

The Development Of Islamic Banking Laws In Malaysia: An Overview

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ABSTRACT

Malaysia is well regarded by the international community as one of the leading Islamic financial centers. This was evidenced by the launching of an initiative by the Malaysian Government known as the Malaysian International Islamic Financial Centre (MIFC) on 14 August 2006. Behind this successful achievement, the emergence of Islamic banking in Malaysia stemmed from the establishment of the first full-fledged Islamic bank offering Islamic products and services in 1983 known as Bank Islam Malaysia Berhad (BIMB) under the Islamic Bank Act 1983. This article examined the development of Islamic banking and financial laws in Malaysia. Firstly, the background of Islamic banking and finance is addressed. Secondly, the development of the industry is described from its infancy days until its recent achievement to become an Islamic financial hub. The next section dwells upon the issues relating to the current legislative jurisdiction and Syariah supervision on the matters. Finally, while the study illustrates that the finance industry is evolving progressively, further efforts and reformation are needed for the country to sustain as 'Malaysia International Islamic Financial Centre'.

Keywords: *Islamic banking and financial laws; Islamic product; Syariah supervision; current legislative jurisdiction; Islamic Financial Centre.*

ABSTRAK

Malaysia telah dikenal pasti oleh komuniti antarabangsa sebagai salah sebuah Pusat Kewangan Islam dunia. Pengiktirafan ini jelas terbukti dengan pelancaran Malaysia sebagai Pusat Kewangan Islam Antarabangsa Malaysia (MIFC) pada 14 Ogos 2006. Di sebalik kejayaan ini, sistem perbankan Islam di Malaysia bermula dari pembentukan bank Islam yang pertama menawarkan produk dan perkhidmatan Islam pada tahun 1983 yang dikenali sebagai Bank Islam Malaysia Berhad (BIMB) di bawah Akta Bank Islam 1983. Justeru, artikel ini mengkaji perkembangan undang-undang berkaitan perbankan dan kewangan Islam di Malaysia. Latar belakang sistem kewangan Islam di Malaysia telah dibincangkan dengan mendalam di bahagian pertama artikel ini. Seterusnya, perkembangan industri ini telah diuraikan bermula dari awal penubuhan institusi kewangan hingga ia menjadi hub kewangan Islam. Dalam bahagian seterusnya, isu berkaitan bidang kuasa legislatif transaksi kewangan Islam dianalisis selain peranan serta pemantauan Badan Penasihat Syariah Kebangsaan dalam memastikan pematuhan industri kepada Syariah. Akhirnya, tidak dapat dinafikan bahawa industri kewangan Islam sedang berkembang maju tetapi ia perlu kepada usaha serta reformasi undang-undang yang lebih kukuh dalam mengekalkan Malaysia sebagai 'Pusat Kewangan Islam Antarabangsa'.

Katakunci: *undang-undang perbankan dan kewangan; produk Islam; pemantauan Syariah; bidangkuasa legislative; Pusat Kewangan Islam.*

INTRODUCTION

The development of Islamic banking in the late 19th and early 20th century was the effect of the Islamisation process initiated by the Islamic reformist movement.¹ The aim of the reform is to revive the glory of Islam and demand the comprehensive application of *Shariah* in all aspects of life; politics, socials and economics. This has resulted in the existence of reformation wave among the Islamic community to establish an Islamic banking system.²

BACKGROUND OF ISLAMIC BANKING AND FINANCIAL INSTITUTIONS IN MALAYSIA

The Islamic banking and finance are relatively new compared to conventional. The earliest Islamic financial institution was traced in the form of savings institution based on profit sharing; Mit Ghamar Local Savings Bank, in the Nile Delta Egypt. It was established in 1963 providing basic banking services to the community such as deposit account, loan account, equity participation, direct investment and social services.³ The oil boom in the 1970s has triggered a rapid growth of Islamic financial institutions particularly in the Middle East countries. Hence, in 1975, the first Islamic bank known as Dubai Islamic Bank was established in the United Arab Emirates as well as the Islamic Development Bank (IDB) in the Saudi Arabia. In the West, the first attempt to establish Islamic banking was in Luxembourg in 1978.⁴

In Malaysia, the idea of the establishment of Islamic banking and finance took place in stages. The history has shown that the first institution applying the Islamic transaction concept was the Lembaga Tabung Haji (LTH) or formerly known as Perbadanan Wang Simpanan Bakal-Bakal Haji (Pilgrims Management and Fund Board). This board was established in 1969 with the objective to encourage Muslims to do their savings on installment basis for the purpose of their pilgrimage fund. Its operation is based on the investment concept and profit is to be gained in accordance with *Shariah*.⁵ However, this board cannot be considered as a bank but more towards collecting deposits in assisting Muslim community to perform pilgrimage as well as participate in investment and economic activities.

¹ Among the reformists who have Islamised the world are Jamaluddin al-Afghani (1839), Muhammad Abduh (1849-1905), Rashid Rida (1865-1935), Muhamad Iqbal (1875-1938), Hassan al-Bana (1906-1949), Sayid Qutb (1906-1966) and Abu A'la al-Maududi (1903-1979).

² M. Fazilah Abdul Samad (Ed.), *The Malaysian Financial System An Overview*, Universiti Malaya, Kuala Lumpur: p. 6.

