

THE ROLE OF REGULATORY AND SUPERVISORY
INSTITUTIONS FOR SHARĪ‘AH GOVERNANCE ON
ISLAMIC BANKING IN PAKISTAN: A COMPARISON
WITH MALAYSIAN PRACTICE

BY

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ABSTRACT

This research attempts to analyze the role of three main institutions related to Islamic banking and finance in Pakistan which are the State Bank of Pakistan (SBP), its Shari'ah Advisory Committee (SAC) and the Shari'ah boards of Islamic banking institutions (IBIs) in regulating and supervising the practice of Shari'ah governance at IBIs. Considering the sound regulatory and supervisory arrangement of Malaysian Shari'ah governance practice, the main objective of the research is to critically analyze the role of these three institutions in Shari'ah governance while comparing it with the role performed by Bank Negara Malaysia (BNM), its Shari'ah Advisory Council (SAC) and the Shari'ah Committees of IBIs in practicing Shari'ah governance in Malaysia. Applying descriptive methodology, the research mainly depends on the data collected from secondary sources such as the regulatory guidelines, policy documents, standards and directives issued by central banks of Malaysia and Pakistan as well as research articles, papers and books on subject matter. The research findings reveal that the basic regulatory arrangement for Shari'ah governance practice is similar in both countries. The similar aspects indicate that the central banks in the two countries play their regulatory roles under the auspices of their central Shari'ah advisory bodies. Likewise, at the industry level, a Shari'ah Governance Framework has been implemented in both countries where the affairs of IBIs are supervised by institutional Shari'ah bodies. The research has discovered that there are no legal provisions dedicated to the regulatory arrangements of SBP for Shari'ah governance practice which need an adequate legal support. In addition, some regulations have inconsistencies and are not defined distinctively to cater the regulatory needs of IBIs. Considering the significant role of central SAC, its composition, criteria for appointment and resolutions are yet to be supported with legal provisions and specified regulations so it could reflect the apex position in the Shari'ah governance of IBIs. The establishment of Shari'ah board at IBI, its composition and membership affiliation lack legal basis and sound regulatory arrangement. It requires additional members with diversified qualifications to meet the challenges of the dynamics of Islamic banking industry, and restriction to single board membership to avoid conflict of interest. Besides, there should be a regulatory arrangement for assessing the performance of Shari'ah boards to ensure accountability and productivity of the members. Also, the role of the Shari'ah board should be made comprehensive and independent. In order to ensure consensus and produce conclusive ruling, the role of the Shari'ah board in IBI should be made supreme while the other organs such as Shari'ah compliance department and Shari'ah review functions should facilitate the role of the Shari'ah board.

