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SUBSTANTIVE SHARIAH COMPLIANCE: REASSESSING MALAYSIA'S REGULATORY FRAMEWORK FOR ISLAMIC BANKING PRODUCT DEVELOPMENT

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Abstract

Islamic banking institutions are expected to continually innovate new products to remain competitive while ensuring compliance with Shariah principles. In Malaysia, this process is governed by a legal and regulatory framework under Bank Negara Malaysia. This study aims to analyse the framework governing Islamic banking product development to assess whether it effectively facilitates product development while ensuring substantive Shariah compliance, aligning products with its *maqasid `aqd* (contract objectives), which ultimately realises the *maqasid shariah* (Shariah objectives). Adopting a qualitative doctrinal legal methodology, the study analyses primary legislation and regulatory policies and draws on literature identified through library research. The study finds that Malaysia's framework offers legal certainty, centralised Shariah governance and clear operational guidance for product development. However, the article concludes that the existing framework is comprehensive in ensuring procedural or formal compliance but less clearly oriented towards evaluating whether products achieve the broader objectives of Shariah in substance.

Keywords: *islamic banking, product development, shariah governance, maqasid shariah, substantive shariah compliance*

I. INTRODUCTION

Innovation in banking has accelerated in response to increasing market competition, evolving consumer demands and rapid technological advancements. In Islamic banking, product development plays a critical role not only in maintaining competitiveness but also in ensuring that financial offerings adhere to Shariah principles. Thus, Islamic banking institutions (IBIs) have been providing a range of innovative products and services to modernise, enhance competition, and increase efficiency in the financial system.[1] The diversity of products offered by IBIs is crucial for meeting the needs of different communities and without innovation, there is a risk of idling capital due to a lack of investment opportunities and financial tools.[2] From an Islamic commercial law perspective, innovation is generally permissible under the principle that all *muamalat* (commercial transactions) are permissible unless there is clear evidence to the contrary. This principle provides IBIs with flexibility to develop new products, provided that such innovations adhere to established Shariah principles, including mutual consent (*`an taradin*) and the proper allocation of rights and obligations between contracting parties.

In Malaysia, Islamic banking product development operates within a comprehensive legal and regulatory framework supervised by Bank Negara Malaysia (BNM). This framework is widely recognised for providing legal certainty, centralised Shariah governance, and structured regulatory processes. Nevertheless, such strong regulatory frameworks may have unintended consequences, particularly when standardisation and risk control impede genuine innovation in Islamic banking. At the same time, increasing standardisation and regulatory control raise important concerns about whether the framework merely facilitates formal Shariah compliance or also promotes genuine innovation aligned with the broader objectives of Shariah (*maqasid shariah*). This concern is particularly relevant considering the continued dominance of debt-based structures, which have sparked ongoing debates about the authenticity and substance of Islamic banking products.

The literature on Islamic banking product development, while extensive, primarily focuses on the mechanics of product structuring, the use of specific Shariah contracts or the operational challenges faced by IBIs. The literature conceptualises several stages of the approval process rather than discussing the overall process and the regulations governing product development in IBIs.[3] This gap in understanding makes it difficult to evaluate how the legal and regulatory framework affects the entire product development lifecycle, from conceptualisation through development to commercialisation. Ahmed's study on Islamic banking product development provides a comprehensive understanding of the process, including a critique of products that fail

[1] Mohamad Syafiqe Abdul Rahim and Ahmad Hidayat Buang, "The Theory of Product Innovation and Its Application in Islamic Banking," *Journal of Islamic Finance* 10, no. 2 (2021): 112, DOI:10.31436/jif.v10i2.601.

[2] Fadziani Yaakub and Ahmad Hidayat Buang, "The Application of Promise (Wa'd) in Islamic Banking Contracts in Malaysia: A Maslahah Perspective," *International Journal of Banking and Finance* 19, no. 1 (2024): 46, https://doi.org/10.32890/ijbf2024.19.1.2.

[3] Syahidawati Shahwan et al., "Ranking the Compliance of Islamic Banking Home Financing Products with Maqasid Shariah Using AHP," *International Journal of the Analytic Hierarchy Process* 14, no. 3 (2022): 5, https://doi.org/10.13033/ijahp.v14i3.891.

to prioritise social value. The study identifies three primary phases in the development of Islamic banking products: ideation, implementation of concepts into products and commercialisation. It further suggests that the nature of the product development system depends on factors such as the regulatory environment, the potential for market expansion and the bank's inclination towards innovation.[4]

The focus of more recent studies has shifted towards a deeper concern as to whether the current trajectory of Islamic banking product development genuinely reflects Islamic economic values or merely mirrors conventional financial products in Shariah-compliant forms. Several studies have examined the challenges associated with the appropriate implementation of Shariah contracts in the development of new Islamic banking products. The discussion mostly focused on the use of sale contracts, which include the continued dominance of debt-based instruments such as *tawarruq* in Islamic banking, a pattern seen as inconsistent with the values of the Islamic economy.[5] Several studies also reveal a structural gap between regulatory efficiency in ensuring procedural compliance and the depth of Shariah scrutiny needed to evaluate whether products achieve broader Shariah objectives, including the contract's primary objective. Farooque et al. claim that the current Islamic finance industry somewhat reflects the trend of conventional finance.[6] Hasan et al. argue that Shariah experts and industry players must pursue genuine alternatives rather than merely replicating conventional banking products.[7] This convergence undermines the very purpose of Shariah, which is to ensure that Islamic banking products serve distinct objectives rooted in Shariah principles.

In addition, the available literature on objects of contracts (*maqasid `aqd)* remains limited, whereas extensive discourse exists regarding *maqasid shariah* within the context of Islamic banking. However, this discussion often lacks comprehensive details about the regulatory framework governing product development. Abdul Kadir et al. explicitly state that the growth of the Islamic

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[4] Habib Ahmed, *Product Development in Islamic Banks* (Edinburgh University Press, 2011), DOI:10.1515/9780748644889.

[5] Mehmet Asutay, "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," *Asian and African area studies* 11, no. 2 (2012): 101, https://doi.org/10.14956/asafas.11.93; Muhammad Al-Bashir Al-Amine, "Product Development and Maqāṣid in Islamic Finance: Towards a Balanced Methodology," *Islamic Economic Studies* 23 (2015): 34-36, http://iesjournal.org/english/Docs/175.pdf.

[6] Winwin Yadiati et al., "Human Capital, Quality of Sharia Supervisory Board and Maqasid Shariah Based Performance: Cross Country Evidence," *Jurnal Dinamika Akuntansi dan Bisnis* 9, no. 2 (2022): 262, https://doi.org/10.24815/jdab.v9i2.26740.

[7] Aznan Hasan et al., "Innovation in Islamic Finance: The Way Forward," *Al-Shajarah: Journal of the International Institute of Islamic Thought and Civilization (ISTAC)* 21, no. 3 (2016): 4-6, https://doi.org/10.31436/shajarah.v21i3.410.

banking and finance industry should not be limited to profitability only but should adhere to *maqasid shariah*, which covers economy, community and environment. Similarly, innovation in Islamic banking products should not be limited to legal compliance but must also conform to *maqasid shariah* principles.[8]

Meanwhile, Amin et al. found that IBIs in Malaysia have made minimal efforts to incorporate *maqasid shariah* into their business operations, including specific products such as *tawarruq* personal financing. Although *maqasid shariah* is not a formal requirement to validate transactions, it remains important to ensure that products promote justice and welfare.[9] Wahab and Naim warned that ignoring *maqasid shariah* and *maslahah* (public good) will cause Islamic financial products to lose their intrinsic values and become unacceptable in the global market. They argued that product innovation should be a tool for creating new value propositions that contribute to social responsibility-based development.[10] Moreover, Javed et al. argued that financial products offered by IBIs cannot be considered truly Shariah-compliant unless they play a significant role in achieving *maqasid shariah*, which requires circulation of wealth, transparency and justice.[11]

Although existing literature has examined Islamic banking products from the perspectives of Shariah contracts, product structuring and operational challenges, relatively little attention has been paid to the legal and regulatory framework as a subject of analysis in its own right. In particular, insufficient attention has been paid to whether the regulatory design facilitates or constrains innovation and to whether it promotes substantive Shariah compliance beyond formal regulatory requirements. This study seeks to address this gap by examining Malaysia's regulatory framework governing the development of Islamic banking products. Therefore, the key research question is: to what extent does Malaysia's regulatory framework facilitate the development of Islamic banking products while ensuring substantive Shariah compliance rather than merely formal compliance?

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[8] Aizurra Haidah Abdul Kadir et al., "Realisation of Maqasid Al-Shariah Using Value-Based Intermediation in Islamic Banks: Acceptance or Refusal," *Management and Accounting Review* 23, no. 1 (2024): 45, https://ir.uitm.edu.my/id/eprint/93588/1/93588.pdf.

[9] Hanudin Amin et al., "Maqasid-based Consumer Preference Index for Tawarruq Personal Financing (TPF)," *International Journal of Islamic Economics and Finance (IJIEF)* 5, no. 1 (2021): 22-23, DOI:10.18196/ijief.v5i1.11823.

[10] Muhammad Zarunnaim bin Haji Wahab and Asmadi Mohamed Naim, "Sustainable and Responsible Investment: Concept and the Commonalities with Islamic Financial Institutions," *Etikonomi* 19, no. 1 (2020): 150-151, https://doi.org/10.15408/etk.v19i1.13772.

[11] Muhammad Mansoor Javed et al., "Impact of Partnership Based and Non-Partnership Based Shariah Compliant Products on the Financial Performance of Islamic Banks," *Audit and Accounting Review* 3, no. 1 (2023): 83, https://doi.org/10.32350/aar.31.04.

This study adopts a qualitative doctrinal legal methodology, analysing primary legislation including the Islamic Financial Services Act of 2013 (IFSA 2013) and the Central Bank of Malaysia Act of 2009 (CBMA 2009) as well as relevant BNM regulations. These are supplemented by recent academic literature on Islamic finance, Shariah governance and product development. The analysis is guided by a conceptual distinction between formal compliance (adherence to legal and regulatory requirements) and substantive Shariah compliance (alignment with *maqasid shariah* and *maqasid ʿaqd*).

