The Paradox Struggle Between the Islamic and Conventional Banking Systems

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Abstract: Malaysia is a multi religious and a multi ethnic society with a plural legal structure. The banking system of country is essentially dual in nature and hence, there are two different sets of legal framework working simultaneously. Today, the Islamic Banking system which emerged in 1983 has levelled up to the conventional banking system which had rooted itself in the society a long time ago. Whether we believe it or not there are challenges and clashes at hand due to the existence of the dual system in the society and they need to be addressed properly, so that the clashes between these two types of banking system can be minimized. There are several quarrels between conventional and Islamic Banking laws. Some of these clashes are created due to the application of common law or conventional law based legislation to resolve the problems in the Islamic banking system. The impact of this is huge, primarily because, Islamic economics has a different premise from conventional banking and applying the same legal principles to resolve disputes for both markets does not work. Unlike conventional banking’s capitalist conviction that winner takes all, Islam argues for a fair distribution of profit and loss and bans purely speculative activity.

Keywords: Islam, Malaysia, Banking, Capitalism, Religion

Introduction

The Islamic banking system in Malaysia traces its root of inception to 1983 and over time, has emerged itself to be one that, not only can keep the pace with its conventional counterpart, but to one which can offer its fair share in terms of competition. Systems which function on two different paradoxical statements but operating in the same pluralistic system are inevitably bound to open quarrels with each other in terms of its basis, operation and mind-set.
Emergence of two systems within the same organism would predictably give rise to certain clashes and a need arises where these clashes and challenges are addressed if the effort to bridge the gap is to be effected at a useful level. These clashes include those based on legislative grounds and those faced in the process of judicial adjudication in dispute. It even includes those which are relevant to alternative means of dispute resolution.

While the Pakistani (and essentially Iranian, Sudanese as well) model of establishing Islamic banking which saw an almost overnight implementation, surfacing problems of its own, Malaysia chose to do it gradually. But, while the aforementioned model had its drawbacks, there might be certain lessons Malaysia may learn from it. The national scale at which it was kicked off, the several legislation which were drafted, the extensive administration and management, at least at the initial stages, the subsequent weathering of the whole device, the desperate attempt to revitalize by the Pakistani Supreme Court, the subsequent National Bank’s directive are all lessons from which examples may be drawn.

It is interesting to note how Pakistan managed to take a step back and re-evaluate their measures and stands on Islamic banking and how they saw that complete transformation of the financial system, bringing about several practical problems, and that the parallel approach was seen the best interest of the country.

Malaysian Islamic finance establishment can very well be said to have started in 1963 with the establishment of the Tabung Haji, under the guidance of National Fatawah Committee of Malaysia. The long-term objective of the Central Bank of Malaysia, when it setup the Bank Islam Malaysia Berhad (BIMB) was to create an Islamic banking system operating parallel to the conventional banking system. The application of Islamic finance received a tremendous boost in Malaysia with the passing of the Islamic Banking Act 1983 (Act 276) followed by the establishment of the first commercial bank, licensed under the Islamic Banking Act, to operate on Islamic principles in Malaysia, namely Bank Islam Malaysia Bhd. This is generally seen as the formal entry of Islamic law into the mainstream of the laws and legal system in this country. The desire to establish a comprehensive Islamic financial system, however, has
created a overrun effect to the non-bank Islamic financial intermediaries which also started to offer Islamic financial products and services under Islamic banking schemes. In its efforts to establish an Islamic Banking system, Malaysia has seen the emergence of the Interest Free Banking Scheme (now replaced with Islamic Banking Scheme, IBS), several Takaful Companies, savings institutions (examples in Bank Simpanan Nasional & Bank Rakyat) developmental financial institutions (examples in Bank Pembangunan dan Infrastruktur Malaysia and Bank Pertanian), the National Shariah Advisory Council on Islamic Banking and Takaful (NSAC), and the second Islamic bank, Bank Muamalat Malaysia Berhad, Islamic Inter-bank Money Market (IIMM).

Indonesia, on the other hand, is a good as to how exclusive prerogative afforded to Shariah Courts can be problematic. Islamic banking in Indonesia started to operate from 1992 by virtue of the enactment of the Banking Act No. 7/1992 and amended in 1998, to provide an opportunity to conventional banks to open an Islamic window. Since that time, the growth of Islamic banking in Indonesia has been progressing steady and fast. But the problem was that the jurisdiction of the civil courts did not extend to Shari’ah matters, within which Islamic banking disputes apparently came. On the other hand, the jurisdiction of the religious courts was limited to Personal law matters. This incongruity was rectified in February 2006 expanding the jurisdiction of the Religious courts to cover adjudication of disputes belonging to Islamic economic matters, including Islamic banking.

There are several clashes between conventional and Islamic Banking laws. The main focal point of this paper would be on the clashes created due to application of the common law or conventional law based laws to resolve the problems in the Islamic banking system. The impact of this is huge. This is because, Islamic economics have a different premise from conventional banking and applying the same legal principles to resolve disputes for both markets does not work. One encouraging point is that the Central Bank is focusing on strengthening the institutional infrastructure, enhancing the regulatory framework, strengthening the Shariah and legal
infrastructure as well as enhancing intellectual capital development and consumer education in Malaysia. Islamic finance is based on the Shariah, or Islamic law. It avoids the interest-based formula of conventional banking and argues that gains must be derived from ethical investing and for profits and losses to be shared between venture partners. The one institution which is entrusted in safeguarding this element is the Shariah Advisory Council sitting at Bank Negara. The Malaysian model on this matter is exemplary. The Central Bank of Malaysia Act 1958 enhanced the role and functions of its Council according sole Shariah authority in Islamic finance. Regardless of this, there is a need for the Council to synergize between Shari’ah requirements with the legal and taxation framework and find a place for innovation in Shari’ah compliance and viable products. And the most notorious dilemma is in balancing the monetary gains and fulfilling of the Shari'ah objectives, with the use of clear and transparent procedure in decision making.

An appropriate legal, institutional and tax framework is a basic requirement for establishing sound financial institutions and markets. Islamic jurisprudence offers its own framework for the implementation of commercial and financial contracts and transactions but commercial, banking and company laws appropriate for the enforcement of Islamic banking and financial contracts do not exist in many countries. While countries such as Malaysia, Turkey, Sudan, Yemen and United Arab Emirates they have enacted Islamic Banking laws parallel to the existing conventional banking system; countries like Saudi Arabia, Egypt, Qatar, Pakistan, Iran Jordon and Bahrain have not enacted any new laws to accommodate Islamic banks, but instead operate under the existing legislations which legalize the conventional banks.

Malaysia is a good example in illustrating the clashes caused by applying the conventional laws to Islamic Banking. The Islamic Banking Act (IBA) and Islamic law generally are to be applied and implemented within the existing common law system and the regime of all other existing laws. For instance, neither the IBA nor section 124 of BAFIA exclude the application of the civil law to Islamic banking transactions. Alternatively, there is no provision in either Act
stipulating that Islamic law shall apply exclusively to such transactions. Reflection will bring into focus the enormity of the problem, which to a practitioner, is nightmarish. Another threat that may be considered is uncertainty in the law and a lack of specification as to the law applicable. To what sources would a judge deciding the case refer? And if there are conflicting opinions in the Shariah, which one should he adopt? Problems of such nature are usually understated in the industry. Now another question which can be posed here is whether changing the Islamic Banking jurisdiction from Civil courts to the Shari'ah courts would solve the complex problem of lack of knowledge in the judges?

Devising Specific Legal Frameworks to Incept Islamic Banking

Islamic banking has revealed vital potential as a competitive and sometimes even an improved substitute against conventional banking system in many countries of the world. Currently, two different approaches are utilized towards the development of Islamic banking. First way employed by Pakistan, Iran and Sudan is to implement Islamic banking on a comprehensive country wide basis. Second, way is to setup individual Islamic banks in parallel to the conventional interest based banks. Pakistan and Malaysia can be assumed as the two leaders of Islamic Finance. Both countries selected dissimilar tracks to achieve the same goals of developing full fledged Islamic banking and gained different results.