خلاصة البحث

يحاول هذا البحث تحليل دور ثلاث مؤسسات رئيسية ذات صلة بالخدمات المصرفية والتمويل الإسلامي في باكستان وهي: البنك المركزي الباكستاني (SBP)، واللجنة الاستشارية الشرعية التابعة له (SAC) والهيئات الشرعية التابعة للمؤسسات المصرفية الإسلامية (IBIs) وذلك في تنظيم ومراقبة ممارسة الحوكمة الشرعية في المؤسسات المصرفية الإسلامية. مع مراعاة النظر إلى الترتيب التنظيمي والإشرافي السليم لممارسة الحوكمة الشرعية في ماليزيا، هذا ويعتبر الهدف الرئيس من البحث هو التحليل النقدي لدور هذه المؤسسات الثلاث في إدارة الحوكمة الشرعية مع المقارنة بالدور الذي يؤديه بنك نيغارا ماليزيا (BNM) ومجلسه الاستشاري الشرعي (SAC) وكذلك الهيئات الشرعية التابعة للمؤسسات المصرفية الإسلامية الماليزية في موضوع ممارسة الحوكمة الشرعية. وبتطبيق المنهج الوصفي، فقد اعتمد البحث بشكل رئيسي على البيانات التي تم جمعها من مصادر ثانوية؛ مثل المبادئ التوجيهية التنظيمية، ووثائق السياسة العامة، والمعايير والتوجيهات الصادرة عن البنوك المركزية في ماليزيا وباكستان، فضلاً عن المقالات البحثية والأوراق والكتب حول الموضوع. وتكشف نتائج البحث أن الترتيب التنظيمي الأساسي لممارسة الحوكمة الشرعية متشابه في كلا البلدين. وتشير الجوانب المماثلة إلى أن المصارف المركزية في كلا البلدين تؤدي أدوارها التنظيمية تحت رعاية هيئاتها الاستشارية الشرعية المركزية. أيضاً، على مستوى الصناعة، تم تنفيذ إطار الحوكمة الشرعية في كلا البلدين حيث تشرف هيئات المؤسسات الشرعية على شؤون المؤسسات المصرفية الإسلامية. وقد اكتشف البحث أنه لا توجد أحكام قانونية مكرسة للترتيبات التنظيمية للبنك المركزي الباكستاني لممارسة الحوكمة الشرعية التي تحتاج إلى دعم قانوني كافٍ. وبالإضافة إلى ذلك، تتسم بعض اللوائح بتناقضات ولا يتم تعريفها بشكل واضح لتلبية الاحتياجات التنظيمية للمؤسسات المالية الإسلامية. وبالنظر إلى الدور الهام الذي تضطلع به اللجنة المركزية الشرعية، فإن أمر تكوينها ومعايير التعيين والقرارات لم يتم دعمها بعد بأحكام قانونية ولوائح محددة حتى تعكس دورها العالي في إدارة الحوكمة الشرعية لدى المؤسسات المالية الإسلامية. ويتسم أمر إنشاء الهيئات الشرعية في

المؤسسات المالية الإسلامية، وتكوينها وانتساب الأعضاء فيها بالافتقار إلى الأساس القانوني والترتيب التنظيمي السليم، وهذا يتطلب أعضاء إضافيين من ذوي المؤهلات المتنوعة لمواجهة تحديات طبيعة الصناعة المصرفية الإسلامية، وتقييد عضوية مجلس الإدارة الواحد لتجنب تضارب المصالح. وإلى جانب ذلك، ينبغي أن يكون هناك ترتيب تنظيمي لتقييم أداء الهيئات الشرعية لضمان مساءلة الأعضاء وإنتاجيتهم. كما ينبغي أن يكون دور الهيئات الشرعية شاملاً ومستقلاً. ولضمان توافق الآراء وإصدار حكم قاطع، ينبغي أن يكون دور الهيئة الشرعية لدى المؤسسات المالية الإسلامية هو الأعلى، في حين أن الأجهزة الأخرى في تلك المؤسسات؛ كإدارة الامتثال الشرعية، ووحدة المراجعة الشرعية ينبغي أن يكون دورها مُيسراً لدور الهيئة الشرعية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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I sincerely dedicate this dissertation to my beloved parents and teachers.

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In the name of Allah, the Most Gracious and Most Merciful. With the blessings of Allah S.W and His utmost mercy, the journey of my doctoral research project has come to its completion. At the edge of this extremely emotional moment, I feel myself absolutely blessed.

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TRANSLITERATION TABLE

ء	’	خ	kh	ش	Sh	غ	Gh	ن	N
ب	B	د	D	ص	ṣ	ف	F	هـ	H
ت	T	ذ	dh	ض	ḍ	ق	Q	و	W
ث	Th	ر	r	ط	ṭ	ك	K	ي	Y
ج	J	ز	z	ظ	ẓ	ل	L		
ح	ḥ	س	s	ع	‘	م	M		

