

**ISLAMIC BANKING SYSTEM IN MALAYSIA:
A STUDY OF THE LEGAL AND *SHARĪAH*
FRAMEWORK WITH SPECIAL REFERENCE TO
DEBT FINANCING PRODUCTS**

BY

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ABSTRACT

Islamic banking system in Malaysia has been developed as a 'dual-banking' system in which Islamic banks operate parallel with the existing conventional banking system under current legal framework. Since the *Shari'ah* compliance is an integral feature of Islamic banking, Islamic banks must firstly conform to the *Shari'ah* principles and at the same time they should comply with the various laws governing contract and commerce as well as regulations and guidelines issued by the Bank Negara Malaysia (BNM). Islamic Banking Act 1983 (IBA) is above all a regulatory piece of regulation and does not intend to provide detailed substantive provisions on the subject. Furthermore, current rapid developments of the Islamic banking system have led to the invention of various new products. The over enthusiasm in creating these new products might has trapped the Islamic banks into duplicating and modification the products offered under the conventional banks with '*Shari'ah*-sounding' names. In light of the above, this thesis attempts to investigate the legal and *Shari'ah* frameworks that govern the Islamic banking system in Malaysia with regard to the application of the debt financing products. The thesis suggests that there are some potential conflicts between Islamic law and civil law which give the impression that some of the practices of Islamic banking system are not fully compliant to its intended philosophy. The legal framework of Islamic banking is not in line with the rapid development of the Islamic banking industry, and therefore, it needs to be revised and modified to suit the Islamic banking practice. Similarly, an effective and conducive *Shari'ah* framework is needed to ensure such compliance and strengthen the regulatory and supervisory process as well as harmonising the *Shari'ah* interpretations.

ملخص البحث

لقد أنشئ نظام البنك الإسلامي في ماليزيا في إطار نظام البنك المزدوج حيث تتعامل البنوك الإسلامية مع البنوك الوضعية الأخرى التي وجدت من قبل. بما أن التطبيق لموجبات الحكم الشرعي هو الميزة الأولى للبنوك الإسلامية وهو الفارق بينها وبين البنوك الأخرى، فعلى البنوك الإسلامية - وقبل كل شيء - أن تطبق المبادئ الشرعية في معاملاتها، إلا أنها تجد في سبيل ذلك عقبات ليست بالسهلة، وهي أنها في معاملاتها التجارية تخضع لقوانين وضعية أخرى هي بدورها تتحكم وتؤثر في العقود والمعاملات التجارية التي تمارسها البنوك الإسلامية، وفي الوقت نفسه يجب على البنوك الإسلامية أن تتقيد بإرشادات وتوصيات أصدرها البنك المركزي. وكل هذا حدث، وسيحدث لأن قانون البنك الإسلامي (1983) الذي وضع يوم وضع لم يكن غرض الحكومة إلا لتأسيس البنك الإسلامي وترخيص إنشائه فقط، ولم يذكر القانون مبادئ مفصلة لنظام البنك الإسلامي. وقد شهد - في الآونة الأخيرة - تطوراً سريعاً حيث تسابقت البنوك في اختراع، وتقديم إنتاجات وآليات مالية جديدة تحمل أسماء إسلامية. هذا التطور قد دفعت البنوك الإسلامية إلى أن تنخرط في نفس المسلك، ويسعى سعياً حثيثاً وراء هذا الاتجاه، وهو بهذا قد وضع نفسه في ورطة لا ينجو منها إلا بشق الأنفس. ففي ضوء ما ذكر آنفاً يحاول هذا البحث دراسة المبادئ الإسلامية التي تتحكم وتراقب سير نظام البنك الإسلامي في ماليزيا، ويدرس كذلك تطبيق أساليب وصيغ التمويل القرصي في البنوك الإسلامية. ولاحظ الباحث أن هناك بعض تناقضات بين القانون الإسلامي و القانون المدني حيث يجر ذلك إلى مخالفة البنوك الإسلامية لمبادئها و فلسفتها، وأن خطة العمل القانونية للبنك الإسلامي لا تتفق مع التطور السريع في نظام البنك الإسلامي، الأمر الذي يدعو إلى إعادة النظر فيه لكي يسير النظام وفقاً لمبادئ البنك الإسلامي عملياً. ويدعو كذلك - والحالة هذه - إلى تصميم خطة العمل الشرعية متينة فعالة لتحقيق الانقياد التام والانضباط المستمر للحكم الشرعي المتعلق بنظام البنك الإسلامي، وضمان المراقبة الدقيقة لمسيره، والتوفيق بين الآراء الفقهية المختلفة في قضايا البنوك الإسلامية.

