Legal Obstacles Facing Islamic Banking in Malaysia

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Islamic banking is a concept which has proven itself to the world. Malaysia is considered as the cranium of Islamic banking and the rest of the world take lessons from Malaysia. The reason for this maybe because Malaysia is the first nation in the world to develop a sophisticated and a systematic legal infrastructure to welcome, develop and sustain Islamic banking parallel to the conventional banking in the country. The systematic and the dual banking approach adopted by Malaysia did gain the attention of the whole world. More than two and a half decades later, the question that still persists is what needs to be done for the sustainable development of Islamic banking in Malaysia? It is observed that without eliminating the legal obstacles facing Islamic banking in Malaysia, it would be impossible to sustain Islamic banking in the country. The main focus of the paper is to find out the legal obstacles facing Islamic banking in Malaysia.

JEL Codes: K19, K29 and K39

1. Introduction

Islamic banking can be described as the shari’ah or Islamic law acquiescent way of banking. There are certain strict rules that should be observed in Islamic banking. If these fundamental rules are breached, the Islamicity of Islamic banking would be lost. In Islamic banking, riba (interest), maysir (gambling) and gharar (uncertainty) shall be eliminated. Apart from it, the investments made, shall also be for shari’ah compliant products, which shall not include commodities classified as haram (prohibited) like alcohol and pork.

Islamic banking is poles apart from conventional banking. In order to fully understand this difference, it is vital to comprehend the nature of conventional banking. Under English law, there is no exhaustive definition of a bank. But in the case of United Dominions Trust Ltd v Kirkwood (1966), the Court of Appeal defined the characteristics of “banking business” as: (1) conduct of current accounts; (2) payment of cheques drawn on bankers; and (3) collection of cheques for customers. Furthermore, the relationship created between the customer and the bank in conventional banks is generally that of debtor and creditor, as held by Lord Cottenham in the landmark case of Foley v Hill (1848 2 HL Cas 28).

The nature of Islamic banking is different from conventional banking as the activity it carries out is beyond the functions of a conventional bank. Islamic banking creates multi-contractual relationship between the customer and the bank depending on the nature of the contract to which they enter. For example, an Islamic bank may enter into a partnership agreement with the customer and do trade and share profit. If so,

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the Islamic bank and the customer would be considered as partners and the partnership law of the respective country would be applicable to their relationship.

In Malaysia, the formal inception process of Islamic banking began in 1983 with the enactment of the Islamic Banking Act 1983. This Act (IBA 1983) regulated the establishment of Islamic banks in the country. This led to the launch of the first Islamic bank of the country, Bank Islam Malaysia Bhd. Later on, the conventional banks operating in the country were given the opportunity to offer Islamic banking services to the public. The underlying reason was to create more players in the market. This approach created dual banking system in the country.

Having a dual banking in an economic system is not an easy task. There are many challenges confronting it. One of the challenges is from the legal perspective where loopholes in the legal system might exacerbate the smooth running of the system in the country. The objective of this research is to find out the legal obstacles facing Islamic banking in Malaysia. This is to facilitate the sustainable development of Islamic banking in Malaysia. It is hoped that this research would contribute to the development of the legal infrastructure of the country in a positive way.

2. Literature Review

Malaysia is a country which is unique with a dual banking system and a dual legal infrastructure; one based on Common law and the other based on Islamic law (Muneeza, et.al, 2010). There are legal obstacles facing Islamic banking in Malaysia (Abdul Mutalip, 2008; Hassan, 2007; Malaysian Bar, 2008; Yasin, 2001; and Adawiah, 2008). The literatures found are not consistent about the specific legal problems facing Islamic banking in Malaysia. Different authors put forth different legal obstacles. For example, Abdul Mutalip (2008) views things like insufficient legal protection, jurisdiction struggle between civil and shari’ah courts, difficulties in turning concepts into practice and assets to be used as underlying assets as some of the practical legal issues in Islamic banking. It is viewed that the reason for creating these legal obstacles is because of application of Common law to Islamic banking system for which the *lex loci* is Islamic law (Muneeza, et.al, 2010; Yasin, 2001; Adawiah, 2008). It is evident from the literatures written on this point that solving the legal obstacles facing Islamic banking is vital for the sustainable development of Islamic banking parallel to the conventional banking in Malaysia. Hence, the first step would be to systematical identification of the legal obstacles facing Islamic banking in Malaysia and the scope of this research is this.

3. Methodology

As this is a legal research, the authors have used qualitative research methodology. The authors have done this research through the analysis of the library materials and case law relevant to the subject. This descriptive study would encompass incumbent research on the area of focus and compile findings based on the different perspectives. It is hoped that this research would be a valuable contribution to the matter and its beneficiaries.
4. The Findings

It is found that the beginning of the legal obstacles facing Islamic banking in Malaysia is that in Malaysia, the law applicable to Islamic banking is conventional laws based on English Common law which may be inconsistent with Islamic law. In real sense, Islamic law shall be the law applicable to Islamic banking matters. Not only should the basic principles of Islamic banking like elimination of *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling) shall be derived from Islamic law; but starting from the basic principles up to the dispute resolution, all the mechanisms should be derived from Islamic law.

