

## **ALTERNATIVE DISPUTE RESOLUTION IN ISLAMIC FINANCE: RECENT DEVELOPMENT IN MALAYSIA**

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### **-Abstract-**

On 31<sup>st</sup> March 2009, Court of Appeal has revoked the decision made by High Court to announce that the contract of Bay Bithaman Ajil is null and void in the case of *Arab-Malaysia v Taman Ihsan Jaya Sdn. Bhd. & Onor* [2008] 5 MLJ 631. Interestingly, the judgement made by Appeal Court has touched the basic elements of Islamic law especially the fundamental issues of BBA such as sell and buy contract, acceptance of difference views of school of laws in Islam and other basic issues of *Shari'ah* principles. This subject matter of *Shari'ah* principles should be decided by the *Shari'ah* judges who are more expert in Islamic law than the civil court.

At the same year, the Government of Malaysia has passed the Central Bank of Malaysia Act 2009 (Act 701) that provided the court shall refer to the Shari'ah Advisory Council or arbitrator before giving any judgment on Islamic Finance dispute. This paper is looking into recent development of legal framework of Islamic Financial System in Malaysia and also the jurisdiction of Shari'ah Court pertaining that matters.

**Key Words:** *Islamic Financial System, Legal Framework, Malaysia*

**JEL Classification:** K23 –Regulated Industries and Administrative Law

## 1. INTRODUCTION

The *Shari'ah* regulates all aspects of life, ethical and social, and to encompass criminal as well as civil jurisdiction. Every act of believers must conform to Islamic law and observe ethical standards derived from Islamic principles (Mervyn K Lewis, 2007:3). Islamic banking and finance is part and parcel of the *Shari'ah* and product development through *Shari'ah*, *fiqh* and *ijtihad*. *Fiqh* is the science of understanding the derived rules obtained from their particular sources or the exercise of intelligence (*ijtihad*) in deciding a point of law from its sources. *Ijtihad* refers to the efforts of individual jurists to extract solutions to problems and is the vehicle by which rules of behavior not explicitly addressed to problems that arise as human societies evolve are determined. (Zamir Iqbal & Abbas Mirakhor, 2007: 13).

## 2. SALIENCE FEATURES OF ISLAMIC FINANCE

The *Qur'an* and the *Sunnah* or traditions of the Prophet (pbuh), as the primary sources of Islamic law provide the basic principles of Islamic transactions and commercial laws. The *Qur'an*, which was later supplemented by the traditions of the Prophet, has outlined the parameters within which any economic transactions must comply (Securities Commission Malaysia, 2009: 5).

The *Qur'an* and the *Sunnah* have enumerated clearly the prohibited elements which could render a contract null and void. Among the most important prohibitions in Islamic commercial law are *riba*, *gharar* and *maysir*. *Gharar* is uncertainties that are to be avoided and *maysir*, zero sum game or any investment in non-*Shari'ah* compliant companies or conventional bond. *Riba'* can occur in all interest-based lending activities, fixed return on deposits in conventional banking and forward forex contract. In addition to make the contract lawful it requires two basic conditions, firstly, voluntary consent from competent contracting parties and

secondly the lawful contractual objective or aim based on general rule deduced from *Surah al-Nisa'* (4:29).

### **3. REGULATORY AND LEGAL FRAMEWORK ISSUES AND CROSS BORDER TRANSACTIONS IN ISLAMIC FINANCING**

Bank Negara Malaysia is vested with comprehensive legal powers to regulate and supervise the financial system. The main Act is the Central Bank of Malaysia Act 2009 (Nik Norzrul Thani, 2003:). According to Central Bank Act 2009, "Islamic Financial Business" means any financial business in ringgit or other currency which is subject to the laws enforced by the Bank and consistent with the *Shariah*". Also "Islamic financial institution" means a financial institution carrying on Islamic financial business. Meanwhile "financial business" refers collectively to conventional financial business and Islamic financial business".

There have been some cases in the courts which have interpreted the meaning of the definition and divergent views have been expressed by the courts. In the case of the *Arab- Malaysia Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors; Koperasi Seri Kota Kota Bukit Cheraka Bhd (Third Party) And Other Cases* [2009] 1 CLJ 419 (HC), the judge ruled that for a *Shari'ah* principle to be in accordance with the Religion of Islam it must be approved by all the four *madhahib* (Islamic schools of law). However that decision has been overruled by the Court of Appeal in the case of *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and Other Appeals* [2009] 6 MLJ 839 (CA). A peculiar but interesting feature of the Islamic banking and finance practice in Malaysia is the law applicable to it. Is it the *Shari'ah* or the civil law or both?