Short Vowels	
ـَ	a
ـِ	i
ـُ	u

Long Vowels	
ا + ـَ	ā
ي + ـِ	ī
و + ـُ	ū

LIST OF STATUTES

Banking and Financial Institution Act 1989 (Malaysia)
Banking Companies Ordinance 1962 (Pakistan)
Central Bank of Malaysia Act 2009
Companies Act 2016 (Malaysia)
Development Financial Institutions Act 2002 (Malaysia)
Deposit Protection Act 2016 (Pakistan)
Financial Services Act 2013 (Malaysia)
Islamic Banking Act 1983 (Malaysia)
Islamic Financial Services Act 2013 (Malaysia)
State Bank of Pakistan Act 1956

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[2009] 6 MLJ

JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd (President of Association of
Islamic Banking Institutions Malaysia & anor, interveners) - [2019] 3 MLJ 561

Tan Sri Abdul Khalid Ibrahim v Bank Islam (M) Bhd [2013] 3 MLJ 269

LIST OF ABBREVIATIONS

BAC	Board Audit Committee of Islamic banks in Malaysia
BAFIA	Banking and Financial Institution Act 1989 of Malaysia
BCO	Banking Companies Ordinance 1962 of Pakistan
BOD	Board of Directors
BNM	Bank Negara Malaysia
BPRD	Banking Policy and Regulations Department
CBMA	Central Bank of Malaysia Act 2009
CII	Council of Islamic Ideology (Pakistan)
DFIA	Development Financial Institutions Act 2002 of Malaysia
EC	Enforcement Committee of Bank Negara Malaysia
FSA	Financial Services Act 2013 of Malaysia
FSC	Federal Shariat Court of Pakistan
IBA	Islamic Banking Act 1983 of Malaysia
IFSA	Islamic Financial Services Act 2013 of Malaysia
IBI	Islamic Banking Institution
IFI	Islamic Financial Institution
IBD	Islamic Banking Department of State Bank of Pakistan
IBTD	Islamic Banking and Takaful Department of BNM
KHF	Kuwait House Finance Malaysia Berhad
LHC	Law Harmonization Committee of Malaysia
RSBM	Resident Sharī'ah Board Member
SBPA	State Bank of Pakistan Act 1956
SBP	State Bank of Pakistan
SAC	Sharī'ah Advisory Committee of State Bank of Pakistan
SAC	Sharī'ah Advisory Council of Bank Negara Malaysia
SECP	Securities and Exchange Commission of Pakistan
SBP	State Bank of Pakistan
SGF	Sharī'ah Governance Framework
SGPD	Sharī'ah Governance Policy Document
SCP	Supreme Court of Pakistan
SCI	Sharī'ah Compliance Inspection State Bank of Pakistan
SCD	Sharī'ah Compliance Department of State Bank of Pakistan

CHAPTER ONE

INTRODUCTION

1.1 RESEARCH BACKGROUND

The Islamic banking industry has witnessed tremendous growth in the last two decades, particularly in Pakistan and Malaysia. The regulatory and supervisory arrangements made by the State Bank of Pakistan (SBP) and Bank Negara Malaysia (BNM) for the sustainability of the Islamic banking sector has proven effective. Consequently, the assets and deposits of the Islamic banking business in Pakistan reached over two billion rupees each by the end of September 2018, whereas, during the same period, the market share of Islamic banking assets and deposits in the overall banking sector increased to 13.6 percent and 14.7 percent respectively. The profit ratio of the industry was recorded as Rs. Twenty-three billion before tax by the end of September 2018, which was Rs. Eighteen billion during the same quarter last year (2017) as well as return on assets and equity before tax was recorded as 1.3 percent and 20.2 percent.¹

On the other hand, in Malaysia, the industry is adequately supported by comprehensive market infrastructure, sound regulatory framework, and dynamic market participants. They contributed to the growth of the Islamic banking industry. Therefore, the market share of total Islamic banking assets in Malaysia has been recorded at 28% in 2016 which was at a level of 7.1 % in 2010.²

¹ “Islamic Banking Industry - Progress & Market Share” *Islamic Banking Bulletin*, (Islamic Banking Department: SBP, July – September, 2018), p3, Retrieved 29 March 2019, <http://www.sbp.org.pk/ibd/bulletin/2018/Sep.pdf>.

