EMERGING ISSUES IN ISLAMIC FINANCE LAW AND PRACTICE IN MALAYSIA
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Umar A. Oseni, M. Kabir Hassan and Rusni Hassan
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Part I

Introduction
Chapter 1

Introduction: Revisiting the Confines and Significance of Islamic Finance Law

Umar A. Oseni, M. Kabir Hassan and Rusni Hassan

Introduction

Islamic finance law is becoming increasingly important in any discourse involving the Islamic financial services industry. This important aspect of Islamic finance comprises both the legal and Sharīʿah aspects from the pre-contract stage up to the post-execution phase and even post-contract termination phase. Such an all-embracing understanding of Islamic finance law is significant in appreciating the dynamics of such aspect of law in the modern Islamic financial services industry. While considering the confines and significance of Islamic finance law, this book focuses on emerging issues in legal and Sharīʿah aspects in Malaysia.

In recent years, Malaysia has assumed the position of the world’s most comprehensive and sophisticated Islamic finance marketplace (Abdul Manaf et al., 2014). The country’s Islamic finance leadership at the international level is largely characterised by the thriving and integrated market components, comprising of competitive financial institutions offering Sharīʿah-compliant banking, takaful, Islamic capital market and Islamic money market products and services (Oseni & Ahmad, 2016). In 2017, Malaysia (9.1%) was ranked fourth among twelve jurisdictions that collectively account for 92% of the global Islamic banking assets, behind Iran (34.4%), Saudi Arabia (20.4%) and the United Arab Emirates (9.3%) (IFSB, 2018). Comprising a significant share of 24.9% of the domestic total banking assets as at the second quarter of 2017 and contributing more than 70% of average increase in bank financing, the Malaysian Islamic banks are set to become the growth drivers for the country’s banking industry. Bank Negara Malaysia (BNM) has determined that the sustained domestic demand for Sharīʿah-compliant protection contributed to the remarkable growth of the Malaysian takaful industry in 2017 (BNM, 2017). The combined net contributions of family and general takaful business increased by 9.5% (2016: 10.6%) up to RM8.3 billion, while the net contributions rose up to 15.2% (2016: 14.6%) in 2017. Malaysia also continued to be the key leader for both sukuk outstanding
and issuance with a market share of 51% and 36.2%, respectively, as at end-2017, owing to the issuance of innovative sukuk such as the world’s first green sukuk of Tadau Energy of Malaysia.

Another strong value proposition of the Malaysian Islamic finance market place lies in the orderly and sound implementation of dedicated Islamic finance law, as well as a robust regulatory and Sharīʿah governance framework. This is highly important to create an enabling environment in which financial institutions and other stakeholders of the Malaysian Islamic financial industry will benefit from high regulatory responsiveness to the changing market behaviour, macroeconomic events and the global market trends (Engku Ali, 2008).

With today’s rapid product innovation through Fintech and blockchain technology and the greater demand for an increasingly stringent banking regulation and supervision to address valid concerns about consumer protection and cybersecurity, this book aims to provide a critical insight on the need to revisit the value relevance of the current Islamic finance laws and regulations in Malaysia. A thorough relook into the confines and significance of the existing Sharīʿah and legal frameworks for Islamic finance operations in the age of disruption and the dawn of the Fourth Industrial Revolution is highly necessary for several reasons such as to: (1) provide the industry with clarity with regard to the adherence to Sharīʿah principles on several areas including risk management, corporate governance, transparency and customer protection; (2) ensure the certainty and enforceability of Sharīʿah-based contracts; (3) promote consistency and conformity with the international Sharīʿah-compliant best practices; (4) provide a level-playing field with conventional finance through cost effectiveness; and (5) instil investor confidence on the robust and vibrant Islamic capital markets in Malaysia.

