

Laws Governing Islamic Banks and Financial Institutions in Malaysia: An Overview

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Abstract: Section 2 of the Islamic banking Act 1983 defines "Islamic Bank" as "any company which carries on Islamic banking business and holds a valid licence and "Islamic banking business" as "banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam". However, the term "banking business" itself is not defined and the Islamic Banking Act 1983 does not stipulate how that term is to be understood in the context of Islamic banking. The definition of "Islamic banking business" in the Act also appears to be confusing. The expression "any element which is not approved by the Religion of Islam" is blurred. Is the phrase of the "Religion of Islam" similar to the word *Syariah*? *Syariah* could carry a wider concept of the practice of Islam and it is quite misleading to equate the religion of Islam with the word *Syariah*. This paper seeks to highlight some legal problems and issues of Islamic banking innovations and transactions in Malaysia and offers some flexible proposals to overcome them. This paper compares laws governing Banks and Financial Institutions and their Operation in Malaysia and the U.A.E.

Key words: Islamic Banking · Law · Malaysia

INTRODUCTION

The main legislation that governs the Islamic Banking transaction in Malaysia is the Islamic Banking Act 1983.

It is unique piece of legislation which provides for the setting up and licensing of "Islamic banks". The Act came into force on 19 March 1983 and applies through out Malaysia.

Dispute Resolution in Islamic Banking Cases: The dispute resolution in Islamic Banking cases comes within the jurisdiction of civil courts which was modelled on the English system and not under the *Syariah* (Islamic) court system. This means that such dispute resolution in Islamic banking cases apply the civil court procedures. Thus, the issue of conflicts between the civil laws and Islamic law might arise.

The Definition of "Islamic Bank" and "Islamic Banking Business":

Section 2 of the Islamic banking Act 1983 defines "Islamic Bank" as "any company which carries on Islamic banking business and holds a valid licence and "Islamic banking business" as "banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam". However, the term "banking business" itself is not defined and the Islamic Banking Act 1983 [1] does not stipulate how that term is to be understood in the context of Islamic banking. The definition of "Islamic banking business" in the Act also appears to be confusing. The expression "any element which is not approved by the Religion of Islam" is blurred. Is the phrase of the "Religion of Islam" similar to the word *Syariah*? *Syariah* could carry a wider concept of the practice of Islam and it is quite misleading to equate the religion of Islam with the word *Syariah*.

Procedures in Civil Courts of Malaysia Rules of the Court: There are two important Rules on procedures of Civil Courts in Malaysia as far as Islamic Banking transactions are concerned namely; The Rules of the High Court 1980 and the

Subordinate Courts Rules 1980 [2]. These two Rules however, were before Islamic banking was introduced into Malaysia and, naturally, the peculiarities of claims made and actions filed under Islamic financing were not taken into account.

English Law vs Syariah Law for Islamic Banking?:

Another danger zone may be considered can be seen from two perspectives as follows: First ; is the uncertainty in the law a lack of specification as to the law applicable to resolve Islamic banking disputes. The *Syariah* imposes certain requirements for a contract to be valid under it. But these requirements may not all be the same under all the schools of jurisprudence of Islam. So it is possible for a contract to be valid under the tenets of one madhab of the *Syariah* and not under another madhab. If the civil court has to determine the validity of such a contract, how should the court if the validity of such a contract falls to be determined by a civil court, how should the court decide it? What sources would a judge deciding the case refer? If there is a conflict between Islamic law and the civil laws applicable to the matter, which one should prevail? Second; since there is no Islamic Contracts Act is enacted, the Contract Acts 1950 which based on English law should be made applicable as long as it does not contravene the principles of *Syariah* but to what extent? One might also argue that sections 3 and 5 of the Civil Law Act 1956 allow the application of English law to fill the gaps in existing laws in Malaysia; this include Islamic banking. Moreover, since there are many identical provisions in Malaysian Contracts Act 1950 which are *pari materia* with provisions of Indian Contract Act 1872 (since there is no difference between the law of undue influence in Indian Contract Act 1872 and English law, the proposal to adopt English law and principles to reform this area should not be a problem) [2]. It is also not inconsistent with the provisions in Civil Law Act 1956 to apply English law on issues pertaining to undue influence in Malaysia [3]. The Civil Law Act 1956, for instance through sections 3 and 5 permit the application of English law in Malaysia. Historically, it is through the first Charter of Justice 18071 that English law was first imported into the colony. The Second Charter of Justice 1826 introduced into the Straits Settlements, which then comprised the states of Penang, Malacca and Singapore [4], the law of England as it stood in 1826, including all

English statutes of general application. However, it was officially introduced into these states so far as the several religions, manners and customs of the inhabitants will admit.

