

# **The Process of Shari‘ah Assurance in the Product Offering: Some Important Notes for Indonesian and Malaysian Islamic Banking Practice**

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*Shari‘ah compliance is one of the important legal and fiduciary duties of Islamic banks. Its importance is growing in the wake of the challenging business environment and the increasing needs for innovative products and instruments faced by Islamic banks. The present paper seeks to analyze the process and procedures for Shari‘ah assurance in the product offering in Islamic banking sector in Indonesia and Malaysia. Starting with the theoretical overview of the Shari‘ah assurance, the regulatory framework designated to cater such processes and procedures are then mapped and evaluated. Having this at hand, practical implementations are discussed to draw any distinctive features in both jurisdictions. Lastly, suggestions are presented to be proportionally adopted for the purpose of achieving better process and procedures of Shari‘ah assurance in the product offering in Islamic banking sector in both, Indonesia and Malaysia.*

## **1. Introduction**

The discussion in this paper is not designated to cover all the aspects of Shari‘ah compliant corporate governance, which may be very broad. As the topic of the article suggests, the discussion is specifically directed to the duty and responsibility of Shari‘ah board<sup>3</sup> members pertaining to the process that Shari‘ah compliance is ensured within Islamic banking. As such, the deliberation on Shari‘ah compliance cannot be separated from the discussion on Shari‘ah compliant corporate governance.

Apart from diversity in models of the Shari‘ah board (referred to as Board here in after) across various countries, there are some common methods and procedures that the Board members undertake to examine and ascertain Shari‘ah compliance of the products and operations of Islamic banking. These methods and procedures are called instruments for supervision which, according to Abd al-Hamid al-Ba‘li , are three:<sup>4</sup>

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<sup>3</sup> Shari‘ah board is the general term for a certain body which is responsible to advise or supervise the Shari‘ah aspects of Islamic banking. To be specific, there will be some different names in these two countries, like Shari‘ah committee in Malaysian banking industry and Shari‘ah advisory council within Bank Negara Malaysia, While in Indonesia, the Shari‘ah supervisory council within Islamic banking industry and national Shari‘ah council at national level.

<sup>4</sup> ‘al-Ba‘li, (2003).

- 1) Researching and evaluating the operations of the bank
- 2) Issuing verdicts relating to the products and operations, as and when necessary.
- 3) Withdrawing or cancelling former decisions and operations, which are not in line with Shari'ah principles.

To achieve the effectiveness in Shari'ah supervision, it is utmost necessary for the Board to examine the whole aspects related to the operations of the bank and to ensure that these are according to Shari'ah principles. This supervision is not limited solely in giving opinions or issuing *fatwās* or advices before certain products are launched by the bank, rather it also encompasses reviewing and auditing of the operations after the products have been launched.

For these reasons and irrespective of the method of supervision that may be adopted, pre-launch, on-going, and post-launch supervisions are needed.<sup>5</sup> Pre-launch supervision means ascertaining Shari'ah compliance through analyzing portfolios and the simulation of the products. On-going supervision means the control along the practical operations of the banking business, such as how various financial contracts are factually undertaken by the parties involved. Post-launch supervision means the rechecking after the bankig business is being undertaken. Thus the compliance to Shari'ah can be assured through the three step procedure.<sup>6</sup>

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), has devised a set of legal framework to ascertain that the products and operations of Islamic banks comply to Shari'ah principles. The Islamic Banks have therefore associated prominent scholars and experts in their Shari'ah boards and assigned them with the responsibility to ascertain compliance to Shari'ah, particularly in the following aspects:<sup>7</sup>

- (a) Planning review procedures for adoption by the Islamic banks and financial institutions.
- (b) Executing review procedures and preparation as well as review of working papers.
- (c) Documenting conclusions and reports after the review has been completed.

In particular reference to the review procedures following steps must be undertaken:<sup>8</sup>

- i) Understanding the management's awareness, its commitment and compliance to control procedures for adherence to the Shari'ah.
- ii) Reviewing contracts, agreements, etc.

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<sup>5</sup> Abu Ghuddah, (2002), p.22.

<sup>6</sup> In auditing terminology, certifying permissible financial instruments through *fatwās* is called "ex-ante Shari'ah audit", whereas verifying that transactions comply with issued *fatwās* is called "ex-post Shari'ah audit". Wafik Grais and Matteo Pellegrini (2006).

<sup>7</sup> AAOIFI (1423H-2002), p.16.

<sup>8</sup> AAOIFI, Governance Standard, p. 16.

- iii) Ascertaining whether transactions are authorized by Sharī'ah board.
- iv) Reviewing other information and reports issued.
- v) Consultation/coordination with advisors, such as external auditors.
- vi) Discussing findings with the management of the Bank.

It is clear from the above procedures that the Board members are required to collaborate intensively with other boards or parties relevant to the banking business, including external auditors. It again shows that the assurance of Sharī'ah compliance is an inter-divisional responsibility in which the Boards cannot work alone.

To substantiate the procedures of Sharī'ah review, the Islamic Financial Service Board (IFSB) recommends an appropriate mechanism in obtaining rulings from Sharī'ah scholars, applying fatwās and monitoring Sharī'ah compliance in all aspects of the Islamic banking activities. In this regards, two mechanisms are important for assuring Sharī'ah compliance:<sup>9</sup>

- Scrutiny of all financial transactions carried out by the Islamic banks, both before (ex ante) and after (ex post) aspects
- Watching the operations of the Islamic bank, including investment policies, disposal of non- Sharī'ah compliant income, charitable activities, etc.

It is interesting to note that both AAOIFI and IFSB have focused on similar point as also emphasized by 'Abd al-Hamid al-Bā'li, albeit with slight improvements made by the two relevant authorities.

The common problems faced by the Board members is how to monitor intensively the activities of the bank. It should be understood that the existence of the Board is essentially needed by the bank, despite the fact that it is created merely to fulfill the requirements of obtaining a license. Therefore, the ignorance of Board members towards the issues related to Sharī'ah compliance may be deemed as failure of the Board to accomplish its basic mission. On the other hand, it seems difficult for members of the Board to closely understand the practical operations of the Islamic banking business when certain methods of monitoring are not available .

For the purpose of providing efficient supervision in Islamic banking, it is proposed that a permanent office of the Board be established within the premises of the bank that will facilitate the members to check and review all products and related documentations. This will enable the board members, via assistance of an administrative officer as in-charge for the job, to monitor the activities of the bank. In addition, it may be possible to arrange periodical (regular) meetings of the Board with the management of the bank to discuss all the entailing issues and respond to all the queries of practical nature raised by

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<sup>9</sup> Islamic Financial Services Board (IFSB) - Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*takāful*) Institutions and Islamic Mutual Funds) 2006, Retrieved May 7, 2007. <http://www.ifsb.org>

the management. This method, however, is more formal, and may put the management in an uncomfortable situation to some extent. Indeed, this highly formal situation also means that the Board members may not obtain the necessary information directly. Another possible method for supervision is that the Board undertakes to check samples of the banking documentations and other relevant issues.<sup>10</sup>

In order to identify the parallelism between the theory and practice and also for the purpose of comparison, we discuss the practices followed for assuring Shari'ah compliance in Islamic banking sector, of Malaysia and Indonesia intensively as under:

## **2. Shari'ah Compliance in Islamic Banking Malaysian Case**

The process of assuring Shari'ah compliance in Islamic banking may involve a long chain of activities, which are interconnected. The process involves various parties and covers various activities from the initial formation of the products till such products are launched and marketed. In a nutshell, there are five steps for the Shari'ah compliance process adopted by Islamic banking practitioners in Malaysia. First is to establish measures for the product offered, second is to pinpoint the advisory or supervisory activities. The next step is to obtain a Shari'ah opinion or *fatwā* about the validity of a new product. Fourth is to take necessary action in case of non-compliance towards *fatwās* or decision. The last step is to pass Shari'ah opinions on the annual report of the bank to be presented in the shareholders' general meeting. Deliberation of each step will be presented in the following discussions.