APPROVAL PAGE

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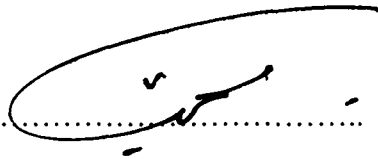
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DECLARATION

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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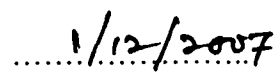
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All praise to Allāh SWT, the Great, the Most Gracious and the Most Merciful, by whose grace, guidance and blessing I am able to complete this thesis, instead of facing some difficulties, challenges and shortcomings.

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LIST OF STATUTES

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Contracts Act 1950 (Act 136) (Revised 1974)
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Finance Companies Act 1969 (Act 6)
Government Investment Act 1983 (Act 275)
Hire Purchase Act 1967
Income Tax Act 1967
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LUTH Act 1969 (Act 8)
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National Land Code 1965 (Act)
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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for the Islamic Financial Institutions
ADR	Alternative Dispute Resolution
AGM	Annual General Meeting
AGM	Assistant General Manager
AIBIM	Association of Islamic Banks Malaysia
ASBI	Amanah Saham Bank Islam
BAFIA	Banking and Financial Institution Act
BBA	<i>Bay' Bithaman Ajil</i>
BBMB	Bank Bumiputra Malaysia Berhad
BBMBK	BBMB Kewangan Berhad
BI	Bank Industri
BIMB	Bank Islam Malaysia Berhad
BLR	Base Lending Rate
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BOCB	Bank of Commerce (M) Berhad
BPIM	Bank Pembangunan dan Infrastruktur Malaysia
BPM	Bank Pertanian Malaysia
BR	Bank Kerjasama Rakyat Malaysia
BSN	Bank Simpanan Nasional
CBA	Central Bank Act
CBKL	Central Bank of Kuwait Law
CEO	Chief Executive Officer
CII	The Council of Islamic Ideology
CMMP	Capital Market Masterplan
DFIs	Development Financial Institutions
ESOS	Employee Share Option Scheme
FSMP	Financial Sector Master Plan
GIA	Government Investment Act of 1983
GICs	Government Investment Certificates
GIIs	Government Investment Issues
IAB	Islamic Accepted Bill
IBA	Islamic Banking Act
IBD	Islamic Banking Division
IBF	Islamic Banking Fund
IBS	Islamic Banking Scheme
IBU	Islamic Banking Unit
ICCS	Islamic Cheque Clearing System
ICMU	Islamic Capital Market Unit
IDB	Islamic Development Bank
IECR	Credit Financing of Export Based on Islam
IFBS	Interest-free Banking Scheme

IFI	Islamic Financial Institution
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IICG	Islamic Investment Company of the Gulf
IISG	Islamic Instrument Study Group
IKIM	Institut Kefahaman Islam Malaysia
IMF	International Monetary Fund
IMM	Islamic Inter-Bank Money Market
IOFC	International Offshore Financial Centre
IPDS	Islamic Private Debt Securities
IS	Islamic Subsidiaries
KLIA	Kuala Lumpur International Airport
KLRCA	Kuala Lumpur Regional Centre for Arbitration
KLSE	Kuala Lumpur Stock Exchange
LC	Letter of Credit
LOFSA	Labuan Offshore Financial Services Authority
LUTH	Lembaga Urusan Tabung Haji
MGS	Malaysian Government Securities
MGTB	Malaysian Government Treasury Bills
MII	<i>Mudārabah</i> Interbank Investments
MoU	Memorandum of Understanding
MPDC	Market and Product Development Committee
NLC	National Land Code
NSC	National Steering Committee
NST	News Strait Times
OIC	Organisation of Islamic Conference
PDS	Private Debts Security
PERKIM	Muslim Welfare Organisation of Malaysia
RENTAS	Real-Time Gross Settlement System
RHB	Rashid Husin Berhad
SAB	Shariah Advisory Board
SAC	Shariah Advisory Council
SC	Securities Commission
SPEEDS	Sistem Pemindahan Elektronik untuk Dana dan Sekuriti
SPI	Skim Perbankan Islam
SPTF	Skim Perbankan Tanpa Faedah
SSB	Shariah Supervisory Board
SSC	Shariah Supervisory Committee
STMB	Syarikat Takaful Malaysia Berhad
THLD	Treasury Housing Loan Division
UAE	United Arab Emirates
YPEIM	Yayasan Pembangunan Ekonomi Islam Malaysia