² “Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance”, *BNM/RH/DP 034-2*, 12 March 2018. p8. Retrieved March 29, 2019, <http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=612&bb=file>.

According to the BNM's financial stability report (2017), Islamic finance market share has reached 34.9% of total loans and financing, which was 5.3% in 2000, whereas the investment accounts and deposits reached 11.7% compared to 9.4% in 2016.³ The figures indicate that the Islamic banking industry has gained tremendous recognition in both countries. These indicators reflect the sound regulatory and supervisory arrangements that provide a healthy environment for the Islamic banking and finance industry to prosper. In this regard, the regulatory and supervisory arrangements of SBP for Shari'ah governance of Islamic banking in Pakistan play a pivotal role. It has established an Islamic Banking department to facilitate the regulatory arrangements for Shari'ah governance in Islamic banking institutions (IBIs).

To get advised and assisted on Islamic banking regulations, SBP has formed a dedicated central Shari'ah Advisory Committee (SAC), which also plays a monitoring role in the Islamic banking industry of the country. Shari'ah Board of each IBI is responsible for advising and supervising IBI on Shari'ah governance and compliance function as well as to ensure that Islamic banking business operation always fulfills Shari'ah requirements within the institution.⁴ Conversely, in Malaysia, the leading role played by the BNM's Shari'ah Governance system for IBIs which is supported by robust regulatory and legal frameworks. It is globally acknowledged by the Islamic banking and finance industry due to its comprehensive and sound attributes.⁵ Shari'ah governance practice in Malaysia involves the regulatory role of BNM, the supervisory

³ "Islamic Finance Development", *Financial Stability and Payment System Report*, (BNM: 2017), P 93, Retrieved April 1, 2019, http://www.bnm.gov.my/files/publication/fspd/en/2017/fs2017_book.pdf

⁴, Shamshad Akhtar, "Shari'ah Compliant Corporate Governance." in *Keynote Address delivered at Annual Corporate Governance Conference*, Dubai, vol. 16, 2014, p3-4, Retrieved <http://www.sbp.org.pk/ibd/speeches>

⁵Itam, Muhammad Issyam, Rusni bt Hasan, and Syed Musa Alhabshi. "Shariah Governance Framework for Islamic Co-Operatives as An Integral Social Institution In Malaysia." *Intellectual Discourse* 24Special Issue (2016) 477–500, IIUM Press, P 480

and advisory role of national SAC and the Shari'ah Committee of IBIs. This regulatory and supervisory arrangement has been supported through legal infrastructure such as the Central Bank of Malaysia Act (CBMA) 2009 and Islamic Financial Services Act (IFSA) 2013. Therefore, the regulations and policy guidelines issued by BNM under the guidance of its SAC's advisory role and the execution of these regulations and policies at the industry level by the Shari'ah Committees are protected by a sound legal framework.

Generally, governance is considered as the cornerstone of a business entity, whether it works in the conventional system or Islamic banking. The rudimentary reason for governance in a corporation is; to ensure that all organs of the entity follow the rules and regulations, policies within the given process and to achieve the goals and objectives of the corporation. All these processes need to be done with the help of a resilient risk management mechanism, transparency, fairness, responsibility, accountability, and independence.⁶

Therefore, it is defined that "corporate governance is the mechanism through which the problems of corporations, stakeholders including the shareholders, creditors, management, employees, consumers and the public at large are framed and sought to be resolved with the help of its three main ingredients which are transparency, accountability, and adequate disclosure."⁷ Correspondingly, Shari'ah governance practice depends on the organizational structure, which is formulated not only to govern any corporation but the existence of Shari'ah compliant practices and its related

⁶Imran Hussain Minhas, Shari'ah Governance Model (SGM) and Its Four Basic Pillars, *Islamic Finance News Malaysia*, (Red Money Publication: April 18, 2012), p1, Retrieved <http://ssrn.com/abstract=2153106>