The civil laws of the country, passed by the Federal Parliament, are laws of general application. So, the Contract Act 1950, for instance, should apply to all contracts, including Islamic contracts. As a general principle, therefore, the civil laws will also apply to Islamic banking transactions.

In addition, Islamic banks in Malaysia are licensed under the Islamic Banking Act 1983 and the Islamic Bank Act authorizes them to carry on Islamic banking business. Section 3 (5) of the Act provides that a license will not be granted to an applicant for an Islamic Banking license unless the Minister is satisfied:

- (a) *That the aims and operation of the banking business which is desired to carry on will not involve any element which is not approved of by the Religion of Islam, and*

Thus, Islamic banking business is defined in section 2 of the Islamic Bank Act as follows: “Islamic banking business”... means “*banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam*”. This means the courts have to ensure that Islamic banks operate within the parameters set out.

Meanwhile, section 3 (5) (b) Islamic Banking Act 1983 also provides that license will be granted if the aims and operations of the banking business to be carried on will not have any element that is not approved by Islam and the articles of association of the bank concerned has a provision for the establishment of a *Shari’ah* Advisory Body. In addition, under section 13A stated that an Islamic bank shall seek the advice of the *Shari’ah* Advisory Council (establishes under Central Bank Malaysia Act 2009) on *Shari’ah* matter relating to its banking business and the Islamic bank shall comply with the advice of the *Shari’ah* Advisory Council.

Meanwhile, existing conventional banks that wish to adopt Islamic banking principles, namely interest free banking, cannot do so unless they comply with the provisions of the Islamic Banking Act, particularly as regards the requirement of section 3 (5). Furthermore the bank has to obtain a valid license authorising it to carry on Islamic banking business under section 3 (1) of the Act. Section 15 (1) (b) (ii) of the Banking and Financial Institutions Act 1989 (BAFIA) provides that no institution shall be allowed to carry on business under a name which include the word “Islamic” or “Muslim”, or any other words in any language capable of being construed as indicating that the institution is carrying on Islamic banking business, except with the written consent of the Minister. Section 124 (1) stated that except as provided in section 33, nothing in this Act or the Islamic Banking Act 1983 shall prohibit or restrict any licensed institution from carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business or any Islamic financial business. Section 124 (4) provides any licensed institution carrying on Islamic banking business or Islamic financial business shall comply with any written directions relating to the Islamic banking business or any other Islamic financial business, carried on by such licensed

institution, issued from time to time by the bank, in consultation with the *Shari'ah* Advisory Council.

#### 4. CASES IN ISLAMIC FINANCE

In the case of *Bank Islam v Adnan Omar* [1994] 3 CLJ 735, where Bank Islam Malaysia Berhad has filed a suit in the High Court for recovering of money owing pursuant to a guarantee, the defendant raised a preliminary issue that as the plaintiff was an Islamic bank, the civil court had no jurisdiction to hear the case in view of clause (1A) of Article 121 of the Federal Constitution which provides that the High Court shall have no jurisdiction in respect of any matter within the jurisdiction of the *Shari'ah* Court. NH Chan Judge overruled the preliminary objection. The plaintiff relied on Ninth Schedule, List 1 and 11, wherein it is stated that banking comes within the Federal List. Since bank Islam is a corporate body it was argued that it does not have a religion and will not be subject to the jurisdiction of the *Shari'ah* courts (Nik Norzrul Thani at al., 2003:93).

More controversially, in *Dato' Hj. Nik Mahmud bin Daud v Bank Islam Malaysia Berhad* [1996] 4 MLJ 295 High Court, the court ruled that *bay bithaman ajil* transaction was not a genuine and complete sale and purchase but only a process that was necessary to facilitate the financing made by the bank (Mohd Daud at al, 2008: 281).

The decision of *Arab- Malaysia Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors; Koperasi Seri Kota Kota Bukit Cheraka Bhd (Third Party) And Other Cases*[2009] 1 CLJ 419 (High Court) had created some uncertainty within the fraternity of the Islamic banking community in Malaysia. In July 2008, cases decided by KL High Court involved 12 cases, Bank Islam (11) and Arab-Malaysian Finance (1).