The Governments of Pakistan has tried to institutionalize Islamic banking system at once at a national level. The overnight exercise of Islamisation did not produce the desired results due to lack of required support and continued efforts to eliminate the interest (Riba) from the economy. Most of the Islamisation efforts either had been reversed or at least, further progress clogged. Since 2001, the Central Bank of Pakistan has started adopting the gradual policies of implementing Islamic banking which Malaysia has adopted twenty years back. Al-Meezan Bank in Pakistan (fully Islamic and independent commercial bank) and separate full fledged Islamic banking branches from few
commercial banks are vigorous indicators for positive expectations. Malaysia endured the gradual approach of implementing Islamic banking. Although, the country is facing problems in segregating Islamic and conventional banking fixed assets and overheads expenses but, no doubt, it has successfully developed a viable Islamic financial system. After developing an Islamic banking infrastructure and Islamic instruments for financial investments and liquidity management, the country is actively progressing towards the development of Islamic capital market. Malaysia is now also inviting the international market to experience its new dual banking system.

It shall be noted here that the incongruous legal struggle stems from the dodges in the devised legal frameworks. Hence in this part of the paper, a comparative study of a country which transformed all of its laws to accommodate Islamic banking would be divulged into, followed by a description of a country in which an Islamic Banking framework co-exist with a conventional banking system in harmony.

**Pakistan: a convert of Islamic banking**

The process of Islamizing the financial structure of Pakistan is in conjunction with the global resurgence of Islamic banking in the late seventies. Pakistan was among the three countries in the world that has been trying to implement Islamic banking at national level. This process started with presidential order to the local Council of Islamic Ideology (CII) to prepare the blueprint of interest free economic system on September 29, 1977. The council included panelists of bankers and economists, submitted their report in February 1980, highlighting various ways and sufficient details for eliminating the interest from the financial system of Pakistan. This report was the seed for Islamizing the banking system in Pakistan.

The Islamic banking movement in Pakistan was countrywide. As it was a gargantuan mission, the barter plan was implemented in phases. The development was started by transforming the operations of specialized financial institutions like National Investment Trust (NIT), Investment Corporation of Pakistan (ICP), and House Building Finance Corporation (HBFC) to the system conforming to the Islamic
principles with effect from July 1, 1979. Separate Interest-
free counters started operating in all the nationalized
commercial banks, and one foreign bank from January 1,
1981, to mobilize deposits on profit and loss sharing basis.
As from July 1, 1985, all commercial banking operations
were made 'interest-free'. From that date, no bank in
Pakistan, including foreign banks, was allowed to accept any
interest-bearing deposits. All existing deposits in banks were
treated to be on the basis of profit and loss sharing.
However, foreign currency deposits/loans were continued to
govern on interest basis. The government meanwhile also
passed the Mudarabah Companies Act 1984, enabling
financial institutions or business groups to setup special
Mudarabah Companies in the country.
The modification of administration with regard to the
overture of fresh system is constantly an urbane job
requiring extensive planning and commitments. This is
particularly true in case of present day financial systems
wherein the interests of the stakeholders are embedded and
considered a weighty ingredient. Only a well devised plan
with committed and continuous efforts could lead to
success.
Regrettably the efforts of the economics managers in
Pakistan, were in vain to the desired outcome. Currently,
there are hardly any transaction deals in inter-banks, intra-
banks or the government related financial activities which
can be called as Islamic. In the beginning of Islamisation
process the banks expressed some anxiety adjusting to the
new system and tried to develop methods to eliminate the
interest from their transactions. But the issuance of BCD
circular No.13 of June 1984 allowed banks to provide
finance on mark-up and on buy-back agreement basis. The
technique of buy-back agreements are nothing but disguised
forms of interest, a point on which most Islamic scholars
agree. With the help of new terminology the financial
institutes retained the conventional methods of interest
bearing finance. The Islamic modes of finances such as
musharikah, mudarabah, ijara, ijara wa iktina, were not
adopted in majority of the cases. The aggressively
established Mudarabah Companies also failed to continue
their subsistence; with most of them currently either in
losses or are in the process of getting agglomerated with other financial institutions in a desperate bid for survival. The current financial system is basically based on ‘mark-up’ technique with or without buy-back arrangement. This procedure was, however, declared un-Islamic by the Federal Shariat Court in November 1991. Appeals were made to the Shariat Appellate Bench of the Supreme Court of Pakistan (the apex court). The Supreme Court delivered its judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. In the judgment, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with Islamic laws (Shariah). It also directed the government to set up, within specified time frame, a commission and task forces for the transformation of the financial system, to achieve the objective. The Court also indicated some measures related to the infrastructure and legal framework, which needed to be taken in order to have an economy conforming to the injunctions of Islam.

The Commission for Transformation of Financial System (CTFS) set-up in the State Bank of Pakistan submitted its report in August 2001 that mainly comprised the recommendation given in the two Interim reports submitted earlier in October 2000 and May 2001. Currently, a task force is working in the Ministry of Finance to suggest the ways to eliminate interest from government operations. Another task force has been set-up in the Ministry of Law to suggest amendments in legal framework to implement the Supreme Court’s Judgment.

Pakistan after the gap of twenty years has now decided to shift towards interest free economy in a gradual and phased manner minimizing any further disruptions. Some extracts from the affidavit submitted by the Deputy Governor of the State Bank of Pakistan (SBP) in the Supreme Court of Pakistan reflected the future policy of the Bank for the time being.1

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1 “That having taken a series of steps to promote Islamic banking… and considering all other practical problems associated with the complete transformation of the financial system, discussed herein, it is the State Bank of Pakistan’s considered judgment that the parallel approach will be
State Bank of Pakistan issued detailed criteria in December 2001 for the establishment of full-fledged Islamic commercial banks in the private sector. Newly established Islamic banks can be listed on the stock exchange provided minimum of 50 percent of total shares be offered to the general public. At least 15 percent of the total paid-up capital should be subscribed personally by sponsor directors. Islamic banks are also required to maintain a minimum capital adequacy ratio of 8 percent based on risk weighted assets. Meezan Bank Limited (MBL) received the first Islamic commercial banking license from SBP in January 2002. At the end of 2003, MBL has a small network of 10 branches with total deposits of US $ 130 million.

In January, 2003 the State Bank issued detail instructions upon setting up subsidiaries and stand-alone Islamic banking branches by existing commercial banks. Accordingly six existing commercial banks including one foreign bank are allowed to open separate Islamic banking branches. Out of which eight branches of four banks have already started their operations since June 2004. Islamic banks are also allowed to maintain statutory liquidity requirements (SLR) and special cash reserve (SCR) deposits in current accounts with the State Bank to the maximum extent of 40% of SLR and SCR for other banks in order to avoid interest.

Some developments have also been witnessed in the capital market with regard to Islamisation. During the last few years, numerous companies have issued Term Finance Certificates (TFC) to raise redeemable capital on the basis of Musharaka. The payments of profit or sharing of loss with the TFC holders are linked to the operating profit/loss of the TFC issuing companies. Therefore, the investors assume the in the best interest of the country. This means that Islamic banking is introduced as a parallel system, of which beginning has already been made; it is provided a level playing field vis-à-vis the existing conventional banks, and its further growth and development is supported by Government and State Bank of Pakistan through appropriate actions. The approach will eliminate the risk of any major cost/damage to the economy, give a fair chance to Islamic banks to develop alongside the conventional banks, and will provide a choice to the people of Pakistan, and the foreigners doing businesses in/with Pakistan, to use either of the two systems.”
risk of sustaining losses proportionate to their principal amount in case of operating losses incurred by the company. In September 2002, Securities and Exchange Commission of Pakistan (SECP) also allowed the Mudaraba companies to float Musharakah based TFC’s. Another significant development during the year 2003 is the permission to set up ‘SME Modaraba’ with the participation of about 20 Modarabah companies to undertake SME businesses in the smaller towns and distant areas. SME Modaraba will resolve the problem of the individual Modarabah companies which do not have a big branch network to reach out to the prospective clientele.

