



A CONTEMPORARY ANALYSIS ON THE  
PRACTICES OF SHARIAH REVIEW BY THE  
ISLAMIC BANKS IN MALAYSIA

BY

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A research paper submitted in fulfilment of the  
requirement for the degree of Master of Science in  
Islamic Banking and Finance

IIUM Institute of Islamic Banking and Finance  
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## ABSTRACT

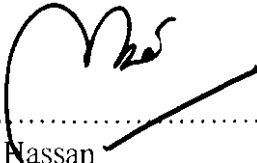
The key value proposition offered by Islamic banking and finance is an end-to-end Shariah compliant business environment. In supporting the above proposition, Bank Negara Malaysia (BNM) had on October 2010 issued the Shariah Governance Framework for Islamic Financial Institutions (the Framework) with the aims to strengthen the Shariah Governance process, accountability, decision making and independence of Shariah Committee. One of the important expectations of BNM via the Framework is for the Islamic Financial Institutions (IFIs) to outline and perform the functions of Shariah Risk Management control, Shariah Audit and Shariah Review for a comprehensive Shariah compliant environment in their operation and business activities. Shariah Review is a new mechanism in managing and controlling Shariah compliance and being allocated an important function to continuously assess Shariah compliance of IFIs' operations and business activities. Its introduction received several comments from the Islamic banking players, which stated that its function is more or less similar to Shariah Audit function that would entail to duplication of function. It was also proposed by the Islamic banking players to merge the Shariah review function with those under Shariah audit or Compliance. This paper focuses on the Shariah Review function performed by the Islamic banks for the past three years and to evaluate whether their Shariah review function is similar to those of Shariah audit and Compliance. Hence, the objective of this paper are (1) to analyze the existing practices of Shariah review function by the Islamic banks, (2) to identify gaps in the Shariah review function performed by Islamic banks in comparison to those stipulated in the Framework and (3) to gather feedbacks and comments from the Islamic banks on whether there is a need to propose enhancement to the Shariah review function of the Framework, which could contribute towards clarity and more effective Shariah review function in delivering its deliverables.

## ملخص البحث

إن القيمة الجوهرية التي تقدمها الصيرفة والمصارف الإسلامية هي بيئة عمل متوافقة مع الشريعة من البداية حتى النهاية. ودعماً لذلك فإن البنك المركزي الماليزي أوجد إطار التحكيم الشرعي في أكتوبر 2010 بهدف تقوية كلٍّ من عملية التحكيم الشرعي، والمساءلة، واتخاذ القرارات، واستقلالية اللجنة الشرعية. من أهم المخرجات المتوقعة من البنك المركزي الماليزي عبر هذا الإطار هو قيام المؤسسات المالية الإسلامية بتحديد وإجراء أعمال الإدارة الشرعية للمخاطر والتدقيق الحسابي الشرعي والمراجعة الشرعية وذلك بهدف إيجاد بيئة متوافقة مع الشريعة للقيام بعملياتها وأنشطتها التجارية. المراجعة الشرعية تعتبر آلية جديدة في إدارة والتحكم بالتوافق الشرعي حيث لها دور مهم في التقييم المستمر لتوافق عمليات المؤسسات المالية الإسلامية وأنشطتها التجارية مع الشريعة. عقب تطبيقها فقد حظت بالعديد من ردود الفعل من العاملين في الصيرفة الإسلامية حيث رأوا أن وظيفتها تشبه إلى حد كبير وظيفة التدقيق الحسابي الشرعي فاعتُبرت استنساخاً لها. كما اقترح العاملون في مجال الصيرفة الإسلامية القيام بدمج وظائف المراجعة الشرعية مع تلك المندرجة ضمن التدقيق الحسابي الشرعي أو التوافق الشرعي. هذا البحث يسعى للتركيز على المراجعة الشرعية التي قامت بها المصارف الإسلامية خلال السنوات الثلاثة الماضية وتحديد إن كانت عملية المراجعة الشرعية شبيهة بالتدقيق الحسابي الشرعي والتوافق الشرعي. بناء على ذلك فأهداف هذا البحث هي (1) تحليل الممارسات الحالية لعملية المراجعة الشرعية في البنوك الإسلامية، و(2) تحديد المفارقات في عملية المراجعة الشرعية التي تقوم بها المصارف الإسلامية مقارنة مع تلك المنصوصة في إطار التحكيم الشرعي، و(3) جمع المعنومات والملاحظات من المصارف الإسلامية بخصوص الحاجة إلى اقتراح تعزيز لعملية المراجعة الشرعية ضمن إطار التحكيم الشرعي حيث يُتوقع أن يسهم ذلك في المزيد من الوضوح والفاعلية لعملية المراجعة الشرعية في أداء مهامها.