The study finds that Malaysia's regulatory framework provides a high degree of legal certainty, institutional clarity and procedural robustness in governing the development of Islamic banking products. The centralised role of the BNM's Shariah Advisory Council (SAC), coupled with detailed policy frameworks and governance requirements, has contributed to consistency and stability within the industry. However, the findings also indicate that the framework is predominantly oriented towards ensuring procedural and formal compliance. There is limited regulatory emphasis on systematically evaluating whether products achieve the substantive objectives of Shariah, particularly regarding the purpose of the Shariah contract, which contributes to economic justice, risk-sharing, and social welfare.

This article contributes to the body of literature in two principal ways. First, it goes beyond describing Malaysia's Islamic banking regulatory framework to critically evaluate the structural implications of its regulatory design. Second, it advances the argument that a clearer distinction must be made between formal compliance and substantive Shariah outcomes in product development. On this basis, the article proposes a shift towards a more outcome-oriented regulatory approach that integrates more substantive Shariah evaluation during product development and the approval process. Such an approach has important implications for regulatory policy, institutional governance and the future direction of Islamic banking product innovation.

II. CONCEPTUAL FOUNDATIONS: SHARIAH COMPLIANCE IN PRODUCT DEVELOPMENT, *MAQASID `AQD* AND *MAQASID SHARIAH*

II.A. Shariah Compliance in Product Development

Shariah compliance constitutes the foundational differentiator between Islamic and conventional banking institutions. It has been described as the compliance of operations and activities with the precepts of Shariah in their implementation, the requisites of various Shariah contracts, and the fulfilment of welfare objectives.[12] The concept has existed in the Malaysian legal framework since 1983, with the enactment of the Islamic Banking Act 1983. The authority has later issued several regulations to incorporate Shariah compliance into the financial legal framework.[13]

In the context of Islamic banking product development, it involves creating new banking products and services that comply with Shariah principles to meet market demands.[14] Product innovation in Islamic banking should move beyond simply replicating conventional products within a Shariah-compliant framework. Replicating the entire conventional product structure and aligning it with the Shariah compliance framework is neither the primary nor the ultimate goal in building a genuine IBI. Innovation should adopt a systemic approach to develop new Islamic banking products. This critique resonates with broader concerns that the commercial nature of Islamic banking has led to further financialisation rather than serving as an instrument for Islamic development. The so-called Shariah-compliant approach, instead of being Shariah-based, where existing conventional financial products are evaluated against Shariah requirements and non-compliant portions are removed and remodelled, has been criticised for conforming to "the hegemony of interest" as upheld by debt-based conventional finance.[15] This raises fundamental questions about whether the regulatory framework encourages genuine innovation or merely facilitates the Islamisation of conventional products.

In Islamic banking, the permissibility principle in Islamic commercial law creates room for innovation, provided that no clear Shariah prohibition is violated and the product is assessed against authoritative Shariah sources and objectives.[16] Shariah compliance in product development can be achieved through various mechanisms, including Shariah governance structures, Shariah supervisory boards, Shariah audit functions, and regulatory oversight.[17] In the Malaysian context, the regulatory framework has been praised for its comprehensiveness, with scholars noting that Shariah governance processes are well managed and that current regulatory measures are sufficient to ensure Shariah compliance. However, critics contend that the prevailing approach to

[12] Javed et al., "Impact of Partnership.": 80

[13] Muhammad Sholihin et al., "Shariah Compliance in Islamic Economics: A Bibliometric Analysis," *Malaysian Journal of Economic Studies* 58, no. 2 (2021): 317, https://doi.org/10.22452/MJES.vol58no2.7.

[14] Hanudin Amin, "Critical Success Factors for the Receptiveness of Islamic Home Financing in Malaysia," *International Journal of Emerging Markets* 15, no. 5 (2020): 853, https://doi.org/10.1108/IJOEM-04-2018-0187.

[15] Adnan Zikri Jaafar and Marc Brightman, "From Structure to Purpose: Green and Social Narratives, and the Shifting Morality of Islamic Finance in Kuala Lumpur," *Sustainability* 14, no. 9 (2022): 7, https://doi.org/10.3390/su14095433.

[16] Rahim and Buang, "The Theory of Product Innovation," 119.

[17] Sholihin et al., "Shariah Compliance in Islamic Economics." 324-327

Shariah compliance in Islamic banking often overlooks its substantive aspects, namely the fulfilment of Shariah objectives.[18]

II.B. Maqasid Shariah: Beyond Formal Compliance

Maqasid shariah, or the objectives of Shariah, represents a high-level framework for evaluating whether Islamic banking products achieve the broader purposes intended by Islamic law. Literally, the concept is rooted in the notion of *maslahah* (public interest), defined by Imam Abu Hamid Al-Ghazali as seeking benefit and repelling harm. According to Al-Ghazali and later Al-Shatibi, the theory of *maqasid shariah* classifies *maslahah* through a three-level hierarchy, namely necessities (*darurriyat*), needs (*hajiyyat*) and refinements (*tahsiniyyat*).[19]

The *maqasid shariah* principles encompass the protection of religion, life, intellect, lineage and wealth, providing a holistic approach to Islamic banking by emphasising the impact of financial practices on individuals, society and the environment.[20] Importantly, *maqasid shariah* provides a framework for understanding the broader intents of Islamic law beyond its specific legal provisions, serving as a set of objectives that become standards and guidelines rooted in revelation (*wahyu*) to solve problems and guide human lives. The relationship between Shariah compliance and *maqasid shariah* is critical to understanding the effectiveness of regulatory frameworks. The development of Shariah compliance based on the *maqasid shariah* paradigm supports the concurrent development of IBIs within both Shariah-compliant and *maqasid shariah* frameworks.[21]

II.C. From General *Maqasid Shariah* to *Maqasid ʿAqd*

In Islamic banking, a contract (*ʿaqd*) is the fundamental building block of all financial products and transactions. Muslim scholars tend to harmonise Islamic commercial law around the contract (*ʿaqd*), and new products receive Shariah-compliant status when they have fully complied with the existing

[18] Jaafar and Brightman, "From Structure to Purpose;" 12-23 Shahwan et al., "Ranking the Compliance," 15.

[19] Ahmad Zoolhelmi Alias et al., "Malaysian Takaful Reporting from a Maqasid Shariah Perspective," *Journal of Islamic Philanthropy and Social Finance* 5, no. 1 (2023): 2, https://doi.org/10.24191/jipsf.v5i1.2655.

[20] Nur Izzati Ibrahim et al., "Potentials of Blockchain for Claim Management of Islamic Insurance (Takaful) Operators in Malaysia," *Environment-Behaviour Proceedings Journal* 9, no SI19 (2024): 17, https://doi.org/10.21834/e-bpj.v9iSI19.5757; Admir Meskovic et al., "The Influence of National and Individual Islamic Governance on Islamic Banks' Social Performance," *Journal of Islamic Accounting and Business Research* 15, no. 6 (2023): 913, https://doi.org/10.1108/JIABR-03-2022-0077.

[21] Sholihin et al., "Shariah Compliance in Islamic Economics." 328

contractual terms and conditions.[22] The transition from general *maqaṣid shariah* to the specific objectives of contracts (*maqasid ʿaqd*) represents a critical methodological step in Islamic jurisprudence. Muhammad al-Tahir Ibn ʿAshur, in his book entitled *Maqaṣid al-Shariah al-Islamiyyah*, classified *maqasid* into two broad categories: first, general objectives of legislation (*maqasid ʿammah min al-tashriʿ*), which include preserving *fitrah*, tolerance, bringing about *maslahah* and removing *mafsadah* (harm), equality, and freedom. Secondly, it is essential to establish specific objectives within the scope of *muamalat* (commercial transactions), encompassing areas such as commercial law, family law and charitable transactions.[23]

In the context of financial transactions, Ibn ʿAshur articulated five specific objectives of Shariah in property (*maqasid al-tasarrufat al-maliyyah*), namely, circulation of property (*rawaj al-mal*), clarity/transparency of property (*wuduh al-mal*), preservation of property (*hifz al-mal*), legal formality/enforceability of property (*thabat al-mal*) and justice in property (*al-ʿadl fi al-mal*).[24] These five objectives serve as the specific *maqasid ʿaqd* for financial contracts and provide a comprehensive framework for evaluating Islamic banking products. According to Ibn ʿAshur, these five specific objectives standardise the legality of a contract and its processes. If any one of these objectives is not fulfilled, it has implications for the contract's validity.[25]

The essential purpose of a contract is the core objective that the contracting parties intend to realise through their agreement. This construct, when applied to exchange contracts (*ʿaqd al-muʿawadah*) represents the fundamental purpose that the contract is designed to achieve. Any supplementary condition (*shart*) that contradicts the essential purpose of the contract (*muqtada al-ʿaqd*) renders either the condition or the contract itself void.[26] This principle is foundational to ensuring that Islamic banking products maintain their substantive purpose. Each contract type has its own spirit and objective that must be preserved. For

[22] Ayu Yuningsih and Rifqi Muhammad, "Shariah Compliance Analysis of Islamic Crowdfunding: Case Study of ethiscrowd.com," *Iqtishoduna: Jurnal Ekonomi Islam* 9, no. 1 (2020): 83, https://doi.org/10.36835/iqtishoduna.v9i1.472.

[23] Anton Sudrajat, "Kepatuhan Bank Syariah terhadap Pembiayaan Murabahah (Studi Kasus pada BPRS Mitra Mentari Sejahtera Ponorogo)," *Bisnis: Jurnal Bisnis dan Manajemen Islam* 9, no. 1 (2021): 149, http://dx.doi.org/10.21043/bisnis.v9i1.11534.

[24] Mohammad Ridwan, "Analisis Maqasid Al-Tasarrufat Al-Maliyyah Muhammad Al-Tahir Ibn Ashur Terhadap Akad Al-Ijarah Al-Muntahiyah Bi Al-Tamlik (Studi pada PT. BRI Syariah KCP Ponorogo)," *Journal of Islamic Economics (JoIE)* 1, no. 2 (2021): 95, https://doi.org/10.21154/joie.v1i2.3594; Khafid Abadi et al., "Cryptocurrency and Crypto Assets in the Perspective of Islamic Legal System Philosophy," *Hikmatuna Journal for Integrative Islamic Studies* 9, no. 2 (2023): 142, https://doi.org/10.28918/hikmatuna.v9i2.1216.

