

HARMONISATION OF SHARIAH AND COMMON LAW IN THE IMPLEMENTATION OF ISLAMIC BANKING IN MALAYSIA

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The growth and development of Islamic banking industry is undeniably adhering much by having a comprehensive legal and syariah framework. In Malaysia, Islamic banks have not only a duty to meet the syariah compliance and also to comply with other statutory laws which are mainly based on common law. For that purpose, a few approaches have been implemented and it includes revision of the existing laws and introducing new statutory legislation to regulate the establishment and operation of Islamic banks. These approaches are actually being implemented by integrating the syariah and common law principles which are applicable in Malaysia. This paper will present a general overview of both legal systems and its applicability in the implementation of Islamic banking. It is submitted that both the syariah and common law traditions make valuable contributions towards the development of Islamic banking particularly in Malaysia.

Keywords: Shariah, common law and harmonization.

1.0 Introduction.

Malaysia has a very unique legislative framework consisting of mixed jurisdictions and mixed legal systems namely the common law and the syariah. The common law principles were applied in the civil court in almost matter of jurisdiction. Islamic law in contrast is practiced in the syariah court and only pertaining to the family matters and law of inheritance. Federal Constitution put Islamic banking matter under the jurisdiction of the civil court¹.

It could not be denied that Malaysia has achieved a tremendous growth in developing Islamic banking industry locally as well as internationally. This achievement adheres much on the comprehensive approach of the authorities as well as Islamic banking players especially to its legal aspects.

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¹ Schedule 9 List 1 of the Federal Constitution.

The growth and development of Islamic banking industry are supported through goods governance and its comprehensive legal frameworks. As Malaysia is one of the common law countries, it is very essential to have standard law of practice, which harmonizes both the shariah and civil law. The integration of these two traditions is really necessary in the context of Islamic banking in Malaysia.

In tackling this topic, the preceding discussion will be divided into four parts. Part 1 refers to the introduction and brief historical background of the Islamic banking in Malaysia. Part 2 elaborates Malaysia's approach in harmonizing the shariah and common law. Part 4 concludes the discussion. This paper suggests that certain shariah and common law principles could be integrated and hence makes valuable contributions to the Islamic banking growth in Malaysia provided that the two traditions are duly respected and kept in equilibrium.

2.0 Harmonization.

Briefly, common law is originated from England. It is a system that based on precedent derived from judgments by judges. In contrast, shariah refers to rules of law originating from *al-Quran*, as well as practices and explanations rendered by the prophet Muhammad *Sallallahu Alaihi Wasallam*, *Ijma*, *Qiyas* and *ijtihad* of *fuqaha*'. Shariah governs many aspects of day-to-day life, including politics, economics, banking, business law, contract law, and social issues. Due to the diversity of both legal systems, the issue arises whether harmonisation of the shariah and common law is feasible and acceptable or not?

Harmonisation in arabic term known as *tawfiq* which means to bring one thing (two or more different types of ideas) into harmony or agreement with another². Malaysia, a country within Islamic law and the common law traditions, the term harmonization of laws refers to the integration between Islamic and common laws. It is interesting to note that the issue of harmonization arose since the negotiation leading to the formation of

² Muhammad Amanullah, *Principles to be followed in partial harmonization between Islamic fiqh and Man Made law*. 29-30th June 2005, IIUM p 5.

Malaysia in 1963. With different historical, racial and cultural background the process of harmonization was carried out through modification of the existing laws³.

Harmonisation of the shariah and common law in the context of Islamic banking matters does not mean to combine these two systems without taking into consideration the shariah principles. Process of harmonization here refers to the implementation of common law principles which are not contrary to the Islamic law. It means the existing laws such as common law principles in the law of contract that in line with the shariah principles could be integrated to strengthen further the legal infrastructure on Islamic banking.

