

SHARIAH GOVERNANCE IN THE ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA

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ABSTRACT

Dynamic and good shariah governance is the very essence in the development of Islamic banking and finance sector in Malaysia. Good shariah governance guarantees the dynamicity of Islamic financial growth. In Islamic financial institution shariah governance mostly refers to the management, establishment and affairs of the Shariah Committee. The Shariah Committee who is normally consisting of fiqh scholars, practitioners and academicians has a duty to advise Islamic financial institutions on the shariah compliance in all aspects and its operations. This paper aims at providing a general overview and the recent development on the shariah governance in Islamic financial institution in Malaysia by referring to the Shariah Committee with special emphasize on its legal framework.

1.0 INTRODUCTION.

Malaysia aspires to transform the country into becoming Islamic banking and finance hub and one of the efforts is through strengthening the shariah governance in the Islamic financial sector. The development of Islamic finance industry strongly needs good shariah governance and thereafter the government imposed statutory conditions for the establishment of the Shariah Committee (hereinafter referred to as “the SC”).

The establishment of the SC is a statutory requirement to all banks and takaful operators which offer Islamic banking and takaful products pursuant to section 3 (5) (b) of the Islamic Banking Act 1983 (IBA 1983) for Islamic banks, section 124 (7) of the Banking and Financial Institution Act 1989 (BAFIA 1989) for Islamic Banking Scheme Banks, section 8 (3) (a) Takaful Act 1984 (TA 1984) for Takaful operators and section 16B of the Central Bank of Malaysia (Amendment) Act 2003 (CBA 2003) for Central Bank of Malaysia.

The main objective of the establishment of the SC is to advise Islamic financial institutions on any shariah matter and also to ensure compliance with the shariah tenets and requirements in their operations. Section 3 (5)(b) of IBA provides that the Central Bank shall not recommend the grant of a license, and the Minister shall not grant a license, unless he is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a shariah advisory body. Section 124 (7) of the BAFIA 1989 provides for the establishment of a Shariah Advisory Council to advise the Central Bank on the shariah relating to Islamic banking business or Islamic financial business. Section 8 (3) (a) of the TA 1984 states that a Religious Supervisory Council, whose members would be made up of Muslim religious scholars in the country, shall be established to advise the Company on the operations of its takaful business in order to ensure that they do not involve any element which is not approved by the religion of Islam.

Section 16B (1) of the CBA 2003 provides that the Bank may establish a Shariah 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 Shariah principles and is supervised and regulated by the Central Bank. Based on those provisions it is understood that the statutory functions of the Shariah advisory body are to advise the Islamic financial institutions on shariah matters and to ensure that their operations do not involve any element, which is not approved by the religion of Islam.

2.0 THE DEVELOPMENT OF SHARIAH GOVERNANCE IN ISLAMIC FINANCIAL INSTITUTION

Dynamic and good shariah governance is very important. The ultimate purpose of the establishment of the SC in Islamic financial institutions is to ensure shariah compliance to its operations and products. All banks and takaful operators must have provision regarding the establishment of SC in their Articles of Association and Memorandum of Association.

The term shariah committee or shariah advisory body or shariah advisory council has been used interchangeably for the past 21 years. IBA 1983 (refer to section 3 (5) (b)) used the term shariah advisory body while BAFIA 1984 (refer to section 124 (3)) used the term shariah advisory council. The term shariah committee has been introduced by Central Bank of Malaysia (CBM) in section 3 of the Guidelines and Procedures for Shariah Committee (BNM/GPS1) issued in December 2004. With the issuance of this Guidelines and Procedures all shariah advisory council of Islamic financial institutions and Takaful operators will be recognized as Shariah Committee and the term National Shariah Advisory Council (hereinafter referred to as “the SAC”) will be used by CBM.

The first Shariah Committee was set up in 1983 by Bank Islam Malaysia Berhad (BIMB). BIMB started its operations as Malaysia’s first Islamic bank on 1st July 1983, set up with an initial authorized capital of RM600 million and a paid-up capital of RM 79.9 million. The bank has gradually increased its authorized and paid-up capital to RM 2 billion and RM 563 million respectively, to accommodate the growth of its assets and to better position itself in meeting future expansion and growth (<http://www.bankislam.biz>).

