



THE LEGAL NATURE OF BANKER-CUSTOMER
CONTRACTUAL RELATIONSHIP:
A COMPARATIVE CASE STUDY ON THE
BANKING DEPOSIT ACCOUNT BETWEEN
CONVENTIONAL AND ISLAMIC BANKING
SYSTEMS

BY

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the degree of Doctor of Philosophy in Law

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ABSTRACT

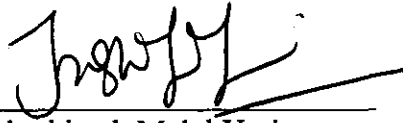
This research had attempted to compare the legal nature of the banker-customer contractual relationship in banking deposit accounts in Islamic and conventional banking systems. The existing legal characterization of the contractual relationship of banking deposit is based on loan contract in the conventional banking system and in some Islamic banks. Other Islamic banks have more options for customer to choose like wadi'ah. The actual features of banking deposit and its modus operandi do not however fully fit the characteristics of the loan and Wadi'ah contracts. The research also highlighted inefficiency that exists in the application of deposit insurance schemes which is in form of limiting or the ceiling of the coverage amount as well as brief highlight of some obstacles that exist in the adjudication of Islamic banking cases. The objective of this study is to comparatively study the banker-customer relationship and address the gape that exists between the underlying concepts and the actual operation of banking deposit. This research assumed that the banking deposit contract, regardless of whether it is Islamic or conventional, is a new contract and it ought to be recognized as such. The research scope is limited to compare the legal nature of banking deposit in the Islamic, civil and Common Law systems. There is no geographical limitation in this research. This study is conducted using descriptive, analytical, and comparative study approaches. From the analysis of the relevant literatures, the study has found that the banking deposit is wrongly considered to be based on loan contract. The features of the banking deposit were found to be not compatible with the nature of a loan contract. For example the customers believe that they have money in the bank, not a debt. It is the customers who seek the bank to withdraw their money, not the bank seeking the customers to settle a debt. The customer has free access to withdraw his money any time he wishes as oppose to a loan contract. There are no duties and obligations involved in a simple loan contract, unlike a deposit contract. There is no collateral involved in deposit account, unlike the loan contract. The Islamic banking system was found to provide more options for deposit contract, although there is a gap between some concepts of deposit like wadi'ah and the actual deposit operation. The deposit insurance scheme (not taking into account the Malaysian Government interim measure of full coverage) does not achieve its desired objectives due to the limited amount of coverage. Based on the above findings, the research recommended reconsideration of the legal nature of deposit contract to reflect its true nature and to reconsider the method of how deposit insurance is implemented. It also recommended Proper Avenue and qualifies adjudicators for Islamic banking cases.

