



## To Appoint *Shariah* Committee Member as an Independent Non-executive Director of Islamic Banks in Malaysia: Issues and Challenges

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### ABSTRACT

*Shariah* compliance is a vital element in the operation of Islamic banking business carried out by Islamic banking institutions. In order to strengthen the *Shariah* governance, the existing legislations regulating Islamic banking business in Malaysia encourage the Islamic financial institutions and Islamic banks in particular, to appoint a member of its *Shariah* committee (SC) as a member of the Board of Directors (BoD). This article scrutinizes on this issue and the challenges which probably faced by the appointed SC member as member to the BoD of Islamic Financial Institutions. The study found that the suggestion is good to bridge the gap between the SC and the BoD in ensuring *Shariah* compliance. However it also may invite several legal conflicts and challenges to be faced by the appointed *Shariah* member if the Islamic banks.

**Keywords:** *Shariah* Committee, *Shariah* Advisory, *Shariah* Governance, Independent Non-executive Director, Islamic Bank

**JEL Classifications:** G2

### 1. INTRODUCTION

Adherence to the *Shariah* principles in Islamic financial activities include adherence to the basic prohibitions such as prohibition of usury (*riba*), prohibition of uncertainty (*gharar*) and prohibition of games of chances (*maisir*) (Hassan, 2011). Apart from the basic prohibitions, the Islamic banks should conform to certain Islamic business ethics and norms such as the principle of justice and fair dealing, fulfilling the covenants and paying liabilities, mutual cooperation and removal of hardship, free marketing and fair pricing and freedom from detriment (*darar*) (Ayub, 2007). *Shariah* supervision is a vital element for the Islamic banks to ensure that its operations and Islamic financial business activities always comply with *Shariah* principles. The mandate to ensure the *Shariah* compliance relies on the *Shariah* committee (hereinafter referred to as "SC") established by Islamic banks.

SC can be referred as people entrusted with ensuring the compliance aspects of particular products and instruments used in the Islamic finance industry which broadly includes banking, capital market and *takaful* (Laldin, 2008). The SC is a key organ of governance and becomes part of the corporate governance framework in an Islamic bank (Clode, 2002). It is crucial to ensure that the institutions comply with the Qur'anic sanctions and to prevent such institution from involvement in any unethical investment such as investment in business related to gambling, alcohol or pornography (Brown et al., 2007). SC will act as independent *Shariah* auditors and advisors to the banks, and are involved in vetting all new contracts, auditing existing contracts, approving new products developments and also oversees the collection and distribution of alms (*zakat*) (Latifa and Lewis, 2007).

## 2. THE ROLES OF BOARD OF DIRECTORS IN THE IMPLEMENTATION OF *SHARIAH* GOVERNANCE IN ISLAMIC BANKS

According to *Shariah* Governance Framework for Islamic Financial Institutions (BNM/RH/GL 012-3) (hereinafter referred to as “SGF”) states that the Board of Directors (hereinafter referred to as “BoD”) is ultimately accountable and responsible for the overall SGF and *Shariah* compliance of the Islamic financial institution (SGF, 2010). Ideally, it is appropriate that the BoD should have reasonable understanding of the principles of the *Shariah* and its broad application in Islamic finance in order to ensure the effectiveness of the BoD in carrying out their responsibilities towards *Shariah* compliance of the Islamic financial institutions (SGF, 2010).

Alternatively, SGF suggests that the BoD may consider appointing at least one member of the SC as a member of the BoD that could serve as a “bridge” between the BoD and the SC. In addition, the presence of a director with sound *Shariah* knowledge would foster greater understanding and appreciation amongst the BoD’s members on the decisions made by the SC (SGF, 2010).

In addition, Guidelines on Corporate Governance for Licensed Islamic (GP1-i) (BNM/RH/GL 002-1) (hereinafter referred to as “GP1-i”) requires that the board should comprise of directors who as a group provide a mixture of core competencies such as finance, accounting, legal, business management, information technology and investment management (GP1-i, 2007). The appointment of a member of SC with expertise in the field of *Shariah* and Islamic finance as a member of the BoD is consistent with the requirement of GP1-i. The existence of knowledgeable board members in the field of *Shariah* and Islamic finance may enhance the effectiveness of the BoD in carrying out their responsibilities towards *Shariah* compliances. At the same time such a member may provide necessary checks and balances in ensuring the IFI operates in a safe and sound manner parallel with the objectives of IFI (GP1-i, 2007).

It seems good for the Islamic banks to adopt this approach which could serve as a “bridge” between the BoD and the SC. It is also in line with one of the roles of BoD as Islamic Financial Services Act 2013 (Act 759) (hereinafter referred to as “IFSA”) stipulates that, the BoD shall have due regard to any decision of the SC on any *Shariah* issue relating to the carrying on of business, affairs or activities of the institution (IFSA, section 65(2)(f)). Accordingly, a member of the SC appointed as a member of the BoD may provide the necessary information to the BoD particularly in approving the policies relating to *Shariah* matters as well as ensuring that such policies are implemented effectively (SGF, 2010).

