Foreword

My Islamic Finance which forms part of the My Tax Companion Series provides a general overview of Islamic finance in Malaysia, i.e. the various Islamic principles and basic Islamic financial structures. We hope you will find My Islamic Finance useful and informative. However, do contact us for any assistance or clarification that you may require.

The information in this CD is based on legislation as at 30 September 2009, unless otherwise indicated.

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1. Overview and background

Since its introduction in 1983, the Islamic financial system in Malaysia has progressed rapidly against a backdrop of an increasingly liberalised and competitive environment.

Malaysia’s success in Islamic finance was not achieved overnight. Malaysia’s first Islamic bank, Bank Islam Malaysia commenced operations in 1983 followed by the first takaful operator, Syarikat Takaful Malaysia in 1985.

Malaysia’s sukuk market started in 1990 with a modest issue size of RM125 million (US$36 million) by Shell MDS Sdn Bhd.

Two Shariah Advisory Councils (“SACs”) under Securities Commission Malaysia (“SC”) and Bank Negara Malaysia (“BNM”), were subsequently set up to provide regulatory guidance on the development of the Islamic finance market, instruments and institutions. In 2000, BNM and SC set out a 10-year development Master Plan for Malaysia’s financial sector and capital market, which outlined the strategic directions for the country’s Islamic finance sector.

In late 2006, the Malaysia International Islamic Financial Centre (“MIFC”) was set up in a concerted effort by the Government and various financial regulatory bodies to transform Malaysia into a vibrant, innovative and competitive Islamic financial hub.

Over the last decade, the cumulative Government policies, actions and initiatives have resulted in Malaysia being at the forefront of Islamic finance as well as having one of the largest Islamic financial markets in the world.

Through progressive economic policies and regulations, Malaysia continues to foster the expansion of the dual financial systems with both the Islamic and conventional systems operating in parallel to deliver innovative and competitive financial products and services. Islamic finance in Malaysia has achieved acceptance with a proven track record of competitive returns on investments. The ethical features of Islamic finance provides universal appeal and has started to be accepted worldwide.

Currently, there are 20 Islamic banks (including three International Islamic Banks) representing about 37% of the total number of banks in Malaysia and nearly all the major conventional banks have Islamic banking operations. As at August 2009, the total Islamic banking sector in Malaysia by asset size stands at RM213.8 billion (US$60.7 billion).
2. Malaysia International Islamic Financial Centre (MIFC)

Capitalising on Malaysia’s long and progressive track record of experience and expertise in Islamic finance, the Malaysian Government and regulators have set up the MIFC in 2006 with the aim of promoting Malaysia as an international Islamic financial centre.

The MIFC initiatives are specifically undertaken by the collective efforts of the country’s financial and market regulators, namely:

- Bank Negara Malaysia (“BNM”)
- Securities Commission (“SC”)
- Labuan Offshore Financial Services Authority (“LOFSA”)
- Bursa Malaysia (“Bursa”)

to provide an integrated and comprehensive approach to the development of the MIFC.

Among the objectives of MIFC are to develop Malaysia into a centre for the origination, distribution and trading of Islamic capital market instruments, for example, sukuks and treasury instruments, as well as Islamic fund and wealth management. Products and services under the MIFC can be in any currency and can be offered to both residents and non-residents.

In efforts to promote MIFC, BNM has introduced several new offshore Islamic banking and takaful licenses:

- International Islamic Bank (“IIB”) licence to conduct international banking business in international currencies other than Ringgit
- International Takaful Operator (“ITO”) licence to conduct international takaful businesses in international currencies other than Ringgit
- Existing Islamic banks and takaful operators can set up International Currency Business Units (“ICBUs”) to conduct the full range of Islamic banking or takaful services with non-residents and residents in international currencies
- Flexibility for Labuan offshore Islamic banks, Islamic divisions of the offshore banks as well as offshore takaful operators to open offices anywhere in Malaysia.
Aside from the issuance of the above licenses, SC has introduced Islamic fund management licence to conduct Islamic fund management services in Malaysia. The Government has announced a wide range of incentives in efforts to create the necessary critical mass of players and increase the scale of Islamic finance activities.