خلاصة البحث

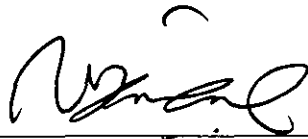
حاول البحث دراسة تكييف طبيعة العلاقة القانونية بين البنك والعميل في حسابات ودائع البنوك (حسابات الجاري والتوفير) في النظامين الإسلامي والتقليدي، حيث يتم تكييف طبيعة العلاقة القانونية لحسابات ودائع البنوك في النظام التقليدي وبعض البنوك الإسلامية على أنه قرض، وبعض البنوك الإسلامية لديها تكييفات أخرى لهذه العلاقة منها عقد ودیعة يد الضمانة. لكن مواصفات ودائع البنوك وطريقة عملياتها لا تتوافق مع عقود القرض والوديعة، وتناول البحث الإشارة لبعض الفجوات الموجودة في تطبيق نظام حماية الدائع والتي تكمن في تحديد سقف المضمون للدائع كما تناول البحث بعض الإشكاليات الموجودة في رفع القضايا المتعلقة بالمصارف الإسلامية أمام المحاكم المدنية. ويهدف هذا البحث إلى إجراء دراسة مقارنة لتكييف طبيعة العلاقة القانونية بين البنك و العميل في حسابات ودائع البنوك و الإشارة إلى الثغرات الموجودة بين العقود التي تُكَيّف بها الدائع وتطبيقاتها العملية. وتفترض هذه الدراسة أن عقود حسابات ودائع البنوك بغض النظر عن كونها إسلامية أو تقليدية هي عقود جديدة غير مسمّاة ويجب اعتبارها كذلك. ويقتصر مجال البحث في مقارنة تكييف هذه العلاقة في قانون الإسلامي والمدني والإنجليزي. وليس هناك اطار جغرافي محدد للبحث. وتم استخدام أساليب الوصف والتحليل والمقارنة في هذا البحث ومن خلال دراسة المراجع المتعلقة بالموضوع توصل البحث إلى أن حسابات ودائع البنوك تم تكييفها تكييفاً غير سليم على أنها قرض، ووجد البحث على أن مواصفات حسابات ودائع البنوك غير متوافقة مع طبيعة عقد القرض، لأن العميل يعتقد عادة أن لديه أموالاً في البنك وليس ديناً له. والعميل هو الذي يذهب عادة إلى البنك لسحب أمواله وليس البنك هو الذي يبحث عن العميل لیسدد دينه، كما أن للعميل حرية تامة لسحب أمواله من البنك متى أراد وهذا عكس القرض، كذلك ليس هناك واجبات على الطرفين تتبع عقد القرض على عكس حسابات ودائع البنوك. وليس هناك ضمانات إضافية مصاحبة لحسابات ودائع البنوك على عكس القرض. وتوصل البحث إلى أن البنوك الإسلامية توفر خيارات أكثر في إختيار عقد الوديعة إلا أن هناك ثغرات بين بعض العقود كعقد الوديعة و التطبيقات العملية لدائع البنوك، وتبين من خلال هذا البحث على أن نظام حماية الدائع لا يحقق الهدف المراد منه بسبب تحديد سقف المبلغ المضمون. وبناء على النتائج المذكورة يوصي الباحث بإعادة النظر في التكييف القانوني الحالي لحسابات ودائع البنوك ليعبر عن طبيعته الحقيقية وكذلك إعادة النظر في أسلوب تطبيق نظام حماية الدائع، كما يوصي بإيجاد المحاكم المختصة والقضاة المؤهلين للبت بالقضايا المتعلقة بالمصارف الإسلامية.

APPROVAL PAGE

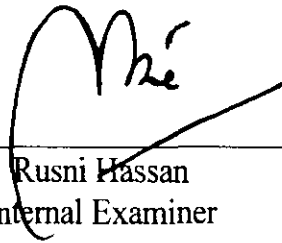
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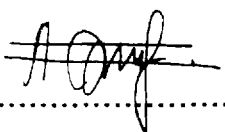
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DECLARATION

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

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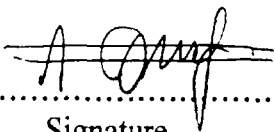
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*To My Late Father and Mother Who Left Me Too Early,
To My Aunty Fatima Hassan and To My Siblings*

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TRANSLITERATION TABLE

Arabic Term	Transliteration	Arabic Term	Transliteration	Arabic term	Transliteration
ء	'	ر	r	ف	F
ب	B	ز	z	ق	Q
ت	T	س	s	ك	K
ث	Th	ص	ṣ	ل	L
ج	J	ض	ḍ	م	M
ح	ḥ	ط	ṭ	ن	N
خ	Kh	ظ	ẓ	هـ	H
د	D	ع		و	W
ذ	Dh	غ	gh	ي	Y
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CHAPTER ONE

1.1 INTRODUCTION

Economies all over the globe are experiencing a tremendous rate of development, and banks are the pivotal instrument for the continuity of this development. The business of banking and finance is getting more and more sophisticated, and the type of services that the banks are offering are getting more diversified. The contractual relationship between a bank and its customer, covering the different services of the bank, may vary as well, as some view that whatever the precise nature of business of a particular institution, the basic relationship between the institution and its client, is created by an agreement between the parties under which that institution accepts money by way of deposit. The legal basis upon which that money is accepted is in theory open to several different analyses¹.