Currently, four Islamic banks licensed under IFSA have taken a positive approach by appointing a member of the SC as a member of the BoD. Affin Islamic Bank Berhad has appoint the Chairman of the SC as Independent Non-executive Director. He also is appointed to sit in the Audit and Examination Committee of BoD (Annual Report of Affin Islamic Bank Berhad, 2015).

Alliance Islamic Bank Berhad has appoint one of its SC member as Independent Non-Executive Director (Annual Report of Alliance Islamic Bank Berhad, 2016). For CIMB Bank Islamic, the bank appoints the Chairman of SC and one of the SC members as Independent Director (Annual Report of CIMB Bank Islamic, 2014). Finally, the public Islamic bank has appoint the Chairman of SC as an Independent Non-Executive Director. He also is appointed as a member of BoD’s Nomination Committee and BoD’s Audit Committee (Annual Report of Public Islamic Bank Berhad, 2015).

## 3. ISSUES AND CHALLENGES

Even though the approach is very good to be practiced in the institution, the consequence that may result upon a member of the SC being appointed as a member of the BoD should also be addressed. Ideally, upon appointment as member of the BoD, such member of the SC will hold two different positions in the same institution. Such member will serves as a member of the SC and at the same time will serves as a member of the BoD.

The first effect is pertaining to the duties and responsibilities of such member of the SC upon being appointed as member of the BoD. In this regard, such appointed member will have different duties and responsibilities as a member of the SC and as a member of the BoD. As a member of the SC, such member is subject to the duties and responsibilities as stipulated in the statutes as well as guidelines. In general, the duties and responsibilities of SC including to advise the board and institution, endorse *Shariah* policies and procedures, endorse and validate relevant documentations, assess work carried out by *Shariah* review and *Shariah* audit, assist related parties on *Shariah* matters, advise matters to be referred to the SAC and provide written *Shariah* opinions (SGF, 2010).

As a member of the BoD, such member is subject to the duties and responsibilities as prescribed by the provisions contained in IFSA and other written law such as Companies Act 1956 (Act 125). According to section 65 of IFSA, the functions and responsibilities of the BoD include the following: (a) To direct and oversee the business and affairs of institution pursuant to IFSA and any other written law which may be applicable to the institution; (b) To set and oversee the implementation of business and risk objectives and strategies and in doing so shall have regard to the long term viability of the institution and reasonable standards of fair dealing; (c) To ensure and oversee the effective design and implementation of sound internal controls, compliance and risk management systems commensurate with the nature, scale and complexity of the business and structure of the institution; (d) To oversee the performance of the senior management in managing the business and affairs of the institution; (e) To ensure that there is a reliable and transparent financial reporting process within the institution; (f) To promote timely and effective communications between the institution and Central Bank of Malaysia (hereinafter referred to as “CBM”) on matters affecting or that may affect the safety and soundness of the institution; and (g) Have due regard to any decision of the SC on any *Shariah* issue relating to the carrying on of business, affairs or activities of the institution.

Pursuant to section 66 of IFSA, the duties of director are; (a) To act in good faith in the best interests of the institution; (b) to exercise reasonable care, skill and diligence; (c) to only exercise powers conferred on him for the purposes for which such powers are conferred; (d) to exercise sound and independent judgment; and (e) to comply with any standards specified by CBM under subsection 29(2) which are applicable to a director.

Apart from that, SGF stipulates that the responsibilities of the BoD include the following; (a) The board is accountable and responsible the overall SGF and *Shariah* compliance of the Islamic financial institutions; (b) to approve all policies relating to *Shariah* matters and to ensure that such policies are implemented effectively; (c) to appoint member of SC; (d) to ensure that the members of SC are aware of their fiduciary responsibilities in discharging their duties; (e) to ensure that an effective communication policy among the key functions of the institution is in place to facilitate smooth escalation of material matters relating to *Shariah* to the BoD; (f) to remunerate the members of SC appropriately as advised by its Remuneration Committee; and (g) to ensure that decisions made by the SC are duly observed and implemented by the Islamic financial institutions (SGF, 2010).

In addition, the GP1-i also clarifies the duties and responsibilities of the directors as well as the BoD of Islamic banks. The guidelines also stipulate that a director shall at all times act honestly and use reasonable diligence in the discharge of his duties pursuant to the requirement of the Companies Act 1956 (GP1-i, 2007). The director's fiduciary duties towards Islamic banks include the following duties; (a) To act bona fide and in the interests of the Islamic bank as a whole; (b) Not to act beyond the power conferred by the Islamic bank; (c) To avoid/guard against conflict of interest situation; and (d) To apply such degree of skills, care and diligence as may reasonably be expected of a person of his knowledge and experience (GP1-i, 2007).

