

REGULATORY REFORM IN ISLAMIC FINANCE IN MALAYSIA: THE EFFECT OF ISLAMIC FINANCIAL SERVICES ACT 2013

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Abstract

The existing framework of Islamic finance in various jurisdictions demonstrates diverse practices and distinct models. Some jurisdictions prefer greater involvement of regulatory authorities and some countries on the other hand favor otherwise. Malaysia as the proponent of regulatory-based approach has instituted several initiatives to promote financial stability and this include the new law passed by the parliament known as the Islamic Financial Services Act 2013. This article discusses significant features of this Act and its new dimensions as well as to highlight its legal consequences in the aspects of demarcation between Islamic banking and its conventional counterpart, element of consumerism, interest of depositors and investment account holders, corporate governance, Shari'ah compliance, liabilities, judicial oversight and products and services.

INTRODUCTION

Islamic finance will grow with rapid pace in the year 2014 and its volume will pass through USD2 trillion, with Islamic banking dominating at 78%, sukuk at 16%, takaful at 1%, Islamic funds at 4% and Islamic microfinance with 1%¹. In 2013, global Islamic banking asset with commercial banks alone reach USD1.8 trillion representing 17% average annual growth². It is estimated that Islamic finance will be able to tip USD6.5 trillion by the year 2020 with the current growth rates³.

In line with the consistent growth globally, Islamic banking in Malaysia is also experiencing considerable growth. In 2013, Malaysia has 16 full-fledged Islamic banks, 12 Takaful operators, five international Islamic banks and six development financial institutions that offering Islamic financial services and products. With the additional players including foreign Islamic banks, the Islamic banking industry in Malaysia has shown significant progress with market share increased up to 24.4% of the total banking system. Total Islamic financing continued to grow 16.6% and represented 26.9% of total loans in the banking system with the household sector continuing to account for the bulk of Islamic financing at 65.9%. Not only that, 799 *Shari'ah*-compliant securities were listed on Bursa Malaysia, representing 87.7% of the total listed securities, with a

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¹ Saudi Gazette, (2014). *Islamic Finance Industry to Reach \$2 Trillion in 2014*. Available at: <http://www.saudigazette.com.sa/index.cfm?method=home.regcon&contentid=20140102191275>

² Ernst & Young. (2013). *The World Islamic Banking Competitiveness Report 2012-2013*. London: Ernst & Young.

³ MIFC. (2013). *Expanding Islamic Finance, How Regulators are Changing the World*. Kuala Lumpur: MIFC.

market capitalization of RM995.7 billion or 63.7% of the total market capitalization⁴.

Malaysian regulator has initiated a robust Islamic finance regulatory framework since its implementation in 1983. Until now, several laws were passed and amended by the parliament such as the Islamic Banking Act 1983, the Takaful Act 1984, the Banking and Financial Institutions Act 1989 and the Securities Commission Act 1993. In 2009, the Central Bank of Malaysia Act 2009 was passed by the parliament to replace the old Central Bank of Malaysia Act 1958. Apart from that, the Central Bank of Malaysia (BNM) also issued several guidelines for IFIs such as the Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks and the *Shari'ah* Governance Framework. All of these initiatives are part of the Malaysian Financial Sector Blueprint 2011-2020, which will complement the ongoing efforts in strengthening the relevant regulatory and legal framework for Islamic finance.

After going through several phases of development in Islamic finance since 1983, Malaysian government finally took a step in enhancing the framework of Islamic finance by passing the IFSA. The IFSA consists of comprehensive provisions, which are specifically aimed to strengthen regulatory framework of Islamic finance, which is now becoming sophisticated, globalised and integrated industry. The IFSA consolidates the previous Islamic Banking Act 1983 and the Takaful Act 1984 and repeals both Acts. This article aims at providing brief commentaries and critical analysis on the significant features of the recent Malaysian Islamic financial stability legislation known as Islamic Financial Services Act 2013, which was passed by the Malaysian Parliament. The Royal Assent to the Act has been announced on 18 March 2013 and it has been gazetted on 22 March 2013. The IFSA is expected to boost further the development of Islamic finance in Malaysia through laying the foundation for a comprehensive regulatory framework to promote a resilient and stable Islamic financial system in Malaysia.

I. REGULATORY REFORM

The legal framework of Malaysia's Islamic finance system has undergone a tremendous change with the enforcement of the Islamic Financial Services Act 2013 and the Financial Services Act 2013. These laws have replaced the existing Banking and Financial Institutions Act 1989 (BAFIA), Islamic Banking Act 1983 and Takaful Act 1984. The new laws provide BNM with the necessary regulatory and supervisory oversight powers to fulfill its broad mandate within a more complex and interconnected environment, given the regional and international

⁴ Business News. (2013). *Economic Report 2013/2014: Islamic Banking Shows Significant Progress*. Available at: <http://www.thestar.com.my/Business/Business-News/2013/10/26/Islamic-banking-shows-significant-progress.aspx/>

nature of financial developments. The law is also expected to place Malaysia's financial sector, on a platform for advancing forward as a sound, responsible and progressive financial system.

In describing the whole idea of the IFSA, Datuk Nor Shamsiah Mohd Yunus, Deputy Governor of the BNM, who was instrumental in the development of the IFSA, summarizes the key features of this act. She said:

'The emphasis on governance framework for an end-to-end Shariah compliance for Islamic financial institutions under IFSA 2013 is a key additional dimension of the regulatory framework for Islamic finance and substantially increases the level of transparency required. In particular, the IFSA provides a comprehensive legal framework that is fully consistent with Shariah in all aspects of regulation and supervision, from licensing to the winding up of Islamic financial institutions. More importantly, IFSA provides the statutory foundation for a Shariah contracts-based regulatory framework in a manner that would facilitate the next level of Islamic banking business, transcending beyond financial intermediation to include real economic sector participation, complete with the consequent regulatory checks and balance. Such a distinctive regulatory approach seeks to realise further the value proposition of Islamic finance, as the industry advances towards a new level of maturity and sophistication⁵.

