

# **INTERNATIONAL FRAMEWORK FOR ISLAMIC FINANCE**

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made for the work of others.

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## Abstract

This research is a study on the international framework for Islamic finance (“the framework”). The roles of dedicated and non-dedicated institutions in Islamic finance are examined and analysed in terms of their structures, functions, and the law-making dynamics in the international setting, and accordingly, their regulatory promulgation towards the adoption at the domestic national context. The framework is cognisant of the contemporary challenges arising from various emerging issues of creative disruptions posed to the existing design and operation of the global financial system. Influenced and modelled by the current global financial architecture, the framework has developed international institutions that issue and promulgate international standards, guidelines, principles, and soft-law instruments, tackling key important areas such as capital adequacy, liquidity, risk management, *Sharī'ah*-compliant ratings, and *Sharī'ah* governance mechanism, as adopted in various jurisdictions. Trust and confidence are the key determinants for the well-functioning system of the international framework for Islamic finance. As banking crisis and global economic recessions are the recurring phenomenon, the global financial safety-net must be safeguarded, and this includes *Sharī'ah*-lender of last resort, depositor’s protection, and ring-fencing mechanism, etc. Malaysia as an exploratory case-study is a heavily-regulated model for operating a framework of supervising and regulating dual-banking and financial systems, whilst the centrality of the *Sharī'ah* Governance mechanism through the supervision of the *Sharī'ah* Advisory Council of Bank Negara Malaysia (BNM) posits legal certainty, predictability, and stability of *Sharī'ah* rulings. The recent promulgation of the Financial Services Act 2013 [Act 758], and the Islamic Financial Services Act 2013 [Act 759] has reinforced the BNM’s position as a strong regulator for banking and financial sector in Malaysia. Last but not least, the *Quranic* worldview and ‘meta-dependence’ analysis of trust and confidence contribute towards novel scholarly contributions for the study of the international framework for Islamic finance.

## Table of Contents

Acknowledgement.....	ii
Abstract.....	iii
Table of Contents.....	iv-ix
List of Abbreviations and Acronyms.....	x-xii
List of Arabic Terms and Glossary of Islamic Banking and Finance.....	xiii-xv
List of Tables.....	xvi
List of Figures.....	xvii
List of Malaysian Laws and Cases.....	xviii-xix

## Introduction

1. Research Background .....	1-3
2. Research Methodology .....	3-5
3. A Critical Examination of the <i>De Jure</i> (In Law) and the <i>De Facto</i> (In Fact) International Framework For Islamic Finance.....	5-9
4. Research Questions and Objectives.....	9
5. Chapters and Milestones .....	9-11

## Chapter One: A Critical Examination of the Global Financial System

1.1. The Global Financial System: Economics And Institutional Standpoints.....	12-14
1.1.1 International institutions.....	14-16
1.1.2 Legal agreements that link their interactions.....	17-18
1.1.3 The participation of various economic actors.....	18-19
1.2. Systemic and Regulatory Paradigm of the Global Financial Framework.....	19-22
1.3. Regulated entities.....	22-24
1.4. Lightly Regulated or Non-Regulated Entities .....	24
1.5. Historical Examination of the Institutionalisation of Global Economic Governance Structure And The Contextualisation of Global Paradigms .....	24-28
1.6. From The Bretton Woods System to A Fiat-Based system.....	28-31
1.7. From the Fiat-Based System to LIBOR.....	31-34
1.8. The Status Quo Operation of Islamic finance in the Global Financial System .....	34-35
1.9. Conclusion.....	35

## **Chapter Two: Islamic Finance within the Global Financial System**

2.1	Islamic Finance: An Examination of the <i>Fiqh Muamalat</i> Fundamentals.....	36-42
2.2	Dedicated Institutions for Islamic Finance: .....	42
2.2.1.	IFSB.....	42-43
2.2.2.	IIFM.....	43-44
2.2.3.	AAOIFI.....	44-45
2.2.4.	IDB.....	45-46
2.2.5.	IAIB.....	46
2.2.6.	ICD .....	47
2.2.7.	IIRA .....	47
2.2.8.	DJMI.....	48
2.2.9.	The International Islamic <i>Fiqh</i> Academy of <i>Fatwa</i> of the OIC.....	48
2.2.10.	CIBAFI .....	49
2.2.11.	LMC.....	49-50
2.2.12.	IILMC.....	50
2.3	Non-Dedicated Institutions for Islamic Finance: .....	50
2.3.1	The World Gold Council .....	51-52
2.3.2	BCBS .....	52-53
2.3.3	LIBOR and Islamic Finance.....	53
2.3.4	IMF .....	54
2.3.5	World Bank.....	54-55
2.4	Other Institutions, Centres, Actors, and Forum on Islamic Finance.....	55-56
2.5	Mapping the International Framework for Islamic Finance.....	56-59
2.6	Conclusion.....	59

## **Chapter Three: Philosophical Foundation for International Framework for Islamic Finance**

3.1.	Fundamental Philosophy for the International Framework of Finance.....	60-61
3.2.	A Critical Examination of the Quranic Worldview of Islamic Finance .....	61-66
3.3.	Islamic Finance: A Critical Examination of Trust and Confidence Within VBI.....	66-68
3.4.	The <i>Quranic</i> Worldview of Islamic Finance: A Critical Examination of Trust in the	

	Professionalisation of IFSI.....	68-70
3.5	A Critical Examination of Trust and Confidence As A Dependent-Interdependent Relationship .....	70-71
3.6	A Critical Examination of the Vulnerabilities of Trust And Confidence for the International Framework for Islamic Finance .....	71-73
3.7	A Critical Examination of Trust and Confidence And The Realm of Choices for the International Framework for Islamic Finance .....	73-75
3.8	A Critical Examination of Trust and Confidence: From Dependent-Interdependent Relationship to the Idea of Meta-economics And 'Meta-dependence' for the International Framework of Islamic Finance.....	75-82
3.9	'Meta-dependent' Fiat-Based Banking And the <i>Qur'anic</i> Worldview of Trust and Confidence for the International Framework of Islamic Finance .....	82-84
3.10	The International Framework for Islamic Finance: A 'Meta-Dependence' and 'Meta-non-Dependence' Analysis .....	84-86
3.11	Conclusion .....	86

#### **Chapter Four: The Global Financial Crisis, the GFSN, and the Context of the International Framework for Islamic Finance**

4.1.	An Examination of the Global Financial and Banking Crisis.....	87-88
4.2.	An Examination of Measures Adopted To Weather the Global Financial And Banking Crisis .....	88-90
4.3.	The Asian Financial Crisis 1997-1998: Malaysia's Approach To Weather the Economic Recession and the Growth of Islamic Finance.....	90-93
4.4.	A Critical Examination on Strengthening the GSFN: The Need for an International Lender of Last Resort (ILOLR)? .....	94-96
4.5	A Critical Examination on the LOLR, and the <i>Sharī'ah</i> -LOLR (SLOLR).....	96-99
4.6.	SLOLR for the International Framework for Islamic Finance: The <i>Sharī'ah</i> Standpoints.....	99-101
4.7	Moral Hazard, SLOLR, and Islamic Finance.....	101-102
4.8.	A Critical Examination of the Restoration of Trust and Confidence Through the Risk Management .....	102-103
	(a) Credit Risk.....	104-105
	(b) Liquidity Risk.....	105-107
	(c) Market Risk .....	107-108

(d) Operational Risk.....	109-110
(e) Investment Risk.....	110-112
(f) Rate of Return Risk.....	112-115
4.9. A Critical Examination of the Restoration of Trust and Confidence Through Basel III, and Managing the Liquidity Risk.....	115-120
4.10. Global Financial Crisis from Ethical Finance, Behavioural Finance and the <i>Quranic</i> Worldview As Novel Scholarly Contributions.....	120-123
4.10.1 The Roles of Economics.....	123-125
4.10.2 The Roles of <i>Quranic</i> Ethics.....	125-130
4.10.3 The Roles of Law.....	130-131
4.11 The <i>Quranic</i> Worldview of Islamic Finance: A Critical Examination of Depositor's Protection, and A Ring-Fencing Mechanism of Islamic Banks.....	132-134
4.12 Conclusion.....	134-135

## **Chapter Five: The Roles of International Law in the Global Financial System and the International Framework For Islamic Finance**

5.1. An Examination of International Law as a Backdrop for the International Framework of Islamic finance.....	136-141
5.2. Enabling Legal Environment for the International Framework of Islamic Finance.....	141-142
5.2.1. IFSB.....	142-146
5.2.2. AAOIFI.....	147-148
5.2.3. The Islamic <i>Fiqh</i> Academy of <i>Fatwa</i> .....	149-150
5.2.4. IIRA Rating .....	150-153
5.2.5. Dow Jones Islamic Market Index.....	154-155
5.2.6. IMF.....	155-156
5.3. A Critical Examination of the Capital Adequacy Requirement, Basel III Standpoints, And <i>Shar'ah</i> -Compliant Issues .....	156-160
5.4. A Critical Examination of the Capital Adequacy Requirement for Islamic Financial Institutions .....	160-162
5.5. International Framework for Islamic Finance: Interdependence, and the Clash of Civilisations .....	162-165
5.6 The Creative Evolution of International Framework for Islamic Finance: A Critical Examination of Islamic Derivatives.....	165-169

5.7	A Critical Examination of the International Framework for Islamic Finance in the context of Brexit and UK As Islamic Finance Hub .....	170-171
5.7.1	A Critical Examination of the Islamic Financial Services in the UK.....	172-174
5.7.2	Hard Brexit and Islamic Finance in the UK .....	174-176
5.7.3	Soft Brexit and Islamic Finance in the UK.....	177-178
5.7.4	Brexit and the UK as Islamic Finance Hub.....	179-180
5.8.	A Critical Examination of War and Peace: the <i>Quranic</i> Worldview for the International Law Making Process for the International Framework of Islamic finance.....	181-184
5.9.	Conclusion .....	184

## **Chapter Six: Malaysia as a Case-Study**

6.1.	Introductory Examination of International Framework for Islamic Finance with Malaysia as a case-study.....	185-186
6.2.	Malaysia: A Multi-Party Parliamentary Democratic System and A Constitutional Monarch Jurisdiction .....	186-188
6.3.	An Examination of the Historical Background of Banking and Finance in Malaysia.....	188-190
6.4.	Early Development of Islamic Banking and Finance in Malaysia: A Dual-Banking Regime.....	190-192
6.5.	Islamic Capital Market and SAC.....	192-194
6.6.	<i>Bursa Malaysia</i> and LFSA.....	194-195
6.7.	Malaysia Deposit Insurance Corporation (MDIC).....	195-198
6.8.	Malaysia International Islamic Financial Centre (MIFC).....	198
6.9.	The International Centre for Education in Islamic Finance (INCEIF) and the International <i>Sharīah</i> Research Academy for Islamic Finance (ISRA).....	198-199
6.10.	BNM: A Centralised Banking Regime in Malaysia.....	199-203
6.11.	Liquidity and Capital Adequacy: BNM's Framework of Regulation and Supervision.....	203-205
6.12.	Malaysia's Banking Resolution and Liquidation Framework.....	205-206
6.13.	AAOIFI's Standards And IFRS in Malaysia.....	206-207
6.14.	Contemporary Development of Islamic Banking and Finance in Malaysia, SAC, and SGF 2010.....	207-209
6.15.	A Critical Examination on the Financial Services Act 2013 [Act 758] and the Islamic Financial Services Act 2013 [Act 759] .....	209-217
6.16.	<i>Sharī'ah</i> Governance Model in Malaysia.....	218-225

6.17.	Critiques, And Challenges Towards the Centrality of the SAC's Model of <i>Shari'ah</i> -Governance.....	225-229
6.18.	<i>Shari'ah</i> Governance Model in Other Jurisdictions.....	229
	6.16.1. <i>Shari'ah</i> -Based Jurisdictions.....	229-230
	6.16.2. Partially- <i>Shari'ah</i> Based Jurisdictions.....	230-231
	6.16.3. Secular-Based Jurisdiction.....	232-233
6.19.	The Prognosis of Malaysia's Model: An Exploratory Case Study for the <i>Shari'ah</i> Governance Framework.....	233-236
6.20.	The Prognosis of Malaysia's Model: An Exploratory Case Study for the Legal and Regulatory Framework.....	236-237
	6.20.1. An Enabling Legal Environment: Malaysia's Experience.....	237-239
	6.20.2. The Effective Mechanism for Dispute Resolution: Malaysia's Experience.....	239-242
	6.20.3. The Enforceability of Islamic Financial Products .....	243-245
6.21.	International Framework for Islamic Finance: 'Meta-dependence' Trust and Confidence Re-examined.....	245-248
6.22.	Conclusion.....	248-250

## **Chapter Seven: Conclusion and Recommendations**

7.1.	Introduction.....	251
7.2	Research Originality.....	251-253
7.3.	Research Findings.....	253-255
7.4.	International Framework for Islamic Finance .....	255-259
7.5.	Recommendations.....	259-260
7.6.	Future Research .....	260-261
7.7.	Overall Conclusion.....	261-262
	Bibliography.....	263-273
	Appendices.....	274-277
	Appendix I.....	274
	Appendix II.....	275
	Appendix III.....	276-277

## List of Abbreviations and Acronyms

Abbreviations	Full Description
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions.
AIAC	Asian International Arbitration Centre.
BIMB	Bank Islam Malaysia Berhad.
BNM	Bank Negara Malaysia (Central Bank of Malaysia).
BCBS	Basel Committee on Banking Supervision.
BIS	Bank for International Settlements.
CPIFR	Core Principles for Islamic Finance Regulation.
CGFS	Committee on Global Financial System.
CIIF	Chartered Islamic Financial Professionals (CIIF) Malaysia.
CIBAFI	Council for Islamic Banks and Financial Institutions.
CPSS	Committee on Payment And Settlement Systems.
DIFC	Dubai International Financial Centre.
DCR	Displaced Commercial Risks.
DJIM	Dow Jones Islamic Market Index.
DFI	Development Finance Institutions.
DIS	Deposit Insurance System.
EU	European Union.
ECB	European Central Bank.
ECSC	European Coal and Steel Cooperation Council.
iETFs	Exchange Traded Funds.
FC	Federal Constitution (in this study, the FC of Malaysia).
FTA	Free Trade Agreement.
FSMA	Financial Services and Markets Act 2000.
FSA 2013	Financial Services Act 2013.
IFSA 2013	Islamic Financial Services Act 2013.
GATT	General Agreement on Tariff and Trade 1947 and 1994.
GATS	General Agreement on Trade in Services.
GCC	Gulf Cooperation Council (consists of the UAE, Bahrain, Saudi Arabia, Oman, Qatar, and Kuwait).
G7	Finance Ministers, which consists of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
G10	Central Banks, consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
GFSN	Global Financial Safety-Net.
FCA	Financial Conduct Authority.
FSA	Financial Services Authority.
FATF	Financial Action Task Force.
FSF	Financial Stability Forum.
IAIB	International Association of Islamic Banks.
IAH	Investment Account Holder.
IAS	International Accountancy Standards.
IASB	International Accounting Standards Board.
IAASB	International Auditing and Assurance Standards Board.
IAIS	International Association of Insurance Supervisors.
IFC	Islamic Finance Council UK.
IFRS	International Financial Reporting Standards.

Abbreviations	Full Description
IFIAR	International Forum of Independent Regulators.
IOSC	International Organisation of Securities Commissions.
IDB	Islamic Development Bank.
IFSB	Islamic Financial Services Board.
IMF	International Monetary Fund.
IFSI	Islamic Financial Services Industry (including banks and Islamic financial institutions).
IFS	Islamic Finance Services.
IFIs	Islamic Financial Institutions.
IIFM	International Islamic Financial Market.
IAH	Investment Account Holder.
IAIB	International Association of Islamic Banks.
ICD	Islamic Corporation for the Development of the Private Sector.
IIRA	International Islamic Rating Agency.
IRTI	Islamic Research and Training Institute.
INCEIF	International Centre for Education in Islamic Finance.
ISRA	International <i>Sharīah</i> Research Academy for Islamic Finance.
IFS	Islamic Financial Services.
ICM	Islamic Capital Market.
IILMC	International Islamic Liquidity Management Corporation.
Labuan IFC	Labuan International Business and Financial Centre.
ICJ	International Court of Justice.
LFSA	Labuan Financial Services Authority.
LCR	Liquidity Coverage Ratio.
LIBOR	London-Interbank Offered Rate.
KLIBOR	Kuala Lumpur-Interbank Offered Rate.
KLRCA	Kuala Lumpur Regional Centre for Arbitration.
MASB	Malaysian Accounting Standards Board.
LMC	Liquidity Management Centre.
MDIC	Malaysian Deposit Insurance Cooperation.
MIFC	Malaysia International Islamic Financial Centre.
NSFR	Net-Stable Funding Ratio.
OIC	Organisation of the Islamic Conference
OECD	Organisation of Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
PER	Profit equalisation reserve.
RIR	Investment Risk Reserve.
PCA	Permanent Court of Arbitration.
PLS	Profit and Loss-Sharing.
PSIA	Profit Sharing Investment Account.
PIOB	Public Interest Oversight Board.
NFR	Net-Funding Requirements.
RWA	Risk-Weighted Average.
ROA	Return on Assets.
SAC	<i>Sharīah</i> Advisory Council.
SQR	<i>Sharīah</i> Quality Rating.
SGF 2010	<i>Sharīah</i> Governance Framework 2010.

Abbreviations	Full Description
(IREITs)	Real Estate Investment Trust and <i>Sharī'ah</i> -Compliant.
SDR	Special Drawing Rights.
SSB	<i>Sharī'ah</i> Supervisory Board.
SQR	<i>Sharī'ah</i> Quality Rating.
UN	United Nations.
UNSC	United Nations Security Council.
UNCITRAL	United Nations Commission on International Trade Law.
TIPS	<i>Takaful</i> (Islamic insurance) certificates, and insurance policies.
VBI	Value-Based Intermediation is defined as an intermediation that aims to deliver the intended outcomes of <i>Sharī'ah</i> through practices, conduct, and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests.
VCLT	Vienna Convention on The Law of Treaties.
WTO	World Trade Organization.

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## List of Arabic Terms and Glossary of Islamic Banking and Finance

Arabic Terms	Explanation, Description, Translation, Illustration
'Adl	Justice.
'Aql	Intellect.
'Aqidah	Faith/belief system/dogma.
Athuraha	Effect.
Bay' al 'ina	Selling goods for cash and buying back at higher price for deferred payment.
Bay' dayn	Sale of debt.
Bay' muajjal	Deferred-payment sale.
Bay' Salam	Pre-paid purchase.
Bay' al kali bil kali	A sale of one debt for another debt.
Bida'ah	Innovation.
Dharurah	Overriding necessity or emergency.
Dharar	Harm.
Fatwa	Legal opinion based on the <i>Sharī'ah</i> .
Fadl	Excess.
Fasid	Void.
Fiqh	Islamic Jurisprudence.
Gharar	Uncertainty (hazard, speculation, risk and deception).
Ghayral-surriyyah	Real and not fictitious.
Ghabn Fahish	Excessive inequality.
Hadith	Prophetic sayings and/or stories narrated by Prophet Muhammad PBUH.
Hajj	Pilgrimage.
Halal	Lawful and Permissible in Islam and under the <i>Sharī'ah</i> .
Haram	Unlawful and Prohibited in Islam and under the <i>Sharī'ah</i> .
Hibah	Profits and dividends.
Hiyal	( <i>Hila</i> , as singular term): a mechanical legal device, or tool used to achieve a certain objective, lawful or not, through lawful means. Although it is generally agreed that <i>hiyal</i> are not merely evasions of the law, their exact nature and place within Islamic jurisprudence remains an open question. It is sometimes regarded as 'legal trickery'.
Ibadat	Acts of worship.
Ijarah	Islamic leasing.
ijarah muntahia bittamleek	Islamic leasing to own—a contract where IFI finances the property or equipment against mutual agreed rental instalments that consist of profit and principle, where profit can be fixed or floated (variable) as agreed. At the end of the lease period, the ownership of property is transferred to the client with the last payment.
Ijma	Consensus among Islamic jurists and <i>Sharī'ah</i> scholars.
Ijtihad	Independent judgment and Islamic legal opinion with regard to certain interpretation and application of legal rules, produced as a careful examination of <i>Sharī'ah</i> surrounding issues in question.