The process of integration depends on the appropriateness of the shariah and common law principles. In term of Islamic banking business, the Islamic banking Act 1983 and Section 124 of the Banking and Financial Institutions Act 1989 do not provide a clear framework. Generally, the Islamic financial institution may involve any type of businesses. The shariah principles such as *Uqud Tamlikāt* (contract of ownership), *Uqud Ishtirāk* (contract of partnership), *Uqud Tawthiqāt* (contract of guarantee), *Uqud Itlāqāt* (general contract), *Uqud Taqyidāt* (contract of restriction), *Uqud Isqātāt* (contract of waiver) and *Uqud Hifz* (contract of deposit) may be offered to the market⁴.

In addition, common law provides a clear provision stipulated in the Contracts Act 1950, the Sale of Goods Act 1957, the Companies Act 1965, and the Hire Purchase Act 1967 and so relevant procedural laws. Here, Islamic banking players must comply with the shariah principles and also follow all of these laws. As an illustration, we may refer to the application of housing scheme under the products of *Bai' Bithaman Ajil*. The shariah principles require the parties to provide options and to fulfil the pillars of contract. The right of options such as *khiyar majlis* and *khiyar aib* must be given to customer. In the

³ Abdul Aziz Bari. Harmonization of Laws: A Survey of the Issues, Approaches and Methodology Involved. 29-30th June 2005, IIUM p 21.

⁴ Wahbah al-Zuhayli. 2002. *Fiqh al-Islami Wa Adillatuhu*. Vol IV. Kuala Lumpur: Dewan Bahasa dan Pustaka. p 246-247. See also Abd al-Nasir Musa Abu al-Basl. 1999. *Al-Qanun al-Madani al-Urduni al-Nazriah al-A'mah Lil Aqd*. Jordan: Dar al-Nafais. p 41.

meantime Islamic financial institution must comply with the common law principles embedded in the Contracts Act 1950.

It should be noted that the harmonization approach in the implementation of Islamic banking could not be simply apply without adhering to certain Islamic principles. In this aspect, harmonization could not be invoked to the things that forbidden in Islam, ethical aspects should not be compromised, rulings stipulated in *al-Quran* and *al-Sunnah* should not be altered, no harmonization should be allowed to make forbidden things as permissible and vice versa and no universal Islamic principles adhering to justice equality in transaction be violated⁵. In carrying this harmonization process also, the principles of objectives of shariah or *maqasid shariah*, public interest or *maslahah*, blocking the means to evil or *sadd al-dhariah* and other principles may be applied.

2.1 Reasons for Harmonization.

Harmonisation is more of a process rather than a goal⁶. The main purpose of harmonization is to develop harmony between the shariah and common law. It is not a process of harmonizing these two legal systems in toto but only harmonizing certain reasonable differentials in selected area of the shariah and common law.

The need of harmonization is really necessary in the case of Islamic banking especially when there is disputes between two or more parties that being brought to the court. The disputes will be heard in the civil court due to Schedule Nine, List 1 of the Federal Constitution. Since Islamic finance takes its place alongside conventional finance, there are a lot of procedural laws and substantive legislation based on common law principles related with the Islamic banking. A number of these existing laws which are necessary for the Islamic banking are in line with the shariah principles. The procedure to implement Islamic banking was ready made in the legislation and we do not need to enact new laws. In fact, there was a study

⁵ Supra note 1 p 12.

⁶ Muhammad Hashim Kamali, *Harmonisation of the Shariah and Civil Law: Proposing a New Scheme for al-Usul FIqh*, A conference paper in international Conference of *Shariah and Civil law* 2. 29-30th June 2005, IIUM. p 244.

performed by Pakistani scholars revealed that only a small portion of Pakistani civil law (which is quite similar with Malaysian law) is considered to be unIslamic⁷.