[25] Abadi et al., "Cryptocurrency and Crypto Assets." 144

[26] Ahmad Hidayat Buang, "Ulasan Buku: Fiqh of Contemporary Financial and Banking Transactions," *Jurnal Fiqh* 17, no. 2 (2020): 316, https://doi.org/10.22452/fiqh.vol17no2.4.

instance, the essential purpose of a sale contract is the transfer of ownership in exchange for a price, whereas the essential purpose of a partnership contract is the sharing of profits and losses. Hence, the *maqasid ʿaqd* for each product type must align with both the specific contractual requirements and the broader objectives of Shariah.

III. EVOLUTION OF REGULATORY REQUIREMENTS FOR THE APPROVAL OF NEW ISLAMIC BANKING PRODUCT IN MALAYSIA

III.A. Early Stage

All IBIs in Malaysia are regulated by BNM. During the early stages of Islamic banking, from the introduction of Bank Islam Malaysia Berhad (BIMB) in 1983, the regulatory approach was relatively conservative. New products had to be discussed with and approved by BNM before launch. Until 2003, all new products were subject to preliminary approval; i.e., IBI was required to discuss them with BNM in advance before they could be launched.[27] In line with BNM's directive to all financial institutions in Malaysia, they are reminded to discuss new products and services to be launched with BNM.

Beginning in 2003, BNM has issued a new guideline whereby the approval system is automatically introduced based on the regulatory principle which is "everything that is not prohibited is permissible".[28] The objective of these guidelines is to replace the pre-approval process for new products (the pre-approval requirement). Under this system, banking institutions may offer new products 21 days after meeting certain basic conditions, starting from the date the information required by BNM is submitted.

III.B. Specific Guidelines for Islamic banking products

The guidelines issued in 2003, as previously explained, apply to conventional banking products and IBI. However, the guidelines are considered not comprehensive in some respects for Islamic banking products. Therefore, in 2004, BNM issued specific guidelines for new product approvals for IBI. The guidelines still maintain the same regulatory principle: "everything that has no prohibition is allowed".[29]

[27] Central Bank of Malaysia, *New Financial Products/Services* (Kuala Lumpur: Bank Negara Malaysia, February 2, 1990).

[28] Central Bank of Malaysia, *Guidelines on New Product Approval Requirements* (Kuala Lumpur: Bank Negara Malaysia, March 26, 2003), https://islamicbankers.center/wp-content/uploads/2013/12/guidelines-on-introduction-of-new-products.pdf.

[29] Central Bank of Malaysia, *Guidelines on New Product Approval Requirements for Islamic Banking Institutions* (Kuala Lumpur: Bank Negara Malaysia, January 2004).

The essence of these guidelines is to replace the existing pre-approval of products with a new product-approval notification process to facilitate and encourage IBI to develop more innovative products. The process for notifying new products is sufficient to ensure that the regulator is aware of them in the market. This new process and approach require IBI to increase a product's transparency to consumers. In line with this development, there is a need to increase research and development efforts for Islamic banking products to expand the range of offerings that meet customer needs.

III.C. "Launch-and-File" System

As part of a continuous effort to improve the effectiveness of the regulatory framework, the need to introduce new products for BNM-regulated financial institutions was further reinforced by new guidelines in 2007.[30] It provides conditions relating to the introduction of new products that apply to conventional banking and Islamic banking. It still applies the same philosophy and principle, which is "everything that has no prohibition is allowed", but with the introduction of a new "launch-and-file" system.

However, this system does not apply to products based on Shariah principles that are still subject to BNM's pre-approval requirements before the product can be launched. This may be because BNM considers Islamic banking products critical areas that require closer monitoring and evaluation, especially regarding Shariah compliance, before a product can be launched. With the flexibility provided by BNM under these guidelines, greater responsibility is placed on the Board of Directors (Board) and the management of each IBI to ensure that product-related risks are well managed and that consumer needs and rights are protected. IBI will continue to be regulated by BNM through continuous oversight and enforcement actions to protect consumer rights and promote sound risk management practices.

III.D. Revision of Guidelines Year 2009

The same guidelines were revised in 2009, opening the door for IBI to introduce their products under the "launch-and-file" system.[31] With the revision, new Islamic banking products may be introduced after going through the "launch-and-file" system, but this is limited to foreign-currency products based on Shariah principles offered under the International Currency Business Unit and Islamic Negotiable Instruments of Deposit. The guidelines further emphasise the bank's responsibility to ensure Shariah compliance, particularly

[30] Central Bank of Malaysia, *BNM Guidelines on Introduction of New Products* (Kuala Lumpur: Bank Negara Malaysia, November 23, 2007).

[31] Central Bank of Malaysia, *BNM Guidelines on Introduction of New Products* (Kuala Lumpur: Bank Negara Malaysia, May 20, 2009).

by implementing an effective Shariah compliance assessment process at both the pre-launch and post-launch stages of the product.

III.E. Post-BNM Shariah Governance Framework

In 2011, BNM amended the guidelines on new product offerings in line with the introduction of the Shariah Governance Framework for Islamic Financial Institutions in October 2010. With the amendment, the "launch-and-file" system now fully applies to all new Shariah-compliant products, subject to certain conditions. However, this system does not apply to new products that require specific resolution from the SAC.[32] All Shariah issues should be carefully studied before being considered by the Shariah Committee. Every decision of the Shariah Committee shall also be supported by the justification of *fiqh*. All members of the Shariah Committee are required to evaluate and discuss new products, but approval by a majority of the Shariah Committee is sufficient.

For Shariah-compliant products that require SAC's resolution, submission of the necessary information to BNM for new product approval can only be made after SAC approval. IBI is required to prepare a Shariah research paper for the SAC for prior approval. Based on the above description, IBI's rules for introducing new products constitute a procedural and regulatory framework intended to facilitate, rather than impede, IBI's innovation and product development. The main purpose of the approach set by BNM is to ensure that every product offered complies with all aspects of legislation, risk management, consumer protection, and Shariah compliance.

This regulatory evolution shows a gradual shift from centralised pre-emptive control to greater institutional autonomy. On one level, this shift supports efficiency, reduces regulatory delay and allows IBI to respond more quickly to market demand. However, regulatory systems that prioritise IBIs' internal governance structures may improve efficiency, but they also shift the responsibility for compliance to institutions that may be influenced by commercial interests.

In Malaysia, the move towards launch-and-file suggests a model that upholds internal governance, but the effectiveness of such a process depends on the robustness of internal Shariah governance, the quality of institutional assessment and the willingness of IBIs to prioritise compliance over speed. Moreover, the evolution of Malaysia's regulatory framework should not be understood solely as a timeline. It should also be viewed as a shift in product innovation to align with the true objectives of Shariah.

[32] Central Bank of Malaysia, *Guidelines on Introduction of New Products* (Kuala Lumpur: Bank Negara Malaysia, October 2011).

IV. LEGAL FRAMEWORK OF ISLAMIC BANKING PRODUCT DEVELOPMENT

IBIs in Malaysia are subject to the IFSA 2013, which has been gazetted to regulate the Islamic banking and financial system. This Act came into force on 30 June 2013 and had repealed the Islamic Banking Act 1983 and Takaful Act 1984. The IFSA 2013 governs the licensing and operation of Islamic financial institutions, including Islamic digital banking. It also establishes the legal basis for BNM's regulatory authority over the Islamic banking sector. For conventional banking institutions offering Islamic banking products under the Islamic Banking Scheme, the offering is subject to sections 47 and 123 (3) of the Financial Services Act 2013 (FSA 2013), which have provisions similar to those under the IFSA 2013. Meanwhile, for Development Financial Institutions, the provisions of the applicable law are set out in section 126 of the Development Financial Institutions Act 2002.

The foundation of Malaysia's legislative framework for Shariah governance in Islamic finance is provided by the Central Bank of Malaysia Act 2009 (CBMA 2009). Section 57 of the Act formally establishes the SAC as the highest authority on Shariah-related matters in the Islamic finance sector. The centralisation of Shariah governance through the SAC is a distinguishing feature of the Malaysian model, which is widely recognised for its effectiveness in promoting consistency and minimising disputes concerning Shariah matters.[33] The SAC stands as the supreme body whose Shariah resolutions are legally binding on all Islamic financial institutions, as well as on courts and arbitral tribunals. The binding nature of these rulings is one of the most distinctive elements of the Malaysian regulatory approach, reinforcing consistency and legal certainty in the handling of Shariah-related issues across the industry. Moreover, it ensures uniformity in Shariah interpretation, eliminating the diversity of rulings that can create confusion and instability in the industry.[34]

This legal certainty and uniformity offer advantages for the development of Islamic banking products. This is because the absence of a dedicated legal framework for Islamic banking can undermine regulatory effectiveness and increase the risk of Shariah non-compliance.[35] IBIs can develop products with confidence that the Shariah resolutions made by the SAC will be upheld by the legal system, reducing the risk of products being challenged or invalidated

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[33] Randi Swandaru and Aishath Muneeza, "Can Fraud in Islamic Financial Institutions Be Prevented Using High Standards of Shariah Governance?" *International Journal of Law and Management* 64, no. 6 (2022): 469–85, https://doi.org/10.1108/IJLMA-07-2022-0162.

[34] Ahmad Fahmi Sheikh Hassan et al., "Central Bank Regulation, Religious Governance and Standardisation: Evidence from Malaysian Islamic Banks," *International Journal of Business Governance and Ethics* 15, no. 1 (2021): 65, https://doi.org/10.1504/IJBGE.2021.112332.

[35] Murat Yas, "Legal and Regulatory Issues of Islamic Finance in Turkey: A Qualitative Discussion," *Journal of Central Banking Law and Institutions* 2, no. 3 (2023): 404-405, https://doi.org/10.21098/jcli.v2i3.169.

on Shariah grounds. The standardisation of Shariah resolutions also facilitates the development of globally accepted Islamic banking products.[36] In relation to policies and regulations concerning Shariah matters, section 59 of the CBMA 2009 and section 29 of IFSA 2013 confer authority on BNM to issue guidelines, circulars and standards on Shariah matters based on the advice or rulings of the SAC. This mandate enables BNM to translate SAC rulings into binding regulatory measures governing Islamic financial business, thereby ensuring that Shariah interpretations are consistently operationalised across the industry.