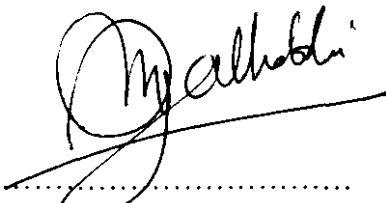
## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research for the degree of Master of Science in Islamic Banking and Finance.



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Supervisor

This research paper was submitted to the Institute of Islamic Banking and Finance and is accepted as a partial fulfilment of the requirements for the degree of Master of Science in Islamic Banking and Finance.

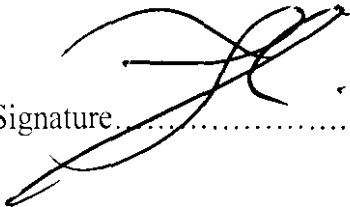


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## DECLARATION

I hereby declare that this research is the result of my own investigation, 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.

Author Name: Zariah Abu Samah

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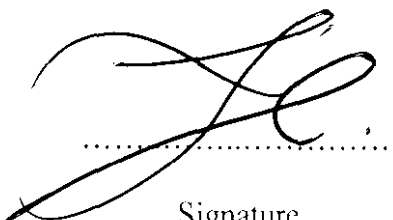
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# TABLE OF CONTENTS

Abstract.....	iii
Abstract in Arabic.....	iv
Approval page.....	v
Declaration.....	vi
Copyright Page.....	vii
Acknowledgement.....	viii
Table of Contents.....	ix
List of Tables.....	xi
List of Figures.....	xii
<b>CHAPTER 1: INTRODUCTION .....</b>	<b>1</b>
1.1 Background of Study .....	1
1.2 Problem Statement .....	3
1.3 Research Objectives .....	5
1.4 Research Questions .....	5
1.5 Scope of Research.....	6
1.6 Significant of Research.....	7
1.7 Limitation of Research .....	7
1.8 Organization of the Research.....	8
<b>CHAPTER 2: LITERATURE REVIEW .....</b>	<b>10</b>
2.0 Introduction .....	10
2.1 The Contemporary Operating Environment of Islamic Banking.....	11
2.1.1 Dual-Banking System.....	12
2.1.2 Impact of Dual-Banking System to Islamic Banking.....	13
2.1.2.1 Replication of Conventional Products.....	13
2.1.2.2 Product Pricing.....	15
2.2 Shariah Compliance .....	17
2.3 Shariah Review.....	21
2.4 Shariah Review - A Mechanism for Shariah Compliance in Products Development End-to-End Process .....	24
2.3 Conclusion .....	28
<b>CHAPTER 3: METHODOLOGY .....</b>	<b>29</b>
3.1 Introduction.....	29
3.2 Research Design .....	29
3.2.1 Qualitative Research Method .....	30
3.2.1.1 Questionnaires Method .....	30
3.2.1.2 Interview Method.....	31
3.3 Respondents and Interviewees .....	39
3.4 Conclusion .....	41