2.2 The Process of Harmonization.

Generally, the process of harmonization of the shariah and common law in Malaysia relating with Islamic banking matters involves several approaches. It can be summarized as follows:-

- a) Dual Banking system and Moderate approach
 - b) Federal List;
 - c) Introducing of the Islamic Banking Act 1983 and Section 124 of the Banking and Financial Institutions Act 1989;
 - d) Amendment and Reviewing of Several Laws;
 - e) Coordination amongst the Authorities; and
 - f) Central Bank of Malaysia's Directives.
- a) Dual Banking System and Moderate Approach.**

Malaysia decided to introduce dual banking system whereby the existing conventional banking is practiced side by side with the Islamic banking system. The first bank that has been set up was in 1983 by Bank Islam Malaysia Berhad. Bank Islam Malaysia Berhad started its operations as Malaysia's first Islamic bank on July 1st 1983, set up with an initial authorized capital of RM600 million a paid-up of RM 79.9 million⁸.

After 10 years, on 4 March 1993, Central Bank of Malaysia introduced a scheme known as "*Skim Perbankan Tanpa Faedah*" (Interest-free Banking Scheme) in which conventional banks may offer Islamic banking products through its windows⁹. With that

⁷ Sayyid Ab Allah Aki Husayn mentioned by Dato Abd Hamid Mohamed in Harmonisation of *Shariah* and Civil Law in Malaysia: Present Reality and Future Actions. A conference paper in international Conference of *Shariah* and Civil law, IIUM Kuala Lumpur 20-21st October 2003 p.2. In Dr Muhammad Amanullah, Principles to be followed in partial harmonization between Islamic fiqh and Man Made law 29-30th June 2005, IIUM p 7.

⁸ 15th February 2006. <http://www.bankislam.biz>.

⁹ Ahmad Ibrahim, "*Legal Framework of Islamic Banking*", IKIM Law Journal, Vol.1 (1): 1997 p. 23.

policy, many conventional banks set up their Islamic windows. On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad¹⁰.

As of to date, Malaysia has 12 Islamic banking institutions operating under the Islamic Banking Act. There are two full fledged Islamic banking institutions, the 3 new foreign Islamic banking players and 7 Islamic banking windows that have been transformed into subsidiaries and six of them have now commenced operations¹¹. It is predicted that there will be more Islamic bank operates in Malaysia from time to time.

The development of Islamic banking industry in Malaysia involved several phases whereby Phase 1 started in 1983 until 1993 and Second Phases began in 1994. Malaysia is now in the midst of liberalizing its policy on the implementation of Islamic banking so as to enable us to lead the sector. These staggered developments are facilitated and supported by legal infrastructure through several legislations and directives namely the Islamic Banking Act 1983, the Banking and Financial Institutions Act 1989, the Central Bank of Malaysia (Amendment) Act 2003, other relevant statutory legislation, Central Bank of Malaysia's directives and also to the court's structure.

b) Federal List.

In Malaysia, separate Islamic legislation and banking regulations exists side-by-side with those of the conventional banking system. Islamic banking was put under the Federal List since it refers to commercial dealings although it actually falls under the purview of Islamic law. The government has taken proactive effort in setting up an Islamic bank in Malaysia. A steering committee was formed by the government in 1981 to study the

¹⁰ Nik Norzrul Thani. 2001. *Legal Aspects of Malaysian Islamic financial Systems*. Kuala Lumpur: Sweet and Maxwell Asia. p.147.

¹¹ *Supra note 6*.

establishment of an Islamic bank in Malaysia and then the Islamic Banking Act 1983 (Act 276) was passed.

c) Introducing the Islamic Banking Act 1983 and Section 124 of the Banking and Financial Institutions Act 1989.

The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) which came into effect on 7 April 1983. The IBA provides Central Bank of Malaysia with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. However, looking at IBA that has 60 sections and divided into 8 parts, it is obviously very brief and it is rather regulatory than substantive in nature.