With pro-active regulatory approach to facilitate the implementation of Islamic finance, the IFSA marks further advancement of Malaysia's legal Islamic finance architecture. This initiative is considered as part of the reforms made to the existing Islamic finance practice in order to foster financial stability, to strengthen *Shari'ah* compliance framework as well as to bring forward Islamic finance industry in Malaysia to be competitive at international level.

A. About the IFSA

The IFSA, which came into force in June 2013, was passed by the Parliament in 2013, received the Royal Assent on 18 March 2013 and gazetted on 22 March 2013. Unlike the previous legislations, the IFSA governs all IFIs including Islamic banks, takaful operators, international Islamic banks, international takaful operators as well as operators of payment systems which the transfer of funds between Islamic bank accounts or which enables payments to be made by means of Islamic payment instruments, issuers of Islamic payment instruments, takaful brokers and Islamic financial advisor. The IFSA nevertheless excludes development financial institutions and cooperative societies.

The IFSA streamlines the Islamic financial provision for IFIs under single legislation. There are 18 Parts in the IFSA with 291 sections and 16 Schedules.

⁵ MIFC. (2013a). *Malaysia Islamic Finance Market Place, Gains Clarity and Certainty Through Islamic Financial Services Act 2013*. Available at: http://www.mifc.com/newsletter/2013_oct/A_Special_epicentre_Interview_IFSA_2013.pdf

Part I: Preliminary, Part II: Regulatory Objectives and Powers and Functions of Bank, Part III: Authorization, Part IV: Shariah Requirements, Part V: Payment Systems, Part VI: Prudential Requirements, Part VII: Ownership, Control and Transfer of Business, Part VIII: Financial Groups, Part IX: Business Conduct and Consumer Protection and Part X: Islamic Money Market and Islamic Foreign Exchange Market Part XI: Submission of document or information, Part XII: Examination, Part XIII: Directions of Compliance, Part XIV: Intervention and Remedial Action, Part XV: Other Powers of Bank, Part XVI: Enforcement and Penalties, Part XVII: General Provisions, Part XVIII: Repeal, savings and transitional. Interestingly, there are several new elements incorporated in the IFSA as compared to the old laws such as strict liability and consumerism dimension.

II. SIGNIFICANT FEATURES OF THE IFSA

A. Objectives

Section 6 provides that two principal regulatory objectives of the Act namely to promote financial stability and compliance with Shariah. To actualize this aim, the IFSA clearly authorize the BNM as the authoritative body to ensure stability particularly to foster the safety and soundness of Islamic financial institutions, orderly functioning of the Islamic money market and the Islamic foreign exchange market as well as efficient and reliable payment Islamic payment instruments and fair, responsible and professional business conduct of Islamic financial institutions. The IFIs are also required to strive to protect the rights and interests of consumers of Islamic financial services and products.

B. Statutory Duty

In general, the IFSA imposes two statutory duties to IFIs namely Compliance and Reporting. In term of Compliance section 28 (1) requires IFIs to ensure at all times that their aims, operations, business, affairs and activities are in compliance with Shariah. to ensure that its internal policies and procedures are consistent with the standards specified by BNM, to manage its business, affairs and activities in a manner which is not contrary to Shariah and to establish a Shariah Committee The BNM also requires IFIs to carry out an audit on Shariah compliance. The BOD, CEO, Senior Officer and Shariah Committee shall be responsible to ensure that IFIs are at all times to comply with the standards specified by BNM.

As regard to reporting duty, IFIs are required to immediately notify the BNM and its Shariah committee of any non-Shariah compliant activities and immediately cease from carrying on such business, affair or activity. The IFIs are required, within 30 days, to submit to the regulator a plan on the rectification of

the non-compliance as provided in section 28(3)(c). Section 37 requires IFIs to submit Shariah audit compliance report.

C. BNM as a Financial and *Shari'ah* Regulator

One of the unique characteristics of the IFSA is the role of the BNM as a regulatory authority in both aspects financial activities and *Shari'ah* related matters. In term of *Shari'ah* governance, the IFSA embeds Shariah principles and affirms *Shari'ah* Advisory Council rulings. More importantly, the IFSA clearly confirms BNM's powers to specify standards on Shariah governance or matters related to Shariah compliance including assessment on potential Shariah non-compliance events and IFI's rectification of Shariah non-compliance⁶.

The IFSA empowers the BNM to specify the duties and functions of the Shariah committee. For purpose of independence, Shariah committee members enjoy statutory protection for actions for breach of confidentiality provided they have acted in good faith in the course of the discharge of their duties and performance of their functions. Shariah committee members are also statutorily protected from actions for defamation in respect of any statement made by them without malice in the discharge of their duties as stipulated in section 36 (b). Table 1.0 summarizes the provisions related with *Shari'ah* requirements:-

Table 1.0: *Shari'ah* Related Requirements under the IFSA

| Division | Provision |
|--|--|
| Division 1: <i>Shari'ah</i> Compliance | Section 27: Interpretation Section 28: Duty of institution to ensure compliance with Shariah Section 29: Power of Bank to specify standards on Shariah matters |
| Division 2: <i>Shari'ah</i> Governance | Section 30: Establishment of <i>Shari'ah</i> committee Section 31: Appointment of <i>Shari'ah</i> committee member Section 32: Duties of <i>Shari'ah</i> committee and its members Section 33: Cessation as member of <i>Shari'ah</i> committee Section 34: Notice of cessation as member of <i>Shari'ah</i> committee |