In addition to the many incentives, the Government has further liberalised the foreign exchange administration rules to allow multilateral financial institutions, multinationals and other national corporations to issue both Ringgit and non-Ringgit denominated instruments from Malaysia’s capital market. The effort will help deepen and widen the sukuk markets, provide linkages with international issuers and investors, and reinforce the international dimension of Malaysia as an international Islamic financial centre.
3. Islamic finance principles

Shariah is the key pillar of Islamic finance from which Islamic finance derives its unique characteristics. The Shariah directives require Islamic financial transactions to be accompanied by an underlying productive activity or an asset base. In Islamic finance, there is always a close link between financial and productive flows.

The main principles of Islamic finance include:

3.1 Prohibition of riba (usury)

Riba which covers interest can be described in Islamic finance as an increase in a loan deal / agreement or a commodity exchange which accrues to the lender without a corresponding value or recompensation in return to the other party. The laws of Islam prohibit any pre-determined fixed increase or charge as a result of advancing one’s money to another.

Islam however allows:

• Profits earned through profit sharing or through a profit margin
• Income earned via fees and commissions

3.2 Prohibition of gharar (uncertainty)

Gharar can be described in Islamic finance as an element of deception either through lack of knowledge of a vital part of the goods, the price, or through deceptive description of the goods, in which one or both parties stand to be misled.

Under Shariah, contracts which include uncertain terms (e.g. subject matter, price and timing of delivery) are prohibited.
3.3 Prohibition of maisir (speculation)

Maisir can be described in Islamic finance as any activity that involves the action of betting, i.e. (the winner takes the bet and the loser loses his bet). Under Shariah, transactions that rely on “speculation” (for example, certain derivative transactions) are prohibited.

3.4 Prohibition to invest in certain sectors (i.e. “haram” items)

Investments in businesses in certain “haram” sectors are prohibited; for example industries related to alcohol, swine, entertainment involving gambling / unethical goods and services, weapons and defense and conventional financial services.
4. Basic Islamic finance transaction structures

There are several basic transaction structures which are adopted in Islamic finance. Some of the structures are explained below together with illustrations, where applicable. There are many variations to the general structures as set out in the illustrations and as such, these illustrations should not be construed as the only means of representing these transactions.

It should be noted that in practice, due to the complexity of current business dealings, financiers often combine several of these basic transaction structures to achieve the required objective.

4.1 Sale and purchase

(i) Murabahah

Murabahah is a sale and purchase contract for financing of an asset whereby the cost and profit margin (mark-up) are pre-agreed by the contracting parties.

Under this arrangement, the seller purchases an asset which has been identified by the customer and sells it back to the customer at a marked-up price (premium) agreed to by both parties. The original price of the asset (including all related expenses) must be made known and the profit to be earned by the seller which may be a certain amount of money or percentage of the asset price is declared to the buyer.

The buyer may settle the agreed price within an agreed time frame either in a lump sum or in instalments. As murabahah is a sale contract, the ownership of the asset with all its obligations, for example insurance, maintenance, and taxes, is transferred to the buyer. This is a sale and purchase contract which is based on trust.

The assets to be purchased by the financier must be assets in existence and this would include intellectual properties such as trademarks, brands, patents and copyright. Assets under construction are not eligible. Physical or constructive possession by the seller is required for the asset to qualify for a murabahah sale.
(ii) Bai Bithaman Ajil (BBA)

The BBA is similar to a murabahah arrangement but payment by the customer to the financier is made on a deferred basis. In a BBA arrangement:

1. The customer identifies the asset to be purchased
2. The financier will determine the requirements of the customer e.g. the financing tenure, etc and the financier will purchase the asset
3. The financier will subsequently sell the asset to the customer at an agreed price. The agreed price would consist of:
   (i) actual cost of asset to the financier
   (ii) the financier’s fixed profit margin
   (iii) other related costs of acquiring the assets, e.g. legal fees, takaful mortgage coverage
4. The customer will pay for the asset purchased by instalments throughout the financing period

The financier has the right to terminate the facility and claim the outstanding balance but not the right to repossess the asset as ownership of the asset has passed to the customer. However if the asset is used as a collateral, the asset may be sold and any balance after deducting the unpaid amount will be released to the customer.

