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Dissecting the Principle of “Due Regard”: Exploring The Interaction Between Board of Directors and Its Shariah Committee in Malaysian Islamic Financial Institution

Analisa Mengenai Prinsip "Pertimbangan Sewajarnya": Meneroka Interaksi Antara Lembaga Pengarah dan Jawatankuasa Syariah di Institusi Kewangan Islam Malaysia

Mohamed Hadi*

Abstract

Board of Directors (‘Board’) of an Islamic Financial Institution (‘IFI’) is statutorily required to ensure that the aims and operations, business, affairs and activities of such IFI are in compliance with Shariah. Despite having the ultimate power to run the IFI, the Board is statutorily expected to seek advice from the Shariah Committee (‘SC’) of such IFI with a view to achieve the compliance in Shariah. Nevertheless, the treatment on the Shariah advice from the SC is debatable. Is it obligatory or merely persuasive for the Board to follow such advice? The law simply mentions that the Board shall have due regard to any decision of the SC on any Shariah issue relating to the carrying on of business, affairs or activities of the IFI. Recently, Bank Negara Malaysia (‘BNM’) issued the Shariah Governance Policy Document which aims to regulate the proper treatment of due regard. Based on this Policy Document, the ultimate accountability of Shariah compliance still lies on the Board. The Board in essence is expected to follow the advice of the SC and giving due regard to such advice, the Board is required to put in place conflict resolution mechanism to deal with any differences in views between the Board and the SC, in the case where the Board refused to accept the views of SC with justifications.

Keywords: Board of Directors, Directors’ Duties, Islamic Financial Services Act 2013, Shariah Committee, Due Regard, Shariah Governance.

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Abstrak


Introduction

Islamic financial institutions (‘IFIs’) in Malaysia are generally governed under two principal laws enacted by the Parliament of Malaysia, namely Companies Act 2016 (‘CA 2016’) and Islamic Financial Services Act 2013 (‘IFSA 2013’). Since majority of IFIs are companies, their registration, administration and related matters thereto

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1 IFI is defined under Section 2(1) of the Central Bank of Malaysia Act 2009 (‘CBMA’) as a financial institution carrying out Islamic financial business. Islamic financial business is defined under the same section as any financial business in Ringgit or other currency which is subject to the laws enforced by the Bank and consistent with the Shariah. To put it differently, IFI is a financial institution which carries out Shariah compliant financial business.

2 Section 21(1) of IFSA 2013 generally provides that a person who is to be licensed to carry on Islamic banking business or takaful business shall be a public company. Some IFIs exist in the form of co-
are ruled by CA 2016. On the other hand, the regulation and supervision as IFIs are governed by IFSA 2013 and effectively regulated by BNM. Conventional financial institutions are allowed to carry on Islamic financial business upon the written approval of BNM under section 15(1) of Financial Services Act 2013 (‘FSA 2013’). For example, conventional licensed banks or licensed investment banks under are allowed to carry on Islamic banking business upon the written approval from BNM.  

Being a director of an IFI is quite different compared to company directors in other institutions. In addition to the statutory duties under CA 2016, a director of an IFI is expected to discharge the duties based on the requirements of IFSA 2013. In this sense, an IFI via its Board is required to ensure that the aims and operations, business, affairs and activities of such IFI are in compliance with Shariah. How can the Board ensure that the ultimate Shariah compliance is achieved in the IFI? Section 30(1) of IFSA 2013 stipulates that such IFI shall establish its SC for purposes of advising the IFI in ensuring its business, affairs and activities comply with Shariah.

It is the aim of the article to examine the relationship between the Board and the SC in terms of achieving the overarching objective of Shariah compliance for the IFI. Does the Board have to strictly follow the SC’s advice whereas the ultimate accountability of Shariah compliance lies on the Board? Can the Board refuse to follow the ruling issued by its SC? The analysis is presented based on the statutory provisions and available guidelines issued by the regulator i.e. BNM.

**Directors’ Duties under Companies Act 2016**

Section 211(1) of CA 2016 provides explicitly that the business and affairs of a company shall be managed by, or under the direction of the Board. Section 211(2) of CA 2016 further provides that the Board has all the powers necessary for managing and for directing and supervising the management of the business and affairs of the company.