### *(i). Establishing Specific Measures for Product Offering*

The first and most important stage in ascertaining Shari'ah compliance is to define the product. The details of the products in Islamic banking business are not clearly stated in the existing regulations, neither in the Islamic Banking Act 1983 (IBA) nor in the Bank and Financial Institutions Act 1989 (BAFIA). Guidelines for product offering however, have been enumerated in SPTF (Skim Perbankan Tanpa Faedah) or Interest Free Banking Scheme Guidelines,<sup>11</sup> which were initially designated for conventional banks offering Islamic banking business.

The absence of a specific legal provision concerning the features of the product for Islamic banks, may be due to the fact that Islamic banks were incorporated under the IBA 1983, in which the Shari'ah Committee (SC) is required to ascertain that any product offered does not infringe Islamic tenets. The Shari'ah Committee (SC) members together with the management of the bank is supposed to be capable of deciding a list of products, which are compliant to Shari'ah principles.

It is observed that the definition of products in Islamic banking business is practically similar to that of conventional banks offering Islamic banking services. This is due to

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<sup>10</sup> Bakar, Mohd. Daud, (2002), p.80.

<sup>11</sup> Bank Negara Malaysia Guidelines on "Skim Perbankan Tanpa Faedah (SPTF)" for Finance Companies 1993. (Acts and Statutes: Malaysia).

the fact that conventional banks conducting Islamic banking business are under the supervision of the Bank Negara Malaysia, and thus they are also subject to the same advisory body, which is the Shari'ah Advisory Council (SAC). As such, it would be understandable that the list of the products and their definitions does not differ significantly from that of conventional banks conducting Islamic banking business (products listed by SPTF Guidelines 1993).

Considering that the definition may be general in nature, the particular products need for further detailed measures. Setting up clear measures of the products is a step that the bank shall take before the application of the product into a real financial contract. The measures are made in such a way that enables both the bank and the customers understand very clearly the nature of the contract (product) and its legal effects.

Under the guidance of Shari'ah Committee (SC) members, the bank formulates the structures of the products according to the specific measures (terms of product). The terms of the product carry a brief description of every product offered that provides an easy and simple process of execution of the contract. *Bay' Bi Thaman al-Thaman al-`ajil* (BBA) financing is a good example to illustrate the point. According to SPTF Guidelines 1993, it is "the sale of goods on deferred payment basis at a price which includes a profit margin agreed by both parties".<sup>12</sup>

Based on the definition, an Islamic bank then redefines it in a way that enables the customers to clearly understand the product. Accordingly, Bank Islam Malaysia Berhad (BIMB) defines this product as follows:

"*Bay' Bi Thaman al-Thaman al-`ajil* means deferred payment sale whereby the Bank will finance customers who wish to acquire an asset but to defer the payment for the asset for a specific period or to pay by installment".<sup>13</sup>

This product then, is formulated into a specific applicable term. Accordingly, BIMB provides that the contract of BBA should be executed in-line with specific product terms. The terms provide that: "Under this facility, the Bank shall first purchase the asset concerned. The Bank subsequently sells the relevant asset to the Customer at a selling price which comprises of the actual cost of the asset to the Bank and the Bank's margin at profit".<sup>14</sup>

As the terms are initiated by the industry, hence there is non-uniformity in the features of the product terms, as it depends on the Islamic financial institutions themselves. For instance, the Maybank Islamic has adopted a slight different definition of BBA. It is defined as: "*Bay' Bi Thaman al-Thaman al-`ajil* or Deferred Payment Sale refers to the sale of goods on a deferred payment basis at a price that includes a profit margin agreed upon by both the buyer and the seller".<sup>15</sup> Since there is no specific terms

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<sup>12</sup> SPTF Guidelines 1993, 4

<sup>13</sup> Bank Islam Malaysia Berhad at: <<http://www.bankislam.com.my>>, accessed May 7, 2007.

<sup>14</sup> Bank Islam Malaysia Berhad at: <<http://www.bankislam.com.my>>. accessed May 7, 2007.

<sup>15</sup> Maybank at: <<http://www.maybank2u.com.my>> accessed July 17, 2007.

and features given, this definition seems to be sufficient to describe the essential aspects of the product.

There are many terms of a product, as many as the *mu'āmalah* contracts, applied in a particular bank. However, as is apparent from the examples of two banks cited above, the difference in delivering such terms is merely in the wording, while substantially they are similar to one another. The additional features may be given by the banks in their terms of the products, as this is a matter of the banks' policy. However, these must be Sharī'ah compliant any way.

*(ii). Advisory and/or Supervisory Activities*

Basically, there are two kinds of supervisory and/or advisory activities that the Sharī'ah Committee (SC) undertakes; namely the periodical meetings with the board of directors, and ad hoc meetings in resolving critical cases.

Periodical meetings are set out to sustainably evaluate the operations and products of Islamic and conventional banks conducting Islamic banking business. Usually, this mode of activity is conducted through the meeting with the board of directors or management of the bank. Since such meetings are a matter of internal policy, their frequency may be different from bank to bank. However, monthly meetings are as the most common schedules.<sup>16</sup> In these meetings, issues related to Sharī'ah can be resolved by the Committee (SC) members. Although the common agenda pertains to the new products, it is also possible to table the issues pertaining to given *fatwās* that need to be evaluated. Although monthly meetings may be rare, however, the banks usually have an established procedure to resolve critical issues through ad hoc meetings. This needs further explanation.

It is observed that periodically scheduled meetings may not be sufficient to resolve some urgent issues faced by the bank. Therefore, the bank normally will call the Sharī'ah Committee (SC) for ad hoc meetings as and when considered necessary. Certain departments within the bank directly concerned with the issue, either because of launching a new product or some other matter related to operations, have to provide the paperwork explaining the context of the issue and a proposed possible solution. The members of the Sharī'ah Committee (SC) have to examine the case and resolve the issue immediately. This provides the rationale for an ad hoc meeting to be called. Situations like these normally arise in the Product Department, which specifically deals with the product development and innovation. The ad hoc meetings are convened on case to case basis. Anyhow, this is indeed the duty of the Sharī'ah Committee (SC) to resolve such issues immediately.

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<sup>16</sup> In this case BIMB has meetings once in every two months, source: Interview with the Head of Sharī'ah Department who is also the secretary of the Sharī'ah Committee in the BIMB, Ustad Nasrudin Yaakub on February 28, 2007. Also, Interview with Dr. Abdul Halim Muhammad, Vice Chairman of the SAC, February 22, 2007

(iii). *Floating Sharī'ah Opinion or Fatwā*<sup>17</sup> (Why using the word *Fatwās*? Why not *Fatāwā*)

The floating of well-considered opinions (*fatwās*) on matters relating to Islamic banking products is one of the most important roles of the Sharī'ah Committee (SC). The procedure can be divided into two stages. First, the revealing of opinions relating to the products or issues while the structure of basic contracts has already been considered by the Sharī'ah Advisory Council (SAC). Second, the floating of *fatwās* relating to the products or new issues in which case no previous opinion or resolution of the Sharī'ah Advisory Council (SAC) exists.

When a certain department or division of the bank faces certain issues that need to be resolved in light of Sharī'ah provisions or intends to launch a new product, the concerned staff prepares a detailed proposal for submission to the Sharī'ah department or to the liaison officer of the Sharī'ah Committee (SC).<sup>18</sup> The Sharī'ah department, pursuant to the proposal forwarded, arranges a meeting of the committee. The said proposal is then presented in the meeting.

The Sharī'ah Committee, besides attending to the presentation, may also ask the Sharī'ah department to conduct the necessary research regarding various aspects of the proposed product. The committee, after considering the proposal and results of the research if any, analyses the issue and resolves the problem in a clear statement, called the Sharī'ah opinion. However, if the Sharī'ah Committee doesn't reach any conclusion to resolve the issue, the matter shall be referred to the Sharī'ah Advisory Council to obtain a formal approval.<sup>19</sup>

The procedure is more relevant when the bank intends to develop or launch a new product. The respective bank requires confirmation and approval from the Sharī'ah Advisory Council situated at the Central Bank, of course through the channel of local Sharī'ah Committee. This approval is necessary on the grounds that the product may be novel and complicated in nature, and that no well defined standards or precedence may be available to the bank. Anyhow, it is the duty of the Sharī'ah Committee to prepare the proposal and provide adequate Sharī'ah reasoning to justify the product. The board of directors of the bank together with the Sharī'ah committee may then forward the proposal to the Islamic Banking and *takāful* Department of the Bank Negara Malaysia for consideration.

