



REMEDIES UPON DEFAULT PAYMENT BY THE
CUSTOMER IN ISLAMIC BANKING IN MALAYSIA

BY

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degree of Doctor of Philosophy in Laws

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ABSTRACT

The study on remedies upon default in payment in Islamic banking in Malaysia is crucial as it involves two (2) different laws namely Islamic law of contract and banking law. The granting of remedies become complex when the court applies the civil law and common law. The purpose of this study is to consider the adequacy of the law of remedies for default in payment in Islamic banking. This study seeks to answer three (3) research questions (i) whether legal remedies, equitable remedies and statutory remedies are adequate remedies in the event of default in payment (ii) what is the amount of damages that the bank is entitled to claim upon default in payment by the customer under *al-bai` bithaman ajil*, *ijarah* and *musyarakah mutanaqisah* and (iii) how far the application of civil law and common law by the court affects the bank in getting adequate remedies. For this purpose, three (3) types of Islamic banking products are chosen as they represent different methods of financing which deal with buying and selling, leasing and a combination of *musyarakah*, leasing and selling. The products are *al-bai` bithaman ajil* (deferred payment sale), *ijarah* (leasing) and *musyarakah mutanaqisah* (diminishing partnership). This study is limited to two (2) banking products namely home and car financing. It is conducted based on doctrinal research. The hypothesis of this study revealed that the laws of remedies upon default in payment by the customer in Islamic banking are not adequate. This inadequacy has resulted in the bank losing adequate remedy on damages, judges misinterpreting or misapplying the law and the remedies failing to fulfill the *maqasid al-Shari`ah* and *maslahah*. The study recommends the creation of *ijarah* act and institutionalizing the recovery of debts by setting up a documentation unit and recovery unit.

خلاصة البحث

إن بحث موضوع تقديم الحلول المتعلقة بالتعويض عند التخلف عن دفع الأقساط في المصارف الإسلامية تعد مسألة حاسمة كونها يتناولها قانونان مختلفان: قانون الشريعة الإسلامية وقانون العقود والمصارف، وهو ما يجعل تقديم الحلول معقداً عندما تُطبق المحكمةُ القانونَ المدنيّ والقانونَ العامّ. وعليه فإن الغرض من هذه الدراسة هو النظر في مدى ملاءمة أحكام التعويضات المتعلقة بالتخلف عن دفع الأقساط في المصارف الإسلامية. والدراسة تسعى للإجابة عن أسئلة البحث الثلاثة، وهي: أولاً: هل يمكن عد التعويضات القانونية والتعويضات بناء على مبدأ العدالة، وكذا المبادئ الأساسية مناسبة في حالة التخلف عن الدفع، ثانياً: ما حجم الأضرار التي بموجبها يحق للمصرف أن يطالب العميل بالدفع عند تقصيره عن الدفع في عقد البيع بثمن آجل، والإجارة والمشاركة المتنافضة وثالثاً: ما مدى تأثير تطبيق القانون المدنيّ والقانون العام بالمحكمة في حصول المصرف على تعويضات منصفة وكافية. لهذا الغرض تمّ اختيار ثلاثة منتجات مصرفية إسلامية لأنها تمثل أساليب مختلفة في التمويل يتعامل فيها بالبيع والشراء والإيجار والدمج بين المشاركة والإجارة والبيع. والمنتجات هي: البيع بثمن آجل والإجارة والبيع والمشاركة المتنافضة. والدراسة تقتصر على تمويل المنازل، وتمويل شراء السيارات. وقد أجريت استناداً إلى الجوانب النظرية والبحثية. وفرضيات هذه الدراسة كشفت أن قوانين التعويض عند التخلف في دفع الأقساط من العميل في المصارف الإسلامية غير كافية. وعدم الكفاية نتج عنه فقدان المصرف سبل التغطية الكافية للأضرار. وكان سبب هذا إساءة تفسير القضاء أو سوء تطبيق القانون ما أدى إلى أن التعويضات المقترحة أخفقت في الوفاء بمقاصد الشريعة والمصلحة. وتوصي الدراسة بإضفاء الطابع المؤسسي على استرداد الديون من خلال إقامة وحدة توثيق، وإقامة وحدة لاسترداد الدّين، ودراسة بشأن إنشاء قانون الإجارة.

