Legal, Regulatory and Governance in Islamic Finance

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Introduction to Islamic Finance

- Islamic finance faced tremendous challenges when it first started. One of the main reasons is because there was no precedent to look up to.

- There was also the business risk of the acceptability of members of the public as bankers and lawyers thought that unfamiliar products might take longer to gain acceptability.

- In the end, banking transactions took their form by emulating products and contracts resembling those of conventional finance.

- Thus, most Islamic banking products began by structuring them to mirror their conventional counterparts, with appropriate adjustments to enable compliance with Shariah.

Legal and Regulatory Systems in Islamic Finance

Legal and Regulatory Systems in Islamic Finance

Central Bank of Malaysia Act 2009
Islamic Financial Services Act 2013
Financial Services Act 2013
Development Financial Institutions Act 2002
Government Funding Act 1983

Legal and Regulatory Systems in Islamic Finance

Consumer Credit Act 2025

Consumer Credit Act 2025 shall be read together with the relevant written laws and the provisions of this act shall be in addition to, and not in derogation of, the provisions of such written laws, including the following:

a) Financial Services Act 2013

b) Islamic Financial Services Act 2013

c) Development Financial Institutions Act 2002

d) Capital Markets and Services Act 2007

e) Securities Commission Malaysia Act 1993

Legal and Regulatory Systems in Islamic Finance

Consumer Credit Act 2025

Consumer Credit Act 2025 shall be read together with the relevant written laws and the provisions of this act shall be in addition to, and not in derogation of, the provisions of such written laws, including the following:

f) Hire-Purchase Act 1967

g) Consumer Protection Act 1999

h) Moneylenders Act 1951

i) Pawnbrokers Act 1972

j) Co-operative Societies Act 1993

k) Malaysia Co-operative Societies Commission Act 2007

Legal and Regulatory Systems in Islamic Finance

Contracts Act 1950
Real Property Gains Tax Act 1976
Stamp Act 1949
National Land Code (Revised 2020)
Anti_Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001

Legal and Regulatory Systems in Islamic Finance

Rules of Court 2012
Electronic Commerce Act 2006
Digital Signature Act 1977
Power of Attorney Act 1949

REGULATORS

- **Bank Negara Malaysia (BNM)**
  - **CENTRAL BANK OF MALAYSIA ACT 2009**
    - Islamic banks, International Islamic banks, Islamic windows and Islamic Development Financial Institutions (DFIs)
    - Family and General *Takāful*, Re-takaful, International takaful operators and intermediaries
- **Securities Commission (SC)**
  - **SECURITIES COMMISSION ACT 1993**
    - Islamic stockbroking companies, Islamic fund management companies, Islamic unit trust management companies, etc
    - Recognised Market Operator
      - Equity Crowdfunding platform
      - Islamic Peer-to-Peer Platform
      - Digital Aset Exchange
      - Property Crowdfunding platform
      - E-Services Platform
- Labuan Financial Services Authority
  - **LABUAN FINANCIAL SERVICES AUTHORITY ACT 1996**
    - Offshore Islamic banks, Offshore Islamic capital market intermediaries,

      Offshore Islamic trusts and

      Offshore retakaful companies, etc

Key Industry Associations

Malaysian Takaful Association (MTA)
Association of Islamic Banking and Financial Institutions Malaysia (AIBIM)
Association of Shariah Advisors in Islamic Finance (ASAS)
Chartered Institute of Islamic Finance Professionals (CIIF)

Other Standard Setters

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
Financial Stability Board (FSB)
Basel Committee for Banking Supervision (BCBS)
The International Organization of Securities Commission (IOSCO)
International Islamic Financial Market (IIFM)
Malaysian Accounting Standards Board (MASB)

Legal Cases and Documentation in Islamic Finance

Constitutionality of Shariah Advisory Council of Bank Negara Malaysia (SAC)

JRI Resources Sdn Bhd v Kuwait Finance House (Malaysia) Bhd [2019] 5 CLJ; Federal Court