Although the IBA is general, non-exhaustive and non-comprehensive¹² which is lead to various interpretations, it is observed that it creates flexibility to Islamic financial institutions to operate their business. This can be illustrated by referring to the section 2 of the IBA whereby it defines "Islamic banking business" as "banking business whose aims and operations do not involve any element, which is not approved by the Religion of Islam". There are negative and positive views on the interpretation of the section. The former views that the IBA does not stipulate how the section is to be understood in the context of Islamic banking In contrast, it could be understood that the purpose of such general provision is to create a flexible approach on the implementation of Islamic banking itself.

As a result, Islamic financial institution in Malaysia may offer various banking products under multiple modes of financing which is based on the shariah principles. For example Malaysia has the distinction of being the first in several issuances of Islamic bonds including the first to issue a global sovereign sukuk¹³. In fact, a lot of Islamic banking products have been introduced in a range of sectors such as financing for personal consumption, small medium entrepreneur and huge corporation. The increasing demands

¹² Norhashimah Yasin. *Legal Constraints in Applying Islamic Banking and Finance in Malaysia*. Seminar on Islamic Banking. Law Students' Society International Islamic University Malaysia. 30th August 2002. p. 6.

¹³ n.a. 2002. *Sektor Perbankan Dijangka Kekal Stabil*. 1st January. Utusan Malaysia.

for Islamic products show a tremendous growth to the Islamic banking sector. Moreover, non-Muslims also were attracted to the package of Islamic products offered in the market.

In responding to the positive demands of the conventional banks to open Islamic counters, Section 124 of the Banking and Financial Institutions Act 1989 (BAFIA) was then introduced which allowed the conventional banks to carry on Islamic banking business. They are required to establish the shariah committee in order to advise them on any matter related to Islamic banking business or Islamic financial business. The introduction of this section allows conventional banks to open Islamic counter to offer Islamic banking products. This scheme is formerly known as Interest Free Scheme Banks and currently known as Islamic Scheme Banks.

d) Amendment and Reviewing of Several Laws.

As Islamic banking sector develops and grows, there should be also continuous revisions of relevant laws. As a matter of fact, Central Bank of Malaysia has formed several committees to review the existing legislation to assimilate with the shariah principles with the aim of removing impediments to the efficient functioning of the Islamic financial system. This review covers inter alia tax and stamp duty laws, company laws, land laws and procedural laws.

Apart from the IBA and the BAFIA, the Central Bank of Malaysia (Amendment) Act 2003 (CBA) plays a major role in term of supervising and monitoring the implementation of Islamic banking. The CBA provides that the National Shariah Advisory Council (SAC) will be the sole authorities to be referred by the civil courts pertaining to Islamic banking and finance. Section 16B (1) of the CBA 1958 provides that the bank may establish an Advisory Council which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on principles and is supervised and regulated by the Central Bank of Malaysia. The effect of this amendment is expectedly to ensure that any deliberation of the SAC will bind the court and should be followed by all Islamic financial institutions in Malaysia.

Section 16 B (8) provides that where in any proceedings relating to Islamic banking business and Islamic financial business which is based on the shariah principles before any court or arbitrator any question arises concerning a shariah matter, the court or the arbitrator may refer such question to the SAC for its ruling. Any ruling made by the SAC pursuant to a reference by a court, be taken into consideration by the court and if the reference was made by an arbitrator, be binding on the arbitrator.

Beside the IBA, the BAFIA or the CBA, there is other related legislation that so significant in the implementation of Islamic banking such as the Hire Purchase Act 1948 (HPA). The HPA only governs certain types of vehicles and it contains an element of interest. Due to the obstacles in meeting the requirement of the HPA, some Islamic banks opts to offer financing for vehicles based on the concept of *Bay' Bithaman Ajil* concept. This creates problem to the bank in term of repossession of the vehicles in the case of default. Under the concept of *Bay' Bithaman Ajil*, the bank could not simply repossess the vehicle without a Court's order whereas under the HPA the bank may do it, through notice of repossession. It is reported that Central Bank of Malaysia also has set up a working committee to study on the needs of Islamic Hire Purchase Act. This act will then cover not only vehicles but as well as financial lease of immovable property.

