The Practice of Shariah Review as Undertaken by Islamic Banking Sector in Malaysia

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Shariah Supervisory Board (SSB) is one of the most important governance mechanisms of an Islamic Financial Institution (IFI) to ensure compliance with Shariah. This paper tries to elaborate the importance of SSB to the establishment of an IFI. It will discuss the roles and responsibilities of an SSB as well as the process of how an SSB reviews the performance of a given IFI. Moreover, it will discuss how the actual Shariah reviews are undertaken in Malaysian IFIs. In order to limit the scope of the subject, this paper will focus only on Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB). The findings resulted from the research on both banks mentioned above will assess the effectiveness of the Shariah reviews on both banks. This paper will evaluate whether the Shariah reviews practiced at the present moment are sufficient to justify the Shariah audit report. In addition, this paper will also examine if there is any expectation gaps between the standards issued by the AAOIFI and the actual Shariah review practice in those Islamic banks.

Field of Research: Islamic Banking, Shariah Review

1.0 Introduction

The industry of Islamic Banking and Finance has grown enormously over the last couple of years. It is very crucial to build on this great development in order to make the industry prosper and at the same time try to free the ummah from riba. In order to enhance the industry, the public’s confidence towards the industry of Islamic banking is believed to be vital. To build the public’s confidence, there are

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so many approaches which can be done by the Islamic Financial Institutions (IFIs). One clear approach which can be taken by the IFIs is to introduce Islamic financial products which are parallel to the Shariah law. Moreover, the purpose of these products should not be to maximize profit by complying with the mechanism of these products with the Shariah law, but instead, the objective of these financial products have to be in line with the Shariah as well, which is to help the public to avoid from riba and poverty (i.e. maslahah).

Another possible approach which can be done by the IFIs is to uphold its transparency in terms of their operations towards the public. This approach alone can be divided into several methods. Firstly, the accounting of the Islamic financial products has to be in accordance to the Shariah. Another possible approach is to audit their operations based on the Shariah, instead of the conventional audit. Lastly, the IFIs should maintain close relationship with the Shariah Supervisory Board (SSB) in order to sustain its accordance with the Shariah.

SSB or in some Islamic financial institutions is known as Shariah Committee, is one of the most important governance mechanism of an IFI to ensure compliance with Shariah. Compliance with Shariah is the distinctive characteristic of an IFI as compared to conventional financial institution. Acknowledging this importance, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) had provided standards on SSB, Shariah Review and Internal Shariah review under its Governance Standard (AAOIFI, 1999). Various authors suggest the needs of an appropriate Shariah report to account for the Islamic based transactions (see for example, Hamat, 1994; Ismail and Latiff, 1999; 2000; 2001).

2. Literature Review

According to the AAOIFI Governance Standard for Islamic Financial Institutions (GSIFI) No. 1, an SSB is an independent body of specialized jurists in fiqh muamalat. In terms of its composition, AAOIFI has stated that an SSB shall consist of at least three members. (AAOIFI, 1999). On the regulatory aspect, in the Malaysian context, the Islamic Banking Act (IBA) 1983 had provided the provision for the establishment of a Shariah Advisory Board as a requirement of granting license to an Islamic Financial Institution. In addition to the IBA 1983, the Malaysian Accounting Standards Board has issued the “Financial Reporting Standards – i” (FRS-i). The purpose of the standard is to provide a guideline which is Shariah compliant as well as applicable in the Malaysian context in order to address accounting issues and practices in Malaysia. (MASB, 2004).