For that reason, it is prudent to know precisely the kind of relationship between banks and their customers, and whether the legal nature of the relationship under English law is able to fit all aspects of banking deposit business, and whether it is the right legal nature of the modern banking deposit-based relationship. Apart from the familiar conventional banking system, the recent development of the Islamic banking system is of particular interest. With the development of Islamic banking and its emergence in the global market as a competitive financier and capital provider, there are dual banking systems in place operating under different regimes in the Muslim world, and even in non-Muslim countries where Islamic banking is expanding. For that, this research aims to comparatively study the contractual relationship between

¹ Everett & Mc Cracken, *Banking & Financial Institutions Law*, 6th Edition, Law Book Co., Australia, 2004.

the bank and its customer, with special reference to the deposit account. The interesting fact is that Islamic and conventional systems have similarities and dissimilarities in considering the deposit-taking relationship between bankers and their clients. This research will provide a comparative analytical study of the deposit-taking relationship under the two systems.

The question of banker-customer relationship arising out of deposit contract has been a complex one; it was the subject of a long debate in conventional banking until the nineteenth century. There has not been a statutory definition of this relationship as yet, although it is that relationship that defines the rights and duties of both banker and customer. Due to the various services that a bank provides in relation to deposit contract, it was hard to encompass or fit all these services into one particular relationship. Thus, the bank could be acting under any of the possible relationships, such as bailor-bailee, trustee-cestui que trust, agent-principal, and debtor-creditor, or there may be more. It was finally in the House of Lord's decision in *Foley v. Hill*² that the court decided the banker-customer relationship to be that of debtor-creditor. This means that the customer, upon deposit of his funds with the bank, becomes a creditor and the bank will be a debtor. In other words it is as if the customer is lending his money to the bank and making a loan contract. This legal nature, although it is now accepted as settled law, is not sufficiently capable of reflecting the true nature of banking deposit and it does not cover all services that the banks provide. Therefore, there is still room for improvement, as it is not possible for all services of a bank and its legal consequences to be governed under one relationship. In other European jurisdictions, such as Germany and France, the banker-customer relationship is generally derived from each type of contract agreed upon by

² *Foley v. Hill* [1848] 2HLC28.9ER

the parties: current account, credit and loan, safe custody, collection of cheques and so on. In these jurisdictions the relationship is generally regarded as that of fiduciary which is based on trust and good faith³. This is not the standard practice however in these jurisdictions as well; the 'depositum irregular' which refers to the bank deposit has close similarities with the Common Law legal nature of deposit contract. This study considers whether the Islamic position regarding the basis of contractual relationship between a bank and its customer has a different classification. In the Argentina Supreme Court decision discussed later, the court also seemed to indicate that the customer's deposit is part of the customer's constitutionally protected property, but the court had a conflicting decision on whether that constitutional right to the customer's deposit can be overridden by public interest, and how that constitutional right is to be classified when it comes to the legal nature of the deposit relationship.

In contrast to the legal nature of banker-customer relationship under English law which is based on debtor-creditor, under Islamic banking system, the relationship of banker and customer is not fitted under one particular category. It is very much depends on the contract the parties have chosen to use. For example, for financing purposes, it could be in the nature of buyer-seller, partner-partner, lessor-lessee, and so on. As for the deposit account, the relationship is mostly that of trust, with the ownership of the money remaining with the customer⁴. It is a very interesting sharp contrast between the two systems, and that is the point that attracted the interest of this research. This study is to discover whether this Wadi'ah legal nature of Islamic deposit contract, which is based on trust, provides a satisfactory legal avenue to the

³ Cranston Ross, *European Banking Law: The Banker-Customer Relationship*, Lloyd's of London Press Ltd., London, 1993.

⁴ Norhashimah Mohd. Yasin, "Multi-Contractual Relationship Under Islamic Banking Law: Moving Away from *Foley v. Hill*" Vol. 1 (2005), *Shariah Law Report, IIUM*.

modern banking deposit operations as well. From the Islamic perspective, the focus will be on the analysis of the various Islamic deposit accounts. The methodology of this research will be library based.

1.2 OBJECTIVES

This research aims to achieve the following objectives:

1. To provide an analytical study of the legal nature of the contractual relationship between depositors and banking institutions and to see whether there is an alternative way to the rule in *Foleyv Hill*. The analysis also includes the nature of this relationship in Civil law countries as well as the nature of banker-customer relationship under Islamic Banking System. It covers analysis of the legal implications from such relationship under both conventional and Islamic banking laws.
2. To examine the Islamic deposit concepts used by the Islamic Banking Institutions in Malaysian.
3. To suggest if there is an alternative way of looking into the legal nature of the contractual relationship between the banker and customer in deposit accounts in general.
4. To analyze the deposit insurance scheme under the Malaysian Deposit Insurance Corporation Act 2005, (MDICA) and compare it with other practices, and to propose the proper mechanism of coverage. It will also include examining how far the maximum coverage of RM 60,000 (Currently RM 250,000), as stated in MDICA, would constitute a remedy to the holders of large deposits in the participating banks. The study will

also look into whether there is another method of providing long term full coverage of deposits instead of providing interim full coverage.