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Subordinate Courts Act 1948 (Act 92)
Specific Relief Act 1950 (Act 137)
Trustees Act 1949 (Act 208)

LIST OF ABBREVIATIONS

AC	Appeal Cases
All ER	All England Law Reports
AMR	All Malaysia Reports
Anor.	Another
AIR	All India Reporter
BBA	<i>Al-bai` Bithaman Ajil</i>
Cap.	Chapter
Ch	Chancery
CLJ	Current Law Journal
CLR	Commonwealth Law Reports
Edn.	Edition
ER	English Reports
etc	et cetra (and so forth)
FCJ	Federal Court Judge
FMSLR	Federated Malay States Law Reports
Ibid	Ibidem (same as above)
I.R.	Irish Report
IIUM	International Islamic University Malaysia
J	Judge
JCA	Judge Court of Appeal
KB	Kings Bench
LJ	Lord Justice
LJ Ch	Law Journal Reports, Chancery New Series
LNS	Legal Network Series
LR	Law Reports
LR Eq	Law Reports, Equity Cases
Ltd.	Limited
MLJ	Malayan Law Journal
MLJU	Malayan Law Journal Unreported
MM	<i>Musyarakah Mutanaqisah</i>
NLC	National Land Code 1965 (Act 56)
No.	Number
Ors	Others
QB	Queens Bench Division
p./pp.	page/pages
P.U. (A)	Pemberitahuan Umum (A)
PC	Privy Council
Ph.D	Doctor of Philosophy
r.	rule
RHC	Rules of the High Court 1980 [PU(A) 50/1980]
s.	section
S.A.W.	SallaAllahu ‘alayhi wa-Sallam (Blessings of Allah S.W.T. and peace be upon him)
Sdn Bhd.	Sendirian Berhad
Supp	Supplementary

UK
v.
vol.
W.L.R

United Kingdom
verses
volume
Weekly Law Reports

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE RESEARCH

Islamic banks as a whole are basically established in the same manner as conventional banks.¹ Bank Islam Malaysia Berhad, for example was incorporated under the Islamic Banking Act 1983 and is a ‘banking’ institution where the law regulating Bank Islam Malaysia Berhad is the Islamic Banking Act 1983² itself. The late Profesor Emeritus Tan Sri (Dr.) Ahmad Ibrahim has formulated the Islamic Banking Act 1983 by taking the Banking Act 1973 (‘the Act’) and modifying the allocations within the Act in line with running an Islamic bank in the manner it is practiced today. The institution of Islamic banking that came into existence in 1983 in Malaysia was in fact an alien concept and without precedence in Islam and Islamic social and business dealings, which still poses a problem to the Muslim Ummah.³ In the early days, the Islamic banking concept was not completely in compliance with the requirements of *Shari`ah*.⁴

Islamic banking has been in operation for thirty one (31) years in Malaysia. Throughout this period, Islamic banking products have expanded at a rapid pace. Its first two (2) products for financing were *bai`inah* and *al-bai` bithaman ajil*. These

¹ Nik Mahani Mohamad, *Between Islamic Banking and the Gold Dinar – A Compilation of Paper and Articles*, Saba Islamic Media, 2007 at 12.

² Now governed under Islamic Financial Services Act 2013.

³ Nik Mahani Mohamad, n.1 at 15.

⁴ *Shari`ah* is an Arabic term which literally means “the way” or “a path to a watering place” or “a clear path to be followed” and more precisely, “the way which leads to a source.” Al-Qurtubi defined *Shari`ah* the canon law of Islam, all the different commandments of Allah (swt) to mankind. Hence, *Shari`ah* represents a body of Islamic teachings and system which were revealed to Prophet Muhammad (pbuh) through the revelation of the Holy *Quran* and later deduced from the Prophet’s *Sunnah* – that itself represents a divinely guided lifestyle and whatever was reported about what the Prophet Muhammad (pbuh) said, did, or gave his tacit approval. See *Islamic Financial System. Principle & Operations, ISRA (2011) at 6.*

were followed by *ijarah*, *musyarakah*, *mudarabah*, *istisna'* and *as-salam* and later hybrid products such as *al-ijarah thumma al-bai'*, *musyarakah mutanaqisah* emerged.