In addition, Bank Negara Malaysia had further issued guidelines on the Governance of Shariah Committee through the “Garis Panduan Shariah 1” (GPS-1). The BNM/GPS1 was effective from 1 April 2005, whereby all IFIs regulated and supervised by BNM are required to comply with all the requirements as
outlined in the guideline. IFIs comprise of Islamic banks licensed under the IBA 1983, financial institutions licensed under the Banking and Financial Institutions Act 1999 (BAFIA) which participates in the Islamic Banking Scheme, development financial institutions regulated under the Development Financial Institutions Act 2002 which carries on Islamic Banking Scheme and takaful operators registered under the Takaful Act 1984. Apart from the GPS-1, Bank Negara Malaysia has also issued another standard known as GP8-i. Unlike the GPS-1 which focuses more on the issue of governance, the GP8-i is more focused on providing the basis for presentation disclosure of reports and financial statements of Islamic Banks in carrying out its banking and finance activities (BNM, 2004).

One of the requirements stipulated in the GPS-1 guideline is that all IFIs must establish a Shariah Committee for the purpose of ensuring that the operations of the IFIs are in line with the Shariah rules. However, Shariah Committee is not required to provide a thorough written report on the activities being carried out by the IFIs that would be included in the Annual Report of the IFIs. Its main function is basically to provide advice and guidance to the Board of Directors of the IFIs on Shariah matters particularly on the new products to be introduced by the IFIs. In terms of reporting, the Shariah Committee is only required to report to the Board of Directors of the IFIs on their opinions pertaining to the Shariah matters whereby the final decision on any operation or product to be carried out or introduced will be made by the Board of Directors (BNM, 2004).

Given that it is not mandatory for the Shariah Review Report to be prepared by the IFIs and the fact that there is no standard format issued by Bank Negara Malaysia on the report to be included in the Annual Report, currently, all the IFIs in Malaysia with the exception of Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB) do not provide Shariah Review Report in their Annual Reports. Hence, the Annual Reports of the IFIs only contain the conventional audit report prepared by the External Auditors such as Ernst & Young, KPMG and so forth.

3. Methodology and Research Design

The present study by nature is a library research. The research aimed to critically analyse how Shariah review and Shariah report are practiced in Malaysia. The sources of information include AAIOFI standard, MASBi standard, bank annual reports and legal standard. Content analysis is the key tolls which we intend to use to extract necessary information materials. We will also examine if there is any expectation gaps between the standards issued by the AAOIFI and the actual Shariah review practice in Islamic banks. From the finding, we will provide some recommendation for the improvement of Shariah review practiced in Malaysia.
We have selected Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB) as two Islamic banks for our study in order to limit the scope of the subject. From these two banks, any necessary information for the study will be extracted using exploratory method, and then will be critically analyzed and interpreted using explanatory method.

4. Discussion and Findings

4.1 Requirement of Shariah Review

As described in the AAOIFI GSIFI No 2: Shariah Review, the main purpose for the requirement of Shariah review for IFI is to make certain that all the activities carried out by the IFIs are truly in compliance with the Shariah rules and regulations as reflected in the fatwas, rulings and guidelines issued by the SSB. AAOIFI has recommended several procedures to be followed by the Shariah reviewers in performing the Shariah review on IFIs. The procedures include the planning review procedures, executing review procedures, preparation and review of working paper as well as procedures in documenting conclusions and preparation of the Shariah review report. In the first procedure of planning and designing the Shariah review, the Shariah reviewer is required to draw up a detailed plan whereby information such as the operations of the IFI including its products, size, locations, branches and subsidiaries should be stated in the plan to ensure that the Shariah review can be conducted and completed systematically and in a timely manner. In addition to the above, the list of all fatwas, rulings and guidelines to be obtained should also be disclosed in the plan. Therefore, it is crucial for the Shariah reviewer to be familiar with the structure, operations, transactions and other related activities of the IFI and its group of subsidiaries to enable the Shariah reviewer to provide accurate Shariah opinions on the overall operations of the IFI. The planning procedure will also assist the Shariah reviewer to ascertain whether the transactions and products of the IFIs which should be approved by the SSB are carried out according to the relevant requirements.