<b>CHAPTER 4: RESULTS AND FINDINGS</b> .....	<b>42</b>
4.1 Introduction.....	42
4.2 Interview Session.....	42
4.2.1 Attendance of the Interview Session .....	42
4.2.2 Tabulation of Results/Findings.....	43
4.2.3 Findings for the Five Questions.....	44
4.2.3.1 Findings for Question (1).....	45
4.2.3.2 Findings for Question (2).....	46
4.2.3.3 Findings for Question (3).....	49
4.2.3.4 Findings for Question (4).....	54
4.2.3.5 Findings for Question (5).....	55
4.3 Research Questionnaires.....	57
4.3.1 Response to the Research Questionnaires .....	57
4.3.2 Summary of Response for Questionnaires in Section A .....	58
4.3.3 Summary of Response for Questionnaires in Section B.....	59
4.3.4 Summary of Response for Questionnaires in Sub-Section B .....	66
4.3.5 Summary of Response for Questionnaires in Section C.....	68
4.3.6 Summary of Response for Questionnaires in Section D .....	69
4.3.7 Summary of Response for Questionnaires in Section E.....	73
4.3.8 Summary of Response for Questionnaires in Section F .....	75
4.3.9 Summary of Response for Questionnaires in Section G .....	75
4.3.10 Summary of Response for Questionnaires in Section H .....	77
4.4 Conclusion .....	77
<b>CHAPTER 5: CONCLUSION</b> .....	<b>79</b>
5.1 Summary of Research.....	79
5.1.1 Research Analysis (1).....	79
5.1.2 Research Analysis (2).....	81
5.1.3 Research Analysis (3).....	81
5.1.4 Research Analysis (4).....	82
5.2 Recommendation.....	83
<b>REFERENCES</b> .....	<b>89</b>

## LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
2.1	List of Islamic Banks in Malaysia	11
3.1	The Difference Between Shariah Review and Shariah Audit	32
3.2	List of Ten Selected Islamic Banks for the Research	39
4.1	Attendance During the Interview Session	43
4.2	Tabulation of Result and Finding	44
4.3	Summarization of Result and Finding	44
4.4	The Detail of Areas to be Reviewed	47
4.5	Staff Strength, Qualification and Number of Branches of Islamic Banks	52
4.6	Major Steps for Shariah Review Work Flow Process	54
4.7	Function of Shariah Review	58
4.8	Scope of Work of Shariah Review	59
4.9	The Work Flow Process of Shariah Review	66
4.10	Guidelines and References for Shariah Review	68
4.11	Qualification and Competencies of Shariah Review Officers	72
4.12	Percentages of Islamic Banks Performing Shariah Review According to the Shariah Governance Framework of BNM Requirement	74

## LIST OF FIGURES

<u>Figure No.</u>		<u>Page No.</u>
2.1	Shariah Governance Framework Model for Islamic Financial Institutions	22
3.1	Product Approval (pre and post) Processes	36
3.2	The Environment of Research Methodology	40
4.1	Shariah Review Platform for Product Implementation	47
4.2	Shariah Review Performed by Dedicated Risk and Compliance Officers	47
4.3	Focus rate for product development (pre product approval) review	61
4.4	Focus rate for product implementation (post product approval) Review	62
4.5	Focus rate for branch and business unit review	63
4.6	Focus rate for non-product related segment review	63
4.7	The overall focus areas of the Islamic banks in performing Shariah Review	65
4.8	Reporting structure of Shariah review of Shariah Governance Framework	70
4.9	Shariah Review Reporting Structure A	71
4.10	Shariah Review Reporting Structure B	71
4.11	Shariah Review Reporting Structure C	71
4.12	Qualification and knowledge of Shariah Review Officer	74

4.13	Qualification & Experience of Respondents	75
4.14	Length of service of respondents	76
4.15	Average Age of respondents of Shariah Review	76

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

Islamic banking and finance is to continue its growth domestically and internationally. There are significant efforts and commitments of the whole banking industry to increase and facilitate cross-border Islamic financial transactions with other global financial communities. On 1 April 2013, the Malaysia Islamic finance marketplace was introduced with a new brand identify, “Malaysia: World’s Islamic Marketplace”, to position Malaysia as an Islamic Market place to world. Significant growth for domestic Islamic banking industry was reported by Ministry of Finance via its economic report 2013/2014 of which the assets has grown by 13.0% to RM542.5 billion in 2013 from RM494.6 billion in 2012. Its deposit rose by 12.7% to RM416.0 billion as at August 2013, from RM386.2 billion in 2012. On 5 February 2014, Islamic Finance news has reported that Islamic banks in Malaysia are to growth further with the expectation of higher demand from SMEs and large corporate participating in infrastructure projects. This continuing growth environment of Islamic banking and finance is again a critical signal to tighten the enforcement of the requirement for Shariah governance in ensuring that the activities and the operations of the Islamic banks is at all times in compliance with the Shariah.