The rapid development of Islamic banking and finance in Malaysia has given rise to legal disputes between the parties involved. This has indirectly pressured the banks to seek remedies when a default in payment has occurred. Although the Islamic banking sector is in no way immune to risks, this sector is confronted with new and unique risks as a result of its unique asset and liability structures.

The main dissatisfaction with Islamic banking since its introduction was over the remedies on *al-bai' bithaman ajil* financing. In the event of default in payment of instalments, the customer has to pay the "outstanding selling price". Many people including judges of the civil courts who hear such cases, think that it is unjust, inequitable, "clearly excessive and abhorrent to the notion of justice and fair play"⁵ when compared with the amount that would have to be paid under the conventional loan.⁶ The burdensome situation has caused injustice to the customer and this injustice is against the basic principles of *Shari'ah*.

The overall aim of Islamic law is meant to promote the welfare or benefit (*maslahah*) of mankind and avoid harm (*masfadah*).⁷ Islamic banking is considered to be a part of the economic system of Islam that has a social orientation existence. The overall goal of this system is to realize the *maqasid al-Shari'ah* which should manifest in the economy to stimulate growth and justice.⁸ According to Habib,⁹ two (2) conditions must be met before the *maqasid al-Shari'ah* can be fulfilled in Islamic

⁵ Hamid Sultan JC in *Malayan Banking Berhad v Ya'kup Oje & Anor* [2007] 6 MLJ 389.

⁶ Abdul Hamid Mohamad & Adnan Trakic. "Granting of Ibra' by Islamic banks in Malaysia: A Matter of Discretion or Obligation?," *Journal of International Banking Law and Regulation* (2013) 361.

⁷ Habib Ahmed, "Maqasid Al-Shari'ah and Islamic Financial Products: A Framework For Assessment," *ISRA International Journal of Islamic Finance* vol. 3 Issue 1 (2011) 149.

⁸ Siddiqi, M. Nejatullah, *Riba, Bank Interest and the Rationale of its Prohibition*, Visiting Scholars.' (Research Series No. 2, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 2004).

⁹ Habib Ahmed, n.7 at 159.

financial transactions. They are the legal aspect of the transaction as well as the social requirement.

In dealing with bank's remedies in case of default in payment, the question of applicability of civil law¹⁰ and common law¹¹ in Islamic banking is vital. Abdul Hamid viewed that civil law and common law should be applied so long as it is not against *Shari`ah*. In *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd*¹² the court held that, although the facility was an Islamic banking facility that did not mean that the law applicable in the said application was different from the law that was applicable if the facility was given under conventional banking. Abdul Hamid Mohamed, JCA (as he then was) stated:

The charge is a charge under the National Land Code ('the Code'). The remedy available and sought is a remedy provided by the Code. The procedure is provided by the National Land Code and the Rules of High Court 1980. The court adjudicating it is the High Court. So, it is the same law that is applied, the same order that would be, if made, and the same principles that should be applied in deciding the application.¹³

¹⁰ A civil law system is founded on a set of legal codes (codified law) which are organised laws that attempt to cover exhaustively the various legal domains, and is characterised by an absence of precedence in the judicial application of those codes. Any reference to civil law in this thesis is made to Malaysian Law unless the context specify otherwise.

¹¹ A common law legal system is a system of law characterized by case law which is law developed by judges through decisions of courts and similar tribunals.