As a director, a Board member shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company. In commenting the “proper purpose” and “good faith”

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操作系统，如Bank Kerjasama Rakyat Malaysia Berhad和Koperasi Co-opbank Pertama Malaysia Berhad.

3 Section 15(1)(a) of FSA 2013
4 Section 28(1) of IFSA 2013
5 Section 213(1) of CA 2016.
provisions, Abang Iskandar JCA (as he then was) in Zaharen Hj Zakaria v. Redmax Sdn Bhd & Other Appeals [2016] 7 CLJ 380 held as follows:

...a director of a company has to give his all to serve in the best interest of the company of which he is a director. Gone are the days when a company director can be heard to say that he was a sleeping director and expect to escape liability. His duty may appear onerous but that is to be expected as he is part of the alter ego of the company. He is a fiduciary, a trustee. It is not his business to act like a rogue, much less to act to the detriment of the company.6

Apart from exercising director’s powers for a proper purpose and in good faith in the best interest of the company, a director is also expected to exercise reasonable care, skill and diligence. In particular, the director shall exercise such reasonable care, skill and diligence with the knowledge, skill and experience which may be reasonably be expected of a director having the same responsibilities. In other words, a director shall exercise his reasonable care, skill and diligence similar to other “reasonable directors” having the similar responsibilities. For example, in determining whether there is unfairness in the decision of the directors, the test of to be adopted by the court is “whether reasonable directors possessing the skills, knowledge, acumen and experience of the directors would have decided that a proposed course of action was unfair”.7

Another example to illustrate is when a company which is in the business of property development may appoint, a director with town planning experience. If it is alleged that this director has breached his duty, then whether there is a breach will be tested by reference to a reasonably competent non-executive director with town planning experience.8

Based on the preceding principle, a reasonable director will not affirm a statutory declaration (‘SD’) regarding the company’s assets

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6 p. 398
7 Per Siti Norma Yaakob J (as she then was) in Jaya Medical Consultants v. Island & Peninsular [1994] 1 MLJ 520 at p. 536
without knowing the truth or otherwise of the contents of the SD.\textsuperscript{9} Any reasonable director who does not actually know about the company’s assets will not affirm any SD regarding the company’s assets.\textsuperscript{10} The fact that a director has affirmed the false SD regarding the company’s assets without knowing as a fact whether such company actually owns assets, greatly undermines the director’s credibility.\textsuperscript{11} In addition, such director is also expected to exercise reasonable care, skill and diligence with any additional knowledge, skill and experience which the director in fact has.\textsuperscript{12} The failure of a director to exercise the statutory directors’ duties is considered a criminal offence under CA 2016.\textsuperscript{13}

**Directors’ Duties under IFSA 2013**

It is worth to mention that IFSA 2013 also replicates the directors’ duties in CA 2016 and provides the similar provisions on directors’ duties under Section 66(1)\textsuperscript{14}. On top of the ordinary duties, IFSA 2013 imposed additional duties to the Board members, as stipulated in Section 65(1), (2) and (3) of IFSA 2013.

In principle, the Board of an IFI shall manage the business and affairs of such IFI under the Board’s direction and oversight.\textsuperscript{15} In addition, the Board of such IFI shall:

\textsuperscript{9} Per Wong Kian Kheong JC (as he then was) in Muniandy a/l Nadasan & Ors v Dato’ Prem Krishna Sahgal & Ors [2016] 11 MLJ 38, at p. 75
\textsuperscript{10} Ibid.
\textsuperscript{11} Ibid, at p. 76
\textsuperscript{12} Section 213(2)(b) of CA 2016
\textsuperscript{13} Section 213(3) of CA 2016 provides that a director who contravenes this section commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM3 million or to both.
\textsuperscript{14} A director of an institution shall at all times –
(a) act in good faith in the best interests of the institution;
(b) exercise reasonable care, skill and diligence with—
(i) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and
(ii) any additional knowledge, skill and experience which the director has;
(c) only exercise powers conferred on him for the purposes for which such powers are conferred;
(d) exercise sound and independent judgment; and
(e) comply with any standards specified by the Bank under subsection 29(2) which are applicable to a director.
\textsuperscript{15} Section 65(1) of IFSA 2013.
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(a) set and oversee the implementation of business and risk objectives and strategies and in doing so shall have regard to the long-term viability of the IFI and reasonable standards of fair dealing;

