Islamic Financial Services Act 2013

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Introduction

The existing framework of Islamic finance in various jurisdictions demonstrates diverse practices and distinct models. Malaysia as the proponent of regulatory-based approach has instituted several initiatives to promote financial stability and this include the new law, the Islamic Financial Services Act 2013.

Features of this Act/ New dimensions/ Legal consequences in the aspects of demarcation between Islamic banking and its conventional counterpart, element of consumerism, interest of depositors and IAH, corporate governance, Shari'ah compliance, liabilities, judicial oversight and products and services

Background

The Islamic Banking Act 1983, the Takaful Act 1984, the BAFIA 1989 and the Securities Commission Act 1993.

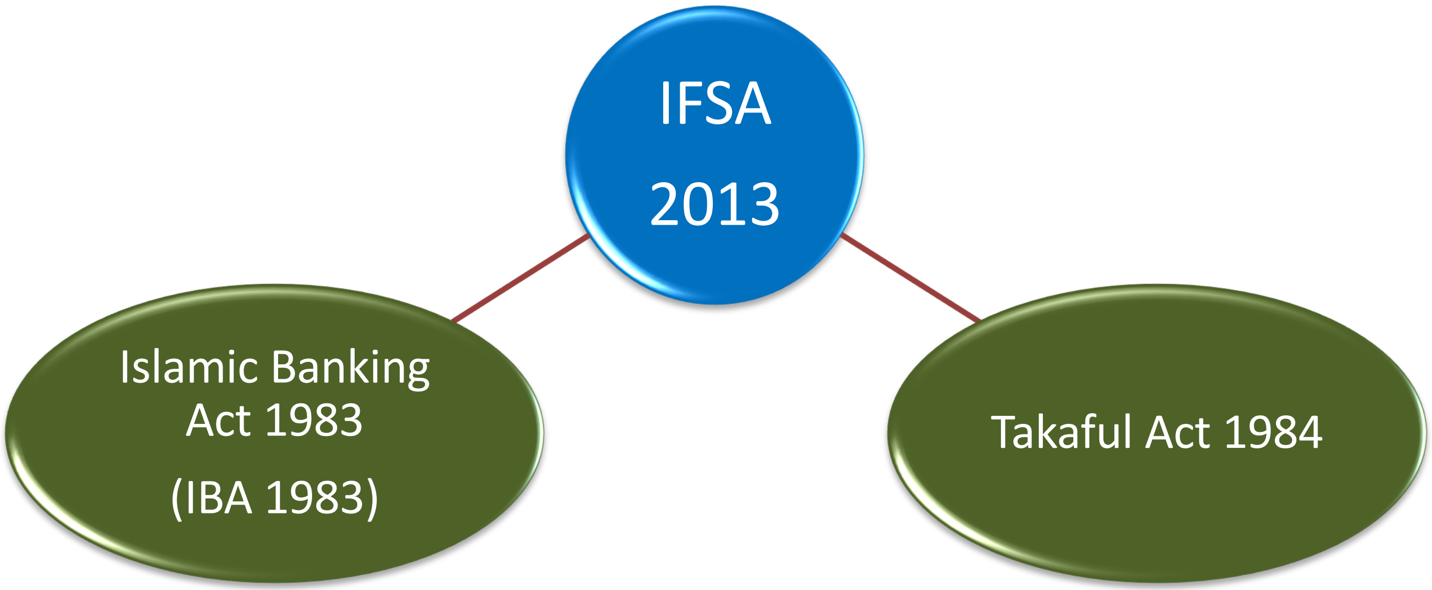
The Central Bank of Malaysia Act 2009

Malaysian Financial Sector Blueprint 2011-2020: to strengthen the relevant regulatory and legal framework.

The IFSA : Consolidates the IBA and the TA and repeals both Acts. Royal Assent on 18 March 2013, gazetted on 22 March 2013 and came into effect in June 2013.

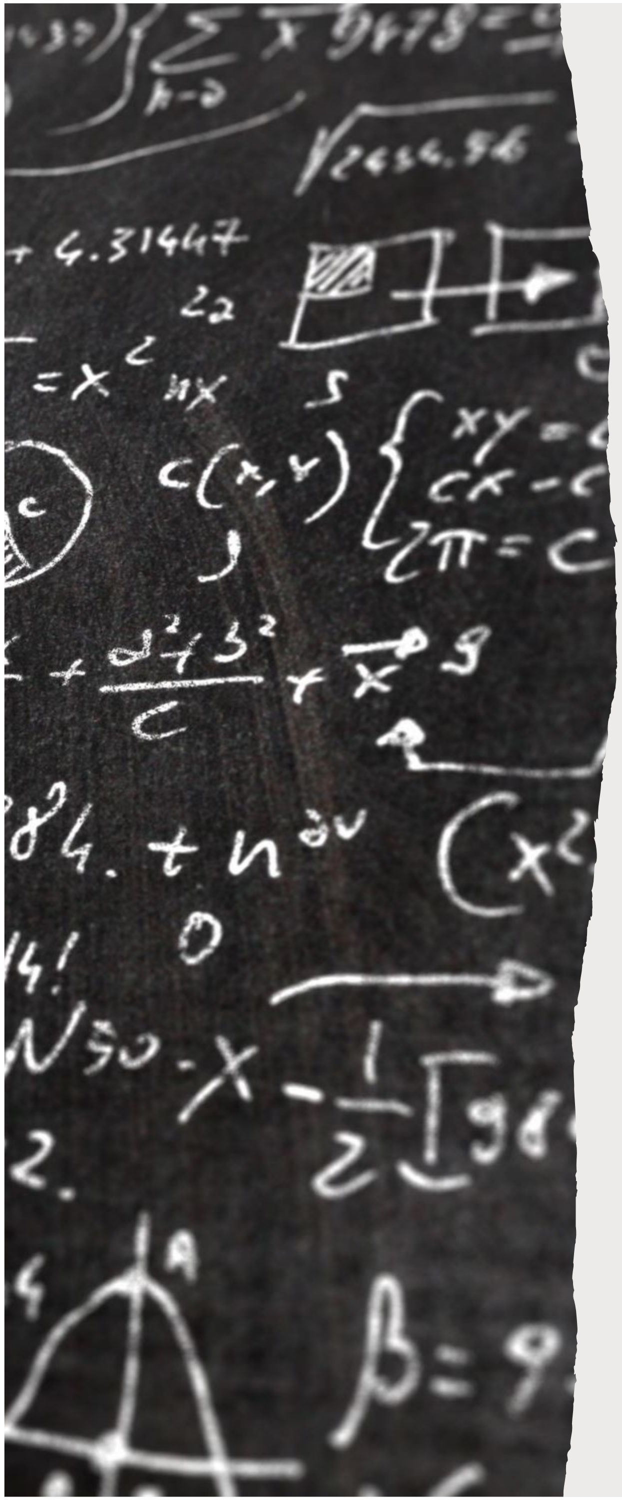
Guidelines for IFIs: Eg. Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks and the *Shari'ah* Governance Framework.

Acts Repealed by the IFSA



IMF Country Report No 14/80

- "The regulatory and supervisory framework for the financial sector was strengthened with the coming into force of the FSA and IFSA on 30 June 2013. This ensures that laws governing the conduct and supervision of financial institutions in Malaysia continue to be relevant and effective in maintaining financial stability, supporting a sustainable, balanced and inclusive growth of the economy, as well as providing adequate protection for consumers. The laws further strengthen BNM's supervisory and regulatory powers, including comprehensive powers to carry out consolidated supervision of financial groups and to extend the regulatory perimeter to systemically important non-bank entities that undertake financial intermediation activities".