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<sup>17</sup> Though scientifically there is no sharp difference between Sharī'ah opinion and *fatwā*, as the two are actually similar in nature, technically, a Sharī'ah opinion is a specific term to call the opinion given by Sharī'ah board within the industry. In contrast, a *fatwā* usually refers to the decision delivered by the higher Sharī'ah body, namely SAC in Malaysia or NSC in Indonesia. Interview with the Head of Sharī'ah Department, Ustad Nasrudin Yaakub on February 28, 2007 and Prof. Asymuni Abdurrahman, member of National Sharī'ah Council Indonesia, February 3, 2007.

<sup>18</sup> Not all the banks conducting Islamic banking business have a Sharī'ah department. In this case, Sharī'ah board members have to do research themselves. Therefore, according to the opinion of Dato' Md. Hasyim Hj. Yahya, a member of the SAC, there should be such department within the BAFIA-IBS bank (Interview with him on March 7, 2007).

<sup>19</sup> Interview with Head of Sharī'ah Department BIMB, Ustad Nasrudin Yaakub, February 28, 2007.

The process of obtaining decisions or opinion (*fatwās*) of the Shari'ah Advisory Council (SAC) about any new product or on any new issues may pass through several stages. It is important to note that prior to the establishment of this council, the Shari'ah Committee could give a decision independently. However, after its establishment, now the decision about a new product is finally given by the council.<sup>20</sup>

In situations where the Shari'ah Committee of the respective bank is capable of resolving the issue, the only requirement is to send the report to the Shari'ah Advisory Council for obtaining its approval. The council may require the Shari'ah Committee to present the proposal in a meeting if further explanation is needed particularly when the issue is complex. Here, the process of the issuance of *fatwās* or decision taking is completed by the Shari'ah Advisory Council in the manner.<sup>21</sup>

**Firstly**, When the Shari'ah Committee of the respective bank proposes to resolve a Shari'ah related issue on a new product, the board of directors of the bank shall send an application to the Bank Negara Malaysia requesting for a verdict (*fatwā*). The application is supported by the proposal together with the explanation of the product and its justification according to the Shari'ah.

**Secondly**, The Islamic Banking and *takāful* Department of the Central Bank, in response to the above application, undertakes necessary research on the problem raised by the proposal. The outcome appears in the form of a draft paper for discussion in the Shari'ah Advisory Council.

**Thirdly**, the Central Bank invites meeting of the Shari'ah Advisory Council members, the board of directors and the Shari'ah Committee of the respective bank for the purpose of getting *fatwā* pertaining to the product. The proposal forwarded by the respective bank, together with the paperwork or draft is then presented in the meeting. The aim behind involvement of all the relevant parties is to comprehend the problem, to discuss all the aspects, and to ensure that *fatwā* is made with full understanding of the issue at hand.

**Fourthly**, the process involves resolving the issue. Having reviewed all the aspects of the proposal, the Shari'ah Advisory Council may then resolve the problem and grant the approval accordingly. If considered necessary, the council may conduct another meeting or a series of meetings to deliberate further and analyze the problems relating to the

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<sup>20</sup> The first Islamic bank in Malaysia was incorporated in 1983 with the inception of BIMB, which comes within the purview of the Islamic Banking Act 1983. At that time, the SAC was not yet established. It is logical to say that the Shari'ah Board of BIMB had to tackle all the responsibilities of doing supervisory work and issuing *fatwās*, relating to Islamic banking. Only after the establishment of SAC pursuant to the amendment of the Central Bank Act (CBA) 1958 on section 16B (which came into effect in 2003), all the responsibilities were shifted to SAC. Initially there was no central body available, and any bank conducting Islamic banking business had to refer to and consult its problems with the SAC working at the Central Bank level.

<sup>21</sup> This process of the issuance of *fatwās* is based on three interviews: (i). Interview with Mr. Hamzah Kamaruzzaman, Department of Islamic Banking and *takāful* the Bank Negara Malaysia, answers were emailed on December 5, 2007, (ii). Interview with Dr. Abdul Halim Muhammad, Vice Chairman of SAC, February 22, 2007, and (iii). Interview with Dato Md. Hasyim Hj. Yahya, member of SAC, March 7, 2007.



proposal. If members of the council are still not satisfied and thus unable to resolve the issues, they may ask the Islamic Banking and *takāful* Department of the Central Bank to do further research on the relevant aspects and submit its findings.

The Shari'ah Advisory Council (SAC) formulates the final result in the form of a *fatwā* or resolution,<sup>22</sup> which is circulated by the Central Bank for information of all concerned, i.e. banks and financial institutions involved in the Islamic banking business and not specifically to the bank from where the case is initiated or Shari'ah issue raised.

Keeping in view different stages that need to be undertaken for the process to complete, it is understandable that the issuance of a *fatwā* or resolution may be delayed. The duration needed for the purpose mostly depends on the complication and intensity of the problem. From the experience of the Shari'ah Advisory Council, the longest time taken to resolve an issue may extend to three months.<sup>23</sup>

Ever since the Shari'ah Advisory Council (SAC) was established in 1997, no less than twenty one *fatwās* or resolutions have been passed, ranging from banking to *takāful* issues,<sup>24</sup> with the exception of issues relating to Islamic securities, since these are dealt with by the Securities Commission of Malaysia (which came into being under the Securities Commission Act 1993) that has independent Shari'ah committee and own resolutions.<sup>25</sup> The resolutions of Shari'ah Advisory Council comprise a wide range, from those pursuant to the applications or requests from the industry to those initiated independently by the Bank Negara Malaysia, particularly by the Department of Islamic Banking and *takāful* relating to Islamic banking and finance.<sup>26</sup>

(iv). *Enforcement of Fatwās or Decisions* (Why using the word *Fatwās*? Why not *Fatāwā*)

The non-compliance towards issued *fatwās* is perceived as ignorance and infringement towards Islamic tenets. It is reasonable therefore, that specific actions can be taken against the relevant institutions which do not comply with the *fatwās*. In this regard, respective administrative bodies which have the authority, namely the Shari'ah Committee and the Central Bank, shall ensure the enforcement of the *fatwās*.

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<sup>22</sup> The official term used for such products of the Shari'ah Advisory Council is "decision", for instance see BNM/GPS1 - Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions, December 2004, whereas the term "resolution" is used for the products of the Shari'ah Advisory Council in the Securities Commission, for comparison see Securities Commission, Malaysia (2006), *Resolutions of the Securities Commission Shari'ah Advisory Council*, (Kuala Lumpur, 2006). However in the publication issued by the Central Bank pertaining to the decisions of this council, the terms used is also resolution, see Shari'ah Resolutions in Islamic Finance (Bank Negara Malaysia, Kuala Lumpur: 2007).

<sup>23</sup> Interview with Dr. Abdul Halim Muhammad, a member of the SAC appointed for the tenure 2004-2006 and 2006-2007. Prior to the appointment he was a member of the SAB in various Islamic financial institutions, such as the Malaysian Development Bank, RHB Bank, Bank Rakyat, Bank Muamalat and Bank Bumi. Interview was conducted on February 22 & 27, 2007.

<sup>24</sup> Bank Negara Malaysia, (2007), *Shari'ah Resolutions in Islamic Finance*.

<sup>25</sup> For the resolutions issued by Shari'ah Committee Securities Commission, see, Securities Commission, Resolutions.

<sup>26</sup> Interview with the staff of Shari'ah Unit, Islamic Banking and *Takāful* Department, Bank Negara of Malaysia, Mr. Hamzah Kamaruzzaman. Written answers of the questionnaires was emailed on December 5, 2006.