¹² [2003] 2 MLJ 408, COA. Facts: The appellant granted the respondent *al-bai` bithaman ajil* facility. Both parties executed property purchase agreement & property sale agreement on the same date. Under property purchase agreement, the respondent sold 22 pieces of land to the appellant for RM20 million. By property sale agreement, the appellant sold to the respondent the same properties upon deferred payment terms for 36 monthly installments. As security for the repayment of the selling price under property sale agreement, the respondent charged to the appellant 15 pieces of the land under the National Land Code. The respondent failed to pay the installments under the second agreement. The appellant issued a Form 16D notice under the National Land Code against the respondent. The respondent failed to comply with the Form 16D notice and the appellant filed an originating summons against the respondent for an order for sale under s 256 of the National Land Code. The High Court dismissed the application on the ground that the respondent had only utilized the facility up to RM4,934,220.48, leaving a balance of RM15,654,186.50 unused. The appellant appealed to the Court of Appeal.

¹³ Abdul Hamid Mohamed, JCA in of *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd* [2003] 2 MLJ at page 412.

While the above court decision shows that civil law is applicable in Islamic banking, Habib Ahmed¹⁴ on the other hand opines that Islamic law should be adapted into Islamic banking and not merely applied. He critically analysed the feature in the light of the two (2) criteria.

The first criterion is the terms used by the western legal system and the Islamic law framework requires an explanation. While civil law is based on statutes and codes which may be called the law of draftsman and common law is based on jurisprudence and is termed by the judges and attorneys, Islamic law is said to be the law of scholars or jurists. In determining the rules for a particular case, scholars take into consideration both *Shari`ah* and human interpretation (*fiqh*). The evolution of Islamic law in this century, on a case to case basis is similar to the common law tradition. The difference however, is that the western legal system is based on the principle of stare decisis and in Islamic law, *taqlid* is used to arrive at the decision. There is no codified law under *Shari`ah*. However *Shari`ah* provides principles that cannot be violated by the jurist. *Shari`ah* principles may be considered at the same time as a statutory law which judges must comply with in giving judgment. The difference between the two, however, is that while statutory law can be changed by legislator, *Shari`ah* principles are considered to be divine and immutable.

The second criterion is the legal justification within the framework of the new regulations. In this regard, the concept of equity in the western legal system will be changed to the *maqasid al-Shari`ah* and *maslahah* under the framework of Islamic banking. It is to keep in mind that the concept of *maslahah* in Islamic law is much broader than the notion of equity under civil law.

¹⁴ Habib Ahmed, "Islamic Law, Adaptability and Financial Development," *Islamic Economic Studies* vol. 13 no. 2 (2006) 83-84.

The debate that Islamic banking shall apply Islamic law is not new. In Malaysia, Islamic law is not the law of the country although it is an Islamic country.¹⁵ According to Sloane¹⁶ the government of a country governed under Islamic law, is permitted to implement statutes to supplement *Shari`ah* provided that they do not contradict *Shari`ah*. Each country under Islamic law is influenced by *Shari`ah* differently.¹⁷ Malaysia falls under the category where it primarily follows the western legal system where *Shari`ah* plays a minor role.¹⁸ In the Middle East, Mabid Ali Al Jarhi¹⁹ has called for modifications to any civil laws and the introduction of an Islamic banking law.²⁰ Al Jarhi told Gulf News “that such measures would promote better Islamic banking practices. The banks are presently guided by their own *Shari`ah* boards and have policies that often differ from those of other Islamic finance houses”.²¹

Generally every legal system has developed its own unique contract law and all legal systems have a means to resolve breach of contract through a remedy. Islamic banking does not have its own law for breach of contract. Therefore, the law of remedies is needed to ensure a contract is in accordance with the agreed terms and the

¹⁵ See Article 3(1) of Federal Constitution 1957.

¹⁶ Peter D. Sloane, “The Status of Islamic Law in the Modern Commercial World” *International Lawyer* vol. 22 no. 3 (1988) 751.

¹⁷ Peter D. Sloane, n.16 at 752. Some scholars suggest that Islamic countries can be divided into three (3) categories based upon the extent to which *Shari`ah* affects their legal system: (i) countries that primarily follow the Western system, where *Shari`ah* plays a minor role; (ii) countries with codified laws based primarily upon *Shari`ah*; and (iii) countries with westernized commercial codes, but legal interpretation and the legal system itself are based upon *Shari`ah*. The countries that make up the first category are Lebanon, Syria, and Egypt; the second category consists of Saudi Arabia, Oman, and Yemen; the third category is made up of Iraq, Jordan and Libya.