In that case the learned judge was of the view that the *bay bithaman ajil* (BBA) is not a valid facility under the *Shari'ah*. The case was appealed to the Court of Appeal and in *Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor And Other Appeals* [2009] 6 CLJ 22, the Court of Appeal overruled the decision of the High Court and said that “judges in civil court should not take upon themselves to

*declare whether a matter is in accordance to the Religion of Islam or otherwise*". The judgement decided that only principle sum can be covered.

## **5. SHARI'AH ADVISORY COUNCIL of CENTRAL BANK**

In Malaysia, Islamic banking and financial institutions are regulated by Bank Negara Malaysia. The problems caused by the divergent views expressed by the courts on the interpretation of the definition of Islamic banking business in the Islamic Bank Act 1983 have been alleviated by various amendments made to BAFIA and later to the Central Bank of Malaysia Act 2009, in the latter case by the addition of the new Section 16B. The amendments related to the establishment of a *Shari'ah* Advisory Council under the aegis of Bank Negara Malaysia. The Central Bank of Malaysia Act 1958 has now been re-enacted as the Central Bank of Malaysia Act 2009 (Act 701).

### **5.1 Central Bank of Malaysia Act 2009 (Act 701)**

"Islamic Financial business" means any financial business in ringgit or other currency which is subject to the laws enforced by the Bank and consistent with the *Shari'ah*. "Islamic financial institution" means a financial institution carrying on Islamic financial business. "Financial business" refers collectively to conventional financial business and Islamic financial business.

It was following the Court of Appeal decision in *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and Other Appeals* [2009] 6 MLJ 839 (CA), that the Repealed Centre Bank Act 1958 was repealed with Act 701 which came into operation on 25 November 2009. The term "may" in section 16 of the Repealed Act was replaced with the mandatory term of "shall" in section 56 of Act 701. Using the purposive approach in interpreting statutes, it could be concluded that the intention of the Parliament in changing the word from "may" to "shall" indicates the mandatory and binding effect. Provisions therein relating to the establishment and functions of the *Shari'ah* Advisory Council are relevant to be considered here.

### **5.2 Part VII- Islamic Financial Business**

In Malaysia, the supervisory authority is the *Shari'ah* Advisory Council (SAC). The SAC was established on 1<sup>st</sup> of May 1997 as the highest *Shari'ah* authority in

Islamic finance in Malaysia. The role of the *Shari'ah* Advisory Council is to advise the bank on the operation of its banking business in order to ensure that they do not involve any element which is not approved by the religion of Islam. The SAC is a committee set up either in Islamic financial institutions or takaful operators with a purpose to ensure *Shari'ah* compliance to its operations and products. It is a statutory requirement provided under the Central Bank of Malaysia Act 2009, the Islamic Banking Act 1983, the Banking and Financial Institutions Act 1984 and the Takaful Act 1984.

It clearly mentions from section 51 up section 58 of Central Bank Act 2009 regarding this issue. Section 51, Establishment of *Shari'ah* Advisory Council:

*(1) The Bank may establish a Shari'ah Advisory Council on Finance which shall be the authority for the ascertainment of Islamic law for the purposes of Islamic Financial business*

Section 52 of Act 701 clearly delineated the function of the SAC. It would be sufficient for one to understand the function of the SAC just by bare reading of that section. Section 52 (1) Function of *Shari'ah* Advisory Council as:

*(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 transaction of the bank;*

*(c) To provide advices 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*

*(2) For the purposes of this Part, "ruling" means any ruling made by the Shari'ah Advisory Council for the ascertainment of Islamic law for the purposes of Islamic financial business.*

Meanwhile under section 55, all bank and Islamic financial institutions to consult *Shari'ah* Advisory Council:

- i. Relating to Islamic financial business ; and*
- ii. For the purpose of carrying out its functions or conducting its business or affair under this Act or any other written law in accordance with the*

*Shari'ah, which requires the ascertainment of Islamic law by the Shari'ah Advisory Council*

2. Any Islamic financial institution may:

- i. *Refer for ruling or*
- ii. *Seek the advice,*

*of the Shari'ah Advisory Council on the operations of its business in order to ascertain that it does not involve any element which is inconsistent with the Shari'ah.*