(b) ensure and oversee the effective design and implementation of sound internal controls, compliance and risk management systems commensurate with the nature, scale and complexity of the business and structure of the IFI;

(c) oversee the performance of the senior management in managing the business and affairs of the IFI;

(d) ensure that there is a reliable and transparent financial reporting process within the IFI; and

(e) promote timely and effective communications between the IFI and BNM on matters affecting or that may affect the safety and soundness of the IFI; and

(f) have due regard to any decision of the SC on any Shariah issue relating to the carrying on of business, affairs or activities of the IFI.

Another peculiarity of IFSA 2013 in relation to directors’ duties is the necessary regard of the Board to the stakeholders. Despite discharging their duties for the interest of shareholders, the Board shall have regard to the interests of, as the case may be, depositors, investment account holders and takaful participants of the institution. Interestingly, the Board of a licensed takaful operator shall, in the event of conflict between the interest of the takaful participants and the shareholders, give precedence to the interest of the takaful participants. This reflects the paramount duty of the Board to prioritize the interest of the takaful participants over the shareholders’ interest at all times. It signifies the position of the Board as the ‘trustee’ in managing monies of takaful participants put on trust.

The compelling point which warrants this article is the due regard treatment expected from the Board on any decision of the SC on any Shariah issue regarding the business, affairs and activities of such IFI.

Roles and Functions of Shariah Committee

As mentioned in the introduction, the Board appoints SC for the purpose to advise the IFI in ensuring its business, affairs and activities

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16 Section 65(3)(a) of IFSA 2013
comply with Shariah. Apart from the statutory duties imposed in IFSA 2013, the detailed particulars of roles and functions of SC are provided in the Shariah Governance Policy Document (‘SGPD’)\textsuperscript{17} issued by BNM on 20 September 2019. Paragraph 10.2 of the SGPD outlines the responsibilities of the SC which includes –

(a) providing a decision or advice to the IFI on the application of any rulings of the Shariah Advisory Council of BNM (‘SAC’) or standards on Shariah matters that are applicable to the operations, business, affairs and activities of the IFI;
(b) providing a decision or advice on matters which require a reference to be made to the SAC;
(c) providing a decision or advice on the operations, business, affairs and activities of the IFI which may trigger a Shariah non-compliance event;
(d) deliberating and affirming a Shariah non-compliance finding by any relevant functions; and
(e) endorsing a rectification measure to address a Shariah non-compliance event.

After IFSA 2013 was introduced in 2013, the superseded SGF (and later the new SGPD) enjoy a statutory status where section 29(2)\textsuperscript{18} of IFSA 2013 upholds the level of the SGF/SGPD and the SGF/SGPD become a standard that shall be complied with by all IFIs. In other words, the SGF/SGPD become a standard which has effect similar to a parliamentary statute.

\textsuperscript{17} Shariah governance of IFI was principally governed by Shariah Governance Framework for Islamic Financial Institutions (‘SGF’) issued by BNM on 22 October 2010. SGF will be superseded by the new SGPD which will take effect on 1 April 2020.

\textsuperscript{18} In addition, BNM may also specify standards relating to any of the following matters which does not require the ascertainment of Islamic law:

(a) Shariah governance including —

(i) functions and duties of the board of directors, senior officers and members of the SC of an IFI in relation to compliance with Shariah;
(ii) fit and proper requirements or disqualifications of a member of a SC; and
(iii) internal Shariah compliance functions; and
(b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shariah.
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The “Missing Link”?

In line with the duty of the SC to advise the IFI on Shariah matters, Paragraph 1.6, Part 2 of the then SGF provides that the SC shall functionally report to the Board of the IFI. Although the SC is expected to perform an oversight role on Shariah matters related to the IFI’s business operations and activities, it is the Board which is ultimately accountable and responsible on the overall Shariah governance framework and Shariah compliance of the IFI.