Summary of the IFSA

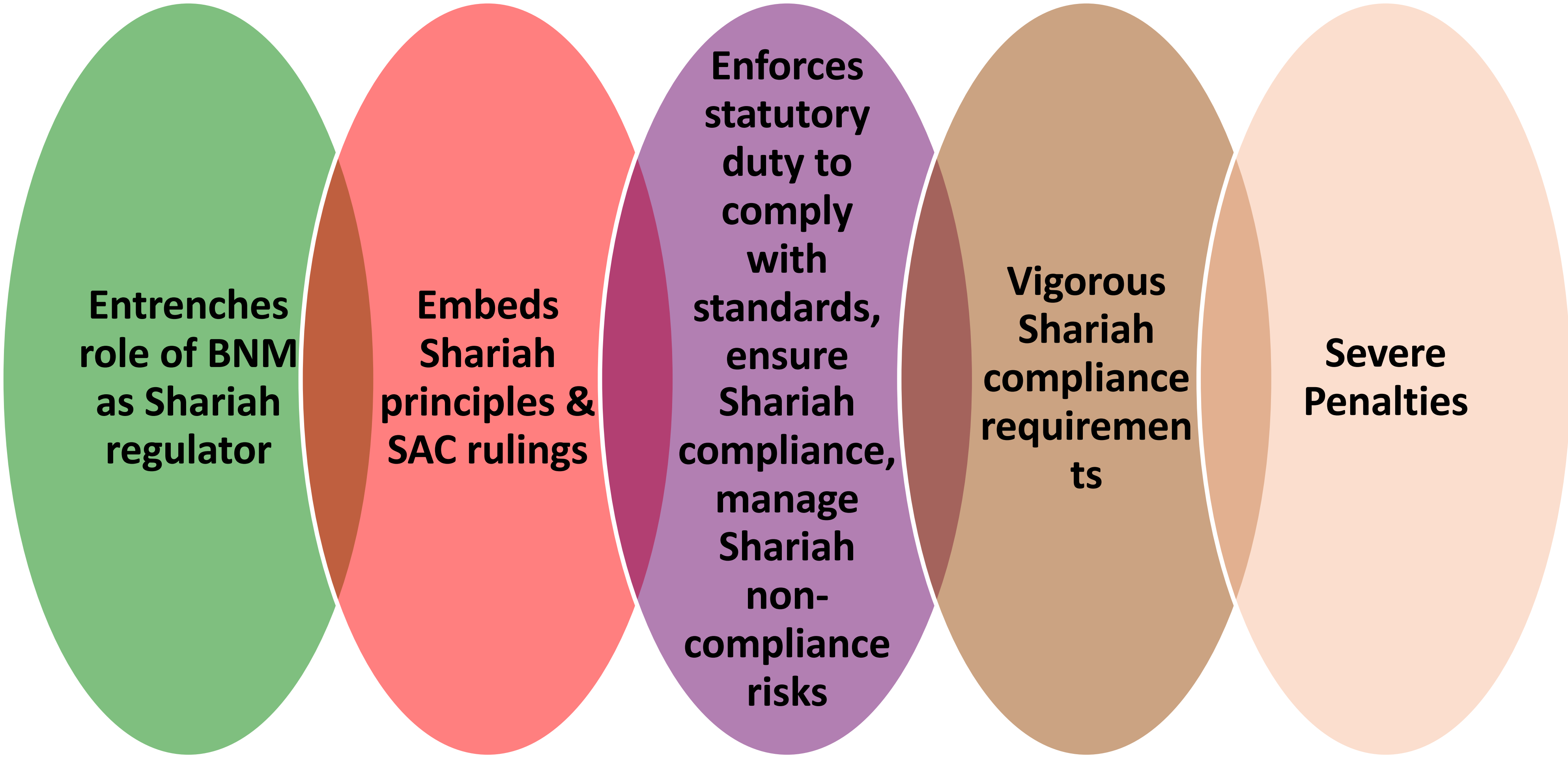
- 18 Parts in the IFSA with 291 sections and 16 Schedules
- Part I: Preliminary
- Part II: Regulatory Objectives, Powers and Functions of Bank,
- Part III: Authorization, Part IV: Shariah Requirements,
- Part V: Payment Systems, Part VI: Prudential Requirements
- Part VII: Ownership, Control and Transfer of Business
- Part VIII: Financial Groups
- Part IX: Business Conduct and Consumer Protection
- 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

Institutions under the IFSA

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.

Regulation on institutions and financial activities



Significant Features of the IFSA

Overview

Datuk Nor Shamsiah Mohd Yunus, Ex-Governor of BNM: ***The emphasis on governance framework for an end-to-end Shariah compliance.***

To provide a comprehensive legal framework that is fully consistent with Shariah in all aspects of regulation and supervision, from licensing to the winding up.

To provide statutory foundation for a Shariah contractsbased regulatory framework 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.

To realise further the value proposition of Islamic finance.

Objectives

- S 6: to promote financial stability and compliance with Shariah.
- 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.

Islamic v Conventional Finance

Statutory foundation for a Shariah contracts based regulatory framework transcending beyond financial intermediation.

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.

To realise further the value proposition of Islamic finance

Eg. IFSA clearly distinguished CASA holders from an IAH.