**Wealth and Consumer Protection**

In this book, Chapters 2–5 provide discussions on contemporary legal issues relating to Islamic wealth distribution and consumer protection in Malaysia. In Chapter 2, Hj Ibrahim et al. present the views of the Islamic finance stakeholders with regard to the practice of Islamic banks in Malaysia in handling unlawful sources of funds, particularly related to the acceptance of funds for deposit and investment and extension of credits to customers who earn from illegitimate activities. These views were gathered through a series of structured survey of mostly officers of Sharīʿah departments and members of Sharīʿah committee of Islamic banks. Hj Ibrahim et al. reveal that while majority of the respondents agree that the bank has a right to scrutinise the legitimacy of the sources of funds received from customers; however, in practice, less than half of the respondents report that their banks require disclosure about sources of funds from customers for opening saving and investment accounts and payment of financing. This does not come as a surprise, since Islamic banks, as per the resolution by Sharīʿah Advisory Council (SAC) of the BNM in its 58th meeting held on 27 April 2006, are allowed to accept any application for the placement of deposit without conducting any
investigation on the Shari’ah-compliance status of the funds, albeit they are not refrained from performing such screening on the received funds.

Hj Ibrahim et al. also show that although the respondents seem not to place any important concern on the need to investigate the legitimacy of the sources of funds, they tend to not proceed with the transaction in the event that they receive information that the funds are derived from non-compliant sources. As for the purification of tainted investment and deposit returns, majority of the respondents opine that only the profits generated from solely unlawful funds should be channelled to charity, and not for the case of the mixture of lawful and unlawful funds. However, in practice, only the latter holds true as less than half of the respondents report that their banks practise such an activity. In respect of financing, there is a congruence between the stakeholders’ views and the real practice of banks, whereby no financing should be extended to unlawful or mixed projects, and the payment received from financing activities can be entirely recognised as banks’ profits regardless of the legitimacy of its sources.

In Chapter 3, Salleh et al. discuss the issue of nomination for the payment of family takaful benefits. Salleh et al. argue that the current application of conditional hibah (gift) as per Islamic Financial Services Act (IFSA) 2013, which allows family takaful participants to freely nominate anyone to be the beneficiaries of the takaful benefits upon their demise based on their discretion, may not reflect the very objectives of Shari’ah. In a case where the nominated beneficiary is not a dependent of the deceased participant, the application of conditional hibah in family takaful is viewed by many as denying the right of the deceased’s legal heirs to receive takaful moneys. This leeway to decide on the takaful beneficiaries is also seen to violate the fundamental purpose of participation in family takaful – to provide financial assistance that serves as a mean of maintenance to the dependents of the takaful participant after his or her passing. Salleh et al. further expostulate that the application of conditional hibah can be contentious as it is only accepted by a small number of Muslim scholars due to its inconsistency with other primary Islamic rulings on wasiyyah (bequest), Islamic inheritance, hibah and many more. To align the current practice of family takaful with the objectives of Shari’ah, their study, therefore, proposes that the takaful operators in Malaysia should segregate the takaful benefits payable upon the demise of the participant into two accounts. First, the amount payable from the Participant’s Account (PA) should be declared as the deceased participants’ estate and hence must be distributed in accordance to Islamic inheritance laws (fara’id). Second, the sum covered payable from the Participant’s Special Account (PSA) is to be paid to the nominated takaful beneficiaries whose criteria will be determined by the SAC and is not subject to fara’id. In the event that the PA and the PSA cannot be segregated, the entire payable amount of takaful benefits should be treated as the deceased participant’s estate and must be distributed according to fara’id.