Section 56 of Central Bank 2009 Act give an important jurisdiction to *Shari'ah Advisory Council* to refer to *Shari'ah Advisory Council* for ruling from court or arbitrator:

*(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 SAC; or*

*(b) Refer such question to the SAC for its ruling*

S. 57. Effect of *Shari'ah* rulings

*Any ruling made by the SAC pursuant to a reference made under this part shall be binding on the Islamic financial institution under section 55 and the court or arbitrator making a reference under section 56*

Section 58 stated that where the ruling given by a *Shari'ah* body or committee constituted in Malaysia by an Islamic financial institution is different from ruling given by the SAC, the ruling of the SAC shall prevail.

Rohana J with regard to *Shari'ah Advisory Council* in *Tan Sri Abdul Khalid v. Bank Islam Malaysia & Another Case* [2010] 4 CLJ which aptly describes the important of the SAC:

*"To my mind there is good reason for having this body. A ruling made by a body given legislative authority will provide certainty, which is a much needed element*



*to ensure business efficacy in a commercial transaction. The designation of the SAC is indeed in line with that principle in Islam.”*

In *Lim Kok Hoe* case, Raus Sharif JCA (as he then was) commented on the SAC as follows:

*“The court, will have to assume that the Shari’ah Advisory Body of the individual bank and now the Shari’ah Advisory Council under the aegis of Bank Negara Malaysia, would have discharge their statutory duty to ensure that the operation of the Islamic banks are within the ambit of the religion of Islam.”*

Recent case in 2011, *Mohd Alias bin Ibrahim v. RHB Bank Berhad*, Suit no. D-22A-74-2010, the plaintiff apply for the fundamental question about the constitutional validity of section 56 and 57 of the Central Bank of Malaysia Act, 2009 (Act 701). The Plaintiff’s argued that the Parliament could not make any law to delegate the judicial power of the court and transferring it onto *Shari’ah* Advisory Council when there is no enabling clause or expresses provision in the Federal Constitution permitting it to do so.

The court decided that it is clear that SAC was established as an authority for the ascertainment of Islamic law for the purposes of Islamic banking business, *takaful* business and Islamic financial business. Therefore, if the court refers any question under section 56 (1) (b) of Act 701 to the SAC, the SAC is merely required to make an ascertainment, and not determination, of Islamic laws related to the question. This is in line with the section 52 (2) of Act 701.

Having regard to the above, it is clear that the SAC was established as an authority for the ascertainment of Islamic law for the purpose of Islamic banking business, *takaful* business and Islamic financial business. Thus, it will bring certainty in Islamic banking in Malaysia. The *Shari’ah* Advisory Council is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic *Shari’ah* rules and principles. The *fatwas* and rulings of the *Shari’ah* supervisory board shall be binding on the Islamic financial institution (Ahcene Lahsasna, 2010:236).

## **6. ARBITRATION IN ISLAMIC FINANCE IN MALAYSIA**

The Kuala Lumpur Regional Centre for Arbitration has recently set up the machinery for the arbitration of Islamic Financial Business disputes. It has published Guideline for such arbitration. The Rules are the Rules for Islamic Banking and Financial Services Arbitration 2007. It also provides a Model Arbitration clause which reads as follows:

*“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 or business which is based on Shari’ah 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).”*

So there is a new formal infrastructure available for the settlement of disputes involving Islamic banking and finance matters by arbitration. (Mohamad Akram Laldin, 2010). There are few disputes that have already been submitted to arbitration under these Rules and it is hoped that more parties will avail themselves of this procedure. The Centre makes it possible to obtain rulings by Islamic finance experts conforming (legally) and substantively) to the provisions of *Shari’ah*. Thus, KLRC will be enhanced to serve as a platform to deal with cases involving Islamic banking and finance and also to extend these services beyond Malaysia border.

## **7. CONCLUSION**

It is true that none of the reported cases involving Islamic banking transactions has turned on the determination of any Islamic law issue. But, considering the marked increase in the number of Islamic banking products and services over the years and the complexity of, and the controversy surrounding, some of them, it is only to be expected that Islamic law issues will feature more frequently and prominently in the courts in the future. Among recommendations to enhance the legal framework of Islamic finance in Malaysia is consideration of ADR (Alternative Disputes Resolution) (*Sulh*) or at least arbitration in Islamic banking related disputes.

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