⁷A.M.AbuA.M. Abu-Tapanjeh, "Corporate governance from the Islamic perspective: A comparative analysis with OECD principles." *Critical Perspectives on Accounting* 20, no. 5 (2009): 556-567. p558

functions distinguish it from the conventional corporate governance practice. Thereupon, Sharī'ah governance system of IBIs is simply the alignment of corporate governance, formed in the light of Islamic principles which is defined as “the set of institutional and organizational arrangements, policies, processes, procedures rules, regulations and laws which leads the organization towards Sharī'ah compliance”.⁸

Sharī'ah governance is specific to IBIs, and its compliance function justifies its presence in the IBIs. The structure of Sharī'ah governance practice depends on four basic pillars comprising of; (1) the management and supervision (2) Sharī'ah advisory (3) Sharī'ah compliance and review (4) transparency and disclosure, and the entire operation is controlled by Sharī'ah board or by the internal Sharī'ah review section under the supervision of the board of directors (BOD).⁹ The key function of Sharī'ah governance in Islamic banks is to organize, manage and systematize Islamic banking activities according to Islamic financial principles and to keep a balance between the credibility of the system and marketability of the business.

Accordingly, IBI is required to establish Sharī'ah governance practice to run the operation in the light of Sharī'ah rules and principles. To meet these requirements, IBI has to establish Sharī'ah supervisory authority which normally consists of *fiqh* scholars, practitioners, and academicians; their duties are to advise IBIs on Sharī'ah compliance in all aspects of operations.¹⁰ A sound Sharī'ah governance structure and its effective implementation are imperative to bring all the business affairs in compliance with

⁸Imran Hussain Minhas, “Sharī'ah Governance Model (SGM) and Its Four Basic Pillars” *Journal of Islamic Banking and Finance*, (April 2013), p.31.

⁹ Ibid, p.30-32

¹⁰ Zulkifli Hassan, Sharī'ah Governance in the Islamic Financial Institutions in Malaysia, *Journal of Management & Muamalah*, (2007), p,77-90.

Sharī'ah.¹¹ It can be accomplished by having an effective and responsible BOD and management coordinated by an independent Sharī'ah committee that is equipped with competency and accountability duly supported by sound internal Sharī'ah research, constant Sharī'ah review, Sharī'ah audit functions, and Sharī'ah risk management process.¹²

In this regard, the Sharī'ah governance practice in Pakistan and Malaysia are considered as the most regulated and efficient models.¹³ Moreover, after gaining a considerable portion of the Islamic banking industry and participating as the mainstream players in the industry, Pakistan and Malaysia had to formulate sound regulated Islamic financial systems. Besides, the diversity of the operational system, the product development process, the legal procedures and the variety of the Islamic financial instruments, so on so forth, required both countries to introduce a mechanism for regulating and supervising the Islamic banking operations.

The SBP and BNM initiated to operate their respected industries through their Sharī'ah governance practices. Although, the course of regulatory arrangements to regulate the businesses of IBIs has a long history, but a full-fledged and an identical Sharī'ah Governance Framework implemented by the SBP in 2015, whereas the Malaysian Sharī'ah Governance Framework was rolled out even earlier in 2010. The current Sharī'ah Governance Policy Document issued in 2019 is considered as a robust regulatory arrangement for Sharī'ah governance practice of IBIs introduced by BNM.

¹¹ Rusni Hassan and Syed Ahmed Salman, "Guiding Principles in Developing Sharī'ah Governance Framework for Islamic Capital Market", *International Journal of Economic Research*, Volume 14, November 6, 2017, pp 27-38, p29

¹² Principle 1, 1.1, Sharī'ah Governance Framework for Islamic Financial Institutions, *BNM/RH/GL_012_3, Islamic Banking and Takaful Department*, BNM, 2010, p5

¹³Zulkifli, Hasan, Sharī'ah Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UU, (Durham Theses, Durham University, 2007). Retrieved <http://etheses.dur.ac.uk/810/>