The most fundamental aspect of introducing Islamic banking and finance and the key difference between itself & the conventional banking is known as ‘Shariah compliance’. Its consistent features of prohibition of *riba* (interest), avoidance of *gharar* (uncertainty), prohibition of (*maysir* gambling), application of *al-bai* (trade and commerce) and prohibition in engaging production and related business of

prohibited communities such as liquor, pork etc. have been embodied into the rules and regulations governing the Islamic financing market. This also means that the services offered by the system such as risk-sharing, liquidity and information must also be Shariah compliant. Any violation of the Shariah principles in any of the Islamic banking and Finance operations and business transactions would lead to Shariah non-compliance risk and legal dispute which will affect the reputation and sustainability of the Islamic Banking and Finance Industry. As a matter of fact, Shariah non-compliance risk is considered to have impact and a significant portion in operational risk (IFSB, 2007). Hence, a robust Shariah governance system at the national and organizational levels is crucial for the avoidance of Shariah non-compliance risk.

Dynamic and comprehensive Shariah Governance is important as it performs an exclusive role in ensuring that the activities & operations of Islamic banks do not contravene with the Shariah. The next step would be an effective and independent oversight on Shariah compliance within the internal Management and the organization of Islamic bank. Being the main regulator, the Central Bank has undertaken an important task in 2010 with the issuance of a framework known as the Shariah Governance Framework (herein after referred as “the Framework”) with the enforcement date on 1 January 2011. The main objective of the Framework is to enforce and strengthen the Islamic Financial Institutions (herein after referred as “IFIs”) Shariah governance structures, processes and arrangements to ensure that all IFIs operations and business activities are in accordance with Shariah principles. Simultaneously, the framework enforced the requirement for the IFIs to institute a structured and comprehensive internal control and processes on handling and addressing Shariah non-compliance in a holistic manner.

The whole structure and pillars of the Framework stood strongly on the foundation of Shariah compliance and research platform, with Shariah Risk Management, Shariah Audit and Shariah Review being the mechanisms to ensure Shariah compliance in the operations and business activities of the IFIs. Shariah Review is considered a new mechanism for Shariah compliance under the Framework in a collaboration manner with Shariah Audit and Shariah Risk Management. However, its importance and enforcement is crucial due to:- (a) Shariah Review is to conduct a regular assessment on a continuous basis, a review on activities and operation carried out by IFIs do not contravene with the Shariah, and (b) Shariah Review is in the category of ‘Second Line of Defense’ for banking industry to safeguarding internal risk control framework. Hence, it is vital for IFIs to conduct Shariah Review in a comprehensive and holistic manner.

This study focuses on Shariah Review and its important contribution towards managing and controlling of Shariah compliance in Islamic banks. Basically, it covers topics related to the practices of Shariah Review by the Islamic banks in Malaysia in relation to its main function, scope, processes and independency of its deliverables in comparison to those stipulated in the Framework.

## **1.2 PROBLEM STATEMENT**

The enforcement of Shariah Review functions by the Framework in January 2011 received several feedbacks and comments from the Islamic banking industry. **Firstly**, Shariah Review function is similar to Shariah Audit function, which would entail to duplication of function. **Secondly**, Shariah Audit framework, processes and documentation were being adopted for Shariah Review, as there is no structured and comprehensive guideline for Shariah Review in comparison to Shariah Audit. In

performing Shariah Audit, the Islamic banks used the conventional Audit framework, guidelines, charter, and other related documentation as their basis of guidelines and references. **Thirdly**, the Shariah Review function was proposed to be performed by Shariah Audit or Compliance Division of the Islamic Banks' parent bank. The above feedbacks and comments from the Islamic banking industry have created an urgent call to analyze on how the current practices of Shariah Review undertaken by the Islamic banks.