**Malaysia: the cranium of Islamic Banking**

In Malaysia, the roots of Islamic finance go back to 1963 when the government established Tabung Haji or Pilgrims Management and Fund Board. The institution was established to invest the savings of the local Muslims in interest free places, who intend to perform pilgrim (Hajj). Tabung Haji utilizes Mudarabah (profit and loss sharing), Musharakah (joint venture) and Ijara (leasing) modes of financing for investment under the guidance of National Fatawah Committee of Malaysia.

The initial call for separate Islamic bank was made in 1980, in a seminar held in the National University of Malaysia. The participants passed a resolution requesting the government to pass a special law to setup an Islamic bank in the country. Responding to the request, the government set up a National Steering Committee in 1981 to study legal, religious and operational aspects of setting up an Islamic bank. The committee established the blueprint of a modern Islamic banking system in 1983, which later enabled the government to establish an Islamic bank and to issue non-interest bearing investment certificates.

The establishment of Bank Islam Malaysia Berhad (BIMB) in July 1983 marked a milestone for the development of the Islamic financial system in Malaysia. BIMB carries out banking business similar to other commercial banks, but along the principles of Islamic laws (Shariah). The bank offers deposit-taking products such as current and savings deposit under the concept of Wadiah (guaranteed custody)
and investment deposits under the concept of *Mudarabah* (profit-sharing). The bank grants finance facilities such as working capital financing under *Murabaha* (cost-plus financing), house financing under *Bai’ Bithaman Ajil* (deferred payment sale), leasing under *Ijara* (leasing) and project financing under *Musharikah* (joint venture). BIMB has grown tremendously since its inception. It was listed on the Main Board of the Kuala Lumpur Stock Exchange on January 17, 1992. At the end of 2003, the bank has a network of 82 branches throughout the country and staff of 1,200 employees.

The long-term objective of the Central Bank of Malaysia was to create an Islamic banking system operating parallel to the conventional banking system. A single Islamic bank (BIMB) did not represent the whole financial system. It required a large number of pro-active players, wide range of products and innovative instruments, and a vibrant Islamic money market. Realizing the situation, the Central Bank introduced the Interest Free Banking Scheme (*now replaced with Islamic Banking Scheme, IBS*) in March 1993. The scheme allowed conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches. Since then, the numbers of IBS banking institutions have increased to 36 till the end of 2003, comprising 14 commercial banks (of which 4 are foreign banks), 10 finance companies, 5 merchant banks and 7 discount houses.¹

The desire to establish a comprehensive Islamic financial system has created a spill-over effect to the non-bank Islamic financial intermediaries which also started to offer Islamic financial products and services under Islamic banking schemes. Such institutions include the Takaful Companies, the savings institutions (i.e. Bank Simpanan Nasional & Bank Rakyat) and the developmental financial

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¹ The Central bank of Malaysia in its annual report (1993, page no 57) stated:

“With the implementation of the interest free banking scheme, Malaysia has emerged as the first country to implement a dual banking system, whereby an Islamic banking system functions on a parallel basis with the conventional banking system”.
institutions (i.e. Bank Pembangunan dan Infrastruktur Malaysia and Bank Pertanian.
In October 1996, the Central Bank issued a model financial statement for the IBS banks requiring them to disclose their Islamic banking operations (balance sheet and profit and loss account) as an additional item under the Notes to the Accounts. The Central Bank also setup a National Shariah Advisory Council on Islamic Banking and Takaful (NSAC) on May 1, 1997. The council was deemed as the highest Shariah authority on Islamic banking and Takaful businesses in Malaysia. On October 1, 1999, the Central Bank issued the license for the second Islamic bank, Bank Muamalat Malaysia Berhad.
The country also introduced Islamic debt securities market, which made its debut in 1990 with the issuance of RM 125 million Islamic bonds. Islamic Inter-bank Money Market (IIMM) on January 4, 1994 to link institutions and Islamic investment based instruments. Since then, both the markets provide variety of securities ranging from two to five years medium terms Islamic bonds to short-term commercial papers one to twelve months.
Today, Malaysia has a full-fledged Islamic financial system operating parallel to conventional financial system. In terms of products and services, there are more than 40 different Islamic financial products currently available in the country. However, differentiating fixed assets and overhead expenses are problematic in case of IBS banks. Usually, an IBS bank consists of a team overseeing Islamic banking transactions. Product development, marketing and other policy issues are conducted at their respective headquarters. At the branch level, there is no delineation over Islamic and conventional transactions. Each branch officer is expected to deal with both systems. Islamic and conventional transactions share the share computers and automated teller machines (ATMs) facilities. To some extent, overhead expenses on wages/salaries, office equipment and furniture etc. can be accounted for at the bank's headquarter, but not at the branch level. The same applies to security systems, land and office premises as these cannot be divided into the Islamic and conventional individual components (Rosley, 2003).
The thrust of the Islamic financial policy in 2004 will continue to be directed at further strengthening the
fundamental essence for progressive Islamic banking industry. The Central Bank is focusing on strengthening the institutional infrastructure, enhancing the regulatory framework, strengthening the Shariah and legal infrastructure as well as enhancing intellectual capital development and consumer education. In 2003, the Central Bank of Malaysia brought forward liberalization in Islamic banking to allow three full-fledged foreign Islamic banks to be set-up in Malaysia.

**Shari’ah Advisors: the Watchdogs of the System**

Some countries like Malaysia and Turkey accommodate the dual banking system. Deliberations are ongoing whether both systems should have same rules and regulations. However, Islamic banks are given special treatment saying that there is an ideological difference between conventional and Islamic Banking system and hence there are operational differences between the two systems. The privileges which stem from this indeed are iniquitous to the conventional banks (Warde, 2000).

Shari’ah councils are indeed advisory bodies. Their main job is to protect the Islamicity in carrying out Islamic banking. In these councils reside scholars of Islamic Law. They are consulted regarding the bank's contractual dealings, the new products of that bank, and daily activities of the bank. They are appointed to ensure that the day to day running of the bank would be complaint with Islamic law. The compositions of these councils are different from country to country. The numbers of scholars in the council differ among countries. The power of this council is colossal. In some countries they have the ultimate saying in matters, whilst in some other jurisdictions they merely have to give advice on the matter. And in some other countries in the case of dispute the Fatwa given by these councils would be binding on the courts.

The Malaysian model of Shari’ah Advisory Council is exemplary. The Bank Negara of Malaysia has amended the Central Bank of Malaysia Act 1958 to enhance the role and functions of its Shariah Advisory Council for Islamic Banking and Takaful (SAC). This amendment has accorded the SAC as the sole Shari’ah authority in Islamic finance. As the sole Shariah authority, the SAC will be referred to by the court or
arbitrators in disputes involving Shariah issues in Islamic banking, finance and takaful cases.

There are challenges facing the Islamic scholars convening in these Councils. Firstly, they have the dilemma of going through the lengthy Islamic Banking instruments and they need to have knowledge and experience to do this, which most of the scholars are found wanting of. Secondly, they need to synergize between the Shari’ah requirements with the legal and taxation framework. Thirdly, they also need to learn how to use innovation in Shari’ah compliance and viable products. And the most controversial problem is with regard to balancing between the monetary gains and fulfilling of the Shari’ah objectives and use of clear and transparent procedure in decision making.