⁶ As regard to the issuance of recent parameters of *Shari'ah* contracts to complement the IFSA and other related legislations, the BNM has issued Resolutions on *Murabahah* and Exposure Drafts on Islamic Financial Contracts (*Shari'ah* Requirements and Optional Practices) and Contract paper on *Shari'ah* Requirements, Optional Practices and Optional Requirements of *Musharakah*, and Contract paper on *Shari'ah* Requirements, Optional Practices and Optional Requirements of *Mudharabah*. These parameters cover various types of *Shari'ah* contracts and these include *hibah*, *bai inah*, *kafalah*, *wakalah*, *wadiah*, *wa'd*, *musharakah*, *mudharabah* and *tawarruq*.

| | |
|---|---|
| | Section 35: Information to be provided to <i>Shari'ah</i> committee Section 36: Qualified privilege and duty of confidentiality |
| Division 3: Audit on Shariah compliance | Section 37: Appointment of person by institution to conduct audit on <i>Shari'ah</i> compliance Section 38: Appointment of person by Bank to conduct audit on <i>Shari'ah</i> compliance |

D. New Requirements under Takaful

Most of the provisions under the IFSA are applicable to both IFIs and takaful operators. Nevertheless, there are several new requirements, which are exclusive to Takaful under the IFSA. For instance, the IFSA introduces a requirement of single licensed takaful business. Section 16 of the IFSA requires takaful operator to separate its family business with general takaful business. To comply with this requirement, BNM grants takaful operators a period of five years to split both business, family business and general takaful business into separate entities.

One of the main objectives of the IFSA is consumer protection and these include provisions in the matter relating with takaful funds, shareholders' fund and *qard*. For instance, section 94 prohibits a licensed takaful operator from making any withdrawal from a takaful fund, whether from the surplus, or otherwise, of that takaful fund unless all the conditions set out is fulfilled. Section 91 makes it mandatory for takaful operator to separate takaful fund and shareholders' fund. The IFSA also requires a licensed takaful operator to provide *qard* or other forms of financial support to the takaful fund from the shareholders' fund for an amount and on such terms and conditions as may be specified by BNM, if the value of the assets of the takaful fund is less than the value specified by BNM as provided in section 95. This makes *qard* or loan provision is compulsory to every takaful operator in the event of deficit of the risk fund.

III. NEW DIMENSION AND LEGAL CONSEQUENCES OF THE IFSA

A. Demarcation Between Islamic and Conventional Finance

Despite the financial stability factors, the IFSA also seems to be the catalyst for clear demarcation between conventional and Islamic finance⁷. Comprehensive provisions and numerous statutory definitions unlike the old laws, including an

⁷ Zaman and Asutay highlight that based on its current performance and practices, the developments of Islamic finance industry indicate that it has converged towards conventional finance and to certain extent has failed to fulfill the institutional and policy aspirations of Islamic economic system. See Zaman, N. & Asutay, M. (2009). Divergence between Aspiration and Realities of Islamic Economics: A Political Economy Approach to Bridging the Divide. *IJUM Journal of Economics and Management* 17(1): 73-96.

attempt to link Islamic finance with real economy, the IFSA indicates that the regulator tries to differentiate the framework for Islamic finance and its conventional counterparts⁸. This is clearly stipulated in section 6 (a) (iv) where it provides that one of the objectives of the IFSA is to foster fair, responsible and professional business conduct of Islamic financial institutions.

For instance, previously under the Islamic Banking Act 1983, “deposit” only applies to a sum of money or monies worth received by or paid to any person, under which the receipt and repayment shall be in accordance with the terms of an agreement made under any *Shari’ah* principle on any basis including custody or profit sharing. Now under section 148 of the IFSA, the term Islamic “deposit” specifically refers to a sum of money accepted or paid in accordance with Shariah (a) on terms under which it will be repaid in full; or (b) whereby the proceeds to be paid shall not be less than such sum of money. May include precious metal or precious stone, or any article or thing as may be prescribed by the Minister regardless of whether the transaction is described as a loan, a financing, an advance, an investment, a savings, a sale or a sale and repurchase or by whatever name called. This statutory definition attempts to provide clear distinction between Islamic deposit and conventional deposit⁹.

Similarly on the definition of depositors, section 2 of the IFSA enhances its meaning by referring to a person entitled to the repayment of an Islamic deposit, whether the Islamic deposit was made by him or any other person. Unlike the Islamic Banking Act 1983, the IFSA clearly distinguished current account and saving account holders from an investment account holder. The Islamic Banking Act 1983 refers depositors as a person who has account at Islamic bank and no clear account demarcation. The IFSA defines investment account as an account for the purposes of investment, including for the provision of finance, on terms that there is no express or implied obligation to repay the money in full and (a) with profits-sharing, or both the profits-or-losses-sharing features (b) with or without any return. As regard to the definition of ‘return’ in relation to the definitions of “financing facility”, “investment account” and “Islamic deposit”, and “Islamic securities” as defined in subsection 224(1), the IFSA also considers any dividend benefit, any fee or gift as part of returns.

B. Corporate Governance

Generally, the IFSA provides a clearer and more comprehensive set of provisions for corporate governance for IFIs. Section 29 of the IFSA mentions that every

⁸ Hasan, Z. (2013). An Analysis on Malaysian Islamic Financial Stability Act, *Journal of International Banking and Regulation*, 28 (1): 297-299.