Another critical issue faced by the Islamic Bank is Shariah non-compliance risk. It is an emerging risk and a challenging issue which require high management prioritized and effective & comprehensive mitigation tools. The concepts of Profit Sharing under the Shariah contract of *Mudarabah*, the Profit and Loss Sharing (PLS) under the Shariah contract of *Musharakah* and the sale-based contracts of *Murabahah* and *Bai-inah* for their financing and deposit products, have contributed to a more complex risk management scenario. According to Islamic Financial Services Board (herein after referred as "IFSB")(2005), Shariah non-compliance being part of operational risk arises due to the failure to comply with Shariah rules and principles as determined by Shariah Advisor of any relevant body of jurisdiction of the IFIs or the relevant body in the jurisdiction in which the IFIs operations. Hence, enforcement of Shariah Review function in Islamic banks is regarded as a positive initiative in strengthening the Shariah compliance foundation, processes and documentation. This is vital because the failure to manage the end-to-end Shariah non-compliance risk would cause the affected business transaction to be considered as null and void, and the income generated from that particular transaction is required to be purified via channeling it to charity.



This study is looking into the practices of Shariah Review by the Islamic banks in Malaysia with benchmarking the practices against the Framework. Identified gaps (if any) between the practices and the Framework would provide an opportunity in enhancing the existing practices of Shariah Review practiced by the Islamic banks and/or an enhancement to the Framework for a more user friendly guidelines or framework to the Islamic banks.

### **1.3 RESEARCH OBJECTIVE**

The above problem statement environment has built up the basis for the main objectives of this research / study as follows:-

- (1) To analyze the existing practices of Shariah Review by the Islamic banks in comparison with those stipulated in the Framework with respect to Shariah Review function, review scope, mode of assessment, review processes and independency of its deliverables.
- (2) To identify gaps in the practices of Shariah Review by the Islamic banks in comparison to the requirements of Shariah Review in the Framework.
- (3) To evaluate the need to propose further enhancement with supporting guidelines to the Shariah Review requirement of the Framework for clarity, standardization and consistency in the practices of Shariah Review throughout the Islamic banking industry.

### **1.4 RESEARCH QUESTION**

As stipulated in the Framework and Accounting and Auditing Organisation for Islamic Financial Institutions (herein after referred as “AAOIFI”) governance standards, the main objective of Shariah Review is to ensure that the activities and the

operations of the IFIs do not contravene the Shariah principles. Contravention of the Shariah principles would lead to Shariah non-compliance risk which would cause a negative impact to the overall performance of the IFIs. All profits of Shariah non-compliance transactions cannot be recognized as income. Hence, it is crucial to analyze the following concerns in relation to the practices of Shariah Review by the Islamic banks:-

- a) Are the existing practices of Shariah Review by the Islamic banks meeting the standards requirement of the Framework?
- b) Are there gaps in the current practices of Shariah Review by the Islamic banks in comparison to the requirement of the Framework?
- c) Would there be a need to enhance any parts, elements & requirements of the Shariah Review in the Framework for effective Shariah Review deliverables by the Islamic banks?

## **1.5 SCOPE OF RESEARCH**

The main source and reference of this research is the Framework which provide comprehensive guidance for the board, Shariah Committee and management of IFIs in discharging their duties in Shariah matters. This research focuses on one of the Shariah compliance management mechanisms as stipulated in the Framework, which is known as Shariah Review. Being the latest mechanism for Shariah compliance, in comparison to Shariah Audit and Shariah Risk Management, it is important for this research to analyze on the practices of Shariah Review with a focus to the Islamic banks. The findings of this research would justify the level of compliance by the Islamic banks in performing Shariah Review, in comparison to the requirement of the Framework.