³ Lee Mei Pheng & Detta Ivan Jeron, 2007, *Islamic Banking and Finance Law*, Petaling Jaya: Pearson Longman, p. 4.

⁴ Mohamad Akram Laldin, 2007, *Islamic Banking History and Current Global Trends* (Presentation during Islamic Banking and Finance Course (Advanced), ILKAP).

⁵ Joni Tamkin Borhan, 2005, *Pelaksanaan Prinsip-Prinsip Syariah Dalam Amalan Perbankan Islam di Malaysia*, in Abdullah Alwi Hj. Hassan (Ed.), *Teori dan Aplikasi Kontemporari Sistem Ekonomi Islam di Malaysia*, Kuala Lumpur: Utusan Publication, p. 44.

Later, the Muslim community in Malaysia has voiced out their intention for an Islamic bank and financial institution that is free from riba transaction. Therefore, on 30 July 1981, the Government has appointed a National Steering Committee of Islamic Bank to establish an Islamic bank. A year later, the Committee has proposed a basic framework of licensing and supervising of Islamic banking system in Malaysia.⁶ Finally, the Government has passed the Islamic Bank Act 1983 (IBA) which came into force on 7 April 1983. This was followed by an official establishment of the first Islamic bank, the Bank Islam Malaysia Berhad (BIMB) on July 1983.

The main objective of the bank is to operate as a merchant Shariah compliance bank and to provide facilities that conform to Shariah principles. As the ultimate financial regulatory body of the country, the Central Bank of Malaysia (CBM) was provided with the power under the IBA to supervise and regulate the Islamic bank, similar with other licensed banks in the country. After more than 20 years in operation, BIMB has proved to be a viable banking institution where it has successfully expanded its activities rapidly throughout the country and introducing new products in the financial market.

The Islamic banking and financial system in Malaysia had undergone a well coordinated and systematic process of implementation. The process can be divided into three phases. The first phase is considered as the period of familiarization (1983-1992). This was the period of IBA officially enacted and BIMB operated. The second phase, from 1993-2003, was aimed at creating the ambience of competition among banks. It tried to capture larger market share and public awareness on the system. Hence, conventional banks were allowed to offer Islamic banking services by setting up Islamic windows in 1993. The third phase that commenced from 2004 was the period of financial liberalisation. During this period, the CBM paved the way for new foreign Islamic banks to operate in Malaysia by means of issuing licenses to them. Simultaneously, the conventional banks were also allowed to establish their subsidiaries operating a full-fledged Islamic banking system.⁷

THE DEVELOPMENT OF ISLAMIC BANKING AND FINANCIAL SYSTEM IN MALAYSIA

A. THE ESTABLISHMENT OF BANK ISLAM MALAYSIA BERHAD (BIMB)

BIMB was incorporated in 1983 and claimed as the Malaysia's first Islamic bank and the first regulated under the IBA. According to the Memorandum of Association and the Articles of Association of the BIMB, the operations and the transactions run by the BIMB shall be in line with the Shariah principles. The BIMB was prohibited from engaging any

⁶ Zamri bin Hassan, 2002, *Islamic Banking: Its Legal Impedements and Reformation With Special Reference to Malaysia*, Law Majalla, Vol. 1, p. 97.

⁷ Hamim S. Ahmad Mokhtar, Naziruddin Abdullah & Syed M. Alhabshi, 2008, *Efficiency and Competition of Islamic Banking in Malaysia*, United Kingdom: Emerald Grouping Publishing Limited, Vol. 24 No. 1, p. 31.

business activities which are totally against the Shariah law. One of the most important keys in the business operations of the BIMB is the Interest-Free Banking Scheme (IFBS) or Skim Perbankan Tanpa Faedah (SPTF).

When the first Islamic bank began its operation, the bank could not among other things, purchase or trade in Malaysian Government Securities (MGSs), Malaysian Treasury Bills (MTBs) or other interest-bearing instruments. However, there was a serious need for the Islamic bank to hold such liquid papers to meet the statutory requirements as well as to park its idle funds.⁸ To satisfy both requirements, the Malaysian Parliament passed the Government Investment Act 1983 [Act 275] (GIA) or currently known as Government Funding Act 1983 [Act 275] to enable the government of Malaysia to issue Government Investment Certificates (GIC) which are government securities comprise of government bonds and papers issued based on Shariah principles. As the GIC are regarded as liquid assets, the Islamic bank could invest in the GIC to meet the prescribed liquidity requirements as well as to invest their surplus funds.⁹ The GIC initially offered on the basis of *qardhul hasan* but subsequently was changed to *bay' al-'inah*. In this regard, Malaysia was the first country in the world to issue government bonds of an Islamic character.¹⁰

Besides the Islamic banking business, the BIMB has moved a step further by introducing a *takaful* scheme to complement the operations of the Islamic banking. In 1984, the BIMB has set up a *takaful* company known as Syarikat Takaful Malaysia Sdn. Bhd. which run *takaful* (Islamic insurance) businesses comprising of family *takaful* (Islamic life insurance) and general *takaful* (general Islamic insurance). Another *takaful* company established by the BIMB was a nominee company known as Al-Wakalah Nominees (Tempatan) Sdn. Bhd.