Islamic banking products especially for debt financing involve trading transaction. It is different with conventional bank whereby it only involves a loan transaction. Basically this concept refers to the financing of houses, motor vehicles, lands, consumer goods, cash line facilities, education financing packages and personal consumption. Trading transaction requires two separate agreements namely purchase and selling agreement and these reflect double taxation. In order to stimulate the growth and the development of Islamic banking sector, the government then introduced incentives for Islamic financial institutions through tax exemption. Any legal documentation that involves trading transaction will only incur a normal cost of tax as provided under the Stamp Act 1948. This incentive is very effective and in fact the statistic shows that debt financing portion,

is the biggest contributor in terms of growth and profit to the Islamic financial institutions in Malaysia¹⁴.

e) Coordination between the National Shariah Advisory Council and the Court.

A report in the New York Times of February 8, 2005 mentioned that “Among Islamic Banks, a Shortage of Scholars”. It certainly surprised to read that, “There are no more than several dozen scholars with the right combination of knowledge of Islamic law, modern finance and technical English to serve on the *Shariah* committees of institutions based around the Gulf and beyond”. This report shows that the Islamic banking sector needs an expert and scholars who are well versed in Islamic law, common law, modern Islamic finance and proficient in technical English as well as Arabic especially to the members of the shariah committee.

In Malaysia, cases on Islamic banking were put under the jurisdiction of the civil courts. This is due to the fact that Islamic banking is considered as under the item ‘finance’ in the Federal Constitution. The issue here is the judges in civil courts face difficulties to understand certain concepts and terms of Islamic finance.

As a matter of fact, Central Bank of Malaysia with a cooperation of judicial body has agreed to set up a special High Court in the Commercial Division known as the Muamalah bench. According to Practice Direction No.1/2003, paragraph 2, all cases under the code 22A filed in the High Court of Malaya will be registered and heard in the High Court Commercial Division 4 and this special high Court will only hear cases on Islamic banking. Section 16B (8) provides that the court shall take into consideration of the SAC’s deliberation if the case involves shariah issues. The court may refer to the National Shariah Advisory Council looking for advice and deliberation on any shariah issue involves in the disputed cases. This is due to the background of the judges who are normally well trained in English law and lack of knowledge on the shariah aspects.

¹⁴ n.a.. 25th May 2006. http://www.Central Bank of Malaysia.gov.my/files/ib_statistic/2005/pdf/fin_by_concept.pdf

f) Directives on the Governance of the Shariah Committee.

As regard to the shariah committee's governance, the Central Bank of Malaysia has issued "Guidelines on the Governance of the Syariah Committee for the Islamic Financial Institutions (BNM/GPS 1) to regulate the governance of the shariah committee (SC) of Islamic financial institution. This guideline consists of 10 parts with 24 sections and one appendix. The contents include objectives, scope of application, establishment of the SC, membership, restrictions, duties and responsibilities of the SC and Islamic financial institutions, reporting structure, effective date and secretariat of the SAC's Central Bank of Malaysia. Islamic financial institutions have to comply with the guideline by 1st April 2005 (Section 23) and the dateline has been extended to a development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) which carries on Islamic Banking Scheme to 1st September 2005.

Section 10-13 mentions the qualifications to be the SC members who shall be an individual and have qualification or possess necessary knowledge, expertise or experience in Islamic jurisprudence (*Usul al-Fiqh*); or Islamic transaction or commercial law (*Fiqh al-Mu'amalat*). At this point, the guidelines provides that the SAC has the authority to decide which view it sees best on any issue on Islamic finance either it is in line with the principles of the shariah or not. In fact, a court and an arbitrator may refer to the SAC on any dispute involves shariah issues whereby the former just as a matter of taken into consideration and the latter is absolutely binding.