## **1.6 SIGNIFICANCE OF THE RESEARCH**

Shariah compliance is perceived to be the rule of thumb for Islamic banking and finance, which requires comprehensive and effective management and control mechanism. Being one of the important mechanisms in ensuring Shariah compliance in the activities and operations of the Islamic banks, there is an urgent need for the Islamic banks to fully understand the requirement to perform Shariah Review including its rules and guidelines as laid down in Section VI of the Framework. A structured and comprehensive framework and operational guidelines for Shariah Review with its execution performed by knowledgeable and skilled resources would gradually lead to elimination of Shariah non-compliance risk.

This research work would be significant specifically to the Islamic banks and generally to other researches, as it would:-

- i) Increase the understanding and knowledge of the Islamic banks on Shariah Review and its significance in controlling and managing Shariah non-compliance risk in Islamic banks.
- ii) Identify gaps in the current practices of Shariah Review by Islamic banks, for further enhancement and conformity to the standard requirement of the Framework.
- iii) Upgrade the credibility of Shariah Review unit/section/department in delivering Shariah Review deliverables.

## **1.7 LIMITATION OF RESEARCH**

This research is primarily a qualitative research analyzing related literatures and conducting of interviews with selected personnel of the Islamic banks in supporting the research topic. Majority of the available literatures discussed and deliberated

Shariah Review within the requirement of the Framework together with the present of Shariah Audit and Shariah Committee. Above all, the principle limitation of this research is the inability to have all the sixteen Islamic banks to participate in this research. Only ten of them were able to allocate their precious time for the interview sessions and responding to the research questionnaires. The remaining six Islamic banks were unable to confirm their commitment to participate in this research due to their tight working schedules. Hence, the results and findings generated from the participation of the selected ten Islamic banks in this research could be taken as representing all Islamic banks, because the ten participating Islamic banks in this research represent 63% of the Islamic banks in Malaysia.

## **1.8 ORGANISATION OF THE RESEARCH**

Chapter two which is on literature review is organized into four sections. Section 2.1 provides information on the contemporary operating environment of Islamic banking with a focus to Islamic banks. It describes on the dual banking system and its impact to the overall activities and operation of Islamic banks in relation to product and product pricing. It is important for Shariah Review officers to be in the known of the actual operating environment of Islamic banks to ease out their review function. Section 2.2 is on the deliberation of Shariah compliance in relation to its definition, importance and requirement as per the Framework. This section also highlighted on the environment of Shariah non-compliance risk and its implication to the Islamic banks. Shariah Review is described in Section 2.3 with the importance of its function and followed by the differences between Shariah Review and Shariah Audit for more clarity to the Islamic banks. More information on Shariah Review is deliberated in Section 2.4 in relation to its function in end-to-end process for product development

process and its important role in the second line of defence for controlling and managing Shariah non-compliance risk.

Chapter three is mainly on methodology of the research and organized into 2 sections. Section 3.2 described on research design and the reasoning why the qualitative, interview and questionnaires methods were chosen. This section further explained on the selected questions for the interview session and the contents of the questionnaires. Section 3.3 is on the information of the respondents for the questionnaires and the interviewees for the interview sessions.

Chapter four provides the results and findings of the research under two sections. Section 4.2 deals on the result and findings of ten interview sessions with the personnel of the ten selected Islamic banks. The interview sessions were conducted based on five selected questions directly related to the Shariah Review requirements of the Framework. Section 4.3 is on the responses to the research questionnaires by the respondents from the selected ten Islamic banks. The questionnaire was divided into 8 sections comprising of standard of requirements related to the Shariah Review of the Framework.

The conclusion for this research is deliberated in Chapter five under two sections. Section 5.1 is on the summary of the overall research analysis with major findings on gaps on the current practices of Shariah Review by the Islamic banks to those in the Framework. The last section 5.2 outlines the recommendations based on the overall research analysis for future enhancement of Shariah Review practices throughout the Islamic banking industry.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 INTRODUCTION**

This chapter comprises of four sections. Section 2.1 provides information on the contemporary operating environment of the Islamic banking with four sub-sections explaining on the dual-banking system and its impact to the operation of the Islamic banks, which had resulted to an environment of replicating conventional products coupled with product pricing being benchmarked against the interest rate of conventional products. This is important information for the Shariah Review officers as it would provide better understanding on the current operating environment of Islamic banks and the related banking portfolios to be reviewed. Section 2.2 deals on Shariah compliance with deliberation of its importance for Islamic banks with related literatures supporting its enforcement to be seriously managed within this section is a brief highlight on Shariah non-compliance risk and its implication to the activities and operation of Islamic banks.