The BIMB was given a grace period of 10 years to operate without competition. Being the sole Islamic financial institution in Malaysia, the BIMB managed to protect its growth and development whereby it has achieved an average annual growth rate of 48% over the period of 1983-1993. The BIMB has progressed tremendously as it was listed on the main board of Kuala Lumpur Stock Exchange on 17 January 1992.¹¹

The regulator of the Malaysian banking and financial business is the Central bank of Malaysia (CBM). As been mentioned earlier, the operations of the Islamic banking of the BIMB are regulated and supervised by this body. Looking into the viability of the Islamic banking business and the increasing demands of the community for Islamic products and financial assistance, the CBM has adopted the approach to spread the virtue of Islamic banking by disseminating Islamic banking on nation wide basis.¹² This initiative is in line with the objective of the CBM to create an Islamic banking system operating on a parallel basis with the conventional banking system. However, a single Islamic bank does

⁸ Aly Khorshid, *Islamic Insurance, A Modern Approach To Islamic Banking*, New York: RoutledgeCurzon, Taylors&Francis Group, p.125.

⁹ Ibid.

¹⁰ Ibid, p. 113.

¹¹ Zainal Amin Ayub, Mohammad Azam Hussain, Nurretina Ahmad Shariff & Dr Hassan Ali, 2007, *Harmonizing Civil Litigation With Syariah Litigation in Islamic Banking: Malaysian Experience*, Current Law Journal, Vol. 2,

p. x.

¹² Ibid.

not constitute a system. Recognizing the above, the CBM adopted a step-by-step approach to achieve the above objective. Hence, it requires 3 vital elements to qualify as a viable system as follows:-

- a. A large number of players (there must be an adequate number of different types of institutions participating in the system. This is required to provide depth of the system);
- b. A broad variety of instruments (a large variety and range of different types of financial institutions must be available to meet the various needs of financial institutions and customers); and
- c. An Islamic inter-bank market (there must be an efficient and effective inter-bank money market to link the players (institutions) and the instruments).¹³

B. THE INTRODUCTION OF ISLAMIC WINDOWS IN CONVENTIONAL BANKING SYSTEM

Owing to the increasing growing demand by the Muslim as well as non-Muslim population in the country to the Shariah compliance financial products, conventional banks are increasingly becoming interested in entering the market of Islamic financial products. Moreover, it is the policy of the regulator to establish a large number of players in the Islamic banking and financial system. This has triggered the implementation of a dual banking system which allowed the Islamic and the conventional banking to co-exist and run concurrently in the financial system. Thus, in 1993, commercial banks, merchant banks and finance companies operating the conventional banking system were allowed to offer Islamic banking products and services under the Skim Perbankan Tanpa Faedah (SPTF) or Interest Free Banking Scheme (IFBS), known as "Islamic windows".¹⁴

An Islamic window is simply a window within a conventional bank via which customers can conduct business utilizing only Shariah compatible instruments.¹⁵ Following this, there were more than 40 Islamic financial products and services that may be offered by banks using various Islamic concepts such as *Mudharabah*, *Musyarakah*, *Murabahah*, *Bay' Bithaman Ajil*, *Ijarah*, *Qardhul Hasan*, *Istisna'* and *Ijarah Thumma al-Bay'*. This option was seen as the most efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame.¹⁶

One of the most important principles behind the Islamic banking and financial system is the desire to maintain the moral purity of all transactions. The funds intended for *Shariah*-compatible investments should therefore not be mixed with those of non-Islamic investments. This has required the bank opening an Islamic window to establish the appropriate firewalls to avoid the co-mingling of Islamic and conventional funds. In other words, the banks wishing to offer Islamic products must guarantee that the funds devoted to conventional activities will not be mixed with and be segregated from those destined for Islamic activities. In operational terms, this requires that banks to establish different capital funds, accounts and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, it is in fact establishing a separate entity from the rest of the bank.¹⁷

¹³ Alya Khorshid, *op.cit.*, p.123.

¹⁴ Zainal Amin Ayub, Mohammad Azam Hussain, Nurretina Ahmad Shariff & Dr Hassan Ali, *op. cit.* p. x.

¹⁵ Juan Sole, 2007, *Introducing Islamic Banks into Conventional Banking Systems*, Washington: International Monetary Fund, IMF Working Paper No. 07/175, p. 8.

¹⁶ Zainal Amin Ayub, Mohammad Azam Hussain, Nurretina Ahmad Shariff & Dr Hassan Ali, *op. cit.* , p. x.

¹⁷ Juan Sole, *op. cit.* p. 5&8.

On January 3, 1994, the CBM has introduced an Islamic Inter-Bank Money Market (IIMM). The IIMM was put in place as a short-term intermediary to provide a ready source of short term investment outlets based on Shariah principles. Through the IIMM, the Islamic banks and banks participating in the Interest Free Banking Scheme (IFBS) would be able to match the funding requirements effectively and efficiently. The scope of activities of the IIMM included the purchase and sale of Islamic financial instruments among market participants (including the Bank), inter bank investment activities through the Mudaraba Inter bank Investment (MII) Scheme and a cheque clearing and settlement system through an Islamic Inter bank Cheque Clearing System (IICCS). The investments through the IIMM would ensure that that all the elements involved in the funding of the Islamic banks and conventional banks offering Islamic products are in compliance with Shariah principles. This is due to the fact that those banks investing in the IIMM must comply with certain requirements set by the CBM so as to be recognized as the Islamic financial institutions.