Arabic Terms	Explanation, Description, Translation, Illustration
<i>Istihsan</i>	Juristic preference.
<i>Istinaa'</i>	Commissioned manufacture.
<i>Khilaf</i>	Differences of Islamic legal opinions among Islamic jurists.
<i>Maslahah</i>	General public interest, and greater good for greater community.
<i>Maqasid Shari'ah</i>	Objectives of <i>Shari'ah</i> (preservation of religion ( <i>Din</i> ), intellect ( <i>'Aql</i> ), physical ( <i>Nafs</i> ), property ( <i>Maal</i> ), and lineage ( <i>Nasl</i> )).
<i>Mazhab</i>	Islamic Schools of Legal Thoughts.
<i>Maysir</i>	Gambling or a game of chance.
<i>Mal</i>	Wealth/Property.
<i>Mu'amalat</i>	Commerce or Islamic Commerce.
<i>Murabahah</i>	A mark-up sale.
<i>Mudharabah</i>	Trustee finance between provider of capital ( <i>rabbul-mal</i> ), and manager of capital or entrepreneur ( <i>mudharib</i> ).
<i>Mudharib</i>	Entrepreneur.
<i>Musharakah</i>	Partnership. Joint venture between a financier and an entrepreneur.
<i>Mustahab</i>	Recommended.
<i>Musharakah</i>	Diminishing Partnership. Upon gradual repayment of debt, the status of lender who is also a partner in the partnership transaction will gradually be diminished as the lender no longer holds the asset when the buyer (the other partner) gradually pays the lender, resulting in the eventual transfer of ownership.
<i>Mutanaqisah</i>	
<i>Musawamah</i>	Bargaining.
<i>Nafs</i>	Life.
<i>Parallell Salam</i>	Seller (the short), or buyer (the long), in the original (previous) <i>salam</i> becomes a buyer (long) or seller (short), respectively, in another contract which entails the delivery and taking delivery of the same underlying commodity, without making the execution of the new <i>salam</i> contract dependent on the execution of the previous one. Similar to offsetting in the conventional finance transactions.
<i>Qabdh</i>	Taking and holding something in one's hands, and the immediate transfer of goods.
<i>Qardul Hasan</i>	Interest-free loan, usually given for charitable purposes.
<i>Rahn</i>	Islamic mortgage.
<i>Rabbul Mal</i>	Provider of capital, who can be a sleeping partner.
<i>Riba / Ribawi</i>	Interest. An unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more species, or as the Islamic legal maxim states that "any loan that generates benefits [the lender] is <i>riba</i> ."
<i>Riba Al-Buyu'</i>	The usury of trade.
<i>Riba Al-Duyun</i>	Interest that is accrued because of debt.
<i>Riba An-Nasi'ah.</i>	Interest that is accrued because of the increase of the repayment of loans. The usury of delay.
<i>Riba Al-Fadhli</i>	The usury of surplus.

Arabic Terms	Explanation, Description, Translation, Illustration
<i>Riba Al-Qurud</i>	The usury of loans.
<i>Sadaqah</i>	Pious work of charity.
<i>Shari'ah</i>	Islamic Law.
<i>Sukuk</i>	Islamic bonds.
<i>Sukuk Al-Ijarah</i>	Lease-based <i>sukuk</i> (Islamic bonds)
<i>Salam (Contract)</i>	Advance Purchase.
<i>Shari'ah</i>	Islamic law.
<i>Sunnah</i>	Practices and rulings deduced from the deeds, utterances, and unspoken approvals of Prophet Muhammad PBUH.
<i>Tajdid</i>	Renewal.
<i>Takaful</i>	Mutual Guarantee/Islamic insurance.
<i>Taradhi</i>	Willing consent and mutual agreement
<i>Tahawwut</i>	Islamic Derivatives
<i>Tahrir</i>	Deception
<i>Tawarruq</i>	Synthetic <i>Murabahah</i> (a commodity is bought on credit and immediately sold for cash). A form of finance where buyer (X) purchases a commodity from a seller for a deferred payment and then resells it to buyer (Y) for cash at a price that is usually lower than the original cost.
<i>Tauhid</i>	Oneness of God.
<i>Usury</i>	Lending at excessive interest rate.
<i>'Urf</i>	Custom.
<i>Usul Fiqh</i>	Principles of Islamic jurisprudence.
<i>Wa'ad</i>	Promise made by buyer to purchase an item.
<i>Wajib</i>	Obligatory.
<i>Wadi'ah</i>	Deposit or safe-keeping.
<i>Wakalah</i>	Agency.
<i>Waqaf</i>	Charitable trust or property endowment for the community benefit.
<i>Zakat</i>	Voluntary alms giving (for purification of property purposes).

## List of Tables and Appendix

Tables	Description	Page
Table 1	<i>Fiqh Muamalat</i> and Its Fundamental Principles.	39-41
Table 2	Types of Islamic Banking Products and Services.	67
Table 3	Intervention by Financial Authorities in the market (Appendix III)	276
Table 4	Aspects of IFSA 2013 and FSA 2013.	213-214
Table 5	Comparison Between IFSA 2013 and FSA 2013.	214
Table 6	Comparison Between IFSA 2013 and FSA 2013, and Takaful Act 1984/Insurance Act 1996.	215
Table 7	Comparison Between Takaful Act 1984 and IFSA 2013.	216-217
Table 8	Key Organs and Functions for <i>Sharī'ah</i> Governance Framework.	220
Table 9	Guideline on Corporate Governance for Licenses of Islamic Bank (Revised BNM/GP-i).	220-221
Table 10	<i>Sharī'ah</i> Review and <i>Sharī'ah</i> Audit.	222-223
Table 11	<i>Sharī'ah</i> Audit and Statutory Audit.	223
Table 12	Comparative Analysis among <i>Sharī'ah</i> Governance Framework and Guidelines.	224

## List of Figures and Appendices

Figures	Description	Page
Figure A	Global Committee Structure – A Regulator’s Overview.	20
Figure B	<i>Shari’ah</i> comprising <i>Aqidah</i> (Fundamental Faith), <i>Akhlak</i> (Moral), and <i>Muamalat</i> (Commerce).	36
Figure C	Trust and Confidence for the International Framework for Islamic Finance: Dedicated and Non-dedicated Institutions.	57
Figure D	Meta-dependence Framework (Appendix I)	274
Figure E	Meta-non-dependence Framework (Appendix I)	274
Figure F	Rogoff/Reinhart Banking Crisis Patterns (1900 to 2010) (Appendix II)	275
Figure G	Comparison Between Basel III and Basel II (Capital Adequacy).	158
Figure H	Financial Institutions and Markets regulated by Bank Negara Malaysia	201
Figure I	<i>Shari’ah</i> Governance Framework 2010.	219

## **List of Malaysian Laws and Cases**

### **List of Malaysian Laws:**

- (1) Federal Constitution of Malaysia.
- (2) Bank Negara Malaysia Act 2009 [Act 701].
- (3) Central Bank Ordinance 1958.
- (4) Capital Market and Services Act 2007 [Act 671].
- (5) Civil Law Act 1956.
- (6) Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 [Act 613].
- (7) Islamic Banking Act 1983 (repealed).
- (8) Takaful Act 1984 (repealed).
- (9) Banking and Financial Institutions Act 1989 (repealed).
- (10) Deposit Insurance Corporation Malaysia Act 2005 [Act 642].
- (11) Development Financial Institutions Act 2002 [Act 618].
- (12) Exchange Control Act 1953 (repealed).
- (13) Islamic Financial Services Act 2013 [Act 758].
- (14) Financial Services Act 2013 [Act 759].
- (15) Labuan Financial Services Authority Act 1996 [Act 545].
- (16) Labuan Financial Services and Securities Act 2010 [Act 704].
- (17) Stamp Act 1949 [Act 378] / Act A723 of 1989 (amendment).
- (18) Real Property Gains Tax Act 1976 [Act 169].
- (19) Income Tax Act 1967 [Act 53].
- (20) Insurance Act 1996 (repealed).
- (21) Payment Systems Act 2003 (repealed).
- (22) Labuan Financial Services and Securities Act 2010 [Act 704].
- (23) Money Services Business Act 2011.

### **Cases within Malaysia's Jurisdiction:**

- (1) Affin Bank Berhad v. Zulkifli Abdullah [2006] 3 MLJ 67.
- (2) Arab Malaysian Merchant Bank Berhad v. Silver Concept Sdn Bhd [2005] 5 MLJ 210.
- (3) Arab Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota).
- (4) Bukit Cheraka Bhd, third party) [2008] 5 MLJ 631; [2009] 1 CLJ 419.
- (5) Bank Islam Malaysia Berhad v. Adnan Omar [1994] 3 CLJ 735; [1994] 3 AMR 44; [1994] 4 BLJ 372.
- (6) Bank Islam Malaysia Bhd v. Lim Kok Hoe & Anor And Other Appeals [2009] 6 CLJ 22; [2009] 6 MLJ 839.
- (7) Bank Islam Malaysia Bhd v. Shamsuddin Bin Haji Ahmad [1999] 1 LNS 275; [1999] MLJ 450.

- (8) Bank Islam Malaysia Berhad v. Pasaraya Peladang Sdn Berhad [2004] 7 MLJ 355.
- (9) Bank Islam Malaysia Bhd v. Azhar Osman & Other Cases [2010] 5 CLJ 54 [2010] 1 LNS 251.
- (10) Bank Kerjasama Rakyat Malaysia Bhd v. PSC Naval Dockyard Sdn Bhd [2008] 1 CLJ 784; [2007] MLJ 722.
- (11) Bank Kerjasama Rakyat Malaysia Bhd v. Nesaretnam Samyveloo [2002] 8 CLJ 95; [2002] 7 MLJ 103.
- (12) Bank Kerjasama Rakyat Malaysia Berhad v. Emcee Corporation Sdn. Bhd. [2003] 2 MLJ 408; 1 CLJ 625.
- (13) Bank Kerjasama Rakyat Malaysia Bhd. v. Sea Oil Mill (1979) Sdn Bhd & Anor [2010] 1 CLJ 793.
- (14) Bank Muamalat Malaysia Bhd. v. Suhaimi Md. Hashim [2006] 3 CLJ 796.
- (15) Dato' Hj. Nik Mahmud Bin Daud v. Bank Islam Malaysia Berhad [1996] 4 MLJ 295.
- (16) Jamil bin Harun v. Camden [1984] 1 MLJ.
- (17) JRI Resources Sdn. Bhd. v. Kuwait Finance House (Malaysia) [2019] MLJU 275.
- (18) Ketua Pengarah Jabatan Alam Sekitar & Anor v. Kajing Tubek & Ors and Other Appeals [1997] 3 MLJ 23.
- (19) Light Style Sdn Bhd v. KFH Ijarah House (Malaysia) Sdn Bhd [2009] CLJ 370; [2009] 1 LNS 193.
- (20) Majlis Amanah Rakyat v. Bass bin Lai [2009] 2 CLJ 433.
- (21) Malayan Banking Berhad v. Yakup bin Oje & Anor [2007] 6 MLJ 398.
- (22) Malayan Banking Berhad v. Marilyn Ho Siok Lin [2006] 7 MLJ 249; 3 CLJ 796.
- (23) Repco Holdings Sdn. Bhd. v. Pengurusan Danaharta Nasional Bhd (No.1) [2002] 5 MLJ 637
- (24) Sea Oil Mill (1979) Sdn Bhd & Anor v. Bank Kerjasama Rakyat Malaysia Berhad [2003] MLJ 207/[2003] 1 LNS 718.
- (25) Tahan Steel Corporation Sdn Bhd v. Bank Islam Malaysia Berhad [2004] 6 CLJ 25; [2004] 6 MLJ 1.
- (26) Tan Sri Khalid Ibrahim v. Bank Islam Malaysia Berhad [2009] 6 MLJ 416.
- (27) Tinta Press Sdn Berhad v. BIMB (1987) 1 MLJ 474; 1 CLJ 474.



## Introduction

### 1. Research Background

This is a study of international framework for Islamic finance, spanning across its global governance structure, consisting of various international institutions, dedicated and non-dedicated ones that promulgate Islamic finance in terms of standards, guidelines, principles, with a focus of Malaysia as a case-study.

The originality of this study is evident from the title itself being chosen as an original scholarly research topic to be examined in the context of international framework for Islamic finance, starting from the historical examination of the global financial system,<sup>1</sup> and the various international institutions that operate within the international framework for Islamic finance,<sup>2</sup> the philosophical foundation of the international framework for Islamic finance,<sup>3</sup> the global financial crisis and the global financial safety-net (GFSN) including the examination of *Sharī'ah* Lender of Last Resort,<sup>4</sup> the roles of international law in Islamic finance,<sup>5</sup> and last but not least, Malaysia as a case-study.<sup>6</sup> Further, the *Quranic* worldview as well as 'meta-dependence'<sup>7</sup> analysis are introduced and examined as novel scholarly contributions towards understanding and developing the trajectory course of development of international framework for Islamic finance, including a critical examination of *Sharī'ah* governance mechanism, its structure, and implementation in Malaysia, and selected jurisdictions that actively adopt Islamic finance.

This study examines the key determinants that enable the current international framework for Islamic finance to operate, and potentially be enhanced, and any impediment to the existing and future development of the framework. While Malaysia is examined as the focus of this study for its dual banking model, comprising the conventional and the Islamic banking systems, and the centrality of Malaysia's *Sharī'ah* governance mechanism, the study will also examine comparatively the *Sharī'ah* governance mechanisms in selected jurisdictions that

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<sup>1</sup> Thesis, Chapter One.

<sup>2</sup> Thesis, Chapter Two.

<sup>3</sup> Thesis, Chapter Three.

<sup>4</sup> Thesis, Chapter Four.

<sup>5</sup> Thesis, Chapter Five.

<sup>6</sup> Thesis, Chapter Six.

<sup>7</sup> See Chapter Three on the theorisation and analysis of 'meta-dependence' (Figure D in Appendix I) and 'meta-non-dependence' (Figure E in Appendix I).

consist of secular-based jurisdictions,<sup>8</sup> partially-*Sharī'ah* based jurisdictions,<sup>9</sup> and *Sharī'ah*-based jurisdictions.<sup>10</sup>

The choice of Malaysia as the main focus is due to its dual banking model, and the centrality of its *Sharī'ah* governance mechanism. Further, Malaysia is a progressive jurisdiction in terms of its legal and regulatory framework, providing an enabling legal environment that accommodates Islamic financial services and industry (IFSI).<sup>11</sup> In addition, Malaysia's international trade and investment connection with various free markets<sup>12</sup> is also of pertinent consideration to be examined in the contemporary context of how international framework for Islamic finance currently shapes the global governance of Islamic finance and/or will be shaped by endogenous and exogenous factors of socio-politics, and economics.<sup>13</sup> Malaysia, being part of the Commonwealth countries, adopts the Common Law system for its legal and regulatory environment for banking and finance.<sup>14</sup> To implement the international framework for Islamic finance, particular consideration of *Sharī'ah* principles in Islamic banking and finance are accorded to support IFSI, and for the purposes of ensuring *Sharī'ah*-compliance in product issuance and development in Malaysia.<sup>15</sup> The unique dual-banking model, as exemplified in Malaysia's legal and regulatory framework should be of an exploratory interest and case-study for policy-makers, academia, bankers, regulators, and lawyers to understand and decipher how the conventional and Islamic banking systems in Malaysia co-exist, and operate side-by-side.<sup>16</sup> While embracing the edifice of the

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<sup>8</sup> The term 'secular-based jurisdictions' refers to those countries whose jurisdictions constitutionally and institutionally adopt the Common Law or Civil Law systems, such as the United Kingdom, the United States, and Singapore.

<sup>9</sup> The term 'partially-*Sharī'ah* based jurisdictions' refers to those jurisdictions which adopt both the Common Law and the *Sharī'ah*, including among others, Malaysia, Indonesia, and Pakistan.

<sup>10</sup> The term '*Sharī'ah*-based jurisdictions' refers to those jurisdictions that promulgate the *Sharī'ah* as the law of the land, and this includes Iran, Saudi Arabia, and Sudan.

<sup>11</sup> Malaysia has enacted its Financial Services Act 2013 [Act 758] and Islamic Financial Services Act 2013 [Act 759], which came into force on 30<sup>th</sup> June 2013.

<sup>12</sup> As a Member of the World Trade Organization (WTO), Malaysia is an active trading nation which has also concluded many Free Trade Agreements (FTAs) either bilaterally, regionally or plurilaterally. The FTAs include Malaysia's commitment to trade and investment liberalisation through the market opening of several sectors of the economy such as in the trade in services and goods industry. See 'Malaysia's FTAs' <<http://fta.miti.gov.my/>> accessed on 15 March 2017.

<sup>13</sup> Masudul Alam Chaudhury, 'Financial Globalization and Islamic Financing Institutions: The Topics Revisited' (2001) 9 (1) *Islamic Economic Studies* 20-31.

<sup>14</sup> Wan Arfah Hamzah and Ramy Bulan, *An Introduction to the Malaysian Legal System* (Penerbit Fajar Bakti, 2003) 6.

<sup>15</sup> Mohamed Ariff, 'Islamic Banking in Malaysia: Framework, Performance and Lessons' (1989) 2 *Journal of Islamic Economics* 67-68.

<sup>16</sup> Nik Norzrul Thani, Mohamed Ridza Abdullah, Megat Hizaini Hassan, *Legal Aspects of the Malaysian Financial System* (Sweet & Maxwell Asia, 2001) 101-116.

conventional banking and finance system, it is Malaysia's ability to adopt flexibly the international framework for Islamic finance, and interpret the *Sharī'ah*, using Islamic sources of jurisprudence mainly the *Quran*, *Sunnah*, and *Hadiths* (Prophetic sayings and actions) in the contemporary context of modern banking and finance, alongside the operational influence of the Common Law system makes the case-study relevant and significant.