Scope of IFSA

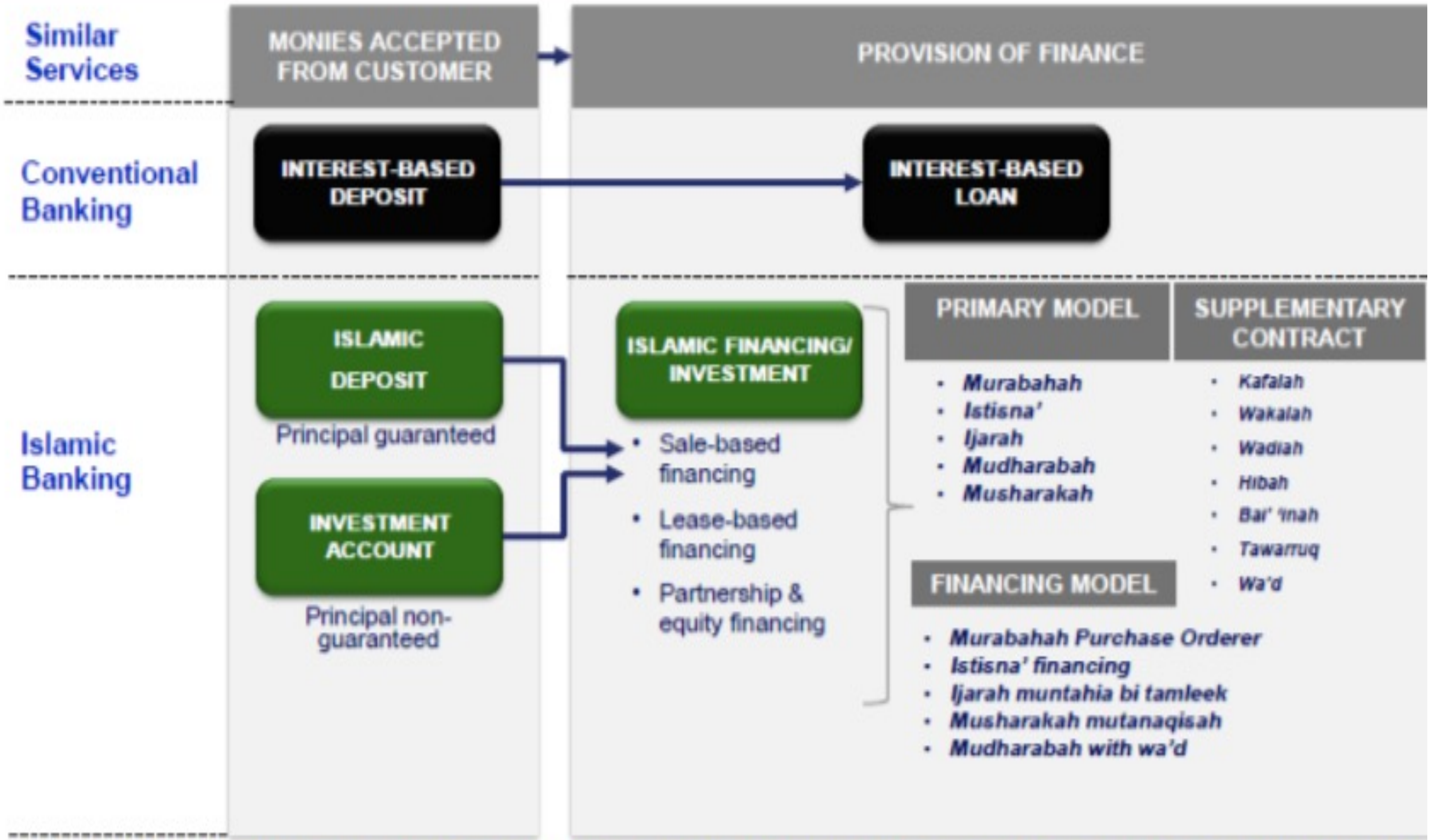
- Focus of regulation on financial activities and not just financial institutions
- Specific provisions on consumer protection and shareholding.
- Corporate Intervention
- Consumer Shareholding
- Governance Protection
- New and enhanced powers
- Market Conducts

IFIs

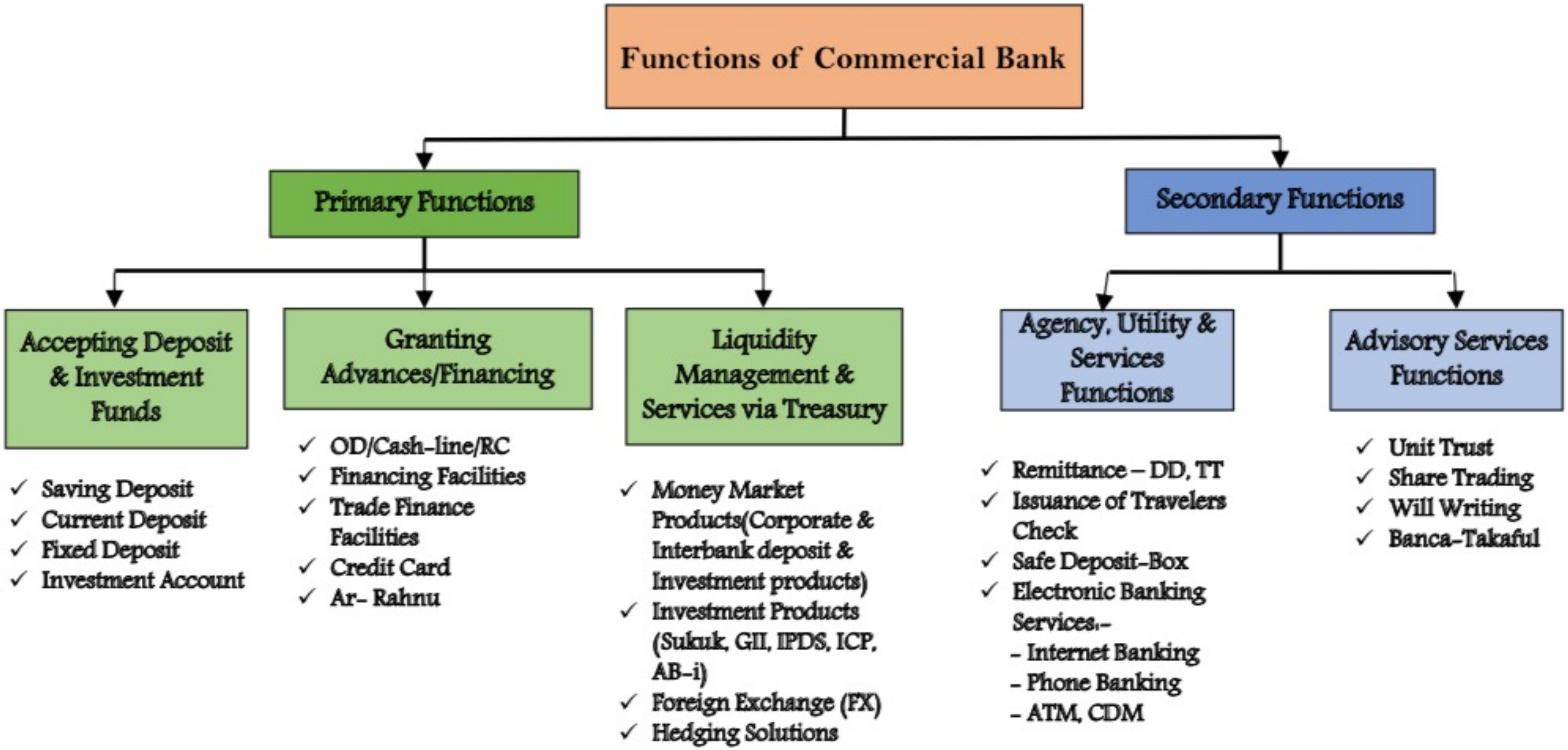
"IFIs" means a financial institution carrying on Islamic financial business;

S 2 IFSA: Islamic banking business" means the business of *(a)* accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers; or *(b)* accepting money under an investment account; and *(c)* provision of finance; (d) such other business as prescribed by the Minister.