In Chapter 4, Syed Abdul Kader and Mohamad emphasise on the urgent need to have diverse options for creating security over waqf assets in order to facilitate financing of waqf property development in Malaysia. From a Shari’ah point of view, Syed Abdul Kader and Mohamad find that it is not permissible to create a charge on waqf lands, as practised conventionally under the National Land Code.
1965 that would otherwise render the land liable as a security and hence entitle the chargee to seek statutory remedies including sale of the land if the chargor defaults in his payment obligation. This is due to several Sharīʿah restrictions to preserve the nature and characteristics of waqf assets which ownership is fully vested in Allah the Almighty – among others, include irrevocability, inalienability and perpetuity. The absence of alternative feasible ways for creating security over waqf lands, as a result, has caused financial institutions to have less appetite to finance any waqf property development project. The study of Syed Abdul Kader and Mohamad then suggests for the creation of a charge on a lease of waqf assets, which is allowed by majority of Muslim jurists to be transferred, sold and pledged. Nevertheless, this proposed alternative approach is not entirely free from legal impediments and hence creates reservations for financiers to opt for this type of security transaction to finance the purchase of a lease on waqf lands. These impediments include the ones related to the number of chargor in the charge on a lease is limited to only one, the right of the lessor to forfeit the lease upon the breach of any provisions of the lease or where the lessee becomes a bankrupt or in the case of a company going into liquidation and many more. Syed Abdul Kader and Mohamad also look into the possibility of resorting to a hybrid form of a traditional security transaction in Malaysia called ‘Jual-Janji’, which is similar to the concept of bay’ al-wafa’ in Islamic commercial jurisprudence for the purpose of financing the development of waqf land without compromising its perpetual requirements.

In Chapter 5, Hassan and Ilias explore the roles of hisbah (ombuds) institutions for promoting customer protection in Malaysia, particularly in the Sharīʿah-compliant consumer credit industry. Hassan and Ilias begin by arguing that the existing regulators and supervisors, responsible for overseeing consumer credit industry in Malaysia including BNM and Malaysia Co-operative Societies Commission may demonstrate a certain degree of departure from the ideal structure of hisbah and hence are subject to several criticisms. The most salient one being the wide spectrum of supervisory responsibilities of these regulators that is not limited to customer protection, covering both Sharīʿah and non-Sharīʿah-compliant institutions. Hassan and Ilias further assert that these multiple functions may consequently lead to the rights of the Islamic products consumers being overlooked in many instances. Given the intricacy of today’s financial market structures and products, they urge the need to establish a single regulatory body, which is mandated to ensure the provision of comprehensive protection to all credit consumers in the light of traditional hisbah structure. They believe that this revitalisation of hisbah institutions in the modern Islamic financial environment is essential to enhance the institutional framework of Islamic consumer credit industry in Malaysia. In doing so, they have prescribed a number of qualitative characteristics that a muhtasib must possess to be deemed fit for delivering his or her duties. An effective muhtasib must not only be religiously excellent, but also must have adequate expertise and knowledge of contemporaneous financial matters in order to exercise ijtihad (independent legal reasoning) on any market query. In the current market setting, a muhtasib may be associated with two pertinent roles, namely: (1) the officers who are responsible for ensuring the enforcement
of the country’s consumer credit regulations and (2) the ombudsman to adjudicate consumer credit disputes. To conclude, Hassan and Ilias emphasise that the transformation of hisbah to a new paradigm is very much in line with the intrinsic purpose of Sharīʿah in commanding good and forbidding evil.