As has been generally understood, the Shari'ah Committee is basically designated to perform advisory activities in the respective bank. The Committee has no internal auditor towards the implementation of Shari'ah compliance within the bank. To ascertain and monitor such implementation, a dedicated department is established for the purpose in certain banks. For instance, in Bank Islam Malaysia Berhad (BIMB), it is the Department of Audit and Shari'ah Risk that is designated to do the monitoring work. Periodically, a team is appointed to monitor the branches to ensure if there are Shari'ah issues or cases of non-compliance. Normally the audit exercise is conducted once in two months. When the Department finds a Shari'ah issue or case of non-compliance, a report of the findings must then be presented to the Shari'ah Committee (SC) for resolving the issue.<sup>27</sup>

In the Malaysian structure of financial authority, it is the responsibility of the Central Bank to ensure the enforcement and compliance towards *fatwās*. It is the Supervision Department in the Bank Negara Malaysia which is responsible for any non-compliance and ignorance.<sup>28</sup> After passing through certain set procedure, this department will bring any non-compliance cases into the notice of Central Bank, and the Bank will then take necessary actions.<sup>29</sup>

In the case of non-compliance, the Central Bank may conduct an investigation at any time without prior notice and if the case is found correct, the personnel concerned will be subject to the respective punishment.<sup>30</sup> This is part of the authority of the Central Bank to control banks in Malaysia, as the provision below states:

“The Central Bank shall from time to time investigate, under condition of secrecy, the books, accounts and transactions of each Islamic bank and of any branch, agency or office outside Malaysia opened by an Islamic bank”.<sup>31</sup>

It is also stated in BAFIA 1989, that the Central bank holds similar authority over conventional banks conducting Islamic banking business. It is stipulated that the Central Bank shall, from time to time, examine various documents and transactions of the licensed financial institution.<sup>32</sup>

In addition to above, it is legally stated that the Central bank, with the directives from the Minister, may conduct special investigation if there is sufficient reason to believe that the Islamic bank is carrying on its business in a manner that contravenes the Act.<sup>33</sup>

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<sup>27</sup> Interview with the Head of Shari'ah Department, BIMB, Ustad Nasrudin Yaakub, Feb 28, 2007.

<sup>28</sup> Interview with the staff of Shari'ah Unit, Islamic Banking and *Takāful* Department, Bank Negara Malaysia, Mr. Hamzah Kamaruzzaman. Written answers of the questionnaires were received on December 5, 2006.

<sup>29</sup> Islamic Banking Act (IBA) 1983, Section 37 (a), (b) (Malaysia).

<sup>30</sup> The punishment ranges from administrative penalties, such as letter of reminder, till petition for winding up the bank. Islamic Banking Act (IBA) 1983, Section 37 (a), (b) (Malaysia).

<sup>31</sup> IBA Section 31, (Malaysia).

<sup>32</sup> Banking and Financial Institution Acts (BAFIA) 1989, Section 69, (Malaysia).

<sup>33</sup> IBA Section 32, (Malaysia).

Thus, the authority of the Central Bank to control the Islamic banks or other commercial banks conducting Islamic banking business is clearly noticeable here.

In the case of infringement towards the standing legal framework, or towards Sharī'ah compliance, there are a few types of penalties that shall be imposed on any institution which is proven to infringe the *fatwās*. In short, the penalties range from requesting banks to take certain steps to rectify the infringement as determined by the Ministry of Finance or the Central Bank, like the revocation of the license, and/or presenting a petition to the High Court for termination of the Bank.<sup>34</sup> These provisions indicate that compliance to Sharī'ah principles by the bank is mandatory.

*(v). Displaying Sharī'ah Opinions in the Annual Report*

The annual report is an expression of the responsibility of the institution to the shareholders and to the public. For this reason, a complete performance of the bank and a comprehensive audit should be clearly presented in this annual report. In this regard, Islamic banks, or any banks conducting Islamic banking business, are obliged to provide various presentations that compare their performance with other banks operating under interest system. Besides the presentation on prudential aspects, they shall also present the Sharī'ah compliance aspect. Thus, the annual report of Islamic banks and conventional banks conducting Islamic banking business must contain the prudential audit<sup>35</sup> as well as Sharī'ah audit.

As the prudential aspect is mandatory for corporate governance of the banking industry, Islamic banks are also required to attend to this aspect. In this regards, the Islamic banks are treated equally with conventional banks. Variables which are used to review the prudentiality of conventional bank are also applicable for Islamic banks. Having audited in their prudential aspect, the next component of the annual report is the Sharī'ah audit; This is the distinctive feature which differentiates Islamic banking from conventional banking as the Islamic bank has to comply with Sharī'ah principles in all operations and products. For the purpose of the annual report, the Sharī'ah Committee must conduct a comprehensive audit for a period of one year, and issue the opinion with regards to compliance of the products and operations of the bank with Sharī'ah principles. In the annual report, the statement of Sharī'ah opinion must be included. An example of such an opinion is as follows:

“.....We, Dr Yosuf bin Ramli and Mohd Bakin bin Mansor, being two of the members of the Sharī'ah Supervisory Council BIMB Holding Berhad, do hereby confirm on behalf of the Council, that in our opinion, the operations of the Group and of the Company for the year ending 30 June 2006 have been conducted in conformity with Sharī'ah principles”.<sup>36</sup>

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<sup>34</sup> IBA section 37 (f), BAFIA, Section 73, (Malaysia).

<sup>35</sup> Prudential audit is the audit which is based on measures showing the fitness of financial aspects, such as Capital Adequacy Ratio (CAR) and Non Performed Loan (NPL).

<sup>36</sup> Bank Islam Malaysia Berhad, Annual Report 2006, p.84.

Based on the above procedures, the display of Sharī'ah opinion in the annual report is the last stage of the whole process involved in ascertaining Sharī'ah compliance of Islamic banking.

### *2.1 Issues in Sharī'ah Advisory Process and the way Forward*

#### *(a). Problems of Sharī'ah advisory process*

Sharī'ah advisory or supervisory is a relatively new profession and hence further effort to enhance this profession is much demanded. This is a new area where Sharī'ah scholars can play a significant role. Being a new area of profession, there exist some problems which need solutions. The authority of the body and its independence are cases in point. In turn, these problems affect the efficiency of the Board members in performing their duties. With specific reference to the operations of Islamic banking in Malaysia, the problems faced in the process are discussed below:

##### *i) Rapid development of the product.*

Banking industries are marked with continuous change and development of the products. In addition, product innovation is a main concern of the industry. The new products are sometimes formulated in the form of a mixture between or among the existing products, as well as in a form which is totally new and novel.<sup>37</sup> Since the contract principles in Islamic law are well established, therefore, to accommodate a new product and fit it in the Islamic contracts, there is a need for a complicated contractual engineering.

Since most of the members of the Sharī'ah Committee have the technical background of Islamic law of Contract (Sharī'ah or fiqh muamalat ) they may find problems and difficulties to fit the new banking products into the Sharī'ah context. The compromise between classical Fiqh and modern financial products is not that much easy.

##### *ii). The conflict of law (ikhtilāf)*

It is a well established fact that in many matters pertaining to Fiqh (jurisprudence), there are areas of disagreement (ikhtilaf) among the jurists, especially among different schools of law (*madhhab*). Malaysia, which so far holds onto Shafii madhhab, needs to reconsider its stance. It seems that the Sharī'ah opinions solely based on this madhhab cannot be accepted globally. The application of *bay' al-'inah* is a case in point. In addition to this legal controversy, the problem has become increasingly complicated due to expanding activities of foreign financial institutions in Malaysia. Sometimes, these institutions have to follow the *fatwās* of Sharī'ah boards in their countries of origin, which may be affiliated to a madhhab different from that commonly followed in

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<sup>37</sup> For instance, the new product may be in the form of “three in one” means three contracts in one product, or “two in one”, means two contracts in one product, as has been stated by Dato Md. Hasyim Hj. Yahya, a member of the SAC in the interview on March 7, 2007.

Malaysia. Al-Rajhi Bank is a case in point.<sup>38</sup> Hence, the Malaysian practitioners are now considering opinions (*Fatwās*) that are more globally acceptable. To bring about harmony in *Fatwās* based on different schools of law and to find a practicable solution, the role of international agencies such as AAOIFI, IFSB, Majma' al-Fiqh al-Islami, or any other standard Sharī'ah boards is very significant.