However, under the new SGPD, the above provisions are no longer available and there are no equivalent provisions to reflect the relationship between the Board and the SC. In other words, the new SGPD is ‘silent’ on the functional reporting of the SC to the Board. Is this a “missing link”? Does the omission is deliberately intended?

It is worth to highlight that Paragraph 8.1 of the new SGPD maintains that the Board has the oversight accountability over Shariah governance and compliance of the IFI. Furthermore, Paragraph 9.5 of the SGPD puts a duty on the Board to establish a formal process to assess, at minimum annually, performance and effectiveness of the SC and every SC member. This impliedly indicates that the Board is still the ultimate authority over the SC within the corporate governance structure. In other words, it can be argued that the absence of similar aforementioned SGF provisions in the new SGPD is immaterial because eventually, it is the Board which is ultimately accountable and responsible over Shariah governance and compliance. The mandate of the SC is still preserved statutorily – the SC acts as the Shariah advisor to the IFI on the operations, business, affairs and activities of the IFI. It is pertinent to highlight that despite the ultimate accountability of the Board over Shariah governance and compliance of the IFI, the Board must ensure that the SC is free from any undue influences that may hamper the SC from exercising its professional objectivity and independence in deliberating issues brought before them. The Board is responsible if it allows the practice and culture of corporate environment which may affect the independence of the SC in discharging the latter’s duties and responsibilities.

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19 Paragraph 2.8, Section 2, the SGF
20 Paragraph 2.1, Section 2, the SGF
21 Paragraph 9.2 of the SGPD
The “Due Regard” Relationship

In relation to Shariah compliance, it is the duty of the Board to have due regard to any decision of the SC on any Shariah issue relating to the carrying on of business, affairs or activities of the IFI.\(^\text{22}\) It is argued that the definition of due regard is rather ambiguous. Is it obligatory for the Board to follow the decision of the SC on Shariah issue relating to the IFI or the Board can have some reservations to decline the advice of the SC, based on any credible reason?

The literal definition of due regard gives a compelling, but not an obligatory consideration upon the Board to assess the advice of the SC. The Board may or may not adopt such advice. After all, the Board holds the ultimate accountability and responsibility on the overall Shariah governance framework and Shariah compliance of the IFI, as provided in IFSA 2013 and CA 2016. It would be against the legal provisions of CA 2016 if due regard is understood to mean the Board is statutorily required to follow the advice of the SC on Shariah matters.

It is submitted that there is always room for discussion between the Board and the SC should the former is not agreeable to the Shariah decision resolved by the latter. Nevertheless, the SC should have the final say on the Shariah issue and due regard here must be construed as binding to the Board. Otherwise, the function and integrity of the SC will be questioned as people may perceive that the SC is compromising with the Board on Shariah issues related to the business, affairs or activities of the IFI.

Paragraph 10.7 of the SGPD illustrates a situation when the Board wishes to adopt the ruling of the SAC of BNM which is less stringent than the ruling of its SC. In the event where the SC decides or advises to place additional restrictions on the operations, business, affairs and activities of the IFI in applying the SAC rulings, the IFI must–

(a) document the deliberations and justifications of the SC’s decision or advice;
(b) ascertain the Board’s views on the decision or advice made by the SC with regards to the SAC ruling; and
(c) ensure immediate notification to BNM of such decision or advice.

Paragraph 10.7 of the SGPD does not mention which opinion must be followed. Paragraph 10.7(b) simply requires the IFI to ascertain the views of the Board and the SC in relation to the SAC ruling and

\(^{22}\) Section 65(2)(f) of IFSA 2013
Paragraph 10.7(c) requires the IFI to notify such decision or advice immediately to BNM. This provision imply the function of BNM as the regulator which will provide an internal mechanism to reconcile the opinion of the Board and the SC regarding the application of the SAC ruling.

Perhaps this is the only given situation in the SGPD which may trigger the conflict of opinion between the Board and the SC. It is not directly clear about other situations which may draw the conflict of opinion between these two organs.