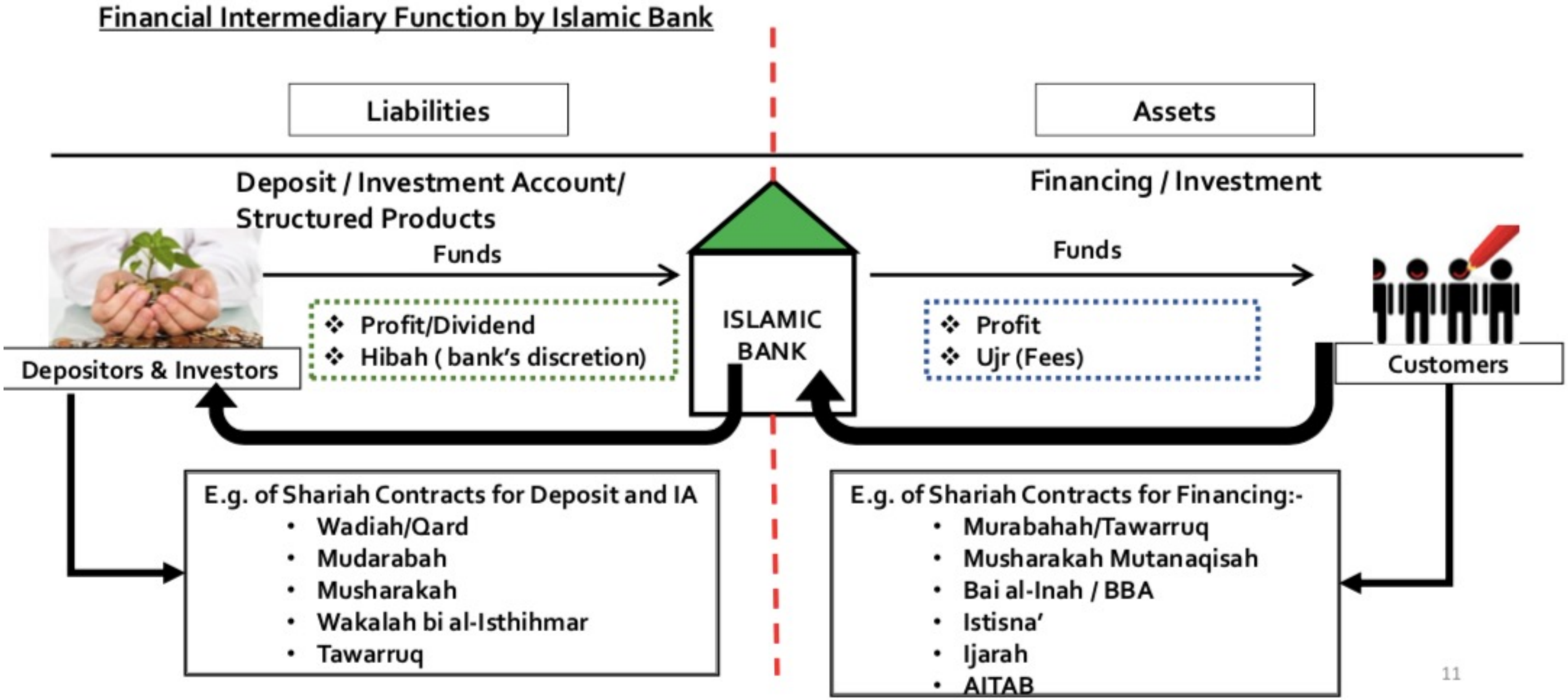
Wider Intermediation Opportunities in Islamic Finance



Guided by the Investment Account Framework, Islamic finance offers greater flexibilities in its intermediation role guided by multiple Shariah contracts to meet different needs & deliver values to customers



Functions of Commercial Bank
Primary Functions
Secondary Functions
Accepting Deposit & Investment Funds
✓ Saving Deposit
✓ Current Deposit
✓ Fixed Deposit
✓ Investment Account
Granting Advances/Financing
✓ OD/Cash-line/RC
✓ Financing Facilities
✓ Trade Finance Facilities
✓ Credit Card
✓ Ar- Rahnu
Liquidity Management & Services via Treasury
✓ Money Market Products(Corporate & Interbank deposit & Investment products)
✓ Investment Products (Sukuk, GII, IPDS, ICP, AB-i)
✓ Foreign Exchange (FX)
✓ Hedging Solutions
Agency, Utility & Services Functions
✓ Remittance – DD, TT
✓ Issuance of Travelers Check
✓ Safe Deposit-Box
✓ Electronic Banking Services.-
- Internet Banking
- Phone Banking
- ATM, CDM
Advisory Services Functions
✓ Unit Trust
✓ Share Trading
✓ Will Writing
✓ Banca-Takaful


Financial Intermediary Function by Islamic Bank
Liabilities
Assets
Deposit / Investment Account/
Structured Products
Financing / Investment
Funds
Funds
ISLAMIC
BANK
Depositors & Investors
Customers
❖ Profit/Dividend
❖ Hibah (bank's discretion)
❖ Profit
❖ Ujr (Fees)
E.g. of Shariah Contracts for Deposit and IA
• Wadiah/Qard
• Mudarabah
• Musharakah
• Wakalah bi al-Isthihmar
• Tawarruq
E.g. of Shariah Contracts for Financing:-
• Murabahah/Tawarruq
• Musharakah Mutanaqisah
• Bai al-Inah / BBA
• Istisna'
• Ijarah
• AITAB
11

S 15 of the FSA 2013

Upon an application to the Bank and where the Bank has granted its written approval–

- A licensed bank or licensed investment bank may carry on Islamic banking business
- An approved insurance broker may carry on takaful broking business
- An approved financial adviser may carry on Islamic financial advisory business
- An operator of a designated payment system or approved operator of a payment system may facilitate participants engaged in Islamic financial business to transfer, clear or settle funds or securities
- An approved issuer of a designated payment instrument may issue a designated Islamic payment instrument

Subjected to the following provisions of the IFSA 2013 particularly

- Parts IV (Shariah Requirements), VI (Prudential Requirements), IX (Business Conduct and Consumer Protection), X (Islamic Money Market and Islamic Foreign Exchange Market) and XIII (Directions of Compliance)
- Any standards, notices, directions, conditions, specifications or requirements specified or made under the IFSA

Definition of ‘Depositors’

Previously under the Islamic Banking Act 1983:

- means a person who has an account at an Islamic bank, whether the account is a current account, a savings account, an investment account or any other deposit account

The IFSA 2013:

- means a person entitled to the repayment of an Islamic deposit, whether the Islamic deposit was made by him or any other person ***and distinguished from an “investment account holder”, as:***
- “investment account” refers to 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

Definition of ‘Islamic Deposit’

Previously under the Islamic Banking Act 1983:

- means 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 Syariah principle on any basis including custody or profit sharing

Now under the IFSA 2013:

- means 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.

- <u>May include precious metal or precious stone, or any article or thing as may be prescribed by the Minister</u> 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!

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), includes any form of rental, profit, dividend or benefit, and any fee or gift, payable or to be given.

BANK & CUSTOMER RELATIONSHIP

Banks	Deposit & Investment Account	Financing / Loan	Services
ISLAMIC BANK	• Wadiah – **Depositor & Custodian** • Qard – **Creditor & Debtor** • Mudarabah – **Capital Provider & Entrepreneur** • Musharakah – **Partnership** • Wakalah - **Agency** • Murabahah/Tawarruq – **Seller & Buyer**	• Murabahah – **Seller & Buyer** • Musharakah – **Partnership** Mutanaqisah • Bai al-Inah – **Seller & Buyer** • Mudarabah – **Partnership** • Istisna' – **Seller & Buyer** • Ijarah – **Leasee & Leasor**	• Ujrah/Fee – **Al-Ajir (Service provider) & Musta'jir (Person who make the payment)** • Jualah/Commission – **Offerer (Ja'il) & Worker('Amil)**
CONVENTIONAL BANK	Lending Transaction ➢ **Creditor & Debtor**	Lending Transaction ➢ **Creditor & Debtor**	➢ **Fee** ➢ **Commission**

Hibah Arrangement Under *Qard*

Shariah Parameter on Hibah S 20.2 The borrower under a qard contract must not grant hibah that is conditional to the qard contract to the lender, in the form of cash, in kind or benefit.

S 20.3 The granting of hibah that is solely based on the borrower's discretion to the lender is allowed.

S 20.4 The borrower must not disclose, promote or market the indicative rate or prospective granting of hibah.

S 20.5 The borrower shall have the discretion to disclose historical information on the hibah granted provided that such information shall not– (a) be construed as an indicative hibah; or (b) give rise to any obligation on the part of the borrower to provide such hibah to the lender.