**Regulatory Compliance and Legal Documentation**

Regulatory compliance and issues relating to legal documentation remain a major challenge in the Malaysia’s Islamic financial services industry. Chapters 6–11 present studies examining unfair contractual terms in Islamic finance, the impact of anti-money laundering/combating the financing of terrorism (AML/CFT) regulation, default in Islamic financing facility and consumer protection in the context of Islamic banking institutions in Malaysia. In Chapter 6, Noor Mahinar Abu Bakar et al. examine the roles of BNM to protect Islamic banking consumers from unfair contract terms using content analysis of BNM’s Financial Stability and Payment Systems Report 2012–2016 and the IFSA 2013. Abu Bakar et al. propound that despite a considerable number of standards and guidelines issued by BNM to enhance fairness, transparency and governance, Islamic banks’ customers are far from an exception to the risks of being adversely affected by unfair dealings due to complex product design and multifarious products’ terms and conditions. Nevertheless, the study finds that BNM remains committed to exercising pragmatic and inclusive regulatory mechanisms for consumer empowerment in the current banking system. For example, BNM, for the first time, had required two financial service providers to revise their contractual terms, which were identified to be unfair or detrimental to customers’ interests in 2015. The study also outlined several other ‘market conduct and consumer empowerment’ initiatives taken by BNM. These, among others, include reviewing more than 900 banks’ advertisements so far to identify and prevent misleading and false information being disseminated and the establishment of ‘One-Stop-Contact Centre’ known as BNMLINK and BNMTETELINK as avenues for consumers to submit their feedbacks and complaints against financial services providers (e.g. disputes over interest rate calculations, fees charged and outstanding balances as well as poor customer services). Moving forward, Abu Bakar et al. proposed that Islamic banks to undertake the value-based intermediation (VBI) strategy developed by BNM for generating sustainable profits while not discounting the need to provide fair and just treatments to their customers. Stronger consumer protection is anticipated to be practised by Islamic banks under the customer-focussed VBI strategy given its underlying principles of good self-governance, transparency and ethical conducts.

In Chapter 7, Mhd Sarif et al. highlight the quandary faced by financial institutions in embracing the new age of digital-economy – while the anti-money laundering regulations are placed to protect the public interest and bring stability to markets, it is argued that such laws also hinder financial innovation. In the context of mobile payment system, Mhd Sarif et al. assert that efforts promoting financial innovation, which is part and parcel of digital economy, is pivotal in instigating an effective transmission of market information, and thus ensuring smooth
electronic financial transactions to take place. In face-to-face interviews with the selected technopreneurs, who heavily rely on mobile payment systems in closing their daily transactions, majority of the informants agree that the introduction of the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (AMLATFPUA) (Act 613) may hamper the dynamic features of modern days’ financial transactions. It creates some sort of ‘disturbances’ to banks’ internal control system (e.g. people, process, information technology system, etc.) and the worst case to the entire global financial ecosystem upon transactions that have been sanctioned by the Act. Nevertheless, it is inarguably important for the regulators to enforce the AML/CFT regulations for safeguarding the country’s economy from being misused for illegal endeavours. Building on this, the study of Mhd Sarif et al. conclude that while the imposition of the laws on AML/CFT is necessary, some forms of flexibility must be given by the market regulators to facilitate innovation in the mobile payment system sector.

Efforts towards combating money laundering and terrorism financing were examined from the Shari’a perspectives in Chapter 8. In the chapter, Raja Alias et al. provide a unique Shari’a analysis of how Islamic legal principles prohibit money laundering and terrorism financing through the preservation of property and people’s wealth. Since the early days of Islam, core principles relating to the preservation of property and the prohibition of unauthorised usurpation of other’s wealth are well entrenched in the primary and secondary sources of the Shari’a. As such, Muslim countries may take the lead in the fight against money laundering and terrorism financing for a better world.