As far as the legislative framework is concerned, the existing IBA only governs the establishment of an Islamic bank. This is to say that the registration and the administration of the Islamic bank shall be made thoroughly in accordance with the provisions of the IBA. However, nothing in this Act that concerns on the establishment of Islamic windows in the conventional banks. Undoubtedly, the establishment of the conventional bank is governed by the Banking and Financial Institutions Act 1989 (BAFIA). Therefore, section 124 of the BAFIA has been amended in 1996 to cater the operations of Islamic banking and financial business in the conventional banks.

Finally, in December 1998, the term IFBS used for Islamic windows was replaced by Islamic Banking Scheme (IBS) or Skim Perbankan Islam. In that year, all banking institutions that have Islamic windows were also required to upgrade the Islamic banking unit to Islamic banking division so as to further expand the Islamic banking industry.¹⁸

C. THE ESTABLISHMENT OF THE SECOND MALAYSIAN ISLAMIC BANK, BANK MUAMALAT MALAYSIA BERHAD (BMMB)

In 1999, the second full-fledged Islamic bank governed under the IBA known as Bank Muamalat Malaysia Berhad (BMMB) was set up. The establishment of the BMMB was the result of merger arrangements between Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce Malaysia Berhad (BOCB). The arrangement was made in such a way that the Islamic banking operations of these two banks were transferred to this newly established bank. With the merger, BMB stands to lose its monopoly status as the only full-fledged Islamic bank.

D. THE EMERGENCE OF FOREIGN FULL-FLEDGED ISLAMIC BANKS AND THE ESTABLISHMENT OF ISLAMIC BANKING SUBSIDIARIES

In the year 2004, the government has implemented a financial liberalisation policy whereby the CBM has allowed for new foreign Islamic banks to operate in Malaysia. Similar to other Islamic banks, these banks were also licensed under the IBA.

¹⁸ Refer to Langkah-langkah Pengukuhan Perbankan, Guideline issued on 12 November 1998. However, The Guideline was superseded by Guidelines on Skim Perbankan Islam issued by Central Bank of Malaysia.

The strategy behind this was to create more competition and to tap new growth opportunity as well as raise the performance of the Islamic banking industry as a whole. As a result of the introduction of this liberalisation policy, three new foreign full-fledged Islamic banks from the Middle-East have joined the Malaysian banking market. The three banks were Kuwait Finance House, Al-Rajhi Banking & Investment Corporation and a consortium led by Qatar Islamic Bank and Asian Finance Bank Berhad.

Later, all the Islamic windows were encouraged to set up as Islamic subsidiaries. Islamic subsidiaries are for all purposes treated as full-fledged Islamic banks. In this regard, these subsidiaries are governed and shall be licensed under the IBA, similar with their Islamic banks counterpart, i.e. the BIMB, the BMMB and the newly established Islamic foreign banks, even though their parent companies are governed under different legislation i.e. the BAFIA. This is due to the fact that the new Islamic subsidiaries established are considered as separate legal entities from their parent companies.

The first bank that launched Islamic subsidiary was RHB Group, which opened RHB Islamic Bank Berhad in year 2005. The second was Commerce Group when it launched the Commerce Tijari Bank Berhad and the third banking group was Hong Leong Group, which established the Hong Leong Islamic Bank. Subsequently, a number of subsidiaries were established by their respective banking group. Below is the list of Financial Institutions offering full-fledged Islamic banking services as at March 2009 :-

Bank Islam Malaysia Berhad
 Bank Muamalat Malaysia Berhad
 Kuwait Finance House (Malaysia) Berhad
 Al-Rajhi Banking and Investment Corporation (Malaysia) Berhad
 RHB Islamic Bank Berhad
 CIMB Islamic Bank Berhad
 Hong Leong Islamic Bank Berhad
 Affin Islamic Bank Berhad
 Alliance Islamic Bank Berhad
 AmIslamic Bank Berhad
 Asian Finance Bank Berhad
 EONCAP Islamic Bank Berhad
 HSBC Amanah Malaysia Berhad
 Maybank Islamic Berhad
 OCBC Al-Amin Bank Berhad
 Public Islamic Bank Berhad
 Standard Chartered Saadiq Berhad

THE LEGAL FRAMEWORK OF ISLAMIC BANKING AND FINANCIAL SYSTEM IN MALAYSIA

In practice, Malaysia has dual financial system; namely the conventional and the Islamic financing. Since Islamic banking and financial system appeared later than the conventional part, the *Shariah* legal framework complements the existing one. The *Shariah* legal framework operated in two ways, some of the laws were newly enacted and the others were modifications of the current laws.

A. THE LEGISLATIVE JURISDICTION OF THE ISLAMIC FINANCIAL TRANSACTION IN MALAYSIA

Malaysia has a dual system of courts, the civil court and the *Shariah* court system. The jurisdiction of the civil court is laid down in the Federal List of the Ninth Schedule of the Federal Constitution which includes inter alia Item 7 under the heading of Finance which includes banking, money lending, pawnbrokers, control of credit, bills of exchange, cheques, promissory notes and other similar instruments.