Illustration

In Malaysia, murabahah is normally used for short-term financing while BBA is used for longer term financing.
This is a version of the BBA which is used in the Middle Eastern Region.

Illustration

1. Bank purchases commodity from supplier

2. Customer purchases commodity from bank on deferred instalment basis

3. Customer sells the commodity to buyer

4. Customer uses cash proceeds from sale of commodity for personal use / house purchase
4.2 **Ijarah (leasing)**

Ijarah is the equivalent of leasing for conventional financing and involves the leasing of an asset to a customer in return for periodic rentals. The basic ijarah arrangement has the following features:

1. The customer identifies the asset to be leased
2. The financier will buy an asset (e.g., equipment, buildings or other facilities) from a supplier
3. The financier then leases the asset to the customer
4. The periodic rent paid by the customer will include a pre-agreed profit element

Ownership of the asset remains with the financier who takes responsibility for insuring and maintaining the leased asset.

Ijarah arrangements can help financiers create a secondary market through securitisation of the leased assets. Since the lessor in an ijarah arrangement owns the leased assets, the lessor can sell the assets to a third party who will then assume the seller’s rights and obligations.

**Illustration**

In an Ijarah Thumma al-Bai, the lease agreement includes the subsequent purchase of a leased asset at the end of the lease tenure.
4.3 Musharakah (partnership / joint venture)

Musharakah is a partnership financing agreement between two or more parties to engage in a specific business activity. Musharakah’s main features are as follows:

1. Contribution of capital by partners. The contributions need not necessarily be in equal shares and may be disbursed immediately or progressively depending on the agreement signed.

2. Sharing of profits or losses
   - All partners are entitled to a share in the profits of a project at a mutually agreed ratio. The mutually agreed ratio is not solely based on the percentage of shareholdings, but also subject to agreement amongst the partners.
   - Losses are shared in proportion to the amount invested except for losses caused by negligence or deceit.

Partners who contribute funds have the right to exercise executive powers in the project. Each partner has a right to manage the business himself or appoint an agent on behalf of the other partners under the agency of wakalah. A partner is permitted to withdraw from management if he so chooses.

Illustration

A variation of musharakah financing would be the musharakah mutanaqisah (diminishing ownership) financing where one party gives the right to the other party to gradually acquire his share of equity or capital throughout the contracted period. An example would be where a financial institution and its customer jointly acquire a property (say, a house) and the customer gradually pays periodic instalments over a contracted term to acquire the portion owned by the financial institution.
4.4 Mudharabah (profit sharing)

Mudharabah is a joint venture or partnership between persons which provide capital (Rabbulmal) and an investment manager / entrepreneur (the Mudharib) which provides the expertise or entrepreneurship.

The main features of mudharabah financing are as follows:
1. The Rabbulmal provides the capital for the Mudharib to manage the joint venture or project
2. Sharing of profits or losses
   • The agreed profit sharing ratio between the Rabbulmal and the Mudharib must be determined at inception of the contract (aqad)
   • The Rabbulmal will bear the losses from the venture unless there is misappropriation of capital / negligence / misuse of funds by the Mudharib

There are two main types of mudharabah financing:
• Mudharabah muqayyadah (restricted mudharabah)
  [specifications have been put into place, i.e. on types of investment, etc]
• Mudharabah mutlaqah (unrestricted mudharabah)
  [there is no imposition on any limitation on the type / place of business, methods of payment, period of investment, etc]

Illustration

- Rabbulmal
  1. Provision of capital
  2. Profit share
- Mudharib
  1. Project management
  2. Losses (if any)
- Specified investment / asset / project
  1. Profit share
4.5 Istisna’ (bridging financing)

Istisna’ refers to an agreement to sell to or buy from a customer a non-existent asset which is to be manufactured or built based on the specifications outlined by the ultimate buyers at an pre-agreed selling price and which will be delivered on a specified date in the future.

