



The Procedures of Appointment and Cessation of the *Shariah* Committee Member of the Islamic Banks and *Takaful* Companies in Malaysia: Legal Analysis

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ABSTRACT

The *Shariah* Committee (SC) is entrusted with the duties and responsibilities to ensure that the Islamic banking and *Takaful* institutions comply with the *Shariah* principles in its operations and business activities. The procedures of appointment and cessation are among the important points that should be discussed in relation to the SC. Such elements reflect the effectiveness, objectivity and independence of the SC in discharging their duties. In Malaysia the appointment, re-appointment and cessation of the member of the SC are regulated by legislations governing Islamic financial business. With the objective to scrutinize the procedures prescribed by legislations, this study adopted legal research method. By using content analysis, the study found that several loopholes existed in the existing legislations which should be addressed by relevant authoritative. This is significant in order to strengthen the legal framework as well as to avoid any legal conflict in the future.

Keywords: *Shariah* Committee, Appointment of *Shariah* Committee, Islamic Finance

JEL Classifications: G02, G2

1. INTRODUCTION

The existence of the *Shariah* Committee (SC) in the Islamic banks and *Takaful* companies is essential to monitor the *Shariah* matters and to ensure that the practices and activities of the institutions are comply with *Shariah* requirement (Ali and Odierno, 2008). It is to ensure that the Islamic bank's practices comply with the Qur'anic sanctions and to prevent such institution from involvement in any unethical investment (Brown et al., 2007). The existence of the SC will enhance the credibility of the Islamic banks (Siddiqi, 2007). It is also considered as a prerequisite to the commencement of the *Takaful* operation (Billah, 2007). However, the setting up of the SC is different from one county to another. The appointment method is different also from one bank to another. In addition, for some countries, the establishment of such advisory board is deemed unnecessary (Haron and Shanmugam, 2001).

According to Article 3 of Governance Standards for Islamic Financial Institutions No. 1, *Sharia* Supervisory Board: Appointment, Composition and Report, which issued by Accounting and Auditing Organization for Islamic Financial Institutions, specifies that the appointment of the SC member is made by the shareholders of the institution in its General Meeting. The appointment made by shareholders relies on the recommendation of the Board of Directors (BoD) for deliberation and endorsement in the General Meeting. The local legislation and regulations should also be considered. Pursuant to this standard, Even though the shareholders have a power to appoint the members of the SC, the candidature of such members still relies on the nomination by the BoD (Bakar, 2002).

The other method is the appointment made by the BoD of the institution (Hammad, 2006). In several situations, the appointment

of members is made by the manager of the bank, government or other parties (Dawud, 1996). More than 70% of SC were appointed by the BoD compared to the appointments made by the shareholders. Even for some institutions, the appointment is made by the management, the government and the nomination committee (NC) (Hasan, 2011).

Although the appointment of the members of the SC can be done in several ways, the method of selection by shareholders in the General Meeting is perceived to be the most practical way. This method enables the delegates to select the entrusted individuals to be appointed as members of the SC (Hammad, 2006). This can also avoid any influence by the management board during the appointment since the management board does not have the authority to appoint or to dismiss them (Bakar, 2002). Another reason is to ensure the effectiveness and the independence of the SC to carry out their duties and responsibilities (Al-Ba'li, 1983).

In contrast, the appointment of the SC if made by the BoD will establish a link between the two parties which could lead to internal pressure from the BoD on the SC in discharging their duties. Integrity should be constantly practised by the institutions. Any element which may lead to the conflict of interest should be avoided (Laldin, 2009). Therefore, it can be observed that, the selection of SC made by the shareholders is one of the mechanisms to ensure the independence of the SC in discharging their duties.