On the other hand, the jurisdiction of the *Shariah* courts is stated under Item 1 of the State List of the Ninth Schedule of the Federal Constitution which includes personal laws comprises of succession, testate and intestate, family law matters, gifts, *wakafs* and the determination of Islamic law and Malay custom. On top of that, the *Shariah* courts shall have jurisdiction only over persons professing the religion of Islam in respect of any of the matters set out in Item 1.

As far as the matter of jurisdiction is concerned, cases relating to Islamic banking are at present dealt with in civil courts and there have been a number of decisions involving Islamic banking. There are several reasons why the Islamic banking matter falls under the jurisdiction of the civil court.

It was clear that matters such as banking (including Islamic banking), insurance (including *takaful*), and companies are in the Federal List. Hence, the power to enact laws to govern these matters is within the jurisdiction of the Parliament. The results were the passing of the IBA, section 124 of the BAFIA, section 16B of the CBMA and the *Takaful* Act 1984.

However, constitutional issue then arises when Islamic financial products include instruments which are purely in the jurisdiction of the State List. For instance, Islamic banking products with which include the principles of *hibah* (gifts) and *wakafs* (endowments) as part of their supporting documents. Both *hibah* (gifts) and *wakafs* (endowments) are clearly under the jurisdiction of the State under Item 1 of State List of the Ninth Schedule of the Federal Constitution. The submission of the whole Islamic banking business matters, including the one which is clearly stipulated to be under the State matter, is clearly against Article 121(1A) of the Federal Constitution. The issue then arises on which Court has the jurisdiction to hear this kind of Islamic financial transaction?

To answer this question, Item 4(k) of Federal List of the Ninth Schedule can be invoked. Item 4(k) states that the Parliament shall have power to enact laws for ascertainment of Islamic law and other personal laws for purposes of federal law. For the Parliament to have power to enact laws would mean the power of the civil courts to adjudicate the matter. The power to ascertain Islamic law given to the Parliament is reflected in section 16B of the CBMA on the establishment of the SAC of the CBMA as the authority for the ascertainment of Islamic law for the purpose of Islamic banking business etc. For this matter, Item 4(k) would be the most appropriate to be invoked in answering question on the jurisdiction of the courts and the power to enact laws pertaining to Islamic banking business.

This is due to the fact that it is undeniable that the powers of the State on any matter relating to *Shariah* since Item 1 of State List is so wide so much so that it covers the power of the determination of any matters of Islamic law. Even though banking matters are within the purview of the Federal, the determination of Islamic matter issues as the substance in the Islamic banking cannot be dispensed with. Hence, recognizing the power of the State in Islamic banking matters as well as the jurisdiction of the *Shariah* courts is highly inclined. However, this is difficult to implement considering some other factors such as the dual nature of Islamic banking (combination of conventional mechanism and Islamic principles of *muamalat*). Thus, the best practice is by invoking Item 4(k) of the Federal List.

The jurisdiction of the *Shariah* courts only confine to persons professing the religion of Islam. However, in Islamic banking activities, the parties involved range from Muslims, non-Muslims, companies, partnerships and statutory bodies.¹⁹ Hence, giving jurisdiction on that matter to the *Shariah* courts would be impossible. Even the Islamic banks cannot be considered as persons professing the religion of Islam since they are not individuals, what more conventional banks.²⁰

The above discussion revealed that Islamic banking matters are within the jurisdiction of the civil courts. Therefore, in 2003, the Muamalat Bench was set up, located at High Court Commercial Division 4.²¹ The Muamalat Bench was presided by the High Court Judge. The setting up of the Muamalat Bench would entail the gradual integration of the two systems of law into one, evolving in the process a system of court structure and court procedure that would have incorporated and integrated elements from both the systems and one that would apply to both systems. In the course of time, this would give rise to a court system and court procedure capable of handling all types of cases both under Islamic law, other than those that come within the jurisdiction of the *Shariah* courts, as well as common law that would be unique in this country and which could serve as a model for other countries to follow.²²

Further to facilitate the litigation process at this court, it has been proposed that written substantive laws governing Islamic business, banking and finance (i.e. Islamic commercial law or *Muamalat*) in the form of a comprehensive Islamic Commercial Codes needs to be introduced to lend support to existing regulatory laws governing this area.²³

¹⁹ Mohamed Ismail bin Mohamed Shariff, 2005, *The Legislative Jurisdiction of the Federal Parliament in Matters Involving Islamic Law*, Malayan Law Journal, Vol. 3, p. cv.

²⁰ Refer to the case of *Dato' Nik Mahmud Bin Daud v. Bank Islam Malaysia Berhad* [1996]4 MLJ 295; [1998] 3 MLJ 393.

²¹ Practice Note No. 1/2003 enforced on 1st of March 2003. All muamalat banking cases will be registered under the Code 22A. The insertion of the alphabet "A" will differentiate the Islamic and conventional cases under Code 22 which was used in writ of summon cases.

