

# **THE LEGAL FRAMEWORK OF THE ISLAMIC FINANCIAL SYSTEM : A STUDY ON THE CASES IN MALAYSIA**

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## **Abstract**

*The legal framework of the Islamic financial system in Malaysia is subjected to civil law. This is because the Federal Constitution which divides the jurisdiction of the civil and shari'ah matters is silent on whether the Shari'ah Court has the power to hear cases or disputes relating to Islamic finance. As such, numerous interpretations of the Civil Court in contractual and financial applications are given. Some of them conflict with the Shari'ah law and rather emphasise on the usage of the civil law. Henceforth, this study will be focusing on the results and interpretations of the Civil Court in cases of Islamic finance and banking. Furthermore, the authors recommend some amendments to the Constitution and relevant Acts, to strengthen the laws relating to Islamic finance and to enhance the role of the Shari'ah Court.*

**Keywords:** *framework of Islamic Finance, transactions, court, Islamic bank*

## **Introduction**

Malaysia has emerged as a comprehensive and active player of the Islamic financial system since the mid 80s. The introduction of the Islamic Banking Act (IBA) in 1983 and the Government Investment Act 1983 has

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enabled Islamic banking and financial transactions to be carried out in accordance with the *Shari'ah* principles. This further developed the Islamic insurance coverage system through the Takaful Act (TA) in 1984. Then, the Banking and Financial Institutions Act (BAFIA) 1989, was amended to include Section 124 to establish Islamic Banking Systems (IBS) in the conventional banks. The Securities Commission Act 1993 was later introduced and it made the Islamic financial system progress a step further, especially in the Islamic capital market. However, despite the positive achievements, obstacles began to arise in various forms, including in legal aspects. The legal framework is still ambiguous and overshadowed by the civil authority granted by the Constitution and not based on the principles of *Shari'ah*. Cases relating to Islamic transactions show how *Shari'ah* laws are given little regard in Civil Courts.

This article will discuss the matter above by focusing on three main elements:

1. The position of Islam and the *Shari'ah* Court in the Federal Constitution;
2. The legal framework of the Islamic financial system; and
3. Analysis of cases and issues relating to Islamic finance and recommendations in improving the operation system.

## **Islam in the Federal Constitution**

The Federal Constitution is the supreme law in Malaysia. Article 3 (1) of the constitution states that Islam is the religion of the federation. However, according to Article 74 (2), matters pertaining to persons professing the religion of Islam are placed under the jurisdiction of the states and not the federal. Thus, while Islamic laws have jurisdiction, they are subjected to limitations as specified in the Ninth Schedule, List II (State List) as follow:

*“1. Except with respect to the Federal Territories of Kuala Lumpur, Labuan and Putrajaya, Islamic law and personal and family law of persons professing the religion of Islam, including the Islamic law relating to succession, testate and intestate, betrothal, marriage, divorce, dower, maintenance, adoption, legitimacy, guardianship, gifts, partitions and non-charitable trusts; Wakafs and the definition and regulation of charitable and religious trusts, the appointment of trustees and the incorporation of persons in respect of Islamic religious and charitable endowments, institutions, trusts, charities and charitable institutions operating wholly within the State; Malay customs; Zakat, Fitrah and Baitulmal or similar Islamic religious revenue; mosques or any Islamic public places of worship, creation and punishment of offences by persons professing the religion of Islam against precepts of that religion, except in regard to matters included in the Federal List; the constitution, organization and procedure of Shari'ah courts, which shall have jurisdiction only over persons professing the religion of Islam and in respect only of any of the matters included in this paragraph, but shall not have jurisdiction in respect of offences except in*

*so far as conferred by federal law; the control of propagating doctrines and beliefs among persons professing the religion of Islam; the determination of matters of Islamic law and doctrine and Malay custom.”*