(b). *The way forward*

For the purpose of addressing the existing problems, some plans and actions may be suggested. As can be seen from the following, some of the problems have been responded to while the rest are still in the process of consideration:

i). *Enhancing the expertise*

In order to overcome the difficulties in resolving cases pertaining to the new product, proper training to members of the Sharī'ah Committee is necessary. In addition to this, the composition of the members of the Sharī'ah Committee is also a mixture of scholars in Sharī'ah and experts in the field of finance.<sup>39</sup> Consequently, the appointment of the members who are mostly academicians from well established universities may seem to be a suitable solution for the moment. They are in possession of the ability to do research, an ability which is very essential for doing Sharī'ah advisory.

ii). *Converging with the globally acceptable Fatwās*

For the purpose of introducing *Fatwās* which are globally acceptable, various legal opinions from major schools of thought (Madhahib) in the Muslim society need to be considered. The precedence set by the AAOIFI, IFSB, Majma al-Fiqh al-Islami and other standard bodies for Islamic financial business can be considered as reference for the Sharī'ah Advisory Council (SAC) in issuing *Fatwās* or resolution. Further, the establishment of some foreign Islamic banks in Malaysia has brought about implications to the *Fatwās* that they follow. In principle, being licensed companies, they have naturally to follow the decisions of Sharī'ah Advisory Council. Alternatively they may adopt an operation standard that may be different from the Malaysian standard, with the approval of the SAC within the Central Bank.<sup>40</sup> This process enhances the standardization of *Fatwās* (Sharī'ah opinion), which is globally acceptable.

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<sup>38</sup> The initiative for globally acceptable *fatwās* conforms to the observation that international boards relating to Islamic banking may significantly play a role in bridging the gap in the Islamic legal aspect. As stated by Thomas, Abdul Kadir, (2007), "this body of 22 scholars represents broadly all members of the Organization of Islamic Conference (OIC), assuring that the Malaysian and other East Asian voices are heard on a peer basis with scholars from West Asia, South Asia and Africa. It is at AAOIFI and the IFSB that the convergence of East and West Asia is slowly but surely being hammered out into proper accounting and governance guidelines".

<sup>39</sup> The action has been introduced by BIMB - Interview with the Head of Sharī'ah Department of BIMB, Ustad Nasrudin Yaakub, February 28, 2007.

<sup>40</sup> For instance, Al-Rajhi Bank (Saudi based) is willing to use a scheme under the *mushārah mutanaqīshah* in lieu of the *Bay' Bi Thaman al-Thaman al-Ājil*, and this bank has actually followed the said procedure - Interview with Dr. Abdul Halim Muhammad, Vice Chairman of the SAC, February 27, 2007.

It is observed from the above deliberation that the existing legal framework provides clear duties and responsibilities of all the parties involved in the process of assuring compliance to Shari'ah ruling and so the objective can be attained accordingly. However, in regard to the proposal for creating globally acceptable *Fatwās* and resolution on matters pertaining to Islamic banking business, Malaysia needs a concerted effort to accommodate various opinions from different schools of law (madhahib) without losing their strong hold of the Shafi'i madhhab, which has been in practice for centuries.

### 3. Shari'ah Compliance in Islamic Banking Indonesian Case

In general, the process of assuring Shari'ah compliance in Islamic banking in Indonesia resembles that of Malaysia. However, slight differences are apparent due to the fact that the Shari'ah Supervisory board in Islamic banking in Indonesia, as the term "supervisory" implies, is designated for supervisory tasks, instead of advisory.<sup>41</sup> The notion of supervision, will appear in the process to imply maintaining the compliance of Shari'ah principles, as the discussion below will cover.

#### (i). *Establishing Specific Measures for Products Offering*

Bank Indonesia Regulation has adopted various *fatwās* issued by the National Shari'ah Council (NSC) to be enforced to Islamic banks and conventional banks conducting Islamic banking business. The *Fatwās* mostly relate to the types of contract from which Islamic banking products are derived.

In addition to this adoption, the regulation also provides a detailed description in which various contracts discussed in the *fatwās* are formulated into clear points to measure various aspects of compliance towards Shari'ah principles. This spade work has laid down an elementary foundation for further developments towards Shari'ah compliance. The example of how the measures have been developed, can be seen from the minimum requirements laid down for the *Murābahah* financial scheme below.<sup>42</sup>

- "The applicable minimum requirements for financing of funds in the form of *Murābahah*-based financing are as follows:
  - a. The Bank shall provide funds for financing on the basis of an agreement for sale and purchase of goods.
  - b. The term for payment of prices for goods by the customer to the Bank shall be based on the terms agreed by the Bank and the customer;
  - c. The Bank may finance all or part of the purchase price for the goods at agreed quality specifications;

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<sup>41</sup> Although the standing regulation in Malaysia requires an "advisory" board, not all banks conducting Islamic banking business follow the same convention. In particular, BIMB still maintains the term "supervisory", namely Shari'ah Supervisory Council –for reference see the Annual Report of Bank Islam Malaysia Berhad, (Kuala Lumpur: 2006), 44.

<sup>42</sup> Bank Indonesia Regulation Number: 7/46/PBI/2005 concerning funds mobilization and financing agreements in conducting business based on Shari'ah Principles, section 9 & 10.

- d. If the Bank delegates the purchase of the goods to the customer as ‘agency’ (*wakālah*), the *Murābahah* agreement must be executed after the goods in principle have become the property of the Bank;
  - e. The Bank may request the customer to make a down payment or *Ñurbun* upon signature of the initial agreement for the customer order for the goods;
  - f. The Bank may request the customer to provide additional collateral other than the goods financed by the Bank;
  - g. Agreed terms on margin must be determined once at the beginning of the Agreement and may not change throughout the duration of the agreement;
  - h. The financing installments must be executed on a pro rata basis throughout the duration of agreement.
- If the Bank requests the customer to make a down payment or *Ñurbun* as referred to in paragraph (1) (e), the following provisions shall apply:
    - a. In the case of down payment, if a customer refused to purchase the goods after making the down payment, the real costs of the Bank must be paid from the down payment and the Bank must return the surplus down payment to the customer. However, if the down payment is insufficient to cover the loss borne by the Bank, the Bank may demand further payment from the customer to cover the remaining loss;
    - b. In the case of *Ñurbun*, if the customer cancels the purchase of goods, the *Ñurbun* previously paid by the customer shall be forfeited to the Bank to a maximum of the loss borne by the Bank as a result of the cancellation, and if the *Ñurbun* is insufficient, the customer shall be required to pay the shortfall.
  - In *Murābahah* financing, the Bank may discount the total payment obligation only for customers who have paid installments promptly and/or customers who have suffered a loss of repayment capacity.
  - The amount of the *Murābahah* discount for the customer may not be promised in the agreement and shall be at the discretion of the Bank policy.”

These guidelines have set out the minimum requirement for a specific contract *Murābahah* in a very clear illustration. Based on these standards, the measures for Sharī‘ah compliance in this contract seem to be less complicated. In addition to these requirements, the respective banks may set out the terms of each product that they offer. The content of the terms of product is certain and the steps which must be taken by the parties involved, namely the bank authority and the customers, are clear. To analyze what the terms of product consists of, it is important to consider an example.<sup>43</sup> In the terms of products of Bank Muamalat Indonesia (BMI), *Murābahah* for instance, is defined as:

“Financing facility in the form of sale: Bank purchases any Sharī‘ah permissible (*Halāl*) asset you need, and resells it to you for deferred payments with the affordable installment. This mode of financing may be utilized to meet the needs

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<sup>43</sup> Product and services, at Bank Muamalat Indonesia, at <<http://www.bankmuamalat.com>> accessed on May 7, 2007. See also, product simulation, in the respective website. This term is translated by the author from the original term in Bahasa Indonesia.

for enterprise (working capital and investment, purchasing assets such as machineries, tools, etc) as well as personal needs (such as purchasing motor vehicles, houses, etc)”<sup>44</sup>.

Prior to the emergence of Bank Indonesia Regulation Number: 7/46/PBI/2005 concerning funds mobilization and financing agreements conducting business based on Shari‘ah principles, it seems that the terms of products provided by the respective bank were good guidance in the product offering. However, the introduction of the guidelines, as stipulated in section 9 and 10 of the above Regulation seems to be more comprehensive, and provides detailed instructions in the product offering. As such, the respective bank’s terms of products seem to be less important. This is because the measures of the financial contracts, given by the Bank Indonesia Regulation referred to above, seem to be more detailed and exhaustive in deriving the elements of the contract, which must be there while concluding such financial contracts.

An additional stage in the process of assuring Shari‘ah compliance is the implementation of such measures by the board of directors with the advice and supervision of the Shari‘ah Supervisory Board (SSB). Since the measures in product offering are comprehensive, further stages towards Shari‘ah compliance in Islamic banking lies in the hands of members of this board.