In the context of Islamic banking products, IFSA 2013 also provides a detailed interpretation of the true form of Islamic banking business activities. Section 2 of IFSA 2013 defines Islamic banking business as including:

a. accepting Shariah-compliant deposits (e.g., current, savings, or fixed/deposit accounts), whether or not the bank also provides cheque services;
b. accepting money under investment accounts;
c. providing Shariah-compliant financing; and
d. any other activities that the law may later specify.

For financing products, the same section states the form of financing products that can be developed by IBI. Provision of finance denotes the undertaking of, or the arrangement for another person to undertake, Shariah-compliant businesses or activities, including: (a) equity- or partnership-based financing (including *musyarakah*, *musyarakah mutanaqisah* and *mudarabah*); (b) lease-based financing (including *al-ijarah, al-ijarah muntahia bi al-tamlik* and *al-ijarah thumma al-bai*); (c) sale-based financing (including *istisna, bai bithaman ajil, bai salam, murabahah* and *musawamah*); (d) currency exchange contracts; (e) fee-based activities (including *wakalah*); (f) the purchase of bills of exchange, certificates of Islamic deposit or other negotiable instruments; and (g) the assumption of, or the provision of a guarantee in respect of, any person's liability, obligation or duty.

The provisions stipulate the categories of activities and Shariah contracts that can be applied to develop financing products. As for products under the category of bank liabilities such as deposit and investment products, section 2 of IFSA 2013 also provides a clear classification to distinguish between Islamic deposit and investment accounts. IBI is required to classify customer funds under the Islamic deposit or investment account category in accordance with the requirements of the legislation, including ensuring that the selection of Shariah contracts meets the characteristics of the product category.[37]

[36] Hassan et al., "Central Bank Regulation," 79.

[37] Mohamad Syafiqe Abdul Rahim, "Islamic Financial Services Act 2013: Analysis from Islamic Deposit Product Perspective," MPRA Paper 123100, Munich Personal RePEc Archive, 2014, accessed April 2, 2026: 5-6, https://mpra.ub.uni-muenchen.de/id/eprint/123100.

From the above, IFSA 2013 provides the legal architecture for identifying the categories of Islamic banking business, including financing, deposit-taking and investment account activities. This is important for product development because it determines the legal form within which products must be structured. IFSA 2013 has introduced a new landscape for Islamic banking products in two key areas, namely the interpretation of Islamic banking business and the adoption of a Shariah contract-based regulatory framework. This framework is based on the risk profile of each underlying Shariah contract.

Based on this principle, IBIs may offer a wide spectrum of Shariah contracts with diverse risk and return profiles through two main models. Firstly, the primary model; secondly, the financing or deposit model. The primary model operates using a single principal Shariah contract. The contracting parties either share the same type of risk or undertake specific risks. Under the primary model, IBIs must not only manage financial credit risk but are also exposed to broader risks, such as investment risk or risks related to the holding and management of physical assets, depending on the applicable Shariah contract.[38] Strengthening regulation and promoting profit-and-loss sharing mechanisms can enhance the developmental impact of Islamic banking.[39]

The statutory distinction between Islamic deposits and investment accounts, for instance, has significant implications for the selection of Shariah contracts and the legal treatment of customer funds. Thus, the law does more than merely regulate the industry at a general level. It shapes the boundaries within which innovation may occur. The law defines the institutional powers of BNM, the authority of SAC and the permissible categories of Islamic banking business. The legal framework established under IFSA 2013 also provides clarity through precise definitions and structured categories for Islamic banking business and Shariah contracts.

V. REGULATORY FRAMEWORK OF ISLAMIC BANKING PRODUCT DEVELOPMENT

As explained in the preceding subsection, BNM has the authority to issue policies or guidelines governing the introduction of new Islamic banking products. On that note, some of the key policies and guidelines for introducing new products are as follows:

[38] Central Bank of Malaysia, *Financial Stability and Payment Systems Report 2013* (Kuala Lumpur: Bank Negara Indonesia, March 14, 2004), https://www.bnm.gov.my/-/financial-stability-and-payment-systems-report-2013.

[39] Vera Novia Anisa et al., “Assessing the Role of Islamic Banking in Driving Indonesia’s Economic Growth during COVID-19,” *Journal of Central Banking Law and Institutions* 4, no. 3 (2025): 403, https://doi.org/10.21098/jcli.v4i3.290.

a. Policy Document on the Introduction of New Products;[40]
b. Guidelines on Transparency and Product Disclosure;[41]
c. Guidelines on the Imposition of Fees and Charges of Banking Products and Services;[42]
d. Shariah Governance for Islamic Financial Institutions;[43]
e. Policy Documents based on Shariah contracts (depending on Shariah contracts underlying the product structure);
f. Value-Based Intermediation; and
g. Other product-related policies.

V.A. Policy Document on Introduction of New Product

The policy aims to enhance the time-to-market for new financial products, promote sound risk management and ensure product suitability for targeted consumer segments. It outlines regulatory procedures and expectations for managing risks associated with new financial products and services.[44] IBIs that offer new Shariah-compliant products must ensure a sound, robust Shariah governance framework is in place, including a comprehensive end-to-end Shariah-compliant product development and implementation process.

V.B. Guidelines on Product Transparency and Disclosure

The document places significant emphasis on the consistent and comprehensive aspects of product transparency. Their primary objective is to ensure that financial service providers adequately disclose information about the products and services that they offer. The Guidelines promote consumer awareness and understanding of financial products and services, ensuring appropriate offerings and informed decision-making.[45]

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[40] Central Bank of Malaysia, *Introduction of New Products* (Kuala Lumpur: Bank Negara Malaysia, March 7, 2014).

[41] Central Bank of Malaysia, *Guidelines on Product Transparency and Disclosure* (Kuala Lumpur: Bank Negara Malaysia, June 4, 2013).

[42] Central Bank of Malaysia, *Guidelines on Imposition of Fees and Charges on Banking Products and Services* (Kuala Lumpur: Bank Negara Malaysia, May 11, 2012).

[43] Central Bank of Malaysia, *Policy Document on Shariah Governance* (Kuala Lumpur: Bank Negara Malaysia, September 20, 2019), https://www.bnm.gov.my/documents/20124/761679/Shariah+Governance+Policy+Document+2019.pdf.

[44] Central Bank of Malaysia, *Policy Document on Introduction of New Product* (Kuala Lumpur: Bank Negara Malaysia, March 7, 2014).

[45] Central Bank of Malaysia, *Guidelines on Product Transparency and Disclosure* (Kuala Lumpur: Bank Negara Malaysia, December 2, 2024), https://bnm.gov.my/documents/20124/938039/pd_product_transparency_and_disclosure_dec2024.pdf.

V.C. Imposition of Fees and Charges on Banking Products and Services
The document aims to ensure that the fees and charges imposed on financial products and services offered in the market are reasonable for both consumers and banks. It applies only to all fees and charges imposed on financial products and services offered to individuals and small and medium enterprises.[46] IBI is required to obtain BNM's approval before imposing any revisions or introducing fees and charges on customers. For any revision to reduce the fee or charge rate, no approval is required from BNM unless the reduction results in a reduction in the product's benefits or characteristics.

V.D. Shariah Governance Framework for Islamic Financial Institutions
Malaysia operates a pioneering dual-layer Shariah governance system that is central to its regulatory framework for the development of Islamic banking products. At the national level, the SAC serves as the centralised Shariah body within the central bank and holds supreme authority over the Islamic banking industry. At the institutional level, individual Shariah Committees are responsible for providing independent Shariah assurance and endorsing the Shariah-related matters in IBI's operations and products.[47]

The Shariah Governance Framework (SGF), first introduced by BNM in October 2010, set out the roles of different governance organs within this dual-layer system.[48] This was subsequently enhanced by the Shariah Governance Policy Document (SGPD) issued in September 2019, which outlines BNM's expectations for effective Shariah governance. It emphasises the integration of Shariah governance with the business strategy and risks of Islamic financial institutions. BNM expects a more active role from the Board, Shariah Committee, senior management, and other key organs involved in implementing Shariah governance.[49]

The policy document places significant emphasis on supervision and promotes a strong culture of Shariah compliance risk within Islamic financial institutions, including in product development. It provides detailed roles and responsibilities for the Shariah Committee, including the Chairman's responsibility for ensuring a robust Shariah decision-making process. It also highlights the importance of the internal control function, which includes the

[46] Central Bank of Malaysia, *Guidelines on Imposition of Fees and Charges on Banking Products and Services* (Kuala Lumpur: Bank Negara Malaysia, May 11, 2012).

[47] Nurfarahin Mohd Haridan et al., "Financial Innovation in Islamic Banks: Evidence on the Interaction between Shariah Board and FinTech," *Journal of Islamic Accounting and Business Research* 14, no. 6 (2023): 914, 10.1108/JIABR-11-v2022-0305;

[48] Hassan et al., "Central Bank Regulation," 69.

[49] Meskovic et al., "The Influence of National and Individual Islamic Governance." 2-3

review function, Shariah risk management, and Shariah audit, in ensuring the effective management of Shariah non-compliance risk.[50]

All key functions under Shariah governance are responsible for ensuring a comprehensive and robust product development process to minimise the risk of product nullification on Shariah grounds. IBIs must ensure the implementation of appropriate controls and measures, such as risk-mitigation tools, to address instances of Shariah non-compliance. Research has confirmed that this dual-layer system contributes to standardising practice without hampering creativity in the development of new Shariah-compliant financial products. The SAC has proven instrumental in resolving disputes arising from the extensive application of the *ijtihad* (legal reasoning) principle by the Shariah Committee at the IBI level. However, considerable bureaucracy has been reported to exist due to the current approval process, which can impede efficient decision-making.[51]

V.E. Shariah Contract-Based Policy Documents

BNM has issued policy documents on Shariah contracts to ensure the consistent and uniform application and operational practices of These contracts in Islamic financial products and services. This covers aspects of Shariah transactions as well as banking practices, including risk management, consumer and market rights, and financial reporting and documentation. These policies were not issued during the early stages of Islamic banking. The effort has only begun since the amendments to the IBA 1983, due to legal polemics arising from court cases that led to Shariah and operational issues involving Islamic banking products. As of this study, there are 11 policy documents that have been issued which involve Shariah contracts *of tawarruq*, *murabahah*, *musyarakah*, *mudarabah*, *istisna'*, *ijarah*, *hibah*, *wa'd*, *wakalah*, *kafalah* and *rahn*.[52]

The Shariah contract-based policy document plays a crucial role in ensuring the successful development of Islamic banking products. It takes into consideration the risk profile and distinctive features of each Shariah contract, enabling the products to be aligned with the primary objective of the contract. This policy document serves as a valuable reference for Shariah contracts and also outlines the operational requirements for executing each contract within the product. As explained earlier, these policy documents complement the expectations espoused in IFSA 2013 by promoting product

[50] Central Bank of Malaysia, *Policy Document on Shariah Governance* (Kuala Lumpur: Bank Negara Malaysia, September 20, 2019).
[51] Hassan et al., "Central Bank Regulation," 60.
[52] Shariah Advisory Council of Bank Negara Malaysia, "Shariah Standards & Operational Requirement," accessed November 15, 2019.

development through a wider spectrum of Shariah contracts with diverse risk and return profiles, using both the primary model and the financing or deposit model. Moreover, it emphasises the importance of Shariah compliance at all levels, thereby safeguarding the interests of consumers and promoting sound operating practices within the Islamic banking sector.