- Legal issue: Constitutionality of Section 56 and 57 of the Central Bank of Malaysia Act 2009, which mandate reference to the SAC in cases involving Islamic law

- Judgment: The Federal Court in a majority decision upheld the constitutional validity of the SAC's role. It ruled that:
  1) The SAC's advisory jurisdiction is consistent with Article 74 and the Federal List of the Federal Constitution
  2) Referring Shariah matters to the SAC does not violate the doctrine of separation of powers or usurp judicial authority as the SAC does not decide facts or final legal outcomes
  3) The SAC serves a specialised interpretative role on Shariah matters to assist the judiciary

Significance: This case cemented the SAC's position as the sole authority on Shariah issues in Islamic finance litigation, reinforcing the hybrid adjudication model used in Malaysian courts

Sanctity of Shariah

Low Chin Meng v CIMB Islamic Bank Berhad [2015] 5 CLJ 324 (Court of Appeal)– Idrus Harun JCA

Facts of the case:

- Low Chin Meng ("LCM") entered into a *Bai' Bithaman Ajil* (BBA) Facility agreement by executing a Sale and Purchase Agreement (SPA), Asset Lease Agreement (ALA), and a gift letter, in which LCM gifted the shares to the company.
- The company failed to make payments, causing CIMB to exercise its rights under the Security Deposit Memorandum by selling the shares.
- LCM filed a counterclaim for damages regarding the unlawful disposal of the shares by CIMB and sought a declaration that the transaction was void and invalid, claiming it contravened **Section 67 and Section 67A of the Companies Act,** which prohibits a company from dealing with its own shares

Issue: Whether the BBA transaction violates **Section 67 and Section 67A** (financial assistance and prohibition for a company to deal with its own shares), thereby rendering the transaction invalid.

Low Chin Meng v CIMB Islamic Bank Berhad [2015] 5 CLJ 324 (Court of Appeal)– Idrus Harun JCA

Decision of the case:

- **The Court stated that if the transaction does not result in a reduction of the company's capital, there is no prohibition for the company to deal with its own shares, and therefore, it does not contravene Section 67**.
- **The Court also found that the sale of the shares was not intended to reduce the company's capital, but rather to fulfill the prerequisites of the BBA facility in order to ensure compliance with Shariah principles.**
- *"[56] We must emphasise that executing asset purchase and immediate resale agreements is a mandatory prerequisite to facilitate Bai Bithaman Ajil (BBA) Islamic Financing. BBA transactions cannot be classified merely as simple or standalone asset sales, as the sale and buy-back mechanism is strictly designed to deliver financial facilities. The share transfers under these agreements serve as part of a sale and buy back financing structure, making them fundamentally different from standard corporate share repurchases using the company's own funds as established under Section 67A of the Companies Act 2016*

Shariah non-compliance

Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor and Other Appeals [2009] 6 CLJ 22; Court of Appeal

- Legal Issue: Appeal concerning the nature of BBA contracts and their legal enforceability when compared to conventional loan agreements

- Judgment: The Court of Appeal decisively overturned previous judgments (including Taman Ihsan Jaya and others influenced by Affin Bank v Zulkifli) holding that:
  a) A BBA contract is a sale agreement, not a loan
  b) Courts have no authority to rewrite contracts agreed to by both parties
  c) Judges should not adjudicate Shariah compliance issues without proper reference to the SAC

- Significance: This case reaffirmed the legal validity of BBA contracts and served as a corrective response to earlier inconsistent judicial interpretations. It also reiterated the necessity of Shariah input from qualified authorities, thus anticipating the future significance of Sections 56 and 57 of the Central Bank of Malaysia Act 2009

Section 281 of the Islamic Financial Services Act 2013

Except as otherwise provided in this Act, or in pursuance of any provision of this Act, no contract, agreement or arrangement, entered into in breach or contravention of any provision of this Act shall be void solely by reason of such breach or contravention: Provided that nothing contained in this section shall affect any liability of any person for any administrative, civil or criminal actions under this Act in respect of such breach or contravention

RHB Islamic Bank Bhd v Alam Maritim (L) Inc [2025] 8 MLJ 525

- Legal Issue: [56] As the provision pertaining to financial institution's duty to comply with Shariah principle and the rulings of SAC is within s 28 of the IFSA 2013, it follows that based on s 281 of the IFSA 2013, the non-compliance of such section does not render the banking facility or any instrument thereunder void.