While Chapter 8 focusses on the Shari’a aspects, Chapter 9 explores the phenomenon of money laundering within the context of legal compliance in Islamic banks in Malaysia. Mohd Yasin et al. analyse the oversight functions at the Malaysian Islamic banks in compliance to the AMLATFPUA 2001. Based on the interview sessions with compliance personnel at eight Islamic banks, Mohd Yasin et al., in general, find that the Islamic banks’ oversight functions have significantly improved since the release of BNM’s report on the AML/CFT thematic review of banking and insurance sector in 2013. In details, majority of the respondents were able to demonstrate a comprehensive understanding about the requirements stipulated in P28 of the BNM’s AML/CFT Guidelines as well as the nature and severity of AML/CFT risks that their banks are exposed to. In respect of the effectiveness of the banks’ AML/CFT internal audit function, the respondents have commented that although AML/CFT audit visitation is currently in place, its intensity and robustness may vary from one bank to another and the auditors’ knowledge on the AML/CFT Guidelines has been lacking in the past. As for human capital, employee screening practices by Islamic banks seems to be distinctive from one another and more thorough screening requirements are expected in the future. Moreover, different banks may have different approaches in the provision of AML/CFT training to their staff. Some banks are far left behind (e.g. Head of Compliance does not hold AML/CFT professional qualifications) due to lack of qualified trainers in the respective areas and inadequate access to e-learning AML/CFT modules. Also, although not mandatory, majority of Islamic banks would encourage their employees to enrol in
professional AML/CFT courses. Lastly, being asked about their opinions on the AML/CFT Guidelines, at least half of the respondents have agreed that some areas of the existing Guidelines are too generic, and hence are subject to different interpretations and the possibility of being manipulated by bank managers. For example, Paragraph 28.7.4 of the Guidelines states that the scope of independent audit shall include among others, adequacy and effectiveness of the AML/CFT Compliance Programme. However, as the control function on AML/CFT exercised by banks’ Compliance Officers are normally on a best effort basis and there is no clear definition as to what it takes to be ‘adequate and effective’, an auditor may not be able to issue his professional opinions.

Furthermore, Chapter 10 examines legal issues in Sharīʿah-compliant home financing in Malaysia and provides an anonymised case study based on a true-life experience with an Islamic bank in Malaysia. In the chapter, Oseni et al. give a practical analysis of the dynamics of a typical deferred payment contract otherwise called bai bithamn ajil in Malaysia. This seemingly controversial Islamic finance product has been one of the most litigated products in the Malaysian courts. Recommendations are provided to enhance Islamic finance documentation involving home financing based on the experiences of the case study provided. In order to complement the case study, Chapter 11 by Mat Ali et al. examine procedural laws governing event of default in Islamic financing in Malaysia. It adopts a doctrinal legal approach in analysing the relevant laws and identifying the numerous loopholes that require the attention of policy makers with a view to introducing amendments to the laws.

**Fintech and Blockchain Technology**

Meanwhile, the scholarly discussions provided in the last four chapters of this book revolve around the advancement of Fintech solutions, digital currency and blockchain technology from the legal and regulatory perspectives. In Chapter 12, in relation to the ongoing debate on the need to regulate activities in the Fintech industry, Hui et al. seek to ascertain whether Sharīʿah and the current Islamic banking regulations can accommodate Fintech innovations. Prior to answering the main research inquiry, Hui et al. underscored several important implications on the Islamic banking industry in Malaysia, subsequent to the embrace of Fintech innovations. These implications, among others, include the possibility of profit margin cuts and reduced deposits due to growing customers and investors’ preference for internet-based financial platforms. Though Islamic banks may enjoy higher competitive advantage through the formation of innovative financial platforms (e.g. the launch of Investment Account Platform or IAP in Malaysia in early 2016) as a result of collaboration with Fintech companies, customers are expected to benefit from wider product offerings and alternative investment avenues that suit their financial needs exclusively. As to whether Sharīʿah would accommodate Fintech innovations, Hui et al. opine that Fintech is likely to assist unbanked entrepreneurs through pooling of investment funds in the spirit of collective cooperation, just and equitable distribution of wealth and protecting public interest (maslahah). Scrutinising the IFSA 2013 and the BNM’s Financial
Technology Regulatory Sandbox Framework, Hui et al. contend that although the existing regulatory frameworks cover wide aspects of Islamic banking practices, including Sharīʿah-compliant payment systems, the fact that digital banking or Fintech solutions are considerably distinctive from the traditional ways that banks operate may trigger the need for the relevant regulatory frameworks to be revised. Moving a step further, the study of Hui et al. suggest that a dedicated legislation that governs Sharīʿah-compliant Fintech solutions and a Sharīʿah Supervisory Committee at Fintech company level (i.e. adopting a two-tier Sharīʿah governance approach similar to Islamic financial institutions) need to be established to oversee the adherence of Fintech innovations to Sharīʿah principles.