NOTES ON TRANSLITERATION

This work adopt the rules of transliteration used by *Encyclopedia of Islam*, with slight variations

Consonants

ء	(hamza)	ء		ض	(ḍād)	ḍ
ب	(bā')	ب		ط	(ṭā')	ṭ
ت	(tā')	ت		ظ	(ẓā')	ẓ
ث	(thā')	ث		ع	(ayn)	c
ج	(jīm)	ج		غ	(ghayn)	gh
ح	(ḥā')	ح		ف	(fā')	f
خ	(khā')	خ		ق	(qāf)	q
د	(dāl)	د		ك	(kāf)	k
ذ	(dhāl)	ذ		ل	(lām)	l
ر	(rā')	ر		م	(mīm)	m
ز	(zay)	ز		ن	(nūn)	n
س	(sīn)	س		و	(wāw)	w
ش	(shīn)	ش		ه	(hā')	h
ص	(ṣād)	ص		ي	(yā')	y

Vowels

_____ (fathah)	a		long <i>fathah</i>	ā
_____ (kasrah)	i		long <i>kasrah</i>	ī
_____ (ḍammah)	u		long <i>ḍammah</i>	ū

- *Tanwīn* ^{ـَ} ^{ـِ} ^{ـُ} is represented by *an, in, un* respectively.
- Transliteration will involve only Arabic words. Others will be written in *italics*.

TABLE OF CONTENTS

	Pages
Abstract	ii
Abstract in Arabic	iii
Approval Page	iv
Declaration Page	v
Copyright Page	vi
Acknowledgements	vii
List of Statutes	ix
List of Cases	x
List of Abbreviations	xi
Transliteration	xiii
CHAPTER 1 : INTRODUCTION.....	1
1.1 Preliminary	1
1.2 Statement of the Problem	3
1.3 Literature Review	9
1.4 Objective of the Study	17
1.5 Significance of the study	18
1.6 The Scope and Limitation of the Study	18
1.7 Methodology of the Research	19
1.8 Thesis Outline	19
CHAPTER 2 : THEORY OF ISLAMIC BANKING AND FINANCE	22
2.1 Introduction	22
2.2 The Evolution of Islamic Economics and Financial System	23
2.3 Historical Development of Modern Banking System	31
2.4 The Establishment of Islamic Banking and Financial Institutions in Modern Times	35
2.5 Theoretical Framework of Islamic Financial System	39
2.5.1 Sources and Principles of Laws in Islamic Banking and Finance	40
i) Al-Qur'ān	42
ii) Al-Sunnah	46
iii) <i>Al-Ijmā'</i>	50
iv) <i>Al-Qiyās</i>	52
v) <i>Al-Istihsān</i>	56
vi) <i>Al-Maslahah al-mursalah</i>	58
vii) <i>Al-Istishab</i>	59
viii) <i>Al-'Urf</i>	60
2.5.1 Definition of Islamic Banking and Finance	62
2.5.2 Philosophy of Islamic Financial System	63
2.5.3 Objectives of the Islamic Financial System	66