According to Mahmud Saedon (1998), although Article 3 states that Islam is the religion of the Federation, it does not mean that Islamic law is the law of the land. In fact, if a state law enacted is contrary to the Constitution; it would be rendered void to the extent of its contrariness as construed in Article 4 (1). Thus, the jurisdiction of the state to enact laws relating to Islam is limited. The scope of Islamic laws as stated above may be classified as follow:

- i. Islamic family matters such as engagement, marriage, divorce, maintenance, guardianship and child custody.
- ii. Management of Islamic assets such as inheritance, matrimonial property, wills, *waqf*, *baitulmal*, alms or the Islamic treasury.
- iii. Management of mosques and Muslim places of worship.
- iv. Criminal Offences involving Muslims as authorised by the Constitution as according to respective state laws such as failure to perform the Friday prayers in congregation, failure to fast during Ramadan, consumption of intoxicants and so on.
- v. Control over the development and propagation of religion or doctrine towards Muslims.

Islamic law currently applies only to Muslims and its purview is limited to personal and religious matters. In fact, Section 3 (1) and 5 (1) of the Civil Law Act 1956 provide:

3. (1) Save so far as other provision has been made or may hereafter be made by any written law in force in Malaysia, the Court shall - (a) in Peninsular Malaysia or any part thereof, apply the common law of England and the rules of equity as administered in England on the 7 April 1956;

5. (1) In all questions or issues which arise or which have to be decided in the States of Peninsular Malaysia other than Malacca and Penang with respect to the law of partnerships, corporations, banks and banking, principals and agents, carriers by air, land and sea, marine insurance, average, life and fire insurance, and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in the like case at the date of the coming into force of this Act, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law.

As a result, unless there is a specific written law in Malaysia, the basic law that would be applicable and referred to would be the English law, as both the federal and state laws. (Ahmad Mohamed, 1997, p. 14 -15).

### ***Shari’ah* Court in the Federal Constitution**

Federal Constitution empowers the government to establish *Shari’ah* Courts by virtue of the provision of the Ninth Schedule, List II (State List) of the Federal Constitution. The provision reads as follows:

*“...except in regard to matters included in the Federal List; the constitution, organisation and procedure of Syariah courts, which shall have jurisdiction only over persons professing the religion of Islam and in respect only of any of the matters included in this paragraph, but shall not have jurisdiction in respect of offences except in so far as conferred by federal law; the control of propagating doctrines and beliefs among persons professing the religion of Islam; the determination of matters of Islamic law and doctrine and Malay custom.”*

The provision clearly indicates that the powers granted to the *Shari'ah* Court are limited to a specific scope and it applies to Muslims only. Currently, the *Shari'ah* Courts operate under the respective Administration Enactment that exists in the states. They also have their own jurisdiction with regards to criminal and civil matters, similar to the type of jurisdiction that Civil Courts have. Be that as it may, the ambit of criminal jurisdiction for the *Shari'ah* Courts is limited to criminal offences that do not exceed the sentence of three years imprisonment, a fine of RM 5,000.00, six strokes or a combination of these punishments. (Abdul Aziz B., 2000).

Similarly, on civil matters, the *Shari'ah* Court is only authorised to hear cases that affect the affairs of Muslims within the scope as provided in the List II (State List) of the Ninth Schedule mentioned above. According to Mahmud Saedon (1998), the Islamic law can only be applied in the narrow sense, that is, it must only pertain to personal and family laws, upon Muslims only and under the limited jurisdiction as what has been construed in the Federal Constitution.

However, the constitutional amendment of Article 121 (1A) which separates the jurisdiction of the *Shari'ah* Court and the Civil Court has given some room for the former to operate without interference from the latter. This 1988 amendment states that the Civil Court has no jurisdiction on matters that are within the *Shari'ah* Courts' jurisdiction. However, the question here is whether Islamic finance matters would then fall within the specific ambit of the *Shari'ah* Courts' jurisdiction. Unfortunately, the answer is no. This is because nowhere it is expressly stated in the provision of the Ninth Schedule that such matters shall fall under the *Shari'ah* Courts' jurisdiction. Furthermore, the *Shari'ah* Court can only hear cases of persons professing the religion of Islam. Currently, all cases relating to Islamic finance are heard in the Civil Courts. This is very unfortunate for the Islamic financial system in our country as it is the Civil Court that will be the decision maker for disputes relating to Islamic laws instead of the *Shari'ah* Court.