While the scope of 'banking' falls under the 'Federal List' of Malaysia's Federal Constitution (FC), 'Islamic banking and finance' also falls within the Federal purview.<sup>17</sup> Pursuant to the promulgation of Bank Negara Act 2009 [Act 701], all *Sharī'ah* issues pertaining to Islamic banking and finance shall be referred to the *Sharī'ah* Advisory Council (SAC) of the Bank Negara Malaysia (BNM) as the highest *Sharī'ah* authority and the sole authoritative body on *Sharī'ah* matters pertaining to Islamic banking, *takaful* (Islamic insurance), and Islamic finance in Malaysia.<sup>18</sup> Thus, the rulings of the SAC shall be applicable to Islamic financial institutions (IFIs), and likewise to the courts and arbitrators, which are required to refer to the rulings of the SAC for any proceedings relating to Islamic finance, and such rulings are legally binding.<sup>19</sup> Chapter Six will further examine this position as a case-study.

## **2. Research Methodology, Remit, and Scope**

This study undertakes theoretical and doctrinal research methodologies, which survey and review various written resources from existing literatures, practitioner's commentaries, and critiques, as well as scholarly opinions that pertain to the legal and regulatory framework for Islamic finance, and the key determinants that enhance or impede the international framework for Islamic finance. Theoretical research is aimed at gathering various theories that support the enhancing factors as well as the impeding factors that contribute towards the international framework for Islamic finance. Hence, such theoretical surveys will not be limited to the legal considerations as the international framework for Islamic finance is not stagnant, but dynamically responsive to the global market environment. Hence, the enhancing and impeding factors are examined in an inter-disciplinary manner, taking into account the background of history, politics, social, economics, legal framework, and

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<sup>17</sup> FC, Ninth Schedule 'Legislative Lists', List I.

<sup>18</sup> Bank Negara Malaysia Act 2009 [Act 701], see sections 51-52

<sup>19</sup> Bank Negara Malaysia Act 2009 [Act 701], see section 57. Further analysis on the binding nature of SAC's resolutions is examined in Chapter Six.

reported market insights, prescribing the positive and normative contexts of the current global finance. Doctrinal research is chosen for this study in light of the existing writings on the international institutions that promulgate Islamic finance, although segmented in their respective institutional promulgations, but are examined holistically, systematically, and coherently in this study. Challenges have been on the reliance and dependability on the availability of literatures, and on-line resources as secondary data, and the necessity to gather the most up-to-date information.

This study recognises the limitation of input gathering, especially from the industry viewpoint, and hence, does not envision for a complete empirical and comparative study. Rather, the study seeks to understand, explore, analyse, map out, develop, and examine how the international framework for Islamic finance, as it currently operates will continue to manoeuvre its course, and interact in the long-term trajectory development of global IFSI within the global banking environment. The study also seeks to examine how the existing doctrines, and standpoints shape the international framework for Islamic finance, and then examine these studies in theoretical, and conceptual framework for Islamic finance, taking into account the industrial insights, and various developments on global issues, economic, and financial systems. This study also examines the *Quranic* worldview, trust and confidence, and the 'meta-dependence' analysis, as novel scholarly contributions. At the outset, the study underscores that *Quran*<sup>20</sup> constitutes an Islamic revealed knowledge.<sup>21</sup> In the context of this study, the *Quranic* worldview constitutes an enshrined articulation of the Islamic revealed knowledge through the revelation of the *Quranic* Chapters (*Surah*) and verses, constituting the *Quranic* worldview for the purposes of guidance on matters concerning Islamic finance, Islamic economics, trade (*bay'*), and commerce. In this study, the *Quranic* worldview is used as lenses to examine the *de jure* and the *de facto* contextual understanding of the international framework for Islamic finance.

The study is conscious of the evolving process of the international law-making dynamics, and thus, the evolutionary dimension of this research that is either shaped via the lenses of an 'institutionalist' paradigm that is more pertinent for the legal and regulatory approach for Islamic finance, or 'the liberalist' that would be

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<sup>20</sup> The word '*Qur'an*' derives from the Arabic word '*qara'a*' which means 'read' since the first revelation revealed by Archangel Gabriel to Prophet Muhammad PBUH was '*iqra*'. Hence, the *Quranic* worldview in this study can be used as reading lenses, which are appropriately in line with its meaning.

<sup>21</sup> Abbas Mirakhor, 'Theoretical Framework of Islamic Economics and Finance: On Islamic Economics' in Zamir Iqbal and Zurina Salleh (eds.) *State of Islamic Finance*, (USIM, 2015), 29-32.

more propelled to be influenced by the industry, and stakeholders' interests.<sup>22</sup> These two theories are not exhaustive in demonstrating the outlook, and prospect for the international framework of Islamic finance. The 'realist' response would treat the international framework for Islamic finance as a competitive force of power contest with the conventional banking system, as developed by the West.<sup>23</sup> The current global landscape of banking and finance is also intertwined with Islamic finance framework, and this attracts an interdependent study of various factors and determinants that enhance, or impede the international framework for Islamic finance. This study will first examine a descriptive state of play of the international framework for banking regulation and finance, and following thereof, describe and critically examine the current state of play and development of the international framework of Islamic finance. The study is apprised that the international framework of Islamic finance is not stagnant. It is a living framework that will grow, and adapt to the global market environment. This heralds a *raison d'être* for the international rules, standards, and guidelines to be catered to the present context of IFSI, the global economy, international banking, and the entire global financial system.

### **3. A Critical Examination of the *De Jure* (In Law) and the *De Facto* (In Fact) International Framework for Islamic Finance**

The international framework for Islamic finance, as it currently exists, operates on the basis of 'sectoral division of functions',<sup>24</sup> as these functions are assumed and carried out by various international institutions that issue, and promulgate IFSI's standards, principles, guidelines, research, education, training, and product development. The existence and establishment of these institutions cater for sectors such as, the global prudential standards and guiding principles, the accounting and auditing, the *fiqh* development, the issuance of *fatwas*, the *Sharī'ah*

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<sup>22</sup> The study is apprised of the roles of international institutions that constantly promulgate international standards and guidelines to be adopted by regulators and industry, and this connotes an 'institutionalist' standpoint, which propagates institutional rules and guidelines, for the national-based adoption in the process of international law-making dynamics. Be that as it may, the endogenous context that is often shaped and influenced by public opinions, political will, economic policies, and domestic stakeholders' interests are the inward-looking factors for the 'liberalist', who shape the international rule-making process to be influenced by domestic interests, positions, and concerns. For more detail, see Andrew Moravcsik, 'The New Liberalism', in Christian Reus-Smit and Duncan Snidal (eds) *Taking Preferences Seriously: A Liberal Theory of International Politics* (OUP, 2008) 10-55.

<sup>23</sup> See Chapter Five on the examination on the realist response.

<sup>24</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 28-40.

rating, research and training, and the list goes on.<sup>25</sup> This has led to the creation of an enabling international framework for Islamic finance that is constantly being shaped and influenced by international institutions that issue international standards and many other soft-law<sup>26</sup> instruments to guide the implementation of IFSI, and modern Islamic banking and finance.<sup>27</sup> Therefore, the coordination and cooperation amongst these international institutions become pivotal as international banking becomes more seamless, digitalised, integrated, interconnected, and interdependent.<sup>28</sup> According to the Centre for Economics and Business Research, the world's dependence on online financial services is growing exponentially. Internet banking use among British customers, for example, is projected to rise from 53% in 2014 to 66% by 2020, representing 7.5 million internet banking users.<sup>29</sup> Due to globalisation, international trade and finance have become increasingly interconnected and interdependent. In light of this increasing interconnectedness that is also spurred by emerging banking technologies to date,<sup>30</sup> it remains to be examined whether in the future, this account of sectoral division of functions will still prevail in featuring itself as a structure for the international framework for Islamic finance, which consists of sector-based, and dedicated as well as non-dedicated institutions that promulgate Islamic finance, in terms of standards, guidelines, etc.

From the conventional perspective of 'sectoral division of functions', when examined categorically and disjunctively, it demonstrates that the international framework for Islamic finance is a disjointed framework that distinguishes itself from the conventional finance framework.<sup>31</sup> A categorical reading of this perspective will delineate that Islamic finance is a system of its own league that upholds the *Sharī'ah* as its core pillar, underpinning the system.<sup>32</sup> In this light, the framework is examined in the *de jure* implementation viewpoint, which means, Islamic finance, in and of itself appears, as a system that caters for everything Islamic and *Sharī'ah*-compliant, ranging from products and services, to the standards that are in compliance with the *Sharī'ah*. It is a framework that appeals to the Muslims' community, whose interests are vested to espouse the Islamic values of life, albeit

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<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> John Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (Profile Books, 2015) 5-60.

<sup>29</sup> Emily Perryman, 'A New Cyber Framework' *Chartered Banker* (October/November 2018) 36-37.

<sup>30</sup> Don Tapscott and Alex Tapscott, *Blockchain Revolution: How The Technology Behind The Bitcoin Is Changing Money* (Penguin Random House, 2016) 15-82.

<sup>31</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 28-40.

<sup>32</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, 2010) 93.

the religious aspect is only one part of the consideration for the development of IFSI, and the international framework for Islamic finance.<sup>33</sup>

Despite that *Shari'ah* is the core pillar underpinning the IFSI, the *de facto* implementation of Islamic finance attests to the fact that Islamic finance is currently gaining its momentum, and embraced by many walks of life and jurisdictions, regardless of religious dogmas and beliefs.<sup>34</sup> To date, Islamic finance has emerged to become an avenue for modern banking and finance. It is accepted internationally and nationally, as it continues to propagate an ethical-based finance,<sup>35</sup> taking into account the *Shari'ah*, and the *Quranic* worldview of social welfare, utilitarian benefits, and greater good (*maslahah*) of the society. That notwithstanding, the conventional framework of finance still claims the lion's share of the operational aspect of the global financial framework and regulatory regime.<sup>36</sup> In light of these dynamics, the two international frameworks, as they both currently exist, showcase that predominantly, the conventional framework is leading in terms of shaping international rules, standards, guidelines, principles, and soft-law instruments, to which the international framework for Islamic finance resorts to, as and where appropriate, although not holistically, due to the need to devise a *Shari'ah*-compliant framework to operationalise the modern Islamic banking and finance.<sup>37</sup>

On a more integrated and conjunctive outlook of the international framework for Islamic finance, it does not suggest that the framework operates disjointedly from that of the conventional finance framework.<sup>38</sup> The only delineation between the conventional framework of banking and finance vis-à-vis Islamic finance is the application of *Shari'ah*-compliance requirements by IFIs for the purposes of legitimising Islamic banking products, such as *musyarakah*, *murabahah*, *ijarah*, etc. in accordance with the *Shari'ah*.<sup>39</sup> The international institutions that were long established like the International Monetary Fund (IMF), and the World Bank do take

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<sup>33</sup> Robert R. Bianchi, 'The Revolution in Islamic Finance' (2007) 7(2) *Chicago Journal of International Law* 569-580.

<sup>34</sup> Warde, *Islamic Finance In The Global Economy* (n 32) 93.

<sup>35</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Outlook at the United Kingdom and Malaysia* (Routledge Research in Finance and Banking Law, 2011) 26-36.

<sup>36</sup> Howard Davies And David Green, *Global Financial Regulation, The Essential Guide* (Polity, 2008) 32-154.

<sup>37</sup> See Chapters Three and Four.

<sup>38</sup> Muhammad Nejatullah Siddiqi, *Banking Without Interest* (Islamic Foundation Leicester, 1983) 19-37.

<sup>39</sup> Alfred Kammer, Mohamed Norat, Marco Pinon, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and IMF Staff Team, 'Islamic Finance: Opportunities, Challenges, And Policy Options' (2015) Staff Discussion Notes No. 15/5 <<https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf>>, accessed 15 March 2017.

into consideration the *Sharī'ah*-compliance requirements, when deliberating the issuance of guidelines for IFIs, and the publication, as well as the dissemination of their working papers.<sup>40</sup> The consideration for the *Sharī'ah*-compliance standards and products are not ignored by the non-dedicated institutions for Islamic finance.<sup>41</sup> In a mutual sense of moral dimension, these institutions also regard the *Sharī'ah* from the ethical standpoints that are of universal acceptance and application, such as transparency, disclosure, justice (*'adl*), and honesty (*amanah*) principles.<sup>42</sup> Hence, the applied value of this ethical consideration is well-shared, and cannot be said to be in contravention, but rather applicably in consonance with the *Sharī'ah* consideration, as enshrined by the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM), the Accounting and Auditing Organisation for IFIs (AAOFII). These institutions, despite their variety of roles, do have the *de jure* acknowledgment of the *Sharī'ah*, when deliberating various Islamic finance issues and product developments, internationally.<sup>43</sup> In the *de facto* context of the international framework for Islamic finance, there are certain ethical aspects of banking and finance, such as disclosure, and honesty (*amanah*) principles that are pragmatically shared to be of an applied value in both realms of the conventional banking system, as well as, the Islamic banking and financial system.

#### **4. Research Questions and Research Objectives**

The study aims to answer two questions. First, whether the existing international framework for Islamic finance impedes, or enhances its development. To this end, the study aims to answer its main research objective, which is to examine the key determinants that enhance, or impede the international framework for Islamic finance. Secondly, and related to the first objective, the study aims to answer a question of whether, Malaysia can be used as a model, that has been progressive in developing IFSI domestically, and internationally, and the fact that Malaysia has thus far, developed an enabling legal environment for Islamic finance, an effective dispute resolution mechanism system, and domestic enforceability of Islamic financial products. Having identified the key determinants, the study further examines the main characteristics that enable, enhance, or potentially impede Malaysia's model for the prognostication, and further development of the

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<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

<sup>42</sup> Ibid.

<sup>43</sup> Ibid.

international framework for Islamic finance. The study is cognisant that there exists various factors for consideration. Thus, this study will examine those factors, having regard to the changing landscape of the world economy that is induced by the intertwined aspects of global politics, geopolitical, and geo-economic influences, as well as emerging issues in modern banking and global financial system.

## **5. Chapters and Milestones**

This study encapsulates seven Chapters, which undertakes an examination of specifically identified research areas and issues, surrounding the international framework for Islamic finance.

### **5.1. Chapter One: A Critical Examination of the Global Financial System**

Chapter One investigates and examines a descriptive framework of the global financial system. It underscores an analysis on the state of play of the conventional framework for global banking and finance. This includes a critical examination on the institutional overview of the global financial system, from the economics and institutional standpoints, systemic and regulatory paradigm of the global financial framework, the regulated, the lightly regulated and the non-regulated entities, the global economic governance structure from the Bretton Woods system to the fiat-based system, the London-Interbank Offered Rate (LIBOR), and the status quo operation of the international framework for Islamic finance, which is examined to also mimic the conventional banking and finance framework.

### **5.2. Chapter Two: Islamic Finance within the Global Financial System**

Chapter Two discusses and examines the international framework for Islamic finance within the global financial system. This includes an examination of the dedicated and the non-dedicated international institutions that promulgate, promote, and enhance the international framework for Islamic finance. This Chapter maps out the contemporary international structure, as regards the co-existence of the dedicated institutions, and the non-dedicated institutions for Islamic finance that undertake the roles of promulgating the international framework for Islamic finance, in terms of standards, guidelines, etc.

**5.3. Chapter Three: Philosophical Foundation for International Framework for Islamic Finance**

Chapter Three critically examines and analyses the philosophical foundation for the international framework for Islamic finance. It encapsulates the examination of the key characteristics and determinants of trust and confidence in the global financial system, including the trust and confidence in Islamic finance. This Chapter critically examines the standpoint of trust in Islamic finance from a dependent-interdependent relationship in banking, which brings the discourse towards a meta-economics analysis, which introduces a new analytical tool in the form of a 'meta-dependence' analysis in order to further explore, and examine the roles of trust and confidence in the international framework for Islamic finance. A meta-non-dependence analysis is also examined in this philosophical sense of the international framework for Islamic finance, vis-à-vis the explication of Quranic framework for Islamic finance, as enshrined in verse 275 of *Surah Al-Baqarah*. For further illustrative explications, Appendix I is to be consulted in terms of diagrams for 'meta-dependence' trust and 'meta-non-dependence' trust.

**5.4. Chapter Four: The Global Financial Crisis, the GFSN, and the Context of the International Framework for Islamic Finance**

Chapter Four critically examines the causes of the global banking and financial crisis, the lessons learnt from Malaysia's experience in managing the Asian financial crisis of 1997-98, the responses from the economics' standpoints, behavioural finance, ethical finance, the roles of law, and other measures, as availed by the GFSN framework with a cautious reflexion of moral hazard. This Chapter particularly examines IFSB's risk management, Basel III on managing liquidity risk, and global financial crisis from the behavioural finance, the ethical finance, and the *Quranic* worldview as novel scholarly contributions to the study of the international framework for Islamic finance. The roles of Lender of Last-Resort (LOLR), and international LOLR (ILOLR), and *Shari'ah*-LOLR are also examined with other GFSN measures such as depositor's protection, and ring-fencing mechanism, as may be availed for IFIs. These discussions contribute towards positive trajectory development of international framework for Islamic finance, particularly from the perspective of long run sustainability of Islamic banking and finance.

**5.5. Chapter Five: The Roles of International Law in the Global Financial System and the International Framework for Islamic Finance**

Chapter Five critically examines the international law-making dynamics within the global financial system, and the international framework for Islamic finance comprising the IFSB, the AAOIFI, the Islamic *Fiqh* Academy of *Fatwa*, the IIRA Rating, the Dow Jones *Sharī'ah* Indices, and the IMF. Basel III on capital adequacy requirement is also examined for the purposes of compliance by Islamic banks. In light of Brexit, the position of the United Kingdom is also examined for her to remain the leading hub in Islamic finance for western jurisdictions, and globally. Issues such as Islamophobia, war, the clash of civilisations, and the creative evolution of the international framework for Islamic finance, in terms of developing a market for Islamic derivatives are also examined.

**5.6. Chapter Six: Malaysia as a Case-Study**

Chapter Six critically examines Malaysia as an exploratory case-study within the context of operation of international framework for Islamic finance, including also, Malaysia's dual banking model, and the centrality of the SAC of the BNM in the context of the *Sharī'ah* governance structure. Malaysia's approach on *Sharī'ah* governance is compared with selected jurisdictions that espouse differing styles of *Sharī'ah* governance mechanism. Critical arguments are underscored for Malaysia's model as a case-study, vis-à-vis a self-initiative model of the *Sharī'ah* governance framework. Malaysia is prognosticated as an exploratory case study but yet exemplary, for her endeavours in espousing the international framework for Islamic finance.

**5.7. Chapter Seven: Conclusion and Recommendations**

Chapter Seven concludes this study by providing its research originality, research findings, future research areas, recommendations, and an overall conclusion of the study on the international framework for Islamic finance. In essence, the international framework for Islamic finance is a living framework, based on trust and confidence, whilst the *Quranic* worldview of 'meta-dependence' trust and confidence is of significant contribution in this study.