⁹ Similar requirement is also applicable to takaful business. Section 91 of the IFSA requires for the nature of *Shari’ah* contracts embedded in any takaful business model. Takaful operators must segregate the funds owned by the takaful participants and the shareholders of a takaful operator.

institution, its director, chief executive officer, senior officer or member of a *Shari'ah* committee shall at all times comply with BNM standards applicable to such person. In fact, section 28(6) of the IFSA provides that a failure to comply with the standards issued including guidelines or standards on corporate governance is an offence under the Act and carries with a maximum penalty of eight years imprisonment or a fine of 25 million ringgit or both. In other words, the IFSA expects greater responsibility to IFIs particularly to those who involve in policy making decision and issuing *Shari'ah* rulings. This high expectation is translated by looking at potential exposure to board or directors, management, officers and even *Shari'ah* committee members with heavy penalties including imprisonment.

It is worth noting that the IFIs cannot simply rely on their professional advisors or experts such as external auditors, lawyers, advisory firms and any other professional entities. The IFIs must ensure that they have taken reasonable measures to ensure that all business operations comply with the IFSA and any other related requirements. This position is affirmed in the case in *Khiudin bin Mohd & Anor v Bursa Malaysia Securities Bhd and another Application* [2012] MLJU 445 where Rohana Yusof J held that reliance to advisor is no longer a good defense. She said: "*A CEO and a director have duties to exercise care and diligence in the exercise of their functions in the company. Relying on the expert did not per se discharge directors from their duties. Reasonable steps must be taken which requires each individual to take up upon themselves the responsibilities which commensurate their roles in relation to reading and understanding the financial statement. Complexities and volume cannot be an excuse*¹⁰."

The IFSA also complements and strengthens the *Shari'ah* governance requirements as stipulated under the *Shari'ah* Governance Framework issued by the BNM¹¹. The element of transparency and good disclosure practice is embedded in several provisions. The IFSA is expected to significantly raise the level of transparency in IFIs. For instance, section 35 of the IFSA requires IFIs to supply accurate, complete, not false or misleading information to the Shariah committee. While enjoying that privileges, the Shariah committee is expected to keep relevant information as private and confidential. Corporate and *Shari'ah* governance related provisions requires IFIs to be more vigilant and diligent in carrying their business which failure may lead to potential jail terms and heavy fine to their personnel.

¹⁰ In this case the Applicants argued on the ground of reliance on professional internal auditor namely Moores Rowland Risk Management Sdn. Bhd. and the external auditors Delloite & Touche in the financial advisers of the company. The judge rejected this contention and held that a CEO and a director have duties to exercise care and diligence in the exercise of their functions in the company. Similar decision can be found in the Federal Court of Australia in the case of *Australian Securities and Investment Commission v. Healey* (2011) 278 ALR 618.

¹¹ The IFSA is also in line with statutory provisions pertaining to Islamic financial business stipulated under Chapter 1 of Part VII of the Central Bank of Malaysia Act 2009. Sections 51–58 clarify and enhance *Shari'ah* governance framework for IFIs in Malaysia.

C. Element of Consumerism

Element of consumerism can be seen through additional liabilities of the BOD with due regard to interest of depositors, investment account holders and takaful participants. Section 6 (b) of the IFSA clearly mentions this consumerism element whereby the IFIs are required to strive to protect the rights and interests of consumers of Islamic financial services and products. The IFSA places numerous responsibilities to board of directors, senior managements and *Shari'ah* committee in actualizing this objective.

Unlike the Islamic Banking Act 1983, which requires the BOD to have due regard to shareholders, the IFSA adds further liabilities to the BOD particularly section 65 (3) of the IFSA 2013 which includes: (f) have due regard to any decision of the Shariah committee on any Shariah issue relating to the carrying on of business, affairs or activities of the institution. (3) In carrying out its functions or duties under this Division (a) the board of directors of an institution shall have regard to the interests of, as the case may be, depositors, investment account holders and takaful participants of the institution or participants. At this point, the BOD has the duties to act in the best interests of the IFIs and to act in the best interests of customers.

The element of consumer protection on takaful under the IFSA can be clearly seen in the matter relating with takaful funds, shareholders' fund and *qard* as provided in several provisions of the IFSA such as sections 90 (establishment and maintenance of takaful fund), 91 (takaful funds to be separate from shareholders' fund), 92 (requirements relating to takaful funds), 93 (requirements relating to shareholders' fund in respect of takaful funds), 94 (Withdrawal from takaful funds) and 95 (deficiency of takaful funds). In term of takaful operation, the IFSA provides that for family takaful contracts, takaful operators can no longer argue that an inaccurate answer constitutes a breach of warranty to render a consumer takaful contract void from its inception as provided in section 13 of the IFSA. On the other hand, takaful operator need to show that the statement was on a material matter or suppressed a material fact and that it was fraudulently made or omitted to be made by the takaful participant. In other words, this provision impliedly indicates that takaful operators can only void a consumer takaful contract on grounds of misrepresentation. Not only that, the IFSA also provides

D. *Shari'ah* Compliance

Another interesting development of *Shari'ah* governance in Malaysia refers to potential exposure of *Shari'ah* scholars to jail terms for rule breaches as stipulated under the IFSA. As the only legislation of its kind in the world at this point of time, the IFSA makes *Shari'ah* scholars accountable and liable for their duties. This is very significant to the practice of *Shari'ah* governance as any *Shari'ah* committee members may be jailed for up to eight years or fined up to RM25

million which is equivalent of approximately USD7.6 million if they fail to comply with the rules. This latest development also raises another issue of having professional indemnity Islamic insurance as in the case of advocate and solicitor or medical practitioners.