Business and Market Conduct of Hibah

- Shariah Parameter on *Hibah*;
- S 25.3 In the event an IFI discloses any historical information on hibah granted under a qard contract, the IFI must–
- (a) ensure that the historical *hibah* information is based on the actual *hibah* rate; and
- (b) provide a clear disclaimer that at minimum, contains– (i) a customer may or may not receive any *hibah* for *qard* deposits; and (ii) the historical h*ibah* information is not to be construed as an indicative or prospective rate of return, a guarantee or a legally binding promise that *hibah* will be granted on placement of *qard* deposits.

Islamic Deposit v Conventional Deposit

Conventional Deposit	Islamic Deposit
Conventional banks accept deposits on the basis of loan (Term Deposit, Savings and Currents accounts).	Islamic Banks offers deposit products based on *Qardh, Wadiah yad Dhamanah and Tawarruq.*
Conventional bank invests the deposits in non-shariah compliant avenues and subsequently earns non-shariah compliant returns.	Islamic bank invests the deposits in Shariah compliant avenues.
Interest based returns	No interest. Hibah for *Qardh* and *Wadiah Yad Dhamanah* (Refer Parameter on Hibah) Profit for *Tawarruq* and *Mudharabah (GIA)*.
All deposits are guaranteed	"Investment account" is not guaranteed.

BNM as Financial and *Shari'ah* Regulator

Division	Provision
Division 1: *Shari'ah* Compliance	S 27: Interpretation S 28: Duty of institution to ensure compliance with Shariah S 29: Power of Bank to specify standards on Shariah matters
Division 2: *Shari'ah* Governance	S 30: Establishment of *Shari'ah* committee S 31: Appointment of *Shari'ah* committee member S 32: Duties of *Shari'ah* committee and its members S 33: Cessation as member of *Shari'ah* committee S 34: Notice of cessation as member of *Shari'ah* committee S 35: Information to be provided to *Shari'ah* committee S 36: Qualified privilege and duty of confidentiality
Division 3: Audit on Shariah compliance	S 37: Appointment of person by institution to conduct audit on *Shari'ah* compliance S 38: Appointment of person by Bank to conduct audit on *Shari'ah* compliance

Corporate and Shari’ah Governance

- The IFSA expects greater responsibility to IFIs
- Responsibilities: S 29: every institution, its director, chief executive officer, senior officer or member of a *Shari’ah* committee
- *Offence:* S 28(6): failure to comply with the standards is an offence under the Act.
- Duty of Care: IFIs cannot simply rely on their professional advisors or experts. The IFIs must ensure that they have taken reasonable measures
- Potential exposure to board or directors, management, officers and even *Shari’ah* committee members with heavy penalties including imprisonment.

Functions and duties of board of directors (Section 65 of the IFSA 2013)

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

Khiudin bin Mohd & Anor v Bursa Malaysia Securities Bhd and another Application [2012] MLJU 445

- 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."*

Shariah Governance Framework

2.1 The board is ultimately **ACCOUNTABLE & RESPONSIBLE** on the overall Shariah governance framework & 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

Can the Shari’ah Committee be sued?

Will they be immune from liability suits in exercising collective ijtihad?

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**”

Board of Directors

BOD to have due regard to interest of depositors, investment account holders and and policy holders

Compare with previous duty to only act in the best interest of shareholders

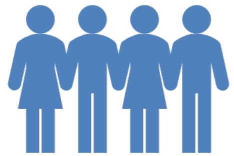
Potential conflict of interest between majority shareholder and depositors or policy Holders.

Additional Duties of BOD

- Higher and wider standards expected of boards of companies under FSA
- Ultimate responsibility moved to Board of Directors
- Consumerism invades the Board of Directors:
- Duty to act in best interests of company
- Duty to act in best interests of third party consumer
- Duty to prevent breaches

Consumerism

- Specific provisions in the IFSA have significantly strengthened the preconditions for an effective regulatory and supervisory regime for business conduct and consumer protection.
- Shall have due regard to the interest of depositors, IAH and takaful participants.
- S 6 (b): IFIs are required to strive to protect the rights and interests of consumers of Islamic financial services and products.
- The BOD has the duties to act in the best interests of the IFIs and to act in the best interests of customers.
- Takaful: Establishment and maintenance of takaful fund, takaful funds to be separate from shareholders' fund, requirements relating to takaful funds, shareholders' fund, withdrawal from takaful funds and deficiency of takaful funds).



Statutory Duty

- In general, the IFSA imposes two statutory duties.
- Compliance: (1) aims, operations, business, affairs and activities. (2) Internal policies and procedures. (3) To carry out an audit on Shariah compliance. Responsibilities: The BOD, CEO, Senior Officer and Shariah Committee.
- Reporting duty: IFIs are required to immediately notify the BNM and its SC of any non-Shariah compliant activities and immediately cease from carrying on such business, affair or activity. Within 30 days, to submit to the regulator a plan on the rectification of the non-compliance.

<table>
<tr><th colspan="5">EVERY</th></tr>
<tr><th>Institution</th><th>Director</th><th>CEO</th><th>Senior officer</th><th>Shariah committee</th></tr>
<tr><td colspan="5">• at all times comply with the standards specified by BNM</td></tr>
<tr><td>• to ensure that its internal policies and procedures are consistent with the standards specified by BNM</td><td colspan="4">• to comply with the internal policies and procedures adopted by such institution to implement the standards specified by BNM</td></tr>
<tr><td>• to manage its business, affairs and activities in a manner which is not contrary to Shariah (S.28)</td><td colspan="4">• not to accept appointment unless have met the requirements specified by BNM and has obtained BNM’s prior written approval (S.31 & 64)</td></tr>
<tr><td>• to establish a Shariah Committee (S.30)</td><td colspan="3">• institution to notify BNM within <u>7 days</u> upon cessation of positions (S.71)</td><td rowspan="2">• Institution and the member to notify BNM within <u>14 days</u> upon cessation of position (S.33 & 34)
• An institution cannot terminate the appointment of a member of its Shariah Committee without prior written approval of BNM (S.33)</td></tr>
<tr><td>• to have a CEO (S.63)</td><td>• <u>have due regard</u> to any decision of the Shariah committee (S.65(2)(f))
• <u>have regard</u> to the interests of depositors, investment account holders and takaful participants (S.65(3)(a))</td><td colspan="2"></td></tr>
</table>

Statutory Duty: Compliance

- S28 (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
- 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.

Shari’ah Compliance

- The IFSA complements and strengthens the *Shari’ah* Governance Framework.
- 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.
- Potential exposure of *Shari’ah* scholars to jail terms (First of its kind).
- Strict condition and vigorous *Shari’ah* compliance process and requirements.
- BNM Circular on Shariah Non-Compliance Reporting issued on 15 March 2013 and came into effect on 1 May 2013.

Duty of institution to ensure Shariah compliance (s.28)

- (3) Where 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 Shariah or the advice of its Shariah committee or the advice or ruling of the SAC, the institution shall —
- *(a)* **immediately notify** BNM and its Shariah committee of the fact;
- *(b)* **immediately cease** from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and
- *(c)* **within 30 days** of becoming aware of such noncompliance or such further period as may be specified by BNM, **submit to BNM a plan** on the rectification of the non-compliance.