Looking from another perspective, if the Board wishes to blatantly disregard the Shariah decision of the SC based on any reason, it is pertinent to note that the duties of the SC have been discharged and the Board may need to justify their move to the regulator, when the need arises. After all, the Board is eventually answerable to the shareholders (and public), thus the SC is absolved from any legal consequences after the issuance of such Shariah decision.

“Due Regard” Explained

For almost 10 years, the SGF served as the guiding documents governing the IFIs. Prior to the issuance of the final SGPD in 2019, BNM issued the Shariah Governance Exposure Draft (‘SGED’) with the aim to obtain feedbacks from the stakeholders among industry players. While the SGF is silent on the “due regard” relationship between the Board and the SC, the SGED tried to offer a significant insight on this relationship.

Paragraph 9.1 of the SGED reiterates the responsibility of the Board to have due regard to any decision or advice of the SC on any Shariah issue relating to the operations, business, affair or activity of the IFI. Paragraph 9.1 of the SGED further explains this responsibility which requires the Board to –

(a) give sufficient attention to the facts, rationale and basis for any decision or advice of the SC before arriving at its own decision;
(b) give fair consideration to the implications of implementing any decision or advice of the SC;
(c) take reasonable steps to resolve any differences in views between the Board and the SC; and
(d) maintain a record of any differences between a decision of the Board and a decision of the SC in accordance with paragraph 9.2.

Item (a) to (c) above indicate the responsibility of the Board to ensure the exercise of their highest consideration over the decision of the SC. In the same vein, they also denote the principle that it is still the Board which holds the ultimate accountability over the Shariah compliance of such IFI.

With regard to item (d) above, Paragraph 9.2 of the SGED illustrates the maintenance of record by referring to the situation where the SC holds a stricter view on a Shariah matter relative to a published ruling of the SAC and the Board seeks to apply the ruling of the SAC. Where such a situation arises, the Board must document the justifications for the decision and inform BNM no later than fourteen (14) days from the date that such decision was made.

Interestingly, Paragraph 9.2 of the SGED suggests that the Board may depart from the SC’s decision when the SC’s decision is stricter than the decision of the SAC. In other words, the Board can choose to adopt SAC’s decision which is more lenient than the SC. The old SGF allows the SC to adopt a more stringent Shariah decision than the SAC. However, the SGF is silent on the treatment when the SC holds a stricter view than the SAC but the Board wishes to adopt the more lenient view of the SAC. Paragraph 9.2 of the SGED effectively allows the Board not to follow the decision of the SC, after due regard has been given on the SC’s view, provided that the Board is adopting the SAC’s view which is less stringent than the SC.

Paragraph 9.2 of the SGED also provides a discreet understanding that the Board can only depart from the SC’s view in this single situation only i.e. when the Board wishes to adopt a less stringent view of the SAC. There is no other situation which the Board can override the SC’s view despite after having the due regard to such SC’s view.

The new SGPD which was issued on 20 September 2019 contains significant changes on this “due regard” relationship. Apparently, the proposed Paragraph 9.2 of the SGED which explains the permissibility of the Board to follow the less stringent view of the SAC over the stricter view of the SC was removed.

The proposed Paragraph 9.1(d) is revised. The Board is now required to maintain a record of deliberations between the Board and the

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23 Paragraph 6.4, Principle 5, Section V
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SC in matters where the differences in views exist, and its resolution. In other words, the differences of opinions between the Board and the SC may not only happen in one situation (i.e. permissibility of the Board to follow the less stringent view of the SAC over the stricter view), but it can happen in any possible situation. The maintenance of record of deliberations between the Board and the SC is pertinent for further scrutiny if required by BNM later on. The revision of Paragraph 9.1(d) upholds the accurate spirit of the law, i.e. the Board legally holds the ultimate accountability over the Shariah compliance of the IFI, after giving due regard to the Shariah advice from the SC.