²² Mohamed Ismail Mohamed Shariff, 1998, *Development of Islamic Banking Law in Malaysia*, Malayan Law Journal, Vol. 1, p. cxlv in Dr Nik Norzrul Thani, Mohamde Ridza Mohamed Abdullah & Megat Hizaini Hassan, 2003, *Law and Practice of Islamic Banking and Finance*, Petaling Jaya: Sweet & Maxwell Asia, p. 94.

²³ Zainal Azam Abd Rahman, *Islamic Business and Banking Laws in Malaysia*, IKIM 2003 in Dr Nik Norzrul Thani, Mohamde Ridza Mohamed Abdullah & Megat Hizaini Hassan, *op. cit.*, p. 94.

B. SHARIAH SUPERVISION OF ISLAMIC BANKING IN MALAYSIA

On the first inception of Islamic banking in Malaysia by the passing of IBA in 1983, the Act, by virtue of section 3(5)(b) provides that Islamic bank's Articles should provide for the establishment of a *Shariah* Advisory Body. The provision states that the CBM shall not recommend the grant of a license and the Minister shall not grant a license unless the CBM or the Minister, as the case may be, is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a *Shariah* Advisory body, as may be approved by the Central Bank, 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.

In 1996, section 124 of the BAFIA was incorporated and the provision *inter alia*, provides that the any institution carrying on Islamic banking activities shall refer the matters to a *Shariah* advisory body to ensure that they do not contravene the *Shariah* principles. Following this, the CBM has established a *Shariah* Advisory Council (SAC) and the appointment were made on 2 August 1996. However, the appointment of this Council was administrative in nature and no amendment made to the CBMA as yet.

Even though SAC of the CBM was established, every Islamic banks and conventional banks licensed under the Section 124 of BAFIA carrying on Islamic banking activities are required to have their own *Shariah* Committee to advise on the Islamic banking and financial activities. These *Shariah* Committees issued their rulings respectively without referring to each other even there are possibilities involving the same issues. This has resulted in various rulings on the same issues.

It is therefore, the CBM through their Cabinet Paper in 1997 has proposed that the recognition and the formulation of the SAC shall be incorporated through the amendment to the existing CBMA so that the SAC of the CBM shall be the sole supervisory body of the *Shariah* banking and finance industry.

Subsequently in 2003, section 16B of the CBMA on the establishment of the *Shariah* Advisory Council was inserted. By virtue of subsection 16B(1), a SAC of the CBM is established and shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, *takaful* business, Islamic financial business, Islamic development financial business, or any other business which is based on *Shariah* principles and is supervised and regulated by the CBM. Since all the Islamic banking activities in Malaysia are supervised and regulated by the CBM, the SAC of the CBM shall be the ultimate body in supervising the Islamic banking business of all the financial institutions carrying on such business. As far as the members of the SAC are concerned, they are to be appointed from among persons who have knowledge or experience or both in the *Shariah* and also banking, finance, law or any other related discipline. The appointment shall be made by the Minister on the recommendation of the CBM. At present, there were 19 members of the *Shariah* Advisory Council of Bank Negara Malaysia chaired by YAA Datuk Sheikh Ghazali bin Haji Abdul Rahman.²⁴

²⁴ Bank Negara Malaysia, 2007, *Shariah Resolutions in Islamic Finance*, Kuala Lumpur: Bank Negara Malaysia.

However, it is to be noted that notwithstanding the introduction of section 16B into the principal Act, the existing SAC which was appointed on 2 August 1996 is deemed to have been validly appointed and shall continue to perform the functions for which it was appointed until a SAC is appointed in accordance with subsections 16B(2) and (3) of the CBMA.

This amendment has resulted to consequential amendments to the IBA and section 124 of the BAFIA in 2003. As such, section 13A of the IBA was inserted which provides that an Islamic bank may seek the advice of the SAC pertaining to Islamic banking and financial business. Whereas section 124(7)(a) of the BAFIA was amended to the effect that SAC for the purpose of this Act means the SAC established under section 16B(1) of the CBMA.

Even the establishment of the single SAC for Islamic banking industry was recognized by the law, the Islamic banks and conventional banks operating Islamic banking business are still required to have their own *Shariah* body. This is pursuant to the CBM's guidelines issued i.e. "Guidelines on the Governance of *Shariah* Committee for the Islamic Financial Institutions" which provides that a *Shariah* Committee is to be established by each and every Islamic banks, Islamic windows and takaful operators. With regard to relationship between the SAC and these committees, all these committees play a complementary role to the SAC of the CBM.²⁵

Besides, the appointment and the reappointment of a *Shariah* Committee member shall obtain prior written approval of the CBM. In approving the appointment and the reappointment, the CBM may impose necessary conditions it deems fit in addition to the requirements in these Guidelines. The failure to comply with any of such conditions shall nullify the approval.

In conformity with section 16B (6) of the CBM, an Islamic financial institution is not allowed to appoint any member of the SAC to serve in its *Shariah* Committee. This is to avoid conflict of interest and for reasons of confidentiality within the industry. An Islamic financial institution shall not appoint any member of a *Shariah* Committee in another Islamic financial institution of the same industry.