V.F. Value-Based Intermediation

While ongoing product innovation signals progress in Islamic banking, it is equally important that the industry delivers broader positive impacts. For that reason, the introduction of Value-Based Intermediation (VBI) by BNM in 2017–2018 represents an important regulatory initiative intended to move IBIs beyond mere Shariah compliance towards value creation and broader impact. VBI seeks to strengthen the sustainable finance ecosystem by expanding the role of IBIs through four underpinning thrusts: entrepreneurial mindset, community and consumer empowerment, good self-governance, and best conduct.[53] BNM pioneered VBI to achieve Shariah objectives by offering products and practices that deliver sustained economic, social, and environmental benefits, aligning with global initiatives such as the United Nations Sustainable Development Goals. Although not a regulatory obligation for IBIs, VBI encourages IBIs to integrate environmental, social, and governance (ESG) factors into financing and investment decisions, thereby enhancing credit assessment by considering positive impacts on communities and job creation. Implementation is tailored to each bank's readiness and supported by the Community of Practitioners, strategic guides, and frameworks such as the VBI Financing and Investment Impact Assessment Framework and the VBI Scorecard.[54]

V.G. Other Product-Related Policies

There are other policies which IBIs are required to observe when developing new Islamic banking products. For example, policies related to the reference

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[53] Abdul Kadir et al., "Realisation of Maqasid Al-Shariah," 45; Siti Nurain Muhmad et al., "Sustainable Development Goals and Islamic Finance: An Integrated Approach for Islamic Financial Institutions," *Indonesian Journal of Sustainability Accounting and Management* 5, no. 1 (2021): 124, https://doi.org/10.28992/ijsam.v5i1.286.; Aisyah Syahidah Shafruddin and Shahida Shahimi, "Strategy and Challenges of Value-Based Intermediation Implementation: The Case of BIMB," *Qualitative Research in Financial Markets* 17, no. 1 (2024): 159, https://doi.org/10.1108/QRFM-04-2023-0101.

[54] Central Bank of Malaysia, *Strategy Paper on Value-based Intermediation* (Kuala Lumpur: Bank Negara Malaysia, July 20, 2017); Central Bank of Malaysia, *The Implementation Guide for VBI* (Kuala Lumpur: Bank Negara Malaysia, October 3, 2018).

rate framework, risk-informed pricing, and responsible finance.[55] There are additional regulations that IBIs must comply with, depending on a product's characteristics and structure. IBIs need to make an assessment or perform "gap analysis" of all relevant regulations during the product development process.

VI. KEY REQUIREMENTS AND PROCESSES FOR THE INTRODUCTION OF NEW ISLAMIC BANKING PRODUCT

VI.A. Ascertaining a "New Product"

In determining whether BNM's product introduction requirements apply, IBIs must first assess whether the proposed offering constitutes a "new product." From the BNM perspective, "product" refers to products and services developed or marketed by a financial institution, including those developed or marketed on behalf of another financial institution or a third party, such as Bancatakaful or an agent for a remittance service provider. IBIs must determine if a newly developed product meets the definition of a "new product," necessitating prior approval from BNM. In this context, the BNM requirements define a "new product" as follows:

1. a product that is being offered by a financial institution in Malaysia for the first time and includes a product that has never been offered by the financial institution before in Malaysia, notwithstanding the fact that the product may have already been offered by other entities within the financial institution's group outside Malaysia; or
2. a combination of a product and any existing or new product, or variation to an existing product being offered by a financial institution in Malaysia, that results in a material change to the structure, features, or risk profile of the existing product.[56]

The Chief Risk Officer or other designated senior risk officer identified by an IBI shall be responsible for determining whether a combination of a product and any existing or new product or variation to an existing product constitutes a material change for the purpose of the above definition of "new product." In determining whether a material change exists, the identified officer shall consider the risk implications of the change from both the bank's perspective

[55] Central Bank of Malaysia, *Reference Rate Framework* (Kuala Lumpur: Bank Negara Malaysia, August 18, 2016), https://www.bnm.gov.my/documents/20124/938039/Reference+Rate+Framework.pdf; Central Bank of Malaysia, *Risk-informed Pricing*, (Kuala Lumpur: Bank Negara Malaysia, December 16, 2013), https://www.bnm.gov.my/documents/20124/938039/20131216_B_PL_0043.pdf/c0dfc80a-a83f-da90-dae9-2317689c42b9?t=1592216160990; Central Bank of Malaysia, *Measures to Promote Responsible Financing Practices* (Kuala Lumpur: Bank Negara Malaysia, November 21, 2011), https://www.bnm.gov.my/-/measures-to-promote-responsible-financing-practices.

[56] Central Bank of Malaysia, *Policy Document on Introduction of New Products* (Kuala Lumpur: Bank Negara Malaysia, March 7, 2014), https://www.bnm.gov.my/documents/20124/938039/std_028_5.pdf/.

(as provider) and the consumers' perspective (as purchasers). The identified officer for Shariah-compliant products must consult the Shariah Committee to determine whether the proposed variation, which would result in a material change, would raise any Shariah issue not yet discussed by the SAC.[57]

VI.B. Product Development Process

Product development covers both pre-product approval (the process of structuring and developing a product prior to its introduction to the market) and post-product approval (the process after the product has been offered to customers and transactions have been carried out). To minimise the risk of product nullification on Shariah grounds, an IBI offering new Shariah-compliant products must establish a sound and robust Shariah governance framework, which includes a comprehensive end-to-end Shariah-compliant product development and implementation process.

Generally, Shariah non-compliance may occur during the product development process and may stem from improper product structuring, insufficient internal research to understand appropriate Shariah concepts, or misrepresentation of the product at the issuance or marketing stage. IBI is expected to refer all Shariah issues related to its end-to-end product development design and process to the Shariah Committee. The Shariah Committee must make a comprehensive request for advice or a decision to ensure effective deliberation. This includes explaining the process involved, the documents used and other necessary information. In that respect, the product developer must ensure that the new product complies with all applicable BNM Shariah contract-based policy documents, in terms of both Shariah and operational requirements.

Normally, the product developer will work with IBI's Shariah Department to facilitate product development. The function will assist in carrying out in-depth research and studies on Shariah issues, as well as providing day-to-day Shariah advice and consultancy. In undertaking such research, advice and input from experts on technical matters, such as legal counsel or accountants, may be sought to ensure comprehensiveness and completeness, and to support a sound understanding of the relevant concepts and approaches. Shariah professionals must possess analytical skills in order to effectively evaluate new products. In fact, the Shariah Committee should maintain regular communication with internal parties in IBIs to acquire precise information while assessing new contracts and products, particularly those related to digital technology applications.[58]

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[57] Ibid.

[58] Haridan et al., "Financial Innovation in Islamic Banks." 918

To ensure that the new product proposal is complete, all new Shariah-compliant products must meet the following conditions:

1. The Shariah Committee must endorse the product (including its accompanying documentation) and support it with relevant *fiqh* literature, evidence and reasoning. All members of the Shariah Committee are required to assess, validate, and approve new product applications, but approval by a majority of the Shariah Committee members is sufficient.
2. The underlying Shariah contract, structure and features of the product must resemble those of the products that the SAC has approved.
3. The product must be consistent with the SAC resolutions.

There must be a rigorous deliberation process among the Shariah Committee, as well as detailed scrutiny of the legal contracts, advertising materials and other documents relevant to the products or transactions. The Shariah Committee must endorse the documents beforehand.[59]

VI.C. Risk Management Assessment

The Board and senior management of IBI are responsible for effectively managing product risks and appropriately addressing consumers' needs and rights. Essentially, there must be appropriate policies and procedures in place to prudently manage the risks associated with the products it offers and its responsibilities to consumers. The policies and procedures should be appropriate for the level of risk associated with an IBI's products. They should aim to identify and manage product risk throughout the entire value chain, including product development, authorisation and governance, pricing, marketing, sale, distribution, portfolio management, accounting and ongoing service and maintenance. Regarding pricing strategy and practices, IBI must adhere to the requirements outlined in BNM's risk-informed pricing policy for retail financing products.

During the product development stage, the management of Shariah risk and the operationalisation of the product structure should be integrated into the IBI's overall risk management framework. This includes having a Shariah risk management control function that systematically identifies, measures, monitors and controls Shariah non-compliance risk. By adopting a systematic approach to managing Shariah non-compliance risks, IBI can effectively carry out its operations and activities while minimising exposure to unacceptable levels of risk.[60]

[59] Ibid.

[60] Central Bank of Malaysia, *Shariah Governance*.

VI.D. Internal approval

Senior management and/or the Board, as appropriate, must approve all new products. The bank must clearly define and document the approving authorities, indicating the extent of the authority, the individuals receiving it and the possibility of further delegation. The levels of authority established shall appropriately reflect the nature and complexity of IBI's range of product offerings, the market segments in which it competes, and IBI's capacity to manage related risks.

Some IBIs, depending on their internal structure and arrangements, have established a dedicated committee, known as the New Product Approval Committee, to scrutinise and approve all new product proposals before submission to BNM. The committee members are functional specialists from the various functional areas and departments in the bank, such as Treasury, Legal, Regulatory Compliance, Tax, Accounting, Market Risk, Credit Risk, Operational Risk, Asset & Liability Management, Information Security Risk, Operations, Technology, as well as from the Shariah Department and Shariah Risk.