Shariah Review is an agenda for section 2.3 which mostly related to its requirement as stipulated in the Framework including the related literature in the IFSB and AAOIFI on standard requirement for Shariah Review. This is followed by the information on the differences between Shariah Review and Shariah Audit in term of definition and function. Section 2.4 specifically focuses on the Shariah Review for the end-to-end product development process in relation to factors of operational risk.

## 2.1 THE CONTEMPORARY OPERATING ENVIRONMENT OF ISLAMIC BANKING

Islamic banking is operating in the same environment and society, where conventional banking is operating, and, it performs the function which is expected from a financial institution. Saving mobilization from the savers (Surplus Unit) to the entrepreneurs (Deficit Unit) and providing of general banking services such as remittances/fund transfer, safe-keeping of valuables financial advices and other fee-based services are the major functions performed by Islamic banks, which is similar to those of the conventional banks. They are over 300 Islamic Financial Institutions operating in 75 countries with total assets reaching USD1.8 trillion in 2013, with an average annual growth of 15%-20% (Malaysia International Financial Centre (MIFC, January 2014). Apart from Sudan and Iran, the Islamic banks globally are operating side by side with the conventional banks in an environment of dual-banking system.

Islamic banking development in Malaysia has gone through maturity process, well engaged to the Bank Negara Malaysia (herein after referred as “BNM”) and well-regulated in a dual-banking system environment. Currently, there are sixteen Islamic banks, of which 10 are locally-owned, whilst 6 are foreign-owned as listed below:-

**Table 2.1 List of Islamic banks in Malaysia**

No	Locally-Owned IBs	No	Foreign-Owned IBs
1	Affin Islamic Bank Bhd	11	Al-Rajhi Banking & Investment Corporation (Malaysia) Berhad
2	Alliance Islamic Bank Berhad	12	Asian Finance Bank Berhad
3	AmIslamic Bank Berhad	13	HSBC Amanah Malaysia Berhad
4	Bank Islam Malaysia Berhad	14	Kuwait Finance House (Malaysia) Berhad
5	Bank Muamalat Malaysia Berhad	15	OCBC Al-Amin Bank Berhad
6	CIMB Islamic Bank Berhad	16	Standard Chartered Saadiq Berhad
7	Hong Leong Islamic Bank Berhad		
8	Maybank Islamic Berhad		
9	Public Islamic Bank Berhad		

No	Locally-Owned IBs	No	Foreign-Owned IBs
10	RHB Islamic Bank Berhad		

Adopted from BNM website.

Growing within the dual-banking system has speed-up the growth of the above sixteen Islamic banks with some positive and negative impact to their overall activities and operations.

### 2.1.1 Dual-Banking System

Dual-banking system emerged in Malaysia, when Islamic banking was first introduced in 1983 and the first Islamic bank known as “Bank Islam Malaysia Berhad”, operating side-by-side with the conventional banks till today. Operating in this dual-banking system, has automatically forced Islamic banking to ‘fit-in’ itself into the conventional banking operating environment which is surrounded by the following banking characteristics and features:-

- (a) Interest-based banking operation.
- (b) Offered debt-based loan and deposit products.
- (c) Interest income growth based on ‘Fractional Reserve Banking (FRB)’ system.
- (d) Fiat money /currency which is treated as a commodity in fiat monetary system.

The above environment is further supported by Meera & Larbain (2006), when they deliberated on the three main features of the current monetary system, which have been much criticized by the Muslim Scholars. They are (1) Fiat Money comprises of paper money, bank money and electronic money, (2) Interest, and (3) Fractional Reserve Banking (FRB) for multiple credit creation. Islamic banking/ Islamic banks are operating in this same environment and created money in the same form, but the newly created money is used according to the adopted Shariah principles and contracts.