It is true that no Islamic financial transaction can be closed without the sign-off of the Shariah Advisory Board as to whether the transaction or structure satisfies the tenets of Fiqh Al-Muamalat (Islamic law relating to financial transactions). In many markets, the reputation of the so-called top tier of international Shariah advisories do not mean much as retail customers in particular prefer to have the input of their local imam or Shariah scholar. This is a potentially a major problem for the development of the sector because not every local imam or Shariah scholar is conversant with the rubrics of Fiqh Al-Muamalat, which is a highly complex yet under-developed area of Islamic jurisprudence.

The Islamic finance sector not only has a human capital development challenge but, perhaps equally importantly, also a Shariah advisory development challenge. While the universities and specialized academies are now starting to offer academic and training courses in this respect, they are still few and far between and their curricula are at best mixed and not quality controlled. This leads to the complicating matter relating to lack of globally accepted qualification as a Shariah scholar, just as there are no globally accepted standards for Shariah rules, which are to some extent open to interpretation. Since Shari’ah Advisors are the backbone of the industry, it is put forward here that the composition of these Councils need to be reformed and standardized globally. This is because, today the scholars of Islamic law have monopolized the Islamic Banking system
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and this might lead to abuse. And also scholars with only Islamic knowledge might jeopardize the competitive development of Islamic Banking products. Therefore, it is suggested that the appointment of scholars with parallel knowledge of Islam and finance would make Islamic banking more competitive in the system. But to be realistic, it should be noted here that it would be very hard to get scholars of this nature. Hence, until we get a supply of such scholars, it is put forth here to appoint financial consultants and Islamic scholars to the Councils. This way, the financial aspect and the Shari'ah issues can be solved simultaneously. And the contact between the market players and the Islamic scholars need to be improvised.

Although there is a clamor for standardization or uniformity of Shariah interpretations, this is impracticable given the various Madhabs (schools of Islamic law). In any case, even in conventional finance there is no uniformity of rules and laws, and can differ even within one country as in the US where the state laws on banking differ from each other. It would be prudent to consider that in Islam there is no Vatican. Diversity of Shariah opinions is strength and not an Achilles' heel. Then only the Islamic finance sector will prosper.

On the positive aspect, there are signals that the Shariah governance process in Islamic finance is progressively embryonic and gaining maturity with the call by prominent Saudi Shariah scholar and economist, Mohamed Elgari, for a scientific approach to Shariah compliance. This was followed by the recent call by another prominent Shariah scholar, Sheikh Esam Ishaq of Bahrain, that Shariah advisors serving the Islamic finance industry should be regulated. Elgari has called on fellow Shariah advisors to adopt a scientific methodology in reaching their deliberations on Islamic finance. "To be respected," said Elgari, "Shariah scholars should follow scientific methods to reach their conclusions. We have seen many mistakes where declarations have been issued. Only the correct resolutions will prevail. Shariah is not a group of infallible people. It is a science. It requires methodology, and resolutions require peer review and market consultation."

Elgari is also a big supporter of the codification of Fiqh Al-Muamalat, which could contribute immensely to clarifying
the rubrics and the contentious issues relating to products and services in the nascent Islamic finance industry. Similarly, he believes that greater transparency in the Shariah governance process, more professional articulation of the resolutions and statements, and prior debate and consultation between scholars and other stakeholders in the industry, could go a long way in mitigating the misconceptions and confusion that has arisen as a result of some of the recent Shariah rulings.\(^1\)

Another major development in August 2009 was the issuance by Bank Negara Malaysia of the first in a series of Shariah references. The first one, Shariah Parameter Reference 1 or murabaha Parameter (SPR1), will be followed by Shariah Parameters on ijarah (leasing), mudaraba (trust financing), musharaka (partnerships), istisna (construction financing) and wadiah (current accounts). SPR1 outlines the main Shariah requirements in the contracts and provides examples, methods and models for practical application of the contract, and is issued as guidance and reference to all IFIs. It also marks a key advancement in the bank's efforts to promote greater harmonization in the development of the Islamic finance industry.

Sagacity of Conventional Legislations with the Islamic Banking System

An appropriate legal, institutional and tax framework is a basic requirement for establishing sound financial institutions and markets. Islamic jurisprudence offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking and company laws appropriate for the enforcement of Islamic banking and financial contracts do not exist in many countries. And this is a dilemma. In different jurisdictions of the world, the legal frameworks of Islamic Banking vary. It totally depends on the legal systems existing in the country. For example in Malaysia, Turkey, Sudan, Yemen and United Arab Emirates they have enacted Islamic Banking laws parallel to the existing conventional

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\(^1\) Arab news (11\(^{th}\) October 2009); Islamic Banking Special Supplement: Shariah governance a challenge to Islamic banking by Mushtak Parker.
banking system. On the other hand in countries like Saudi Arabia, Egypt, Qatar, Pakistan, Iran Jordan and Bahrain they have not enacted any new laws to accommodate Islamic banks, but instead Islamic Banks are operated under the existing legislations which legalize the conventional banks. In Lebanon they have not enacted any laws for Islamic Banking, but the banks operate subject to the country’s fiduciary laws. In most countries banks are supervised by the Central Bank, where as in Kuwait the Ministry of Commerce is the authority which supervises banks.

To illustrate the clashes caused by applying the conventional laws to Islamic Banking, delving the current situation in Malaysia would suffice. In Malaysia, the Islamic Banking Act (IBA) and Islamic law generally are to be applied and implemented within the existing common law system and the regime of all other existing laws. This includes not only the laws but also the courts system and court procedure. It is lucid, that the system and those laws and procedure were not drafted or designed with Islamic law in mind or to facilitate the application of Islamic law.

A minute’s reflection will bring into focus the enormity of the problem. To a practitioner this is a legal nightmare and for a layman this is indeed foreboding. The complexity is that any document that is to be used in an Islamic banking transaction has to conform with both Islamic law (or in the words of the Act it must “not involve any element which is not approved by the Religion of Islam”\(^1\)) and also with all other applicable laws, eg Contracts Act, 1950, Bills of Exchange Act1949 just to name two. To take a simple illustration: a contract made in a banking transaction by an Islamic bank or as an Islamic transaction must be valid under Islamic law and also under the civil law, for it to be enforceable in the civil courts. For example, a contract may be valid under Islamic law yet it could fail in the civil courts for want of consideration and thus be unenforceable. The reverse situation can quite as well happen.

Thus any document or instrument to be used in Islamic banking has to be in accord with Islamic law, existing civil laws and must be structured in a way to as to be enforceable

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\(^1\) Section 2 of IBA
in civil courts. This problem was realized at the outset when banking documents were first drafted for use by Bank Islam and a great deal of caution was exercised to ensure their compliance with the above-stated requirements. Over the years these documents have been modified and improved upon. The validity of some of these documents was challenged in the courts but, favorably, none of those challenges have been successful.

There are multitudes of existing laws (including procedural laws) that need to be amended to make them applicable to Islamic banking. Some of these are: 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. A comprehensive study of all such legislation must be made and appropriate amendments passed by Parliament. As an interim measure, a general all-embracing provision may be enacted in the IBA and BAFIA to deal with situations of conflict among the laws that may be applicable and uncertainty in the law.  

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. Indeed, the latter can do more since s. 124 (1) also authorizes 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 within that term that is also not within the term Islamic banking business.

The Rules of the High Court 1980 and the Subordinate Courts Rules 1980 were drafted in the year shown in their titles. This was before Islamic banking was introduced into this country and, naturally, the peculiarities of claims made

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1 Section 2 of IBA and section 2 of BAFIA provides that Islamic banking and/or 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.”
and actions filed under Islamic financing were not taken into account. But the rules have not been amended since to provide for these peculiarities. This became clearly evident in the unreported case of Bank Islam Malaysia Berhad v Adnan Bin Omar.¹

The foregoing instances illustrate the type of dangerous living that lawyers practicing Islamic law in this country have to undergo in arguing cases in the civil courts. But their luck may not always hold and the danger may become real that an Islamic banking transaction (perfectly valid under the Shariah) may be held unenforceable or void because the civil law has not been equipped to handle it. That would be a legal tragedy.