## **Legal Framework of Islamic Finance in Malaysia**

The Federal Constitution has no specific provisions on matters related to Islamic banking or finance. In fact, the provisions in the Ninth Schedule, List II (State List), which touches on Islamic law and the jurisdiction of the *Shari'ah* Court only specifically mentions other matters such as personal and family laws. Be that as it

may, the clauses 'Islamic law' and 'Islamic law and doctrine', are open to interpretation and as such, arguably it may include matters relating to Islamic finance. However, on the other hand, matters relating to finance is expressly stated to fall under the federal jurisdiction by virtue of Article 7, the Ninth Schedule, List I (Federal Register). Thus, any disputes relating to Islamic financial transactions will be tried in Civil Courts and not the *Shari'ah* Court.

Having said that, the Islamic banking and financial system in Malaysia is quite profound. This is because the Islamic Banking System (IBS) is at par with the conventional banking, as the former is allowed to operate in a similar manner to the latter. In fact, apart from the Islamic products and facilities that are available in Islamic banks, this system has been established in conventional banks by offering products based on Islamic contracts. Islamic banking and financial system has its own uniqueness because its framework is subjected to the *Shari'ah* principles and civil law. Section 2 Islamic Bank Act 1983 (Act 276) provides the following:

*"Islamic banking business" means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam."*

The interpretation of the terms 'takaful business' in Section 2 of the Takaful Act 1984 and "Islamic banking business' in Section 124 (7) (c) of BAFIA 1989 also bear similar purpose, i.e. having elements that are in line with the Shariah principles. In fact, Sections 8 (5) and 11 (1) (a) of the TA 1984 which provide for the registration of takaful business state that the license of such business can be rejected and may be revoked if the elements involved conflict with the Islamic law. Therefore, any Islamic financial transaction must be based on *Shari'ah* law as well as the existing civil law. The transaction must be free from unlawful elements in Islam such as usury, *gharar* (uncertainty), gambling, fraud and others.

The legal framework for the Islamic financial system in Malaysia is actually subjected to the federal power as specified in the Constitution. This means it is subjected to the laws passed by Parliament before they can actually operate (Lee Mei P., 2001). Thus, there are several Acts passed to regulate the operations of Islamic banking and finance. These Acts may be divided into primary laws (regulatory) and secondary laws (substantive). Primary laws are Acts legislated to control the operations of Islamic banking and finance, such as the National Bank Act 1958 (now the National Bank Act, 2009), IBA 1983, the Government Investment Act 1983, TA 1984, the Banking and Financial Institutions Act 1989 and Securities Commission Act 1993. Secondary laws are amendments made to some provisions of the existing Acts related to Islamic banking and financial system so that it can operate properly and it can be ascertained that contracts involved would be free from elements of usury. Examples of such Acts are the Contracts Act 1950, Companies Act 1965, the National Land Code 1965, the Hire Purchase Act 1967, the Income Tax Act 1967, the Bankruptcy Act 1967, Anti-Money Laundering Act 2001 and so on.

The operation of the Islamic financial system is regulated by Bank Negara Malaysia (BNM) as the main body which supervises and oversees the course of all the financial and banking institutions in Malaysia, be it Islamic or conventional systems. Any application or revocation of licenses of financial institutions, banking, products and so on are under the approval of BNM (Sudin and Bala, 1997). In addition, Section 3 (5) (b) IBA 1983 and Section 124 (3) BAFIA 1989 also require all Islamic banks and conventional banks which participate in SPI to establish the *Shari'ah* Advisory Council (SAC) of its own and this is obligatory. The Council serves to monitor whether the operations of Islamic financial products offered are in accordance with *Shari'ah*. In fact, the BNM itself by virtue of Chapter I, Part VII (Islamic Financial Business) of the National Bank Act, must establish a National *Shari'ah* Advisory Council. This Council was established in 2007 and serves to give recommendations and opinions relating to the *Shari'ah* legal rulings on the financial and banking system.