2. THE PROCEDURES OF AN APPOINTMENT AND REAPPOINTMENT OF THE MEMBER OF THE SC OF ISLAMIC BANKS AND TAKAFUL COMPANIES IN MALAYSIA

Since 1983-2004, the SC established by Islamic banks and *Takaful* companies were regulated by Islamic Banking Act (IBA) 1983 (Act 276) and *Takaful* Act (TA) 1984 (Act 312) respectively. At that time, the regulatory framework existed in general form. Islamic banks and *Takaful* operators were required to establish their own SC. In addition, the statutes require the Islamic banks and *Takaful* operators to include additional clause for the establishment of the SC in their Article of Association. Similarly, both acts in a general manner specified the role of the SC as to advise the institution pertaining to Islamic financial business (IBA, 3(5)(b); TA, 8(5)(b)). Due to the generality of the legal provisions, matters relating to the appointment procedures of the SC were subject to the discretion of the institution to determine it. Nevertheless, this is no longer an issue, since IBA and TA are repealed by Islamic Financial Services Act (IFSA) 2013 (Act 759). In short, IFSA has better provisions in dealing with the affairs of the SC compared to the repealed statutes particularly relating to the appointment of SC members and the cessation as member of the SC.

Apart from statute, the SC have been regulated by several Guidelines issued by Central Bank of Malaysia (CBM). In December 2004, CBM has issued Guidelines on the Governance of SC for the Islamic Financial Institutions (BNM/RH/GL/012-1)

(GPS 1) which clarified significant aspects relating to the SC including the appointment procedures. However, effectively from 1st January 2011, GPS 1 is no longer applicable parallel with the implementation of *Shariah* Governance Framework (SGF) for Islamic Financial Institutions (BNM/RH/GL 012-3).

In addition to SGF, there are other Guidelines which should be observed by the IFI in regulating SC including the policy on Fit and Proper Criteria (BNM/RH/GL 018-5), Guidelines on Introduction of New Products (BNM/RH/GL 008-3), Guidelines on Introduction of New Products for Insurance Companies and *Takaful* Operators (BNM/RH/GL/010-14), Guidelines on Applications for Registration and Operation of Re-*Takaful* Operator (BNM/RH/GL/004-12), Guidelines on Financial Reporting for Islamic Banking Institutions (BNM/RH/CP 022-1), Guidelines on Financial Reporting for Development Financial Institutions (BNM/RH/GL 005-16), Guidelines on Financial Reporting for *Takaful* Operators (BNM/RH/GL 004-6) and Guidelines on Corporate Governance for Licensed Islamic (GP1-i) (BNM/RH/GL 002-1).

In general, IFSA does not explain in detail the procedures to be followed except that it stated that any appointment, reappointment, or the acceptance of the appointment shall be subject to prior written approval from CBM (IFSA, 31). On the other hand, SGF provides more specific procedures to be adopted by the Islamic banks and *Takaful* companies in this regard. The appointment and reappointment procedures are pursuant to Paragraph 2.3, Paragraph 3.8 and Appendix 2 of the SGF.

The procedures begin with a vetting process conducted by the institutions to ensure that the proposed person is qualified and deemed fit and proper to be appointed as a member of SC (SGF, Appendix 2). In this regard, the NC of the institution plays an important role in screening the proposed individual in order to ensure that the person meets the requirements laid down by SGF and eligible for appointment as a member of the SC (GP1-i). If the person is eligible for such position, the NC will recommend the proposed person to the BoD. The BoD, upon recommendation of its NC, shall nominate the appointment of the proposed person to CBM (SGF, Appendix 2). In this regard, the final decision as to who shall be nominated to CBM is the responsibility of the BoD (GP1-i, Appendix 2).

The application for the appointment of the proposed person shall be submitted to the CBM at least sixty days before the proposed date of appointment using the specific form namely BNM/JKS 1 as enclosed in Appendix 8 of SGF (SGF, Appendix 2). Application must be submitted to CBM for approval from CBM and the *Shariah* Advisory Council (SAC) of CBM before a proposed person is appointed as a member of the SC. Prior written approval of CBM and the SAC is necessary before the appointment of the member of SC is made by institutions. CBM may also impose necessary conditions it deems fit in addition to the requirements stipulated in SGF. Failure to comply with any conditions shall nullify the approval (SGF, Appendix 2; GP1-i, Paragraph 2.10(vi)). Finally, after acquiring written approval of CBM and the SAC, the appointment of the member of the SC shall be made by the

BoD (SGF, Paragraph 2.3 and 3.8 of Part 2; GP1-i, Subparagraph 2.10(vi)).