Nevertheless, the SAC of the CBM has accorded with the sole *Shariah* authority in Islamic banking and finance. As the sole authority, the SAC will be referred by other Islamic financial institutions and its ruling pursuant to such reference shall be binding upon them. The functions and role of the SAC is clearly stated under section 16B of the CBMA.

Other than the Islamic financial institutions, the SAC also been referred by the arbitrator and the courts in disputes involving *Shariah* issues in Islamic banking and finance. In the case of arbitrator, the SAC's resolution shall be binding on the arbitrator (obligatory). However, in the case of the court, the SAC's resolution shall be taken into consideration on the court (advisory). This is clearly stated under subsection 16B(9) of the CBMA.

²⁵ Mohamad Akram Laldin, 2008, *Shariah Supervision of Islamic Banking From Regulatory Perspective With Special Refence to Malaysia* (Slide Presentation).

The non-binding effect of the rulings of the SAC on the courts has resulted the refusal of the High Court judges to follow the rulings issued hence departing from what have been agreed upon by the SAC scholars. The recent judgment of the High Court in the case of *Arab-Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn. Bhd. & 2 Ors [2008]* and 12 other cases has caught the attention of local Islamic finance players in Malaysia. In this case, the judge has declared that the *Bay' Bithaman Ajil* contracts as null and void. Even though the SAC of the CBM has allowed the application of such form of sale, the Court in this case summarily dismissed the need to refer to the SAC and said that there is neither necessity nor reason to refer to these concepts to the SAC for any ruling, which in any case, while they are to be taken into consideration, are not binding upon the Court.²⁶ The judge ruled that since the IBA requires that any Islamic banking activities shall not involve any element of not approved by the religion of Islam, it necessarily means that they contain any element not approved by any recognized Mazhab. This interpretation tends to demonstrate the Court's lack of appreciation of the matters related to *ijtihad* and the role of Mazhab. This is because when Islamic jurists rule upon *Shariah* matter, they are not bound to interpret based on any particular Mazhab.²⁷ In this case, the *bay' al-'inah* transaction in the BBA contract was recognized by the SAC on the ground that it is allowed by the minority of Shafi'i scholars but not the majority of the scholars.²⁸ The majority of the scholars described this form of sale as back door to *riba*, hence disallowing it. However, in *fiqh al-muamalat*, as mentioned earlier, the principles to be adopted are not necessarily based on the opinion of majority of the *Mazhab*. Even though the SAC has ruled that it is allowed, the court still refuse to refer it to the competent body recognized by the law in deciding the matter on the ground it is not bound by the rulings of the SAC.

C. ISLAMIC BANKING ACT 1983 (IBA)

In 1983, the government has passed an Act known as Islamic Banking Act 1983 (IBA) for the purpose of allowing the establishment of an Islamic bank in Malaysia. The IBA basically provides for the licensing and the regulations on the management and the operations of Islamic banking business. Besides that, it also provides for the financial requirements and duties of Islamic banks, ownership and control of Islamic banks, restrictions on business and powers of supervision and control over Islamic banks.

Section 2 of the Act defines the term Islamic banking business as "business whose aims and operations do not involve any element which is not approved by the religion of Islam". On the other hand, Section 3 of the Act provides that in order for the Islamic banking business to be transacted, the Islamic bank shall obtain license from the relevant Minister in accordance with the procedures specified therein.

However, it is to be noted that the Act only governs the Islamic banks. In other words, conventional banks operating Islamic banking business are not under the purview of this Act. As to date the Islamic banks governed under the IBA are the two local full-fledged Islamic banks, the foreign full-fledged Islamic banks and the Islamic subsidiaries banks.

²⁶ Rafe Hancef, 2008, *Stormy Times Ahead For Islamic Banking*, Malaysian Reserve, p. 30.

²⁷ *Ibid.*

²⁸ Bank Negara Malaysia, 2007, *Shariah Resolutions in Islamic Finance*, Kuala Lumpur: Bank Negara Malaysia, p.25.

D. BANKING AND FINANCIAL INSTITUTIONS ACT 1989 (BAFIA)

Pursuant to the CBM's policy in allowing the conventional banks to operate Islamic banking business via Islamic windows, the Banking and Financial Institutions Act 1989 (BAFIA) was amended in 1996 in order to allow any conventional bank licensed under this Act to carry on Islamic banking business or Islamic financial business provided that prior consultation with the CBM for that purpose shall be made.

The amendment has been made to section 124 of BAFIA whereby the whole provision was designed to facilitate the establishment of Islamic banking and financial business in the conventional banks. Subsection 124(7)(b) of BAFIA specifically defines "Islamic banking business" as having the same meaning as assigned thereto under the IBA. This shows that the nature of the Islamic banking business allowed in the Islamic banks are the same as allowed in the conventional banks.

In addition, the provision also provides that conventional bank shall seek the advice of the Syariah Advisory Council established under the CBM Act 1958 from time to time to ensure that the Islamic banking or financial business operated shall be in compliance with Shariah principles.

