

Conflicts Facing Islamic Banking in Malaysia: Dual Banking System Versus Dual Legal System

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Abstract: Islamic banking is everywhere in the world today. But Malaysia is still considered as the leader and cranium of Islamic banking as it has succeeded in creating a full fledged Islamic banking system parallel to the existing conventional system irrespective of the challenges it faced. Today, the new Central Bank of Malaysia Act 2009 has openly declared this reality to the world. Section 27 of the new Central Bank of Malaysia Act states that Malaysia has dual financial systems that works in parallel that are conventional and Islamic financial system. The adoption of dual banking system is, however been perceived as creating the room for possible legal conflicts. The possible legal conflicts may be due to the fact that the law applicable to Islamic banking is not totally derived from Islamic law and the judiciary system of the country is complex as the court that hears Islamic banking matters are Civil Courts. This paper aims to unravel the reasons or cause of obstacles in Islamic banking in the Malaysian dual banking structure. This research is novel as few literatures are found on the reason for the cause of conflicts even after the establishing and sustaining Islamic banking in the country for nearly three decades. This is a legal exploratory study primarily focused on library research.

Key words: Islamic banking, law, dual banking, legal system.

INTRODUCTION

Malaysia is the first country in the world in which a dual banking system was created and the success of it became evident. The creation of dual banking system was important for Malaysia as it is a multi religious and a multi ethnic society with a plural legal structure. Islamic banking was formally incepted to the country in 1983 with the introduction of Islamic Banking Act 1983 and the opening of the first Islamic bank of the country, Bank Islam Malaysia Berhad. In 2009, with the introduction of the new Central Bank of Malaysia Act 2009, the country legally recognised the existence of dual financial systems in the country. Furthermore, the creation of Law Harmonization Committee at the Central Bank level further proved that there are some legal challenges facing the development of Islamic banking in Malaysia.

Even from the beginning it was understood that creation of dual banking system was the objective and that it would not be an easy task under the given circumstance where the conventional legal infrastructure is applicable to Islamic banking. The prefix "Islamic" attached to banking created an additional flavour to the banking as for Islamic banking it is a must to apply Islamic law which later coined the application of Islamic law to the phrase "Shari'ah compliance" or "Shari'ah governance". The banking industry in Malaysia consist both conventional and Islamic banks and hence the banking atmosphere is very competitive. The banking customers in Malaysia have a wide range of choice to choose from. This research would identify the reasons for the obstacles faced by Islamic banking in the dual banking world of Malaysia. This is indeed a topic worth researching as often observers consider the existence of the dual banking systems as the reason for the conflicts facing Islamic banking where as in this research it is proved that the existence of dual legal system in the country is the reason for the conflict in the arena of Islamic banking in Malaysia.

Materials and Discussion:

Development of Islamic Banking:

Islamic banking system has risen as an economical and a feasible proxy for the conventional banking system during the last three decades. It is particularly for Muslim world where presently Islamic banking exists at two separate fronts. At one side, efforts are also in progress to clandestine the full financial systems in accordance to Islamic laws. At the other side, separate Islamic banks are allowed to operate in parallel to conventional interest based banks.

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The General Secretariat of the Organization of the Islamic Conference (OIC) defines an Islamic bank as a financial institution whose statutes, rules and procedures expressly state its commitment to the principle of *Shari'ah*, and the banning of the receipt and payment of interest on any of its operations (Hasan, 1999). Islamic banking was invented to curb the "unislamic" elements in the banking system. According to Tahir (2004), Islamic banking started in earnest in the 1970s with the personal initiative of respective Muslims to eliminate *riba*. It has been said that the collapse of Uthmanic Khilafah or empire in Turkey created the waves of fear in the minds of the Islamic world that the teachings of Islam is erasing from the humankind and a preventive measure is needed to revive it in the so called modern way of life. Ahmad al Naggar, the father of Islamic banking was residing at Germany during this time. He witnessed how the German Government was applying the Social Saving bank to sustain the economic growth of the country. And from here, the father of Islamic banking wanted to implement the same concept in Egypt. This German idea was accepted by the Egyptian government and eventually, the first Islamic bank in the name of Mit al Ghamr was established to achieve the objective of exploring possibilities of mobilization of saving and local credits as an essential condition for social and economic development (Al-Omar, 1996). It is said that in the first three years of the operation of this bank, the number of depositors increased from 1,000 founding members to 60,000; and by 1967 the number has increased to 357, 637 (Yacob, 1986). Despite of this ever booming success, Gamal Abdul Nasser closed down the bank.