In the case of reappointment of any member of the SC, the same process should be observed by the IFI. Yet there are additional requirements to be observed by the member of the SC as well as the institutions. SGF stipulates that, upon expiry of the term and until the CBM grants approval for renewal of term to any member of the SC, the respective member is not considered as a member of the SC and is not allowed to perform his role as a member of the SC of the said institution. Meanwhile, the institution must refrain from making any public announcements about any proposed changes of its members of the SC prior to obtaining the CBM's written consent for the proposed changes (SGF, Appendix 2).

Based on the above procedures of appointment and reappointment of a member of the SC, it can be concluded that the NC plays a significant role in screening and ensuring that the proposed person for appointment and reappointment as a member of the SC meets the qualifications as prescribed by the law. Even though the appointment and reappointment of a member of the SC is made by the BoD, the final say on whether a proposed person is eligible for appointment or reappointment as a member of the SC is absolutely subject to the decision and written approval from CBM and the SAC.

3. THE CESSATION AS MEMBER OF THE SC

Prior to IFSA, the matters pertaining to the cessation of members of SC are stipulated in SGF. Pursuant to SGF, two ways of cessation has been provided, including the resignation by the member and the dismissal by the institution. The resignation and removal of member of SC shall be made by the BoD, subject to approval of CBM and the SAC (SGF, Paragraph 3.8 of Part 2). In this regard, the institution is required to notify CBM of such resignation and dismissal of any member together with the reasons of such resignation and termination. Such resignation or dismissal will only take effect upon approval from CBM and the SAC (SGF, Appendix 2).

Likewise, SGF reserves a right to CBM together with the approval from the SAC to disqualify any member of SC who fails to meet the requirements as stipulated in SGF including:

- a. Acting in a manner which may cast doubt on his fitness to hold such position;
- b. Failing to attend 75% of the meeting in a year without reasonable excuse;
- c. Being declared a bankrupt or a petition under bankruptcy laws is filed against him;
- d. Being found guilty for any serious criminal offence or any other offence punishable with imprisonment of one year or more; or
- e. Being subject to any order of detention, supervision, restricted residence or banishment.

The institution shall terminate the appointment of such member of the SC if such member is found to have become liable

to disqualification or otherwise becomes unfit to hold such appointment as provided in SGF, and/or in the letter of approval from CBM and SAC (SGF, Appendix 2).

According to IFSA, subsection 33(1) explains the circumstances that a member of a SC shall cease to be a member when:

- a. Such a member resigns as a member;
- b. The institution terminates the appointment of such member;
- c. Such member is disqualified pursuant to any standards specified by CBM under Subparagraph 29(2)(a)(ii); or
- d. Such member no longer meets the fit and proper requirements as may be specified by the CBM under Subparagraph 29(2)(a)(ii) to the satisfaction of CBM.

Any member who resigns from his position or aware that he has been disqualified by virtue of any standards issued by CBM automatically ceases to be a member of a SC. In this regard, the disqualification is referred to SGF as mentioned earlier. In both events, such member shall notify CBM of that fact and the reasons thereof immediately or in any case not later than fourteen days of such circumstance (IFSA, 33(2)). In the case of termination by institution, prior written approval from CBM is needed (IFSA, 33(3)). Similarly, the institution shall notify CBM in writing of that fact and reasons of such termination immediately or in any case not later than fourteen days from the date of such cessation (IFSA, 34(1)).

IFSA also empowers CBM to issue an order in writing to remove any member of the SC if (IFSA, 33(4)):

- a. Such member is disqualified pursuant to any standards specified by CBM under Subparagraph 29(2)(a)(ii) but still hold a position as a member of a SC;
- b. Such member no longer meets the fit and proper requirements as may be specified by CBM under Subparagraph 29(2)(a)(ii) to the satisfaction of CBM but still holding a position as a member of a SC; or
- c. Such member has contravened any provision of IFSA or failed to comply with any standards applicable to him.