The next stage of the Shariah review involved execution of the planned procedures as mentioned above. In this stage, the Shariah reviewer would be required to obtain the understanding of the IFI’s Management on their awareness, commitment and compliance control procedures for adherence to Shariah rulings. Thereafter, the Shariah review to be conducted can be considered to some extent similar to the work of an auditor whereby Shariah reviewer shall go through, among others, the contracts, agreements and transactions entered into by the IFI to see whether they are in compliance with Shariah rules and principles. Apart from reviewing the above, the Shariah review also covers the review of other information or reports of the IFI such as circulars, minutes of meeting, operating and financial reports, policies and procedures. For the purpose of performing an effective Shariah review, the Shariah reviewer is encouraged to consult and collaborate with advisors such as the external auditor. All the review procedures undertaken by the Shariah reviewer are required to be
documented in proper working papers. Upon completion of the Shariah review, any findings would be discussed with the Management of the IFI for further action to be taken, if necessary. The final procedure in the Shariah review as suggested by AAOIFI would be the documentation on the conclusions of the review and preparation of the Shariah review report to the shareholders that will be read at the IFI's annual general meeting and published in the annual report.

4.2 Shariah Review in Malaysia

It is noted that there is an absent of a Shariah review regulation in the Malaysian context. The AAOIFI had developed standards on Shariah review and internal Shariah review. However the standards had not been adopted by the regulators in Malaysia and implementation of such review is currently voluntary. Development of the Shariah review field, guidelines, best practices and importantly the Shariah reviewer as the main resource of the field has not been addressed to date and require further research and advancement.

Acknowledging the current lack of development in the Shariah review field the group had examined the Shariah review practices undertaken by Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB). These two banks have their own Shariah department / secretariat whose purpose is to assist Shariah committee of the banks. In BIMB, the Shariah Committee is named as the Shariah Supervisory Council (SSC) while in BMMB it is known as the Shariah Committee.

The SSC in BIMB was established in compliance with the provision of the Islamic Banking Act 1983. The main purpose in the establishment of SSC is to advise the bank on the operation of its banking business in order to ensure that they do not involve any element which is not approved by Shariah. The SSC advises the Directors on matters pertaining to the operational issues of the bank. The SSC also liaises with the relevant authorities such as The National Shariah Council of Bank Negara Malaysia and Shariah Advisory Council of the Securities Commission from time to time on issues relating to the industry (BIMB, n. d.). BIMB has its own Internal Shariah Audit Section which is formed under The Internal Audit Department. This section is assigned to undertake internal Shariah audit or review of the bank transactions and operations. The findings from the Shariah review are reported to the Shariah Supervisory Council through the Shariah Compliance Department and the Shariah Department (Danneaux, 2005).

On the other hand, the Shariah Committee in BMMB was established in accordance with the requirements of Islamic Banking Act 1983 and the Bank's Article of Association. The purpose of the establishment of this committee is to ensure that the bank conducts its affairs in accordance with the Shariah principles. All the bank’s business activities are subject to the scrutiny of the committee to ensure Shariah compliance (BMMB, n. d.). This committee gives their report directly to the Board of Director of the bank. From the interview with manager of Internal Audit Department of the bank, it is found that before coming
out with the Shariah Committee report, the committee will review the principles and the contracts relating to the bank’s transactions and operation provided by Shariah Review report.

In Bank Muamalat, the Shariah review is assigned to the Shariah Section of The Risk Management Department. The Shariah review entails in the examination and review of Shariah concepts and Islamic structures based on specific guideline for respective bank’s products. Through the query made, the Bank did not follow any Shariah review standard issued by AAOIFI. However the bank’s Internal Audit Department assists the Shariah Section in undertaking any Shariah issues during regular audit.

4.3 Shariah Committee Report
Bank Negara Malaysia through its “Garis Panduan 8 –i” (GP8-i) had required the Shariah committee to produce a Shariah committee report expressing their opinion on the Islamic Bank’s compliance with Shariah. Currently the minimum requirement of the report is shown in Appendix I. The current Shariah Committee report for both Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB) had been issued in compliance with the minimum requirement as been outlined by Bank Negara Malaysia through the GP8-i. This is evidence as been observed in their respective annual report.