2.5.4	Salient Features of Islamic Banking and Finance	70
2.5.5	Theorists' Models of Islamic Banking	76
2.6	Conclusion	78

CHAPTER 3 : DEVELOPMENT OF THE ISLAMIC FINANCIAL SYSTEM IN MALAYSIA

	83	
3.1.	Introduction	83
3.2.	Background of the Establishment of the Islamic Bank	85
3.3.	The First Phase of Development : The Establishment and Development of Bank Islam Malaysia Berhad (BIMB)	91
3.3.1.	Legislation of the Islamic Banking Act 1983	91
3.3.2.	Legislation of the Government Investment Act 1983	95
3.3.3.	Establishment of Syarikat Takaful Malaysia Berhad	96
3.4.	The Second Phase of Development : Creating an Islamic Banking System (IBS)	97
3.4.1.	Introduction of an Interest Free Banking Scheme (SPTF) ..	99
3.4.2.	Introduction of an Islamic Inter Bank Money Market	102
3.4.3.	Establishment of an Islamic Capital Market	103
3.4.4.	Establishment of the BNM Syariah Advisory Council	110
3.4.5.	Establishment of the Second Islamic Bank	111
3.4.6.	Development Financial Institutions	112
3.5.	The Third Phase of Development: Developing an Efficient, Comprehensive and Competitive Islamic Banking System	114
3.5.1.	Financial Sector Master Plan (FSMP) for Islamic Banking..	114
3.5.2.	International Developments of Islamic Banking System ...	117
3.5.2.1.	Labuan as an International Offshore Financial Centre (IOFC)	117
3.5.2.2.	Formation of the International Islamic Financial Market (IIFM)	119
3.5.2.3.	Launching of the First Sovereign Global Islamic Sukuk	120
3.5.2.4.	Establishment of the Islamic Financial Service Board (IFSB)	121
3.5.2.5.	Licensing of Islamic Banks Subsidiaries and Foreign Islamic Banks	122
3.6.	Conclusion	123

CHAPTER 4 : LEGAL AND REGULATORY FRAMEWORK OF ISLAMIC BANKING SYSTEM

	125	
4.1	Introduction	125
4.2	Introduction and Application of English Law in Malaysia	127
4.2.1	Application of English Commercial Law	130
4.3	The Position of Islam and Islamic Law in the Federal Constitution	133
4.4	The Laws and Regulations Governing Islamic Banking and	

Finance	137
4.4.1 Islamic Banking Act 1983	138
4.4.1.1 Salient Features of Islamic Banking Act of 1983..	140
4.4.2 The Government Investment Act 1983.....	150
4.4.3 Banking and Financial Institution Act 1989 (BAFIA)	152
4.4.4 Guidelines for Islamic Banking Operations	157
4.4.5 Development Financial Institution Act 2002.....	157
4.4.6 Central Bank of Malaysia Act (Amendment) 2003	159
4.4.7 Islamic Bank Act (Amendment) 2003 (Act A1214)	163
4.4.8 Bank and Financial Institutions Act (Amendment) 2003 (Act A1211)	163
4.5 Statutes Which are Relevant to Islamic Banking and Finance ...	164
4.5.1 Companies Act 1965	165
4.5.2 Contract Act 1950	166
4.5.3 National Land Code 1965	168
4.5.4 Sales of Goods Act 1957	172
4.5.5 Hire Purchase Act 1967	174
4.6 Statutes Relating to Tax Implications	176
4.6.1 Income Tax Act	176
4.6.2 Stamp Act 1949 (Act 378)	178
4.6.3 Real Property Gains Tax Act 1976 (Act 169)	180
4.7 Rules of the Court..	182
4.8 Jurisdiction of Courts over Islamic Banking Disputes	184
4.9 Conclusion	192

CHAPTER 5 : *SHARĪ'AH* FRAMEWORK OF ISLAMIC BANKING SYSTEM

5.1 Introduction	194
5.2 <i>Shari'ah</i> Basis of Commercial and Financial Contracts	195
5.2.1 <i>Shari'ah</i> Principles in Contract and Commercial Transactions	196
5.2.2 Classifications of Contract (<i>Taqwīn al-Uqud</i>)	201
5.2.3 Reflections and Overview on the Classifications of Contract	203
5.3 Salient features of Commercial Transactions	204
5.4 Shariah Advisory Council (SAC)	209
5.4.1 Definitions and Establishment of the Shariah Advisory/ Supervisory Council	210
5.4.2 The Functions and Duties of the Shariah Advisory Council/Committee	218
5.4.3 Roles of <i>Shari'ah</i> Adviser in Product Development and Product Enhancement	223
5.5 Bank Negara Guidelines For Islamic Financial Institutions	228
5.5.1 Guidelines on New Product Approval Requirements for Islamic Banking Institutions.	228
5.5.2 Guidelines on the Governance of Shari'ah Committee for	