However, if CBM proposes to take any action against any member of a SC pursuant to subsection 33(4), CBM is subject to procedures set out in section 273 of IFSA as follows (IFSA, 273(1)(b)):

- a. CBM shall serve on such person a written notice of the proposed action (IFSA, 273(1)).
- b. The written notice shall set out:
 - i. The action that CBM proposes to take and the grounds for such action (IFSA, 273(2)(a));
 - ii. The period within which such member may make a written representation to CBM (IFSA, 273(2)(b));
- c. Such member shall be given a reasonable opportunity to make a written representation to CBM, by submitting such representation to CBM within fourteen days from the date of the notice by CBM (IFSA, 273(3)).
- d. After the expiry of the period of fourteen days from the date of the notice by CBM and considering any written representation from such member, CBM shall decide whether to proceed with the proposed action or a variation of such action or take no further action (IFSA, 273(4)).

- e. CBM shall give such member a written notice of the decision and the decision shall take effect from the date specified in the notice (IFSA, 273(5)).
- f. CBM may first take the proposed action and the opportunity to make representations shall be given immediately after the action has been taken if any delay in taking the proposed action would be detrimental to the interests of any authorized person, *Takaful* participants, participants, creditors, the financial system or the public generally (IFSA, 273(6)). In this regard, CBM may confirm, amend or revoke the exercise of action taken in consequence of representations made by such member (IFSA, 273(7)).

The removal of a member of a SC by CBM shall be lawful and valid notwithstanding anything contained in a contract of service or any other agreement relating to his appointment and whether or not made or provided for under any written law, and a person so removed from office shall not be entitled to claim compensation for the loss of office (IFSA, 33(5)).

IFSA requires the institution to notify CBM in writing the cessation of any member of a SC including the fact and the reasons of such cessation immediately or in any case not later than fourteen days from the date of such cessation (IFSA, 34(1)). Subsequently, the institution shall appoint a new member of its SC in accordance with section 31 within such period as may be specified by CBM (IFSA, 34(2)).

Based on the above discussion, it can be observed that IFSA has better provisions in regulating the cessation of a member of the SC compared to SGF. IFSA empowers CBM to remove any member of the SC if such member is disqualified or no longer meets the fit and proper requirements pursuant to any standards specified by CBM even the institution still retains such member in its SC. No such right is provided under SGF which only reserves right to CBM to disqualify any members, but the termination is done by the institution. In addition, IFSA provides the specific procedures to be observed by CBM in removing any members of SC.

However, no such specific procedures are prescribed by IFSA as well as SGF to be observed by the institution in the event institution terminates any member of its SC. The specific procedures are significant to enable such member to be informed that such action will be taken against him and give him the right to make representation against the proposed action taken by the institution. In addition, this will facilitate CBM in approving the termination that will be done by the institution is based on reasonable grounds and is recognized by the law.

It would be better if in the case of dismissal by the institution, the same procedures as apply in the case of termination by CBM are used. For examples, institution serves on such a member a written notice of the proposed action to take and the grounds for such action. In addition, the notice also should state the period within which such member may make a written representation to the institution.

In this regard, such member shall be given a reasonable opportunity to make a written representation to the institution, by submitting

such representation to the institution within fourteen days from the date of the notice by the institution. Upon the expiry of the period of fourteen days from the date of the notice by the institution and considering any written representation from such member, the institution shall decide whether to proceed with the proposed action or a variation of such action or take no further action. If the institution decides to proceed with the termination, the institution should notify CBM on such termination. Finally, upon approval from CBM and the SAC, the institution should give such member a written notice of the decision and the decision shall take effect from the date specified in the notice.

Hence, it is highly desirable if CBM improves the existing procedures relating to the termination of membership of the SC by the institution. Such procedures may indirectly avoid any wrongful or unjustified termination taken by the institution against any member of the SC.

4. CONCLUSION

Based on this paper, it can be seen that IFSA and the Guidelines are complementary to each other in regulating the appointment, reappointment and cessation of the member of the SC. Although the above provisions of IFSA and guidelines are good in regulating the legal aspects of the SC, the study reveals that there are several deficiencies which still need to be improved. The institution in appointing a member of SC shall ensure that the process should be done carefully by using an appropriate method. Moreover, the appointment process must be done independently and not be influenced by any parties. The SC shall not expose themselves to any situations which may lead them to conflict of interest and loss of freedom in performing their duties. In relation to cessation of SC, the standard procedures should be created to be adopted by the institutions in the event of the termination of any SC member made by the institution.

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