- [57] This is supported by the academic analysis of Mohd Johan Lee in his book titled Islamic Banking in Malaysia, Lexis Nexis (2017), where he posits that s 281 of the IFSA 2013 preserves the validity and enforceability of a contract even though it is non-Shariah compliant.

RHB Islamic Bank Bhd v Alam Maritim (L) Inc [2025] 8 MLJ 525

- [59] Post-2013, allegations of non-compliance with Shariah principles appear to be a matter between Bank Negara Malaysia and the individual financial institutions, potentially arising from a customer complaint. If a financial institution or its officers fail to adhere to the required Shariah principles, they may face criminal sanctions under s 28(5) of the IFSA 2013. However, under s 281, non-compliance with Shariah principles alone does not invalidate an agreement between the parties. Therefore, an agreement that contravenes SAC rulings is not necessarily void unless it also violates provisions of the Contracts Act 1950. This may include considerations such as whether the reasons for Shariah non-compliance involve factors that could render the contract void due to illegality (s 24) or uncertainty (s 30).

SECTION 66 OF THE CONTRACTS ACT 1950

Section 66 - Obligation of person who has received advantage under void agreement, or contract that becomes void

Obligation of person who has received advantage under void agreement, or contract that becomes void

When an agreement is discovered to be void, or when a contract becomes void, any person who has received any advantage under the agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it.

Maybank Islamic Berhad v Golden Base Construction Sdn Bhd & Ors [2019] 1 LNS 1785 (HC)

EXTRACT OF THE JUDGMENT

[50] It was further submitted that pursuant to section 281 of the Islamic Financial Services Act 2013 ("IFSA 2013"), a contracting party cannot avoid a contract solely on the ground that it has breached or contravened the provisions of IFSA 2013 and that the financial institution which granted the non-Shariah compliant financing product will be subject to penalty/punishment by the regulatory body for offering a non-Shariah compliant financial product.

As stated above, at this juncture this court is not in the position to determine whether the Financing granted to the 1st Defendant is Shariah compliant or otherwise merely by relying on affidavit evidence. Thus the issue whether the Plaintiff is only subject to penalty (in the event the Financing is non-Shariah) and whether section 66 of the Contracts Act applies is premature at this stage as they are consequential to the issue of the legality of the Financing.

Maybank Islamic Bhd v M-IO Builders Sdn Bhd & Anor [2017] 2 MLJ 69 (COA) (1/3)

ISSUE

Whether any non-compliance with Murabahah principles render a contract illegal and unenforceable

DECISION

The provisions of the Contracts Act 1950 still govern Islamic contracts, and as such, reference should be made to the Contracts Act 1950 when determining whether a contract is void

The court found that none of the circumstances in s.24 of the Contract Act 1950 were applicable to the bai' al inah contract in question and therefore found the contract to remain enforceable.

Maybank Islamic Bhd v M-IO Builders Sdn Bhd & Anor [2017] 2 MLJ 69 (COA) (2/3)

SECTION 24 CONTRACTS ACT 1950

The consideration or object of an agreement is lawful, unless-

(a) it is forbidden by a law;

(b) it is of such a nature that, if permitted, it would defeat any law;

(c) it is fraudulent;

(d) it involves or implies injury to the person or property of another; or

(e) the court regards it as immoral, or opposed to public policy.

In each of the above cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

Arbitration in Islamic Finance

Relevance of Alternative Dispute Resolution (ADR) in Islamic Finance

ADR aligns well with Islamic legal principles, particularly those that encourage reconciliation (sulh) and amicable settlement (musalaha). In fact, the Qur'an promotes resolving disputes through dialogue and justice:
" And if two parties of the believers fight, then make peace between them" (Surah Al-Hujurat [49:9]
In the context of Islamic finance, ADR provides several distinct advantages, including:

- Shariah-compliant dispute resolution mechanisms, such as the i-Arbitration Rules developed by the Asian International Arbitration Centre (AIAC).