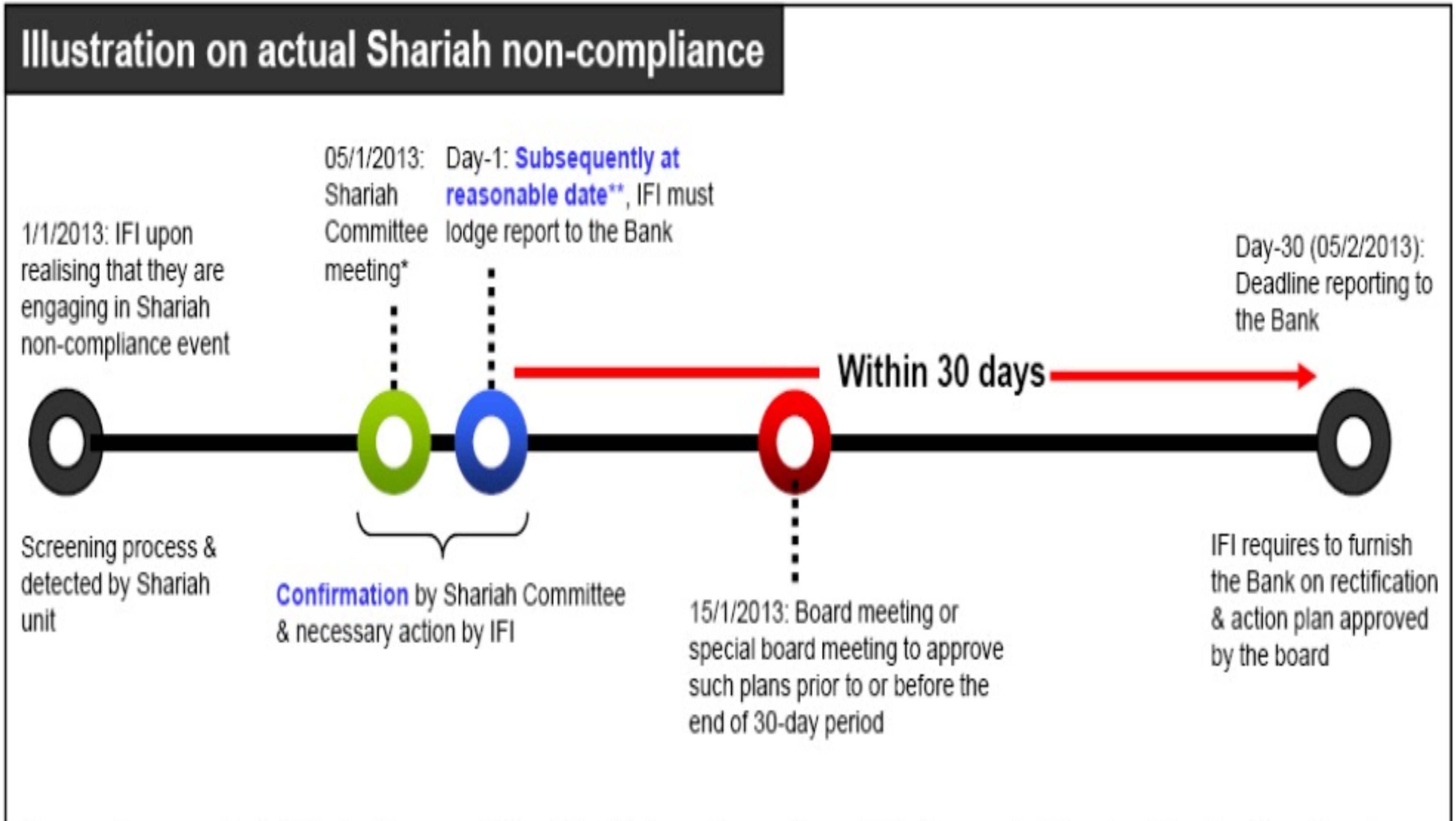
Statutory Duty: Reporting

- 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.

BNM Circular on Shariah Non-Compliance Reporting 15 March 2013 and came into effect on 1 May 2013

Actual Event	*Potential Event*
• Report shall be submitted on an "immediate"(14 days upon realization) basis "as and when" necessary. • During this period, the IFIs are required to obtain the confirmation from the Shariah Committee. • To submit rectification plan, to be approved by the BOD and the SC within 30 days.	• Any pending decision by the SC on the identified issue shall be treated as potential Shariah non-compliance event. • Report shall be made on a monthly basis based on a calendar year which is not later than 2 weeks after the end of each monthly period.

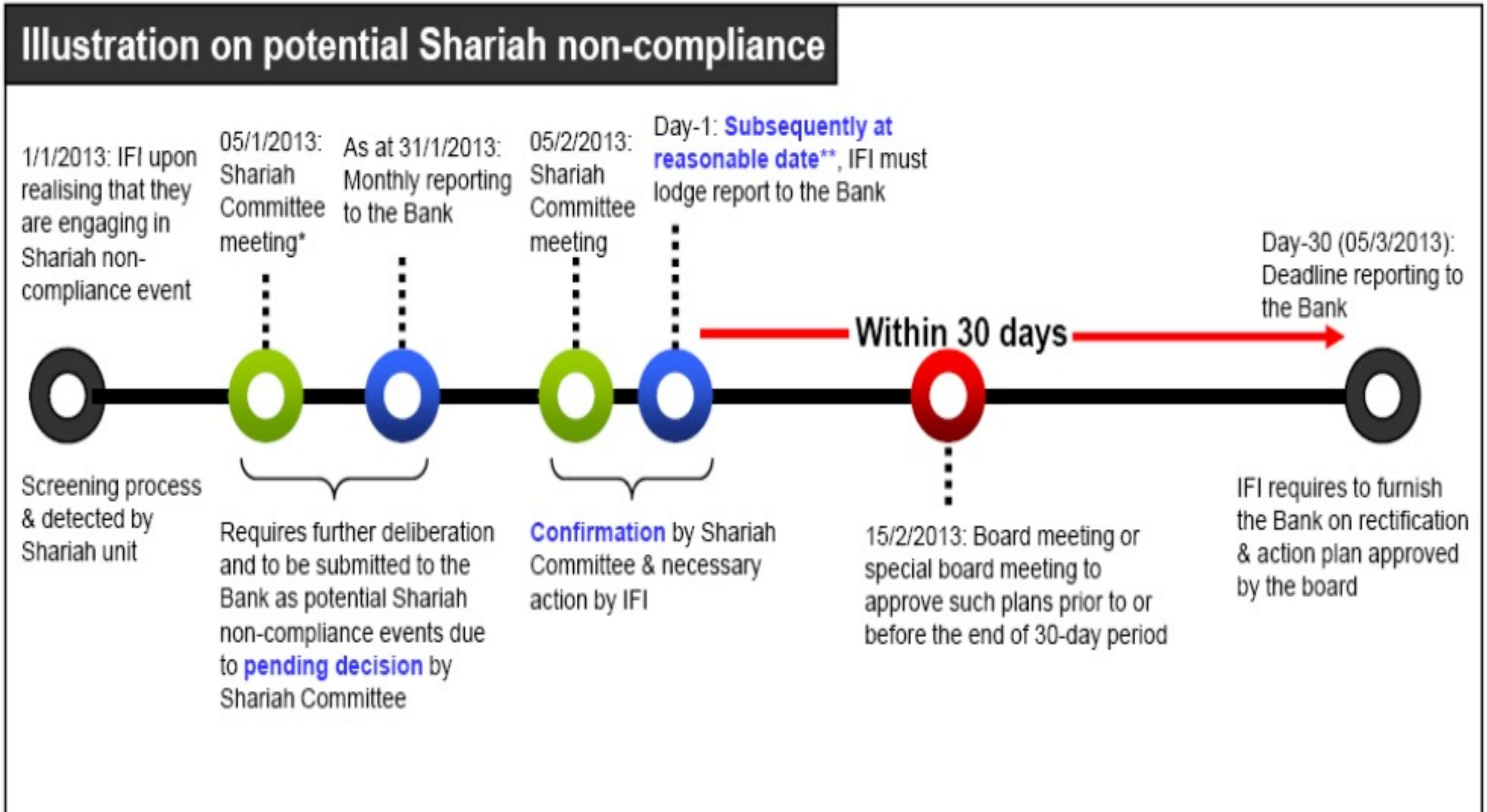
Diagram 1: Timeline for actual Shariah non-compliance reporting



*Non-compliance event to be tabled on the nearest date of Shariah Committee meeting or IFI shall ensure that it must not later than 14 working days, whichever is earlier. To meet the requirement, IFI may have to conduct special Shariah Committee meeting.