However, because of Mit al Ghamr, the Arab world was excited to experiment the same in their respective countries. This was the years in the 1970's. Due to this growing interest, in 1972, the government of Egypt presented "a study on the institution of an Islamic bank" and in 1975 the Islamic Development Bank was established in Jeddah. This was followed by the establishment of Dubai Islamic Bank in UAE in the same year. And this development encouraged the formation of banks in different regions. Like wildfire Islamic banks spread throughout the world. In 1977, Faisal Islamic Bank in Egypt and Sudan was created and at the same time Kuwait Finance House was established in Kuwait. In 1978, Jordan Islamic Bank was created in Jordan; and in 1983 Malaysia created its first full fledged Islamic Bank, Bank Islam. And Citibank is the first conventional bank in the world which began to provide Islamic shari'ah products. By 1997, there were 177 Islamic Banks in the world; among these 51 banks is in South Asia, 36 banks in Africa, 31 banks in South East Asia, 37 banks in Middle East and 12 banks in Europe, Central Asia and Europe (Kahf,n.d). As for the creation of conventional banks, it has been said that the conventional banks were originated from Vienna in the 16th Century. The first conventional bank in Malaysia is opened in 1859 in the name of Chartered Mercantile Banks of India, London and China at Penang. The second bank is the Chartered Bank opened in 1875 followed by the opening of HSBC, Easter Bank and OCBC in 1959.

Pheng, L. M. et. al. (2007) in her book "Islamic banking and financial law" has briefly and concisely explained history and development of Islamic banking in general in Chapter 1. This consist of explaining the Islamic banking in the early days of Islam; Islamic banking in the modern era; and last, but not least the developments of Islamic banking in some Muslim countries. As for the development of Islamic banking in Malaysia, she has written that Islamic banking system in Malaysia is the most progressive as separate legislations and banking regulations existed parallel to the conventional banking system. The first bank established in Malaysia is the Bank Islam Malaysia Berhad which was established under the Islamic Banking Act 1983. Under this piece of legislation, like the conventional banks which existed in the society at the time, Islamic banks are supervised and regulated by the Central bank or Bank Negara (BNM). Subsequently, the government also passed the Government Investments Act 1983 which gave the power to the government to issue Government Investment Issues which are government securities issued in accordance with Islamic principles. It is also mentioned in her book that the long term goal of BNM is to create Islamic banking system operating parallel to the conventional banking system and in order to make this possible, Islamic banking system needed a large number of players; a variety of instruments and an Islamic money market. Apart from this, it also needs to reflect the socio-economic values in Islam in both form and the substance without compromise. BNM did indeed make all this possible by taking progressive approach (Pheng, 2007).

However, Seidu, A.M. (2002) believes that the initial start of Islamic banking in Malaysia was not from 1983, but it dates back to the 1963 when Tabung Haji (the Pilgrims Management Fund Board) was established by the government. Tabung Haji is a special financial institution which provides a methodical allocation of funds from Muslims to assist them perform pilgrimage in Makkah. Not only this, but it also helps them to find chances to invest and participate in other economic activities. And it should be stated here that Tabung Haji seems to be the first of its kind in the whole Islamic world. Similarly, Thani N. N, *et al* (2003) shares the same view by indicating that the Tabung Haji, a merger of the Pilgrims Affairs Department and the Malaysian Muslim Pilgrims Savings Corporation, pays its subscribers dividends instead of interests earned out of its investments in equities and other securities.

Hence it can be said that the Malaysian government moved forward to legislate Islamic Banking Act from the favourable experience it gained from the Tabung Haji. The first call for separate Islamic bank was made in 1981, in the National Seminar on the Concept of Development in Islam held at 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 (Thani *et al*, 2003). 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 blue print 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 (Kaleem, 2000).

The systematic approach used by the government is divided into three phases (BNM, 2004). The following diagram summarised the three stages involved.

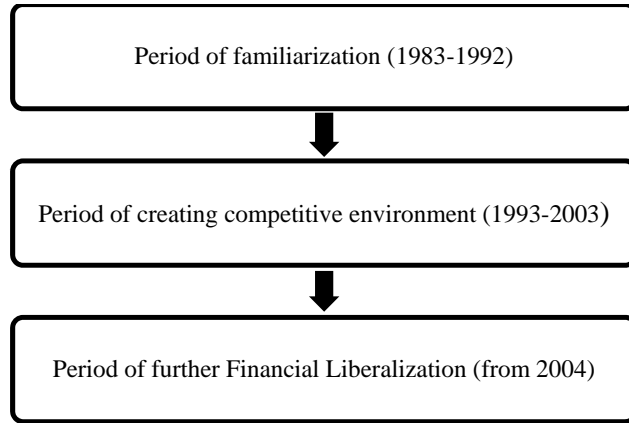


Diagram 1: Stages involved in the Development of Islamic Banking in Malaysia.

