

Legal Aspects of Islamic Banking: Malaysian Experience

*Norhashimah Mohd. Yasin**

Introduction

Malaysia is the forerunner in Islamic banking. The world is looking to this country and trying to learn from its experience in developing modern and sophisticated instruments which are said to be Shari'ah compliant. This is the first country in the world to introduce and promote an Islamic inter-bank money market to link all the market players and promote short-term liquidity. The main contributing factor leading to its success is the undeniable support of the Government. To further spur its growth, Bank Negara Malaysia (BNM) in 2001 introduced the Financial Sector Master Plan (FSMP), which includes the aim of a 20 percent market share for Islamic Banking and Takaful vis-à-vis conventional by 2010.

In Malaysia currently there are two Islamic banks, Bank Islam Malaysia Berhad (BIMB), which commenced operation in July 1983 and Bank Muamalat Malaysia Berhad (BMMB) in 1999, a relatively new bank as the result of a merger and takeover exercise.¹ They were established by virtue of an act of Parliament; the Islamic Banking Act 1983 (IBA), which is considered as the beginning of the effort to assimilate Islam into the Malaysian economic system. Thereafter, more statutes were enacted to

* Advocate & Solicitor - High Court of Malaya, Ph.D (Warwick), LLM (Warwick), MCL (IIUM), LLB (Hons) (IIUM), Postgraduate Diploma, Islamic Banking & Finance (IIUM). External Adviser (Islamic Banking & Financial Services), Azmi & Associates. Also, Associate Professor, Ahmad Ibrahim Kulliyah of Laws (AIKOL), International Islamic University Malaysia (IIUM). E-mail: norhashimah@iiu.edu.my

govern and regulate the financial sector in Malaysia. For instance, the Government Investment Act 1983 (GIA),² and the Takaful Act 1984 (TA).³

The full monopoly of BIMB in Islamic Banking lasted for ten years until 1993, when three commercial banks, i.e., Maybank, Bank Bumiputera and United Malayan Banking Corporation were given the opportunity to participate in the pilot project of the Interest-free Banking System (IBS),⁴ probably to test the market as to the profitability and viability of Islamic banking offered by conventional banks. Certainly, the project has been shown to be a remarkable success with many commercial banks getting on the bandwagon of IBS. Now almost every commercial bank offers Islamic banking which attracts both Muslim and non-Muslim customers.

The Islamic banking system without the law is futile and meaningless. The legal system is supposed to regulate and license the Islamic banking business, besides imposing control and supervision of the affairs of the Islamic banks. With the rapid development of the Islamic banking system in Malaysia, the law must also be able to keep up with the speed of that development. As such, the study on the development of the legal regime becomes an important area to be understood. Realizing that purpose, the article intends to delve into the various legal issues relating to Islamic banking in Malaysia.

2. Statutory Provisions

In Malaysia, there are two laws governing Islamic banking. One is the IBA 1983 which exclusively governs BIMB and BMMB and the other is the Banking and Financial Institutions Act 1989 (BAFIA) which regulates conventional banks and Islamic Banking Divisions (IBDs) or SPI banks.⁵ The nature of these laws is somewhat different as the IBA was enacted with the intention of Islamic banking in mind while BAFIA was enacted to govern conventional banking.⁶ Section 124(6) of BAFIA specifically provides that “The Act shall not apply to Islamic banks.” As such, one can loosely say that the IBA, as the name implies, is an Islamic statute while BAFIA is a conventional or civil statute to govern their respective banks. The nature of the dual banking system; a full-fledged Islamic banking system operating in parallel with a sophisticated conventional banking system is unique. So far, Malaysia is the only Muslim country to implement such a model with both types of banking working hand-in-hand or side-by-side utilising essentially the same banking infrastructure.

2.1 IBA 1983 Versus BAFIA 1989

IBA 1983 was the first law in Malaysia covering Islamic matters that deals with economic activity and is a good attempt to enhance the role of Islamic law by not being only restricted to family and matrimonial matters per se. Nevertheless, this Act is substantially modelled on the Banking Act 1973 (repealed and replaced by BAFIA). Having a first look at the said Act, one could feel that there is nothing Islamic about it except where it states “...aims and operation not contrary to the religion of Islam.” It could be said that the IBA is merely a piece of legislation to permit the establishment and operation of an Islamic bank in Malaysia. This is probably why the Act is relatively brief and simple compared to BAFIA, its civil law counterpart.⁷ The Act, for example, only defines ‘Islamic banking business’ to mean “banking business whose aims and operation do not involve any element which is not approved by the religion of Islam.”

This blanket definition seems to be very ambiguous and may carry far-reaching implications. This definition surely poses the question: What is Islamic banking business? Shari‘ah contracts used by Islamic banks and SPI banks, such as *muḍārabah*, *mushārahah*, *ijārah*, *murābahah* and *wakālah*, are not mentioned in the Act. The definition seems to be very simple and open-ended, literally “everything under the sky and above the soil of Islam” is a permissible (*ḥalāl*) type of Islamic banking. In other words, legally an Islamic bank is allowed to engage in all types of business which are lawful in the eyes of Shari‘ah. In fact, the generality of the definition of Islamic banking business⁸ could benefit the Islamic banks in Malaysia as they can practise ‘Universal banking.’ ‘Universal Banking’ can be defined as the conduct of a range of financial instrument services comprising deposit taking and lending, trading of financial instruments and foreign exchange, underwriting of new debt and equity issues, brokerage, investment management and insurance. In brief, Universal Banking is similar to the concept of the ‘financial supermarket’ which offers every financial need under one roof.⁹ On the negative side, in the absence of a statutory definition of ‘banking business’ in the Act, it is the practice, and the law (by virtue of Sections 3 and 5 of the Civil Law Act 1956), to have regard to the English law to determine its meaning. In the case of interpreting what would be “Islamic banking business”, the Civil Court and the practitioners could define it in similar terms as conventional banks in the Common law jurisdictions. The only exception is that the aims and operations of such banking business should not involve any element that is not approved by the religion of Islam. Probably due to this, Islamic banks have emulated the ‘Anglo-Saxon’ style of

banking by having co-companies to undertake various financial functions, even though the IBA 1983 allows an Islamic bank to run Universal Banking.