Singapore has the Application of English Law Act (Cap 7A), in particular, ss 4(1), 5(1), 6(1) for the limitation of application of English law in Singapore. Section 4(1) provides, inter alia, that certain English enactments to the extent as specified in the first schedule to the Act shall with the necessary modifications apply in Singapore. Section 5(1) states that no English enactment shall be part of the law of Singapore except as provided in the Act. All these sections are discussed in the case of *Re Will in Loke Soh Lui (decd)* , 1997 SLR Lexis 253 at 18 and 34; also available in 1999 3 SLR 370. 4 *The Sultan of Johore v Tunku Abu Bakar and Ors* 1949 MLJ Lexis 90; *Mong Binte Haji Abdullah v Daing Mokka Bin Daing Palamai* 1935 MLJ Lexis 48 1935; *Khalik v Thai Craft Ltd* 1965 MLJ Lexis 20. Johore was the last part of the Malay States to receive English law. See case of *Re Dato' Bentara luar, Deceased; Haji Yahya Bin Yusof and Anor v Hassan Bin Othman and Anor* Federal Court Civil Appeal 1982 MLJ Lexis 418.

Similarly, the Law of Sarawak Ordinance 1928 introduced the English law into Sarawak and the Civil Law Ordinance 1938 provided for the reception of English law in Sabah. Section 3 (1)(a) of the Civil Law Act 1956 provides that the Court shall: 'in West Malaysia or any part thereof, apply the common law of England and the rules of Equity as administered in England on 7 April 1956'. Section 3(1)(b) of the same Act continues: "in Sabah, apply the common law of England and rules of equity, together with statutes of general application, as administered or in force in England on 1st day of December 1951" Section 3(1)(c) further states: "in Sarawak, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on 12th day of December 1949..." The above dates are important because the English common law and rules of equity as administered in England only on that date are applicable in West Malaysia (7 April 1956), Sabah (1 December 1951) and Sarawak (12 December 1949). Is it interesting to note that the pattern of this historical background has instigated numerous cases dealing with the extent of the application of English law in Malaysia. Hence, it is arguable that section 3 in its proviso restricts the application of English common law and rules of equity in Malaysia. This is especially true as s 3 of the Civil Law Act 1956 concerning the application of the common law of England and rules of equity provided that the said

'common law and rules of equity shall be applied so far only as the circumstances of the states and settlements and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary', if there was a lacuna in the law and if there was no other written law in force [5].

However, a closer look at the provision reveals that the application of English law is permitted in this country, especially when there is a lacuna in the law or if there is no other written law in force [6]. Furthermore, in the recent case of *PL Narayanan and Anor v PL Subramaniam and Ors*, it was stated that 'A court shall administer the common law of England and the rules of equity so far only as Malaysian circumstances and Malaysians permit.' Section 5 of the same Act further provides for the application of English law in commercial matters:

The Section Reads: (1) In all questions or issues which arise or which have to be decided in the States of West Malaysia other than Malacca and Penang with respect to the law of partnerships, corporations, banks and banking, principals and agents, carriers by air, land and sea, marine insurance, average, life and fire insurance and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in the like case at the date of the coming into force of this Act, if such question or issue has arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law. (2) In all questions or issues which arise or which have to be decided in the States of Malacca, Penang, Sabah and Sarawak with respect to the law concerning any of the matters referred to in subsection (1), the law to be administered shall be the same as would be administered in England, in the like case at the corresponding period, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law. Section 5(1) above introduces into the states of West Malaysia other than Malacca and Penang (namely Pahang, Selangor, Kelantan, Terengganu, Kedah, Perak, Johore, Negeri Sembilan and Perlis) the principles of English commercial law as it stood on 7 April 1956 in the absence of local legislation. In contrast, section 5(2) above which applies to the states of Penang, Malacca, Sabah and Sarawak, introduces English commercial law at the date on which the matter has to be decided. Thus, there exist certain differences in applying English commercial law between the first group of Malay states and Penang, Malacca, Sabah and Sarawak. In the latter group of states there is a continuing reception of English commercial law in the absence of local legislation.