	The Islamic Financial Institutions	231
5.6	Conclusion	233
CHAPTER 6 : LEGAL AND <i>SHARI'AH</i> FRAMEWORK OF DEBT FINANCING PRODUCTS IN ISLAMIC BANKING SYSTEM		
		236
6.1	Introduction	236
6.2	The Concept of Debt/Credit in Islamic Law	237
6.3	Debt Financing Products as Practised in the Malaysian Islamic Banking System	241
6.3.1	<i>Murābahah</i> and Bay ^c bi Thaman Ājil (BBA)	241
	6.3.1.1 <i>Murābahah</i> and Bay ^f bi Thaman Ājil (BBA) Arrangements	249
	6.3.1.2 Issues of Debt Discounting on Early Settlement (<i>Ḍā' wa Ta'ajjal</i>)	258
6.4	Personal Financing via Bay ^f al- <i>Īnah</i>	261
	6.4.1 <i>Al-Naqd</i> Financing and Refinancing	263
	6.4.2 Juristic Analysis of Bay ^f al- <i>Īnah</i>	264
6.5	<i>Murābahah</i> and Bay ^f al- <i>Dayn</i> in Trade Financing	269
	6.5.1 Juristic Analysis of Bay ^f al- <i>Dayn</i>	272
6.6	Contract of <i>al-Istiṣnā'</i>	279
	6.6.1 Current Practice of <i>Istiṣnā'</i>	282
6.7	Conclusion	284
CHAPTER 7 : PROPOSAL FOR ISLAMIC LEGAL FRAMEWORK OF ISLAMIC BANKING AND FINANCE IN MALAYSIA		
		287
7.1	Introduction	287
7.2	Regulatory and Procedural Law Compliance for Islamic Banking and Finance	288
7.3	Proposed Substantive Legal framework for Islamic Banking and Finance	294
7.4	Disputes Solution Mechanism	297
	7.4.1 Litigation	297
	7.4.2 Arbitration	304
7.5	Shariah Supervisory/Advisory Board	311
7.6	Harmonisation of <i>Shari'ah</i> Interpretation	319
7.7	Other Proposals	324
7.8	Conclusions	326
	SUMMARY AND CONCLUSIONS	330
	BIBLIOGRAPHY	335

CHAPTER ONE

INTRODUCTION

1.1 PRELIMINARY

Over the last few decades, Islamic resurgence in the Muslim world has led to a revival of Islām in both the personal and public life. Efforts have been made to reconstruct contemporary life in economics, politic, education, etc., in accordance with Islamic principles.¹ In the monetary and financial sphere, traditional Islamic commercial law has been modified and implemented in the modern banking and financial institutions.² This could be seen with the emergence of Islamic banks in the 1970s and 1980s which set the beginning of a new era in the banking and financial system in the Muslim world. At present, it is estimated that more than 200 Islamic Banks and Financial Institutions have been established in more than 45 countries all over the world.³

In this respect, Malaysia is considered one of the countries where the development of Islamic financial system have undergone rapid growth compared to other Muslim countries.⁴ The main factors that contribute to the successful growth of Islamic banking and finance in this country are the support from the government i.e both the Ministry of Finance and the Bank Negara Malaysia (The Central Bank

¹ Khurshid Ahmad (ed), *Studies in Islamic Economics* (Leicester: The Islamic Foundation, 1980), pp. xiii-xiv.

² Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (London: Graham and Trotman, 1995), p. 1.

³ Munawwar Iqbal *et. al.* (eds), *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk*, (Cheltenham U. K. : Edward Elgar, 2002), p. 1; Daphne Buckmaster (ed), *Islamic Banking An Overview*, (London: Institute of Islamic banking and Insurance, 1996), p. 17.