It is acceptable fact that the conventional banks have no choice but to have subsidiaries to undertake various financial businesses because they are legally constrained under BAFIA. Section 2 of BAFIA states:

“ ‘Banking business’ means:

- a) the business of –
 - i) receiving deposits on current account, deposit account, savings account or other similar account;
 - ii) paying or collecting cheques drawn by or paid in by customers; and
 - iii) provisions of finance; or
- b) such other business as the Bank (Central Bank of Malaysia (CBM)) with the approval of the Minister, may prescribe.”

From the above, BAFIA has restricted conventional banks to 3 main businesses; viz. (i) receiving deposits (ii) paying and collecting cheques and (iii) giving loans. Furthermore, Section 32 restricts conventional banks from engaging in trade, either retail or wholesale, except in connection with the realisation of security given to or held by it for the purpose of carrying on its licensed business. Section 66 prohibits conventional banks from being involved in investment.¹⁰ Both these sections are absent in IBA on purpose so as to give effect to the operation of Islamic banking business which is centrally based on trade and investment, albeit as mentioned above. IBA is basically a carbon copy of the conventional Banking Act 1973, a predecessor of BAFIA. This is the example where the exceptions were done in order to comply with “the aims and operations must not involve any elements which are not approved by the Religion of Islam”. This would easily distinguish Islamic banking from that of conventional, as while the latter earns most of its profits against a fixed interest rate for the granting of loans, the former earns the profit from trading and investment activities.

Besides being brief and general, the IBA has limited licensing to companies under the Companies Act 1965. Section 3 of the IBA states:

“Islamic banking business shall not be transacted in Malaysia except by a company which is in possession of a licence in writing from the Minister authorising it to do so.”

The above provision limits the licensing of an Islamic bank to a company only. According to the definition section of the IBA (Section 2), a ‘company’ means a company enacted under the Companies Act 1965 and therefore, only companies enacted under the Companies Act can operate Islamic banking. As a result, statutory bodies or companies enacted under different laws, cannot operate an Islamic bank. Mainly due to this legal constraint, Bank Kerjasama Rakyat Malaysia (Bank Rakyat) was unsuccessful in its attempt to be the second full-fledged Islamic bank, although its operations have been Islamised. Bank Rakyat is actually *de facto* an Islamic bank but *de jure* it is not as it was enacted under the Co-operative Societies Act 1948. As one expert observed:

“The establishment of Bank Muamalat Malaysia (sic) as the country’s second Islamic bank caught many by surprise since Bank Kerjasama Rakyat Malaysia had been tipped to be the second of such banks after Bank Islam Malaysia Bhd. It is surprising as Bank Rakyat was always having the idea that it would be the (country’s) second Islamic bank...but most probably the plan was somewhat delayed as Bank Rakyat was still under the Co-Operative Act.”¹¹

This limitation should be removed and the rule applicable in BAFIA adopted. This is of wider application as BAFIA extends to “any individual, corporation, statutory body, local authority, society, trade union, co-operative society, partnership and any other body, organisation, association or group of persons, whether corporate or unincorporated.”

IBA has also posed legal uncertainties when it comes to the conflict of laws. Section 55 of the IBA reads:

“An Islamic bank which is incorporated under the Companies Act 1965 shall be subject to the provisions of the Act as well as the provisions of this Act, save where there is any conflict or inconsistency between the provisions of that Act and the provisions of this Act, the provisions of this Act shall prevail.”

The above section is quite clear that when there is a conflict between the IBA and the Companies Act, the IBA shall prevail, but the effect could be far-reaching. What about other laws that an Islamic bank is subject to, such as the Contracts Act, National Land Code, Hire Purchase Act and Sale of Goods Act? If there is a conflict between any of these other Acts, which law shall prevail? Would the court apply the legal maxim of *expressio unius est exclusio alterius* (the express mention of one thing implies the exclusion of another). Since the legislature’s intention is to limit the scope only to cover the Companies Act, as such, in other situations where there are conflicts

between Islamic law and other statutes, the former will not necessarily prevail.

This oversight should be rectified. Perhaps a lesson could be taken from Pakistan where the Islamic banking law has been constructed as follows:

“The provisions of this ordinance shall have effect notwithstanding anything contained in the Companies Act 1913 (VII of 1913), or any other law for the time being in force.”¹²

The above provision overrides all other laws so that if there is a conflict between the Islamic banking law and any other law currently in force in Pakistan, the provision of the former shall prevail.

One interesting statutory requirement for an Islamic bank in Malaysia which is not present in BAFIA is the establishment of an in-house Sharī‘ah Advisory Body (SAB) to advise the bank management as to Sharī‘ah compliance. Section 3(5)(b) provides:

“That there is, in the articles of association of the bank concerned, provision for the establishment of a Syariah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.”

The details of the SAB is not elaborated in the Act. It is to be detailed by the bank’s Articles of Association. The IBA only provides that the statutory duty of the SAB is to “advise the bank on its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam”. The Islamic Banking (Amendment) Act 2003 has been recently passed.¹³ It incorporates a new section 13A on the “Advice of Sharī‘ah Advisory Council” which provides:

“An Islamic bank may seek the advice of the Syariah Advisory Council on Syariah matters relating to its banking business and the Islamic bank shall comply with the advice of the Syariah Advisory Council.

In this section, “Syariah Advisory Council” means the Syariah Advisory Council established under subsection 16B (1) of the Central Bank of Malaysia Act 1958.”