**Reasonable date is defined as no longer than 3 working days after Shariah Committee meeting. In this scenario, the immediate reporting to the Bank shall be on 06/01/13 (not later than 09/01/13).

Diagram 2: Timeline for potential Shariah non-compliance reporting



*Non-compliance event to be tabled on the nearest date of Shariah Committee meeting.

**Reasonable date is defined as no longer than 3 working days after Shariah Committee meeting. In this scenario, the immediate actual Shariah non-compliance reporting to the Bank shall be on 06/2/13 (not later than 08/2/13).

BNM Circular: Shariah Non-Compliance Reporting

No Shariah non-compliance event is detected: Where there is no Shariah non-compliance event in the IFIs for any particular period, the IFIs are still required to submit the reports on a monthly basis which serves as a declaration or official attestation on the status of Shariah compliance of the IFIs.

Responsible Person: The Chief Risk Officer/ senior management in charge of statutory reporting of the IFI is responsible and will be held accountable for the quality and accuracy of the information submitted to the Bank.

Information to be provided to Shariah committee (S 35 of the IFSA)

(1) An institution and any director, officer or controller of such institution shall —

- *(a)* provide any document or information within its or his knowledge, or capable of being obtained by it or him, which the Shariah committee may require; and
- *(b)* ensure that such document or information provided under paragraph *(a)* is <u>accurate, complete, not false or misleading in any material particular</u>, to enable the Shariah committee to carry out its duties or perform its functions under this Act.

(2) Except as provided in section 36, a member of a Shariah committee shall not disclose any document or information furnished under subsection (1) to any other person.

Shari’ah Audit

- S 37 and 38: External Shari’ah Audit
- BNM may require an IFI to appoint any person to carry out Shariah audit.
- BNM may appoint for an IFI any person to conduct a Shariah audit
  - The IFI will bear remuneration & expenses of the Shariah auditor/s.

Extended to Financial Holding Companies

- The BNM has powers to control, supervise and monitor FHC and these include authority to issue prudential requirements and directions.
- S 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
- Less than 50% of shares but has “control”, i.e. power:
  - to elect, appoint remove or prevent the election, appointment or removal of a majority of the directors of the licensed entity;
  - to make or cause to be made business decisions of the licensed entity;

Strict Liability

- A director may be deemed guilty of an offence committed by a company, unless he proves that the **offence was committed without his knowledge, consent or connivance and that**
- *"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…"* (**s.241(4), FSA**) (*in relation to civil actions for compensation*)
- *"he exercised such **diligence to prevent** the commission of the offence **as he ought to have exercised**, having regard to the nature of his function in that capacity and to the circumstances."* (**s.249(1), FSA**) (*in relation to criminal offences*)

Strict Liability and Defense

- The words “deemed to be committed” by Director, Controller, Officer, Partner or anyone concerned with management of its affairs: Presumption that they have committed the offence unless if they can prove otherwise.
- The burden of proof is upon them to show that they have taken all reasonable precautions and exercised due diligence.
- Limit the element of defence
    - (1) the act done without consent and connivance and (2) diligent action taken to prevent commission of offence, as he would have exercised.

Penalty

- The BNM may impose monetary penalty to IFIs in the case of breach to comply as provided in section 245 (4).
- The penalties provided in the IBA just range from a fine not exceeding RM2k for every day during which the default continues to RM50k or three to five years imprisonment or both.
- IFSA: the penalties provided range from one year to 10 years imprisonment or 5 to RM 50m fine or both. Eg. 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 RM50 m or to both.

Penalties

The IFSA vests the BNM with wide ranging powers to issue standards which are binding upon every director, officer or Shariah committee member of the institution.

Section 28 (6) provides that a failure to comply with the standards issued is an offence under the Act and carries with a maximum penalty of 8 years imprisonment or a fine of 25 million ringgit or both.

Penalties	
Form of Penalties	**Penalties**
Administrative	**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**
Monetary	**such amount as the Bank considers appropriate, not exceeding (RM5 mil- body corporate or RM1mil- individual);**
Criminal Offence	**Up to 10 years imprisonment or 5-50 million ringgit fine or both**

Offence/Breach S 28 and 29	Penalty
Failure to comply with BNM standards on Shariah matters/ that give effect to SAC rulings, ruling of BNM SAC, advice of SC, Shariah principles (in general)	Not exceeding 8 years imprisonment or RM 25 M fine or both.
Failure to immediately report, or cease Shariah noncompliant activity, or submit rectification plan in accordance with the IFSA & Circular	Not exceeding 8 years imprisonment or RM 25 M or both.
Failure to comply with BNM standards on Shariah governance	s.245 (3), or 247, Schedule 15 (3). - not exceeding RM 5M if body corporate/RM 1 M if individual; - shall not exceed 3x the gross amount of pecuniary gain made or loss avoided as a result of the breach; or - shall not exceed 3x the amount of money which is the SM of the breach, whichever is greater for
Failure to comply with BNM standards in relation to the business, affair & activity of an institution for the purpose of Shariah Compliance	
Failure to ensure that internal policies & procedures on are consistent with BNM standards	
Failure to comply with internal policies &	

Director, controller, officer, partner, management deemed liable for offences.

- Only defense is that offence was committed without consent AND diligence has been exercised to prevent its commission
- Delegation to or reliance on 3rd parties is not a defense
- Civil actions can be brought by any persons or institutions or by BNM on their behalf against any persons who contravenes or is in breach of the IFSA provisions.

Statutory Protection

- the BNM to specify the duties and functions of the SC.
- SC enjoys 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).

IFSA 2013	IBA & TA
Express provision to empower the Minister **on recommendation of BNM** to prescribe certain activities	BNM had implied power to prescribe for certain businesses or activities
Powers of the Bank to prescribe Prudential Requirements – relates to capital adequacy, liquidity, corporate governance, risk management, maintenance of reserve funds, etc.	Provides for business to be conducted in a prudent manner – relates to maintenance of net assets, integrity and skill of business,

IFSA 2013	IBA & TA
'Fit and Proper' requirements for directors, etc. – BNM allowed to set and specify requirements in the future	Scope of 'Fit and Proper' requirements are laid out in the Acts
BNM empowered to fix breaches of IFSA/ prudential issues. Broader triggers for exercising power. **Ministerial approval not required.**	Power to step in where interests of depositors affected. Intervention by BNM requires Ministerial approval.