The main features of istisna’ financing are as follows:

1. There are normally two istisna’ agreements entered into on a back-to-back basis
   • Agreement 1: Customer agrees to construct or manufacture and deliver to the financier a specified asset for a pre-agreed amount
   • Agreement 2: The financier agrees to construct or manufacture and deliver to the customer a specified asset for a sum which comprises the principal and a profit
2. Customer contracts with the supplier / contractor to manufacture or construct the asset
3. Payments to supplier / contractor are normally arranged based on a schedule of work completed

Illustration

Istisna’ transactions are normally applied to housing, building and construction of commercial and industrial building projects. Istisna’ is also suitable for long-term project financing, e.g., infrastructure construction.
5. Islamic financial instruments

Sukuk are Islamic bonds which have similar characteristics with a bond with the main difference being that they are asset-based and free from usury (interest).

Sukuk are essentially financial instruments that sit above a Shariah-compliant underlying structure which generates income for the instrument holder. Through investment in sukuk, Islamic banks and institutional investors are able to invest their idle surplus cash while adhering to Shariah principles. Sukuk can also be structured to offer the issuer greater financial flexibility and to open up more options to meet the issuer’s funding requirements. This effectively establishes an active secondary market and promotes efficient liquidity management.

Sukuk are structured and linked to the returns and cash flows relating to the assets purchased or the returns generated from the assets purchased. This is done to avoid trading of debts, which is prohibited under Shariah. Among the major sukuk-based concepts in Malaysia are:

- Musharakah
- Murabahah
- Ijarah
- Istisna’
Sukuk structures

5.1 Sukuk al Musharakah

In the following example of a Sukuk al Musharakah arrangement, the following would take place:

1. Sukuk holders contribute a capital amount to the sukuk issuer which is a special purpose vehicle (SPV)
2. The SPV then enters into a joint venture with the party seeking finance (originator). The SPV provides the capital whilst the originator provides the assets / or their own capital required to run the business
3. Profits are distributed to the SPV and the originator on a pre-determined basis whilst any losses are shared out in proportion to the capital contributed
4. A periodic distribution is paid to the sukuk holders out of the musharakah profit distribution

The project upon completion will be sold / disposed off and the proceeds will be shared between the issue and originator on a predetermined basis. The proceeds received by the issue will be used to redeem the sukuk from the sukuk holders.

Illustration
5.2 Sukuk al Murabahah

In the following example of a Sukuk al Murabahah arrangement, the following would take place:

1. Sukuk holders contribute a capital amount to the sukuk issuer which is a special purpose vehicle (SPV)
2. The SPV acquires the asset and sells it to the customer at a pre-determined price
3. The customer pays periodic instalments to the SPV for acquisition of asset. The periodic instalments will include the repayment of cost and the profit component
4. A periodic distribution is paid to the sukuk holders out the periodic instalments made by the customer

At the completion of the arrangement tenure, the sukuk will be redeemed by the SPV.

Illustration

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Sukuk holders

1. Sukuk proceeds
2. Asset sale
3. Periodic instalments

Customer

SPV

2. Asset purchase

1. Sukuk proceeds
4. Periodic profit distribution

Asset owner
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5.3 Sukuk al Ijarah

In the following example of a Sukuk al Ijarah arrangement, the following would take place:

1. Sukuk holders contribute a capital amount to the sukuk issuer which is a special purpose vehicle (SPV)
2. SPV purchases property / asset from obligator and holds the title in trust for the sukuk holders
3. SPV leases the property / asset to the obligator for a pre-agreed period
4. SPV collects rentals from the obligator
5. SPV pays a periodic distribution to the sukuk holders using the rental proceeds

At the completion of the arrangement tenure, sukuk from the sukuk holders will be redeemed by the SPV.

Illustration

- Sukuk holders
- Obligator
- SPV

1. Sukuk proceeds
2. Asset sale
3. SPV leases asset to obligator
4. Collects periodic rental from obligator
5. Periodic profit distribution
2. SPV pays for asset
5.4 Sukuk al Istisna’

In the following example of a Sukuk al Istisna’ arrangement, the following would take place:

1. Sukuk holders contribute a capital amount to the sukuk issuer
2. The sukuk proceeds are used to pay the contractor to construct and deliver the future asset. The asset title is transferred to the SPV
3. The completed asset is consequently leased or sold to the end buyer
4. Monthly instalments are paid to the SPV
5. SPV pays a periodic distribution to the sukuk holders using the rental proceeds

At the completion of the arrangement tenure, the sukuk will be redeemed by the SPV.