The Board ‘versus’ the SC

Is it appropriate for the Board to take a different view from the advice of the SC? While some quarters may argue that this situation effectively undermines the ‘sanctity’ of Shariah advice provided by the SC, it does not mean that the Board can simply ignore the advice of the SC. In fact, the new SGPD imposes the requirement for a director to continuously develop and strengthen his knowledge and understanding on Islamic finance, as well as keep abreast with developments that may impact Islamic financial business, to fulfil his responsibility to the IFI.24

If the knowledge and understanding of the Board on Islamic finance is adequate, the issue of the Board not accepting the Shariah advice of the SC does not arise. The knowledge and understanding of the Board on Islamic finance should be harmonious with the Shariah advice of the SC.

The non-adherence of the Board to adopt the Shariah advice of the SC may indicate the possible lack of knowledge and understanding of the Board members on Islamic finance. In addition, it is highly unlikely for the SC members to provide incompetent Shariah advice without detailed research and deliberation. The record of deliberations between the Board and the SC as required by the new SGPD shall serve as a tool for BNM to evaluate true state of divergence between these two key organs.

Another important mechanism to harmonize the view of the Board and the SC is through the appointment of the SC member as a Board member. The superseded SGF has encouraged this practice by allowing the Board to consider appointing at least one (1) member of the

24 Paragraph 8.2 of the SGPD
SC as a member of the Board that could serve as a ‘bridge’ between the Board and the SC.\textsuperscript{25} The paramount reason is clear, to foster greater understanding and appreciation amongst the Board members on the decisions made by the SC.\textsuperscript{26} The new SGPD continues promoting this practice by the encouraging the Board to appoint an SC member as a Board member.\textsuperscript{27} The SC member appointed is expected to foster closer integration of Shariah governance consideration within the business and risk strategy of the IFI.\textsuperscript{28} The integration expected from such appointment should be able to harmonize the understanding of the Board and the SC and mitigate any misunderstanding and confusion that may arise from the Shariah advice provided the SC to the Board.

**Conclusion**

The recent SGPD throws a new light on the relationship between the Board and the SC vis-à-vis the due regard requirement. From the preceding discussion, the relationship between these two pertinent corporate organs can be summarized as follows:

(i) Legally, the Board holds an ultimate responsibility towards ensuring the Shariah compliance of the aims and operations, business, affairs and activities of the IFI, as required by IFSA 2013, CA 2016 and the superseded SGF/new SGPD;

(ii) Legally also, the SC serves as an advisor to advise the IFI in ensuring the latter’s business, affairs and activities comply with Shariah, as required by IFSA 2013 and the superseded SGF/new SGPD;

(iii) Despite the ultimate responsibility of the Board to ensure Shariah compliance of the IFI, the Board is statutorily required to have due regard to any decision of the SC on any Shariah issue relating to the carrying on of business, affairs or activities of the IFI. This due regard treatment must be given in addition to the regulatory requirements for the Board to ensure that the SC is free from any undue influences that may hamper the SC in exercising its professional objectivity and independence in deliberating Shariah issues;

\textsuperscript{25} Paragraph 2.4, Principle II, Section II of the SGF
\textsuperscript{26} Ibid.
\textsuperscript{27} Paragraph 12.10 of the SGPD
\textsuperscript{28} Ibid.
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(iv) Under the new SGPD, the Board may adopt different view from the SC, despite after having due regard to the advice of the SC. The Board is required to maintain a record of deliberations between the Board and the SC in matters where the differences in views exist, and its resolution;

(v) The permissibility for the Board to depart from the advice of the SC in all cases is in line with the legal position of IFSA 2013 and CA 2016 since the ultimate responsibility to ensure the Shariah compliance of the IFI lies at the Board and not at the SC;

(vi) Once the SC has provided the Shariah advice to the Board, the SC is absolved from any further consequences arising from the refusal of the Board to follow the advice of the SC;

(vii) The Board members are expected to possess adequate knowledge and understanding on Islamic finance. Understandably, the sufficient knowledge and understanding on Islamic finance can minimize the potential difference of Shariah views between the Board and the SC;

(viii) The Board is encouraged to appoint an SC member as a Board member with the aim to foster closer integration of Shariah governance consideration within the business and risk strategy of the IFI.
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