Another danger zone that may be considered is uncertainty in the law and a lack of specification as to the law applicable. The Shariah 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 or under the civil law. So it is possible for a contract to be valid under the tenets of one madhab of the Shariah and not under another madhab or the civil law. If the validity of such a contract falls to be determined by a civil court, how should the court decide it?

To what sources would a judge deciding the case refer? And if there are conflicting opinions in the Shariah, which one should he adopt? If there is a conflict between Islamic law and the civil laws applicable to the matter, which should take precedence? These are all questions to which there are no straightforward answers. Problems of such nature would indeed be a predicament.

It cannot be over emphasized that there must be answers in the law to the types of questions raised above. These can only be provided by legislation and that must be done in haste as they are long overdue. Apparently the same laws and rules will apply to Islamic banking business carried on by both Islamic banks and conventional banks, though it is plausible, that in certain matters the opinions of the Shari’ah Advisor Councils may differ.

¹ [1994] 3 CLJ 735
An exemplary situation of an effort to adjust the existing conventional legislations to accommodate the need of Islamic Banking laws can be evident from Pakistan. Hence, it is imperative to grasp and analyze the impact of this change on the Islamic Banking sector of the country. By doing this the countries with parallel legal systems might get some idea on how to crack their legislation struggles.

When Islamic Banking was introduced to Pakistan, some of the laws dealing with conventional banking and finance in Pakistan was over one hundred years old. For instance, the Negotiable Instruments Act dated back to the year 1881. There were laws which regulate the conduct of affairs of banks as a separate legal entity. There were laws which authority to regulate the monetary and credit system of the country of which banks from an integral part. Laws pertaining to limited companies and partnership firms were also relevant to banks as they are part of banks’ clientele. So were some other laws which govern the contractual obligations of banks with their customers. Besides the above there were laws which provide for recovery procedures.

These legislations were important to Islamic banks too as the vigor of the banking system depends on quick adjudication of disputes and prompt recovery in cases of customers’ defaults. The laws dealing with all matters concerning banks were enacted in a context which recognized ‘interest’ as the kingpin of the system. Elimination of interest has lot more technical ramifications than what may meet the eyes on the surface. Hence the government put lot of effort to restructure these laws based on conventional system.

In 1962 a Banking Companies Ordinance was promulgated which sought to consolidate and amend the law relating to banking companies. The provisions of this ordinance were intended to the supplement and in addition to the Companies Act of 1913 and other laws except where it was expressly provided. According to Banking Companies 1962 ‘banking’ means the accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise. Deposits accepted by a company for financing of its own business of manufacturing or trading are therefore excluded from the definition of ‘banking’.
Likewise, lending of money alone falls outside the scope of banking as defined. The accepting of deposits from the public repayable on demand or otherwise always implied that the repayment of the principal sum was guaranteed and payment of a fixed rate of interest was also guaranteed if it was agreed to between a bank and its depositors. In theory this meant that the system of banking in Pakistan prior to January 01, 1981 was based on the certainty of repayment of the principal sum and also return on it formed the basis of the contract.

Introduction of interest-free banking in Pakistan as from January 01, 1981 needed suitable amendments in the existing banking laws. Consequently some amendments were made in the Banking Companies Ordinance 1962 which took effect from December 24, 1980. One of the amendments added a new section 26A which authorized the banks in Pakistan to accept deposits as under: on participation in profit and loss of the banking company; Free of interest or return in any form.

Since, the then existing system of interest-based deposits was not intended to be abolished overnight, section 26A also provided that banks could continue to accept deposits on the basis of interest until such time it is notified by the Federal Government that domestic operations of banks are to become interest-free. Section 26A also required that the banks accepting deposits on the basis of participation in profit and loss maintain separate accounts in respect of PLS deposits, investments made, cash and liquidity reserves maintained there against as well as all income and expenditure relating to these deposits. The amendment requires that the PLS deposits accepted by banks can only be invested in such transactions or business from which income does not accrue by way of interest. The amendment further provides that the depositors on the basis of participation of profit and loss of the banks are entitled to a share in the profits calculated according to general directions of State Bank of Pakistan issued from time to time in light of the needs of monetary stability. In case banks suffer a loss, the depositors are to bear the loss proportionately.

That the depositors are now to share in the profits or loss of their banks replaces a well established traditional system of
banking which rests on the principle of certainty of capital and certainty of return on it. Equally unique is the other side of the new system which requires the banks to share their profits or loss with their depositors against their traditional role of being the residual claimant. The 'rigid financial intermediation' of interest-based system has been replaced by a system of 'participatory financial intermediation' in which there is participation for the common benefit. This change in the relationship of depositors and banks though seemingly innocuous carries seeds of basic structural changes in the financial and monetary order. A system in which depositors and banks agree to share in profits or loss of banks seems to possess sufficient intrinsic strength to withstand many a crises which sometimes lead to bank failures in the traditional system of interest-based banking which prides itself on the certainty of depositors' capital and return on it only as long as the weather is fair.

Subsequently, the Partnership Act was amended too. Accepting deposits from clients on the basis of sharing of profit and loss had another legal implication in the light of section 4 of the Partnership Act 1932 which defines "partnership" as the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. The new system of accepting deposits by banks on the basis of sharing of profit and loss within the meaning of section 4 of the Partnership Act 1932 could possibly be interpreted to the effect that depositors had become partners of the bank. Under the Act a partner's liability is unlimited and the liabilities of a partnership can be recovered from any one of the partners. In a situation like this the liability of a PLS depositor could even exceed the principal sum of his deposits though it is difficult to believe that a partnership can inadvertently come into existence between a bank and its depositors. Another limiting factor is that the Partnership Act 1932 restricts the number of partners in an ordinary partnership to twenty and it is hardly to be expected that the number of PLS depositors of a bank could be so scant. However, to remove this confusion
an amendment has been made on December 31, 1984 by adding a new section 6A in the Partnership Act 1932.1

The phrasing of the amendment indicates that the law makers were overly concerned to exclude finances provided by banks to others on the basis of sharing profit & loss from the provisions of Partnership Act 1932. Obviously cases of finance provided by banks to others on the basis of sharing of profit & loss are very small in number while the number of domestic depositors sharing in the profit and loss of banks runs into millions. This demanded that the relationship of depositors with their banks should have been more explicitly excluded in the newly added section 6A. The intention of the law makers is however sufficiently evident that the profit-sharing relationship between banks and others is excluded from the purview of the general provisions of the Partnership Act 1932.

Now, if the relationship of PLS depositors with their banks and of banks with others using banks' finance on the basis of sharing of profit or loss is not to be treated as ‘partnership’ then what is the legal basis of this new relationship under interest-free banking in Islamic context. Under interest-based system it was a settled issue that the banker-customer relationship was that of debtor and creditor depending on the state of a customer’s account.2 Whoever owed money to the other was a debtor and this position could change several times in the course of a day. Since Islam does not permit transactions on the basis of interest, the debtor-creditor relationship is relevant only in the context of benevolent loan (qard al hasan). Where profit is desired to be carried by owners of funds several Islamic alternatives such as Mudaraba, Musharaka, Murabaha, Ijara etc. are available. According to Islamic law in each of these

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1 "Act not to apply to certain relationship — Nothing contained in this Act shall apply to a relationship created by any agreement between a banking company and a person or group of persons providing for sharing of profits and losses arising from or relating to the provision by the banking company of finance to such person or group of persons, For the purpose of this section, "banking company" and "finance" shall have the same meaning as is in Banking Tribunals Ordinance 1984”.