It is thus clear that under the Civil Law Act 1956, in West Malaysia, the common law of England and the rules of equity and certain statutes as administered in England on 7 April 1956, Sabah (1 December 1951) and Sarawak (12 December 1949) shall be applied so far only as the circumstances of the States of Malaya and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary. Generally, in *Polygram Records Sdn Bhd v The Search and Anor*, it was stated that there are number of identical provisions in the Contracts Acts that are in pari materia with the provisions in the Indian Contract Act 1872. *PL Narayanan and Anor v PL Subramaniam and Ors* 1996 MLJ Lexis 1290 at 15.

The division of states was due to historical reasons. See also Sinnadurai, Visu, *Law Of Contract*, (Lexis Nexis Butterworths: 2003) at 1.02-1.07. 12 1994 MLJ Lexis 396.

Gopal Sri Ram JCA in the local Court of Appeal's decision in *Jurutera Consultant (SEA) Sdn Bhd and Ors v Eddie Lee Kim Tak and Ors*,¹³ stressed the Indian Contract Act 1872 on which Malaysian Contracts Act of 1950 is based. Since Malaysian Contract Act 1950 is a replica¹⁴ of the Indian Contract Act 1872, the Indian authority, though not binding in Malaysia, would have been useful; how the Indian courts deal with certain similar issues should have been investigated. For instance, the case of *Lec Contractors (M) Sdn Bhd (formerly known as Lotteworld Engineering and Construction Sdn Bhd) v Castle Inn Sdn Bhd and Anor* Court of Appeal (Kuala Lumpur) referred to several Indian cases to see the approach of Indian courts to similar problems. Cases referred to were *United Commercial Bank v Bank of India*; *Damatar Paints (P) Ltd v Indian Oil Corp*, *Pesticides India v State Chemicals and Pharmaceuticals Corp of India* (1982) AIR 78 on issues of performance bond.

Gopal Sri Ram JCA in the above *Jurutera Consultant (SEA) Sdn Bhd and Ors v Eddie Lee Kim Tak and Ors* referred to large numbers of Indian cases such as *Anant Das v Ashburner and Co Protap Chunder Dass v Arathoon*, *Rameshwardas v New Jooria Bazar Sugar Co* and *Kedarnath v Sitaram* and including the case of *Moonshee Amir Ali v Maharanee Inderjeet Singh* which was decided by the Judicial Committee of the Privy Council before the coming into force of the Indian Contract Act 1872 on the issue of contractual agreement. More specifically, Edgar Joseph Jr J (as he then was) in the Malaysian case of *Saw Gaik Beow v Cheong Yew Weng and Ors*³⁸ had this to say: 'In *Poosathurai v Kannappa Chettiar and Ors* (1911) LR 47 IA 1 (1920) AIR

65, Lord Shaw . . . indicated that there was no difference on the subject of undue influence between the Indian Contract Act 1872 and the English law. Accordingly, the general principles of equity as illustrated by the English authorities would afford considerable assistance in resolving problems concerning undue influence in our courts.' It is therefore arguable that Civil Law Act 1956 through its sections 3 and 5 appears to be wide enough to cover areas which the existing local legislation has failed to address. To hold that view would not be in consistent with Malaysian current judicial approach. This was clearly set out in the case of *Hong Leong Equipment Sdn. Bhd. v. Liew Fook Chuan* which offers a caution when adopting the views of foreign courts and thus, by analogy, foreign legislation.