## Chapter One: A Critical Examination of the Global Financial System

### 1.1. The Global financial system: Economics and Institutional Standpoints

From the lenses of economists, the world economic system is viewed categorically as adopting the capitalist model of economy or the socialist economic model.<sup>44</sup> The socialist economic system is adopted by China and Russia, while the rest of the world are engaged with international trade on the basis of free market and capitalism.<sup>45</sup> China is a unique case. Despite her communist political system, China is a *laissez-faire* market. China joined the World Trade Organization (WTO) in 2000 to liberalise its trade, and at the international arena, China has engaged actively in various FTAs. From the Keynesian economics, to Adam Smith, and to Francis Fukuyama, the proposition for the underlying philosophies for the global economic system remains in support of the principles of liberal democracy, market economy, and capitalism, with minimal government intervention in the free market.<sup>46</sup>

As the aforementioned philosophies become aspiration, it engenders a vision that has emerged to have great bearing in defining a feature of a financial system that is averse towards straining regulatory control, to a regime that is more dynamic, based on financial innovations, and a more seamless market interaction between financial players, key institutions, and regulators. Free market, capitalism, and a free flow of financial capital are the principles that the financial players operate to yield maximisation of wealth.<sup>47</sup> From the 1997 Asian financial crisis to the 2008 global economic recession, to the Eurozone crisis, the global financial system is entrenched in the capitalist framework. This framework has influenced the way in which the financial markets interact and operate with some form of regulatory and supervisory oversights that exist at the international level, and sovereign regulatory and supervisory oversights that are implemented at the national jurisdiction level.<sup>48</sup>

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<sup>44</sup> Keneichi Oh Mae, *The End of Nation State* (Simon & Schuster, 1995) 2-45.

<sup>45</sup> Francis Fukuyama, *The End of History and the Last Man* (Simon & Schuster, 1992) 5-40.

<sup>46</sup> Ibid.

<sup>47</sup> Peter Dicken, *Global Shift: Transforming the World Economy* (Guilford Press, 1998) 380-401.

<sup>48</sup> Thomas L. Friedman, *The World is Flat* (Farrar, Straus, and Giroux, 2005) 10-45.

It is not ascertainable that an absolutely free-market economy exists. Tension arises from the domestic protectionist front that compels a serious regard to the role of sovereign state in the supervisory and regulatory regime, and this orchestrates a framework of a state-led capitalism.<sup>49</sup> There is no such thing as free lunch.<sup>50</sup> In the massive interconnected web of globalisation, various laws, rules, regulations, and national policies are at times designed and drafted to preserve the sovereign power to uphold and maintain protectionist measures in the domestic economy.<sup>51</sup> This denotes that not all foreign banks can be allowed to operate in the territory of a country, lest the sudden influx may not be favourable to that jurisdiction. The banks are subjected to the operative laws, rules, regulations, and national policies, governing the banking and financial activities in the operative jurisdiction.<sup>52</sup>

Other than the operational aspect of the regulatory control, the central banks and financial services authorities in various jurisdictions often maintain to keep their banking functions aligned with the international standards, guidelines, and recommendations so that the entire banking system remains inter-connected, fluid, and functioning, and that the GFSN can be preserved, safeguarded, and operational, notwithstanding the caution on moral hazard.<sup>53</sup> This probes a critical examination on the current state of resilience of the GFSN, and whether the entire global banking system can still function, and not tether on the brink of collapse, as fears and uncertainties surround the Brexit deal,<sup>54</sup> as well as market uncertainties in the United States, and her trade war with China. When it comes to Brexit, there are many political biases that are clouding market's judgment. As the UK is faced with the deadline to leave the European Union (EU), either with a deal or no-deal Brexit, effective forecasting should not be influenced by political leanings, preconceptions, or patriotism, as these preconceived opinions and beliefs may result in skewed forecasts, as they are not based on logic, fact, and previous experience.<sup>55</sup>

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<sup>49</sup> Ibid.

<sup>50</sup> Milton Friedman, 'There is no such thing as free lunch' < <https://blog.degruyter.com/milton-friedman-no-thing-free-lunch/> > accessed 23 July 2019

<sup>51</sup> John Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (n 28) 5-60. See also Chapter Five of this study, this issue is examined in the context of 'passporting rights' due to Brexit.

<sup>52</sup> Slughter and May, 'Basel III: A New Capital Adequacy And Liquidity Framework for Banks' (2011) < <https://www.slaughterandmay.com/media/1550585/basel-iii-a-new-capital-adequacy-and-liquidity-framework-for-banks.pdf> > accessed 15 March 2017.

<sup>53</sup> Ibid.

<sup>54</sup> Chapter Five critically examines Brexit and Islamic finance.

<sup>55</sup> Kostas I. Nikolopoulos and Dimitrios D. Thomakos, 'Check the forecast before you go' *Chartered Banker* (October/November 2018) 44-45.

As the market reacts to these events, the expectation for the normalisation, and market stabilisation are aspired, despite the uncertainties of international politics may seem eroding the trust and confidence in the global financial system. The rise of ethno-nationalism, humanitarian crisis, the fear of Islamophobia, and the clash of civilisations, evocative post 9/11, signify an overlapping context as to how the global financial system and markets are made responsive, or non-responsive to these events, viewpoints, and rising instabilities across the globe, the implications of which may impede, enhance, or enable the international framework for Islamic finance. Despite these viewpoints, the global financial system can be examined from an 'institutionalist' standpoint, as a worldwide framework, which involves an interaction between, and among three key elements, i.e. as follows:

- 1.1.1 International institutions;
- 1.1.2 Legal agreements that link their interactions; and
- 1.1.3 The participation of various economic actors.

#### **1.1.1. International institutions**

The global financial system is a worldwide framework that involves international institutions, whether in the spheres of trade, commerce, banking, finance, and investment, which operate through various modes of legal agreements, involving the participation of various economic actors, whether the states, and the non-state actors.<sup>56</sup> These actors and institutions are the main players that contribute towards the global flow of financial capitals that are used for domestic, and international banking, financing, trade, and investment. These players are not just facilitative to one another, they are also inter-operative. In this vein, the international trade and investment environment requires the mobilisation of funds and capitals that should be facilitated by the financial institutions and regulators, especially in the context of a free transfer, and an efficient international payment system. These interactions do not operate in isolation. International trade becomes more globalised through the reduction and elimination of barriers to trade and investment, as well as the facilitation of financial capital in the form of shares and cash that operate and inter-operate in the spectrum of a seamless digital economy and cross-border electronic banking and finance.<sup>57</sup> As the banking system is faced with its own legacy systems, the smart-app future in the financial ecosystem also appears to be

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<sup>56</sup> Peter Howells and Keith Bain, *Financial Markets And Institutions* (Prentice Hall, 2007) 4-55.

<sup>57</sup> Mohamed Naif Alotaibi and Mehmet Asutay, 'Islamic banking and Islamic E-Commerce: Principles and Realities' (2015) III (4) 1-13.

incorporated. These ecosystems rely on strong partnerships based on an alignment of objectives, robust standards and interoperability, and more crucially, the trust and confidence to operate a well-functioning global financial ecosystem.<sup>58</sup>

The integrated nature of the globalised economies has also propelled closer co-ordination and co-operation between international institutions that are linked by institutional memberships and legal agreements that back their operations with a worldwide participation of economic actors.<sup>59</sup> Banks and central banks also co-ordinate, and co-operate, in terms of their responses in the early warning mechanism to keep abreast with the various market responses, public, and investors' confidence, and the emerging risks in the global financial economy.<sup>60</sup> Such a co-operation also exists at the highest level of the global financial architecture via the creation of the Financial Stability Forum (FSF), which comprises the finance ministers, the central banks, and the financial regulators. Banks, acting as financial intermediaries, will facilitate the financial flow between borrowers and lenders, and in the same vein, they are in fact inter-operative, as they operate within the worldwide framework of global banking and financial ecosystem.<sup>61</sup>

From the dot-com bubble to the sub-prime mortgage crisis, the world economy and the global financial system are no longer locally operative, but rather, highly globalised, inter-dependent, and inter-connected, because every day funds are mobilised, capitals are transferred across national borders, and international payments are made.<sup>62</sup> The impact of the Euro-zone crisis, and the tapering policy i.e. a gradual reversal of a quantitative easing policy (an unconventional monetary policy in which a central bank buys securities from the market in order to increase the money supply), implemented by a central bank to encourage economic growth in the United States, would not only be felt in a particular region, but the worldwide framework of the economy, as the global banking reacts to the trust and confidence, vested in the global financial system, and the functionality of the GFSN, if things go wrong.<sup>63</sup> Since part of the causes of the crisis is also attributed to the issue of sovereign debt, and the propensity for default for the international loan settlement,

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<sup>58</sup> \_\_\_\_, 'Exploring the Super-App Universe' *Chartered Banker* (October/November 2018) 20.

<sup>59</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-55.

<sup>60</sup> Ranjana Sahajwala and Paul Van den Bergh, 'Supervisory Risk Assessment and Early Warning Systems', Basel Committee on Banking Supervision Working Papers, No.4-2000, <[http://www.bis.org/publ/bcbs\\_wp4.pdf](http://www.bis.org/publ/bcbs_wp4.pdf)> accessed on 15 March 2017.

<sup>61</sup> Adrian D. Hamilton, *The Financial Revolution* (Penguin Books, 1986) 5-30.

<sup>62</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-55.

<sup>63</sup> Mark Carney, 'Rebuilding Trust in Global Banking', 25 February 2013, <<http://www.bis.org/review/r130226c.pdf>> accessed on 15 March 2017.

banks which are not well capitalised, at least in alignment with the Basel Committee on Banking Supervision (BCBS)' minimum capital adequacy and liquidity requirements, will struggle their way to remain a going-concern, and in the event of a gone-concern, national bail-out at the expense of taxpayers' money, and government debt are burdensome.<sup>64</sup> It is debatable still, as this type of crisis unfolds, whether a sovereign state should intervene through a provision of liquidity, and LOLR by the central bank, at the expense of triggering moral hazard. States could resort to foreign borrowing from the IMF to offset the balance of payment deficit. And in light of the recent financial crisis, it seems that lenders need to approach lending decisions objectively.<sup>65</sup> Even Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board (FSB) had underscored that, “[g]lobally systemic banks that fail will in future be resolved without recourse to the taxpayer and without jeopardising financial stability.”<sup>66</sup>

The unsettling questions either make a nation state, be subjected to further indebtedness, and financially challenging capacity, or incapacity to repay the loans, which can in turn, affect the country's fiscal condition.<sup>67</sup> Hence, the roles of banks as providers of liquidity, and the roles of the GFSN, are important for the well-functioning global financial system. In another functional context, banks often diversify their activities, and hence, they are not apprehended with the confined domain of being financial intermediaries, and providers of liquidity per se. The diversification of activities encapsulates that, banks are also commercial entities that are actively involved as market participants in international trade, wholesale banking, off-balance sheet banking, securitisation, financial investing, and various other diversified portfolios for banking and financing.<sup>68</sup> Further, a bank acting as a deposit-taking institution is debated in terms of its role in keeping its fractional reserve function model, which then allows the investment activities of the bank to take its course to yield profits. But whether the extent to which the deposit-taking function of the bank should be ring-fenced against the riskier part of the investment activities by the bank is an unsettled policy choice in differing jurisdictions.

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<sup>64</sup>Jeroen Dijsselbloem, 'No crisis' on Greece bailout deal' <<https://www.theguardian.com/business/2017/feb/10/no-crisis-greece-bailout-deal-says-eurozone-chief-dutch-finance-minister-jeroen-dijsselbloem-emergency-meeting>>accessed on 15 March 2017.

<sup>65</sup>\_\_\_\_\_, 'Duty of Confidentiality' *Chartered Banker* (August/September 2016) 47-48.

<sup>66</sup>Mark Carney, 'The future of financial reform', 17 November 2014 [www.bankofengland.co.uk/publications](http://www.bankofengland.co.uk/publications) accessed 15 March 2017.

<sup>67</sup> See a critical examination of GSFN and LOLR in Chapter Four.

<sup>68</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-75.

### 1.1.2. Legal agreements that link their interactions

In order to formalise this inter-dependent and inter-operative nature of the relationship, legal agreements are developed, and entered into, between the economic actors, i.e. the states, and non-state actors like corporations. At the institutional level, the legal agreements can take in the form of an Establishment Agreement, or a Host-Country Agreement, to establish institutions, like the Articles of Agreement of the IMF, and the Establishment Agreement for the World Bank.<sup>69</sup> These legal agreements define the objectives of the establishment, functions, international legal personality, terms of reference, financial standing and contributions, privileges and immunities, and various other operational issues that are required to formalise the legal stature of the international institutions. Some may refer these agreements akin to a nature of a charter for an international organisation, whilst in the context of a corporation, it is akin to a memorandum, or articles of association. These international institutions, when establishing their institutional presence, require a statutory backing in the form of a national legislation that accords them with legal powers and functions to operate in a domestic jurisdiction, and to be equipped with implementable measures at the national level, so that their institutional operations are covered legally, under the scope of international law and domestic law of the host state's jurisdiction.<sup>70</sup> On a pragmatic global approach, these institutions promulgate guidelines, standards, principles, recommendations, publish working papers, and coordinate research projects, in which an agreement for that purpose may be legally formalised, and entered into by collaborating parties. The international guidelines and standards are persuasive in effect. Their adoption at the national level is on voluntary basis.<sup>71</sup> Upon adoption, the standards and guidelines may be legally enacted as binding regulations to enforce their application at the domestic level.<sup>72</sup> Hence, from the international promulgation to the domestic regulatory measures, compliance with international standards are enforceable towards domestic banking sector. This creates a regulated, monitored, and supervisory regime for the international framework of Islamic finance.

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<sup>69</sup>Articles of Agreement of the International Monetary Fund, <<https://www.imf.org/external/pubs/ft/aa/>> accessed on 15 March 2017.

<sup>70</sup> Zulkifli Hasan, 'Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 82-115.

<sup>71</sup> Davies and Green, *Global Financial Regulation* (n 36) 32-154. See also, Gerard McCormack, 'Why 'Doing Business' with the World Bank May Be Bad for You' (2018)19(3) *European Business Organization Law Review* 649-676.

<sup>72</sup> *Ibid.*

At the international level, there is no single undertaking of a rules-based system in which the global financial framework *de jure* operates.<sup>73</sup> Nation states are sovereign states, and hence they are *de facto*, not obliged to adopt any international standards, rules, and principles, except when they have carefully decided to adopt, and incorporate them into their domestic legislative framework. The relevant national authorities in the banking sector, and central banks of any jurisdictions will choose a particular adoption and incorporation of the international standards and guidelines into the national system of banking and finance, as and where appropriate.

### 1.1.3. The participation of various economic actors

Despite the nature of voluntary incorporation of the international banking standards, most economies choose to adopt these standards, which later create a harmonised legal regime that facilitates international banking operation, in the context of capital adequacy, liquidity requirements, transfer, and repatriation.<sup>74</sup> Besides, various phases of an economic integration are also forged to form a supra-national form of an economic integration, aiming at harmonising differing standards, rules, and guidelines.<sup>75</sup> This can be examined in the context of a creative evolution of an FTA into a Customs Union, to a Common Market, to an Economic Union (EU) which instigates the creation of a Single Monetary Union, through a central bank for the said Union, such as the European Central Bank (ECB) for the Eurozone.<sup>76</sup>

Although it appears that the global financial system operates within its own framework, consisting of economic actors, such as nation states, and international financial institutions, the creative evolution of a free trade area may have shaped a more integrated outlook in the way the economic and financial systems operate. As such, international trade and investment activities have important roles to play not only in fostering free market, better facilitation of funds, and cross-border transfer, but also, the integration of economies which can forge an integrated system of monetary and fiscal policies.<sup>77</sup> That notwithstanding, the wider participation of economic actors propels a struggle in the realm of policy advocacy framework to adopt a system that is either prone to over-regulation, supervision, deregulation,

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<sup>73</sup> Miroslava Filipovic, *Governments, Banks and Global Capital: Securities Markets in Global Politics* (Ashgate, 1997) 170-180.

<sup>74</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-75.

<sup>75</sup> Davies and Green, *Global Financial Regulation* (n 36) 155.

<sup>76</sup> Claude E. Barfield, *International Financial Markets: Harmonisation versus Competition* (The American Enterprise Institute Press, 1996) 5-58.

<sup>77</sup> John Zysman, *Governments, Markets and Growth* (Cornell University Press, 1983) 4-55.

liberalisation, or re-regulation.<sup>78</sup> The debate is alive and no single policy can be identified to have a one fit-for all solution for the development of the global financial framework.<sup>79</sup> As businesses expand their operations beyond national borders, international economic actors like banks and financial investors require massive capital and liquidity support to operate their outbound investment activities. Hence, an enabling international legal environment for banking and finance is required in the form of a global financial framework that is accommodative and facilitative to these actors, forging their participation on the basis of trust and confidence.

## **1.2. Systemic and Regulatory Paradigm of the Global Financial Framework**

A critical examination of the global financial system shows, it is a system that intensely involves various international institutions that are tasked with their respective roles and sector-based functions. This includes that the modern financial activities attract interest-bearing transactions, where the interest rates are benchmarked against the London-Inter-Bank Offered Rate (LIBOR).<sup>80</sup> From the regulator's viewpoint, the global structure of the financial regulation comprises, at the top of the *de facto* institutional framework, the G7 Governments consisting of Finance Ministers, then the FSF which works closely with international institutions such as the IMF, the World Bank, the BCBS, the International Accounting Standards Board (IASB), the International Accounting Standards Committee, the International Auditing and Assurance Standards Board (IAASB), the Public Interest Oversight Board (PIOB), the Organisation for Economic Co-operation and Development (OECD) Governments, the WTO on financial services related matter, the FATF, the G10 (central banks) comprising the BCBS, the Committee on Global Financial System (CGFS), and monitoring groups such as the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Forum of Independent Audit Regulators (IFIAR).<sup>81</sup> Figure A highlights and examines from the regulator's viewpoint, the structure of the global financial system, consisting of various

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<sup>78</sup> John Gerard Ruggie, 'International Regimes, Transactions, and Change: Embedded Liberalism in the Post-war Economic Order,' in Stephen D. Krasner (ed), *International Regimes* (Cornell University Press, 1983) 5-45.

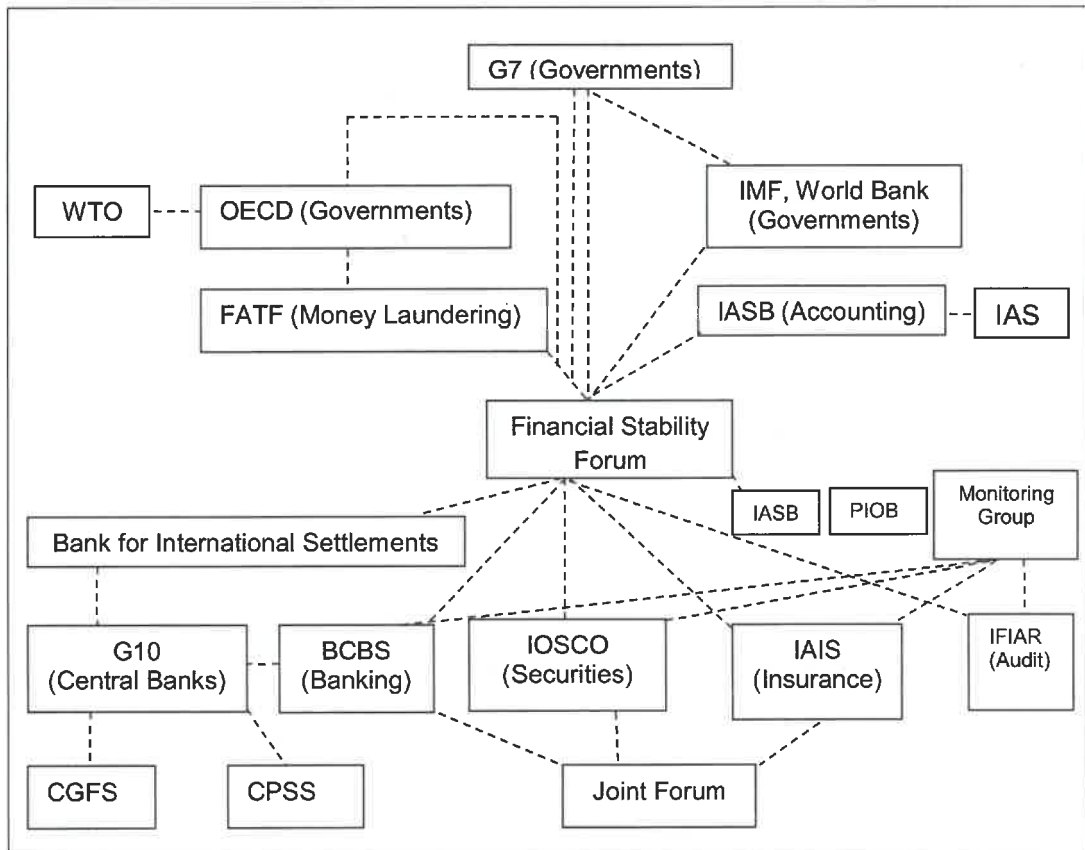
<sup>79</sup> Ibid.