1.3 PROBLEM STATEMENT

The characterization of the nature of banker-customer contractual relationship as that of creditor-debtor alone under the Common Law system has many loopholes as it does not reflect the true nature and complexity of the banking deposit operation. It also contains some elements which are not fair to the customers with regard to their deposit fund. This research will highlight the arguments against this characterization.

With regard to the contractual nature of the Islamic banking deposit, although the relationship of banker and customer under Islamic banking system is multi-contractual and it is determined by the type of contract used when depositing money, there is a concern whether these concepts reflect the true nature of banking deposit operations. There is also a question of how the law should characterize these Islamic deposit concepts, because Islamic banking disputes are adjudicated in civil courts and decided by civil law judges who rely on civil law principles and procedures in deciding Islamic banking cases.

Under existing contractual legal nature, the customer stands as unsecured creditor, since the Deposit Insurance Scheme has been introduced under the Malaysia Deposit Insurance Corporation Act 2005, to safeguard the depositors' interest in the event that the bank cannot meet its obligation to pay back the deposit fund, the existing coverage limit does not offer a satisfactory solution to deposit holders due to

the ceiling of the coverage amount⁵. A better method of full coverage that provides long term deposit protection is needed for both Islamic and conventional deposits.

1.4 HYPOTHESIS

There are 3 assumptions that this research aims to prove with regard to this topic:

1. The banker-customer relationship is an independent contract with its own characteristics, and it has to be recognized as such, rather than fitting it into other contracts that are not fully compatible with its features.
2. The legal nature of the Islamic deposit account is not characterized under one contract; it depends on the type of contract used in the deposit.
3. There can be a better method to provide long term security to the depositor which is capable of serving the purpose and providing peace of mind to them regardless of the size of the deposit and also sustain market stability.

1.5 METHODOLOGY

This research will be library based study. With regard to the research approaches used in this work, it combines both descriptive and analytical approaches. Regarding the descriptive approach, it is utilized to explain the historical background of banking, both conventional and Islamic. It also covers the definitions of banker and customer in both systems and types of deposit accounts offered under the two systems.

The second approach has been to analyze the main differences between the two systems, especially with regard to deposit account. The analysis will cover the contracts that the deposit accounts are based on both under conventional and Islamic banking systems such loan under conventional and Qard, Wadi'ah and other Islamic

⁵ This does not include the temporary measure taken by the Malaysian government in the wake of the 2008 financial crisis where the deposits are fully guaranteed. See pp. 244-245 of this research.

Banking deposit concepts. The analysis also includes the relationship that results out of these various types of contracts which is the crux of this research.

Since this research aims to have a comparative study of both systems, the same approach will be applied in tackling the relevant issues under the two banking systems, i.e. descriptive and analysis. The description will involve review of the relevant materials and literature in Islamic and conventional banking systems relating to their historical backgrounds, definitions, and type of services. The study also looks into the different types of deposits in conventional and Islamic banking systems, under which contract deposits take place. In relation to conventional banking, the analysis includes the privileges the depositors may have under the deposit contract, such as whether or not they are secured in case of insolvency, i.e. whether they will have preference against other creditors, since the basic relationship between them and the bank is that of debtor-creditor. It also includes analysis on the relatively recent Deposit Insurance Scheme which was set up under the Malaysian Deposit Insurance Corporation Act 2005, (MDICA).