In general, the legal framework of Islamic finance can be illustrated by the following table:

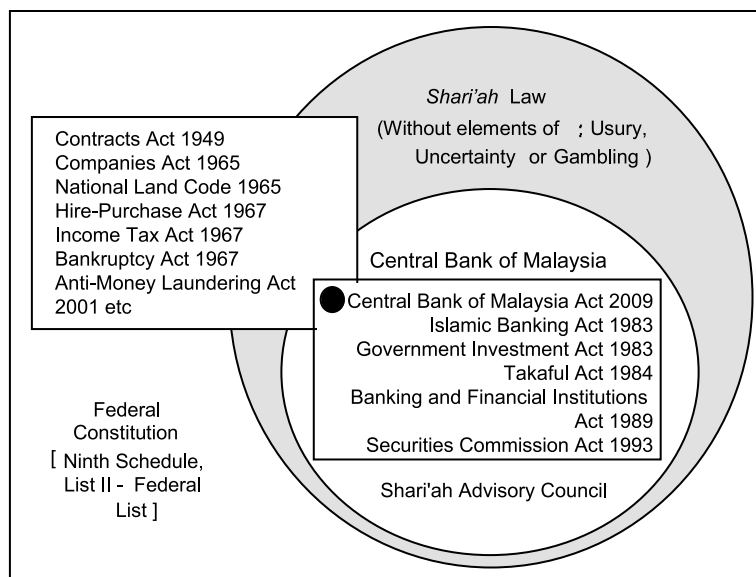


Figure 1 : The Legal Framework of Islamic Finance in Malaysia

## Cases Relating to Islamic Finance

As mentioned above, the financial issues are under the purview of the federal authority and thus the *Shari'ah* Court has no jurisdiction to hear disputes relating to Islamic finance. Therefore, all court cases relating to Islamic transactions are registered and heard in the Civil Courts, specifically in the High Court of Commerce 4 if registered in the High Court of Kuala Lumpur. According to the Annual Report of the Superior and

Subordinate Courts in Malaysia 2006/2007, a total of 478 cases were registered in the High Court of Malaya in Kuala Lumpur from 1<sup>st</sup> July 2006 to 30<sup>th</sup> June 2007 with 80 percent of the cases or 382 cases successfully completed. However, the overall outstanding balance of the cases until 1<sup>st</sup> July 2007 amounted to 554 cases.

International *Shari'ah* Research Academy (ISRA) for Islamic Finance has listed 26 landmark cases related to Islamic finance from the years of 1987 to 2007. The list of cases is as follows:

1. Tinta Press Sdn Bhd v Bank Islam (M) Bhd [1987] CLJ 396 / [1987] 2 MLJ 192.
2. Bank Islam Malaysia Berhad v Adnan Bin Omar [1994] 3 CLJ 735 / [1994] 221 MLJU.
3. Dato 'Hj Nik Daud Mahmud v Bank Islam Malaysia Bhd [1998] 3 CLJ 605.
4. Bank Islam Malaysia Bhd v Shamsuddin Bin Haji Ahmad [1999] 1 LNS 275 / [1999] MLJU 450.
5. Bank Kerjasama Rakyat Malaysia Bhd v Nesaretnam Samyveloo [2002] 8 CLJ 1995 / [2002] 7 MLJ 103.
6. Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd [2003] 1 CLJ 625 / [2003] 2 MLJ 408.
7. Bank Islam Malaysia Berhad v Farmers Supermarket Sdn Bhd [2004] 7 MLJ 355.
8. Tahan Steel Corporation Sdn Bhd v Bank Islam Malaysia Bhd [2004] 6 CLJ 25 / [2004] 6 MLJ 1.
9. Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd [2008] 6 MLJ 295.
10. Affin Bank Bhd v Zulkifli Abdullah [2006] 1 CLJ 438.
11. Malayan Banking Bhd v Marilyn Ho Siok Lin [2006] 3 CLJ 796.
12. Malayan Banking Bhd v Ya'kup Oje & Malili [2007] 5 CLJ 311 / [2007] 6 MLJ 389.
13. Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd [2008] 1 CLJ 784 / [2007] MLJU 0722.
14. Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors, Seri Kota Bukit Cheraka Co Ltd (Third Party) and Other Cases [2009] 1 CLJ 419 / [2008] 5 MLJ 631.
15. Majlis Amanah Rakyat v Bass Bin Lai [2009] 2 CLJ 433.
16. Bank Islam Malaysia Berhad v Lim Kok Hoe & Malili and other Appeals [2009] 6 CLJ 22 / [2009] 6 MLJ 839.
17. Light Style Sdn Bhd v KFJ Ijarah House (Malaysia) Sdn Bhd [2009] CLJ 370 / [2009] 1 LNS 193.
18. Arab-Malaysian Merchant Bank Berhad v Foreswood Industries Sdn Bhd [2007] MLJU 664.
19. Fadzillah Ahmadi Bin Alii v Mayban Finance Berhad [2007] MLJU 663.
20. Bank Muamalat Malaysia Bhd v Suhaimi Bin Md Hashim & Malili [2007] 1 MLJ 275.
21. Southern Bank Bhd v Ayer Keroh Park Sdn Bhd [2005] 6 CLJ 134 / [2005] 4 AMR 597.
22. Malayan Banking Berhad v Zainal Abidin Abdullah & Malili [2008] MLJU 180.
23. Assets Investments Pte Ltd v OSK Securities Bhd [2005] 6 MLJ 643 / [2005] 7 CLJ 401 / [2005] 6 AMR 671.

24. Bank Kerjasama Rakyat Malaysia v Sea Oil Mill Sdn Bhd & Malili [2003] MLJU 207 / [2003] 1 LNS 718.
25. Oriental Bank Berhad v The collaboration of Knowledge Sdn Bhd & Ors [2003] MLJU 485.
26. Industrial Bank (M) Bhd v Technopro Corporation (M) Bhd [1998] 6 MLJ 754

## **Legal Issues Regarding the Islamic Financial System**

Some may say that the Islamic Financial System in Malaysia has been firmly established since the existence of the IBA 1983. However, until now many legal polemics have arisen. The issues that arise can sometimes hinder the operation and lower the credibility of Islamic finance in the eyes of the public. Among the issues that appear in court regarding this matter are as follow:

### **i. The jurisdiction of the *Shari'ah* Court and Civil Court in the transactions cases.**

Cases relating to Islamic finance are not heard in the *Shari'ah* Court but instead registered and tried in Civil Courts. It has been argued in the case of *Bank Islam Malaysia Berhad v Adnan Bin Omar* [1994] 3 CLJ 735 / [1994] 221 MLJU that the *Shari'ah* Court has jurisdiction to hear matters under the Ninth Schedule, List II (State List) of the Federal Constitutions only. Furthermore, the parties involved must be Muslims only. Thereafter, the Court has no authority to hear such cases because bank customers consist of non-Muslims too. Even more so, since Islamic banks are corporate bodies and not persons professing the religion of Islam, this means that the *Shari'ah* Court has no authority to hear the case. The IBA 1983 and TA 1984 also do not provide for any jurisdiction to the *Shari'ah* Court to act in dispute relating to Islamic transactions. Hence, only a civil court has broad powers in this regard.