Illustration

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1. Sukuk proceeds
2. Asset sale
3. Completed asset sold at mark-up
4. Monthly instalment
5. Periodic profit distribution

Sukuk holders

Contractor

Asset manufactured / constructed

SPV

2. Payment by SPV

Customer
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At the completion of the arrangement tenure, the sukuk will be redeemed by the SPV.
6. Takaful industry

The Malaysian takaful market has achieved commendable growth since its inception in 1983. Currently, there are eight takaful operators, four retakaful operators and one international takaful operator, of which six are joint venture with foreign players from the United Kingdom, Bahrain, Germany and Japan, conducting both domestic and foreign currency businesses. This makes up 22% of the number of insurance and takaful players in Malaysia.

As at July 2009, total assets of Malaysia's takaful industry amounted to RM11.7 billion (US$3.3 billion), with market share of 7.5%. Takaful fund assets and net contribution income experienced strong growth with an average annual growth rate of 20.4% and 28.1% respectively from 2004 to 2008.

Retakaful is a vital part of the takaful sector to provide risk-mitigating mechanism, capital relief provision and to provide the essential technical capabilities in managing risks. Currently, there is shortage of retakaful capacity and this has caused the takaful industry to be still dependent on conventional reinsurance. There is room for growth in this sector.
6.1 Operating models in Malaysia

Takaful is based on solidarity and risk-sharing principles. It is an Islamic form of financial protection, similar to conventional insurance, and has been established in its modern form for more than 25 years.

Takaful arrangements can be used to pool either general insurance risks or life (known as family takaful) risks, covering the same spectrum as conventional insurance. As with all Islamic forms of finance, takaful companies follow Shariah principles.

The basic concept for takaful sees the customers (policyholders) of the takaful business pooling their contributions and sharing the liability of each policyholder. So if one policyholder has to be paid a claim, this is paid out of the combined pool of contributions.

In Malaysia, participants (policyholders / shareholders) contribute a sum of money into a common fund, which is used to mutually assist against a defined loss. The fund is managed by a takaful operator, who runs the operation as an economic venture, deriving income from investment of the shareholder’s fund and a share of the takaful fund, agency fees and surpluses of the takaful fund.

The operating contract between the participants and the takaful operator depends largely on the needs and preferences of the parties. Malaysia has adopted a flexible framework for operators to choose a suitable model, with the condition that parameters are drawn based on Shariah principles and prudential requirements. However, the future may see some form of streamlining by the regulators to a common operating model.

6.2 Mudharabah (profit sharing)

The takaful industry started with two operators which adopted the mudharabah (profit sharing) model, under which takaful contracts set out a profit-sharing basis between operator and participant.

In a mudharabah model, the shareholders are paid:

- A pre-agreed proportion of any surplus generated by the policyholder’s fund in return for running the insurance operations of the takaful business on behalf of the policyholders
- If the policyholders’ fund makes a loss, the operator will provide an interest free loan
6.3 The wakalah (agency)

The subsequent incorporation of new operators saw the wakalah (agency) operating model being adopted. The takaful contract under wakalah works on the basis of wakalah fees being charged. It is generally perceived that the wakalah takaful contract is simpler.

In a wakalah model:

- The operator acts as an agent of the participants
- The shareholders are paid a pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the takaful business on behalf of the policyholders
- If the policyholders’ fund makes a loss, the operator provides an interest-free loan to the policyholder’s fund that is repaid out of future surpluses in the fund

6.4 Hybrid model

A hybrid model can also be used which is a mixture of the mudharabah and wakalah models. The operator could receive a wakalah fee for managing the insurance operation of the policyholders’ fund as well as a mudharabah fee for managing the investment fund.
7. Tax

7.1 Tax neutrality

Currently, the Malaysian tax legislation has tax neutrality provisions so that Islamic finance transactions are treated similarly to conventional financing transactions for tax purposes.

Section 2(7) of the Income Tax Act 1967 provides that gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Shariah, will be treated as interest.