The period of familiarization was the period in which the first Islamic bank in Malaysia, that is Bank Islam Malaysia Berhad (BIMB) was created by enacting Islamic Banking Act 1983. BIMB is the first *Shari’ah* compliant bank operated in Malaysia. The second phase of the development of Islamic banking in Malaysia was exclusively to educate the public in the new concept of banking and to create an environment which is competitive. The opportunity was given for the Islamic banks to capture bigger portion of market shares, so that the Islamic banking can be sustained in the country. The conventional banks were also given the opportunity to open Islamic banking branches during this period by amending section 119 of the Banking and the Financial Institutions Act. As a result of this in 1993 “Islamic windows” under the “Islamic banking scheme” was set up. And this created more players in the market. The objective of the Malaysian government is to develop the Islamic banking system parallel to the conventional system (Ahmad and Haron, 2002). In addition, those “Islamic windows” were required to upgrade their Islamic Banking Unit into an Islamic Banking Division which took effect from January 2 1999. During this phase also, the Central Bank set up the Islamic interbank money market (IIMM) as well as a new Islamic interbank cheque clearing system that took effect in 1994 for Islamic banks and “Islamic windows”(Thani *et al*, 2003). In the third phase, further financial liberalisation began by giving the golden opportunity for the foreign banks to operate in the Malaysian territory.

Conflicts Facing Islamic Banking in Malaysia:

Before the cause of the obstacles facing Islamic banking in Malaysia is explored, it is imperative for one to understand the conflicts facing Islamic banking in Malaysia. For this purpose, the authors believe that the best way is to discuss some of the critical conflicts facing Islamic banking in Malaysia that have been discussed by scholars found in literatures. One of the most comprehensive bunch of conflicts facing Islamic banking is described by Muneeza et.al. (2011) and their classification of conflicts facing Islamic banking is summarized in the following table (Table 1).

As discussed above, Malaysian banking arena is dominated by two super powers; that are conventional and the Islamic banking. Hence, the banking legal framework is set up in a way to give space for both to autonomously work without overlapping each other. The reality is that this is how this legal framework theoretically works. From a microscopic view, it would be understood that the Islamic bankers face several serious conflicts in practise when they operate within the dual banking systems. The following diagrams would simplify the root of the legal obstacles facing Islamic bankers today:

Diagram 2 (above) shows that before 1983, the Malaysian banking system was dominated by the conventional banking system which accepts interest as an integral part of the system and, hence, in this system money can make money. Lending and borrowing activities are the main types of banking activities in which income is derived. Malaysia has a dual legal system in which Islamic law and the common law exists parallel to each other. By virtue of List I of the Ninth Schedule of the Federal Constitution, banking is a matter for federal legislature to deliberate on. Hence, conventional banking is a matter governed by the federation. By virtue of

List II of the Ninth Schedule of the Federal Constitution, Islam is a matter for the state government. Hence, everything related to Islam and Islamic law would be determined by the rulers of the state. This is the reason why the Islamic laws applied in Malaysia are not uniform throughout the federation. The gist here is that in Malaysia, all the federal laws like the Contracts Act 1950, which governs contractual agreements between the parties; National Land Code, the laws which indicate the rights related to land; and all the procedural laws related to Civil Courts formed by Article 121 of the Federal Constitution are based on Common law. These Federal laws are not necessarily made consistent with the Islamic law. This means that the procedural and substantive federal laws of the federation of Malaysia are totally based on Common law principles of Law.

Table 1: Summary of the Conflicts Facing Islamic Banking in Malaysia as described by Muneeza *et al.*, (2011).

Type of Conflict	Explanation
Legislative	These are the conflicts found in the legislations applicable to Islamic banking. For example, what will happen when National Land Code 1965 is applicable to Islamic banking? Shariff (2002)- S.330 of National Land Code 1965 which only allows the lodging of private caveat as a security for a loan, not to an Islamic banking product Yasin (2001)- S.55 of Islamic Banking Act 1983 is silent on the effect of conflict arising between Islamic Banking Act 1983 and other legislations except the Contracts Act 1950.
Money Laundering	These are the conflicts faced in curbing money laundering when dealing with Islamic banking.
Judicial	These are the conflicts faced when the disputes related to Islamic banking is heard by the Civil Courts that apply conventional laws. In the case of Bank Islam Malaysia Bhd v Adnan Omar [1994] it was held that the Civil courts in Malaysia have the jurisdiction to hear Islamic banking cases and Shariff (2002) have identified that the application of civil law to Islamic banking to which Islamic law is ought to be applied.
Documentation	These are the conflicts faced by the Islamic banking when the documents related to the Islamic banking products are executed.
Shari'ah Governance	These are the conflicts facing Islamic banking when applying the additional layer of Shari'ahgovernance to the existing corporate governance structure.