VI.E. Submission to BNM

Once the IBI meets the requirements outlined in the relevant policy and receives all internal approvals and the Shariah Committee's endorsement, it can immediately offer the new product to consumers by submitting a complete list of the required information to BNM. This process is referred to as the "launch-and-file" system. The Chief Executive Officer, Chief Risk Officer, or Chief Operating Officer must sign off on the information submission to the bank, ensuring its completeness and accuracy.[61]

Notwithstanding**,** the "launch-and-file" system is not applicable to the following new products:

1. products involving innovative structures that are being introduced in the Malaysian market for the first time;
2. Shariah-compliant products that require the SAC's resolution which-
   a. involve the application of a new Shariah contract that has never been introduced in the Malaysian market, and there is no current SAC's resolution on such contract; or
   b. are a combination of two or more products that were previously approved on a stand-alone basis or constitute a variation in an existing Shariah-compliant product that attract Shariah issues that have not been deliberated by the SAC;

[61] Central Bank of Malaysia, *Introduction of New Products*.

3. investment products that may potentially expose a consumer to losses exceeding the principal amount invested; and
4. designated payment instruments (DPI) and designated Islamic payment instruments (DIPI) which require BNM's approval.

With respect to any of the products stated above, IBIs must submit the required information to BNM as prescribed by BNM prior to offering such a new product. To facilitate the SAC's deliberation process, IBIs must prepare the relevant information in the format required by BNM for products that require prior SAC endorsement.[62] Some of the key requirements for submission to BNM are as follows:

1. The product description should provide a detailed overview of its features, structure, target market or customers, and distribution channel. The risk-informed pricing policy document requires the submission of the estimated hurdle rate for retail financing products.
2. An example of the product term sheet.
3. Details of any arrangements (including distribution arrangements) with other parties or strategic partnerships (if any) in offering the new product, including information about the strategic partner, associated risks, and actions taken to minimise or mitigate the identified risks.
4. Describe the inherent risks of the product from the bank's and consumers' viewpoints, along with the systems or procedures implemented to mitigate these risks.
5. For new products that involve enhancements to the internet, wireless, or other electronic banking platforms, financial institutions must also submit an assessment of the IT-related risks, the measures put in place to mitigate those risks, and other required information.
6. All fees and charges are in compliance with the requirement as set out in BNM's Guidelines on "Imposition of Fees and Charges on Banking Products and Services". IBI is required to obtain an endorsement from the Shariah Committee on all fees and charges. The introduction of fees and charges must be approved by BNM, along with details of their rationale, cost breakdown, and comparison with other financial service providers.[63]
7. For products that have been endorsed by the SAC, IBI must also submit the following information:
   a. product description, including name and features;
   b. Product structure, including transaction flows;
   c. types of Shariah contracts used;

[62] *Ibid.*
[63] Central Bank of Malaysia, *Guidelines on Imposition of Fees and Charges on Banking Products and Services* (Kuala Lumpur: Bank Negara Malaysia, May 11, 2012

d. The relevant SAC resolution approving the new product structure.
e. The Shariah Committee has verified that the new product structure doesn't raise any Shariah issues that the SAC hasn't discussed.
f. The chairman of the Shariah Committee must sign off on the statement. Furthermore, the statement must include any dissenting views from members of the Shariah Committee, as well as the deliberations and rationale that support those views.

VI.F. Business Conduct Requirements

IBIs must give due regard to consumers' interests in the development, marketing, and sale of new products. The Board shall approve policies and procedures that describe the appropriate parameters and guidance for the fair treatment of consumers, which shall serve to avoid the potential for misselling, unfair terms and conditions, and business practices that restrict the freedom of choice for consumers.

In this regard, IBI must also comply with the requirements set out in the Guidelines on Product Transparency and Disclosure. IBI should pay attention to their customers' information needs by adopting the following disclosure principles:

1. timely;
2. clear and concise;
3. accurate and relevant;
4. highlight important information; and
5. consistent and comparable.[64]

The principles aim to enhance the quality of disclosure and enable customers to make informed decisions. IBIs are obligated to provide a product disclosure sheet that includes key information, allowing customers to compare products and make informed choices. Effective disclosure occurs when customers receive timely and relevant product information, enabling them to make informed decisions. BNM requires information disclosure at three stages of the contractual process: pre-contractual, contract entry, and contract term. This ensures that customers receive the necessary information throughout the process, enabling them to understand the product's terms and conditions before entering into a contract and throughout its duration.[65]

The business conduct and disclosure requirements imposed by BNM further demonstrate that product development is not treated solely as an internal design matter. It is also a matter of consumer fairness. However, even

[64] Central Bank of Malaysia, *Guidelines on Product Transparency and Disclosure* (Kuala Lumpur: Bank Negara Malaysia, June 4, 2013).

[65] Ibid.

here, the focus remains largely on whether the IBI has met its procedural obligations. The regulatory framework is less explicit about how regulators might assess whether a product serves a broader Shariah purpose beyond formal procedural requirements.

VI.G. Ongoing Product Risk Monitoring and Control

For post-product approval, IBIs must ensure that adequate procedures are in place and operating effectively to monitor and control product risks on an ongoing basis. The procedures must provide for the ongoing identification, measurement and mitigation of existing and potential risks inherent in the bank's product offerings.[66] Furthermore, there must be an effective process in place to monitor products' Shariah compliance on an ongoing basis. This involves aligning all operational decisions with Shariah.

IBIs must ensure that post-product approval is included in its Shariah governance framework, as well as internal Shariah review and Shariah audit. Without such follow-up, IBIs would be unable to monitor the consistency of their Shariah compliance and effectively manage any Shariah non-compliance risks that may arise over time.

VI.H. Reporting Requirement

The board effectively oversees the senior management of IBIs to ensure adherence to BNM requirements when introducing new products. The Board must submit an annual attestation to BNM confirming that it has complied with the requirements of the relevant BNM policies throughout the reporting period. In addition, upon BNM's request, Islamic Bank shall submit to BNM information on its policies and procedures for managing product risk and ensuring the fair treatment of consumers.[67]

VII. CRITICAL ANALYSIS OF THE LEGAL AND REGULATORY FRAMEWORK

From the elaboration above, it is clear that Malaysia's legal and regulatory framework for Islamic banking product development is undoubtedly comprehensive. It provides legal certainty, centralised Shariah authority at SAC, strong internal governance expectations, detailed Shariah contract-based guidance and structured product approval processes. These are major strengths and have contributed significantly to Malaysia's reputation as a leader in Islamic

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[66] Central Bank of Malaysia, *Policy Document on Introduction of New Product* (Kuala Lumpur: Bank Negara Malaysia, March 7, 2014).

[67] *Ibid.*

banking. Notwithstanding these strengths, a closer examination reveals several structural limitations that affect the nature and direction of innovation in the Islamic banking sector.

VII.A. Structural Gap Between Regulatory Efficiency and Depth of Shariah Evaluation

Malaysia's regulatory framework exhibits a structural gap between regulatory efficiency and the depth of Shariah scrutiny applied to product development. Although the centralised model with the SAC as the apex body offers a significant advantage, it also poses a potential limitation. A highly centralised Shariah governance may prioritise uniformity over interpretative diversity, especially by the IBI's Shariah Committee. In product development, this may limit IBIs' ability to explore alternative structures, particularly when innovation requires novel Shariah juristic reasoning or a broader interpretation of Shariah. Moreover, the SAC, while providing legal certainty and standardisation, may inadvertently reduce the depth of Shariah analysis applied to products. The centralised system can create considerable bureaucracy that impedes efficient decision-making, therefore showing the conflict between thoroughness and efficiency.[68]

Another concern is the SAC's effectiveness in promoting substantive Shariah compliance. This is particularly significant because it suggests that the centralised governance structure, while effective in ensuring procedural compliance, may not adequately promote the achievement of *maqasid shariah*. Research indicates that the social and moral expectations that motivate substantive Shariah compliance do not originate from the centres of power. Consequently, top-down regulatory approaches may be inherently constrained in promoting outcome-oriented compliance.[69]

Furthermore, the "launch-and-file" system mandated by BNM aims to enhance time-to-market and foster innovation. However, by minimising comprehensive regulatory intervention, it places greater reliance on the internal IBI's governance and self-assessment processes. While this approach may be efficient, it poses a risk that the speed and practicality of operations could compromise the thoroughness of Shariah deliberation.

VII.B. Prescriptive Shariah Contracts: Regulatory Constraints and Impacts on Innovation

Although the IFSA 2013 is comprehensive in supporting and recognising the application of Shariah contracts in Islamic banking products, ideally, the

[68] Hassan et al., "Central Bank Regulation," 75

[69] Meskovic et al., "The Influence of National and Individual Islamic Governance." 927

provisions under IFSA 2013 should not be drafted in an overly prescriptive manner to specify the structure or form of any particular Shariah contract. Due to the explicit and prescriptive nature of these provisions, introducing new, innovative Shariah contracts or products that extend beyond the established framework would likely require legislative amendments or authoritative reinterpretations. This is necessary to prevent multiple interpretations that could give rise to legal issues going forward. Moreover, such requirements have the potential to impede the pace of innovation, raising important concerns about the regulatory environment's adaptability to dynamic market needs, particularly for emerging financial technologies in Islamic finance.

For example, with regard to Islamic deposit accounts under the IFSA 2013, this refers to the acceptance of funds which will be returned with or without any form of return. In practice, returns under Islamic deposit accounts utilise the *hibah* contract, which must be made only on a discretionary basis under strict requirements. Indeed, BNM also recognises the application of *hibah* in Islamic deposit accounts by introducing a policy document specifically for the *hibah* contract. However, the provisions of IFSA 2013 do not define returns for Islamic deposit accounts to include *hibah*.