2 Foley v Hill (1848) 2 H.L.C. 28, 9 E.R. 1002
arrangements the relationship between the financier and the financed is different. To cope with this situation and to avoid dislocation definitions of 'Creditor' and 'Debtor' have been enlarged through an amendment on December 24, 1980 in Banking Companies Ordinance 1962. New clauses (dd) and (ee) have been added in section 5 of the Companies Ordinance 1962.\(^1\)

With these amendments the banker-customer relationship under the interest-free banking system in Pakistan continues to remain that of 'debtor' and 'creditor' as before. The most probable rationale of this is that even in a profit and loss sharing arrangement the principle sum subject to adjustments for profit or loss, as the case may be, is recoverable at the end of the contracted period.

Similarly definition of "loans, advances and credit" has also been enlarged by adding clause (gg) in section 5 to include finance provided on the basis of participation in profit and loss, mark-up in price, lease, hire-purchase or otherwise. This change in the definition of 'loans, advances and credit' is relevant to many other laws such as State Bank of Pakistan Act 1956, Banks (Nationalisation) Act 1974, Banking Companies (Recovery of loans) Ordinance 1979. Further amendments in various laws have again been made on December 31, 1984 through a Banking and Financial Services (Amendment of Laws) Ordinance. The definition of 'Debtor' in section 5 of the Banking Companies Ordinance 1962 has been further changed. Anyone who is provided 'finance' is a 'Debtor'. Through another amendment 'loans, advances and credit' include 'finance' which has been exhaustively defined in the Banking Tribunals Ordinance

\(^1\) (dd) "Creditor" includes persons from whom deposits have been received on the basis of participation in profit and loss and a banking company or financial institution from which financial accommodation or facility has been received on the basis of participation in profit and loss, mark-up in price, hire-purchase, lease or otherwise.

(ee) "Debtor" includes a person to whom or a banking company or financial institution to which financial accommodation or facility has been provided on the basis of participation in profit and loss, mark-up in price, hire purchase lease or otherwise"
The definition of 'finance' throws light on the nature of the new system of banking. Another issue of importance pertains to 'interest'. Though the pivotal issue in the whole exercise is the elimination of interest (Riba), yet the definition of 'interest' has not been provided as has been done in the case of debtor, creditor, loan, advances, credit etc. A legal definition of interest is badly needed to avoid controversies. A Bill of Exchange is defined as an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay on demand or at a fixed or determinable future time a certain sum of money only to or to the order of a certain person or to the bearer of the instrument. The requisites of a valid bill of exchange are mentioned in it.

1 "Finance includes an accommodation or facility under a system which is not based on interest but provided on the basis of participation in profit and loss, mark-up or mark-down in price, hire-purchase, lease, rent-sharing, licensing, charge or fee of any kind, purchase and sale of any property, including commodities, patents, designs, trade marks and copy rights, bill of exchange, promissory notes or other instruments with or without buy-back arrangements by a seller. Participation Term Certificate, Musharika Certificate, Modaraba Certificate, Term Finance Certificate or any other mode other than an accommodation or facility based on interest and also includes guarantees, indemnities and tiny other obligation, whether fund-based or non-fund based and any accommodation or facility the real beneficiary whereof is a person other than the person to whom or in whose name it was provided".

2 In the context of unclaimed deposits or articles of value after the word 'interest' the words 'or rank for a share of profit or loss' have been added in sub section (4) of section (31) of Banking Companies Ordinance 1962. In the third paragraph of section 5 of the Negotiable Instruments Act 1881 after the word 'interest', the words 'or return in any other form' have been added by a legal amendment. This amendment has been made in a reference to the definition of Bill of Exchange and also to a Promissory Note.

3 i) it must be in writing and signed by the maker
As regards to the additional amount of interest at a given rate in a bill of exchange or promissory note, the sum payable with interest was considered 'CERTAIN' within the meaning section 5 and 4 of the Negotiable Instruments Act 1881. Now with the abolition of 'interest' and its replacement with the words 'or return in any other form' which may comprise of a share in profit or loss (an unknown sum), mark-up in price in a deferred-payment sale and rental in lease or hire-purchase. This additional 'return' may not be capable of being described with the same certainty, as was 'interest' at a given rate per annum.

Whether a bill of exchange or a promissory note could remain a valid financial instrument within the meaning of the Negotiable Instruments Act 1881 if it was payable with 'return' the amount or rate of which could not be specified in the manner of rate of interest per annum. To overcome this problem a new paragraph has been added after the third paragraph in section 5 of the Negotiable Instruments Act 1881 which reads as under:

"A promise or order to pay is not conditional nor is the sum payable 'uncertain' within the meaning of this section or section 4 by reason of the sum payable being subject to adjustment for profit or loss, as the case may be of the business of the maker."

Section 79 and 80 of the Negotiable Instruments Act 1881 dealt with the relief of debtors in the context of payment of interest expressly made payable at a specified rate without mentioning dates or when the promissory note or bill of exchange were silent as regards to interest or its rate. With the introduction of interest free banking addition has been made through a legal amendment in section 79 and 80 of the

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ii) it must contain an order to pay on demand or at a determinable future time.

iii) Order contained in the bill must be unconditional

iv) the person directed to pay must be certain

v) the sum payable must be certain
The Paradox Struggle Between Islamic and Conventional Banking Systems

Act. The new provisions added and lay down set of Islamized rule for payment of return.¹

An amendment in code of Civil Procedure 1908 has also been made which provides that in a decree for payment of money due to a banking company in repayment of a loan advanced by it, the court shall in the decree provide for return on the judgment debt from the date of decree till payment in the case of finance provided on the basis of mark-up in price, lease, hire-purchase or service charges for the contracted rate or at the latest rate of the banking company whichever is higher but in case of finance provided on the basis of participation of profit and loss, for return at such rate, not being less than the annual rate of profit for the preceding six months paid by the banking company on term deposits of six months accepted by it on the basis of participation in profit and loss, as the court may consider just and reasonable in the circumstances of the case keeping in view the profit sharing agreement entered into between the banking company and the judgment debtor when the finance was contracted.

Section 7 of the Banking Companies Ordinance 1962 provides for forms of business in which banking companies may engage. The list is long and exhaustive and is similar to business conducted by banks in a well-regulated system. In addition to the list of existing forms of business banks have now been allowed through an amendment and addition of sub section (bb) to act as a "Mudaraba Company" under the provisions of the Mudaraba Companies and Mudaraba (Floatation and Control) Ordinance 1980. Restrictions on banks against forming subsidiary companies except for

(i) In the case of return on the basis of mark-up in price, lease, hire-purchase or service charges, at the contracted rate of mark-up, rental, hire or service charges as the case may be and

(ii) In the case of return on the basis of participation in profit, and loss at such rate as the Court may consider just and reasonable in the circumstances of the case, keeping in view the profit-sharing agreement entered into between the banking company and the judgement debtor when the loan was contracted. And the return on an amount due on an instrument shall be allowed from the date it becomes due till the date it is actually paid.
specified restricted purposes have been relaxed and banks can now form subsidiary companies for carrying on the business of Mudaraba.

In 1980 through another amendment and addition of sub-section (ee) in Section 7, banks were allowed the purchase of properties, moveable or immovable, exclusively for being leased out or for being sold on hire-purchase basis or on deferred payment basis with mark-up. Banks were also allowed to underwrite the issue of Mudaraba Certificates and Participation Term Certificates. Forms of business in which banking companies may engage has been further amended on December 31, 1984 and clause (ee) in section 7 of Banking Companies Ordinance has been substituted.\(^1\)

The Banking Tribunal Ordinance 1984 also provides that anyone who intentionally destroys or removes or reduces (without the prior approval of the bank) the value of property on the security of which finance was provided or transfers such property or any part of it, is punishable with imprisonment extending up to five years in addition to a fine. The tribunal may further order the refund of the value of the property destroyed, removed, reduced or transferred. If the person guilty of the above offences is a company then the same punishments can be awarded to its chief executive, executive directors, managers, secretary or any other officer unless they prove their innocence in the commission of the offence. All offences under the Banking Tribunals Ordinance 1984 are bailable, non-cognizable and compounding. A Banking Tribunal is to consist of two members and a chairman who has been or qualifies for appointment as a Judge of High Court or a District Judge. In civil jurisdiction the tribunal carries the powers vested in a civil court under the Code of Civil Procedure 1908 while in criminal jurisdiction it carries the powers vested in a Court of Sessions under Code of Criminal Procedure.