In 1997, the AAOIFI has issued a Governance Standard 1 for Islamic Financial Institutions that provides the definition, composition and report of the SSB. With regards to the report to be produced by the SSB as part of the annual report of the IFIs, AAOIFI has outlined the information in Appendix II that should be included in the report (AAIOIFI, 1999). The sample of the recommended report by AAOIFI is attached in the same appendix.

In view of the above, it is clearly shown that the Shariah Review Reports currently prepared by the Shariah Committee of the Islamic Banks in Malaysia are lacking in several information as compared to the information provided in the report presented by AAOIFI. Therefore, it is essential that necessary actions be taken by the relevant authorities to come up with a standard Shariah review report which contains the necessary information to provide strong assurance to the shareholders and others users (such as the consumers, investors, governments, creditors and depositors) of the Annual Reports that the activities, operations and transactions carried out by the Banks are in compliance with the Shariah.

Merely confirming that all the operations of the Banks conform to the Shariah rules is insufficient because the stakeholders may also be interested to understand and know that review has been carried out to support the opinion of the Shariah committee apart from the provision of other relevant disclosures to assist them in their decision making. Islamic finance products and operations are becoming more sophisticated and complex, thus additional information are
necessary so as to ensure the credibility of the Banks as well as enhancing the public confidence on their operation. As such, the report issued by the AAOIFI can be used as a benchmark for the preparation of the standard report format for the Shariah Committee in Malaysia.

Considering that the Shariah Committee Report provided by AAOIFI is meant as a guideline of a minimum Shariah committee report, the group had compared other reports produced by selected foreign Islamic Banks outside Malaysia. The report contains more information as compared to the minimum information provided in the Malaysian Shariah Committee Report. For instance, the contents of the Shariah reports prepared by Abu Dhabi Islamic Bank, UAE and Jordan Islamic Bank are in compliance with the requirements as recommended by AAOIFI. However, Meezan Bank, Pakistan has taken a step further by disclosing more detailed information in its Shariah report such as description on new products issued by the bank within the year of reporting, detailed explanation on the activities of the bank on both the assets and liabilities as well as providing recommendation on ways to improve the management of assets and liabilities of the bank. This shows the independence of the committee from the management of the bank and showed their opinion on the operation of the bank aside from providing recommendation for further improvement for compliance.

4.4 Expectation Gap and Overcoming Challenges

Through the findings above, there are two main expectation gap identified by the group. The first expectation gap is in the report produced by the Shariah Committee on compliance of the operation with Shariah as observed from the issued report. The second expectation gap centers on the execution of Shariah review by the respective banks to support the report issued by the Shariah committee. Both the Shariah committee report and execution of Shariah review is important in exercising governance especially in ensuring the Banks compliance with Shariah.

With respect to the Shariah committee report currently provided by the respective banks’ Shariah committee, it lacks the depth of providing such assurance. It is merely an endorsement of the bank’s Shariah compliance in general without any emphasize on the actual operational or conduct of the respective banks. The AAOIFI standard had emphasized that the Shariah committee “is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Shariah rules and principles”. This connotes a greater duty of not only endorsing and approving the Bank’s products but ensuring its compliance through directing, supervising and importantly reviewing its operations.

On the other hand, The Islamic Banking Act 1983 had state that “the establishment of a Shariah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.” Thus the function of the Shariah
committee is more on an advisory role on the bank’s operation. In order to effectively execute the advisory role, the Shariah Committee still needs to have Shariah review as an indicator of the bank compliance with Shariah before dispensing an advice. In addition to the above, the roles of the Shariah committee as outlined in the GPS-1 is generally more on the Shariah compliance of the bank products aside from giving consultation and advise on any Shariah issues faced by the Bank. The minimum content of the Shariah report provided by GP8-i had included that the operation of the bank is in compliance with Shariah. Though it is a general statement, this indicates that there must be sufficient Shariah review being conducted before the Shariah committee can form an opinion that the operation is in compliance with Shariah.