While a structured regulatory approach ensures legal certainty and compliance, it may also pose challenges for IBIs seeking to develop innovative financial instruments or products based on evolving Shariah interpretations. The balance between regulatory certainty and flexibility is thus a pivotal factor in fostering creativity in innovation within the Islamic banking sector. Therefore, IFSA 2013 should be amended to specifically state that financing products also encompass any form of transaction, activity or other business not limited to the list of activity categories and Shariah contracts enumerated under IFSA 2013, so long as they comply with Shariah requirements and are approved by the SAC. The purpose of this clause would be to prevent legal disputes that could challenge the validity of a Shariah contract or product if it is not explicitly mentioned in IFSA 2013. This is based on court cases involving Islamic banking products in Malaysia, where Islamic banking has faced legal challenges.[70]

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[70] *Arab Malaysian Merchant Bank v Silver Concept* (2005) 5 MLJ 213; (2008) 9 CLJ 522; *Affin Bank Bhd v Zulkifli bin Abdullah* (2006) 3 MLJ 67; *Malayan Banking v Marilyn Ho Siok Lin* (2006) 7 MLJ 249; *Bank Muamalat Malaysia Bhd v Suhaimi bin Md Hashim dan satu lagi* (2007) 1 MLJ 275; *Malayan Banking v Ya'kub bin Oje* (2007) 6 MLJ 389; *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Anor* (2009) 1 CLJ 419.

VII.C. Formal Compliance Versus Substantive Achievement of Shariah Objectives

Formal compliance involves meeting legal, contractual and procedural requirements, while substantive compliance focuses on whether products align with Shariah's broader values and objectives. This distinction matters because a product may be formally compliant without necessarily substantively meeting the objective of contract and Shariah. The existing Malaysian legal and regulatory frameworks are highly effective at ensuring formal compliance but less so at ensuring substantive Shariah compliance. That is, it helps IBIs ensure that products are properly structured, documented, approved and monitored.

Moreover, the framework provides clear interpretations of Islamic banking business and introduces a tailored, Shariah contract-based approach aligned with each contract's risk profile. With precise definitions of Islamic banking business and legally recognised applications of Shariah contracts, IBIs are guided in structuring products according to this framework. This approach aims to support industry standardisation and reduce both Shariah and legal risks. Although it does not explicitly require achieving Shariah objectives in product offerings, it establishes frameworks that enable IBIs to develop innovative products and clearly distinguish Islamic banking from the conventional system.

The emphasis is on the use of Shariah contracts and their unique features, which meet its objective (*maqasid `aqd*), such as employing primary models, i.e., Shariah contracts that are not solely concentrated on credit risk but involve broader types of risks. For example, parties contracting under pure partnership contracts such as *musharakah, mudarabah* or leasing contracts (*ijarah),* are exposed to other risks, such as business risk or risks related to the holding and management of physical assets. If this aspect is considered during product development, it can simultaneously fulfil the requirements of the underlying Shariah contract and contribute towards achieving the broader objectives of Shariah.

However, standardisation can improve discipline but may also lead IBIs to use familiar structures. It can unintentionally narrow the innovation space, while structural and regulatory conditions contribute to the repeated use of common structures, such as debt-based instruments, rather than risk-sharing models. For that reason, what is less certain is whether the framework is equally effective in encouraging products that reflect the broader socioeconomic and ethical objectives of Shariah (*maqasid shariah*) especially reflecting the true wisdom of the Shariah contract. This raises the question of whether regulations can spark genuine innovation and the development of truly Islamic products, or merely technical compliance?

For instance, a product based on *tawarruq,* which was originally used for cash facilitation, may satisfy the relevant contractual and regulatory requirements, yet still attract criticism if it closely resembles conventional debt financing in substance, or if it is misapplied for other financial instruments beyond its intended sole purpose. Despite improvements to the structure and offerings of Islamic banking products in Malaysia implemented by IBIs, innovation and development remain largely concentrated in credit-risk-based financing and deposit models. IBIs typically prefer established product structures that are simple to structure and carry lower regulatory risk. As a result, the industry has adopted straightforward Shariah contracts, which are appreciated for their lower risk profiles and operational efficiency.

This may partly explain why certain Shariah contracts continue to dominate product development, such as the over-reliance on the *tawarruq* contract in structuring all types of product portfolios. Based on the reported financing composition, *tawarruq* accounted for approximately 65% of total Islamic banking financing in 2025, indicating its continued dominance in industry practice.[71] The *tawarruq* contract has become the preferred choice because it raises fewer Shariah and operational concerns than other Shariah contracts. Despite BNM's efforts to reduce reliance on *tawarruq*, the product continues to dominate the market because of its lower risk profile in terms of operation and Shariah risk profile. IBIs should be more proactive in developing non-*tawarruq* products to enhance product innovation and minimise heavy reliance on debt-based products.[72]

On the liability side, IBIs have mostly continued to offer Islamic deposit accounts rather than investment accounts based on *mudarabah* or *wakalah bi al-istithmar*, due to the simpler operational and regulatory requirements. As at year-end 2025, total Islamic banking deposits represented about 70.34% of total liabilities. In contrast, investment accounts contribute only about 7.16% of total liabilities.[73] The investment account products have seen limited acceptance, with most IBIs shifting portfolios to Islamic deposit accounts. Strict regulations have reduced product innovation, leading IBIs to favour *tawarruq*-based deposit accounts over other Shariah contracts, such as *salam* and *ju`alah*, and to avoid more complex investment accounts.

Another example is the introduction of VBI. Essentially, it represents BNM's recognition of this limitation and an attempt to move beyond formal

[71] Central Bank of Malaysia, "Monthly Highlights and Statistics in December 2025," December 2025, https://www.bnm.gov.my/-/monthly-highlights-statistics-in-december-2025.

[72] Norhazlina Ibrahim and Safeza Mohd Sapian, "Does Tawarruq Still Remain the Top Option for Islamic Home Financing (IHF) Products in Malaysia?" *Qualitative Research in Financial Markets* 15, no. 1 (2022): 183-184, https://doi.org/10.1108/QRFM-07-2021-0118.

[73] Central Bank of Malaysia, *Monthly Highlights.*

compliance towards value creation.[74] VBI is described as "a tool and an opportunity for IBIs to move beyond just being Shariah-compliant". However, VBI has yet to be fully embraced by all IBIs in Malaysia, as some argue that they had already adopted similar concepts before the introduction of VBI. This suggests a continuing gap between regulatory aspiration and industry-level adoption. Although these social finance initiatives foster inclusivity, they have not fundamentally altered product models or diversified Shariah contracts, leaving the core product structure and Shariah contract largely unchanged despite more comprehensive regulatory frameworks. This resistance suggests that the transition from compliance-oriented to outcome-oriented regulation faces significant institutional challenges.[75] VBI clearly demonstrated that stronger regulatory alignment alone is insufficient without institutional support to maximise financial inclusion and optimise the socio-economic role of Islamic banking.[76]

VII.D. Policy Applicable to Both Islamic and Conventional Banking

There are regulations that are combined and applicable to both conventional and Islamic banking. For example, this can be observed in issues related to the imposition of default rates as a credit risk mitigation measure, as outlined in the Reference Rate Framework. In this case, the default rate mechanism may not be practical or permitted in Islamic banking products.[77] Therefore, ideally, for policies or guidelines that apply to both conventional and Islamic banking, BNM should assess whether any issues could affect Shariah compliance. This is because not all commercial regulations align with Shariah requirements, such as the imposition of charges for payment defaults and the determination of reference rates for financing.

In this regard, separate, non-combined policies should be issued specifically for Islamic banking, given the unique characteristics of Shariah contracts and Islamic banking products. Although there are similarities in banking, commercial, and risk management aspects across both industries, there are unique features and Shariah requirements that must be complied with and are not applicable to conventional banking. If a regulation is issued for compliance

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[74] Shafruddin and Shahimi, "Strategy and Challenges." 154

[75] Abdul Kadir et al., "Realisation of Maqasid Al-Shariah," 51-52.

[76] Komarudin Umam and Berlian Widya Tama, "Integrating Islamic Social Funds in Sharia Banking for Empowering Indonesia's Productive Poor," *Journal of Central Banking Law and Institutions* 5, no. 1 (2026): 40, https://doi.org/10.21098/jcli.v5i1.498.

[77] Mohamad Syafiqe Abdul Rahim and Ahmad Hidayat Buang, "The Practice of Imposing Default Rate in Islamic Home Financing Product in Malaysia: Analysis from Regulatory and Shariah Perspective," *The Journal of Muamalat and Islamic Finance Research* 18, no. 2 (2021): 115-116, https://doi.org/10.33102/jmifr.v18i2.378.

by both conventional banks and IBIs, the question arises as to whether it must first be approved by the SAC. This is because product development teams, including the Shariah Committee, are bound to use it as the primary reference. This, in turn, can create difficulties for IBIs in structuring dynamic Islamic banking products, as they still have to comply with commercial regulations that may be irrelevant and perhaps only applicable to conventional banking.

Even though BNM has issued policy documents based on Shariah contracts for IBIs to develop products, there are still some other policies and guidelines that are general in nature and apply to institutions under the IFSA 2013 and the Financial Services Act 2013. If the need for combined regulations to ensure compliance by both industries persists, they should first be reviewed and approved by the SAC. Moreover, such requirements should be clearly stated in regulations to avoid confusion within the industry.

VII.E. The Impact of Leverage Model for Islamic Banking Product Development

The leverage model adopted by Islamic banking subsidiaries in Malaysia enables these institutions to utilise the infrastructure, resources and broader distribution channels and networks of their parent conventional banks. The positive impacts of this model are evident in IBIs' ability to manage costs more effectively, sustain business operations, and leverage the technological and infrastructural capabilities of their parent institutions. This holistic approach can enhance the competitiveness of Islamic banking and support the gradual introduction of innovative products, especially in a regulated environment where operational costs and compliance requirements are significant.

Despite its advantages, the leverage model presents several limitations. While it enhances operational efficiency, it may not substantially promote product innovation, as the emphasis often focuses on cost reduction and functional integration rather than on developing innovative Islamic banking products. There is a potential for Islamic banking subsidiaries to become excessively dependent on their parent banks, which can restrict their independence in making decisions and their ability to differentiate their offerings. This is because they must always be subject to the banking group's business strategy. Any deviation from the internal strategy may significantly alter their banking business model, potentially leading to unintended competition and cannibalisation among entities.

BNM should review this leverage model regulations, as current practices have not achieved the desired diversification in Islamic banking products. Performance assessments and responsibilities related to Islamic banking should also extend to conventional banking to ensure accountability and encourage greater product innovation.