*(ii). Advisory and/or Supervisory Activities*

It is clear from the above description that the enforcement of Shari‘ah compliance measures in Indonesia lies in the hands of both the SSB and the board of directors of the bank. In fulfilling this responsibility, the Board (SSB) members have adopted a method of periodical meetings and ad hoc meetings for the purpose.

Periodical meetings are normally scheduled as manual (operational procedures) in the respective bank.<sup>45</sup> The Board (SSB) members are obliged to attend the meetings with the board of directors, on a minimum of monthly basis.<sup>46</sup> The periodical meetings provide a forum in which the board of directors and board of management of the bank may request consultation pertaining to Shari‘ah issues. In view of the Board (SSB) members, they also benefit from the meetings by raising some issues where they need a clarification and explanation by the board of directors, particularly when the issues are related to the company policies.

Although the meetings are generally scheduled on monthly basis, however under specific circumstance where the bank needs advice on certain urgent Shari‘ah issues or when it is preparing to launch a new product, the meetings may be called more than once

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<sup>44</sup> *ibid*, accessed on May 7, 2007.

<sup>45</sup> Interview with K.H. Ma’ruf Amin, member of the Shari‘ah Supervisory Board (SSB) of BMI, January 26, 2007.

<sup>46</sup> Certain banks allow meetings of the Shari‘ah Board (SSB) up to four times in a month, thus it is purely a matter of necessity. However, the minimum requirement is monthly meeting: Interview with Prof. Asyuni Abdurrahman, member of the National Shari‘ah Council Indonesia, February 3, 2007.



in a month. In these cases, the attendance is based on the necessity to resolve the issues at hand, and this is what we call ad hoc meetings.

In ad hoc meetings, the board of directors, pursuant to the requirement from the product department, invites members of the Board (SSB) to give advice (Sharī'ah opinion) concerning the proposal of a new product or an urgent issue. When the problems or cases are forwarded to the SSB liaison officer, the board of directors or the board of management then requests the Board (SSB) members to resolve the issue. The procedure is however somewhat different from the case of Malaysia where the liaison officer or Sharī'ah department is normally responsible for the preparation of proposal and conducting research relating to the issues to be discussed. However, since the intermediation of liaison officer is a new phenomenon,<sup>47</sup> therefore it is the responsibility of Sharī'ah Supervisory Board (SSB) members themselves to undertake necessary research for the purpose of floating a Sharī'ah opinion.

(iii). *Floating Sharī'ah Opinions or Fatwās*

The outcome of the meetings of the Sharī'ah Supervisory Board (SSB), as mentioned above, is nothing but a concerted opinion. Under the prevailing rules, this opinion is possible only for cases in which the main mu'amalah contracts have been defined by the National Sharī'ah Council (NSC). So far as the case of innovation or a new product is concerned, the Board (SSB) members cannot give any Sharī'ah opinion; instead they have to request the National Sharī'ah Council (NSC) for the verdict (*Fatwā*) and guidance.

Similar to the case of Malaysia, before the establishment of the national level Sharī'ah board in Indonesia, the Sharī'ah board at the industrial unit (bank) was the only body to issue Sharī'ah opinions (*Fatwās*) and its members were working independently without any other superior authoritative body. However, the National Sharī'ah Council (NSC), after its establishment in the year (???), is now the highest authority for not only issuance of *Fatwās* but also to resolve controversies in Sharī'ah matters throughout Indonesia.

As has been obvious from the above deliberation, the Sharī'ah Supervisory Board (SSB) does not possess authority to resolve Sharī'ah related issues in case of new products. In such cases, the bank which is in need of such guidance and verdicts (*Fatwā*) shall prepare a proposal for the purpose. The process starts from the application stage when the said proposal is forwarded by the board of directors of the respective bank together with the comments of its Board (SSB) members to the National Sharī'ah Council (NSC).

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<sup>47</sup> Ibid and interview with Mr. Nurfi & staff of Sharī'ah Division Bank Negara Indonesia (BNI), January 25, 2007. The first liaison officer was appointed in Bank Muallamat Indonesia in 1992, however in other banks conducting Islamic banking, the office has been adopted since 2006.

Consequent upon the receipt of application and the proposal, the National Sharī'ah Council (NSC) arranges a series of meetings as set out in the *Fatwā* procedure. There are four steps in the procedure for the Council (NSC) to react.<sup>48</sup>

**First**, a general meeting will be held involving all of members of the Council (NSC). The representatives of the concerned bank and the Central Bank of Indonesia will be invited in this meeting. The said bank shall present the proposal of the new product for which the *Fatwā* is sought. The presence of the Central Bank of Indonesia in the meeting is important, being the regulator of Islamic banking business in Indonesia and the sole authority responsible for incorporation of all *Fatwās* into the Bank Indonesia Regulation. At this forum, every related party may raise questions and offer suggestions regarding the issue.

**Second**, the outcome of the general meeting in the first stage is then brought into an intensive deliberation forum. In this stage, only members of the executive board of the National Sharī'ah Council (NSC) are involved. This meeting is designated to analyze the case independently. It is considered important to have an independent atmosphere and to approach the issue from the point of view of the advantages and disadvantages (*masaleh and mafasid*) without any inconvenience and influence, which may occur if the concerned parties are also present.

**Third**, the results from the special meeting are then discussed in the second general meeting. The relevant parties are invited to ensure that they fully understand the decision made. However, suggestions from the parties concerned can still be considered in this meeting. The objective of this second general meeting is to review the proposal and to obtain responses and suggestions to enable the National Sharī'ah Council (NSC) to issue a good, relevant and well considered *Fatwā*.

**Fourth**, suggestions and responses appearing in the second general meeting are then accommodated in the finalizing and drafting of the *Fatwā*. To finalize the process, another special meeting is then called for, with only members of the executive board to participate. This is the final step of the process, and having passed through this step, the *Fatwā* is formally issued. However, the *Fatwā* or verdict so give, is not automatically incorporated into the Bank Indonesia Regulation. It is the Directorate of Sharī'ah Banking at the Central Bank of Indonesia, which holds the authority to do so and also responsible for its adoption, albeit with the advices from members of the meeting.

Apart from the laid down procedures stated above, it is important to note that the proposal or the initiative for the issuance of *Fatwās* may come either from the National Sharī'ah Council (NSC) or the industry. Since this Council (NSC) is an element of the National Ulama Council, which has been recognized as an authoritative body for issuing *Fatwās* in various matters, it has a moral obligation to provide guidance to Muslim public in the country. Due to the unavailability of a regulatory framework in the early stages of

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<sup>48</sup> Interview with Mr. Irfan, the Liaison Officer of Executive Committee of National Sharī'ah Council (NSC), at January 17, 2007. This procedure is resolved in *Ijtimā' Sanawi* of National Sharī'ah Council (NSC) in 2006.

Islamic banking in Indonesia, this body initiated to issue *Fatwās*, which were very fundamental for the operations of Islamic banking. *Fatwās* in some basic contracts, such as *wadeeah*, *Murābaḥah*, *ijarah*, and other general products applied in Islamic banking are examples of the early endeavours initiated by the board.<sup>49</sup>

Since the incorporation of the National Sharīʿah Council (NSC), more than 53 *Fatwās* have been issued so far and compiled in *Himpunan Fatwā Dewan Syariah Nasional*, published in collaboration with the Bank Indonesia.<sup>50</sup> In contrast to Malaysia where a nationally recognized Sharīʿah Advisory Council (SAC) deals solely in Banking and *takāful*, the National Sharīʿah Council (NSC) in Indonesia deals with all aspects of Islamic financial business, which encompasses Islamic banking, insurance, mutual funds, and other businesses. Hence, the above mentioned compilation also comprises *Fatwās* in other aspects besides banking.

(iv). *Enforcement of Fatwās or Decisions*

The non-compliance of Islamic banks or conventional banks conducting Islamic banking business toward Sharīʿah principles, as has been set out by the existing legal and regulatory framework, brings about some legal consequences that vary from case to case depending on the degree of non-compliance. If it is proven that a bank or financial institution has failed to comply with Sharīʿah principles as laid down in *Fatwās*, the Sharīʿah Supervisory Board, the National Sharīʿah Council and the Central Bank shall exercise their rights to audit the business conducted by the bank.