However, there still exist some legal uncertainties as to the legal position of the SAB which needs to be resolved urgently, such as:

- 1) Are the SAB decisions binding on the bank's management? IBA only provides for the statutory duty of the SAB to give advice but nothing is mentioned about their decision must be acceptable and binding on the bank. It is argued that SAB is not a creation of statute but of its Article of Association. As such, SAB cannot have any legitimacy or power beyond that it has under IBA i.e., merely an advisory role. On the other hand, it could also be submitted that if the decision or the opinion of SAB is ignored by the bank management, it will run the risk of its product or service be challenged in the court as to its Sharī'ah validity;
- 2) Are their decisions subject to judicial review? Can the Court quash or review their decisions on Islamic banking matters?¹⁴

2.2 BAFIA and SPI Banks

SPI (or IBS) banks, formerly known as Interest-free or SPTF banks, are a peculiar and unique creature of the system. SPI banks offer both Islamic and conventional products. However, the whole structure is conventional as they are licensed and regulated by BAFIA 1989.¹⁵ There is no new law enacted to govern them and they can operate within the existing law. Prior to 1989, they were operating Islamic banking business using the second limb of Section 2 of BAFIA which is concerned with "such other business as the Bank (Central Bank of Malaysia (CBM)), with the approval of the Minister, may prescribe." Islamic banking business such as involvement in trade (*bay' bithaman ajil, murābahah*) or investment (*muḍārahah* and *mushārahah*), were therefore not covered under the first limb of the said Section.

In 1999, there was an amendment to Section 124 of BAFIA by virtue of the BAFIA (Amendment) Act 1996¹⁶ which legalised and formalised the carrying on of Islamic banking and financial business by licensed institutions. With this amendment, 6 new provisions were incorporated to govern and regulate the SPI banks. They are as below with commentary connected therewith:

- 1) SPI banks are allowed to carry on Islamic banking business (IBB) or Islamic financial business (IFB) in addition to their existing traditional banking business provided that they consult the Central Bank (CBM);
- 2) SPI banks in carrying out IBB or IFB are subject to other provisions of BAFIA. As such, if there is a conflict between this section and other sections of BAFIA, which one will prevail? For instance, on

the one hand, Section 124(1) of BAFIA allows SPI banks to carry on Islamic banking business and Islamic financial business in addition to their existing business but on the other hand, Section 32 prohibits licensed institutions from carrying on trade, either retail or wholesale, including import and export, except in connection with the realisation of a security given to or held by it for the purpose of carrying on its licensed business. Likewise, Section 66 restricts licensed institutions from involvement in investment activities. Thus, the two provisions seem to be in direct contradiction with the operation and business of Islamic banking and finance, as to be involved in trade and investment is the essential thrust as an alternative to *ribā*. This is to comply with the divine revelation which has legalised trade and prohibited *ribā*.¹⁷ From the foregoing, one can submit that the granting of a BBA facility by SPI banks is tantamount to engaging in trade, and thus in breach of Section 32. Likewise, *mudārabah* and *mushārahah* dealings between SPI banks and their customers are in fact violating Section 66 of BAFIA. That brings up the issue of capacity to enter into a contract which is an important legal issue to be resolved, particularly in the absence of any judicial precedents on the matter. However, on closer scrutiny of BAFIA, such “conflicting provisions” can be mitigated by referring to the BAFIA (Trading by Licensed Banks, Finance Companies and Merchant Banks) Order 1994, which came into force on 1 March 1993. The provision is self-explanatory. It provides that “All licensed banks, finance companies and merchant banks may engage in either or both of the following forms of trade: the sale of property at a price which includes a profit margin and the sale of property on a deferred payment basis at a price which includes a profit margin, so long as such trade is not conducted on the basis of interest.”

- 3) As such, the said Order has actually provided an exemption to SPI banks to engage in sale so as to materialize the operation of Islamic banking business. Likewise, the restriction on investment is mitigated by virtue of the BAFIA (Acquisition and Holding of Shares and Interests in Shares) (Licensed Banks, Licensed Finance Companies and Licensed Merchant Banks) Regulations 1991 which came into force on 1 October 1989;
- 4) In carrying out IBB or IFB, the SPI may seek the advice of the SAC established under subsection (7) of BAFIA on the operations of the business to ensure that it does not involve any element which is not approved by the Religion of Islam;

- 5) SPI banks shall comply with any written directions relating to the IFB or IFB issued by the Central Bank in consultation with the SAC. Subsections (3) and (4) seem to be connected to each other. They provide that the SPI may seek the advice of the SAC to ensure the Sharī‘ah compliance of IBB or IFB. The word used is ‘may’ which in law means optional and not mandatory. It means that SPI banks may seek the advice of the SAC but it is not mandatory as they can consult their own Sharī‘ah consultants as required under the BNM Guidelines. But Subsection (4) uses the word “shall” which means that if an SPI bank refers the Sharī‘ah issue to BNM’s SAC for a ruling, thereby the written directives issued by the CBM in consultation with the SAC has to be complied with;
- 6) An SPI bank is still legally regarded as a conventional bank and shall be deemed to be not an Islamic bank. Although it offers Islamic banking products (along with conventional ones) and abiding strictly by the Sharī‘ah requirements, it is still a conventional bank as its main structure is still conventional-based. This is, in fact, the old provision which remains in the section;
- 7) BAFIA shall be inapplicable to Islamic banks. Pursuant to this, it is a clear intention of the legislature to have two sets of statutes to govern Islamic and conventional/SPI banks;
- 8) Section 124 (7) deals with 2 crucial points:-
 - i) it requires the establishment of the SAC at the CBM to advise the CBM on the Sharī‘ah aspects of IBB or IFB. Pursuant to this, the CBM has created a special department for Islamic Banking and *Takāful* and its Sharī‘ah officer becomes the secretariat to this SAC. As such, in Malaysia, there exists two groups of Sharī‘ah Advisors (a) in-house advisors belonging an Islamic bank by virtue of the IBA 1983 called a Sharī‘ah Advisory Body (SAB) and (b) the national SAC attached to the CBM acting as the central body to advise the CBM on all Islamic matters relating to banking and finance (IBB and IFB), by virtue of BAFIA 1989.

The question remains is what if the decision/opinion of an SAB and the SAC conflicted. Which one would prevail? There was uncertainty over this issue, but with the recent amendment, one can presume that an SAC decision will prevail over that of a SAB as Section 16B of the CBMA (Amendment) 2003 regards the SAC as the authority for the ascertainment of Islamic law for the

purpose of Islamic banking business, *takāful* business, Islamic financial business, Islamic development financial business, or any other business which is based on Sharī‘ah principles and it is supervised and regulated by the CBM.