<sup>80</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-75.

<sup>81</sup> Davies and Green, *Global Financial Regulation* (n 36) 7-110.

international institutions that currently exist, and operate within the international banking, finance, and trade framework.

**Figure A**  
**Global Committee Structure – A Regulator’s Examination<sup>82</sup>**



All these institutions work independently according to their specific sector-based regulatory and supervisory roles. Also, they closely coordinate with each other due to the intertwined nature of the global banking, financial, and trade framework. This collaborative synergy has brought about enhanced standards and guidelines, and in the wake of the recent global financial crisis, a propensity towards a more cooperative approach in deliberating and streamlining various issues, measures, guidance, and recommendations for the purposes of ensuring, and maintaining the well-functioning global financial system. The GFSN is also examined by these institutions to prevent systemic risk, and the justification for an *ex-ante* or *ex-post* intervention. The discussion on this issue is undertaken in Chapter Four.

<sup>82</sup> Davies and Green, *Global Financial Regulation* (n 36) 7-32. The source for Figure A is adapted from Sloan and Fitzpatrick in Chapter 13, *The Structure of International Market Regulation*, in *Financial Markets and Exchanges Law*, OUP, March 2007.

Categorically, the global financial framework comprises the 'regulated' and the 'non-regulated entities' that exist within the financial system.<sup>83</sup> At the macro level, there is no supranational entity, or a single global financial regulatory authority that undertakes the roles of regulating, and supervising global finance.<sup>84</sup> BCBS only appears as a central bank for other national banks, in its *de facto* role, to recommend Basel I, II, and III, for domestic adoption. A model for a supranational authority is exemplified in the case of the EU, establishing the European economic zone. The ECB is a pan-European regulator that regulates and supervises banking operations in the Eurozone. The ECB, established pursuant to the framework of an Economic Monetary Union, has issued guidelines and directives that are to be adopted for compliance by central banks within the EU.<sup>85</sup> This method of propelling compliance is known as the 'principle of subsidiarity'. The enforcement of the EU regulation and directives are undertaken at the lowest level of governance i.e. the central banks of each of the EU Members.<sup>86</sup> It remains to be examined, in post-Brexit context, whether the EU principles for inducing compliance can still be made enforceable to the UK and the Eurozone, as they were applicable before Brexit.

Since there is no single supranational entity that regulates and supervises the global financial framework, the framework is composed of all institutions in the world, whose functions are assigned according to their respective sectors, such as banking, trade, finance, securities, accounting and auditing standards, ratings, etc. As international finance becomes highly sophisticated, money laundering and terrorism financing also surmise in the cross-border context. Their global operations are spread widely across many layers and jurisdictions. This heralds a close coordination and cooperation between central banks and financial authorities of differing jurisdictions. In this regard, the Financial Action Task Force (FATF) is an important international organisation that coordinates closely with various institutions and jurisdictions to formulate strategies to combat money laundering activities.<sup>87</sup> The global financial framework, as it exists presently, is not a rules-based system like the WTO that is self-contained, and based on a single-undertaking. In the single-undertaking regime, the rules are legally binding, directly applicable, and enforceable to all WTO Members. In this regard, the WTO regulates its covered

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<sup>83</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 200-210.

<sup>84</sup> Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Harvard University Press, 1994) 4-60.

<sup>85</sup> Richard O'Brien, *Global Financial Integration: The End of Geography* (Council on Foreign Relations Press, 1992) 1-25.

<sup>86</sup> *Ibid.*

<sup>87</sup> Davies and Green, *Global Financial Regulation* (n 36) 7-110.

agreements that are enforceable to its Members, via the institutionalisation of a Dispute Settlement Understanding (DSU) mechanism.<sup>88</sup> The global financial framework is a fragmented system. It is regulated and supervised based on sectors, such as banking, capital market, ratings, etc. The international guidelines, standards, and principles are issued based on sectors, and not contained in a single-undertaking of a rules-based system like the WTO. For domestic financial framework, national monetary policies, including the adoption of international standards, guidelines, and principles are determined by central banks in each sovereign states' jurisdiction, which exercise their respective regulatory and supervisory powers, by regulating, monitoring, and supervising the operations of banks and financial institutions, operating in their territorial jurisdiction.<sup>89</sup>

### **1.3. Regulated entities**

For the regulated entities, the global financial framework comprises dedicated international institutions, and all central banks that possess the regulatory and the supervisory authority over their financial sector. The roles of the ECB for instance, include issuing directives and guidelines that are adopted by the Eurozone banking sector. This creates a hybrid system of supranational and inter-governmental decision process, a framework upon which the central banks and financial regulators of the EU Members operate.<sup>90</sup> The ECB is the ultimate product of the creation of the Eurozone, and the long evolutionary process of the European Coal and Steel Cooperation Council (ECSC), leading to the establishment of the EU in 1993, pursuant to the Maastricht Treaty.<sup>91</sup>

Other than the ECB, the IMF is an international organisation, established pursuant to its own establishment treaty, which was a by-product of the Bretton Wood's institutions, post-World War II. Nation states retain sovereign discretion to join the IMF, as members. Thus, the IMF, operating pursuant to its Articles of Agreement, attracts the nation states to join it as an IMF signatory party first, and through this membership, the IMF Articles of Agreement will become legally binding, and enforceable towards its member states. Thus, the member states, having also their own central banks and financial sector regulators, shall need to adhere to the letter and spirit of the IMF Articles of Agreement, when enacting their domestic

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<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

legislations. The legislations enacted, whether they are Central Bank Act, or Financial Services Authority Act, shall be in compliance with the IMF Articles of Agreement, including measures to restrict transfer and repatriation of capitals.

In a financial crisis, the adoption of measures by the IMF member states to safeguard the macro-economic imbalance, or deficit in the balance of payments, must comply with the IMF's Articles of Agreement. A mere adoption of measures by the central banks in accordance with its own domestic laws or statutory provisions, although necessary, is not legally justifiable internationally, for the purposes of legitimising an adoption of measures that are found to be inconsistent with international treaty obligations. A domestic law cannot be used as a defence not to comply with international obligations.<sup>92</sup> Thus, a measure adopted by the states must be both domestically and internationally compliant, particularly when the state joins a treaty, or an international organisation. Such a compliance would avoid dispute procedures being taken against the states, at the international level. This explicates, domestic banks and financial entities are *de facto* regulated, and monitored in the global financial framework, through the *de jure* states' membership to an international organisation, such as the IMF, or becoming a member of a supra-national regulator, like the ECB. In the past, the IMF was required to assume the ILOLR's role, but this did not happen due to complexities surrounding the concept.<sup>93</sup>

In addition, there are two types of regulatory styles that are involved in this framework. First, the 'governmental regulatory' framework. Second, the 'self-based regulatory' framework.<sup>94</sup> The governmental regulatory framework refers to the legislations and guidelines, imposed by the government, upon the institutions. This is the case, when the government decides to adopt international treaties, through signing, ratifying, or acceding to them, or becoming a member of an international organisation, which then legally imposes legal standards and provisions towards the member states.<sup>95</sup> The second style of a 'self-based regulatory' framework refers to the regulations imposed by the institutions, upon themselves, based on the standards issued by international standard-setting bodies, such as AAOIFI standards, since IFIs may voluntarily choose to apply, as and where they are to be

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<sup>92</sup> Article 27 of the Vienna Convention on The Law of Treaties (VCLT) states that, "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."

<sup>93</sup> See Chapter Four on the examination of ILOLR.

<sup>94</sup> Rusni Hassan, Nurdianawati Irwani Abdullah, Aznan Hassan, Uzaimah Ibrahim, Mohd Fuad Md.Sawari, Akhtarzaite Abd. Aziz, Agus Triyanta, 'A Comparative Analysis of *Shari'ah* Governance in Islamic Banking Institutions across Jurisdictions', (2013) ISRA Research Paper No.50/2013, 5-43.

<sup>95</sup> Davies and Green, *Global Financial Regulation* (n 36) 32-154.

applicable, for the purposes of *Shari'ah*-governance and compliance.<sup>96</sup> To date, the legal and regulatory framework governing IFIs for mostly cater to the licensing and the procedural aspects of the establishment of IFIs.<sup>97</sup>

#### **1.4. Lightly regulated or non-regulated entities**

The global financial framework also comprises, the lightly regulated, and the non-regulated entities, such as the hedge funds, private equity, and bank-sponsored entities such as off-balance-sheet vehicles that banks invest in the financial market. This scenario is also referred to as the shadow banking system that is without a regulatory framework, or an institutional backstop. The existence of this shadow banking system is a means of skirting regulatory parameters that apply to depository banks, adopting an onerous regime of prudential regulation. This circumvention appears to create regulatory arbitrage.<sup>98</sup> The legal test and regulatory thresholds are still unclear to demarcate clearly the nuances of the shadow banking system, especially in the context of examining its economic functions, the system is likened to a kind of financial innovation, instead of regulatory arbitrage. This scenario highlights, the global financial framework is not clearly regulated. Thus, the aspect of regulating the lightly regulated, and the non-regulated entities still remain an issue for financial regulators. Plus, market can be averse towards over-regulation, and hence, a minimal regulatory and supervisory mechanism may be heeded to monitor the implementation of international standards in the banking and financial sector.

#### **1.5. Historical Examination of the Institutionalisation of the Global Economic Governance Structure, and the Contextualisation of Global Paradigms**

Ever since the World War I, and the World War II, which witnessed the accomplished status of the victors of powers like the US and the UK, taking their respective seats as the Permanent Members of the Security Council of the United Nations (UN), there were great ideological tensions that had led to the Cold War between the US, and the USSR.<sup>99</sup> The tensions had brought about an ideological

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<sup>96</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Agus Triyanta (n 94) 5-43.

<sup>97</sup> Muhammad Zulkhibri Abdul Majid and Reza Ghazal, 'Comparative Analysis of Islamic Banking Supervision and Regulation Development' (2012) 6 (3) Money and Economy 113.

<sup>98</sup> Gary Gorton, Andrew Metrick, Andrei Shleifer, and Daniel K. Tarullo, 'Regulating The Shadow Banking System' (2010) Brookings Papers On Economic Activity 261-312.

<sup>99</sup> Fukuyama, *The End of History and the Last Man* (n 45) 5-30.

conflict, between a liberal democracy that conveyed a worldview of liberalism and capitalism, versus a socialist communism. This was not a mere political struggle with regard to the survival of the fittest. It was seen as a strong projection of an important worldview that would permeate the world civilisations, the nation states, and crucially, the global economic order, and the global financial system. And to date, the trade war between America and China has stirred market uncertainties across the globe, including global trade, international banking, and finance activities.

History has further observed that, despite the propagated Mutually Assured Destruction (MAD) during the Cold War to prevent the progression of the nuclear missile defence theatre, this was not the factor that had led to the downfall of the USSR, which upheld the socialist way of a normative modern economy. It was when the USSR decided to abruptly adopt the free market economy, through the introduction of *Perestroika* by Mikhail Gorbachev in the 1980s, the USSR economy collapsed, leading to the downfall of the socialist economic system.<sup>100</sup> This downfall had brought upon the breakdown of the socialist economic worldview as a promising future for the universally accepted global economic governance order and framework.<sup>101</sup> Thus, capitalism prevails in the new world economic order.<sup>102</sup>

The triumph of capitalism notwithstanding, it is ironic to learn that it was the sudden adoption of the free market capitalism, and the independent restructuring of the government departments to a market-like reform that was identified as the sudden factor that had led to the '*End of History and The Last Man*', as pronounced in the words of Francis Fukuyama.<sup>103</sup> The 'end of history' denotes the end of the socialist economic paradigm to be the universally adopted system, albeit that Russia, in post-*Perestroika*, had reverted to the socialist economic model to govern its entire economic architecture,<sup>104</sup> and 'the last man' to be the 'liberal democracy', and 'capitalism'.<sup>105</sup> As the 'end of history' is more of a product of the Cold War, the discourse on Islam did not previously enter into the frame of an ideological conflict, until the late Harvard Professor, Samuel P. Huntington in 1996, pronounced a future of remaking the new world order, to be based on the clash of civilisations i.e.

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<sup>100</sup> Ibid.

<sup>101</sup> Ibid.

<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

<sup>104</sup> In the 'Socialist' model, it is to be noted that Marx and Lenin did not account interest as a cost factor in the early period, and it was just after the Russian Revolution of 1917, their ideologies relinquished this approach. The Socialists rejected the Capitalist system of production, yet they included interest, for computing the total cost of production, and for fixing the consumer price.

<sup>105</sup> Fukuyama, *The End of History and the Last Man* (n 45) 5-30.

between the West and Islam.<sup>106</sup> It remains to be examined whether, the Huntingtonian worldview of the clash of civilisations will prevail and dominate the mainstream worldview to influence, or impede the development of the international framework for Islamic finance.

The present socialist Russia, though remains engaged politically in the global arena, is not a free market player in so far as the liberal free trade is concerned. Its economic and financial outlook remains domesticated, whilst on certain strategic fronts, Russia is engaged diplomatically on international trade with her strategic dialogue partners.<sup>107</sup> China, on the other hand, remains a communist country in its political administration, but in the wake of the globalisation, China has gradually opened its economy to the world trading system since 2000.<sup>108</sup> It is in this conscious reality that the study is cognisant that the liberal democracy, though may constitute a positive determinant to support the underpinning capitalist model of economy, is actually separately considered by a sovereign state in the administration of its own political affairs, vis-à-vis the administration of its national economic prosperity. The capitalist model of economy appears to be universally organic, and distinctively considered, notwithstanding the communist political structure, governing the national administration.<sup>109</sup> Thus, the *laissez-faire* approach for the global banking and finance, international trade, and investment may be fostered unopposed, despite the embedded communist political structure in the country. The downfall of the USSR had brought about a unipolar structure for the US to emerge as a major superpower in both the international politics, as well as in the economic fronts.<sup>110</sup> Despite the ostensibly projected stature of a unipolar order, the US together with the victors of war, had created and institutionalised a world system that comprises various international institutions.<sup>111</sup> This underscores the efforts not to remake the new world order, within the unipolar emergence of a superpower design, but a global order that is based on institutional rules, guidelines, principles, and other international best standards, that can be universally accepted, enacted, and applied.<sup>112</sup> Learning from the failure of the League of Nations, as proposed by the US President Woodrow Wilson, the Charter of the UN was

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<sup>106</sup> Samuel P. Huntington, *The Clash of Civilizations and The Remaking of a New World Order* (Simon & Schuster, 1996) 10-60.

<sup>107</sup> Friedman, *The World is Flat* (n 48) 2-30.

<sup>108</sup> Ibid.

<sup>109</sup> Ibid.

<sup>110</sup> Francis Fukuyama, *The End of History and the Last Man* (n 45) 5-30.

<sup>111</sup> Ibid.

<sup>112</sup> The United Nations, <<http://www.un.org/en/sections/about-un/overview/index.html>> accessed 15 March 2017.

negotiated, and then promulgated, with the universal acceptance of the UN as an important international organ post the World War II, aiming to promote world peace, security, and stability, since its inception in 1945, until today.<sup>113</sup>

It is in this spirit of world peace that the international norms and customs are continuously being codified by the Sixth Committee of the UN, and the International Law Commission (ILC). This codification of international rules have contributed to the institutionalisation of an international order that is based on the rules of international law to be observed by all nation states, notwithstanding the roles of the Permanent Five in the UN Security Council (UNSC) are still strong and controversial due to the veto power structure, and the strategic alliances between and amongst the UN members. The international framework for Islamic finance also heeds and follows this existing design of the international law-making framework, and accordingly, promulgates their international standards, rules, principles, best practices, guidelines, and recommendations to the nation states, and for IFIs to adopt these soft-law instruments, as voluntary and persuasive considerations.

In 1966, the UN established the UN Commission on International Trade Law (UNCITRAL), with its headquarter based in New York, USA, and the alternate Commission Meetings are in Vienna, Austria. The UNCITRAL was created for the purposes of harmonisation and unification of private international trade rules, particularly between the Common Law, and the Civil Law systems.<sup>114</sup> Six Working Groups were established to examine various matters assigned by the Commission, such as Working Group I (Micro, Small and Medium-sized Enterprises), Working Group II (Dispute Settlement), Working Group III<sup>115</sup>, Working Group IV (Electronic Commerce), Working Group V (Insolvency Law), and Working Group VI (Security Interests).<sup>116</sup> Since its inception in 1966 until today, the UNCITRAL Rules, the Model Law, the treaties, and the guidelines have received wider acceptance by nation states, through their adoption in the national legislative framework, which also interacts with the operation of *Shari'ah* requirements, as applicable, in commercial and financial transactions. These interactions have not always been harmonious. Legal tensions arise when Islamic financial products are interpreted through the canons of the English Common Law, whilst the *Shari'ah* has a limited application in terms of examining the *Shari'ah*-compliant requirements, with regard to product

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<sup>113</sup> Ibid.

<sup>114</sup> UNCITRAL, <<http://www.uncitral.org/>> accessed 15 March 2017.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid.

restructuring, and purification of funds.<sup>117</sup> Chapters Five and Six critically examine this inevitable interaction within the context of international law-making process, and the soft-law implementation of *Shari'ah*-compliant standards and requirements.

## 1.6. From The Bretton Woods System to Fiat-Based System

Alongside the birth of the UN whose task is to ensure the world peace and security, other international institutions were also created, and instituted. The establishment of the World Bank is tasked to provide development financing for the purposes of national reconstruction and development activities. The establishment of the BCBS serves as a committee of banking supervisory authorities.<sup>118</sup> The BCBS, established by the central bank governors of the Group of 10 countries in 1975, serves as a forum for the regular cooperation on banking and supervisory matters, such as issuing guidelines and standards on capital adequacy, and the '*Core Principles for Effective Banking Supervision*', and the '*Concordat on cross-border banking supervision*'.<sup>119</sup> The IMF, conceived at a UN conference in the Bretton Woods, New Hampshire, US, in July 1944, is aimed to ensure the stability of the international monetary system, including among others, to help those countries to receive financial assistance, in order to revive them from the balance of payment deficit, by undertaking structural adjustment programmes for national reform.<sup>120</sup> Prior to the collapse of the Bretton Woods system, currencies were backed by gold to indicate its strong resilience and intrinsic store of values.<sup>121</sup> In this era, nation states were strongly protective of its domestic industries. High levies of tax and customs duties were imposed against foreign products to avoid competitive prices of those products in domestic market. Trade protectionism was high and distortive.