VII.F. Reassessment of the Role of the Shariah Committee in Product Development

With regard to the policy documents based on Shariah contracts issued by BNM, they are seen as a form of codification of Islamic commercial law (*muamalat* law), organised in a prescriptive and rigid manner that legally binds IBIs, thereby constraining the scope for the Shariah Committee to issue contemporary fatwas in response to emerging issues and changes in product and market innovation. Moreover, the role of the Shariah Committee is also increasingly seen as limited to the practical implementation of BNM regulations and resolutions of the SAC. This aligns with Dinc's study, which finds that the product development process model employed by IBIs fails to adequately recognise the involvement of Shariah experts in the governance framework. At present, there is no universally accepted guideline or theoretical framework that clearly explains the specific responsibilities and contributions of Shariah experts in the development of Islamic banking products.[78]

There are several regulations that are rigid and inflexible in their application. This can be observed in several Shariah and operational issues involving products that must conform to the requirements set in policy documents, which in turn impacts product innovation and the selection of Shariah contracts to be implemented. Therefore, the question that arises concerns the actual role of the Shariah Committee, as they are now bound and only need to refer to these policy documents when making decisions. The function of the Shariah Committee, as stated in the Shariah Governance Policy Document, should be reviewed and enhanced by providing it with broader roles and responsibilities in product innovation and development processes. Currently, the Shariah Committee's role is limited to approving product structures, documentation, and discussing Shariah issues, particularly those related to potential Shariah non-compliance events, and is bound by the regulations issued by BNM and SAC's resolutions.

BNM should reevaluate its responsibilities and set clear expectations for the Shariah Committee regarding Shariah decision-making and independent judgement (*ijtihad*). Moreover, with the accelerated adoption of artificial intelligence and digitalisation, the role of the Shariah Committee has gained greater significance in applying these technological advancements to support sound decision-making processes.[79] In addition, the composition of

[78] Yusuf Dinc, "Product Development in Islamic Finance and Banking in Secular Economies," *Journal of Islamic Accounting and Business Research* 11, no. 9 (2020): 1669, https://doi.org/10.1108/JIABR-06-2019-0106.

[79] Mohamad Syafiqe Abdul Rahim, "Revolutionising the Shariah Secretariat Function through Artificial Intelligence: Prospects and Challenges for Malaysia's Islamic Banking Sector," *Journal of Central Banking Law and Institutions* 4, no. 3 (2025): 575-576, https://doi.org/10.21098/jcli.v4i3.444.

Shariah Committee members for each IBI should be reviewed to ensure it is commensurate with their roles and responsibilities, in line with the more prescriptive regulatory approach relating to Shariah. Furthermore, the Shariah Committee should be given a role in providing input on the IBI's business strategy, particularly regarding innovation and product development. This role does not involve the Shariah Committee at the working level; that responsibility falls to the management team. The Shariah Committee can proactively serve as a bridge, facilitating the communication of its opinions to management and the Board. This enables business strategies to focus not only on profit or commercial aspects. Thus, every decision and business strategy can be made collectively, considering all perspectives holistically, including social aspects, consumer interests, the use of Shariah contracts, and dynamic product model structures.

VII.G. No Performance Evaluation or Targets for Product Innovation

Drawing upon the preceding discussion and analysis, it is evident that, despite the introduction of diverse legislative initiatives and new regulatory measures by the authorities to foster innovation and product development within Islamic finance, the anticipated significant impact has not materialised. Since the enactment of IFSA 2013 and the issuance of a series of policy documents on Shariah contracts, IBIs have not widely offered any product models that markedly diverge from conventional banking products. The prevailing landscape remains dominated by Islamic financing and deposit products, rather than by primary product structures and investment accounts as envisaged by legislative efforts under IFSA 2013 and BNM regulations.

The findings of this study indicate a lack of clear regulatory provisions specifying the targets or performance assessments that IBIs must meet to achieve desired levels of product innovation, adoption of product models, or Shariah contracts. IBIs are not proactive in advancing innovative product development, often restricting their efforts to meeting minimum legal and regulatory requirements, provided that the product is straightforward to offer and conducive to achieving profit objectives. This approach highlights the challenges IBIs face in fostering a dynamic environment conducive to developing new products and product models, despite a regulatory framework intended to facilitate such progress.

The continued reliance on the *tawarruq* contract, coupled with insufficient portfolio diversification, is notable. If this pattern continues unchecked, it may lead to legal complications, concentration risk management challenges and ultimately, could have a detrimental impact on the reputation and long-term sustainability of the Islamic banking sector. BNM should establish performance assessments and specific targets for IBIs to achieve a desired level of product innovation and the adoption of particular product models or Shariah contracts. By setting distinct targets for IBIs regarding product innovation and the adoption of product models or Shariah contracts, IBIs will also set corresponding targets for their product development teams within the banks, which will be continuously evaluated by bank management and the Board. In addition, these targets should receive attention and be included in the financial sector masterplan or BNM's annual plans, with reporting in BNM's annual financial statements.

VII.H. Lack of a Clear Regulatory Framework for Artificial Intelligence (AI) Applications for Future Innovative Islamic Banking Products

The integration of AI into Islamic banking has significantly influenced the development of innovative financial products, particularly in areas such as compliance monitoring, risk assessment and decision-making. However, Malaysia's existing regulatory framework does not provide a clear and comprehensive structure governing the use of AI within Shariah governance. While AI offers substantial benefits in enhancing operational efficiency, it introduces complex legal and ethical concerns, particularly regarding accountability, liability and transparency in automated decision-making processes.[80] These challenges are further exacerbated by technological risks and regulatory ambiguity identified in the context of Islamic fintech, including cybersecurity concerns, lack of regulatory clarity and insufficient expertise to oversee emerging innovations effectively.[81]

Moreover, the absence of a clear regulatory framework is particularly problematic in the context of Shariah governance, which relies heavily on human interpretation and scholarly reasoning. Although AI can improve the efficiency and responsiveness of fatwa formulation, it raises concerns about the potential erosion of *istinbath* (methodology in deriving Islamic rulings) and the integrity of Islamic jurisprudence if excessive reliance is placed on automated systems.[82] Comparative and institutional analyses further indicate that Malaysia's regulatory approach to AI remains fragmented and has enforcement limitations, thereby weakening transparency, accountability, and

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[80] Rahim, "Revolutionising the Shariah Secretariat Function." 581-583

[81] Muhammad Ilyas bin Ab Razak and Nur Akma binti Mohd Dali, "The Key Challenges for Islamic Fintech Implementation in Malaysia," *Journal of Central Banking Law and Institutions* 5, no. 1 (2026): 160-164, https://doi.org/10.21098/jcli.v5i1.270.

[82] Anita Priantina et al., "AI in Fatwa Formulation: Transforming Sharia-Compliant Finance," *Journal of Central Banking Law and Institutions* 4, no. 3 (2025): 617-618, https://doi.org/10.21098/jcli.v4i3.446.

consumer confidence.[83] More broadly, effective governance of AI in Islamic finance requires coordinated regulatory efforts between central banks and Shariah fraternities, as well as the establishment of coherent frameworks to address legal uncertainty, algorithmic bias, and data protection risks.[84]

These regulatory shortcomings highlight a significant gap in Malaysia's legal and regulatory framework for Islamic banking product development. As noted in broader regulatory discussions, the absence of a specific legal framework and standardised policies can undermine the effectiveness of governance and increase the risk of Shariah non-compliance.[85] This is particularly critical given the expanding role of IBIs in financial intermediation and social finance, which demands more adaptive and forward-looking regulatory mechanisms.[86] Moreover, the importance of a robust regulatory framework is underscored by empirical evidence demonstrating the role of Islamic banking in promoting economic resilience, financial inclusion, and sustainable growth, particularly during periods of crisis, such as the COVID-19 pandemic.[87]

VIII. CONCLUDING REMARKS

Product development is central to the sustainability and growth of the Islamic banking industry. In Malaysia, BNM regulates this process through a detailed legal and supervisory framework. This article examines whether that framework facilitates the development of Islamic banking products and promotes substantive Shariah compliance beyond formal requirements. Overall, Malaysia's framework provides strong legal certainty through the centralised SAC, reinforced by a dual-layer Shariah governance structure and Shariah contract-based policy documents. The framework has supported market confidence and enabled product development within a clear compliance pathway.

At the same time, the analysis shows that the framework's emphasis is weighted toward procedural and structural formal compliance, ensuring that products are properly documented, endorsed and operationally controlled

[83] Kok Loang Ooi, "Analysis of Artificial Intelligence in Financial Regulation in Malaysia, Indonesia, and the United States," *Journal of Central Banking Law and Institutions* 4, no. 3 (2025): 500-501, https://doi.org/10.21098/jcli.v4i3.417.

[84] Azwar Azwar et al., "Revolutionising Islamic Finance with Artificial Intelligence: A Bibliometric and Strategic Analysis," *Journal of Central Banking Law and Institutions* 5, no. 2 (2026): 268-270, https://doi.org/10.21098/jcli.v5i2.329.

[85] Yas, "Legal and Regulatory Issues." 414-416

[86] Umam and Tama, "Integrating Islamic Social Funds." 43

[87] Umar Habibu Umar and Auwalu Isah Darma, "Evaluating MSME Financing Practices during COVID-19: Evidence from Islamic Bank Annual Reports," *Journal of Central Banking Law and Institutions* 3, no. 2 (2024): 279-280, https://doi.org/10.21098/jcli.v3i2.176.

rather than systematically assessing whether products realise the purposes of the underlying Shariah contracts (*maqasid ʿaqd*) and the broader objectives of Shariah (*maqasid shariah*). Moreover, digitalisation and AI should be integrated into Islamic banking product development within a clear regulatory and Shariah governance framework to ensure that innovation remains transparent, accountable and consistent with the objectives of Shariah. In short, Malaysia's regulatory framework facilitates product development, but it does not yet consistently drive substantive Shariah compliance outcomes. Therefore, Malaysia's framework would benefit from a more outcome-oriented regulatory approach that complements existing governance and legal certainty with *maqasid* (objective) based evaluation. This would mean that, alongside verifying formal compliance, regulators and IBIs assess whether the proposed products credibly deliver their intended economic and ethical effects.

The Securities Commission of Malaysia has implemented this approach, requiring all new Sukuk issuances to undergo assessment by the respective Shariah Adviser to ensure alignment with the principles-based Maqasid al-Shariah Guidance. This measure aims to enhance the authenticity of the Islamic finance ecosystem and align with the true spirit of Islamic finance.[88] Such a shift need not dilute SAC authority or Shariah governance; rather, it would strengthen the regulatory message that Islamic banking innovation should be measured not only by its market competitiveness but also by demonstrable alignment with Shariah objectives.

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