In a case of such a failure or ignorance of the *Fatwās* adopted in the Bank Indonesia Regulation, the Sharīʿah Supervisory Board (SSB) in the respective bank shall take or initiate necessary actions according to rules. Here, the supervisory function means that it is the main responsibility of the board to ensure that the bank complies with Sharīʿah principles. When the issue of non-compliance arises, the board is responsible to resolve it at source. This resolution is usually conducted through successive meetings with the board of directors. However, in severe cases when the act of non-compliance continues, the Supervisory Board (SSB) has to send a report to the Central Bank of Indonesia and National Sharīʿah Council (NSC).<sup>51</sup> Such an action taken by Board (SSB) is based on the provision that the task to ascertain Sharīʿah compliance lies in their hands and the board of directors.<sup>52</sup>

Pursuant to the above, the Sharīʿah Supervisory Board (SSB) shall then begin with the internal audit, following the procedure laid down in the regulations of Directorate of

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<sup>49</sup> Those *fatwās* can be found in National Sharīʿah Library and Bank Indonesia, *Himpunan Fatwā Dewan Syariah Nasional* (Jakarta, 2006)

<sup>50</sup> *ibid.*

<sup>51</sup> Interview with Dr. Dadang Muljawan and Dr. Bambang Irawan, Directorate of Sharīʿah Banking, the Central Bank of Indonesia, January 16, 2007.

<sup>52</sup> This can be seen from the Articles of Association of Bank Muamalat Indonesia (BMI), stating that “The function of the Sharīʿah Supervisory Board is to supervise the operations of the company to be in line with Sharīʿah”- section 17 (1). Also clear from the interview with K.H. Maʿruf Amin, the member of Sharīʿah Supervisory Board of BMI, January 26, 2007.

Shari'ah Banking, Central Bank of Indonesia. The audit process, according to Circular Letter of Bank Indonesia to all Commercial Banks Conducting Business Based on Shari'ah Principles in Indonesia, is made through the analysis of the elements of contracts in every financial product. The standard auditing measures provided in the above mentioned circular, must be followed by the Supervisory Board (SSB) and shall be reported to the National Shari'ah Council (NSC) and the Central Bank. An example of such measures is given below:<sup>53</sup>

- “Shari'ah supervision finding report shall contain no less than:
  - a. Supervision findings on the compliance of Bank operations with the *Fatwās* issued by the National Shari'ah Council.
  - b. Shari'ah opinion on operating guidelines and products released by Bank.
  - c. Analysis on new products and services which have not obtained any *Fatwās* in order to request the National Shari'ah Council for *Fatwā*.
  - d. Shari'ah opinion on the whole operation of Bank in the Bank's condensed financial statement.”

The measures given above seem to be sufficient to facilitate the audit conducted by the Supervisory Board (SSB), as part and parcel of the steps taken by the National Shari'ah Council (NSC) and the Central Bank of Indonesia to ensure Shari'ah compliance.

Pursuant to the report submitted by the Supervisory Board (SSB), the Directorate of Shari'ah Banking in the Central Bank of Indonesia, in the capacity of regulator, has to investigate the case. Indeed, the National Shari'ah Council (NSC) as the issuer of *Fatwās* and highest authority to resolve Shari'ah-based financial issues also has the responsibility to provide necessary assistance to the investigating team appointed by the Central Bank in the matter.

When the investigation discovers the occurrence of non-compliance to Shari'ah in the reported case, then further action may be taken in accordance with the existing legal framework. There are some administrative penalties that the Central Bank may exercise on the non-compliant banks, which have been clearly stipulated in the Act No. 10 of 1998 on Banking, section 2, and reproduced below:

- 1). Compound
- 2). Written reminder
- 3). Degradation of the bank prudential
- 4). Banned from clearing
- 5). Termination of the operation
- 6). Disposal of the directors and staffs
- 7). Blacklisting of the directors, staff and workers in the banking business industries

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<sup>53</sup> Bank Indonesia Circular Letter No. 8/19/DPBS to all Commercial Banks Conducting Business Based on Shari'ah Principles in Indonesia, August 24, 2006, on General Review.

In addition to the above administrative sanctions, there is also a maximum penalty in the form of imprisonment for the persons who have been proven guilty of such non-compliance.<sup>54</sup> Thus, personally and institutionally, those who are in the position to run the business shall also make the necessary effort to maintain that the bank is always in compliance with Shari'ah.

It is worthy to note that various penalties as cited above seem to be sufficient to ensure that the financial institutions conducting Islamic banking business stick to the objective of compliance towards *Fatwās* as Shari'ah regulations adopted into the Bank Indonesia Regulation.

It is also clear from the above discussion that one of the duties of Supervisory Board (SSB) in Islamic banks is to present periodic reports to the Central Bank and the National Shari'ah Council (NSC). Based on these reports, the Central Bank can evaluate the degree of compliance to Shari'ah principles. In case where the report regarding non-compliance of the bank to Shari'ah is proved, necessary actions can be taken by the Central Bank according to regulations.

(v). *Displaying Shari'ah Opinion in the Annual Report*

The annual report of a bank or any other corporation is considered as the authentic source of information on the whole operations and products of the business. Since the business of the bank is in the area of Islamic financial matters, the general audit must include different aspect of Shari'ah compliance. Basically there are two aspects which must be reflected in the annual report, namely the prudential audit and Shari'ah audit.

In prudential audit, the performance of the bank can be seen through different criteria set out by the Central Bank to evaluate the prudential requirements, such as the Capital Adequacy Ratio (CAR), Non Performed Loans (NPL), and other indicators as specified by the Central Bank.<sup>55</sup> The auditing exercise for prudential aspect of the bank is normally undertaken by the authorized accountants and legal consultants.

In addition to above, the evaluation process of the bank also includes the Shari'ah audit, which is conducted by the Shari'ah Supervisory Board. The members of this Board (SSB) need to evaluate the whole products and financial transactions conducted by the respective bank during the given period. The conclusions drawn must be clearly stated in the annual reports. The following example of the statement in the form of Shari'ah opinion in one of the Islamic banks in Indonesia will clarify the point:

“ On behalf of the Shari'ah Supervisory Board of Bank Muamalat, we hereby state that the conduct of operations as well as the products and services of Bank Muamalat in the year 2006 fully complied with the *Fatwās* of the National Shari'ah Council, and the rulings of the Shari'ah Supervisory Board.”<sup>56</sup>

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<sup>54</sup> Act no. 10 of 1998 on Banking, Section 46-50 (Indonesia).

<sup>55</sup> Bank Indonesia Regulation No. 7/35/PBI/2005, Section 36.

<sup>56</sup> Annual Report of Bank Muamalat Indonesia, 2006, 9, accessed on May 7, 2007 from the website: <<http://www.muamalatbank.com/>>

The audit conducted by this bank (BMI), which is comprehensive and covers all aspects of operation, products and services, seems to be a step forward from the basic requirements of audit provided by the legal framework as stated in Bank Indonesia regulations.<sup>57</sup>

### *3.1 Issues in Shari'ah Supervisory and the Way Forward*

#### *(a) Problems of Shari'ah Supervisory board*

The activities pertaining to advice or supervision to ascertain Shari'ah compliance, as may be clearly evident from the above discussion, comprise a process that requires attention not only from members of the Shari'ah Supervisory Board (SSB) but also from the parties involved in the business. Various problems may come to surface during this process, as will be discussed below, and therefore a concerted effort by the parties involved is necessary to ensure Shari'ah compliance.

- 1). The lack of an integrated expertise<sup>58</sup> Members of the Shari'ah Supervisory Board (SSB) should have integrated expertise in both Shari'ah and Islamic financial matters. Since most members of the Board (SSB) and National Shari'ah Council (NSC) have more theoretical knowledge on Shari'ah matters but lack practical experience, this may prove a hindrance in developing Islamic banking in Indonesia. This is due to the fact that the National Shari'ah Council (NSC) is basically an instrumental organization of the Indonesian Ulama Council that normally deals with religious issues, and therefore, most of its members need enhancement in their expertise or experiences in Islamic finance.