In this Case, Gopal Sri Ram Jca at Page 531 Said:

'However eminent an English or an Australian judge may be, it is not to be forgotten that the views he expresses are coloured by the needs of the society of which he is a member [7]. It is on the other hand, have to address the needs of a society quite differently structured, with different aspirations based on an entirely different set of values. Our courts should therefore adopt an approach that is best suited to our own needs and values paying such respect as is due to the approach adopted by the courts of countries whose values upon particular subjects may be at variance with our own.' This denotes that Malaysia should adopt an approach that is best suited to the local needs and values, although it does not prohibit the application of English law in Malaysia [8]. What Gopal Sri Ram JCA actually stressed was the limit and extent of its application in Malaysia. It is more appropriate to state that he merely suggested that it should be the right of Malaysian courts to modify the English principles to suit local needs. The Court of Appeal's case of *Tengku Abdullah ibni Sultan Abu Bakar and Ors v Mohd Latiff bin Shah Mohd and Ors and other appeals* supports this viewpoint. Gopal Sri Ram JCA welcomes the right to modify principles of the common law and doctrines of equity that have their historical origins in England, to suit domestic needs of another jurisdiction, as being recognised by the judicial committee of the Privy Council in *Invercargill City Council v Hamlin* , an appeal from New Zealand. Lord Lloyd of Berwick, when delivering the advice of the board, said: "But in the present case the judges in the New Zealand Court of Appeal were consciously departing from English case law on the ground that conditions in New Zealand are different.

Were they entitled to do so? The answer must surely be yes. The ability of the common law to adapt itself to the differing circumstances of the countries in which it has taken root, is not a weakness, but one of its great strengths. Were it not so, the common law would not have flourished as it has, with all the common law countries learning from each other." It is on this basis that Gopal Sri Ram JCA when discussing whether Unfair Contract Terms Act (UCTA) in the case of *Standard Chartered Bank v Boomland Development Sdn Bhd and Ors* should be applied, had clearly observed that: "Now, the UCTA was enacted by the British Parliament in 1977. It is fair, I think, to say that it was done so in response to the need of that country. Meanwhile, the Civil Law Act 1956, which is being projected as the vehicle to bring in UCTA, has been in existence even before our independence. It is now 1997. Over the years we have been formulating our own laws to suit the needs of our society. That includes the Act which also deals with the law on surety. Surely, the Legislature, in its wisdom, would have responded to the need of our society, if there was any, by including provisions similar to those in UCTA, into the Act. The fact that it did not should be a clear indication that the Act in its present form is sufficient for our present needs without having to resort to UCTA. " He continued: 'To adopt UCTA in some States (as Section 5 (2) of the Civil Law Act 1956 sets the limitation) while excluding the others, would surely create an undue disparity and inequality in such law amongst the States of this country. That would not be conducive to business activities. For that would mean that in some States a different standard or approach is expected when setting down the terms of a contract. This problem might not arise if Section 5 (2) applies to the whole country.'

The Shariah Advisory Council under S. 124: The role and fuction of Shariah Advisory Councils should be made clearer. More experts from other than legal background should be included. An expert should not only possess Islamic jurisprudence knowledge but must also posses some comparative knowledge on conventional banking law. This is relevant since Islamic Banking Act 1983 originates from English law [9]. What would be the position if the advice of Syariah Advisory Council on the same issue differ? How would a court be expect ed to resolve such differences in opinion if a matter in respect of which there are differences between these bodies reaches the civil court?

UAE Legislations: The United Arab Emirates Central bank was formed in 1980 and replaced the Currency Board which was set up in 1973. The establishment of the Central Bank was to bring about control and discipline to the banking sector in the U.A.E. and to provide greater control of national and foreign banks operating within the State in addition to regulating various financial institutions [10].