It is also argued that related laws including financial and banking are included under the Ninth Schedule, List I (Federal Register) that fall under the statute law and English law. In fact, according to Section 5 (a) and reinforced by Section 3 of the Civil Law Act 1956, the courts may use the English law if there is no provision of law on a matter such as issues relating to banks and banking. The application of English law has led to the doctrine of "binding precedent" that is a case decided by the superior court shall be a binding decision to be followed by the lower court (Norhashimah, 2003).

### **ii. The contradiction of the Civil law with the concept of *Shari'ah***

The Islamic financial system in Malaysia does not have a comprehensive law for it to operate. Its implementation and operation are only to the extent of being monitored or supervised by the IBA 1983 and TA 1984. In reality, the operation of Islamic finance is still dependant on civil Acts to operate. In the case of *Bank Islam Malaysia Berhad v Adnan Bin Omar* [1994] 3 CLJ 735 / [1994] MLJU 221, the court held that the Islamic banking operations were subjected to the civil law such as the Contracts Act 1950, the National Land Code 1956, the Companies Act 1965 and the Hire Purchase Act 1967.



As a result, contradictions may happen between the Acts with the principles of *Shari'ah*. For example, the *Shari'ah* prohibits the occurrence of two contracts in one contract. However, the Hire Purchase Act 1967 on the other hand, allows such a contract. This is clearly contrary to the principles of *Shari'ah* which only allows two contracts to be done separately. Because of that, the Islamic financial institutions offer hire purchase contracts by using Al-Ijarah Thumma al-Bay' (lease followed by purchase) or Al-Ijarah Muntahiyah bi Tamlik (lease ends in ownership).

### **iii. Interpretation of Islamic finance contracts with conventional contracts**

In the case of *Tinta Press Sdn Bhd v Bank Islam (M) Bhd [1987] CLJ 396 / [1987] 2 MLJ 192*, the court interpreted that the contract used was a lease contract whereas the bank was using the al-Ijarah contract in the transaction between them (Ahmad Ibrahim, 1997). These two contracts are not similar in character. The Court had also referred to the English law without reference to the Islamic law even though the contract was Al-Ijarah. (Ahmad Hidayat, 2001). Islamic contracts should be interpreted as according to Islamic laws.

Similarly, in the case of *Bank Islam Malaysia Berhad v Adnan Bin Omar [1994] 3 CLJ 735 / [1994] MLJU 221* and the case of *Affin Bank Bhd v Zulkifli Abdullah [2006] 1 CLJ 438*, the judge referred to the Bay 'Bithaman' Ajil (BBA) contract as a loan. This is contrary to Islam which prohibits excess payment to the loan as it is usury, while the BBA contract is allowed as it is an agreed profit margin. This is because the BBA is a sale with a deferred sale price, rather than loans, as understood in conventional contracts. As such, banks that offer Islamic capital through BBA call it "financing" rather than "loan" as what conventional banks offer.

Furthermore, the Court would rather emphasise on the interest of the contract, whereas BBA actually uses the principle of profit. In these and other related cases, the courts did not refer the contract to the principles of *Shari'ah*, but referred to the rules that existed in conventional systems.

### **iv. Claim of total profit before the end of tenure**

BBA is a purchase contract through pending sale where the customer pays the purchase price in installments to the bank. The selling price includes the purchase price plus a fixed profit. However, problems arise when the contract is terminated by reason of default such as customers failed to pay the stipulated installments. This means that although the contract took place half way, the customer must pay the entire balance of the purchase price.

This raised an issue in court on whether the customer has to pay only the purchase price or pay the whole selling price including the profit until the expiration of the agreement. Thus in many cases, the court considers the purchase price to be paid is high and contrary to the concept of justice in Islam. For example, a judge in the case of *Malayan Banking Bhd v Ya'kup Oje & Malili [2007] 5 CLJ 311 / [2007] 6 MLJ*

389 viewed repayment amount in the BBA contract as excessive and unfair when compared with conventional banking. The judge in the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors, Seri Kota Bukit Cheraka Co Ltd (Third Party) and Other Cases [2009] 1 CLJ 419 / [2008] 5 MLJ 631* decided that the BBA contract transactions were considered contrary to Islam and the profits in such contract had elements of usury similar to the conventional bank loan.