2.1 The Impact of Harmonisation

The impact of this harmonization approach can be illustrated through the achievement and growth of Islamic banking sector in Malaysia. Although the achievement is not entirely contributed through the harmonization approach, we may conclude however that it is one of the factors that stimulate the growth of Islamic banking. From 1983 until 2004 the Islamic Banking assets in Malaysia amounted to RM89 billion, accounting for 9.9 per

cent of total banking asset¹⁵. The Islamic banking industry, continues to show good performance with profitability and assets surpassing for the first time the threshold of RM1 billion and RM100 billion respectively at the end of 2005. The Islamic banking sector has become a major contributor to the overall economic growth, with assets equivalent to nearly 25% of the country's gross national product¹⁶.

The above statistics could not be achieved if there is no effective and comprehensive legal mechanism in governing the implementation of Islamic banking in Malaysia. As Malaysia practices dual banking system and a country within both the Islamic and the common law tradition, harmonization process is one of the best approaches taken in facilitating any Islamic banking transactions.

In fact, the coordination amongst the authorities of different background namely Judicial Body and the Central Bank of Malaysia mirrors the smooth running of the process of harmonization. The implementation of the muamalat bench shows a positive result on the increasing numbers of settled cases. From the statistic, it shows that more than 75% out of 656 cases has been settled by the court from year 2003 to 2005. Below is the statistic of cases under Code 22A from the Chief Registrar of the Federal Court's Office.

| Cases Registered from 1.3.2003 – 1.12.2005 | Settled Cases from 1.3.2003-1.12.2005 | Balance of Cases up to 1.12.2005 | Percentage of Settled Cases from 1.3.2003 – 1.12.2005 |
|---|--|---|--|
| 656 | 497 | 388 | 75.7% ($\frac{497 \times 100}{656}$) |

It is observed that majority of the cases on Islamic finance are concerning the issue of unable to pay the financing facility rather than deciding the *shariah* issues. For instance in the case of *Bank Islam Malaysia Berhad v. Adnan Omar* [1994] 3 CLJ 735; [1994] 3 AMR 44 and *Dato' Nik Mahmud Bin Daud v. Bank Islam Malaysia Berhad* [1996]4 MLJ

¹⁵ n.a. 2004. "Al Rajhi, Qatar-led Group Get Islamic Banking Licenses". New Straits Times. Malaysia. 15th October. p. B1.

¹⁶ Datuk Zamani Abdul Ghani. *Deputy Governor's Keynote Address at the Official Launch of Commerce Takaful Berhad*. Kuala Lumpur. 7th April 2006.

295, both cases refer to the issues pertaining to the default payment by the customer. The recent case in the High Court of Kuala Lumpur between *Affin Bank Berhad v. Zulkifli Abdullah* [2006] 1 CLJ 447 also discusses the same issue. In this case, Justice Datuk Abdul Wahab Patail ordered the house that has been purchased through scheme of *bay' bithaman ajil* to be auctioned under the National Land Code to recover over RM582, 000 sought by the bank. Affin Bank Berhad had sued Zulkifli Abdullah, for defaulting on the payment of the facility given out by the bank in December 1997 for a double-storey corner link house.

4.0 Conclusion

From the foregoing discussions, it can be concluded that the main purpose of harmonization is to develop harmony between the shariah and common law particularly in the implementation of Islamic banking in Malaysia. The effectiveness of this approach stimulates the growth and development of Islamic banking as evidenced by the tremendous achievement of the total banking asset as well as products recognition world wide.

Besides, it is interesting to note that harmonization, despite the positive connotations in facilitating Islamic banking operation, is not always a necessary. The process of harmonization is only applicable and feasible to certain reasonable differentials in selected area of the shariah and common law. Indeed, there are conditions to be complied with before it could be invoked and far more essential is to observe the principles of objectives of shariah and other related shariah principles.

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