After 10 years, on 4th March 1993, CBM introduced a scheme known as “*Skim Perbankan Tanpa Faedah*” (Interest-free Banking Scheme) in which conventional banks may offer Islamic banking products through its windows (Ahmad Ibrahim 1997: 23). With that policy, many conventional banks set up their Islamic windows and at the same time they appointed selected Muslim scholars to be members of shariah committee.

On 1st 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) Berhad (Nik Norzrul Thani 2001: 147).

As part of the effort to streamline and harmonise the Shariah interpretations among banks and takaful companies, National Shariah Advisory Council of CBM was established on 1st May 1997 under BAFIA 1984. This Council is the highest Shariah authority on Islamic banking and takaful in Malaysia (<http://www.bnm.gov.my>).

It is important to note that the SC's duties and responsibilities with other *fatwa* institution such as the National Fatwa Committee and the State Fatwa Committee differ in several aspects. In selecting the subject matter of *fatwa*, the latter is subject to three occurrences for example in section 34 of the Administration of Islamic Law (Federal Territories) Act 1993 provided that *fatwa* will be issued if it is ordered by the Yang Dipertuan Agong (YDPA) or if it is upon the request of the general public or on accord of the Mufti himself. The scope of *fatwa* is general and wide and limited to the inquiries of the ruler or the public. Furthermore, any *fatwa* issued will only bind the state if it is gazzeted.

The SC on the other hand has a rather active approach in selecting the subject matter of any issue and its decision will be considered as the SC resolution rather than naming it as a *fatwa*. The SC has to scrutinize the *shariah* principles, evaluating product features and in many instances they have to suggest for alternatives. The nature of studying and analyzing the fiqh in the Islamic finance industry is also technical, complicated and in depth. In addition, the SC will only issue resolution based on the inquiries and needs of its respective Islamic financial institutions and not from the public at large.

3.0 DUTIES AND RESPONSIBILITIES OF THE SC.

The primary objectives of the establishment of the SC are to advise Islamic financial institutions in its operation, to analyse and evaluate Shariah aspects of new products/schemes submitted by the respective banking institutions or takaful companies.

In general, we can sum up the main duties and responsibilities of the SC as follows:-

(a) Concept and Structure of the Products

The SC will evaluate the concept and structure of the new product and will review the existing products. Islamic banking products can be classified into Deposit, Financing, Treasury/Money Market Investment, Trade Financing, Card Services and Banking Services (<http://www.bnm.gov.my>).

Islamic banking products can be under the various concepts such as *Uqud Tamlikat* (contract of ownership) or *uqud al-Mua'wadhat* (exchange), *Uqud Isytirak* (contract of partnership) either *mudharabah* (passive partnership) or *musyarakah* (active partnership), *Uqud Tawsiqat* (contract of security) either *Kafalah* (suretyship) or *Rahnu* (pledge), *Uqud Iqlaqat* (contract pertaining to do a work) either *wakalah* (agency), or *hiwalah* (debt transfer), *Uqud Taqyiydat* (contract of restriction) and *Uqud Hifz* (contract of safe custody) or *wadiah* (safekeeping, *Isqatat* (waiver), *ibra'* (rebate), *muqasah* (offset of the debt), *will* (*wasiyyat*), *endowment* (*fund*) and loan (*al-qard*) (Wahbah al-Zuhaili 2002: 246-247).

For instance, home financing is under the concept of *Bay' Bithaman Ajil*, credit card under the concept of *Bay' Inah*, project financing under the concept *Bay' Istisna'*, *Letter of credit* under the concept of *Bay' Ad-dayn* and machinery financing under the concept of *Bay' Murabahah*. From observation, Islamic banking products under the concept of “*al-Bay'*” or contract of exchange classified under *Uqud Tamlikat* are the biggest contributor in terms of growth and profit to the Islamic financial institutions in Malaysia.

(b) Documentation

Not only the concept of the product must be Islamic, but its documentations as well. The SC will vet meticulously and endorse all documents involved and these include the terms and conditions contained in the proposal form, contract, and agreement or other legal documentation used in executing the transactions; and the product manual, marketing advertisements, sales illustrations and brochures used to describe the product.