In Chapter 13, Miskam et al. describe the evolution of Fintech in the Malaysian Islamic fund management industry from a legal perspective. In doing so, a number of relevant laws and regulations – including the requirements and guidelines made under the Capital Markets and Services Act 2007 and the AMLATFPUA 2001 related to compliance function for fund management companies, Islamic fund management and management of cyber risk, prevention of money laundering activities for capital market intermediaries, respectively, the Digital Signature Act 1997, Personal Data Protection Act 2010 and Computer Crimes Act 1997 – have been thoroughly reviewed to determine the importance of the legal and regulatory aspects of Fintech to the development of the Islamic fund management industry in Malaysia. Further, Miskam et al. discuss several legal issues and challenges that arise from the adoption of Fintech innovations by Islamic fund managers. These include, among others, the ambiguity as to which market regulations Fintech companies should abide by, legal costs and consequences from breaches of customers and investors’ privacy and personal data, the algorithmic malfunction of robo-advisers and failure to detect Sharīʿah non-compliant Fintech activities, which could potentially lead to loss of investor confidence on the security and legitimacy of the entire financial system. To minimise these legal risks, Miskam et al. then suggest market regulators to design an effective regulatory infrastructure and prescribe minimum standards for promoting inclusive finance through Fintech solutions that would provide regulatory clarity and thus ensure market stability. Islamic fund managers, on the other hand, should concurrently dive in deeper into the Fintech ecosystem by utilising their access to client investment profile and information to increase their market shares without compromising the existing legal requirements.

In Chapter 14, Zul Kepli and Zulhuda explain how countries asymmetrically decide on their approaches in regulating cryptocurrency-related activities. For example, the US market regulators have decided to allow Bitcoin futures to trade on major exchanges and the Government of Japan recently passed a new law recognising Bitcoin as a legal form of currency, while in South Korea, financial institutions are totally banned from dealing with virtual currency. Zul Kepli and Zulhuda are of the view that given the possibility of great cross-border extortions posed by cryptocurrency by means of money laundering and terrorism, it is important to have comprehensive international laws and regulations for controlling and managing cryptocurrency-related activities. Apart from that, an integrated action needs to be taken at international level to revise the existing legal
framework for anti-money laundering, taking into account new forms of threats resulting from engaging in cryptocurrency trading including tax evasion, consumer rights violation, copyright issues, fraud, black market and many more.

In the last chapter, Syed A. Rahman first discusses the view of several contemporary Shari‘ah scholars on the permissibility of dealing with cryptocurrency. Syed A. Rahman expressed his concern over the tendency of some scholars to regard cryptocurrency as currency simpliciter in deducing their rulings (i.e. hukm). He has argued that cryptocurrency cannot be compared apples-to-apples with fiat currency. This is because fiat currency is backed by sovereign and completely relies on public confidence as a medium of exchange (although some may disregard its intrinsic utility). This is however not the case for cryptocurrency. Also, he has discerned that potential harms associated with cryptocurrency including excessive speculation that leads to high market volatility, diminution of one’s wealth that contradicts with maqasid al-Shari‘ah or objectives of Islamic law, lack of transparency of its operation and susceptibility to being misused for crimes should be taken into careful deliberation by Muslim scholars in determining the Shari‘ah rulings for cryptocurrency. In addition, this chapter also reviews a number of digital currency regulations of selected jurisdictions, including Japan, the United States, South Korea, the Philippines and Malaysia. In general, some central banks and regulatory and supervisory authorities, being the ‘gatekeepers’, have implemented certain degree of regulation that requires persons with whom fiat currency may be converted into digital currency or vice versa to comply with. On the other hand, others have issued a warning about the risks associated with the holding and transacting using digital currency.

References