Similarly, most of the Board (SSB) members also face the same problem of lacking expertise and experiences in Islamic finance, since they are also chosen from among the members of the National *Shari'ah* Council (NSC). It seems that short courses and trainings to push up the knowledge of the members in financial and economic matters may be helpful in exposing them to practical issues of Islamic banking and finance. However, this may not be always sufficient, since the Islamic banking business is getting becoming more sophisticated and its complexities and technicalities increasing day by day. As such, these courses and training programs should a regular feature of the Islamic banking industry.

- 2). Inadequacy of regulations in terms of independence of the Board (SSB) members.

As a matter of fact, the members of Shari'ah Supervisory Board (SSB) of one bank also hold similar positions in other banks or Islamic financial institutions, being

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<sup>57</sup> Bank Indonesia Regulation Number: 6/24/PBI/2004 on Commercial Banks Conducting Business Based on Shari'ah Principles as amended by Regulation No. 7/35/PBI/2005 and No. 8/3/PBI/2006 on Conversion of Business of Conventional Commercial Banks to Commercial Banks Conducting Business Based on Shari'ah Principles and Establishment of Bank Offices, are the legal basis for the operation of Islamic banking. As mentioned in these regulations, the banks conducting Islamic banking business shall comply to Shari'ah principles in both product and operation. However, the regulation is silent on the audit of services and operations of the bank.

<sup>58</sup> Interview with Dr. Dadang Muljawan and Dr. Bambang Irawan, Directorate of Shari'ah Banking, the Central Bank of Indonesia, January 16, 2007.

consultants for financial products. It is true that there is no legal or administrative constraint on an individual to hold various positions at one time in different institutions. However, from ethical point of view, such practice should not be encouraged.<sup>59</sup> This, to a certain extent, may cause some inconvenience in performing supervisory duties. The issue of objectivity may arise in this context.

3). The conflict of interests between members of the board of directors and SSB

The core duty and responsibility of the members of the Board (SSB) to supervise the industry for Shari'ah compliance has not yet been fully understood by the industry. The board of directors may see that Board (SSB) members are too rigid viz-a-viz more accommodative and have a certain degree of flexibility.<sup>60</sup> This fact suggests the conflict of interests between the two as if they are rivals.<sup>61</sup> Certainly this behaviour needs harmonization towards an integrated vision between the two parties so as to enable the Board (SSB) members to work optimally.

The above are some of the substantial problems and challenges faced in terms of assuring *Shari'ah* compliance in Islamic banking sector in Indonesia. As these problems seem to be very crucial, bold steps are needed by the relevant authorities to address the problems and find appropriate remedies so as to enhance the functioning of the Islamic banking sector.

(b). *The Way Forward*

In response to various problems in the process of assuring Shari'ah compliance in Islamic banking, a few aspects have already been addressed:

1). The establishment of Shari'ah Banking Committee.

The newly established Shari'ah Banking Committee (Komite Perbankan Syariah) pursuant to the Act No. 21 of 2008 on Shari'ah Banking is aimed to resolve the problem of independence and lack of expertise in the area of Islamic finance.<sup>62</sup> This is supposed to be an independent committee working under the Central Bank. The qualification requirements for appointment of members on the Board (SSB) have to be determined by the Committee. The objective is to enhance the advisory or supervisory function of the Shari'ah Supervisory Board.

2). Special commissioner in the Shari'ah compliance aspect.

For the purpose of enhancement of the advisory or supervisory activities to ensure Shari'ah compliance, it is suggested to create a chair in the board of commissioners

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<sup>59</sup> This is different from the case of Malaysia, which strictly regulates that members of SAC cannot be members of the Shari'ah Board (Shari'ah Committee) in any Islamic Bank or *Takāful* Company. See, BNM/GPS1, Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institutions, December 2004, 19 (a), (Malaysia).

<sup>60</sup> Observation in Shari'ah Division, Bank Negara Indonesia, January 16, 2007.

<sup>61</sup> The board of directors (the management of the unit) is required to understand the position of the Shari'ah board within the industry. By mutual understanding, the existing legal framework can be easily implemented. In a case of compliance towards Shari'ah principles, it is hoped that the management will be more lenient in allowing members of Shari'ah board to conveniently conduct Shari'ah audit. Interview with Prof. Didin Hafidhuddin, member of NSC, January 27, 2007.

<sup>62</sup> Section 26 (4) and (5) of the Act No. 21 of 2008 on Shari'ah Banking, (Indonesia).

(directors) of the bank, which should be filled by a person well acquainted with handling the Sharī'ah aspects of the products and operations of the Islamic banking business. The position of a commissioner with sufficient authority will facilitate the process of Sharī'ah compliance and make it more meaningful in directing the industry towards the intended objective<sup>63</sup> (the board of directors will be under the authority of this commissioner?? How??).

It is evident from the above discussion that the process of assuring Sharī'ah compliance in Islamic banking in Indonesia needs further development. Thus, the relevant authority is still in the process of identifying a proper model, which is theoretically and practically acceptable. However, some of the regulations of the Central Bank of Indonesia relating to Sharī'ah compliance, which have been published and distributed to the Islamic banking and financial institutions in the recent two years are good attempts in the relevant direction.

#### 4. Conclusion

The discussions in this paper indicate that the process of assuring Sharī'ah compliance is one of the substantial aspects in shaping the practice of Islamic banking business to be truly reflective of Islamic norms. It is the process to determine the extent to which compliance to Sharī'ah principles is enforced and maintained. In this connection, the advisory and supervisory process supported by an established legal framework, is significant for ascertaining Sharī'ah compliance.

Looking at the theoretical discussions on the methods of assuring Sharī'ah compliance in the beginning of this paper, it is apparent that Islamic banking practice in Malaysia and Indonesia, to great extent, is parallel with what the theories suggest. However, in terms of the responsibilities of Sharī'ah board, both countries still emphasize more on the products as compared to the operational aspects of the Islamic banking business so far as Sharī'ah compliance is concerned. This point should be taken into consideration by both countries in the present established regulations, which exclude the operational aspect as part and parcel of the Sharī'ah compliance requirement. The detailed guidelines in terms of Sharī'ah Compliant Good Corporate Governance (GCG) are important to be initiated soon. This will support the objective of Sharī'ah compliance in the whole operation of the Islamic banking system.

The difference in adoption of the model of Sharī'ah board has brought about a difference in the process of ascertaining the bank complies to Sharī'ah principles. Indonesia has adopted the "supervisory" model that holds the Sharī'ah Supervisory Board (SSB) to be responsible for reporting Sharī'ah issues to the Central Bank, and the later treats this report as a preliminary proof for further investigation to be conducted. The case of Malaysia is somewhat different. The Sharī'ah board members are not obliged for this responsibility. It is the Bank Negara Malaysia, through the Supervisory Department, which holds the authority to handle such cases of incompliance.

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<sup>63</sup> Interview with Prof. Asyuni Abdurrahman, member of National Sharī'ah Council Indonesia, February 3, 2007.



Malaysia has planned to adopt *fatwās* standard that is internationally recognized. However, Indonesia seems to be focused on domestic needs, as the country is still undergoing the process of strengthening the foundation for the Islamic banking business. Following the plan for globalizing Islamic financial business in Malaysia, the policy to harmonize *fatwās* looks to be sensible as this country is striving to be a future hub for the International Islamic financial business in the region.

The position of the Sharīḥ Advisory Council of Malaysia (which draws its authority from the Central Bank) is different from the National Sharīḥ Council of Indonesia (which works in the capacity of a non-governmental body). The process for issuing *fatwās* in Indonesia is more complicated, whereby there must be at least two general meetings and two special meetings. This is because many members and many institutions are involved in the process. In contrast, the process is more simple and straight forward in Malaysia, and therefore less time consuming.

Since the regulatory framework in both countries still needs improvement, a reference to the decisions of international regulatory bodies, especially AAOIFI and IFSB, is very important. The problems arising due to deficiency in the legal provisions can temporarily be avoided.

As Sharīḥ compliance is part and parcel of the legal framework in the two countries, the non-compliance means an infringement of the existing legal frameworks (namely IBA 1983 and BAFIA 1989 in Malaysia and Act No 10 of 1998 on Banking in Indonesia). Therefore, in cases of non-compliance where found, the Central Bank shall undertake necessary investigation leading to direct actions and punishments. In Malaysia, such investigation is clearly stipulated, while in Indonesia, there is no clear provision in the regulations at present.

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