From a tax standpoint, the gains or profits relating to Shariah transactions will therefore have the same treatment as interest under conventional transactions.

Section 2(8) of the Income Tax Act 1967 provides that the disposal of any asset or lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by BNM or the SC, as a scheme which is in accordance with the principles of Shariah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other scheme of financing.

This essentially means that any sale or lease of asset which is performed strictly for the purposes of meeting Shariah requirements would be ignored for tax purposes, so that no additional tax issues would arise from such disposal or lease.

Tax neutrality has also been provided for stamp duty. Paragraph 6 Schedule 1 of the Stamp Act 1949 provides for exemption on any additional instrument executed for the purpose of complying with Shariah principles. This will mean that any additional instruments and transactions executed to fulfill Shariah requirements are exempted from additional stamp duty thereby ensuring tax neutrality for Islamic finance transactions (i.e. no additional stamp duty costs incurred when compared to conventional financing).
### 7.2 Tax incentives

As part of the Malaysian Government’s efforts to promote Malaysia as an International Islamic Financial Centre, substantial tax incentives have been provided in the area of Islamic finance.

The tax incentives provided include:

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<th>Institution</th>
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<td><strong>International Islamic Bank (&quot;IIB&quot;)</strong></td>
<td>• Income tax exemption for IIBs up to YA 2016</td>
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<td></td>
<td>• Withholding tax (WHT) exemption on:</td>
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<td></td>
<td>- Profits received by resident (individuals) and non-resident (individuals and corporates) depositors</td>
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<td>- Income received by non-resident experts in Islamic finance</td>
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<td>• Stamp duty exemption up to YA 2016 on instruments executed pertaining to Islamic banking businesses conducted in foreign currencies</td>
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<td>• Fast and easy immigration approval for expatriates in Islamic finance and their family members</td>
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<tr>
<td><strong>International Takaful Operator (&quot;ITO&quot;)</strong></td>
<td>• Income tax exemption for ITOs up to YA 2016</td>
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<td>• WHT exemption on income received by non-resident experts in Islamic finance</td>
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<tr>
<td></td>
<td>• Stamp duty exemption up to YA 2016 on instruments executed pertaining to takaful businesses conducted in foreign currencies</td>
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<td>• Fast and easy immigration approval for expatriates in Islamic finance and their family members</td>
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<tr>
<td><strong>International Fund Management Company (&quot;IFMC&quot;)</strong></td>
<td>• Income tax exemption on all income derived from a business of providing fund management services to local and foreign investors up to YA 2016</td>
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<td>• WHT exemption on income received by non-resident experts in Islamic finance</td>
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<tr>
<td></td>
<td>• Islamic fund management companies are allowed to invest all their Shariah funds abroad</td>
</tr>
<tr>
<td></td>
<td>• Fast and easy immigration approval for expatriates in Islamic finance and their family members</td>
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- 100% foreign equity ownership allowed for IIB, ITO and IFMC
- Domestic financial institutions setting up International Currency Business Units (ICBU) also enjoy the same tax incentives as IIBs and ITOs
- Non-resident is as determined under the Income Tax Act 1967
Other tax incentives include:

- **Tax exemption** up to YA 2016 for local and foreign companies managing funds of local and foreign investors established under Shariah principles and approved by SC

- **Tax exemption on interest** received by non-resident companies in relation to Islamic securities and debentures, other than convertible loan stock, approved by SC

- **Tax exemption** up to YA 2011 for institutions undertaking activities relating to the arranging, underwriting, distributing and trading of non-ringgit sukuk issued in Malaysia and distributed outside Malaysia

- **Tax deductions** on the expenses incurred on the issuance of Islamic securities based on ijarah, mudharabah and musharakah up to YA 2010 (not usually deductible for conventional securities)

- **Tax deduction** on certain expenses incurred in promoting Malaysia as an International Islamic Finance Center

- **Personal income tax relief** for fees on Islamic finance courses approved by BNM / SC at local institutions

- **Tax exemption** for non-resident Islamic finance experts approved by MIFC Secretariat

- **20% stamp duty remission** on instruments used in Islamic financing products approved by the Shariah Advisory Council of BNM or the SC up to 31 December 2009