- Non-adversarial approaches that align with the ethical principles of Islam, promoting mutual understanding and settlement.

- Confidential handling of commercially and religiously sensitive contracts, including murabahah, sukuk, and takaful arrangements.

Arbitration mechanism

- In Malaysia, the AIAC acts as a neutral and expert-led forum which provides credible and efficient alternative to court litigation.
- It particularly deals with disputes involving parties from different jurisdictions or especially where confidentiality is paramount.
- AIAC introduced the **i-Arbitration Rules** which were first introduced in 2023 to align with contemporary international arbitration standards and Shariah-compliance requirements.
- On 1 January 2026, the i-Arbitration Rules 2026 will come in force.

Arbitration mechanism

- Arbitration in Islamic finance mainly concerns:

  a) *Murabahah*, *ijarah*, *istisna'* and *tawarruq* financing disputes
  b) Sukuk Investment Structures
  c) Cross Border Islamic syndicated financing
  d) Islamic Project Finance
  e) Disputes involving Islamic Financial Institutions and multinational Corporations

Relevance of ADR in Islamic Finance

ADR Mechanism/ Institution	Scope of Disputes	Method	Binding Outcome	Shariah Compliance Mechanism	Remarks
AIAC (i-Arbitration Rules)	High value commercial disputes involving Islamic finance contracts (Murabahah, ijarah, sukuk, etc)	Arbitration	Yes (binding arbitral award)	Reference to SAC or agreed Shariah expert	Suitable for institutional contracts; enforceable under Arbitration Act & NY Convention
Financial Market Ombudsman Service (FMOS) (formerly OFS & SiDREC)	Consumer and investor disputes involving Islamic banks, Takaful operators, sukuk, unit trusts	Mediation & Adjudication	Yes (if accepted by complainant)	Refers to IFI's internal Shariah views; no external SAC referral	Free accessible service for retail clients; covers both banking & capital markets
Private or Court-Annexed Mediation	General Islamic finance disputes (for example, Takaful, debt, waqf)	Mediation	No (unless agreement formalised)	Optional to appoint Shariah-competent mediator	Encouraged under Mediation Act 2012 and court practice directions

Governance in Islamic Finance

Principles of Shariah Governance

1) Oversight, Accountability and Responsibility

- Effective Shariah governance requires clear lines of responsibility and strong oversight mechanism at every level of the institution

2) Competency

- Those involved in Shariah governance must possess the appropriate qualifications, skills and expertise

3) Confidentiality and Consistency

- Shariah governance must be carried out in a manner that safeguards the confidentiality of sensitive information while ensuring consistency in decision

4) Independence

- To be independent is vital, to ensure that Shariah decisions are made objectively and without under influence, Shariah Committee members must be free from conflicts of interest and provide impartial advice and rulings based on Shariah principles

Governance as a pillar in Islamic Finance

1) Real Economic activities: Financial transactions must be supported by genuine, productive economic activities. Speculative dealings and financial instruments without underlying assets are prohibited.

2) Ethical values: Transactions must comply with Shariah rules emphasizing fairness, transparency, and transparency, and avoidance of haram *(mafsadah).*

3) Partnership- based contract: Encourage profit-and-loss sharing and risk-taking under contracts like *mudarabah* and *musharakah.*

4) Governance: Provides the structure, supervision, and accountability needed to ensure all elements adhere to Islamic Principles.

Shariah Governance Policy Document

The Shariah Governance Policy Document (SGPD) 2019 outlines Bank Negara Malaysia's strengthened expectations for effective Shariah Governance.