⁴ Fuad Omar *et. al.*, *Islamic Banking Theory, Practice and Challenge*, (Karachi: Oxford University Press, 1996), p. 84.

of Malaysia), the favourable economic environment⁵ and the creativity of financial engineering in designing new products.⁶

The establishment of Bank Islam Malaysia Berhad (BIMB) in 1983 paved the way for the implementation of Islamic banking and finance in a wider approach. This was because the Bank Negara of Malaysia had a long term objective namely, to allow a large number of institutions offering Islamic banking services. In line with this objective, in March 1993, Bank Negara Malaysia (BNM) introduced a scheme named *Skim Perbankan Tanpa Faedah* (Interest-Free Banking Scheme) or SPTF in short. Through this scheme, existing financial institutions under the Banking and Financial Institutions Act 1989 (BAFIA) were allowed to offer Islamic banking services and products.⁷ An important step to strengthen the development of Islamic banking system during the year 1999 was the setting-up of the second Islamic bank in Malaysia namely Bank Muamalat Malaysia Berhad (BMMB)⁸, which has been operating since October 1, 1999.⁹ The most recent significant developments were the issuance of three new Islamic bank licences under the IBA 1983 to Islamic financial institutions from the Middle East and the setting up of Islamic subsidiaries (IS) among domestic banking groups and foreign Islamic Banking Scheme (IBS) banks under the IBA in 2004.¹⁰

These developments have contributed to the rapid growth of the Islamic banking system. Total assets of the Islamic banking sector continued to increase strongly by RM14.1 billion to RM35.8 billion as at end of 1999. The share of

⁵ Nor Mohamed Yakcop, *Teori, Amalan dan Prospek Sistem Kewangan Islam di Malaysia*, (Kuala Lumpur: Utusan Publication and Distributors, 1996), p. vii.

⁶ Fuad Omar *et. al.*, *Islamic Banking Theory*, p. 84.

⁷ Bank Negara Malaysia, *Money and Banking in Malaysia*, 1994, p. 333.

⁸ Bank Negara Malaysia, *Annual Report 1999*, p. 157.

⁹ Bank Negara Malaysia, *Annual Report 2000*, p. 161.

¹⁰ Bank Negara Malaysia, *Annual Report 2004*, p. 158.

Islamic banking assets in the banking system in Malaysia rose from 3.4% to 5.4% in 1998.¹¹ Since the year 2000, the Islamic banking industry has been growing at an average rate of 19% per annum in terms of asset. By the end of 2004, total assets of the Islamic banking sector had increased to RM94.6 billion, accounting for 10.5% of the total assets in the banking system,¹² while for the year 2005 it amounted to RM111.8 billion.¹³

1.2 STATEMENT OF THE PROBLEM

Islamic banking in Malaysia is governed under the Islamic Banking Act (IBA) 1983, (Act 276) which is substantially modelled after the Banking Act 1973 (now repealed by the Banking and Finance Act 1989 (BAFIA)). It is an Act enacted merely for the setting up and licensing of Islamic banks in Malaysia¹⁴ and does not set any principle of Islamic law except for the definition of “Islamic banking business”¹⁵ where it states “Islamic banking business whose aims and operations do not involve any element which is not approved by the religion of Islām”.¹⁶ It might be noted that the definition is too general and the “banking business” itself is not defined.¹⁷ Therefore, in order to ensure that the activities of Islamic banks do not contravene

¹¹ Bank Negara Malaysia, *Annual Report 1999*, p. 155.

¹² Bank Negara Malaysia, *Annual Report 2004*, p. 158.

¹³ Bank Negara Malaysia, *Annual Report 2005*, p. 62.

¹⁴ Mohamed Ismail Mohamed Shariff, “Salient Features of Islamic Banking Act 1983 and Banking and Financial Institutions Act 1989”, paper presented at *Seminar on Shariah and Legal Aspects of Islamic Banking Practice*, Kuala Lumpur, 1996, p. 2.

¹⁵ Norhashimah Mohd Yasin, *Islamic Banking : Case and Commentaries Involving al-Bayʿ Bithaman Ajil*, [1997] 3 MLJ, p. cxci.

¹⁶ Section 2 of the IBA 1983.