\(^1\) "Purchase or acquisition in the normal course of its banking business of and property, including commodities, patents, designs, trade-marks and copy rights, with or without buy-back arrangements by the seller, or for sale in the form of hire-purchase or on deferred payment basis with mark-up or for leasing or licensing or for rent-sharing or for any other mode of financing."
Courts v Judges: Must they be Special Too?

In jurisdictions which have parallel system of banking, the disputes relating to Islamic Banking lies with Civil Courts. This creates further conflicts. For example in Malaysia, which has parallel legal systems, a related problem arises from the fact that disputes arising in Islamic banking transactions are brought before the civil courts for adjudication. Neither the IBA nor section 124 of BAFIA exclude the application of the civil law to Islamic banking transactions. And sections 3 and 6 of the Civil law Act, moreover emphasize on the utilization of common law and equity in the when ever there is a lacuna in the law and especially to the commercial matters. 

Alternatively, there is no provision in either Act stipulating that Islamic law shall apply exclusively to such transactions. Thus presumably both Islamic law and the civil laws will apply to Islamic banking transactions. And this has to be applied within the existing common law system of courts. This includes substantive as well as procedural laws.

The next major problem is with regard to the scope of Islamic law applicable in the Civil Courts to determine the disputes. In Malaysia, the definition of Islamic Banking given in Section 2 of the Islamic Banking Act is wide enough to validate the views of all school of jurisprudence. The IBA, having authorized Islamic banks to carry on Islamic business, has not defined the Islamic law that is to be applied to Islamic banking transactions. It has not even indicated the sources (e.g. standard texts) from where the law may be derived. The role of the Shariah Advisory Council, important though it is, must as a matter of practicality be restricted. It cannot be expected to provide a ruling or advice on issues that arise in the daily operations of Islamic banking. The lack of guidance in the IBA as to the sources is posing a real problem to both counsel who have to present arguments in court, and to judges who have to decide cases before them.

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1 See section 3 of the Civil Law Act 1956
2 See section 6 of the Civil Law Act 1956
Whilst the applicable principles for the transaction in question, and to some extent the documentation, might have been approved by the respective Shariah advisory council, counsel would be left very much to their own devices in preparing arguments in presenting cases in the courts. Judges, too, would be in a difficult position to decide cases without fully researched arguments by counsel and authoritative reference material to which they could refer in making decisions.

Conversely, the divergence of opinions among Islamic jurists and scholars to which different counsel might have access and which they would each urge the court to adopt might be so complex that deducing a principle of law from them might seem to be as much a deliberate decision after considerable thought as the toss of a coin.

Another point which is worth pondering is what would be the position if the advice of the shari'ah bodies on the same issue differs? How would a court be expected to decide such differences in opinion if a matter in respect of which there are differences between these bodies reach the civil court?

One provision of particular significance to this matter is Section 3(5)(b) of the Islamic Banking Act which provides that the Central Bank (ie Bank Negara Malaysia) shall not recommend the grant of a license, and the Minister shall not grant a license, unless he is satisfied:

(b) that there is, in the articles of association of the bank concerned, provision for the establishment of a Syar'iah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam".

This is an important provision. However, its real purport has not been tested in the courts as yet. The setting up of a Shari'ah advisory body is a statutory requirement and its function is "to ensure that [the operations of the bank] do not involve any element which is not approved by the Religion of Islam". What is the ambit of this subsection? To take an example, if a particular document used in banking transactions by a bank licensed under the Islamic Banking Act has been approved by its Shari'ah advisory body, can it then be challenged in court as being contrary to Shari'ah?
Can the court find such a document to be not in accordance with the Shari'ah? If it does so, what is the effect of it on the decision of the Shari'ah advisory body?

In other words, are decisions of the Shari'ah advisory body open to review by the courts? This is by no means an easy question to answer. And it is not easy either to venture an opinion on the issue since any opinion has to be relative to particular factual situations. It is suggested that the issue should be cleared up by legislation rather than by lengthy and costly litigation in the courts.

Another vital point is that in non-muslim jurisdictions the courts to which the Islamic Banking disputes referred to are wholly based on common law or civil law. And the judges lack the knowledge of Islamic law and the fundamental principles of Islamic economics and finance. For instance, in the English case of *Shamil Bank of Bahrain E.C. (Islamic Bankers) v Beximco Pharmaceuticals Ltd & anor*, the issue was on the option of law applicable to the parties, particularly the selection of shari'ah as governing law. And this case dealt with the problem in enforcing of the shari'ah in a hundred percent secular state where the contracts at issue specified the use of English law as the governing law, subject to the glorious rules of shariah. This problem is worsen because, Islamic banking's legal framework is as fragmented as other aspects of the industry, with little case law to guide judges.

Now another question which can be posed here is whether changing the Islamic Banking jurisdiction from Civil courts to the Shari'ah courts would solve the complex problem of lack of knowledge in the judges? Indonesia is a good model to demonstrate that the solution to the problem of lack of knowledge is not giving the matter to the hands of shar'ah courts. And that the problem do not stem from granting the jurisdiction of Islamic Banking matters to the civil courts.

Islamic banking in Indonesia started to operate from 1992 by virtue of the enactment of the Banking Act No. 7/1992; and when Bank Muamalat was established as the first bank which operates in accordance with Islamic principles. The Banking Act No.7/1992 was amended by Act No. 10/1998,
to provide an opportunity to conventional banks to open an Islamic window. Since that time, the growth of Islamic banking in Indonesia has been progressing steady and fast. In the past, there was confusion on the question which forum was competent to settle Islamic banking disputes: civil court or religious court. Both regarded themselves to be competent to settle such disputes. But the problem was that the jurisdiction of the civil courts did not extend to Shari’ah matters, within which Islamic banking disputes apparently came. On the other hand, the jurisdiction of the religious courts was limited to Personal law matters which did not cover banking disputes, and was confined to a) marriage, b) inheritance, testamentary succession, hiba and waqf. There was no possibility of any deviation as the matter was clearly spelled out in section 49 of the Act No. 7 of 1989.

In the absence of an appropriate body to take charge of the settlement of Islamic banking disputes, an initiative was taken by the Indonesia Council of Religious Scholars to set up BAMUI (Indonesian Muamalat Arbitration Body) in 1993. The name of this body was changed in 2003 to Basyarnas (National Shari’ah Arbitration Body). However due to very poor knowledge of the Islamic law of arbitration possessed by the banks and their banking costumer complainants, the National Shari’ah Arbitration Body could not function effectively due to the fact that a dispute cannot be arbitrated unless there is an arbitration agreement between the parties (i.e., the bank and customer) was not fully appreciated by the parties. Consequently, disputes brought for arbitration by both of them were lacking necessary legal foundation and could not thus be legally arbitrated. Any award made in such arbitration was not enforceable.

As a result of this problem, most of the cases involving Islamic banking disputes continued to be taken to the civil courts, notwithstanding the questionable knowledge of the judges of such courts of matters relating to Islamic banking and finance.

This incongruity was rectified in February 2006 through Law No. 3 of 2006 which amended Law No. 7 of 1989 and expanded the jurisdiction of the Religious courts to cover
The Paradox Struggle Between Islamic and Conventional Banking Systems

adjudication of disputes belonging to Islamic economic matters, including Islamic banking.\(^1\)

This expansion arguably enhanced the status and authority of Religious courts as a dispute settlement institution within the judiciary system in Indonesia. However, this turns out as another challenge for Religious courts due to the fact of the complexity of Islamic economics matter, and needed more time to be properly absorbed and understood.