- ii) Besides “Islamic banking business” which has been defined as in the IBA, Section 124 has introduced a new term, “Islamic financial business” which means “financial business, the aims and operations of which, do not involve any element which is not approved by the Religion of Islam”. The rationale of differentiating them is unknown as in Islam there should be no difference, because an Islamic bank can be involved in banking and financial activities as submitted earlier under the concept of “Universal Banking.” It is the concept of the Anglo-Saxon banking system which differentiates banking institutions from financial institutions which is evident from the celebrated Common law precedent of *United Dominion Trust (UDT) v Kirkwood*.¹⁸

3. Jurisdiction of the Court

Islamic law in Malaysia is only applicable in a very limited sphere; family law and religious offences. Islamic law is provided for under the State list and therefore is under the administration of each state.¹⁹ There was an amendment to Article 121 of the Federal Constitution 1957 in 1988 which restrains Civil Courts from having jurisdiction to hear cases where Islamic law is applicable and is now vested in the Sharī‘ah courts. Previously, the Sharī‘ah Courts and Civil Courts exercised concurrent jurisdiction on certain matters involving Islamic law. With the inclusion of Clause (1A) in Article 121, it was thought that the jurisdiction of the Civil Courts on matters involving Islamic law had been taken away.

Nevertheless, in cases involving a banking transaction based on Islamic principles, the High Court has ruled that the said clause has not taken away the Civil Courts’ jurisdiction and that it does have jurisdiction to hear such a case. Thus, the law relating to commerce and business (*mu‘āmalāt*) is still either the statute law or the English law. Sharī‘ah Courts only have jurisdiction over matters falling under the State list. The Civil Court has jurisdiction to hear all cases falling under the Federal list. Thus, banking and its related matters fall within the ambit of the Federal list, i.e., the Civil Court. Besides, the State List expressly states that Sharī‘ah courts shall have jurisdiction only over persons professing the religion of Islam.

Two leading Islamic banking cases relating to *Bay' Bithaman Ajil* (BBA) were decided by the Civil Court (High Court). Commentary on these cases can be found elsewhere.²⁰ In the case of *Bank Islam Malaysia Berhad (BIMB) v Adnan bin Omar*,²¹ there was a preliminary objection raised by Adnan (Defendant) which was not reported and no written judgement is supplied. The issue was about the courts' jurisdiction.²² The Defendant argued that since BIMB (Plaintiff) is an Islamic bank, the Civil Court has no jurisdiction to hear the case in view of Article 121 (1A) of the Federal Constitution 1957. The judge overruled that objection and submitted that the matter was rightly brought before the Civil Court. It was submitted that List 1 of the Ninth Schedule enumerates the various matters in which Parliament can enact laws. The scope is very comprehensive, including banking. List 11 in the State list provides for the constitution, organisation and procedure of Shari'ah Courts, which shall have jurisdiction only over persons professing the religion of Islam and in respect only of any of the matters included which exclude banking. It was further argued that since BIMB is a corporate body, it does not have a religion and therefore is not within the jurisdiction of the Shari'ah Court.

Perhaps the time has come to set up an Islamic Division under the High Court structure whereby all Islamic banking cases, and any other Islamic related case, can be dealt with. Besides, it could encourage the specialisation of judges and lawyers in this area of law as has been done with the other divisions (commercial, civil, criminal, appeals and special powers). This effort will not lead to duplication of the Shari'ah Court's jurisdiction as it has limited jurisdiction. This Islamic Division would be a good solution to this problem and should be regarded as complying with the intention of the framers of the Federal Constitution that upholds Islam as the religion of the Federation (Article 3). It is also consistent with the official declaration that Malaysia is an Islamic state and intends to be the global centre for Islamic banking and finance.

Recently, there has been a move by the Kuala Lumpur High Court to form a separate court within the Commercial Division to handle Mu'amalat cases, which have been assigned their own registration numbers to differentiate them from conventional cases.²³ For this, the Court in deciding the case will have to refer to the Shari'ah Supervisory Council at CBM,²⁴ and their opinion will have to be taken into consideration, as the Court is not competent to decide the case by itself. Recently, there was an amendment to the Central Bank of Malaysia Act 1958 (CBMA) which has incorporated the following:

“Where in any proceedings relating to Islamic banking business...or any business which is based on Shari‘ah principles and is supervised by the Bank (Central Bank of Malaysia) before any court or arbitrator any question arises concerning a Syariah matter, the court or the arbitrator, as the case may be, may-

- a) take into consideration any written directives issued by the Bank pursuant to subsection (7); or
- b) refer such question to the Syariah Advisory Council for its ruling.”

3.1 Civil Court and its Common Law Principles

In the Civil Court, the judge will decide the case based on the submission made by the counsels and the law as he finds it. Normally, if he is unclear about any part of the law, for instance if it involves foreign law, he will call an expert witness to assist the Court. Since the case of *Ramah v Laton*,²⁵ Islamic law has been regarded as part of *lex loci* (law of the land) of which the Court must take judicial notice. It means that the judge must propound the law and it would not be justified for the judge to call for expert evidence related to any issue pertaining to Islamic law in the court proceedings. The judge is deemed to know the law, as Islamic law is regarded as local law, or at any rate must be able to find it - in statute, case law reports or academic writings. Whenever necessary, the judge will interpret the law and apply it before he/she comes to a decision. Being trained in secular and Common law institutions, one can easily assume that the law that the judge might find and apply is English Common law.