E. DEVELOPMENT FINANCIAL INSTITUTIONS ACT 2002 (DFIA)

There are some development financial institutions that are not governed by any of the Act, the IBA or the BAFIA. For example, the Bank Kerjasama Rakyat Malaysia Berhad which is governed under the Bank Rakyat Act 1978 and the Co-Operative Societies Act 1993. However, it is learnt that the said institutions were also doing Islamic banking business. This is due to the fact that such bank is allowed to run its Islamic banking services by virtue of section 129(1) of the Development Financial Institutions Act 2002 which provides that – "Nothing in this Act or the Islamic Banking Act 1983 [Act 276] shall prohibit or restrict any prescribed institution from carrying on Islamic banking business or Islamic financial business in addition to its existing business, provided that the prescribed institution shall obtain the prior written approval of the Bank before it carries on Islamic banking business or any Islamic financial business."

Other development financial institutions offering Islamic banking services other than the Bank Kerjasama Rakyat Malaysia Sdn. Bhd. are Bank Perusahaan Kecil dan Sederhana Malaysia Berhad (SME Bank), Export-Import Bank of Malaysia Berhad, Agro Bank (formerly known as Bank Pertanian Malaysia) and Bank Simpanan Nasional Berhad.²⁹ As far as their Islamic banking services are concerned, section 129(1) of the DFIA is also applicable to them.

²⁹ www.bnm.gov.my

F. CENTRAL BANK OF MALAYSIA ACT 1958 (CBMA)

In the year 2003, an amendment was made to the Central Bank of Malaysia Act 1958 (CBMA) by inserting a new provision of section 16B which provides inter alia for the establishment, appointment/ qualification and regulation of the Shariah Advisory Council (SAC) of the CBMA that will advise the CBMA on *Shariah* matters in relation to the Islamic financial industry. By virtue of this amendment, any financial institution operating Islamic banking and financial business shall from time to time seek the advice of the SAC in order to ensure that the operations of its business are in compliance with the *Shariah* principles. In addition, such institutions shall also comply with any directions of the SAC relating to the Islamic banking and financial business.

Being the regulator in the industry, the CBMA shall have the power to cancel any license given to any financial institution from operating Islamic banking and financial business for non-compliance with any ruling of the SAC of the CBMA. The reference to the SAC of the CBMA can be seen in the amendment of section 13A of the IBA and section 124(4) of the BAFIA whereby both provisions clearly state that any Islamic bank or any licensed institution carrying on Islamic banking business or Islamic financial business may seek the advice of the SAC and shall comply with any direction made by the SAC.

The above mentioned list of legislations is meant for the management and the operation of the Islamic banking and financial business. However, it is to be noted that the application of the laws in Islamic banking and financial business is similar to that of conventional banking. This would mean that the application of the National Land Code 1965, the Contracts Act 1950 and other laws are still relevant in Islamic banking and financial business as long as the provisions of the laws do not contravene the principles of *Shariah*.

In facilitating the execution of the transaction under Islamic principles, several amendments to the existing laws were made for example the Stamp Act 1949 and the Real Property Gains Tax Act 1976. With these amendments, the customers of Islamic banks would enjoy the same benefits enjoyed by the customers of conventional banks.

On the principles of *Shariah* itself, there are no specific laws that provide what are the principles that should be applicable in the Islamic banking transactions. In *muamalat*, the principles to be adopted are much depending on the circumstances and environment (*masalah*). It is more flexible compared to ibadah whereby everything is fixed and cannot be changed for example a Muslim must perform his prayers five times per day in what ever circumstances (except for *rukhsah*). In addition, the principles to be accepted in the Islamic transactions are not focusing on one Mazhab only.³⁰ There is also no necessity as to the consensus of opinion of the four Mazhab in order for certain principles to be adopted. The best example is *bay' al-'inah*. The Malaysian industry allows the application of such form of transaction on the basis that it is accepted by a minority of Shafie jurists even though majority of the Muslim scholars are opposing such transaction.³¹ This is to say that as long as there is no element of *riba*, *gharar*, *maisir* or involving the producing and selling impure goods, any form of transaction shall be allowed under *Shariah*.

³⁰ Mohamad. Illiyas, 2009, *Documentation For Consumer/ Commercial Financing* (Presentation during Comprehensive Workshop On Islamic Financing For Legal Practitioners, IBFIM).

³¹ Bank Negara Malaysia, 2007, *Shariah Resolutions in Islamic Finance*, Kuala Lumpur: Bank Negara Malaysia, p.25, Securities Commission, (2006), *Resolutions of the Securities Commission of Shariah Advisory Council* (Second Edition), Kuala Lumpur: Securities Commission, p. 20.

Although there are no written laws on the principles of *Shariah* that are allowed to be used in the industry, the application of such are supervised by a Shariah Advisory Council to ensure that any Islamic banking activities operated by the Islamic financial institutions are not contravening the principles of *Shariah*.

CONCLUSION

Malaysia's Islamic banking and finance industry has been in existence for over 30 years. Starting from the establishment of the first Islamic bank in 1983 and thereafter, with the liberalization of the Islamic financial system, more Islamic financial institutions have been established. As to date, Malaysia has seventeen full-fledged Islamic banks providing a broad spectrum of financial products and services based on Shariah principles. Experiencing the several stages of developments have transformed Malaysia into one of the most developed Islamic banking markets in the world. And most recent, Malaysia is working on an initiative to promote the country as a leading international Islamic financial hub known as the Malaysia International Islamic Financial Centre (MIFC).

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