1.6 LITERATURE REVIEW

It is probably the right assertion to make that conventional banking business had been firmly established before the end of the seventeen century. However as J. Milnes stated in his book “The Law and Practice of Banking”, there were no reported cases in either the seventeenth or eighteenth century in which the court had to consider the legal relationship between banker and customer⁶. In the mid-nineteenth century the legal principle of the banker-customer relationship established when it received the imprimatur of the House of Lords, that when the money is deposited into the bank by

⁶ Milnes Holden J., *The Law and Practice of Banking, Vol.1 Banker and Customer*, 3rd edition, Pitman Books Limited, London, 1982.

the customer, the relationship arising out of that contract is creditor-debtor relationship, a view that was first expressed in the celebrated case of *Foley v. Hill*⁷ as stated in Paget's Law of banking,⁸:

In this case, the Lord Cottenham described the money deposited into the bank account as that of the banker for all purposes, so as to do with it as he pleases, and if anything happen to the money, the banker will be liable of no breach of trust, and will not be answerable to the customer. The banker is not bound to deal with the money as the property of the customer, but he is bound to pay the amount equivalent to the money deposited in the bank to the customer when demanded".

But Joan and Graham affirm in their book "the Law Relating to Domestic Banking" that:

the debtor-creditor basis of the contract does not account for all the basic aspects of the relationship, as was stated in *Foley's* case, that there was a superadded obligation arising out of the custom of bankers to honor customer's drafts, which means that the bank under the creditor-debtor relationship may also be acting as agent for the customer, and the agency relationship implies more complex duties than those of debtor-creditor⁹.

In that sense, the creditor-debtor relationship is also augmented by that of agent and principal, as Ellinger argued in his Book "Modern Banking Law", because the bank undertakes to carry out orders for the payment of money issued by the customer, and to collect cheques due to him. It is therefore erroneous to describe the relationship of banker and customer as being merely that of debtor and creditor¹⁰

The debtor-creditor relationship will not only apply in regards to any money deposited by the customer to the banker, but also as regards to any money lent to the customer by the banker, as Lee Mei Pheng stated in her book 'Banking Law'¹¹. This relationship constitutes a general contract between the banker and the customer which

⁷ *Foly v. Hill* [1848]2 HL cas 28.

⁸ Mark Hapgood, *Paget's Law of Banking*, 10th edition, Butterworth, London, 1989.

⁹ Wadsley Joan, Penn Graham, *The Law relating to domestic Banking*, Sweet & Maxwell, London, 2000.

¹⁰ Ellinger E.P, *Modern Banking Law*, Clarendon Press, Oxford, 1987.

¹¹ Pheng, Lee Mei, *Banking Law*, Butterworths Asia, Malaysia, 1995.

was illustrated by Atkin LJ in the case of *Joachimson v. Swiss Bank Corporation*.¹² His

Lordship stated as follows:

'...The bank undertakes to receive money and collect bills for its customer's account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them. The promise to repay is to repay at the branch of the bank where the account is kept, and during banking hours. It includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank at the branch, and as such written orders may be outstanding in the ordinary course of business for two or three days, it is a term of the contract that the bank will not cease to do business with the customer except upon reasonable notice. The customer on his part undertakes to exercise reasonable care in executing his written orders so as not to mislead or facilitate forgery. I think it is necessary a term of such contract that the bank is not liable to pay the customer the full amount of his balance until he demands payment from the bank at the branch at which the current account is kept¹³.

The bank is bound to repay the amount of money deposited by the customer on demand. Poh Chu Chai asserted in his book, "Law of Banker and Customer", that the repayment of that money may be payable after a fixed term varying from one month to a number of years. The practice of operating deposit account may sometimes vary from one place to another, for example, in England, a deposit account normally constitutes a single continuing contract, subject to the customer's prior notice when he wants to withdraw the money,¹⁴ whereas in Singapore, the payment of deposit money depends on the fulfilment of the terms and conditions of the contract. Poh Chu Chai argued that the fulfilment of the conditions of the contract constitutes a condition precedent to the bank's liability to repay the deposit in this case¹⁵. Time will run against the customer only after fulfilment of those conditions, and the bank refuses to make the payment.¹⁶

¹² *Joachimson v. Swiss Bank Corporation* [1921]3KB 110

¹³ Hapgood Mark, *Paget's Law of Banking*, 12th Edition, Lexis Nexis Butterworth, Singapore, 2004.

¹⁴ Chai, Poh Chu, *Law of Banker and customer*, 5th edition, Lexis Nexis; Malaysia, 2004.

¹⁵ *Ibid.*

¹⁶ *Joachimson v. Swiss Bank Corporation* [1921] 3 K.B 110