Prior to the collapse of the Bretton Woods system, there were series of rounds of multilateral trade negotiations. The main objective was to ensure a gradual reduction and elimination of tariffs and non-tariff barriers. The General Agreement on Tariff and Trade in 1947 (GATT 1947) had evolved, and culminated into the General Agreement on Tariff and Trade 1994 (GATT 1994), through the

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<sup>117</sup> Rodney Wilson 'Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience' (2007) 7 (1) *Islamic Economic Studies* 35-59. Wilson argued that, "as the ethical monitoring of the fund for *Shari'ah*-compliance has to be conducted on an ongoing basis, with the purification income deducted weekly, this adds to costs, which are reflected in the funds charges."

<sup>118</sup> Warde, *Islamic Finance In The Global Economy* (n 32) 192-199.

<sup>119</sup> *Ibid.*

<sup>120</sup> *Ibid.*

<sup>121</sup> *Ibid.*

conclusion of the Uruguay Round of negotiations. The signing of the Marrakesh Agreement had led to the establishment of the WTO in 1995. At this juncture of history, the gold-backed currency of the Bretton Woods system was replaced by the fiat-based system. No gold-standard backing was required to support the currency values. Trust and confidence vested in the global financial system was espoused since then, and these characteristics remain vital until today. Chapter Three later examines this philosophical basis for the international framework for Islamic finance.

With the collapse of the Bretton Woods system in 1970s, the introduction of the fiat-based system had witnessed the recognition of four freely usable currencies i.e. US Dollar, British Pound Sterling, Japanese Yen, and Euro.<sup>122</sup> These freely usable currencies have become normatively the most trustworthy currencies that are freely usable, exchangeable, and transferable, within the international framework for lending, borrowing, transfer, repatriation of capital, and international payment. Hence, it is in the spirit of trust and confidence that the world economies have recognised the everlasting stature and value of these freely usable currencies.<sup>123</sup> Other currencies like the Chinese Yuan, the Malaysian Ringgit, and the Saudi Riyal are recognised as freely convertible currencies, which are not readily usable, but instead require a conversion to the freely usable currencies, if needed to be used, internationally.<sup>124</sup> These convertible currencies are highly elastic in demand, leading to the short supply due to the lack of market trust and confidence, attributed to varying factors such as political instability, speculative positioning, the weakness of the economic fundamentals of a country, financial and currency crisis, and the fluctuating market value of those currencies in the volatile market environment.<sup>125</sup>

Despite the deference to the four freely usable currencies, the US Dollar has emerged to be the most denominated and accepted freely usable currency in the world for international banking, finance, payment, and investment. The position of the US dollar has been reinforced with the acceptance of Petro-Dollar in the trading of oil barrels with the US Dollar used as the currency denominator between Saudi Arabia, the US, and the Organisation of the Petroleum Exporting Countries (OPEC).<sup>126</sup> No other currencies could overtake the dominant position of the US

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<sup>122</sup>IMF SDR and Freely Usable Currencies, <<http://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/19/35/Review-of-the-Special-Drawing-Right-SDR-Currency-Basket>> accessed 15 March 2017.

<sup>123</sup> Ibid.

<sup>124</sup> Ibid.

<sup>125</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 234-258.

<sup>126</sup> Warde, *Islamic Finance in the Global Economy* (n 32) 7-177.

Dollar in the global financial system. Further, the oil trading is crucial, as OPEC has been influencing the price of oil per barrel, based on the US Dollar denominator.<sup>127</sup>

The increasing investment of multinational firms from the US from the Silicon Valley, and the transnational multi-billion industrial corporations has injected an enormous piles of cash in the US Dollar into China's economy.<sup>128</sup> As a result, China hosts the largest foreign exchange reserve currencies in the world, with one third is reported to be in the US Dollar.<sup>129</sup> With such a significant international reserve in the US Dollars held by China, and the continuous demand and supply in the *laissez-faire* interaction amongst market participants from the US, and the mainland Chinese economic actors, the US Dollar is still accepted presently as the dominant currency in global banking and finance.<sup>130</sup> Criticisms on the future applied value of the US Dollar are also observed, especially in the light of the US' burgeoning household debt, attributed to the sub-prime mortgage crisis, in the wake of 2008. With the trade war between the US and China, there seems to have been a caution on the everlasting dominance of the US Dollar, but this is still unverified. However, sovereign debt, and international repayment of loans and bonds still necessitate the US Dollar, used as a denominator in international contracts and procurements.<sup>131</sup>

An examination of the financing activities under the auspices of the World Bank and the IMF, shed some light on the on-going operation of the fiat-based system. The IMF and the World Bank, in their respective financing and development financial assistance projects, albeit defer to the US Dollar, as the main denominator, develop and use a formula, known as Special Drawing Rights (SDR) that are formulated and calculated, based on a basket of currencies namely, the freely usable currencies.<sup>132</sup> The SDR formula is used widely by the IMF, as well as in international procurement contracts, involving mega projects. The SDR value of the procurement project is used for the purposes of determining the threshold value of project finance that can be used to ascertain categorically, the thresholds for projects that are either subjected to an international open tender, or direct award,

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<sup>127</sup> Ibid.

<sup>128</sup> US Dollar, <<http://www.tradingeconomics.com/china/foreign-exchange-reserves>> accessed 15 March 2017.

<sup>129</sup> Ibid.

<sup>130</sup> Keyu Jin, 'No, China is Not the Next Japan' < <https://www.weforum.org/agenda/2016/10/no-china-is-not-the-next-japan/>, accessed on 15 March 2017.

<sup>131</sup> IMF SDR and Freely Usable Currencies, <<http://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/19/35/Review-of-the-Special-Drawing-Right-SDR-Currency-Basket>> accessed 15 March 2017.

<sup>132</sup> Ibid.

and negotiations. This type of project financing activities, using the SDR value in an international tender process, again puts deference to the basket of freely usable currencies that are used and maintained, within the operative structure of a fiat-based system. Other than the SDR, banknotes are recognised. In the UK, the banknotes have been changed with its £5 notes being phased out, in favour of improved polymer versions. In this regard, the Scottish banks have been at the forefront of banking innovation, including in the design of banknotes. It is noted that the new polymer banknote is: (i) clean as it is resistant to dirt and moisture, unlike paper banknotes; (ii) secure with enhanced counterfeit resilience; (iii) durable to last at least 2.5 times longer than paper notes; and (iv) sustainable and environmentally friendly, as fewer notes are being printed.<sup>133</sup> The trust and confidence in this regard are the key determinants for the well-functioning framework of banking and finance.

### 1.7. From The Fiat-Based System to LIBOR

At this juncture of an evolutionary process of the international framework of global finance, it augurs well that the international financial architecture is still dependant on the fiat-based system, as a trusted global system. The freely usable currencies are recognised, internationally. The US Dollar prevails in the operation of international trade, investment, international banking, payment, and global monetary system.<sup>134</sup> Acknowledging this stature of the fiat-based economy, the fiat-based system carries another important element recognised as interest rate, as determined and benchmarked by LIBOR.<sup>135</sup> Whilst the strength of a currency is determined by market trust and confidence, which at times, adopts the herd mentality, the interest rates, as benchmarked against the LIBOR rates, appear to be an asymmetrical way of ensuring the predictability of the Kuala Lumpur-LIBOR (KLIBOR) rates for instance, in order to benchmark its interest rate against the overnight policy rate (OPR) in the domestic banking ecosystem.<sup>136</sup> In theory, market equilibrium sets the LIBOR rate, and it is used as a benchmark for the KLIBOR and the OPR.

In the realm of international trade and investment, predictability is key to ensure the stability and the long term sustainability of free market. Market is averse

<sup>133</sup> \_\_\_\_\_, 'From Paper to Polymer' *Chartered Banker* (August/September 2016) 24-25.

<sup>134</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 201-232.

<sup>135</sup> Monzer Kahf, 'Basel II: Implications for Islamic Banking' <<https://mbri.ac.ir/userfiles/file/Islamic%20Banking/%D8%A8%D8%A7%D9%86%DA%A9%20%D9%85%D9%82%D8%A7%D9%84%D8%A7%D8%AA/Regulating%20Islamic%20financial%20institutes/BaseI%20II%20Implications%20for%20Islamic%20Banking.PDF>> accessed 25 April 2018

<sup>136</sup> Ibid.

to the sudden change of government policies, as well as the abrupt reduction and elimination of tariffs, and non-tariff barriers. International trade rules are carefully negotiated. All modalities of tariffs and non-tariffs barriers, and schedules of progressive trade liberalisation for the opening of services and investment sectors are clearly prescribed in the texts and annexes of the FTAs. These carefully negotiated and prescribed regimes of trade and investment liberalisation are agreed upon by the signatory states. Their transcription heralds and informs the market, of a predictable trading environment adopted by a national system that is attractive to foreign investors and services suppliers. No back-tracking is allowed, but rather a more favourable treatment is required to be accorded, unconditionally, and automatically, to another third nation state, subject to the reservations entered into by the signatory FTA parties. The rules and modalities are not only explicit, they are transparently written, and enforced, in order to ensure a predictable trading regime.

The scenario of a predictable trading environment, through the free market capitalism underpinned by the FTAs, or even the WTO, appears to be in stark contrast to that of the fiat-based system that is influenced by the fluctuating LIBOR rates. It is not in the intrinsic nature of the interest-based system that the LIBOR rate is fixed and certain. It floats and fluctuates.<sup>137</sup> The central banks of every jurisdictions would have to be efficient to align themselves with the current rate at the LIBOR market so as to set the benchmark of its interest rate ceiling.<sup>138</sup> In a financial crisis, where sovereign bonds mature, and sovereign debts require repayment, the interest rate becomes an issue, because the fluctuating rates could make the repayment exercise becomes difficult, costly, and burdensome.<sup>139</sup> Aldohni highlighted that "the LIBOR scandal which had come to light in 2012 would not have had any significance if trust in the honest nature of the LIBOR rates' calculation was not given its virtue by all market participants. The honesty and trustworthiness of the institutions involved in setting the LIBOR rate is what gives this rate its true value."<sup>140</sup>

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<sup>137</sup> Ibid.

<sup>138</sup> Feisal Khan, 'How 'Islamic' is Islamic Banking?' (2010) 76 *Journal of Economic Behaviour & Organization* 805-820. Khan examined that the "IDB underscored the use of conventional market interest rates for its generation as its 2006-2007 Annual Report, and stated that the increased level of liquid funds placed in the assets was the result of proceeds from issuance of *sukuk* and short-term *Murabahah* with higher yields in an environment of rising LIBOR-linked rate of returns."

<sup>139</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 149-199.

<sup>140</sup> Abdul Karim Aldohni, 'Is Ethical Finance the Answer to the Ills of the UK Financial Market? A Post-Crisis Analysis' (2016) *Journal of Business Ethics*. Aldohni highlighted that, "given that what banks submit is actually an estimate of the borrowing cost, this demonstrates the importance of honesty and trust to the functioning of the LIBOR, yet it also makes it very susceptible to abuse."

In some government or international contracts, the interest rates are pre-determined, whilst some agrees to the floating interest rates due to the consideration of the market equilibrium, and several variables in the economy. In this regard, the LIBOR rates are used for benchmarking the interest rate. But the fluctuation rates propel a question of whether the existing financial system, based on the free market capitalism cannot be considered predictable, let alone stable. In another context, where the interest rates are pre-fixed, and assuming all contracts for financing are predisposed to this position, the question is whether a more predictable regime of interest rates can be affirmed. A pre-determined interest rate is not only predictable, but also transparent, *ex-ante*. It may thus provide a safe cushion against sudden external shocks during the financial crisis, as opposed to the highly fluctuating interest rates that are exposed to market volatility.<sup>141</sup> But the unexpected changes in the rate of inflation can affect the balance sheets of borrowers, where debt contracts with long duration have interest payments fixed in nominal terms, for a long period of time. When inflation is less than expected, due to unexpected disinflation, or by an outright deflation, the value of corporation's liabilities in real term rises, and its net worth in real terms declines. This decline may increase the chance of an adverse selection, and moral hazard facing the lenders, and diminish economic activities.<sup>142</sup> Thus, the interest rate, if it increases, will affect corporations' financial stability, and the household balance sheets. With the cash flow being decreased, the balance sheets will deteriorate. Hence, a sharp increase of interest rates will play an important role towards ensuring financial stability.

Further, the repayment of loans with interest can be heeded from the Greece-sovereign debt crisis. The severe position of its financial crisis cannot insure Greece for a safe escape, from paying its principal interest, let alone to service the mountainous piles of its sovereign debt.<sup>143</sup> The crisis that occurred in Greece, being one of the Eurozone members became very contagious to other EU Members, such as Spain, Italy, and France, which also suffered from the economic crisis. Despite the EU is seen unified in the monetary and fiscal policies for the Eurozone, the decision not to bail out Greece from its financial predicament was a political one.<sup>144</sup> The Euro remains a freely usable currency, next to the position of the British pound sterling in Europe, and the Greek financial default and indebtedness were

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<sup>141</sup> Dijsselbloem (n 64).

<sup>142</sup> Frederic S. Mishkin, 'Global Financial Instability: Framework, Events, Issues' (1999) 13 (4) Journal of Economic Perspectives 3-20.

<sup>143</sup> Dijsselbloem (n 64).

<sup>144</sup> Ibid.

dissociated from the EU. This had seemed to separate, and insulate the Greece situation, from the overall market confidence of the Eurozone, as one of the well-managed currencies, with its strong fundamentals in Luxembourg.<sup>145</sup> Sovereign debts and interests' repayment by Greece are reduced to an issue of domestic framework on how to tackle her own sovereign debt management issues. Chapter Four further examines the issues of global financial crisis, and the measures adopted to weather the crisis, including Malaysia's experience in handling the 1997-98 Asian financial crisis, and the risk management principles developed within the international framework for Islamic finance. As LIBOR becomes the world's benchmarking system for global banking and finance, Professor John K. Ashton was of the view that "scandals such as Libor and Forex, money laundering and ongoing cases of mis-selling have raised a multitude of questions, but quantifying corporate culture remains a particularly elusive challenge. An entire system of behavioural management has been proposed with bankers and insurers, expected to undertake a professional oath to perform their duties in good faith, and in the interests of the customer.<sup>146</sup> In this regard, Aldohni underscored, there was a virtue of trust embedded in LIBOR, although it is also susceptible to abuse.<sup>147</sup> This study further notes that in the future, LIBOR may cease to operate, and it is unknown what will replace LIBOR, as a new benchmarking system for global banking and finance.

## **1.8. The Status Quo Operation of Islamic Finance in the Global Financial System**

IFSI's total worth, consisting of banking, capital markets, and *Takaful*, was estimated to be US\$2.05 trillion in 2017, whilst global *sukuk* (Islamic bonds) was estimated to worth close to US\$399.9 billion in the same year. The *Shari'ah*-compliant assets worldwide also rose by 8.05% to \$1656 billion in 2018. Further, Islamic finance has expanded not only throughout the Muslim countries, but also across various other non-Muslim countries in the Europe, America, UK, etc. Section 5.5 of Chapter Five further examines the expansion of Islamic finance globally, in the context of international framework for Islamic finance, interdependence, and the clash of civilisations. In this regard, Islamic finance, despite its success stories to date, is still a new industry, having so much potential to grow and develop. Some commentators would like to refer it as an alternative to the conventional banking

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<sup>145</sup> Ibid.

<sup>146</sup> \_\_\_\_\_, 'New Perspectives' *Chartered Banker* (UK April/May 2017) 44-45.

<sup>147</sup> Aldohni (n 140).

system. However, from an institutionalist point of view, in which this study undertakes its research based on the existing global governance structure of banking regulation and supervision, Islamic finance can be construed to operate side-by-side with the conventional banking system as Islamic banking system and its structures follow largely the conventional banking ecosystem, with an additional requirement of *Shari'ah*-compliant mechanism. Chapter Two will further examine the international framework for Islamic finance by mapping out the dedicated and non-dedicated institutions that promulgate Islamic finance, in terms of disseminating standards, guidelines, principles, and various soft-law instruments, etc.

### **1.9. Conclusion**

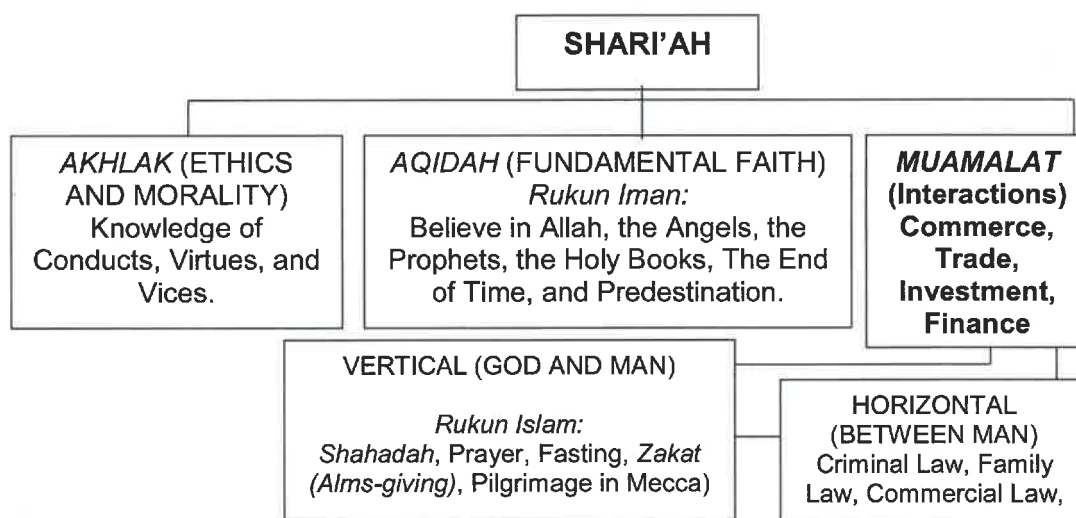
This Chapter has examined that overall, the global financial system is still entrenched with the fiat-based system. The US Dollar remains to date, the preferred international currency in banking and financing activities. The evolutionary process of the global financial system, as traced back from the collapse of the Bretton Woods system to the present stage of the global financial system has led to the emergence of various issues, concerning the predictability, sustainability, and the long-term trajectory aspect of the systemic risk of the fiat-based system, and its interest-bearing debts, including the possible cessation of LIBOR as the world's benchmarking standard, in the future. The establishment of various international institutions, like the BCBS, the World Bank and the IMF, apart from their respective institutional roles, are induced by the global contextual paradigm of the *laissez-faire* principles, capitalism, interest-based banking and financial activities. Islamic finance is still an embryonic industry, although at times, it can also be referred to as an alternative to the conventional banking system. At present, Islamic finance can be construed to operate side-by-side with the conventional banking system as the Islamic banking ecosystem and its structures are modelled largely from the conventional banking ecosystem, with an additional requirement of *Shari'ah*-compliant mechanism. From the *Quranic* worldview, a principle has been established, which upholds that, the main cornerstone for any trade (*bay'*), commercial activities and payment system must be based on the basis of *amanah* (honesty), trust and confidence, as enshrined in *Surah Al-Baqarah*, verse 275. The discourse on the subject is examined more critically in Chapter Three. In light of this backdrop, this study further examines in Chapter Two, the international framework for Islamic finance within the contemporary context of the global financial system.