They will review the documents and will give their comments in order to ensure the compliances to the Shariah principle. Section 20 (b) and (c) of BNM/GPS 1 expected the SC to endorse and validate all relevant documentations and this includes the term and condition, the product manual, marketing advertisement, sales illustration and brochures used to describe the product.

Each Islamic financial institution has their own structure of the documentations and it varies according to the products. The SC may give advice to its respective banks whether

the documents is in accordance with the shariah principles and they may reject the documents which is contrary to Islamic law or require the banks to do some amendments so as to meet the shariah principles.

For instance, home financing product under the concept of *Bay Bithaman Ajil*. Home Financing-i is a contract of deferred payment sale at an agreed selling price, which includes a profit margin agreed by both parties. Profit in this context is justified since it is derived from the buying and selling transaction as opposed to interests accruing from the principal lent out. The documents involved in this type of financing are the Letter of Offer, Property Purchase Agreement and Property Sale Agreement. The SC of the Islamic financial institutions in Malaysia accepts that such documents evidenced a valid sale and purchase transaction. If they found that the documents against the Islamic law, the Islamic financial institutions would have to do the amendment, modification and addition based on the advice and comments given by the SC.

(c) Business Operations

The SC will monitor the Islamic banking operations from time to time. Section 20 (a) of BNM/GPS 1 provides that they shall advise the bank on shariah matters in order to ensure that the business operations of the Islamic financial institutions comply with shariah principles at all times. It includes the procedures for transaction, actual business operations, and system applicable to the banking operations. If the Bank intends to introduce new information system to all its products, they need to clarify with the SC for the determination of the system so as to comply with the shariah requirements.

For example, we may refer to the issue of securitization on the sale and purchase of vehicles (Mohamad Nazri Chik and Nasruddin Yaakub 2004: 112). BIMB requires the customer to charge his vehicles to BIMB as a security so that in the case of default payment, BIMB may repossess that vehicle. This is based on the view of *madzhab Syafii'* upon hadith of Prophet SAW whereby the prophet allowed the companion to ride the animal and to take its milk which is charged to him. The SC follows that opinion and

therefore it is permissible for the bank to impose condition to their customer so that the car will be a collateral security for the vehicle financing offered to him.

(d) To advice related parties on shariah matter upon request.

The related parties of Islamic financial institution such as its legal counsel, auditor or consultant, branches or even customer may seek advice on Shariah matters from the SC. Section 20 (d) and (e) of BNM/GPS 1 states that the SC is expected to provide opinion to them so that compliance with Shariah principles can be assured completely. However, practically Shariah secretariat is actually providing the opinion by doing a short research if it involves simple issue and need quick deliberation. The Shariah secretariat will refer to the SC for deliberation in complicated issues which need depth study on the subject. Sometime the SC may advise Islamic financial institution to consult the SAC of CBM on any Shariah matters which have not been resolved or endorsed by the SAC yet.

(e) To provide written shariah opinion.

Section 20 (f) of BNM/GPS 1 requires the SC to record any opinion given. In particular, the Committee through its secretariat shall prepare written Shariah opinions where Islamic financial institution make reference to the SAC for advice; or where Islamic financial institution submits applications to Central Bank Malaysia for new product approval. This written shariah opinion shall consist of issues, product structures and features, the SC's opinion together with their reasoning from sources of Islamic law.

(f) To endorse Shariah Compliance Manuals.

Islamic financial institution shall have a Shariah Compliance Manual. The manual shall be regarded as a standard operational procedure for shariah governance of Islamic financial institutions. Section 20 (b) of BNM/GPS 1 states that the manual will specify the manner in which a submission or request for advice be made to the SC, the conduct of the SC's meeting and the manner of compliance with any Shariah decision. Shariah

secretariat will prepare the manual in accordance with the policy and procedures of respective Islamic financial institutions and it will be endorsed by the SC.

(g) To assist the SAC of CBM on reference for advice.

Section 20 (e) of BNM/GPS 1 requires the SC to assist the SAC of CBM on any matters referred by Islamic financial institution. If any institution refers the SAC of CBM on certain products and fiqh issues, the SC must explain the shariah issues involved upfront and they have to provide recommendations for a decision. The explanation and recommendation must be supported by relevant shariah jurisprudential literature from the recognized sources. The SC has a duty to ensure that all SAC's decisions that being referred to be properly implemented by Islamic financial institution.

