specifically outlined in the law that defines the responsibilities of a Shariah board. What it does is to formalise the Shariah regulatory system for Shariah compliance within the overall regulatory system in relation to oversight of the process of determining Shariah compliance, and specifically to oversight of the operational details associated with products.

The author concurs with this observation and recommends the following:

- In using the CBM Shariah Governance Framework (SGF 2011) guidelines, we recommend a restructuring and re-engineering of the Shariah Governance system in terms of the composition and formalisation of Shariah boards under the IFSA as a point of reference. Similarly, appointment and tenure of Shariah Committee members should be revised. There is a need for greater clarity on responsibility, accountability, independence and objectivity to prevent conflict of interest and self-review situations; competency building through a comprehensive training programme to preserve or increase the quality of Shariah advisory; and succession planning to ensure continued leadership in this area.

- A separate professional body should be established to govern Shariah advisors similar to the Bar Council for the legal profession: either as a public body under CBM or as an independent regulatory body not governed by the CBM. This professional body may be known as the Governing Council for Shariah Advisors or Association of Shariah Advisors and will decide on fit and proper qualifications and good governance principles and ensure the quality of Shariah advisory services through talent development as well as the setting up of a Disciplinary Board for Shariah advisors or SC members.
- A Central Compensation Fund should be set up by CBM to remunerate Shariah Committee members directly; or alternatively a standard fee imposed by CBM requiring all IFIs to pay at the same rate for hiring the services of SC members to ensure equitable compensation among SC members, to prevent Shariah arbitrage, and erosion of SC members' independence.
- A public policy requirement should be made for Shariah Committee's decisions on product development to be based on a matrix of legality of transactions vis-à-vis *maqasid* impacts (to achieve social justice or public good). A Product Development Framework must show both the legal effect and ethical impact (socio-economic, environmental, etc.) before the product can be approved or certified as Shariah-compliant, or preferably Shariah-based products.

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Reuters, 27 June 2012.

Notes

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1. "Prospects of a Shariah Audit Framework for Islamic Financial Institutions in Malaysia" by Sheila Ainon Yussof as an article in *Islam and Civilisational Renewal*. Vol 4. Number 1. Jan 2013. IAIS Malaysia.
2. "Malaysia's Shariah Governance Framework for Islamic Financial Institutions" by Sheila Ainon Yussof and Abdullah Masoud AlHarthy as a chapter in a book *Islamic Transactions and Finance: Principles and Developments*. Jointly published by IAIS Malaysia and Malaysian Current Law Journal Sdn Bhd, 2013.
3. The "standardised" or "harmonised" Shariah concept is a component of institutionalisation of Shariah. Standardisation of Islamic financial contracts has its major benefit in ensuring the enforceability of such contracts in disputes brought before civil courts that are not legally bound by the Shariah. M.A. Laldin (2010) of ISRA defines institutionalisation of Shariah as the process of embedding Shariah concepts within an organisation which in turn governs the behaviour of a set of individuals in the organisation or outside it.
4. Countries in the Gulf Co-operation Council (GCC) consist of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. With the exception of the Sultanate of Oman, all IFIs in the other GCC countries have their own framework of Shariah governance systems, where Zulkifli (2012) classifies the Shariah governance approach under two distinct categories: regulation through legal and supervisory requirements as in the case of Bahrain, Kuwait, UAE and Qatar, or through self-regulation as in the case of Saudi Arabia.
5. Zulkifli Hasan (2010). "Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK". *Kyoto Bulletin of Islamic Area Studies*.
6. Reuters, 27 June 2012, 'Oman plans Islamic Finance Rules before Year End'.
7. Bahrain was the only country in the GCC to establish a National Shariah Advisory Board in the Central Bank of Bahrain to serve and to verify Shariah compliance, but it does not have authority over the IFIs unlike Malaysia, Sudan, Indonesia, Pakistan and Brunei (Zulkifli, 2012). Dubai has now opted for a centralised Shariah supervisory board.
8. Ibid.
9. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is an international standard setter on audit, governance and Shariah standards based in Bahrain, where the standards are not mandatory for IFIs to adopt.
10. Sharing Risk www.sharingrisk.org Accessed on 8th July 2013.
11. The International Association of Insurance Supervisors (IAIS) is a global standard-setting body which exists to promote consistent regulation in the insurance industry. Its Insurance Core Principles, Standards, Guidance and Methodology (ICPs) provide a "globally accepted framework" used in assessing the effectiveness of supervisory regimes in the insurance sector. The ICPs are used by the World Bank and International Monetary Fund to assess international regulatory regimes under the Financial Sector Assessment Programme (FSAP).
12. The endorsement of IFSB standards by an Executive Director at Bahrain Central Bank, Khalid Ahmad represents this shift as he stated that "The moment it (use of IFSB standards) becomes mandatory then it will serve the purpose better" (2013) .
13. The Star Online, 6 February 2013. Professor Datuk Dr. Rifaat Ahmed Abdel Karim is now the CEO of International Islamic Liquidity Management Corporation (IILM) based in Malaysia. The IILM is an international institution established by Central Banks, monetary authorities and multilateral organisations

to create and issue short-term Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

14. The Financial Stability and Payment Systems Report 2012 outlines Bank Negara Malaysia's assessment of risks and challenges faced by the Malaysian financial system and the capacity of the system to sustain its financial intermediation role in the economy. It also reports on the developmental initiatives pursued by the Bank to reinforce the roles of the financial services sector in supporting and contributing to economic growth and the economic transformation process, as well as the regulatory and supervisory measures undertaken by the Bank to ensure continued safety and soundness of financial institutions and promote overall financial and payment systems stability. The publication is intended to promote greater understanding on issues and developments affecting financial stability, including policy directions of the Bank.
15. Adapted from the Financial Stability and Payment Systems Report 2012, p. 80.
16. The Governor of Central Bank of Malaysia in her keynote address at the 8th World Islamic Economic Forum (WIFE) held in Malaysia on 8th December, 2012.
17. A researcher from the International Shariah Research Academy (ISRA) in an interview with The Edge Malaysia.