Laws Governing Banks and Financial Institutions and Their Operation in the U.A.E. : The most relevant laws, decrees, resolutions and decisions in the field of banking, finance and related areas in the U.A.E. are the following: [11-15]

- Federal Law No. 10 of 1980 concerning the Central Bank, The Monetary System and Organization of Banking.
- Federal Law No. 8 of 1984 concerning Commercial Companies.
- Federal Law No. 6 of 1985 concerning Islamic Banks and Financial Institutions.
- Federal Law No. 5 of the 1985 concerning Civil Transactions.
- Federal Law No. 18 of 1993 concerning Commercial Transactions.
- Central Bank Resolution No.123/7/92 regarding Regulation of Money Changing Business in the U.A.E
- Central Bank Resolution No.164/8/94 regarding Regulation Financial Investment Companies and Banks, Financial and Investment Consultancy Institutions and Companies.
- Central Bank Resolution No.126/5/95 regarding Financial and Monetary Brokers.
- Central Bank Resolution No.57/3/96 regarding Representative Offices.
- Central Bank Resolution No.58/3/96 regarding Finance Companies.
- Central Bank Regulation No. 24 for the Year 2000 concerning Procedures for Anti-money Laundering

Article 2 of the Law No. 6 of 1985 provides that such institutions are subject to the provisions of the 1980 Law in addition to Law No. 8 of 1984 relating to Commercial Companies.

Such banks and institutions are required to adopt the form of a public joint-stock company and must, prior to commencing their operations, obtain a licence from the Central Bank.

An Islamic Bank is entitled to commence all or any banking, commercial, financial or investment operations. In addition, it is also entitled to carry out any of the services and/or operations referred to in the 1980 Law. It may also establish companies or finance projects provided that such projects are undertaken pursuant to Shari'a principles.

An Islamic Financial or Investment Company is entitled to grant loans, provide credit facilities or finance projects. It may also invest in movable property in addition to its ability to accept deposits from the public to invest such monies in accordance with Islamic Shari'a principles.

Such Islamic Banks and financial institutions (including licensed branches and offices of foreign Islamic banks and financial institutions and investment companies) are exempt by virtue of Article 4 of Law No. 6 of 1985, from certain of the prohibitions imposed on commercial banks relating to:

- Carrying on for its own account commercial or industrial activities or acquire, own or trade and goods
- Acquire immovable property for its own account;

Since Islam is the religion of the United Arab Emirates as stated in the UAE Constitution, the UAE is ideally placed to play a leading role in Islamic finance. In addition, implementing Islamic financial mechanisms are well suited to the legal system as it is always better to be an owner rather than a security holder in any transaction.

Further, the UAE Civil Code has a very strong Shari'a foundation which supports the proper regulation of Islamic financial mechanisms. Finally, the judges in the UAE come from an Islamic background familiar with Islamic concepts and contracts. This fact will eventually lead to the speedy conclusion of matters as cases will not be required to be referred to experts as frequently as in the past. Accordingly, judgments will become more predictable leading to more certainty in Islamic banking transactions. (Al-tamimi Advocates and Legal Consultants, <http://www.scribd.com/doc/30210772/Islamic-Finance-a-UAE-Legal-Perspective>)

CONCLUSION

The following must be taken into considerations: a) The law applicable to Islamic banking has to be made certain. b) Guidelines on the law applicable should be made clear. c) Islamic law shall prevail where there is a

conflict between Islamic law and the civil laws in relation to Islamic banking transactions. d) Islamic Banking Act and the Banking and Financial Institutions Act 1989 shall be amended to clarify the position of Islamic law in Islamic banking transactions. e) There shall be amendments to the existing laws such as the Contracts Act 1950, the National Land Code 1965, the Stamp Act 1949, the Companies Act 1965, the Malay Reservations Enactment of the various States of Malaysia, The Rules of the High Court 1980 and the Subordinate Courts Rules 1980 and others. f) The provisions in Islamic banking Act shall be amended ("Islamic financial business" means any financial business, the aims and operations of which do not involve any element which is not approved by the Religion of Islam.").

It is observed that since this section empowers conventional financial institutions to carry on Islamic banking business to the same extent as an Islamic bank, removing in the process the prohibition against the carrying on of Islamic banking business by any person not in possession of a license under the IBA.6 Indeed, the latter can do more since s. 124 (1) also authorises them to do Islamic financial business, although considering the definition of the latter term (which is identical to that of Islamic banking business), it is difficult to see what would come with in that term that is also not within the term Islamic banking business.

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