(h) General Tasks and Duties

Beside, the SC also will deal with certain general duties and tasks relevant to their job scope and this includes to assist the related parties on shariah matter and to determine the *zakah* policy of the banks. Some Islamic banks pay *zakah* for their depositors and some bank requires their depositors to pay *zakah* by themselves. It depends on the SC's approach to the policy of *zakah*.

As an illustration, we may look into BIMB's policy of *zakah* (Mohd Nazri Chik and Nasrudin 2004: 108). The SC of BIMB will revise the policy of distribution of *zakah* and approve the amount of *zakah* including *zakah asnaf* that should be paid by the bank. BIMB paid *zakah* on behalf of all their depositors. This policy actually was adopted from the practice of Faisal Islamic Bank Egypt. BIMB pays *zakah* for all their depositors based on the concept of *Syahsiah I'tibariyah* or body corporate or company.

The SC sometimes is invited to attend shariah dialogue or to present a paper in a seminar or conference representing their respective institutions at national and international level. This is good practice whereby the SC may have contributions in the development of Islamic products particularly to shariah matter. They will get an opportunity to exchange

ideas amongst the scholars and practitioners and also to share experiences of other countries.

3.1 Procedures for Approval of the Islamic Finance Products before the SC.

Every Islamic financial institution has its own procedures for the SC. There are no standard guidelines for the SC whether to the aspects of management, products approval and etc. The practice is that there will be Shariah Secretariat to organize and handle the shariah matter. The Shariah Officer in the secretariat will compile and collect any document and issue involved, which are to be presented during the SC meeting.

In term of procedures, the SC will normally have a meeting once or twice a month depending on the issues involve in the respective Islamic financial institutions. It will take about 3-4 hours per meeting. The SC meeting will be attended by chief executive officer, head of product department, legal officer, lawyers, representative from branches and it depends on the issue involved either operational or product matters.

During the meeting they will discuss specifically on the concept and structure of new and existing products, documentations, and implementation and banking operations. The SC will receive all relevant documents from respective Islamic financial institutions at least one week before the date of the meeting to give sufficient time to the SC members to peruse the documents. Shariah officer and the findings will record all minutes of the meeting or resolutions and it will be compiled and distributed to relevant parties in the banks. Sometimes the SC is unable to come up with a decision during the meeting. It may take 2-4 weeks for deliberation. The delay for a decision is due to among others cross-checking with CBM or Securities Commission's Shariah Advisory Council.

It is observed that majority of the SC members are academician and most of them are involved in administrative task at their institutions. There were comments from some Islamic financial institutions on the performance of the SC especially in the aspects of time, research, difficulties in understanding operational matters and so on. However, majority of the SC members are able to analyze issues and provide very concrete reason

on discussing certain issue. From observation, it is submitted that the SC members must be scholar who have high value proposition on Shariah and law, economic knowledge, critical thinking, able to provide alternative solution and also proficient in English and Arabic.

4.0 LEGAL FRAMEWORK'S DEVELOPMENT.

In Malaysia, separate Islamic legislation and banking regulations exists side-by-side with those of the conventional banking system. Islamic banking and finance is put under Federal List of Federal Constitution since it refers to commercial dealings although it actually falls under the purview of Islamic law. Thus, it is under the power of the parliament to pass any law governing the Islamic financial institutions and takaful operators.

The decision to establish Islamic banking in the country is a result of the Muslim demands to have a sound banking and financial system which is in accordance with the Shariah. A steering committee was formed by the government in 1981 to study the establishment of an Islamic bank in Malaysia (Nik Norzrul Thani 2001: 144).

The legal basis for the establishment of Islamic banks is the IBA which came into effect on 7th April 1983. The IBA provides CBM 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. True as it is, the Act is rather regulatory than substantive in nature. The IBA is general, non-exhaustive and non-comprehensive (Norhashimah Yasin 2002:6).

The concept of takaful was first introduced in Malaysia in 1985 when the first takaful operator was established to fulfill the need of the general public to be protected based on the Islamic principles. The legal basis for the establishment of takaful operators is the TA which came into effect in 1984. Similar to IBA 1983, TA 1984 is also brief and regulatory as compared to its counterpart, the Insurance Act 1996. The Act does not explain the management and operational aspect of the takaful industry. This is evidenced

in its interpretation of section 2 which explains the meaning of takaful merely as a takaful business which has no element contrary to the Shariah. Takaful operations are regulated and supervised by CBM since 1988 with the appointment of the Governor of CBM as the Director-General of Takaful.