The legal risk of Islamic banking and financial matters falling under the Civil Court and triable by Civil-trained judges is that it may lead to the application of laws and concepts that contradict Shari‘ah principles, spirit and even terminologies. There are cases where this has occurred. For instance, *Bay‘ Bithaman Ajil* (BBA) has been referred to as a term loan, whereas it should be termed an Islamic financing facility because BBA is not a loan but a deferred payment sale²⁶. In another case, the learned judge posed controversy about the concept of sale in Islam in his judgement in *Dato’ Haji Nik Mahmud bin Daud v Bank Islam Malaysia Berhad*,²⁷ which was concerned with a deferred payment sale under the contract of BBA. As a matter of fact, the main purpose of sale as far as Islamic law is concerned is to effect the passing of ownership from one party (seller) to another (buyer) against a consideration (price). This is actually the main ‘illah (effective cause) of the sale contract. Nevertheless, the judge ruled that in a BBA contract,

particularly in a re-financing arrangement (where the customer has sold the property to a bank on cash and bought it back on deferred payment), there was no real intention of the parties (customer and bank) to effect the transfer of the property, but is merely a device to facilitate the BBA transaction. Perhaps this judgement, with due respect, should be reviewed in view of its legitimacy as far as Shari'ah is concerned as the main intention of a sale contract (*al-bay'*) is to effect the transfer of ownership from the seller to the buyer.

4. Applicable Law

As far as Islamic banking transactions and legal documentation is concerned, it is submitted that the following laws are relevant and applicable:-

- i) Valid according to Islamic law;
- ii) Compliance with Civil/Federal laws as well as procedural laws;
- iii) State law; and
- iv) English Common law

4.1 Valid according to Islamic Law

IBA and BAFIA have categorically stipulated that Islamic banking business must be able to ensure that their aims and operation do not involve any element which is not approved by the Religion of Islam.²⁸ Furthermore, the Central Bank shall revoke the license if an Islamic bank is carrying out its banking business not in accordance with Religion of Islam.²⁹ It is submitted that Islamic banking documentation must satisfy all the requirements of Islamic law relating to contracts, agreements or arrangements otherwise it would be rendered null and void. This is presumed, as the IBA has not categorically provided the same as in BAFIA. Section 125 of BAFIA states that:

“Except as otherwise provided in this Act, or in pursuance of any provision of this Act, no contract, agreement or arrangement, entered into in contravention of any provision of this Act shall be void solely by reason of such contravention”

Therefore, contravention of the provisions of BAFIA does not render the contract, agreement or arrangement null and void, and it is argued that the same is not applicable to IBA. As such, Islamic banking documentation must ensure the compliance to the aims and operation of banking business in

accordance with Islamic religion and its law (Shari'ah) as this is the main requirement of the law. Although to date there is not a single case which has questioned the validity of the Islamic transaction and the application of Islamic law, it is difficult to believe that Islamic law has no relevance in cases involving *mu'āmalāt*. For instance, what is the purpose of having BBA or *ijārah* financing, if upon dispute, Shari'ah is not to be applied or becomes irrelevant?

4.2 Comply with Civil/Federal and Procedural Laws

Thus far, Islamic commercial documentation must satisfy the requirement of existing laws. For instance, if it is financing for land, the legal documentation must satisfy all the requirements as laid down by the National Land Code (NLC) 1965. If it is a share or bond issue, attention is to be given to the relevant securities law and other rules and regulations as set by the Securities Commission (SC). In the recent case of *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd*,³⁰ The learned judge ruled that the fact that it is an Islamic banking facility (*Bay' Bithaman Ajil* (BBA)) is immaterial as the applicable law and principles are as same as if the case involved conventional banking:

“As was mentioned at the beginning of this judgment the facility is an Islamic banking facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under conventional banking. The charge is a charge under the National Land Code. The remedy available and sought is a remedy provided by the National Land Code. The procedure is provided by the Code and the same law that is applicable, the same order that would be, if made, and the same principles that should be applied in deciding the application.”

In fact, all reported cases on Islamic banking are concerned with the Civil law and its procedure.³¹ None of the cases challenged or questioned the validity of Islamic contracts and principles. All the reported cases related to Islamic banking so far revolve around procedural issues such as related to the NLC, to obtain interlocutory injunction under Specific Relief Act and compliance with Rules of High Court (RHC). Therefore, as the Court in the *Bank Rakyat case* (supra) decided, the remedy sought after is a remedy provided under the NLC, as such the law applicable should be the NLC itself. The fact is, although the case involved an Islamic banking facility, this was immaterial and irrelevant.

The potential legal risk is that what if the Civil law and procedure such as the Rules of High Court (RHC) is in conflict with Shari'ah and its principles? In other words, what if compliance to the law and rules of procedure are impossible, as they do not facilitate the operation and practice of Islamic banking? If this happens, the risk is that the case will be discharged or the decision made against Islamic transactions as a prima facie case has already been established by the other party who opposes it. This presumption is exactly what happened in the case of *BIMB v Adnan* (supra). The customer had challenged the bank's right to obtain a foreclosure proceeding for the following reasons:

- i) the amount of RM583,000.00 which was stated as a loan in the charge document was never received by him as a loan; it was just a facility amount and he only received RM265,000.00. Thus, there is no compliance with O. 83.r.3(3)(a);
- ii) The plaintiff (bank) did not comply with Order 83 Rule 3(3)(c) as the plaintiff's claim did not include a claim for interest. That was in breach of Order 83 Rule 3(3)(a). In this respect, the plaintiff also did not comply with O.83 r.3(7);
- iii) There was no compliance with O.83 r.3(3)(d) because the amount which remained unpaid under the charge was not RM543,995.89 or any definite amount as it was subject to rebate as stated by the plaintiff in its affidavit.

O.83 r.3(3)(a) provides *inter alia* that the plaintiff in its affidavit must show the state of the account between the chargor and the chargee, with particulars of the amount of the advance.

O.83 r.3(3)(c) requires the chargee/financier to state, *inter alia* the amount of any interest or instalments in arrears at the date of issue of the originating summons and at the date of the affidavit.

O.83 r.3(7) provides that where the plaintiff's claim includes a claim for interest to judgement, the affidavit must state the amount of a day's interest.

From the foregoing, it is submitted that O.83 with its rules do not accommodate the operation of BBA, especially for foreclosure proceedings. The rules which require a bank to state the amount of interest is very much contrary to the operation of Islamic banking which is interest free.