With regards to the BBA transaction, other judges in the Civil Courts have also decided in a similar manner. In reality, BBA is a contract of sale, rather than loan. The sale price, namely the price of purchase and profits have been set and agreed upon in advance. The method of the payment of the selling price occurred in installments every month until the end of the period of financing. This is in contrast with the contract of loan which charges interest rates each month.

#### **v The functions of the *Shari'ah* Advisory Council**

Section 3 (5) (b) of the IBA 1983 provides that an Islamic banking institution must be granted license to operate and should ensure the establishment of a *Shari'ah* advisory body to advise the bank on the banking business operations to ensure they are not involved with any elements that are not approved by Islam. Similarly, BAFIA 1989 and TA 1984 also provide for the establishment of the SAC respectively for conventional banks that participate in SPI and takaful companies. In addition to the SAC itself, Section 13A of the IBA 1983 also provides that Islamic banks can also refer to the problems of their operations to the National *Shari'ah* Advisory Council (NSAC) under the supervision of BNM. According to the National Banking Act in 2009, the functions of NSAC are as follows:

*“52. (1) The Shari'ah Advisory Council shall have the following functions: (a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part; (b) to advise the Bank on any Shari'ah issue relating to Islamic financial business, the activities or transactions of the Bank; (c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and (d) such other functions as may be determined by the Bank.”*

Although the existence and role of the SAC is acknowledged, the question is to what extent are its jurisdiction and functions in the Islamic financial system? Another issue is whether the SAC decision bears any weight and carries any legal impact. This leads on to the question of whether the advice of the SAC is accepted in court. Section 56 (1) NBA 2009 provides the following:

*“56. (1) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shari'ah matter, the court or the arbitrator, as the case may be, shall - (a) take into consideration any published rulings of the Shari'ah Advisory Council; or (b) refer such question to the Shari'ah Advisory Council for its ruling.”*

Previous cases have given the perception that the SAC advice has not been taken into account, but the court rather interpreted the issues by the views of civil law and this sometimes has contradicted with the *Shari'ah* law. For example, in the case of *Affin Bank Bhd v Zulkifli Abdullah [2006] 1 CLJ 438*, the judge did not refer to the SAC on whether the bank could claim money from the sales price in a BBA contract when the defendant failed to pay the fee in due time.

In the case of *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors, Seri Kota Bukit Cheraka Co Ltd (Third Party) and Other Cases [2009] 1 CLJ 419 / [2008] 5 MLJ 631*, it appeared as if the SAC did not have the authority in approving the BBA contract that was allegedly contradictory with the Islamic principles. This is because the court simply concluded that the BBA contract used was not fully in accordance with the *Shari'ah* because of BBA was accepted in the *Shafi* sect only and not in all sects. The judge had failed to interpret the BBA contract as according to the legal definition of 'Islamic banking business' as provided in Section 2 IBA 1983 and Section 124 (7) (c) BAFIA 1989 which carries the meaning that it should not involve any element which is not approved by Islam. The judge had instead added another element that the contract must not contain elements that are not approved by other sects.

#### **vi. 'Double Standard' on Islamic Financial Institutions**

Another vital issue in the Islamic financial system is the existence of double standard faced by these institutions and practitioners. Among them, there is a 'dual' taxation faced by Islamic banking institutions when paying the corporate tax and zakat as provided in the IBA 1983 and BAFIA 1989. This does not happen to conventional banks because they only have to pay corporate tax. Thus, Islamic banking should be given rebates as what has been given to Tabung Haji through the Tabung Haji Act to avoid double taxation (Nik Norzrul, Mohamad Ridza and Megat Hizaini, 2003). Even individuals who pay zakat are given rebates in income tax payments as set out in Section 6A (3) of the Income Tax Act 1967 (Norhashimah, 1996).