## Chapter Two: International Framework for Islamic Finance Within The Global Financial System

### 2.1. Islamic Finance: An Examination of the *Fiqh Muamalat* Fundamentals

The Islamic worldview espouses that the resource allocation and the pursuit of an economic stability and wealth cannot be resolved purely by human reason. Homo-economicus (rational economic actors) is distinguished from homo-*Islamicus* (rational economic actors guided by human rationality and Islamic revealed knowledge).<sup>148</sup> Therefore, the Islamic worldview incorporates the consciousness of a higher reality which lies in the fundamental belief and faith in Allah as the Almighty Creator, and the Islamic revealed knowledge as enshrined in the *Quran*, paving Islam as a way of life. This greater consciousness recognises the roles of *Shari'ah* in the administration of man's life which can be examined in **Figure B** as follows:

**Figure B<sup>149</sup>**



As Islamic finance falls within the *Muamalat* section of the *Shari'ah*, it derives its original promulgation from the main sources of Islamic references i.e. the *Quran* (as a holy Book for Islam and the Muslims, but is also intended to be read

<sup>148</sup> Mohammad Farouq, 'Self-Interest, Homo Islamicus and Some Behavioural Assumptions in Islamic Economics and Finance' *International Journal of Excellence in Islamic Banking and Finance* (2011) 2-18.

<sup>149</sup> Saiful Azhar Rosly, *Critical Issues on Islamic Banking And Financial Markets: Islamic Economics, Banking & Finance, Investments, Takaful and Financial Planning* (Dinamas, 2010) 8.

and used widely by all human race), *Sunnah*, or *Hadiths* (the sayings and actions of Prophet Muhammad PBUH). Other sources include *ijma'* of the *Sharī'ah* scholars (worldwide consensus amongst scholars), *khilaf* (divergence of legal opinions among scholars), and *ijtihad* (reasoned and independent legal opinions which can be held, and opined by scholars, or individual Muslims, having a profound understanding, or an expert capability regarding the legal basis for deducing *fiqh*-based rules and principles, based on Islamic sources and references).<sup>150</sup> As Islamic finance falls within the scope of *Muamalat* (commerce) section of the *Sharī'ah*, all transactional dealings have to adhere to the *Quranic* guidance as the primary source.<sup>151</sup> Where the details are concerned regarding the execution of certain commercial deals and trade (*bay'*), *Sunnahs/Hadiths* of the Prophet Muhammad PBUH will be referred to. In the practical implementation of Islam, there exists a division between *Sunni Islam* and *Shi'ites'* Islam. This study does not dwell into these divisional issues, but will take note, and refer to the *Sunni Islam* which comprises the four *Mazhab* (Islamic Schools of Legal Thoughts from the *Sunni Islam*), i.e. the *Shafie's*, the *Maliki's*, the *Hanbali's*, and the *Hanafi's Mazhabs*.

*Fiqh Muamalat* in Islam attracts a divergence of legal opinions amongst the *Sharī'ah* scholars. This requires the harmonisation efforts of scholarly opinions with regard to the legitimisation of *Sharī'ah* products, according to Islamic viewpoint. Since the prohibition of *riba* (interest) is clear in the *Quranic* injunctions,<sup>152</sup> the juristic debates are in relation to the details of Islamic methodologies for certain rulings to be deduced, and this is called *Usul Fiqh*. The establishment of the Islamic *Fiqh* Academy of *Fatwa* of the Organisation for Islamic Countries (OIC) based in Jeddah has discussed and examined various *fiqh muamalat* issues.<sup>153</sup> Recognising the diversity in the legal opinions, the harmonisation efforts in the implementation and interpretation of the Islamic financial products have been called for, and it is coordinated by the Islamic *Fiqh* Academy of *Fatwa*.<sup>154</sup> These harmonisation efforts, through the promulgation of various resolutions, had led to a harmonised worldview of the *fiqh*, and a stable ruling on *Sharī'ah* compliant products based on *ijtima'* (worldwide consensus), reached by qualified *Sharī'ah* experts, contemporary jurists, and scholars.<sup>155</sup> Although there exists differing *Mazhabs* to consider and determine the legitimisation of products according to the *Sharī'ah*, the *Quran* clearly prohibits

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<sup>150</sup> Aldohni, *The Legal and Regulatory Aspects of Islamic Banking* (n 35), 39-55.

<sup>151</sup> Ibid.

<sup>152</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 352.

<sup>153</sup> Aldohni, *The Legal and Regulatory Aspects of Islamic Banking* (n 35), 39-55.

<sup>154</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 352.

<sup>155</sup> Ibid.

interest-based (*riba*) transactions, but permits trade, as prescribed by *Surah Al-Baqarah*, verse 275,<sup>156</sup> and the injunction is translated to read as follows:

“... That is because they say, ‘trade is [just] like interest. And Allah has permitted trade and has forbidden *riba* (interest)...’”

Hence, by virtue of this explicit divine commandment, an absolutely free of interest-based transactions constitute the normative proposition, underpinning the Islamic economics and finance.<sup>157</sup> Ideally speaking, any transactional activities in commercial lending and borrowing which requires payment should not attract any *riba* (interest) imposition, at all, and this had also been the position of the world’s major religions<sup>158</sup> In the *de facto* framework for the implementation of Islamic finance, the current banking model despite operating the Islamic windows for Islamic finance is influenced by the conventional banking system.<sup>159</sup> Instead of using the base-lending-rate (BLR) which often fluctuates as it is benchmarked against the LIBOR rates, Islamic finance adopts a base-finance-rate (BFR), or a Base-Rate (BR) to indicate the financing element of the rates determination. The ceiling rates of BFR or BR will be capped based on the LIBOR rates.<sup>160</sup> This ceiling benchmark will safeguard against the sudden increase of floating interest rates, which are

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<sup>156</sup> Siddiqi, *Banking Without Interest* (n 38) 15-124.

<sup>157</sup> *Riba* is said to equate interest although at times, it is quite far from the whole situation. Nonetheless, charging or receiving interest is not allowed generally, and all traditional banking services which use interest is considered attracting *riba*. Interest was used in Ancient Greece and Ancient Rome. Many philosophers of those times such as Plato, Aristotle and Cicero were against the imposition of interest.

<sup>158</sup> In Judaism, the Old Testament contained specific prohibitions against interest, and it became acceptable for Jewish moneylenders to lend people who were not from the Jewish community, but eventually the prohibition had disappeared. In Christianity, the prohibition of charging interest was provided in the Old Testament, but there is nothing specific in the New Testament. The early Christian churches opposed the use of interest, but the Protestant reformers seemed less bothered, provided that the amounts were reasonable, and did not amount to usury (lending at excessive interest rate). The Roman Catholic Church made its position clear in 1846 by allowing interest, and hence, the modern Christian position is that interest is acceptable, as long as it does not amount to usury. The *Dharmashastras* also disapproved usury on distress loans, and regarded it as greater evil than murder of a *Brahman* (*Brahmhatya*). But the *Shari’ah*’s position is absolute, *riba* is prohibited clearly by the *Quran* and *Sunnah/Hadith*.

<sup>159</sup> Siddiqi, *Banking Without Interest* (n 38) 15-124.

<sup>160</sup> Mohd Azmi Omar, Azman Md Noor, Ahamed Kameel Mydin Meera, Turkhan Ali Abdul Manap, M. Shabri Abdul Majid, Sharifah Raihan Syed Zain, Md. Ali Sarif, Raditya Sukmana, Yusuf Muhammad Bashir, ‘An Islamic Pricing Benchmark’, (ISRA Research Paper No. 17/2010), <http://www.iefpedia.com/english/wp-content/uploads/2011/11/2010-Islamic-benchmark.pdf> accessed on 15 March 2017. It is noted that the State Bank of Pakistan bifurcated the Pakistani banking system, comprising the conventional and the Islamic banking system, which avoids the use of ‘interest rate’, but ‘profit rate’ or ‘mark-up rate’ is used instead.

detrimental to the consumers.<sup>161</sup> BFR or BR is often used in the context of housing loan transactions either *ijarah*-based (lease) financing, or any other Islamic instruments. In the context of an international issuance of *sukuk* (Islamic bonds), BFR or BR are used by benchmarking its ceiling rates against the LIBOR rates. Although in the *de jure* context of Islamic finance, the transactions must be devoid of *riba* (interest), the BFR or BR<sup>162</sup> is a benchmark profit rate, where banks use to price their financing products, which is categorically known as the 'cost of fund'.<sup>163</sup> In addition to the prohibition of *riba* (interest), Islamic finance must fulfil other *Sharī'ah*-compliance requirements such as to avoid financing activities involving *gharar* (uncertainty), *maysir* (gambling), pornography, alcoholic beverages, and any other activities that are considered to be highly risky and haram (forbidden by *Sharī'ah*).<sup>164</sup> An illustrative explication of these basic *Sharī'ah* principles within which the international framework for Islamic finance *de jure* operates, and *de facto* adopts is examined in **Table 1**.

**Table 1**

No.	<i>Fiqh Muamalat</i>	An Examination of The Fundamental Principles
1.	Prohibition of <i>riba</i> (interest).	<i>Riba</i> (interest) is a term which literally means 'an excess' or interpreted as 'any unjustifiable increase of capital whether in loans or sales' is the main principle of the Islamic finance. Any positive, fixed, predetermined rate, <i>an-nasee'ah</i> , or <i>al-fadhli</i> , and the amount of principal (i.e. guaranteed regardless of the performance of the investment) is regarded <i>riba</i> (interest), and hence, is prohibited. Islamic scholars hold generally a consensus that opine <i>riba</i> (interest) covers not only usury, but also the imposition of 'interest' as being practised, charged, and adopted in a contractual deal, particularly in delayed payment. <sup>165</sup>

<sup>161</sup> Ibid.

<sup>162</sup> Ibid. Islamic bonds, generally paying a 'LIBOR + X%' rate, but may have a fixed rate, if backed by *ijarah* or *Murabahah* transactions, and must be asset-backed and *Sharī'ah*-compliant, and sometimes also referred to as *Musharakah* Term Finance Certificates with a nominal equity component.

<sup>163</sup> Ibid.

<sup>164</sup> Aldohni, *The Legal and Regulatory Aspects of Islamic Banking* (n 35) 29-55.

<sup>165</sup> Mahmoud A. El-Gamal, 'An Economic Explication of the Prohibition of *Riba* in Classical Islamic Jurisprudence' (2011) *Islamic Economic Studies* 1-19.

No.	<i>Fiqh Muamalat</i>	An Examination of The Fundamental Principles
2.	Money in Islamic economics, banking, and finance should be regarded and treated as 'capital'.	Money as capital would in turn mean that money itself cannot create money. Instead, money can be considered as having a potential value to be an actual capital, rather than a mere potential capital, in and of itself. When it becomes an actual capital, the money in question is supposed to be used together with other resources and labour, in any kind of activity that would lead to certain production. In this regard, the time value for money will therefore be acknowledged, when the money in question is recognised as an actual capital, instead of making the money works to create another money. This acknowledgment would no longer make the money as merely a potential capital, because there are also labour and production aspects that are being factored into the activities which distinguish business transactions as treating money as the actual capital, and not the potential capital that can speculatively create another money.
3.	Prohibition to engage in speculative behaviour and activities or riskier investments.	Islamic finance strictly prohibits the engagement in activities that dwell upon hoarding, and speculative transactions that attract extreme uncertainty, volatility, and extreme risks as these speculative activities can bring more harmful consequences than benefits to the business, consumers, and the market.
4.	The business model shall only be undertaken in <i>Sharī'ah</i> -compliant activities.	It is important to recognise that Islamic finance shall not engage in non- <i>Sharī'ah</i> -compliant activities, as clearly ordained by the <i>Sharī'ah</i> as prohibited sectors, such as alcohol, gambling, pornography industry, casinos, and other <i>Sharī'ah</i> -prohibited industries that could bring harmful risks and consequences under the <i>Sharī'ah</i> .

No.	<i>Fiqh Muamalat</i>	An Examination of The Fundamental Principles
5.	Profit and Risk-Sharing Approach.	It is important to acknowledge that Islamic finance places a great emphasis on conducting a business on the basis of profit and risk-sharing model. Based on this business model, there will be a provider of capital, or a supplier of financial capital, who will be regarded as investors, and not creditors, to which the business' risks, and return of profits, are shared by an entrepreneur, and the provider of financial capital. The extent to which the sharing equation is approached, and divided, will depend on the types of business models, being adopted in a particular business activity. But the essence of treating the money as the actual capital is seen to be further complemented by the necessity to share the risks and profits, by an entrepreneur, carrying out the business, and the financial capital provider. This avoids passing the risks only to one party, to bear the losses.
6.	Sanctity of the contract through upholding that the terms of the contract are sacred.	Although this is not mutually exclusive to the conventional finance, sanctity of the contract is also ordained in the <i>Quran</i> . Fulfilment of trust and confidence ( <i>amanah</i> ) should be upheld as a matter of contractual obligation so as to reduce the risk of information asymmetry <sup>166</sup> and moral hazard so as to avoid unnecessary and irresponsible financial default.

Against this backdrop of understanding the basic *Sharīah* principles underpinning Islamic finance, this study turns its critical examination on the roles and functions played by international institutions that promulgate Islamic finance. This study examines two categories of the said institutions i.e. the 'dedicated institutions' for Islamic finance and the 'non-dedicated institutions' for Islamic finance. As banking and finance operate on a global scale, various institutions have emerged to promulgate Islamic banking and finance. The list of these institutions is not exhaustive. There are many institutions operating in various jurisdictions and

<sup>166</sup> George Akerloff, 'The Market for 'Lemons': Qualitative Uncertainty and the Market Mechanism,' (1970) 48 (52) *Quarterly Journal of Economics* 488-500.

sectors that promulgate either the *de jure* or the *de facto* Islamic finance standards, principles, rulings, and guidelines. For the purposes of this study, the dedicated and the non-dedicated institutions for Islamic finance are examined as the foregoing.

## 2.2. Dedicated Institutions for Islamic Finance

The dedicated institutions for Islamic finance consist of those institutions that are particularly focused and dedicated to undertake the works of promulgating and disseminating standards, principles, and guidelines for Islamic finance, and they are examined as follows.

### 2.2.1. International Financial Services Board (IFSB)

The establishment of IFSB on 3<sup>rd</sup> November 2002 through the signing of articles of agreement is the result of the culmination of endeavours, and an extensive two-year consultative process, spearheaded by a team of governors and monetary authorities of several Islamic countries as well as combined efforts by the Islamic Development Bank (IDB), the AAOIFI, and the IMF.<sup>167</sup> Located in Kuala Lumpur Malaysia, and comprised the association of central banks, monetary authorities, and other institutions, the establishment of the IFSB is aimed at disseminating, promoting, and harmonising international best practices in the supervision and regulation of the IFSI.<sup>168</sup> As at April 2019, the IFSB consists of 182 members, comprising 79 regulatory and supervisory authorities, 8 international inter-governmental organisations, and 95 market players (financial institutions, professional firms, industry associations and stock exchanges) operating in 57 jurisdictions. The objectives of IFSB are as follows:<sup>169</sup>

- (i) To promote the development of a prudent and transparent IFSI through introducing new or adapting existing international standards consistent with *Shari'ah* and recommending these for adoption by IFIs;
- (ii) To provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and to develop for the IFSI the criteria for identifying, measuring, managing, and disclosing

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<sup>167</sup> IFSB <<http://www.ifsb.org/>> accessed on 15 March 2017.

<sup>168</sup> Ibid.

<sup>169</sup> Ibid.

risks, taking into account international standards, for valuation, income, and expense calculation, and disclosure;

- (iii) To liaise and cooperate with relevant organisations currently setting standards for the stability and the soundness of the international monetary and financial systems, and those of the member countries;
- (iv) To enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management;
- (v) To encourage cooperation amongst member countries in developing the IFSI;
- (vi) To facilitate training and personnel development in skills in areas relevant to the effective regulation of the IFSI and related markets;
- (vii) To undertake research into, and publish studies and surveys on the IFSI; and
- (viii) To establish a database of Islamic banks, and IFSI's experts.

The dissemination of these standards and core principles are done in accordance with the *Shari'ah* to which the member countries will consider for their voluntary adoption in their respective domestic banking framework. Further, the IFSB is also involved in the process of promoting good practices in risk management in IFSI through various avenues of research, technical assistance, and training. This international role played by the IFSB denotes itself as an important international institution for liaising, co-operating, co-ordinating, and collaborating with other standard-setting organisations that oversee the financial and monetary stability.<sup>170</sup> The IFSB's roles are further examined in Chapter Five in the context of its international law making process through the promulgation of various IFSB's published standards, guidance notes, and technical notes.

### **2.2.2. International Islamic Financial Market (IIFM)**

Established through the signing of an agreement with the Governments of Malaysia, Sudan, Indonesia, and the IDB, the IIFM was created and set up in Bahrain to deal with various product development issues that are to be *Shari'ah*-compliant.<sup>171</sup> Founded by the collective efforts of Central Bank of Bahrain, Bank

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<sup>170</sup> Ibid.

<sup>171</sup> IIFM<<http://www.iifm.net/>>accessed on 15 March 2017.

Indonesia, Central Bank of Sudan, Labuan Financial Services Authority (Malaysia), IDB and Ministry of Finance of Brunei, the IIFM is supported by its permanent members i.e. Dubai International Financial Centre Authority and Bank of Pakistan. The central banks, government agencies and leading financial institutions as its members further reinforce the stature of IIFM. The IIFM's roles include, among others, creating financial instruments and maintaining a dynamic market for approximately 200 Islamic banks and financial institutions, internationally.<sup>172</sup> The IIFM has its own *Sharī'ah* Committee whose duty is mainly to examine various structures of financial instruments, and carry out the necessary endorsement for the purposes of *Sharī'ah*-compliance,<sup>173</sup> which is vital for IFSI and IFIs. The IIFM strives to unify the Islamic capital and money market sectors, and standardise documentation, products, and related processes. The IIFM has developed the IIFM Agreement for Treasury Placement (MATP), and the ISDA/IIFM *Tahawwut* Master Agreement (TMA), which are considered a breakthrough in Islamic finance and risk management mechanism as these agreements are meant for privately negotiated Islamic hedging products.<sup>174</sup> This development is further examined in Chapter Five.

### **2.2.3. The Accounting and Auditing Organisation for IFIs (AAOIFI)**

Established in line with the Agreement of Association that was signed by IFIs on 26<sup>th</sup> February 1990 in Algiers, the AAOIFI has now emerged to become an autonomous non-profit making corporate body that is internationally and Islamically-oriented, having the roles in the preparation for accounting, auditing, ethics, governance and promulgation of *Sharī'ah* standards of that regard for the adoption by IFIs.<sup>175</sup> Registered in the State of Bahrain on 27<sup>th</sup> March 1991, the AAOIFI consists of founding members,<sup>176</sup> associate members,<sup>177</sup> members representing regulatory and supervisory authorities,<sup>178</sup> and observer members.<sup>179</sup> The main

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<sup>172</sup> Ibid.