¹⁷ Mohamed Ismail Mohamed Shariff, “*Salient Features*”, p. 3.

the requirement of the Islamic religion, those banks have to establish the *Shari'ah* Bodies/Committees to advise them on the operations of its banking business.¹⁸

Although the development of Islamic banking system in Malaysia has shown good achievements, the Malaysian government does not intend to make the overall financial system in this country operate solely on Islamic principles. This was clearly indicated by the former Bank Negara Malaysia Governor, Jaafar Hussein who believed that the government aimed to create a 'dual-system' financial architecture where Islamic financial system would run parallel to the conventional system.¹⁹ Abdul Halim Ismail, the first Managing Director of BIMB upheld the dual-system which he claimed to be more appropriate to multi-religious and multi-racial Malaysia.²⁰

Having said this, the Government does not pay equal attention to the legal framework of Islamic banking. Since Islamic law is only applicable to a very limited field namely family law and religious offence, the law relating to commerce and banking is sought either from the statute or the English Common law.²¹ Consequently, cases involving Islamic banking must be heard in the civil courts and indeed, there have been a few cases that were already heard in the Civil Court.²²

¹⁸ Section 3(5)(b) of the IBA 1983.

¹⁹ Jaafar Hussein, "Islamic Financial System in the 1990's", a public lecture delivered at the Public Lecture Series, University Sains Malaysia, 9 March, 1990, in *Malaysian Law News*, (June 1990), pp. 346-355; See also in Aidit Ghazali, *Development : An Islamic Perspective*, (Petaling Jaya: Pelanduk Publications), p. 136.

²⁰ See an interview with Abdul Halim Ismail "Should the Whole Banking System be Islamised?" in *The Muslim Reader*, (Singapore, 1989), pp. 19-20.

²¹ Norhashimah Mohd Yasin, *Islamisation/Malaynisation : A Study on the Role of Islamic Law in the Economic Development of Malaysia : 1969-1993*, (Kuala Lumpur: A.S.Nordeen, 1996), p. 283.

²² See Mohd Illiayas, "Islamic/Interest-Free Banking in Malaysia: Some Legal Considerations," [1995] 3 *MLJ*, p. clii, There are only four reported court cases involving BIMB up to the present time. These are (1) *Dato Nik Mahmud Bin Daud v. Bank Islam Malaysia Berhad* [1996] 4 *MLJ* 295 ; [1996] 1 *CLJ* 576, (2) *Bank Islam Malaysia Berhad v. Adnan Bin Omar* [1994] 3 *CLJ* 735 ; [1994] 3 *AMR* 44; (3) *Bank Islam Malaysia Berhad v. Tinta Press Sdn. Bhd* [1986] *MLJ* 256 ; [1987] 1 *CLJ* 474; (4) *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd* [2003] 1 *CLJ* 625 (CA) and (5) *Affin Bank Berhad v Zulkifli Abdullah* [2006] 1 *CLJ* 438.

Problem arises when there is conflict between Islamic law and civil law. In such situation, which law must be applied? Similarly if a particular document used in Islamic banking transactions has been approved by its Shariah Committee, can it then be challenged in the Court as being contrary to *Sharī'ah*? And are decisions of the Shariah Advisory Council of BNM open to review by the Courts? ²³

As an illustration, in the case of *Dato' Haji Nik Mahmud bin Daud v. Bank Islam Malaysia Berhad*²⁴ the Kota Bharu High Court rejected the plaintiff's claim that the land sale transaction which had been made with BIMB was invalid. This was because the plaintiff had never changed his land ownership rights to Bank Islam Malaysia Berhad even though the bank had already purchased the land from the plaintiff through a Property Purchase Agreement. The court was of the opinion that the ownership had never changed hands but what had been transferred were only the rights or interests on that land. In connection to this, the defendant's action, that was, BIMB buying the Kelantan Malay reserve land, was not contradictory to Section 7 (I) of the Kelantan Malay Reserve Enactment.

The question that can be raised here is that the verdict could be understood to be against the meaning and legal consequence in the *bay' bithaman ājil* contract whereby the transfer of ownership is a clear effect from that contract.²⁵ This contradiction also indicates that the practices of Islamic banking system are contradictory to its very theory and principle. It should be noted that, the Islamic banking system is different from the conventional banking system not only in terms of terminology, concept and method of implementation but most importantly, the

²³ Kamalanathan Ratnam, "The Judicial Process Involving Cases on Islamic Banking and Finance," paper presented in *Muzakarah Perbankan dan Kewangan Islam*, (Kuala Lumpur: Putra World Trade Centre, 1997), p. 7.