At first instance, this is a straight-forward case of non-compliance with the procedural law and a prima facie case that has been established by the bank's customer (Defendant). However, the Court was invited by the Bank's

counsel (Plaintiff) to make necessary modifications as well as to be flexible with the rules in view of the impossibility of imposing and charging interest in the Islamic banking practice and operation by an Islamic bank. The learned Judicial Commissioner (JC) supported this argument and was of the view that the words “except where the Court in any case or class otherwise directs” in the preamble to Rule 3(3) indicated that the Court was able to “exercise a discretion to allow a certain flexibility in the requirements of that provision in particular cases.” This was a case, added by the learned JC “where such discretion should be exercised.”³²

This case is one example whereby the Court has exercised discretion from complying with the strict requirements of the procedural law. The case would be different if the judge wanted to comply strictly with the requirement and letter of the law and wished not to exercise an exception to Islamic banking and finance simply for uniformity or any other grounds as the Court may deem fit.

4.3 Compliance to State Law

Not only the document or transaction must be able to comply with the requirement of Islamic law, relevant statutory laws prevalent as well as procedural law, it has to also comply with the provisions of the state law. In Malaysia, Malay Reservation Enactments are enacted by each state and the provision slightly varies from one another, especially for the definition of a Malay and other natives. In the celebrated case of *Dato' Hj. Nik Mahmud bin Daud v BIMB* (supra),³³ the Plaintiff, Nik Mahmud contended that the Property Purchase Agreement (PPA) was null and void as it was in contravention with the provisions of the Kelantan Malay Reservation Enactment 1930 (KMRE), as such the charge agreement is equally ineffective. The brief facts of the case are that the Plaintiff entered into an *Al-Bay' Bithaman Ajil* (BBA) agreement with BIMB. He sold the land to BIMB at RM520,000 payable on cash as manifested by the Property Purchase Agreement (PPA) and BIMB immediately sold it back to him on deferred payment amounting to RM629,000 (cost price plus bank's profit margin) as evident from the Property Sale Agreement (PSA). Thereafter, the land was secured as documented in a charge agreement for the same amount as in the PSA. The land was held under KMRE and Section 7(i) expressly states that:

“No right or interest of any Malay in reservation land and no right or interest in such land acquired by virtue of section 13A by any person not being a Malay shall be transferred to or transmitted to or vest in any person not being a Malay provided that leases of

reservation land shall be valid to the extent specified in subsection (ii) to (v) below, save as provided in this Enactment.”

From the above, it is obvious that the Enactment prohibits any transfer or transmission or vetting of any right or interest of a Malay in reservation land to any person not being a Malay. So, the issue is whether the execution of the PPA, whereby the Plaintiff sold the land to the Defendant, constituted a transfer of right or interest? The plaintiff argued that BIMB is neither gazetted as a Malay or native of Kelantan and therefore the sale of land to BIMB is invalid as it contravened sections 7 and 12 respectively.³⁴ As a matter of fact, the Plaintiff is a Malay under Schedule 2 of KMRE as well as a native of Kelantan. However, the Bank is not.

The Plaintiff actually managed to make a prima facie case about the contravention of the state law (KMRE). However, the learned judge in delivering the judgment in favour of the defendant took an interesting principle, i.e., intention of the contracting parties which is rarely exercised by a Civil trained judge. The judge ruled that:³⁵

“(I)t was never the intention of the parties in as much as it can ever be said to be within their contemplation, to involve any transfer of proprietorship. It so happened that the execution of the property purchase agreement and the property sale agreement constituted part of the process required by the Islamic banking procedure before a party can avail itself of the financial provided by the defendant. ...Accordingly, it is my judgment that the execution of property purchase agreement had not transgressed the provisions of ss 7 and 12 of the Malay Reservation Enactment since there was no dealing or attempt to deal in the said lands contrary to the provisions thereof”.

From the above, the learned judge took intention of the contracting parties as an essential element in construing ‘dealing’ or ‘attempt to deal.’ It was held that there was actually no intention to pass the ownership of the land. All the time, the registered proprietorship of the land was still vested with the bank’s customer (plaintiff) and as such, no intention to infringe the provisions of KMRE. The execution of PPA and PSA were actually the process required by the Islamic banking procedure before a party could avail itself to the BBA facility provided by the Bank. This is considered as an exception to the concept of sanctity of contract which is usually adopted by the Civil Court judge. In a way, on the one hand, the judgment could be applauded, if it had been otherwise, the bank’s customer after obtaining the financial facility (cash) could easily default on his periodical instalments or

could run away without having to pay for the financing amount given by the bank. This will obviously cause adverse loss to the bank and will dampen the smooth operation and activity of Islamic banking in Malaysia. But, on the other hand, the judgment poses a controversial issue about the validity and principles of BBA itself. BBA is a deferred payment sale and it is regulated under a sale contract. As far as Islamic law is concerned, the purpose of a sale contract is to transfer the ownership or proprietorship of the property from a seller to a buyer for a consideration. Nevertheless, with this judgement, the Court concluded that in a BBA contract (particularly in this case where it is better known as “buy-back sale” (*bay' al-ṭnah*)), there was no real intention to transfer the property from one party to another. The sale and purchase agreements were only a device used to be able to effect the BBA transaction. As such, to adopt Imam Malik’s view, “it is simply a device or legal stratagem (*hīlah*) whose function is to attain an illegal end through legal means.”³⁶

4.4 English Common Law

The application of English law in Malaysia is based on the provisions of Sections 3 and 5 of the Civil Law Act (CLA) 1956. Section 5 expressly states that:

“In all questions or issues which arise or which have to be decided in the States of West Malaysia other than Malacca and Penang with respect to partnership, corporations, banks and banking, principles and agents...and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in like case at the date of the coming into force...”

From the foregoing, in matters relating to commerce, English law is to be applied. As such, the jurisdiction is certainly vested to the Civil Court. In addition, Section 3 of the CLA 1956 provides for the application of English Common law and rules of equity when there is a lacuna in the provision of any written law. From the foregoing, it is submitted that the IBA 1983 is not exhaustive and comprehensive. As such, any ambiguity, clarification and interpretation will be referred to the Civil Court. Civil judges who are Common-law trained are likely to use the law which they are familiar with, after listening to the well researched submission of the counsels who have quoted and referred to the Common law precedents.