Meanwhile the director's responsibilities are: (a) To be aware of the Islamic bank's operating environment and to promote safety and soundness of the Islamic bank; (b) to be diligent in undertaking his duties and avoid conflict of interest situations; (c) to be able to exercise independent judgment in decision making and provide sound and objective advice; (d) To understand his oversight role and "duty of loyalty" to the Islamic bank, its shareholders and other stakeholders; (e) to objectively question management; (f) to devote adequate time and attention to discharge his duties and responsibilities effectively; and (g) to contribute actively to the functions of the board and be able to provide special expertise to the board (GP1-i, 2007).

The GP1-i also stipulates the responsibilities of the BoD including: (a) Review and approve strategies, business plans and significant policies and monitor management's performance in implementing them; (b) set corporate values and clear lines of responsibility and accountability that are communicated throughout the organization; (c) ensure competent management; (d) ensure that the operations of the Islamic bank are conducted prudently, and within the framework of relevant laws and policies; (e) ensure that the Islamic bank establishes comprehensive risk management

policies, processes and infrastructure, to manage the various types of risks; (f) institute comprehensive policies, processes and infrastructure to ensure *Shariah* compliance in all aspects of the Islamic bank's operations, products and activities; (g) set up an effective internal audit department, staffed with qualified internal audit personnel to perform internal audit functions, covering the financial, management and *Shariah* audit; (h) establish procedures to avoid self-serving practices and conflicts of interest including dealings of any form with related entities; (i) ensure protection of the interests of the depositors, particularly investment account holders; (j) establish and ensure the effective functioning of various board committees; and (k) ensure that the Islamic bank has a beneficial influence on the economic well-being of its community.

Based on the duties and responsibilities presented above, it is observed that such a member of SC will have great duties and responsibilities. In the meantime, we must keep in mind that a member of a SC already has a permanent job in other institutions such as an academician of a higher learning institution. Hence, the Islamic banks in appointing any member of the SC to sit on the BoD, shall ensure that such member is capable to hold different duties and responsibilities without affecting the current duties and responsibilities as a member of the SC and as well their official duties in their permanent institutions.

Secondly, the appointment of a member of a SC to sit on the BoD of the IFI may invite the issue on the conflict of interest. According to GP1-i, there are three types of Directors namely, Executive Director, Non-Executive Director and Independent Director. In this regard, an Independent Director is subject to the following limitation: (a) Shall not have more than 5% equity interest directly or indirectly in the Islamic bank or in its related companies; (b) shall not be connected to a substantial shareholder of the Islamic bank or under an obligation to act in accordance with the substantial shareholder or any other person; (c) shall not be employed in an executive position in the Islamic bank or its related companies, at least two years prior to his appointment date; (d) shall not have an immediate family member who is, or has been in the past two years, employed by the Islamic bank or any of its related company as a key senior officer. For this purpose, an "immediate family member" means the spouse, parent, brother, sister, child (including adopted or step child) and the spouse of such brother, sister or child, of the independent director; (e) shall not engage in any transaction, or have been engaged in any transaction within the last two years with the Islamic bank, whether with other persons or through a firm or a company of which he is a partner, director or major shareholder, the value of which exceeds RM1.0 million and subject to exceptional; (f) shall not be engaged as a professional adviser by the Islamic bank or any related company of the Islamic bank, either personally or through a firm or company of which he is a partner, director or major shareholder, as the case may be; and (g) have served the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interest of the Islamic bank.

A member of a SC is eligible to be appointed as Independent Non-Executive Director. Accordingly, such member is subject to the above limitation. However, as independent director, such a member

is not barred from having less than 5% equity interest directly or indirectly in the Islamic bank or in its related companies. The question is to what extent such a member is free from any conflict of interest while making decision relating to the *Shariah* issue. In fact, persons empowered with decision making authority (including Directors) should exercise care to avoid situations that may give rise to a conflict of interest situation (GP1-i, 2007). Furthermore, the SC is responsible to make sound decisions on *Shariah* matters in an independent and objective manner (SGF, 2010).

The third point is relating to the legal effect if such member of the SC who is appointed as member of BoD breaches any of the duties and responsibilities which are punishable under any law. In this regard, if legal action is taken for any offences committed by such a member in his capacity as director, the question is whether it will also affect such member in his capacity as a member of the SC. The same if it happened vice versa.

Based on the above discussion, it would be good if the law, in particular, SGF provides a guidance to the institutions in selecting the appropriate member of the SC as a member of the BoD. What is most significant is that there should be a mechanism to ensure that the appointed member will be able to perform the duties effectively and be free from any element which may lead to conflict of interest. Similarly, there is a need to explain the legal effects that may arise if the offence committed by such a member of the SC in a different capacity.

#### 4. CONCLUSION

In conclusion, recommendation by SGF to appoint a member of the SC as a member of the BoD is a very good approach which could serve as a “bridge” between the BoD and the SC of the institution. In addition, it will strengthen the relationship between the two parties which is very important in ensuring *Shariah* compliance by the institution. However, there should be a clarification on several matters including a standard criteria of members to be appointed to the BoD; a proper mechanism to avoid any element of conflict of interest; and the legal consequences that should be

taken if the offence committed by such member of the SC in a different capacity.

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