As regard to the SC's governance, Central Bank Malaysia has issued BNM/GPS 1 that regulates the governance of Shariah Committee of an 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 CBM. 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.

As for the appointment of the SC members, section 8 provides that they will be appointed by the board of directors of an Islamic financial institution upon recommendation of its nomination committee. The appointment shall obtain prior written approval of CBM and the term of appointment shall be valid for a renewable term of two years. Part V section 10-13 mentions the qualifications to be the SC members. A member of a Shariah Committee shall be an individual and the proposed member of the Shariah Committee shall at least either have qualification or possess necessary knowledge, expertise or experience in Islamic jurisprudence (*Usul al-Fiqh*); or Islamic transaction/commercial law (*Fiqh al-Mu'amalat*).

The objective of BNM/GPS 1 is to set out the rules, regulations and procedures in the establishment of the SC, to define its role, scope of duties and responsibilities and to define relationship and working arrangement between the SC and the SAC of CBM. It is also hoped this guideline may solve the issue of clashes of opinion amongst the SC of various Islamic financial institution that may cause confusion to the general public. There are two main branches of schools in Islamic jurisprudence, namely the Sunni branch and

the *Shiah* branch and within the Sunni there are four other *madhahib*, the *Shafii*’, the *Hanafi*, the *Maliki* and the *Hanbali* schools. These *madhahib* varied on many aspects of the Islamic law. 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 Shariah or not.

In Malaysia, cases on Islamic banking and takaful is under the jurisdiction of the civil courts. This due to the fact that Islamic banking and takaful is considered as under the item ‘finance’ provided in First List, 9th Schedule of the Federal Constitution. The issue here is the vulnerable position of Islamic finance principles, whether the SC’s resolution on certain matter could be defended as one of law which has legal standing. In fact, the judges in civil courts face difficulties to understand certain concepts and terms of Islamic finance.

As a matter of fact, CBM 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. Below is the statistic of cases under Code 22A from the Chief Registrar of the Federal Court’s Office.

Table 1: Muamalat Cases Registered in the High Court from 2003-2005.

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% (497x 100) 415

From the statistic, it shows that more than 75% out of 656 cases has been settled by the court from year 2003 to 2005. It is also observed that majority of the cases on Islamic finance are concerning defaulters of facilities payment and not to challenge the decisions of the SC. 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 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 vs 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 *al-bai 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.

Apart from the above development, in providing effective shariah governance amongst the SC of various Islamic financial institutions, the parliament has amended section 16B of the CBA 2003 whereby the National Shariah Advisory Council will be the sole authorities to be referred by the civil courts pertaining to Islamic banking and finance. Section 16B (1) of the CBA 2003 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 CBM. 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.

5.0 CONCLUSION

As a conclusion therefore, effective shariah governance framework requires involvement of the Shariah Committee as the key player, the government as the regulatory body, the Islamic financial institutions as the implementer and also to other persons relevant to the business such as auditors, accountants and lawyers.

The SC plays very important role in ensuring good shariah governance. The role of the SC is to include advising board of directors on shariah matters to ensure that the operations comply with shariah principles at all time, endorsing and validating relevant documentations pertaining to the products and services, as well as the internal policies and manuals and marketing advertisements, assisting related parties, advising on any shariah matters arising before referring the same to the SAC, assisting the SAC on reference for advice and ensuring all its decisions are properly implemented.

The recent development on setting up a special High Court in the Commercial Division or the Muamalah bench and also the amendment of section 16B of the CBA 2003 shows positive indication by the government in providing more comprehensive and effective shariah governance in Islamic finance sector. The muamalat bench in the High Court provides special focus by the respective judges on the disputes on Islamic finance and it also can be considered as an approach of harmonizing the civil and Islamic law in Malaysia. Shariah governance is unique to Islamic system of financial management. It can be considered as vital corporate governance for Islamic financial institutions. Good shariah governance assures a tremendous growth of the Islamic banking and finance industry.

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