5. Concluding Remarks

In Malaysia, in spite of the rapid development of Islamic banking and finance in Malaysia, the legal regulatory regime is lagging behind. Legal reforms are urgently needed in order to facilitate the smooth running and operation of the Islamic banking system. The IBA, which is intended to license and regulate Islamic banking, needs to be more elaborated to rectify the loopholes mentioned in this paper. The area of conflict between the IBA and other laws which influence Islamic banks, such as National Land Code, Hire Purchase Act and Companies Act, needs to be resolved. The lesson from Pakistan in its banking law ought to serve as a lesson to our drafters, so as to bring certainty to the law and be a guidance to the Civil Court as to which law should be applied in the event of conflict of laws.

Further, the role of lawyers and legal practitioners in applying the principles of Islamic law in Islamic banking should be given important consideration. As Islamic transactions (*mu'āmalāt*) are not merely a worldly matter but a kind of worship (*ʿibādāt*), the case should not be made equal to a conventional one. Reference to Islamic law principles should be made, whenever necessary, in order to realize the interest and needs of the contracting parties (especially so if the parties are Muslim). They have chosen the Islamic facility over the conventional for a purpose, i.e. its validity, and surely they would want the case to be regulated by Islamic principles in the event of dispute. Having said that, it is a necessity for the members of the legal profession and judiciary to be conversant and competent in this area. They have to equip themselves with knowledge of Islamic laws on banking and finance as well as existing laws and procedures.

In addition, the learned judges of the Civil Court need to be more flexible, creative and make more exceptions in the application of the existing substantive laws and procedures as these laws were enacted before the establishment of Islamic banking in Malaysia. There are laws and procedures that run counter to the principles of Islamic banks which if applied to them, could cause undue unfairness to the Islamic and SPI banks which would defeat the whole purpose of the law itself, i.e. to promote justice and fairness.

In the absence of a fully comprehensive legal framework for Islamic banking in Malaysia, there is a great dependence on precedents. Thus far, there are very few cases which could be used for reference. Therefore, reference could be made to the practice of other Muslim countries, such as Pakistan. It follows that continuous research on the legal aspects of Islamic banking becomes very necessary.

Notes

¹ At the end of 1999, Bank Muamalat was established following the merger of Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). Under the arrangement, all conventional banking assets and liabilities of BBMB were transferred to BOCB while the Islamic banking assets and liabilities of BOCB and BBMB Kewangan Berhad were moved to Bank Muamalat Malaysia Berhad. See The Star 9 February 1999, New Straits Times 13 August 1999.

² GIA 1983 is an Act which confers on the Minister power to receive investments for a fixed period and to pay dividends thereon. The Act was enacted simply to enable the Government to receive moneys from an Islamic bank for a fixed period. The Act empowers the Government to issue Malaysian Government Investment Certificates (MGIC) with no fixed return (to replace interest) but in the form of a gift (Hibah). The Islamic bank is acting as creditor to the Government (Bank Negara) based on the principle of *al-qard al-hasan* (interest-free loan).

³ TA 1984 provides for the regulation of Islamic insurance (Takaful) business. It allowed for the establishment of the first Takaful company, Syarikat Takaful Malaysia Berhad (STMB), better known as Takaful Malaysia, which operates along Shari'ah principles. Only in 1993 was a second Takaful company incorporated with the name of MNI Takaful, later renamed as Takaful Nasional. To date (January 2004), there are another 2 Takaful operators, namely Mayban Takaful and Takaful Ikhlas.

⁴ It was formerly known as Interest-free banking or Skim Perbankan Tanpa Faedah (SPTF) which was also known as Islamic Windows or Islamic Counters. It means that interest-free products are offered to the customers along with conventional products under the same roof.

⁵ Later, SPTF banks were renamed SPI (Skim Perbankan Islam) banks.

⁶ BAFIA is actually a combination of the former Banking Act 1973 and Finance Act 1969 and is meant to provide a new law for the licensing and regulation of banking institutions, finance companies, discount houses, money-broking business and other institutions carrying on certain other financial business and matters connected to business (Preamble of the Act).

⁷ Both IBA and BAFIA have 8 parts but the former only has 60 sections whereas the latter has 131 sections.

⁸ See for instance, Yasin (1996) and (1999). Also see Shariff (1998).

⁹ For details of this, see Yasin (1999).

¹⁰ By virtue of the BAFIA (Acquisition, Holding of Shares and Interests in Shares (Licensed banks, Licensed Finance Companies and Licensed Merchant Banks) Regulations 1991 provides for exceptions to that prohibition. Subject to the approval of the Central Bank, shares that are approved under s4 and 5 of the Trustee Act 1949 may be held by a bank as long as the total price paid for the shares does not exceed 25 percent of the bank's paid-up capital. The shares held in a single company may not exceed 10 percent of the bank's paid-up capital.

¹¹ Statement by Wan Abdul Rahim Kamil, Managing Director of Abrar Discounts Berhad when commenting about the establishment of Bank Muamalat as the country's second Islamic Bank (New Straits Times, 13 February 1999).

¹² Section 42 of the *muḍārabah* Companies and *muḍārabah* (Flotation and Control) Ordinance, 1980.

¹³ It is now enforced from 1st January 2004.

¹⁴ The IBA has been amended along with other statutes related to Islamic banking such as BAFIA, the CBMA and the Takaful Act. However, the IBA has not amended any provisions relating to SAB. As such, the legal position remains uncertain.

¹⁵ Section 124(5) states that "(Any licensed institution carrying on Islamic banking business or Islamic financial business shall be deemed to be not an Islamic bank)."

¹⁶ Act A954.

¹⁷ Al-Baqarah: 182.

¹⁸ 2 *Quarterly Bulletin* (1966), Vol.2, p.431.

¹⁹ Look at Schedule 9, list 2, Federal Constitution 1957.

²⁰ See Yasin (1997), see also Yasin (2003).

²¹ *Central Law Journal* (1994), Vol.3, p.735.

²² *BIMB v Adnan bin Omar & Others* (KL High Court Civil Suit No S3-22-101-9) also reported by the late Prof. Ibrahim (1996), "Legal Solution", p.1. "Toward a Smoother Implementation of Islamic Banking and Finance", paper presented at the National Congress on Islamic Banking and Finance, KL, December 1996.