IFSA 2013	IBA & TA
Assume control of an institution with approval of the Minister, suspending the powers of the Board. Also, allowed to order the sale of the business or assets, or parts of the business	No direct predecessor. Previously, parties to a transaction could apply to the High Court for approval
Appoint receiver to an Institution	No previous power. Other parties could apply to High Court for such an order.

IFSA 2013	IBA & TA
Requires Ministerial approval on advise by Bank for changes of share control	Changes of control not directly regulated: regulated via requiring changes to holdings of more than 5% to be approved
Bank to order that another company in a corporate group be designated as the group's 'financial holding company', requiring corporate rearrangement.	No power to dictate precise corporate structure

The LHC

- The Law Harmonization Committee Report formulated several recommendations to resolve issues in Islamic finance. The Committee is also studying the legal implications on the implementation of Islamic Financial Services Act 2013.
- The Committee introduced several new legal provisions in court such as rules on imposition of late payment charges on judgment debts, to allow better access to Islamic financing for consumers through recommended amendments to reserve land legislations at all states, to facilitate Islamic financing involving landed property through recognition of Islamic finance in the National Land Code 1965 and to amend the Companies Act 1965

Shariah Non-Compliance Framework

- The BNM utilises an integrated system known as the Operational Risk Integrated Online Network (ORION) for guidance on treatment of *Shari'ah* non-compliant items.
- ORION is the BNM regulatory reporting system and processes. This system enables efficient reporting and supervision. Through this system, the BNM can easily monitor and supervise any *Shari'ah* non-compliance cases in IFIs. It is reported that since its effective date, the BNM received more than 100 submissions from IFIs for *Shari'ah* non-compliance reporting and less than 21% are actual *Shari'ah* non-compliance.

Professional Indemnity Insurance

- the IFSA makes *Shari'ah* scholars legally accountable and liable for their duties 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 IFSA.
- This serious legal implication triggers the need of having professional indemnity Islamic insurance for *Shari'ah* scholars as in the case of advocate and solicitor or medical practitioners.

Reclassification of Deposit

30th June 2015 was the deadline for IFIs to clearly separate between the deposits account and investment account.

IFIs must introduce a new structure of *mudharabah* investment account, which reflect the actual characteristics of investment.

Islamic deposit as principal guaranteed and investment as non-principal guaranteed. The deposit insurance or takaful also will be no longer relevant for investment-type of accounts.

The reclassification of deposits is not favourable to IFIs. The reclassification of deposits imposes a great challenge to IFIs to accumulate deposits, which are based on *mudharabah* principle.

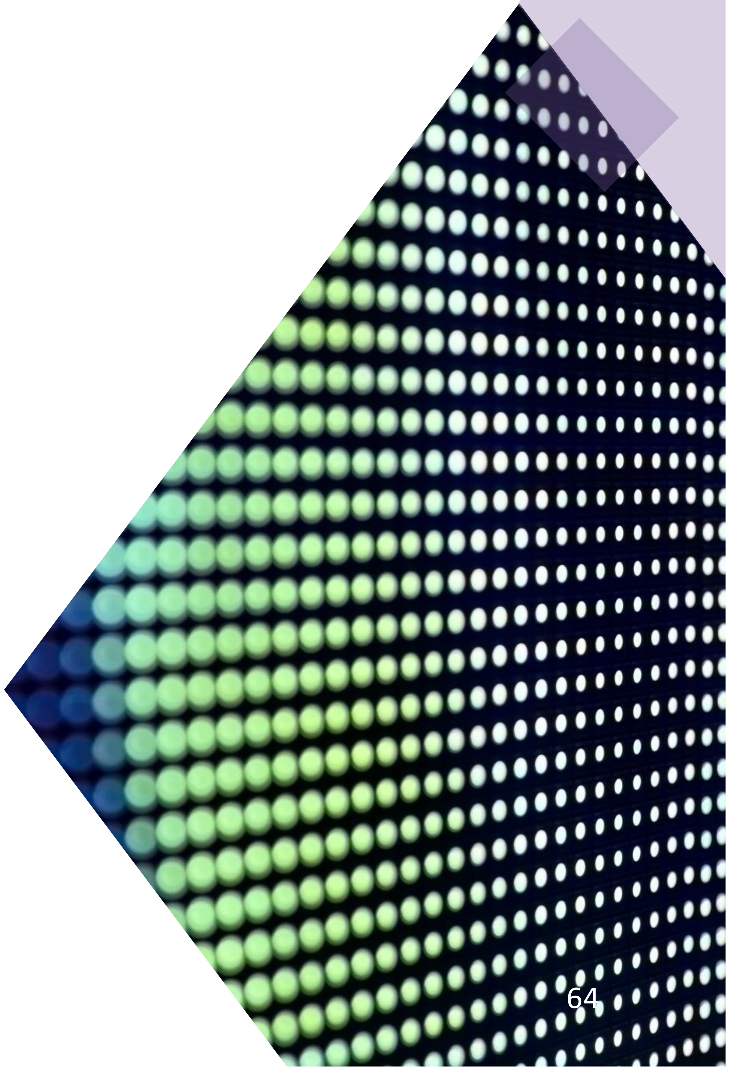
Investment Account Platform

The IFSA requirement on the separation of Islamic deposit and investment account is actually to allow the banks to customise their products according to the customers' profile and risk appetite.

IFIs are now can offer higher returns to any investors for their investment account.

To facilitate this transition period, the Malaysian government backed the IAP with an initial start-up fund for RM150 million and tax exemption for 3 consecutive years. Lembaga Tabung Haji also allocated RM200 million for the establishment of the *Shari'ah* compliant Restricted Investment Account.

There are four IFIs have participated in the IAP namely BIMB, Maybank Islamic, Affin Islamic and BMMB.



Judicial Oversight over the BNM

The BNM has more power to dictate- IFIs and and its holding company and these include its Capital Requirements, Corporate Governance, Consumer Protection, Shareholding, Intervention and even *Shari'ah* compliance.

Power not only to advise but also to recommend the decision made by the Minister.

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.

Potential Conflict of Interest Between Shareholders and Other Stakeholders

Cost and Efficiency

The element of strict liability in the IFSA 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.

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. Eg. Professional Indemnity Insurance.

Innovation of Product and Services

Heavy regulated business environment- may negate innovation/ lack of innovation/ influence the market behavior and the players will opt for products of lesser constrains.

Eg. All contracts under *wakalah* and *mudharabah* are deemed as investment products and hence require additional treatment: Documentation, operation, system and etc.

Effect: Concentrating on debt-based products and consistently neglecting the equity-based products both from asset and liabilities sides.

Best Practices

Exercise extra care & vigilance on Shariah compliance matters through effective internal Shariah compliance functions: Full information on products & transactions; pre- and- post approval monitoring, supervising conduct of Shariah review & Shariah audit reports; monitoring rectification measures.

Examine internal gaps to attain “end-to-end” Shariah compliance;

Examine Shariah review & audit reports & implement rectification plans;

Assess and adhere internal policies & procedures and also BNM standards;

Concluding Remarks

The IFSA provides a framework to facilitate the creation and optimize a healthy and viable environment for Islamic finance system in Malaysia.

Despite positive features of the IFSA, there are loopholes, issues and shortcomings that may negate its objectives.

These factors finally may lead to lack of appetite for product innovation on the part of IFIs.

Considering these great challenges, it is recommended for the BNM and the industry stakeholders to review and discuss seriously the implications and consequences of the IFSA.