Shari'ah compliance requirement under the IFSA should be read together with the BNM Shariah Governance Framework (SGF). The SGF clearly mentions that the ultimate duties and responsibilities of *Shari'ah* governance and *Shari'ah* compliance are not in the hands of *Shari'ah* committee but the board of directors. Section 2.1 of the SGF provides that “the board is ultimately accountable and responsible on the overall Shariah governance framework and Shariah compliance of the IFI, by putting in place the appropriate mechanism to discharge the aforementioned responsibilities. The board is also expected to perform diligent oversight over the effective functioning of the IFI’s Shariah governance framework”¹².

The IFSA imposes strict condition and vigorous *Shari'ah* compliance process and requirements. Section 28 (3) requires IFIs to immediately notify any incidents of *Shari'ah* Non-Compliance whether actual or potential to the BNM and its Shariah committee, immediately cease from carrying on such business, and within 30 days submit a plan to the BNM on the rectification of the non-compliance. BNM Circular on Shariah Non-Compliance Reporting issued on 15 March 2013 and came into effect on 1 May 2013 further detailed out this requirement. Any report on actual Shariah non-compliance shall be submitted to the within fourteen (14) days and the IFIs are also required to submit to the BNM rectification plan, to be approved by the Board of Directors and the Shariah Committee within thirty (30) days. Within 14 days of realization that *Shari'ah* non-compliance has occurred, the IFIs are required to obtain confirmation of the *Shari'ah* committee.

E. Regulation Extended to Financial Holding Companies

Interestingly, the IFSA does not only govern and control the IFIs or takaful operators but also to their financial groups or financial holding companies (FHC). Under sections 122 and 123 of the IFSA, FHC refers to companies that holds in aggregate more than 50% interest in shares in a licensed entity or holds in aggregate no more than 50% of shares in a licensed entity but has “control”,

¹² IFIs cannot simply claim of having internal *Shari'ah* compliance framework but they must ensure that it is properly working in accordance to the required standard. In the case of *Kumpulan Wang Persaraan (Diperbadankan) v Meridian Asset Management Sdn. Bhd* [2012] MLJU 383, Hamid Sultan Abu Bakar J held that “In the instant case the plaintiff has clearly established that there was a lack of an internal check and balance system within the defendant. It must be noted that in the instant case a proper internal check and balance system is essential and necessary to ensure that the defendant’s clients’ interest (inclusive of the plaintiff) is protected in the ordinary course of business”. In this case the defendant, professional fund manager contended that it is not his responsibility on principle of vicarious liability for the conduct of its employee for any criminal act or fraud as the conduct of the employee is beyond the control and authority of the defendant. The nature of professional fund manager as in the case IFIs requires great and extra professional duty of care.

i.e. has the power to elect, appoint remove or prevent the election, appointment or removal of a majority of the directors of the licensed entity; has the power to make or cause to be made business decisions of the licensed entity; is a company whose directions, instructions or wishes the directors, chief executive officer or other senior officers of the licensed entity is accustomed to or obligated to follow; is approved by BNM to be an FHC.

The IFSA grants the BNM powers to control, supervise and monitor FHC and these include authority to issue prudential requirements and directions to FHC and its subsidiaries. Unlike the previous legislation, the IFSA extends the scope of supervision and enhances the BNM authorities to not only IFIs but also FHC¹³. This indirectly means, the BNM has now more rights and authorities over any entities that offer Islamic financial products and services including their financial groups.

F. Strict Liability, Defense And Penalties

Element of strict liability is also incorporated in the IFSA. For instance, section 260 (1) provides that offence committed by IFIs is deemed to be committed by Director, Controller, Officer, Partner or anyone concerned with management of its affairs. The same position can be found in section 252(4) and section 245(5) where a director may be deemed guilty of an offence committed by IFIs unless he proves that the offence was committed without his knowledge, consent or connivance and he took all reasonable precautions and had exercised due diligence to prevent the commission of the offence as he ought to have taken precautions or to have exercised.

The words “deemed to be committed”, to a certain extent, indicate that the BOD is presumed to have committed the offence unless if he can prove otherwise. The burden of proof is upon him to show that he has taken all reasonable precautions and exercised due diligence as stipulated in the provisions. These provisions have limited the element of defence whereby the defence only refers to the act done without consent and connivance and diligent action taken to prevent commission of offence, as he would have exercised.

The IFSA provides different forms of penalties. These different forms of sanctions can be either classified as administrative (section 245 (3)), monetary

¹³ It is reported that Islamic banking subsidiaries in Malaysia are experiencing many problems with their parent companies, which are conventional. The conventional financial holding companies put certain limitations, restrictions and requirements that negate and slow down the development process and growth of Islamic banking subsidiaries. Dato’ Jamelah Jamaludin, the Chief Executive Officer of Kuwait Finance House raised her concern on this issue and highlighted the reality and challenge of managing Islamic bank as a subsidiary of conventional bank. See Utusan Malaysia. (2010). *Hasrat Saya Tersekat: Jamelah*. Utusan Malaysia. Available at: http://www.utusan.com.my/utusan/info.asp?y=2010&dt=0412&sec=Korporat&pg=ko_02.htm. The new provision of the IFSA that extends the authority to include financial holding companies seem appropriate to resolve this significant issue.