²³ See Amalan, Arahan (Practice Note) No. 1/2003 (6 February 2003) issued by Chief Judge of Malaya.

²⁴ Much of this has been dealt with under the sub-heading of "BAFIA and SPI Banks."

²⁵ *Ramah v Laton* (1927) 6 FMSLR 128 (CA).

²⁶ See the case of Adnan Omar, where the learned JC ruled that "(I)n any event, there was no question of early repayments as the loan was not a term loan and the defendant's failure to pay the instalments....(p.737). See also the case of *Bank Kerjasama Rakyat Malaysia v Nesaretnam a/l Samyveloo* [unreported] whereby it was stated that "the plaintiff approved a loan facility under the concept of Al-Bay' Bithaman Ajil in favour of the defendant...."

²⁷ *Central Law Journal*, (1996), 1, p. 737. The case went on appeal and the Supreme Court on 25 February agreed with the findings of the trial judge, see *Malaysian Law Journal*, (1998), 3, p.393-403. More on this case will be discussed later in this paper.

²⁸ Section 2 of IBA.

²⁹ Section 11 of IBA.

³⁰ [2003] *Central Law Journal*, Vol.1, p. 635.

³¹ See the cases of *BIMB v Adnan Omar* and *Dato' Haji Nik Mahmud v BIMB*. These two cases have been commented on elsewhere, see Yasin (1997) and (2003). See also cases of *Bank Kerjasama Rakyat Malaysia v Nesaretnam a/l Samyveloo* [unreported] and *BIMB v Ainin Abdullah & Anor* (1998).

³² *Central Law Journal*, (1994), Vol.3, p. 737, also quoted by Marican (1994), p.9.

³³ *Central Law Journal*, (1996), Vol.1, p. 576 (HC).

³⁴ Section 12 states “(A)ll dealings or disposals whatsoever and all attempts to deal in or dispose of reservation land contrary to the provisions of the Enactment shall be null and void”.

³⁵ *Central Law Journal*, (1996), Vol.1. pp.585-586. The case went on appeal and the Supreme Court upheld the judgment of the High Court, see Supreme Court judgment reported in *Malaysian Law Journal*, (1998), Vol.3, pp. 393-403.

³⁶ See Yasin (1997) and (2003).

References

General References

Ibrahim, Ahmad (1996), “Legal Solution”, p.1, “Toward a Smoother Implementation of Islamic Banking and Finance”, paper presented at the National Congress on Islamic Banking and Finance, KL, December.

Marican, Pawancheek, (1994), “Islamic Banking: Case Comment on BIMB v Adnan Omar” in *Malaysian Law News* (MLN), November, p. 9.

Malaysia, Government of *Federal Constitution 1957*.

Yasin, Norhashimah Mohd. (1996), *Islamisation/Malaynisation: The Role of Islamic Law in the Economic Development of Malaysia (1969-1993)*, Malaysia: A.S. Noordeen, pp. 268-272.

Yasin, Norhashimah Mohd. (1999), “Universal Banking: IBA 1983 v BAFIA 1989”, *Al-Nabdab*, Vol. 18, No. 3, pp.26-29.

Yasin, Norhashimah Mohd. (1997), “Islamic Banking: Case Commentaries Involving Al-Bay’ Bithaman Ajil” *Malaysian Law Journal*, Vol.3, p.cxcii-cciv.

Yasin, Norhashimah Mohd. (2003), “Appeal Court Decision on Al-Bay’ Bithaman Ajil (BBA): Misunderstanding and/or True State of Affairs” in Dato Syed Ahmad Idid (ed), *Judicial Decisions Affecting Bankers and Financiers*, pp 667-682.

Pakistan, Government of. *Muḍārabah Companies and Muḍārabah (Flotation and Control) Ordinance, 1980*.

Shariff, Mohamed Ismail. (1998), “The Development of Islamic Banking Law in Malaysia”, *Malaysian Law Journal*, Vol.1, pp. cxvii-cxlvii.

Newspapers

The Star, 9 February 1999.

New Straits Times, 13 August 1999.

New Straits Times, 13 February 1999.

Law Cases

Amalan, Arahan. (Practice Note) No. 1/2003 (6 February 2003) issued by Chief Judge of Malaya.

“United Dominion Trust (UDT) v Kirkwood”, (1966), *Quarterly Bulletin*, Vol.2, p.431.

“BIMB v Adnan bin Omar & Others”, Kuala Lumpur High Court Civil Suit No S3-22-101-9,

“Bank Islam Malaysia Berhad (BIMB) v Adnan bin Omar”, (1994), *Central Law Journal*, Vol.3, p.735.

“BIMB v Ainin Abdullah & Anor”, (1998), *Central Law Journal*, Vol.4, p.27.

“Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd”, (2003), *Central Law Journal*, Vol.1, p.635.

“Bank Kerjasama Rakyat Malaysia Malaysia v Nesaretnam a/l Samyveloo”, (unreported)

“Dato’ Haji Nik Mahmud bin Daud v Bank Islam Malaysia Berhad”, (1996), *Central Law Journal*, Vol.1, p.737.

“Dato’ Haji Nik Mahmud bin Daud v Bank Islam Malaysia Berhad”, (1998), *Malaysian Law Journal*, Vol.3, p.393-403.

“Ramah v Laton”, (1927), 6 FMSLR 128 (CA).

Acts of Law (Malaysia)

Banking Act 1973.

Banking and Financial Institutions Act 1989 (BAFIA).

BAFIA (Amendment) Act 1996.

Central Bank of Malaysia Act 1958 (CBMA).

Civil Law Act 1956.

Companies Act 1965.

Contracts Act 1950.

Co-operative Societies Act 1948.

Government Investment Act 1983 (GIA).

Hire Purchase Act 1967.

Islamic Banking Act 1983 (IBA).

Islamic Banking (Amendment) Act 2003.

Kelantan Malay Reservation Enactment 1930 (KMRE).

National Land Code 1965 (NLC).

Sale of Goods Act 1979.

Specific Relief Act 1950.

Takaful Act 1984 (TA).