²⁴ [1996] 4 MLJ 295, [1996] 1 CLJ 576.

legal effects (*āthār al-ʿuqūd*) that is determined by Islamic law through any contract that underlies any transaction.

Despite the presence of an Islamic banking system that operates according to *Shari'ah* principles, it actually exists in a capitalist economic environment where interest persists and they exist side by side with interest-based banks. Consequently, the profit rate imposed by Islamic banks is indirectly influenced by the Base Lending Rate (BLR) stipulated by the Bank Negara.²⁶ The mark-up charged by the Islamic banks are about the same as the rates of interest, if not more. This is because the calculation used in mark-up sale is very much similar to the format used in interest-based banks.²⁷ This has resulted in the Islamic banks being seen as 'un-Islamic'.

Likewise, from the aspect of the use of funds, the Islamic banking sector has utilised mainly in the financing modes with zero or low risk of loss which provide a stable and fixed profit²⁸, such as *murābahah*, *bay' bithaman ājil* and *ijārah*, compared to other modes of financing in the shape of profit sharing such as *muḍārabah* and *mushārahah*. For instance, as at end of 2002, *bay' bithaman ājil* or deferred payment sale remained as the most popular mode of Islamic financing in Malaysia with a share of 49.1% of total financing, followed by *ijārah* at 23.3%,²⁹ and by the end of 2004 it had risen to 49.9% followed by *ijārah*, 24% respectively.³⁰ However, for the

²⁵ Mohd Daud Bakar, "Kedinamikan Shari'ah Dalam Memenuhi Tuntutan Muamalah Perbankan Modern", in *Jurnal Syariah*, (1998), Jil. 6, p. 14.

²⁶ Mohd. Ali Baharum, "Cabaran Terhadap Perbankan Islam Dalam Suasana Sistem Perundangan dan Ekonomi Konvensional," paper presented in *Muzakarah Perbankan dan Kewangan Islam*, Kuala Lumpur: Putra World Trade Centre, 1997, pp. 6-7.

²⁷ Zakaria Man, "Islamic Banking: The Malaysian Experience", in Mohamed Ariff (ed), *Islamic Banking in Southeast Asia*, (Singapore: Institutes of Southeast Asian Studies, 1988), p. 91.

²⁸ Frank E. Vogel & Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk, and Return*, (The Hague: Kluwer Law International, 1998), p. 7.

²⁹ Bank Negara Malaysia, *Annual Report 2002*, p. 174.

³⁰ Bank Negara Malaysia, *Annual Report 2004*, p. 168.

year 2005, financing based on *bay' bithaman ājil* decreased to 40.7%. In contrast, financing based on *ijārah* increased to 31.6% of the total financing (2004:24%) following the increase of RM5.8 billion in car financing using *ijārah* principles.³¹

However, for some reasons some Muslim economists oppose the excessive reliance on what they call as the “second-line techniques” of operation, that are *murābahah* and *bay' bithaman ājil*. They argue that *bay' bithaman ājil* and *murābahah* sales may deteriorate into purely financing arrangements with the agreed mark-up and profit-margin being no more than a camouflage for interest.³² Moreover, according to some Muslim economists, these modes of financing which entail fixed profit margin represent “back door *ribā*”. For example, the report of the Council of Islamic Ideology (Pakistan) on the elimination of interest, has expressed the following words:

However, although this mode of financing is understood to be permissible under the *Sharī'ah*, it would be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest.³³

Therefore, a change from an interest-based system to a mark-up based system might be deemed as merely a change of nomenclature, leaving the substance intact.

Furthermore, it has been clearly shown that in financing via *murābahah* and *bay' bithaman ājil* with the higher credit price involved therein, there is a value of time in both finance instruments which leads albeit indirectly to the acceptance of the time value of money. According to some Muslim economics scholars, accepting

³¹ Bank Negara Malaysia, *Annual Report 2005*, p. 63.

³² Muhammad Umer Chapra, *Towards a Just Monetary System*, (Leicester: The Islamic Foundation, 1985), p. 171.

³³ See Ziauddin Ahmad, “Islamic Banking at the Crossroad”, in *Development and Finance in Islam*, edited by Abul Hasan Muhammad Sadeq, *et. al.*, (Petaling Jaya: International Islamic University Press, 1991), p. 161.