- Key Enhancements Introduced by BNM Shariah Governance Policy Document 2019:
  - **Structural & Regulatory Enforcements**
  - **Functional Enhancements and Control Strengthening**

Shariah Governance Policy Document

[S] Paragraph 10.2

- The Shariah committee has the responsibility to provide objective and sound advice to the IFI to ensure that its aims and operations, business, affairs and activities are in compliance with Shariah. This includes–
  a) **providing a decision or advice to the IFI on the application of any rulings of the SAC or standards on Shariah matters that are applicable to the operations, business, affairs and activities of the IFI;**
  b) **providing a decision or advice on matters which require a reference to be made to the SAC;**
  c) **providing a decision or advice on the operations, business, affairs and activities of the IFI which may trigger a Shariah non-compliance event;**
  d) **deliberating and affirming a Shariah non-compliance finding by any relevant functions; and**
  e) **endorsing a rectification measure to address a Shariah non-compliance event.**

Shariah Governance Policy Document

- Issued pursuant to section 29(2), 57(1) & 155 of IFSA and section 33E(2), 41 & 116 of Development Financial Institutions Act 2002.
- Effective Date: 1 April 2020 (except paragraph 12.5 which comes into effect on 1 April 2023)
- This policy document outlines the BNM's strengthened expectations for effective Shariah governance arrangements that are well integrated with business and risk strategies of the Islamic financial institutions.
- Specifically, this policy document sets out strengthened oversight accountabilities on the board, Shariah committee and other key organs involved in the implementation of Shariah governance.
- Another area relates to Shariah committee's objectivity to reinforce sound decision-making process and robustness of internal control functions for effective management of Shariah non-compliance risks.

Shariah Governance Policy Document

- **Structural & Regulatory Enforcements**

  a. **Maximum 9-year Tenure for Shariah Committee Members -** This allows for fresh perspectives while preventing overfamiliarity or bias.

  b. **Mandatory Notification to BNM for Additional Restrictions Beyond SAC Rulings -** If SC imposes stricter rulings than those issued by SAC, IFIs must notify BNM with proper notification and justification.

  c. **Explicit Prohibition on Policy-Exposed Persons (PEPs) -** Policy explicitly prohibits active politicians from serving on SCs.

  d. **Effective Communication Mandated Between Board and Shariah Committee -** Board of Directors are required to proactively engage with SCs on all Shariah-related matters, including governance and non-compliance risk.

Shariah Governance Policy Document

- **Structural & Regulatory Enforcements**

    e. **Shariah Review Personnel Requirements –** Review personnel must possess a sound Shariah understanding.

    f. **No Mandatory Qualification for Shariah Researches –** No standalone requirement for researchers to be qualified Shariah officers.

Shariah Governance Policy Document

- **Functional Enhancements and Control Strengthening**
   a. **Board Oversight of Shariah Function -** Board must provide strategic oversight over Shariah-related matters.

   b. **Robust Shariah Committee Deliberations -** SC meetings must involve meaningful engagement with members equipped to provide in-depth discussions on product development, compliance concerns, etc,.

   c. **Policy and Procedure Enhancement -** Institutions encouraged to refine internal policies to align better with Shariah expectations.

Shariah Governance Policy Document

- **Functional Enhancements and Control Strengthening**

  d. **Shariah Risk Identification Across All Units –** Must be empowered to detect, assess and monitor Shariah non-compliance.

  e. **Quality Shariah Review –** Reviews must be regular, comprehensive and include update of legal and Shariah changes.

  f. **Capability Development and Certification –** Continuous professional development

  g. **Empowerment of Shariah Knowledge Across Business Functions –** Promotes end to end Shariah compliance rather than viewing it as a bank-end control.

Corporate Governance Policy Document

- The policy emphasizes the importance of strong corporate governance for DFIs to ensure they can fulfil their mandate of supporting priority economic sectors and managing public funds responsibly.

- Effective governance is central to BNM's supervisory assessment, requiring boards to be competent, independent, and able to challenge senior management, while senior management is accountable for prudent daily operations.

- A sound governance framework must also be supported by an ethical corporate culture shaped by the board and senior leadership.

Thank you

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