As users of the information, the respective stakeholders expect a Shariah report which could give them the actual performance of the Bank especially in its compliance with Shariah. This is pertinent as Shariah compliance is the backbone of the operation of an Islamic Bank. The absent of Shariah compliance would render an Islamic Bank no difference from other financial institutions.

There is a positive step in the current undertaking of the Islamic Banks in Malaysia in the development of Shariah review. From the inquiries made, both Islamic Banks are in the process of developing their respective Shariah review department either as part of the Internal Audit Department in Bank Islam Malaysia Berhad or as another independent unit evidence through the Shariah Section of Bank Muamalat Malaysia Berhad. The initial step towards the enforcement and a more proactive Shariah review by setting the respective unit and section will give a long run benefit for these Banks. The absent of guidelines from regulators and the lack of experience in the area is a major challenge encountered by the respective section and unit.

Thus currently the review is more in relation to the compliance of the product with the respective approval given by the Shariah committee. Product compliance is only a small part of the operation of the Islamic Bank as respective transactions, implementation, contracts and documentation execution and determination of income. Review on these areas is needed as the management might masks non Shariah compliance contracts in their operation or erroneously executed contracts and transactions rendering it non compliance with Shariah. Expertise and knowledge in conducting Shariah review is currently scarce as the importance of such review is not emphasized. The current audit carried out by internal auditors or the external auditors has not included Shariah compliance as an area to be checked as they too lack the knowledge and expertise in the area. Embedding Shariah compliance in the audit program is view as a feasible way to conduct Shariah review.

The complexity and dynamism of the Islamic Banking and Finance industry had increased the necessity of Shariah review being made to ensure the products,
operation and management of the Islamic Banks and financial institutions are in compliance with Shariah. The main attraction for the establishment of an Islamic Bank is to safeguard the Muslims from indulging into non Shariah compliance transaction especially in their financial affairs. In order for then be assured that these institutions are operating and conducting its business in accordance with Shariah, the Shariah Committee is entrusted to be part of the Governance mechanism overseeing its Shariah compliance.

One of the main obstacles is the lack of expertise to perform the Shariah review. The current auditors lack the Shariah background and the Shariah employees' lacks the experience needed to perform the review, collect documents and evidence and also development of working paper and review checklist. The AAOIFI had laid out that the Shariah review must be conducted with professional proficiency and due care which among others include appropriate staffing and supervision, adherence to the code of conduct of accountants and auditors, having the required knowledge, skills and disciplines and also continuous training and education. The industry must consider these requirements and put effort in developing the required resources to accommodate the need.

The Shariah review must be made with due independence and objectivity as they are to give assurance on the Shariah compliance of the bank. Absence of independent will marred the assurance given by the Shariah reviewer and ultimately the Shariah committee report. It must also be stressed that the Shariah reviewer should have direct access to the Shariah committee without having to go through the management structure as this can impend and affect their report. To further ensure independence, similar to the chief internal auditor whom employment and appraisal is made by the audit committee, the head or chief Shariah reviewer should be engaged, terminated, promoted and evaluated by the Shariah committee. The objectivity of the Shariah reviewer must be intact to ensure that the Shariah review is conducted professionally without any prejudice.

The scope of the Shariah review must be determined and properly documented by the Shariah committee. The defined scope of work will then be the guide for the Shariah reviewer to effectively conduct the required review. Periodic update to the scope must also be incorporated recognizing the necessity of such updates considering the rapid development of the Islamic banking and finance industry and complexity of the industry's operation. The scope of work must also clearly define the Shariah consideration to be taken in the execution of the review. The Shariah reviewer must prepare proper working paper, guideline, plans and checklist to cover the scope of work provided for the Shariah review.