¹⁸ Peter D. Sloane, n.16 at 753.

¹⁹ Dr Mabid Ali Al-Jarhi, the Financial Expert and Head of training at Emirates Islamic bank is also the President, International Associations for Islamic Economics, and member, *Shari`ah* Board on the Dubai Financial Market.

²⁰ Zaher Bitar, “Time ripe for Islamic Banking Law Modification of Civil Process and A Decree Needed to Promote Better the *Shari`ah*-Compliant Practices,” *Gulfnews*, 2 April 2010 <http://www.gulfnews.com/.../banking/time-ripe-for-islamic-banking-law-1.606748> viewed on 4 February 2013.

²¹ Ibid.

remedy is adequate to compensate the bank. Without remedies, contracts would have no backbone and therefore historically some form of remedy would have always been available for the creation of contracts. In facing the conflict between *Shari`ah* and civil and common law on remedies in Islamic banking in the Malaysian current legal environment, neither *Shari`ah* nor civil law shall provide the ultimate answer.²² Thus it follows that the remedies in Islamic banking upon default in payment of instalment is decided by the court. It is against this background that a study on remedies available to the banks against customers who have failed to fulfill their obligations is carried out for the development and advancement of Islamic banking and finance.

1.2 OBJECTIVES OF THE RESEARCH

The purpose of this study is to consider the adequacy of the law of remedies for default in payment. The specific objectives of this study are:

- i. To discuss the concept and principles of remedies under civil law and common law.
- ii. To examine whether the law of remedies under civil law and common law is suitable to be applied in cases of default in payment particularly in *al-bai` bithaman ajil*, *ijarah* and *musyarakah mutanaqisah* financings.
- iii. To provide recommendations to the Islamic banking industry in getting adequate remedies upon default in payment.

²² cf. Noor Inayah el at viewed that Islamic law shall prevail where there is a conflict between Islamic law and Civil law in relation to Islamic banking transactions. See Noor Inayah Yaakub, Wan Kamal Mujani, Kamaruzaman Jusoff, Wan Mohd Hirwani Wan Hussain, Zinatul Ashiqin Zainol, Nurdeng Deuraseh, Adibah Sulaiman, Mohd Abdul Hamid and Ezat Azraai Jamsari, "Law Governing Islamic Banks and Financial Institutions in Malaysia: An Overview", *Middle-East Journal of Scientific Research*, vol. 7, 2011 at 87-92.

1.3 RESEARCH QUESTIONS

In determining whether the law on remedies under civil law and common law bring reliefs to Islamic banks especially when it comes to cases of default in payment, this study attempts to answer the following research questions:

- i. Whether legal remedies, equitable remedies and statutory remedies are adequate remedies in the event of default in payment?
- ii. What is the amount of damages that the bank is entitled to claim upon default in payment by the customer under *al-bai` bithaman ajil*, *ijarah* and *musyarakah mutanaqisah*?
- iii. How the application of civil law and common law by the courts affect the banks in getting adequate remedies?

1.4 STATEMENT OF PROBLEMS

Islamic banking has established its identity. It will stand firm, grow and develop as an alternative to interest-based financial system. In order to ensure Islamic banking business is *Shari`ah* compliant, the emphasis by *Shari`ah* Advisory Council is on the product rather than the operation.²³ The important guideline that the *Shari`ah* Advisory Council does not provide is the “rules” for unforeseen circumstances or non performance of the customer in the financing transaction. The *Shari`ah* Advisory Council only provides limited guidance within the *Shari`ah* parameter in case of default and virtually none when things go wrong.

²³ Agus Triyanta and Rusni Hassan, “The Process of *Shari`ah* Assurance in the Product Offering: Some Important Notes for Indonesian and Malaysian Islamic Banking Practice,” *Islamic Economic Studies* vol. 18 no. 1 (2012) 24.