The obstacles facing Islamic banking can be categorised by its seriousness. For convenience the authors have divided them into (1) legislative obstacle; (2) juridical obstacle; (3) shari’ah governance obstacle; (4) documentation obstacle; and (5) money laundering obstacle. A summary of each of these obstacle are described below:

(1) Legislative obstacle: Legislative obstacle basically means that the existing laws of the country that are applicable to Islamic banking are based on Common law and some of the provisions of these legislations are inconsistent with Islamic law. This eventually makes that specific part of the law incompatible with Islamic banking. In Malaysia, the legal system consist both Common law and Islamic law and the Federal Constitution of the country specifies the application of these two types of law. All the Federal laws are consistent with Common law and the state laws are made in consistent with Islamic law (9th Schedule of the Federal Constitution of Malaysia). As held in the case of *Bank Islam Malaysia Bhd. v Adnan Omar* (1994), the laws applicable to Islamic banking are federal laws. Hence, except the Islamic banking Act 1983 and the Takaful Act, the rest of the laws applicable to Islamic banking in Malaysia are legislations based on Common law before the inception of Islamic banking to the country. Hence, this created obstacles to Islamic banking. This is evident from the case laws decided by the courts in Malaysia. For example, in the case of *Bank Islam Malaysia Bhd. v Adnan bin Omar* (1994), there was dispute over Order 83 of Rules of High Court 1980 in which the interest or *riba* needs to be considered which is against the principles of Islamic commercial law.

(2) Juridical obstacle: Juridical obstacle described the challenges faced to Islamic banking in Malaysia when the courts that decide the Islamic banking cases are not shari’ah courts; but Civil courts in which the procedures and the judges hearing the matters would be trained in Common law; rather than Islamic law, which is the lex loci of the Islamic law. Hence, it is impossible to try an Islamic banking case and provide justice to the parties before the court. This is evident from the Islamic banking cases determined by the Courts in Malaysia. Though there is a special bench created in the Civil Courts in Malaysia, they lack adequate knowledge and qualification to hear Islamic banking matters. Hence, it is vital to train them and teach them Islamic banking law, which is definitely a technical area of law. The birth and persistence of this problem could be proved by case law. In the case of *Bank Islam Malaysia Bhd. v Adnan bin Omar* (1994), the judge equated rebate (*ibra*) to *muqasah* which actually is
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set-off. This proves the ignorance of the civil court judges in matters related to Islamic banking and finance.

(3) Shari’ah governance obstacle: shari’ah governance can be described as the Islamic version of corporate governance. Islamic banks need to have proper governance procedure based on Islamic law; rather than merely following the conventional way of corporate governance. The tumult in shari’ah corporate governance of Islamic banking in Malaysia now after the enactment of Central Bank of Malaysia Act 2009 and the new Shari’ah Governance Framework of 2010 is still is that where actually the shari’ah Boards of the Islamic banks should rank in the organization. Should they be below the Board of Directors or are they in equal ranking to them? What are the statutory liabilities of shari’ah scholars sitting in the Shari’ah Advisory Committee at the Bank Negara (Central Bank of Malaysia) level and the Shari’ah scholars sitting in the shari’ah Advisory Boards of the Islamic banks? For sustainable of Islamic banking this needs to be clarified too.

(4) Documentation obstacle: Sophisticates and unambiguous contracts which reflects the intention of the parties is vital for any transaction which involves cumbersome procedures. In Islamic banking the content and the sequence of Islamic banking documents is also important. In Malaysia, Islamic banking documents need to be valid under the Malaysian law and also the Islamic law. Hence, the burden on the drafter is very high. The documentation obstacle facing Islamic banking in Malaysia is evident from the case law. For example, in the case of Malayan Banking Bhd v Marilyn Ho Siok Lin (2006), the Islamic banking documents presented to the court to prove the case lacks coherence and substance which ought to be in it from shari’ah perspective. The behaviour and the nature of the product advanced to the customer are not mentioned in the document and it would be impossible for a person to understand the nature of BBA facility which was given to Marilyn (client) by reading the documents. Hence, the drafter has failed in achieving the objective of drafting the document as the intention of the parties is not reflected in the documents.

(5) Money laundering obstacle: Money laundering is the biggest challenge faced to any banking institution. People perceive that Islamic banks are prone to money laundering. For example, recent statement by the sections of the American Government implies that all Islamic banks in Islamic countries are poorly regulated against money laundering (Yasin, 2010). But this is not true in Malaysia as there are strict laws made to curb money laundering where death sentence is the highest punishment which could be given to the crime under Anti-Money Laundering and Anti-Terrorism Financial Act 2001 (“AMLATFA”), which is also applicable to Islamic banking Institutions. But the challenge here is that Islamic banks still need to develop internal procedures to fight against this crime. Unlike in the conventional banks, in Islamic banks the methods utilized by criminals would be different and it might be hard to detect these criminals without continuous effort of the officers of the Bank and developing a sophisticated fraud screening method. Hence, there is a vital and imminent need to always try on continuous develop of sophisticated internal procedures.
5. Summary and Conclusions

It is evident from the research that there are legal obstacles facing Islamic banking in Malaysia. The legal obstacles facing Islamic banking in Malaysia discussed in this paper are legislative obstacle; juridical obstacle; shari‘ah governance obstacle; documentation obstacle; and money laundering obstacle. It is imperative to curb these obstacles for the sustainable development of Islamic banking in Malaysia. Further research needs to be carried out on the specific legal obstacles identified here, to find the adequate and practical ways to curb them. It is hoped that this research would contribute to sustain Islamic banking in Malaysia.

References


Cases

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