Therefore, the only sensible solution for the matter relative to lack of education of Islamic matters in civil courts would be to educate them or call experts to give evidence in the matters relating to Islamic Banking. Islamic Commercial matters are indeed technical matters and hence the complexity on the matters can only be explained by an expert. And there is nothing discreditable in calling an expert.

**Islamic Finance and Alternative Dispute Resolution**

Dispute resolution in the Islamic Banking sector has emerged; however the extent to as which it serves as an alternative to litigation is questionable. Islamic finance disputes can be referred to arbitration by specialists in many countries but many Malaysian cases still go court. In Bahrain, such cases have mostly gone to dispute resolution committees staffed by judges and specialized central bank officials. Where as in Indonesia the arbitrators lack ample knowledge of Islamic commercial matters and this inhibits their capacity to solve the disputes in issue.

In Malaysia, under the auspices of the Malaysia International Islamic Finance Centre which was setup in 2006, the International Shariah Research Academy (ISRA) was established in March 2008, with a mandate on researching Shariah issues on Islamic finance, with special focus on contemporary matters. One project currently

\(^{1}\) Gemala Dewi, Aspek-Aspek Hukum dalam Perbankan dan Perasuransian Syariah di Indonesia, (Jakarta, Kencana, 2004), p. 104
undertaken by the ISRA includes avenues in alternative dispute resolution in Islamic banking.

The KLRCA caters specifically to disputes on Islamic bank and finance and employ the use of *Rules For Arbitration Of Kuala Lumpur Regional Centre For Arbitration (Islamic Banking And Financial Services)*. The Rules by itself holds itself out as “applicable for the purposes of arbitrating any commercial contract, business arrangement or transaction which is based on Shariah principles” and propose a model arbitration clause for contracts\(^1\), with additional prerogatives offered as to the number of arbitrators, law applicable etc. One drawback on the matter might be taken as Rule 1 of the aforementioned Rules which state that only in cases where the disputed agreement in writing calls for the auspices of the KLRCA, would these rules apply.

In Bahrain’s Ministry of Justice signed an agreement with the American Arbitration Association (AAA), to establish a new Alternative Dispute Resolution (ADR) centre in Bahrain to be known as the Bahrain Chamber for Dispute Resolution (BCDR). This agreement was signed in August 2009. Having recently enacted legislation which cements the position of the BCDR in domestic law and establishes Bahrain’s reputation as a neutral venue for multinational companies seeking to conduct international arbitrations.

Indonesia faced a general lack of a competent body for resolution of banking disputes. As have been discussed, the Indonesian Council of Religious Scholars to set up BAMUI (Indonesian Muamalat Arbitration Body) in 1993. However poor knowledge of the Islamic law of arbitration crippled the process in Indonesia and the fact that a dispute cannot be arbitrated unless there is an arbitration agreement between the parties (i.e., the bank and customer) did not help the situation at all. Consequently, disputes brought for

\(^{1}\) “Any dispute, controversy or claim arising from Islamic banking business, takaful business, Islamic financial business, Islamic development financial business, Islamic capital market products or services or any other transaction business which is based on Shariah principles out of this agreement/contract shall be decided by arbitration in accordance with the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services)”.

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arbitration by both of them were lacking necessary legal foundation and could not thus be legally arbitrated. Any award made in such arbitration was not enforceable. In short, the system was vulnerable. The country's solution was to amend the laws to enable Shariah Courts with jurisdiction over the matter. In the perspective of alternatives to dispute resolution this may have been an unwelcomed move. Instead of solidifying the arbitration structure of Indonesia, the problem was once again hurled into the Courts. It has to be remembered here that Indonesia's reliance on ADR institutions stemmed not from the conventional problems of the Court system i.e. expedient case management, possibility of mediation, and the other usual pro factors which creates a push for ADR. Their trust in the system initially stemmed from their desire to avoid civil court in matters relating to Islamic finance.

However, it shall be noted here that arbitration is not free from problems. At one stage or the other reference needed to be made to the common law and even after the arbitration award is given, if parties want to enforce the award they still have to go to court. And this does not lessen burden of the courts.

**Conclusion: What Needs to be Done**

Once viewed as a small segment of the financial world, Islamic banking and finance has emerged as a key player in global financing in recent years, gaining worldwide recognition around the world. Today, even global financers such as HSBC are offering Islam compliant products, such as the Shariah compliant mortgages the Bank introduced in 2003, in order to attract Muslim customers with reservations. Today, with products such as HSBC Amanah, they have gone much further in offering Shariah based banking products, as a clear sign of its creeping influence. And today, Malaysia has a full-fledged Islamic system operating parallel to the conventional financial system. Nevertheless, practicality of the system was a challenge that faced the Islamic sibling in its endeavor to replicate the products and services offered by its conventional brother. Unlike conventional Banking's conviction on interest, Islam
argues for a fair distribution of profit and loss and bans purely speculative activity. On a more positive note, amendments brought to the Bank Negara Act in 2009 serves itself as encouraging on the maturity of Malaysia on the issue of Islamic finance, with the recognition of the Shariah Advisory Council as the apex authority on Islamic finance, with its decisions binding upon the Courts. This opens the door to uniformity and informed decision making in cases of resolving disputes.

Forging greater alliances with international financial institutions create instances where both parties may benefit from each other. This give rise to financial innovation and refinery of already established practices. Alliances with other Islamic financial institutions create diversity of views with regard to the already prolific debate on specific products, providing a fresh perspective for the National Shariah Advisory Council as well.

Islamic finance cases are being adjudicated throughout the world under the purview of the respective national Courts in line with the respective systems of law. This situation creates specific groups for countries to be categorized under three main assemblages. The first group is where the Shariah is the supreme source of law, as for example, in Saudi Arabia, Iran, Sudan and Pakistan, the second one is where one of the sources of law in the country is the Shariah. This group houses examples such as Malaysia, Kuwait and UAE. The third category is where Islamic law is not recognized as a source of law at all. No practice around the world today accommodates a specialized bench for adjudication of Islamic finance issues. The scope and implications of the phrase would be witness to its large scale and thus a specialized bench might not be an idea unfeasible.

This would also give the opportunity to place skilled judges who are knowledgeable in Islamic law. Although the 2009 Amendment to the Bank Negara Act has placed an obligation upon judges to refer the matter to, and ultimately being bound by, the Shariah Advisory Council. A specialized bench would be expedient disposal of cases, a factor which is already of concern for lawmakers. The same sentiments were spoken of by Mohamed Ismail Shariff (1998), in his article,
The Development of Islamic Banking Law in Malaysia. However, Shariff spoke of creating a specialized division within the framework of the civil High Court. On the other hand, creating a specialized bench at the civil high Court may be a shorter approach as creation of such benches in the Shariah court system would mean amending laws which afford them jurisdiction over the matter as well.

Another complicating matter is the lack of a globally accepted qualification as a Shariah scholar, just as there are no globally accepted standards for Shariah rules, which are to some extent open to interpretation. Since Shari’ah Advisors are the backbone of the industry, it is put forward here that the composition of these Councils need to be reformed and standardized globally. This is because, today the scholars of Islamic law have monopolized the Islamic Banking system and this might lead to abuse. And also scholars with only Islamic knowledge might jeopardize the competitive development of Islamic Banking products. Therefore, it is our suggestion that the appointment of scholars with parallel knowledge of Islam and finance would make Islamic banking more competitive in the system. But to be realistic, it should be noted here that it would be very hard to get scholars of this nature. Hence, until we get a supply of such scholars, it is put forth here to appoint financial consultants and Islamic scholars to the Councils. This way, the financial aspect and the Shari’ah issues can be solved simultaneously. And the contact between the market players and the Islamic scholars need to be improvised.

1 [1998] 1 MLJA 145