On a different note, the Constitution which gives power to the Civil Courts to try cases of Islamic finance also seems to cast aside the role of *Shari'ah* judges and lawyers. This should not happen because the interpretation of Islamic laws should be done by members in the field rather than civil judges and lawyers who often refer to the civil sources rather than Islamic ones.

Double standard also occurs in Section 3 (1) IBA 1983 which limits the Islamic banking license to be given out only to the 'company' (the corporation) under the Companies Act 1965. This has resulted in the fact that if the company or corporation is not under the Companies Act 1965, it does not qualify for a license to operate as an Islamic bank. For example, Bank Kerjasama Rakyat Malaysia (Bank Rakyat), a bank that applies the principles of Islam cannot operate like an Islamic Bank as the bank is subjected to the Cooperative Society Act 1993 and the People's Bank Act 1978 and not the Companies Act 1965 as required (Norhashimah, 2003). This is unfortunate as Bank Rakyat is recognised only as an institution that practices the concept of Islamic banking. Bank

Rakyat is more than qualified to be called an Islamic Bank for its operations are conducted in line with the *Shari'ah* and is similar to Bank Islam itself.

## **Recommendations**

In summary, although the product of the Islamic financial system is based on the *Shari'ah* principles, however it is overshadowed by the civil legal framework. Therefore, the authors suggest that the *Shari'ah* legal framework should be applied. This can be done through amendments to the Federal Constitution and certain Acts related to the finance and Islamic banking. Similarly, such jurisdiction should be extended to the *Shari'ah* Court to deal with Islamic transaction with the assistance of *Shari'ah* lawyers.

Among the amendments that are recommended are as follow:

1. To amend the Federal Constitution, especially Article 74 (2) and the Ninth Schedule, List I (Federal List) and Acts related to Islamic law as a whole, including the Muamalat included in the Federal Constitution. This would enable Islamic financial system to be operated in line with *Shari'ah* principles and the *Shari'ah* Court would then be given a wider jurisdiction to deal with cases relating to Islamic finance and *Muamalat*, regardless of the background of the customers, Muslims and non-Muslims alike. As such, it is suggested that the List II (State List) of the Ninth Schedule should be amended to include the area of Islamic finance under its purview so that it would not constitute of merely Islamic personal and family laws only.
2. To amend the relevant Acts that deal with Islamic financial system, such as NBA 2009, IBA 1983, BAFIA 1989, TA1984 to include the necessary provisions. Other steps that can also be taken are the formulation of Islamic finance legislation such as the law of contract and sale purchase that already exists in Islam to replace the provisions in the Contracts Act 1950, the Hire Purchase Act 1956 and the Companies Act 1965.
3. To amend Section 3 and Section 5 (1) of the Civil Law Act 1956 which provide that the Court may adopt the English law should there be no provision of the law provided in the present laws either by (i) eliminating the sections, or (ii) introducing the Islamic law as a reference, especially in cases involving issues of *Shari'ah*, or (iii) to exclude the English law in cases relating to Islamic finance and banking.

The authors also suggest that a further study should be made so that a new legal framework that is based on Islamic principles may substitute the present legal framework.

## **Conclusion**

In conclusion, the Malaysian Islamic financial system must move forward to become a model in the world. However, obstacles and challenges mentioned above can lead to some doubts and uncertainties among customers and Islamic financial operators. Thus,

the present legal framework of Islamic finance should be phased out and replaced with one which is truly inclined with the *Shari'ah*. Amendments to the Federal Constitution and relevant Acts must be taken seriously by respective authorities so that the legal framework of the Islamic banking and finance is based on the *Shari'ah* principles. This is because the concurrent system which includes both the civil and *Shari'ah* laws has created unnecessary tension and confusion.

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