(sections 245 (4), 29, 30, 31, 32, 33, 34, 35, 37 and 38) or criminal penalties¹⁴ (sections 258-266). As regard to administrative actions, section 245(3)(a) provides that the BNM may make an order in writing requiring the person in breach to comply with or give effect to or to do or not to do any act in order to ensure compliance with such provision. The BNM may impose monetary penalty to IFIs in the case of breach to comply as provided in section 245(4). The previous law, such as Islamic Banking Act 1983 provides lesser penalties as compared to the IFSA. The penalties provided in the Islamic Banking Act 1983 just range from a fine not exceeding 2,000 ringgit for every day during which the default continues to 50,000 or three to five years imprisonment or both. In term of criminal offence, the penalties provided in the IFSA range from one year to 10 years imprisonment or five to 50 million ringgit fine or both. For instance, a penalty for any person who commits an offence for acting on behalf of unlicensed person shall on conviction, be liable to imprisonment for a term not exceeding 10 years or to a fine not exceeding 50 million ringgit or to both. Tables 2.0-4.0 summarizes the different types of penalties in the form of non-compliance categories:

Table 2.0: Non-compliance by *Shari'ah* Committee Members

| Provision | Type of Non-compliance | Penalty |
|-----------------------------|--|--|
| Section 29 (1) | Non-compliance with the advice or ruling of the Shariah Advisory Council, which requires the ascertainment of Islamic. | Section 29 (6): 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 (2), (3) and (4) | Non-compliance with the BNM standards of <i>Shari'ah</i> governance related matter. | Section 245 (3): (a) An order in writing requiring the person in breach to comply; (b) A monetary penalty not exceeding five million ringgit; (c) Reprimand in writing; (d) An order in writing requiring the person in breach to take such steps as the Bank may direct to mitigate the effect of such |
| Section 29 (5) | Non-compliance with the internal policies and procedures adopted by such institution to implement the standards specified by the Bank. | |
| Section 31 | Non-compliance with the fit and proper requirements for a member of <i>Shari'ah</i> committee. | |
| Section 32 | Failure to perform duties and functions as a member of <i>Shari'ah</i> | |

¹⁴ Section 262 provides that every offence punishable under the IFSA is categorized as a seizeable offence, and therefore a police officer not below the rank of Inspector, or an investigating officer appointed may arrest without warrant a person whom he reasonably suspects to have committed or is committing the offence.

| | | |
|---------------------------------|---|---|
| | committee specified by the BNM standard. | breach; (e) An order in writing requiring an authorized person to remedy the breach. |
| Section 33 (1)(c) and (d) and 2 | Disqualified person as specified by the BNM standard remained to be a member of <i>Shari'ah</i> committee and failed to inform the BNM. | |
| Section 35 (2) | Disclosure of any document or information furnished by IFIs. | |

Table 3.0: Non-compliance by Institutions

| Provision | Type of Non-compliance | Penalty |
|-----------------------|--|---|
| Section 28(1) | Failure to ensure <i>Shari'ah</i> compliance to all of its aims and operations, business, affairs and activities. | Section 28(5): Liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both. |
| Section 28(3) | Failure to comply with the procedure in the event an institution becomes aware that it is carrying on any of its business, affair or activity in a manner, which is not in compliance with <i>Shari'ah</i> . | |
| Section 29(1) | Non-compliance with the advice or ruling of the Shariah Advisory Council, which requires the ascertainment of Islamic. | Section 29(6): 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(3) and (4) | Non-compliance with the BNM standards of <i>Shari'ah</i> governance related matter. | Section 245 (3): |
| Section 30 | Failure to establish a <i>Shari'ah</i> committee. | Section 245 (3): |
| Section 31 | Non-compliance with the fit and proper requirements for a member of <i>Shari'ah</i> committee. | (a) An order in writing requiring the person in breach to comply; (b) A monetary penalty not exceeding five million ringgit; |
| Section 33(3) | Termination of a member of <i>Shari'ah</i> committee without the BNM's approval. | (c) Reprimand in writing; (d) An order in writing requiring the person in |

| | | |
|-----------------------|--|---|
| Section 34(1) and (2) | Failure to inform the BNM the reasons of termination and to appoint a new member of <i>Shari'ah</i> committee in the event of any committee member ceases to be a <i>Shari'ah</i> committee of an institution. | breach to take such steps as the Bank may direct to mitigate the effect of such breach; (e) An order in writing requiring an authorized person to remedy the breach. |
| Section 35(1) | Failure to furnish information and documents requested by a member of <i>Shari'ah</i> committee and to ensure that they are accurate, complete and not false or misleading. | |
| Section 37(1) | Failure to appoint or to conduct <i>Shari'ah</i> audit. | |

Table 4.0: Non-Compliance by the Appointed *Shari'ah* Auditor

| Provision | Type of Non-compliance | Penalty |
|---------------|--|--|
| Section 37(2) | Failure to perform audit duties and functions as specified by IFIs. | Section 245 (3): (a) An order in writing requiring the person in breach to comply; (b) A monetary penalty not exceeding five million ringgit; (c) Reprimand in writing; (d) An order in writing requiring the person in breach to take such steps as the Bank may direct to mitigate the effect of such breach; (e) An order in writing requiring an authorized person to remedy the breach. |
| Section 38(2) | Failure to perform audit duties and functions as specified by the BNM. | |

F. Payment System and Exchange Control

The Financial Services Act 2013 repealed the Banking and Financial Institutions Act 1989, the Payment System Act 2003, the Exchange Control Act 1953 and the Insurance Act 1996. The FSA 2013 replaced these four acts by combining banking and finance, payment system, insurance and exchange control matters. Unlike the IFSA, the FSA 2013 clearly laid down statutory provisions and requirements on payment system and exchange control matters. The IFSA only repealed the Islamic Banking Act 1983 and the Takaful Act 1984 which provided both Islamic banking and takaful related statutory provisions. Part V and VI of the IFSA laid down provisions on payment system and exchange control for Islamic financial business.