The performance of the Shariah review unit or department must be under the constant scrutiny of the Shariah committee to ensure that the review is appropriately done to discharge the entrusted duties of the committee. Periodic reporting and discussion with the unit or department should be held to know the
development, challenges or obstacles faced by the unit or department. In addition to that the Shariah committee should review the respective Shariah review plan against the activity conducted by the department or unit. Quality of work and report forwarded by the department or unit must also be evaluated in order to improve Shariah review processes.

5. Conclusion

The Shariah committee report currently issued by the respective committees of Islamic Banks in Malaysia are only satisfying the minimum requirement of such report as been provided by GP8-i issued by Bank Negara Malaysia. It needs more development and disclosure to provide a deeper assurance to the stakeholders on the Shariah compliance of the institution. Moving towards a more transparent disclosure would require more proactive involvement of the regulators as it seems that the respective institutions will only abide with the minimum requirement as provided by the regulators.

More importantly development must be made on firming Shariah review which is required to support the Shariah report issued by the Shariah committee. Without a strong and proper Shariah review, the Shariah committee would not be able to support their opinion thus failure to discharge their entrusted duties as expected by the stakeholders. An effective Shariah review will be able to assist the Shariah committee in forming their opinion with the appropriate evidence on Shariah compliance or noncompliance. In order to preserve this evidence a methodological approach in conducting the review in accordance to the outlined scope, working paper, proper sampling and documentation must be observed. Thus to firm up the Shariah review area, regulation, training, development of knowledge and skills as well as standardization of the review are required.

References

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Malaysian Islamic Banking Act 1983.
Illustration
Islamic Bank Model Berhad
SHARIAH COMMITTEE’S REPORT

We, ENCIK D and ENCIK E being two of the members of the Shariah Committee of ISLAMIC BANK BERHAD, do hereby confirm on behalf of the members of the Shariah Committee, that in our opinion, the operations of the Bank for the year ended dd/mm/yy have been conducted in conformity with the Shariah principles.

On behalf of the Shariah Committee

Encik D

Encik E

Kuala Lumpur

dd/mm/yy

Shariah Review Report as Outlined in GP8-i
Appendix II

In the name of Allah, The Beneficent, The Merciful

To the Shareholders of The Example Islamic Financial Institution

Assalam Alaikum Wa Rahmat Allah Wa Barakatuh

In compliance with the letter of appointment, we are required to submit the following report:

We have reviewed the principles and the contracts relating to the transactions and applications introduced by the Example Islamic Financial Institution during the period ended. We have also conducted our review to form an opinion as to whether the Example Islamic Financial Institution has complied with Shari’a Rules and Principles and also with the specific fatwas, rulings and guidelines issued by us.

The Example Islamic Financial Institution’s management is responsible for ensuring that the financial institution conducts its business in accordance with Islamic Shari’a Rules and Principles. It is our responsibility to form an independent opinion, based on our review of the operations of the Example Islamic Financial Institution, and to report to you.

We conducted our review which included examining, on a test basis of each type of transaction, the relevant documentation and procedures adopted by the Example Islamic Financial Institution.

We planned and performed our review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Example Islamic Financial Institution has not violated Islamic Shari’a Rules and Principles.

In our opinion:

a) the contracts, transactions and dealings entered into by the Example Islamic Financial Institution during the year ended … that we have reviewed are in compliance with the Islamic Shari’a Rules and Principles;

b) the allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by us in accordance with Islamic Shari’a Rules and Principles;

(where appropriate, the opinion paragraph shall also include the following matters:)

c) all earnings that have been realized from sources or by means prohibited by Islamic Shari’a Rules and Principles have been disposed of to charitable causes; and

d) the calculation of Zakah is in compliance with Islamic Shari’a Rules and Principles.

We beg Allah the Almighty to grant us all the success and straight-forwardness.

Wassalam Alaikum Wa Rahmat Allah Wa Barakatuh

(Names and signature of the members of the Shari’a supervisory board)

Place and Date

Sample of the report issued by AAOIFI as provided in the governance standard

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