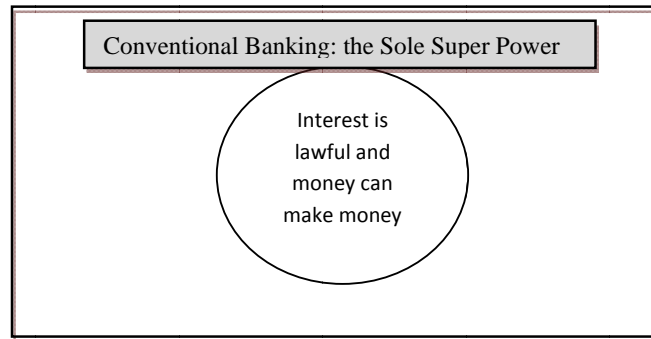


Diagram 2: Malaysian banking system before 1983.

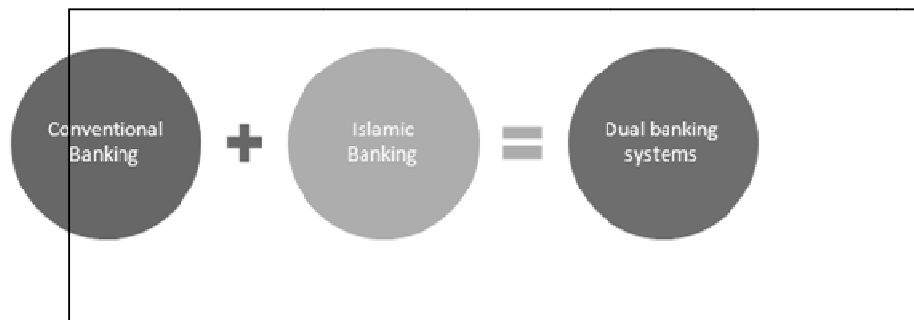


Diagram 3: Malaysian banking system after 1983.

Then, what happened was as the diagram 3 (above) indicates, in 1983, Islamic law breathed into the Malaysia. As a result, Islamic Banking Act was legislated, merely regulating the licensing requirements of the bank, rather than emphasising on the substantial matters relating to the Islamic banking. The reality is that the laws of the federation like the Contracts Act and the procedural laws like Rules of High Court are still applicable to Islamic banking due to the fact that Islamic banking Act is a federal law and because banking is a matter for the federation to decide. The point here is that both Islamic and the conventional banks had to share the same legal infrastructure which is totally based on Common law system. This situation is exacerbated

because of Section 3 of the Civil Law Act 1953 which says that when ever there is a lacuna in law, the law applied to fill the gap should be the English Common law and equity. Now the tumult here is that Islamic banking law is a concept totally based on Islamic ideologies which prohibit *riba* (interest) and everything related to it should be consistent with Islamic commercial law. So the probing question here is how would it be possible to reconcile fundamentally two different ideologies which cannot be harmonised or compromised? Furthermore, when section 119 of the Banking and the Financial Institutions Act was amended to open the Islamic windows in the Conventional banks to create more players in the market in the year 1993, the same legal problems arose as to how Islamic ideologies of Islamic banking can be protected. The root of all legal problems faced by the Islamic bankers today arises from this.

According to Tahir, (2004), there were no serious efforts undertaken to implement the necessary changes in banking laws and laws that affect the Islamic banking industry in Malaysia. Hence, this research is an effort to enhance the legal infrastructure of Islamic banking for a sustainable development of it for the further generations.

Conclusion:

From the above, it is evident that existence of the dual legal systems is the reason for the creation of conflicts in Malaysian Islamic dual banking system. There are no conflicts between conventional and Islamic banking systems; but the conflicts facing Islamic banking arises due to the clashes it has with the civil legal system of the country which is not made considering the Islamic or *Shari'ah* values which is the ground law of Islamic banking. Hence, it is wrong to blame the existence of the dual banking systems for the conflicts facing Islamic banking in Malaysia.

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