IV. ISSUES AND CHALLENGES

Undeniably, Malaysia is still one of the leading players in Islamic finance. Malaysia enjoys consistent considerable growth and has shown significant progress and this can be shown through its market share of 25% of the total banking system. The implementation of Islamic finance is facilitated by various means and approaches and these include pro-active regulatory-based initiative¹⁵. At this point of time, Malaysia is seen to be the only country that supports Islamic finance through having extensive legal infrastructure. As part of the Malaysian Financial Sector Blue Print 2011-2020 strategies under the theme 'Strengthening Our Future', it is expected that Islamic finance in Malaysia will consistently enjoy further growth and development.

Despite positive outlook of Islamic finance in the coming years, there are some potential difficulties and challenges for Islamic finance stakeholders due to the IFSA. With numerous provisions and statutory requirements imposed to IFIs, unlimited authorities given to the BNM and great liabilities to board of directors, managements including *Shari'ah* committee members, the IFSA to certain extent may pose unnecessary hindrance to the development of Islamic finance in Malaysia. This section highlights several challenges and potential issues based on the framework of IFSA.

A. No Judicial Oversight over the BNM

The IFSA entrenches role of BNM as not only financial authority but also *Shari'ah* regulator. Unlike the retired Islamic Banking Act 1983, the IFSA enhances its scope to both *Shari'ah* compliance and financial activities. Not only that, the BNM is now having wide authorities over FHC and financial groups including the appointment of receiver and manager. The IFSA vests the BNM with wide ranging powers to issue standards, prudential matters and directions which are binding upon IFIs and the burden is put on the shoulder of IFIs particularly to board of director, senior management, officer and *Shari'ah* committee member of the institution.

¹⁵ The trust on the regulatory framework of Islamic finance can be evidenced through the initiative of the state-owned Development Bank of Kazakhstan on the issuance of Islamic bonds worth up to USD500 million. It is reported that the *sukuk* will be issued under the laws of Malaysia. See Reuters. (2012). *Kazakh State Bank Plans \$500 million Islamic Bond Issue*. Available at: <http://www.reuters.com/article/2012/03/30/kazakhstan-sukuk-idUSL6E8EU1D820120330>. It is worth to note that the English law and the United States Law are not completely Shariah-compliant. The application of the Rome Convention on the Law Applicable to Contractual Obligations of 1980 and Rome I Regulation further complicates the application of Islamic law. See *Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others* [2004] 1 Lloyd's Rep 1 28.

In line with the Financial Sector Blueprint 2011-2020, the BNM has more power to dictate what is appropriate for an institution and its holding company and these include its Capital Requirements, Corporate Governance, Consumer Protection, Shareholding, Intervention and even *Shari'ah* compliance. The IFSA further grants the BNM with power not only to advise but also to recommend the decision made by the Minister. In other words, under the IFSA, any Ministerial exemptions require the recommendation by the BNM.

In light of the above, the IFSA is silent on the issue of judicial oversight over the BNM. This raises another issue as who will review the functions and roles of the BNM. Judicial oversight over the BNM is also significant, as it will grant the right to review the BNM's action. With so much authorities and power of the BNM, there must be certain legal mechanism to limit and restrict such authorities and to find the best avenue to review and oversee the BNM's action if necessary. This is in line with the best practice of governance that will guarantee the financial stability and to ensure the soundness of Islamic finance practice.

B. Potential Conflict of Interest Between Shareholders and Other Stakeholders

Unlike the previous legislation, which is not clear about the duty to act in the best interest of shareholder and other stakeholders, the IFSA clearly mentions such requirement. Section 65 of the IFSA provides that the board of directors of an institution shall have regard to the interests of, as the case may be, depositors, investment account holders and takaful participants of the institution or participants. In other words, the IFSA seems to promote stakeholders value based approach in Islamic financial institution rather than the shareholders value model as what has been practicing before.

Despite the advantages of stakeholders value model, the statutory requirement of imposing duty to act in the best interest of various stakeholders may raise potential conflict of interest between majority shareholder and depositors or policyholders. In actual practice, shareholders value model is still dominant as compared to the stakeholder value orientation.¹⁶ In the context of Islamic finance, IFIs will face a great challenge to balance the interest of shareholders and the consumers particularly investment account holders or depositors. In fact, Islamic finance practitioners sometime are reluctant to accept changes or reform initiated by the regulator¹⁷. With no clear guidelines as to the rights of investment account

¹⁶ This is affirmed by a study conducted on corporate governance reform in Malaysia, which found the majority of companies prefer to adopt Shareholders value model of corporate governance as a benchmark rather than the stakeholder value approach. See Lim, P.K. (2007). Corporate Governance Reforms In Malaysia: The Key Leading Players' Perspective. *Journal of Corporate Governance*, 15 (5), 724-740.

¹⁷ Lately, even Islamic bankers have criticized the scholars who advocate reform to Islamic finance practice. One of the critics refers to allegation that young scholar wannabes have infiltrated Islamic banks and much more serious is where the criticism includes allegation of changing the meaning of Quranic verses and Hadith. See Hasan, Z. (2013). *Window Dressing, Scholar Wannabes*. Malaysian Reserve (in Association with International Herald Tribune), 25th February 2013.

holders and depositors by the BNM or any other standard-setting agencies, potential conflict of interest is very much likely to happen.

C. Cost and Efficiency

The element of strict liability imposed to Director, Controller, Officer, Partner or anyone concerned with management of its affairs in the IFSA surely will expose IFIs with further cost and expenses. Vigorous *Shari'ah* compliance requirements will also increase the cost of business and finally will affect the level of efficiency. In addition, *Shari'ah* committee members are also at risk and they are liable and subjected to the same liabilities.

Since precautions and due diligence have to be exercised to prevent the commission of the offence, any measures to mitigate this legal risk will cost additional expenses. IFIs even are now thinking of subscribing professional indemnity insurance for their *Shari'ah* committee and increasing the coverage for board of directors. Undeniably, these factors will affect the pricing of Islamic financial products and services in the market. If there is no strategic planning to mitigate this issue, Islamic financial products and services offered will be less competitive with their conventional counterparts.

D. Innovation of Product and Services

Heavy regulated business environment is one of the factors that may negate innovation¹⁸. In fact, legal infrastructure without certain flexibility will lead to lack of innovation for more *Shari'ah*-based Islamic financial products and services. Strict requirement surely will influence the market behavior and the players will opt for products of lesser constrains. In this instance, Islamic finance industry is expected to continuously promoting debt based Islamic financial products and consistently neglecting the equity based instrument as what have been practicing for so many years.

Under the new provision of the IFSA, all contracts under *wakalah* and *mudharabah* are deemed as investment products and hence require additional treatment in terms of documentation, operation, system and etc. With this direction, IFIs have to replace their existing products based on non-principal guaranteed *Shari'ah* contract¹⁹. This requirement surely will affect percentage of the equity-based products in the market. IFIs surely will increase their portfolio by offering fixed profit returns such as *tawarruq* and *wakalah* with the underlying principle of

¹⁸ Siddiqi insists that product innovation is really crucial, especially in designing financial ways that would serve the *maqasid Shari'ah*. See Siddiqi, M.N. (2008). The Future of *Shari'ah* Compliant Finance. *Business Islamica*. Dubai: Business Enterprise, 73-76.

¹⁹ Section 2 of the IFSA defines investment account as an account for the purposes of investment, including for the provision of finance, on terms that there is no express or implied obligation to repay the money in full and (a) with profits-sharing, or both the profits-or-losses-sharing features (b) with or without any return. This definition will implicate capital adequacy requirement of IFIs.

commodity *murabahah*, which are to certain extent, have similar characteristics with conventional deposit products²⁰. As *tawarruq*-based products are flourishing in the market, *mudharabah* and *musharakah*-based products are now at risk of being neglected.

In addition, until now, the BNM is also found to be not consistent with its dynamic approach to foster and promote *Shari'ah*-based Islamic financial products as demonstrated in the IFSA. Most of the short term and long-term scriptless securities such as Malaysian Islamic Treasury Bills, BNMNN-I Discount-Based Murabahah and BNMN-i Sukuk BBA issued by the BNM are debt-based instruments. The BNM still rely on the existing controversial or debatable Islamic financing facility for its liquidity instruments offered to IFIs in the market. Without any special measure to resolve this, Islamic financial products to certain extent will lose their identities and unique characteristics and finally look to be more closer mimicking and converging with conventional banking²¹.

V. CONCLUSION

With the understanding that strong, efficient and robust regulatory framework will lead to market stability, the IFSA was passed by Parliament to further enhance and improve the Islamic finance framework²². Through additional provisions and new dimensions of the Act, the IFSA would be able to provide a clear and precise Islamic finance framework and best practice to facilitate the creation and optimize a healthy and viable environment for Islamic finance system in Malaysia. More importantly, the IFSA will not only be an omnibus for financial stability but also will act as a catalyst towards providing a clear demarcation between Islamic finance and conventional financial system particularly in Malaysia. The unique features of the IFSA and its comprehensive framework on *Shari'ah* compliance aspect will further boost Islamic finance growth in Malaysia.

Despite positive features of the IFSA, there are loopholes and shortcomings that may negate its objectives. Issue on judicial oversight over the BNM powers is

²⁰ Significant criticisms by numerous scholars about the current practice of Islamic finance have led to series of questions as to the distinctiveness of Islamic finance with its conventional counterparts. Chapra views that the practice of Islamic finance seems unable to attain its authenticity and share many common similarities with conventional finance. See Chapra, M. U. (2008), *The Global Financial Crisis: Can Islamic Finance Help?* Jeddah: IRTI

²¹ Balz views that Islamic finance is now experiencing a “formalist deadlock” where the industry is more concerned with formal adherence to Islamic law instead of promoting Islamic ethical values. See Balz, K. (2008). *Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law*. Cambridge: Harvard Law School.

²² Hasan reveals that the jurisdiction with the strongest regulatory framework has better governance practices and this is affirmed by the detailed report of the governors of the central banks of the OIC countries on the “Promotion, Regulation and Supervision of Islamic Banks” and the World Bank Note on Risk Analysis for IFIs. See Hasan, Z. (2012). *Shari'ah Governance in Islamic Banks*. Edinburgh: Edinburgh University Press.

relatively significant. Without further mechanism to support its implementation, the IFSA may raise potential conflict of interest between the shareholders and other stakeholders particularly investment account holders and depositors. Moreover, strict *Shari'ah* compliance with greater responsibilities and liabilities to IFIs especially board of directors, senior management, officers and *Shari'ah* committee will further affect the level of competitiveness and efficiency of IFIs. These factors finally may lead to lack of appetite for product innovation on the part of IFIs. Considering these great challenges and to be fair to both consumers and IFIs, it is recommended for the BNM and the industry stakeholders to review and discuss seriously the implications and consequences of the IFSA.

Malaysia as a pioneer and leader in numerous Islamic finance aspects has extensively facilitated the implementation of Islamic finance by enhancing its regulatory framework. This formula seem working well as we can clearly witness the tremendous development in term of growth in market share, banking asset including the increase of domestic and global players in Islamic finance. Years ahead will be a real test for true potential of Islamic finance in Malaysia. As Malaysian market is relatively small, Islamic finance players have no other options but to venture into more dynamic and competitive global market. In this regard, they must be ready to compete by offering competitive and universally accepted products and services. The IFSA seems positive to facilitate this aspiration.