<sup>173</sup> Ibid.

<sup>174</sup> Ibid.

<sup>175</sup> AAOIFI <<http://aaoifi.com/about-aaoifi/?lang=en>> accessed on 15 March 2017. Founding members consist of financial institutions that are signatories to the Agreement establishing the AAOIFI in 1989 such as the IDB, Dallah Al-Baraka, Faysal Group (Dar Al-Maal Al-Islami), Kuwait Finance House, and Al Rajhi banking & Investment Corporation.

<sup>176</sup> Ibid. Associate members consist of Islamic financial institutions and companies that adhere to *Sharī'ah* principles and rules, such as also the Islamic *Fiqh* academies and institutions, having corporate entities.

<sup>177</sup> Ibid.

<sup>178</sup> Ibid.

objectives of the establishment of the AAOIFI are aimed to cater for the growth and development of IFSI and these include among others:

- (i) To develop accounting and auditing thoughts relevant to Islamic financial institutions;
- (ii) To disseminate accounting and auditing thoughts relevant to IFIs and its applications through training, seminars, publications of periodical newsletters, undertaking and commissioning of research and other means;
- (iii) To prepare, promulgate, and interpret accounting and auditing standards for IFIs; and
- (iv) To review and amend accounting and auditing standards for IFIs.

The AAOFI also improves the uniformity and quality of auditing and governance practices, undertakes the harmonisation of the accounting policies and procedures, and sets and disseminates accounting, auditing, governance and ethical standpoints that take into account the international standards and practices that comply with the *Shari'ah*, and promotes good ethical principles that are related to IFIs.<sup>180</sup> The AAOFI prepares, develops and promulgates Financial Accounting Standards and *Shari'ah* Standards, and their relevant exposure drafts through a system of due process that includes consultations with industry practitioners. The AAOFI also publishes books on Islamic banking finance, and amongst the standards publications are the *Shari'ah* Standards 2010 and *Accounting, and Governance Standards 2010*. The AAOFI's roles are further analysed in Chapter Five, under the critical examination of the international law making process through the promulgation of AAOFI's standards, and Malaysia's domestic practice towards the AAOFI's standards vis-à-vis the internationally accepted accounting standards.

#### **2.2.4. International Islamic Development Bank (IDB)**

Established pursuant to the Declaration of Intent issued by the Conference of Ministers of Muslim Countries in Jeddah in December 1973, the IDB held its inaugural meeting for its Board of Governors in July 1975, and it was formally opened on 20<sup>th</sup> October 1975.<sup>181</sup> Being known as an international Islamic financial

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<sup>179</sup> Ibid.

<sup>180</sup> Ibid.

<sup>181</sup> IDB<<http://www.isdb-pilot.org/>> accessed 15 March 2017

institution, the IDB aims to foster economic and social development of its member countries, and Muslim communities. *Sharī'ah* considerations in pursuance of these efforts are taken into account.<sup>182</sup> Besides the participation in equity capital and the grant of loans for projects and enterprises, the IDB has been actively involved in the provision of financial assistance to its member countries, including the setting up of trust funds, and being authorised to accept deposits, and mobilise financial resources through *Sharī'ah*-compliant avenues. Additionally, the IDB provides technical assistance and training facilities for the purposes of advancement of social and economic well-being activities in the Muslim countries with due regard to various *Sharī'ah*-compatibility initiatives.<sup>183</sup>

### **2.2.5. International Association of Islamic Banks (IAIB)**

Established as an association of banks and financial institutions, the IAIB based in Jeddah was founded on 21<sup>st</sup> August 1977, and operates on the basis of profit and loss sharing (PLS) endeavour.<sup>184</sup> In its efforts to solidify the links among IAIB Member institutions, the IAIB will ensure that its loans operations and other transactions are in observance with the *Sharī'ah*.<sup>185</sup> Besides maintaining a database of differing IFIs, and undertaking research on Islamic finance, the IAIB also mediates and provides arbitrator services on issues arising between and among Islamic Banks.<sup>186</sup> The IAIB represents the common interests of Islamic banks, provides advice in respect of studies undertaken relating to Islamic banks, establishes foundations for cooperation, coordination and sharing of experience among Islamic banks, and undertakes to follow up procedures for establishing Islamic banks at the local and international levels.<sup>187</sup> Comprising four main constituents such as the General Assembly, the Supreme Religions Supervisory Body, the Board of Directors, and the Secretariat General, the IAIB has its membership opens to Islamic banks and financial institutions whose memorandum and articles of association require adherence to the *Sharī'ah*.<sup>188</sup>

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<sup>182</sup> Ibid.

<sup>183</sup> Ibid.

<sup>184</sup> IAIB<<http://www.saudinf.com/main/k311.htm>>accessed 15 March 2017

<sup>185</sup> Ibid. Technical assistance is also provided to the member institutions in the endeavour to develop methods of operation to optimize benefits to shareholders and clients.

<sup>186</sup> Ibid.

<sup>187</sup> Ibid.

<sup>188</sup> Ibid.

### **2.2.6. Islamic Corporation for the Development of the Private Sector (ICD)**

The ICD, being an independent international multilateral financial institution was established during its 24<sup>th</sup> Annual Meeting on 2-3 November in Jeddah and approved by the IDB Board of Governors.<sup>189</sup> The creation of ICD is intended for the development of its member countries where investment and provision of financial services are given to private-sector entities. The ICD serves to provide financial products and services that are in compliance with the *Shari'ah*, broaden access to Islamic capital market (ICM) by private companies in IDB member countries, and avail the private sector with opportunities, including mobilising funds for private sector investments and boosting various privatisation and corporate restructuring programs by encouraging the development of the ICM and direct financing of projects or companies.<sup>190</sup> Equity and term financing are given to commercially viable projects and companies as well as those projects that are impactful, such as technology, telecommunications, power, water and sanitation, healthcare, pharmaceutical and industrial sectors, and greenfield investments.<sup>191</sup>

### **2.2.7. International Islamic Rating Agency (IIRA)**

Registered in Bahrain and established with an objective to support banks and mutual funds that are in compliance with the *Shari'ah*, IIRA is a rating agency that will help the industry entities penetrate the international market.<sup>192</sup> Besides providing an independent assessment of compliance by entities or financial products that should be in accord with the *Shari'ah*, IIRA also undertakes research, analysis, rating of the obligations, dues, commitments, and other securities.<sup>193</sup> Through the dissemination of information regarding credit quality of the issuer, IIRA aims to find its niche in making an objective assessment or judgment in rating various range of *Shari'ah*-compliant products.<sup>194</sup> IIRA's roles are further analysed in Chapter Five, under a critical examination of the international law making process through the methodological process and issuance of IIRA's ratings for IFSI.

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<sup>189</sup> ICD < <http://www.icd-ps.org/> > accessed 15 March 2017.

<sup>190</sup> Ibid.

<sup>191</sup> Ibid.

<sup>192</sup> IIRA < <http://iirating.com/Home.aspx> > accessed 15 March 2017.

<sup>193</sup> Ibid.

<sup>194</sup> Ibid.

### 2.2.8. The Dow Jones Islamic Market Indexes (DJMI)

The DJMI is concerned with the investment and businesses that should be compatible with the *Sharī'ah*, particularly stocks in corporate entities that are to be regarded suitable and compatible for Islamic investing.<sup>195</sup> This *Sharī'ah*-compatibility paradigm has produced Islamic investment guidelines, outlining several indexes that track what is considered as *Sharī'ah*-compliant stocks all around the world so that investors would have a holistic apparatus for the purposes of *Sharī'ah*-compliant investing.<sup>196</sup> It is commonly acknowledged that incompatible *Sharī'ah* investing includes, the prohibition of investment in alcohol, pork-related products, entertainment such as casinos, gambling, and certain conventional financial services, to which the business line runs in contravention with the *Sharī'ah*. Through the establishment of the *Sharī'ah* Board of Islamic scholars to give advice to indexes that are of *Sharī'ah*-compliant, all securities selected for the DJMI will be ensured to adhere to the *Sharī'ah*.<sup>197</sup> The roles of the DJMI are further examined in Chapter Five in the context of international law-making process through the issuance of *Sharī'ah*-compliant indexes.

### 2.2.9. The International Islamic *Fiqh* Academy of Fatwa of the OIC

Pursuant to a resolution adopted by The Third Islamic Summit Conference of the OIC in Mecca, Saudi Arabia in 1981, the International Islamic *Fiqh* Academy of *Fatwa* (the *Fiqh* Academy) was established in 1983 in Jeddah with an objective to focus on various jurisprudential issues relating to the Muslims' community, including Islamic banking and finance.<sup>198</sup> Since its inception, the *Fiqh* Academy has passed several resolutions relevant to Islamic finance.<sup>199</sup> The roles of the *Fiqh* Academy are further analysed in Chapter Five, which identifies and examines the issuance of various resolutions and *fatwas* for IFIs and IFSI.

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<sup>195</sup> DJMI < <http://www.djindexes.com/islamicmarket/> > accessed 15 March 2017.

<sup>196</sup> Ibid.

<sup>197</sup> Ibid.

<sup>198</sup> Islamic *Fiqh* Academy of *Fatwa*,

<<https://www.revolv.com/main/index.php?s=International%20Islamic%20Fiqh%20Academy,%20Jeddah>> accessed 15 March 2017

<sup>199</sup> Ibid.

### **2.2.10. The General Council for Islamic Banks and Financial Institutions (CIBAFI)**

Established in 2001, CIBAFI is an international organisation that is also affiliated with the Organisation of Islamic Cooperation with the headquarter based in Bahrain.<sup>200</sup> The CIBAFI has 120 members over 30 jurisdictions, composing market players, industry associations, and international inter-governmental organisations and professional firms.<sup>201</sup> With a mission to support IFSI by becoming the leading industry voice in advocating regulatory, financial, and economic policies, CIBAFI fosters the development of IFSI and sound industry practice. To date, CIBAFI is recognised as a key institution in the international architecture of Islamic finance.<sup>202</sup> Representing IFSI globally, CIBAFI is steered by its strategic objectives,<sup>203</sup> which are as follows:

- (i) Policy and Regulatory Advocacy;
- (ii) Research and Publications;
- (iii) Awareness and information sharing; and
- (iv) Professional Development.

### **2.2.11. The Liquidity Management Centre (LMC)**

Based in Bahrain, the LMC was instituted as an Islamic Investment Bank, incorporated in July 2002. The LMC is regulated by the Central Bank of Bahrain. Aiming to provide an optimal Islamic financing and investment solutions, the LMC has developed short-and medium-term financial instruments for Islamic banks to use for the purposes of managing their liquidity risks.<sup>204</sup> Currently, the authorised capital of the LMC stands at US\$200 million and a paid-up capital of US\$53.550 million. The LMC has forged a close relationship with its shareholders, namely the Bahrain Islamic Bank, Dubai Islamic Bank, Islamic Development Bank, and Kuwait Finance House Capital Investment Company. The LMC has been facilitating IFIs to manage their liquidity mismatch through the short-and medium term liquid investments that are structured to be *Shari'ah*-compliant. Notwithstanding this development, the

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<sup>200</sup> CIBAFI <[https://www.sri-connect.com/index.php?option=com\\_comprofiler&task=userProfile&user=1076559&Itemid=4](https://www.sri-connect.com/index.php?option=com_comprofiler&task=userProfile&user=1076559&Itemid=4)> accessed 15 March 2017.

<sup>201</sup> Ibid.

<sup>202</sup> Ibid.

<sup>203</sup> Ibid.

<sup>204</sup> LMC<<https://www.lmcbahrain.com/>>accessible 23 July 2017.

international framework for Islamic finance and the growing IFSI are seen to be constrained by the small-scale operation of the LMC which is focused on the Gulf-Cooperation Council (GCC) region, and limited to the Bahraini banking sector.<sup>205</sup>

### **2.2.12. International Islamic Liquidity Management Corporation (IILMC)**

The establishment of the IILMC on 25<sup>th</sup> October 2010 in Kuala Lumpur Malaysia was pursuant to the IILMC Act 2011 [Act 721], and its Articles of Agreement.<sup>206</sup> The IILMC has enabled *sukuk* to be traded in the international financial markets, and where its liquidity management purpose is concerned, the IILMC can be sourced globally by any Islamic banks and IFIs. As an international organisation, the IILMC has been established by the central banks, monetary authorities, and multilateral organisations to create and issue *Shari'ah*-compliant financial instruments to facilitate cross-border Islamic liquidity management.<sup>207</sup> The IILMC *sukuk* complements the intermediate and long-term *sukuk* currently available in the market. The IILMC comprises the shareholders from the central banks of Malaysia, Indonesia, Kuwait, Luxembourg, Mauritius, Nigeria, Qatar, Turkey, the UAE, and ICD. The IILMC's inaugural *sukuk* which stood at US\$590million and rated A-1 by Standard & Poor's Rating Services were issued at a tenor of 3 months and fully subscribed.

### **2.3. Non-Dedicated Institutions for Islamic Finance**

The non-dedicated institutions for Islamic finance consist of those institutions that are institutionally engaged in their endeavours to focus, deliberate, co-ordinate, and co-operate with the dedicated institutions for Islamic finance to undertake various initiatives and works of disseminating standards, principles, guidelines, and working papers on Islamic finance. These non-dedicated institutions for Islamic finance are key international institutions that have been demonstrating great efforts to promulgate Islamic finance, and further develop the international framework for Islamic finance, particularly in terms of their engagement with various initiatives on *Shari'ah*-compliant requirements for financial products' issuance and development.

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<sup>205</sup> Ibid.

<sup>206</sup> IILMC <<http://www.iilm.com/>> accessible on 23 July 2017.

<sup>207</sup> Ibid.

### 2.3.1 The World Gold Council

With an objective to stimulate and sustain the demand for gold, the World Gold Council is the market development organisation for the gold industry, and has today become the global authority on the gold market.<sup>208</sup> The World Gold Council which is based in the UK has close association with members ranging from the world's leading gold mining companies, with operations in India, the Far East, and the US. In Islamic financial transactions, there are six items that are used for exchange in kind and measured equally, by weight and measure literally, i.e. gold, silver, dates, wheat, salt, and barley.<sup>209</sup> The transfer of possession occurs immediately (*qabdh*), in order to prevent an unequal exchange in terms of measures and weights which may risk *riba* in trade (*riba al-fadhl*).<sup>210</sup> If the immediate transfer of possession occurs in conformity with the fulfilment of measures and weights, the transaction will be considered *Sharī'ah*-compliant.<sup>211</sup>

The growing importance of IFSI in terms of scale and market size has called for a collaboration between the World Gold Council, the AAOIFI, and Amanie Advisors<sup>212</sup> to develop a *Sharī'ah* Standard on Gold. The standard, known as '*Sharī'ah* Standard No.57 on Gold and its Trading Controls (Standard No.57)', deals with the *Shari'ah* rulings and parameters for gold transactions, and gold-based financial products. This paves the way for greater understanding of the *Sharī'ah* perspectives on the usage of gold in financial and investment transactions for IFSI.<sup>213</sup> Standard No.57 was developed in pursuance of the usual AAOIFI process, including the consultation and public hearing, and it was finalised at the AAOIFI *Sharī'ah* Board meeting on 17-19 November 2016.<sup>214</sup>

With an aim to increase transparency and harmonisation regarding the use of gold in market practices, specific rules are prescribed for the use of gold as an

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<sup>208</sup> The World Gold Council < <http://www.gold.org/>> accessed 15 March 2017.

<sup>209</sup> Ibid.

<sup>210</sup> Ibid.

<sup>211</sup> Ibid.

<sup>212</sup> Amanie Advisors, <<https://amanieadvisors.com/>> accessible 15 March 2017. Amanie Advisors is a *Sharī'ah* advisory firm based in Malaysia, specialising in Islamic finance solutions, covering a wide range of services, including *Shari'ah* advisory and consultancy, training and research, and development for institutional and corporate clientele, focusing on Islamic financial services. Guided by its international *Shari'ah* Supervisory Board, Amanie Advisors provides end-to-end *Shari'ah* solutions to the client through its global offices.

<sup>213</sup> The World Gold Council (n 208).

<sup>214</sup> Ibid.

investment in IFSI since there have been no such rules before.<sup>215</sup> Standard No.57 elucidates, provided that all the relevant *Shari'ah* rulings are satisfied such as the possession and a proper calculation of *zakat* (Islamic alms giving), the investment in gold is permissible under the *Shari'ah*.

### 2.3.2. The BCBS

For the purposes of the international framework for Islamic finance, the BCBS is an associate member of the IFSB. The BCBS has been supporting the IFSB's initiatives since its operations in 2003, including various outreach efforts to non-members with an aim to promote development of sound supervisory practices.<sup>216</sup> Through the participation in IFSB's working groups, such as the capital adequacy group, the BCBS and the IFSB have strengthened their cooperation to address Islamic finance issues vis-à-vis the conventional banking issues. *Shari'ah* principles are deliberated, such as on the risk management practices, and corporate governance which are pivotal to ensure the safety and soundness of the international banking system.

Through the Basel III framework, stronger and more effective risk management has been improved, including enhancing the risk sensitivity and accuracy of the criteria for assessing banks' capital adequacy.<sup>217</sup> Pursuant to Basel III, the IFSB provides guidance through the issuance of global prudential standards to promote sound supervisory standards and practices globally, and accordingly support resilient financial market infrastructures for IFSI according to safe and sound risk management practices.<sup>218</sup> Although it is still modest in size relative to conventional retail banking, Islamic retail banking is flourishing in the Middle East and the Asia-Pacific regions, where a number of Islamic banks, banking units, and asset managers operate in key international financial centres like the UK and the United States. Although that the IFSB has, in December 2013, issued its IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes), reference was made largely to the BCBS' framework on capital adequacy requirements for banks, with an additional guidance on the *Shari'ah*-compliant

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<sup>215</sup> Ibid.

<sup>216</sup> BCBS < <http://www.bis.org/speeches/sp071210.htm> > accessed on 15 March 2017.

<sup>217</sup> The World Gold Council (n 208).

<sup>218</sup> The World Gold Council, LIBOR and Islamic Finance, (n 208).

requirements, so that the capital adequacy funds are considered purified from the *Shari'ah*-compliant standpoint, although this may at times trigger an extra cost to Islamic banks to comply. Further examination on this aspect is undertaken in Chapter Five with regard to the implementation of Basel III framework on capital adequacy vis-à-vis the IFSB-15, which still takes into account the BCBS' standards.

### 2.3.3. LIBOR and Islamic Finance

In the context of the international framework for Islamic finance, particularly to evaluate the performance of Islamic products in IFSI, LIBOR index has been approved by the *Shari'ah* boards and SSB for its use as a benchmark for Islamic returns.<sup>219</sup> The LIBOR rates, a financial benchmark based on the interbank lending rates is an interest rate-based measurement. Although *riba* (interest) is prohibited by *Shari'ah*, the use of LIBOR rates as benchmark are intended to price the profit mark-up and rental income, and becomes a means of determining the pricing of Islamic financing as well as Islamic investment products.<sup>220</sup> Islamic financing by way of an *ijarah* (Islamic leasing) determines the profit on the basis of the current LIBOR rates, and hence the profit mark-up on the *ijarah* can be equal to LIBOR rates, or some percentage above the LIBOR rates, and likewise, the rental income for an *ijarah* agreement is based on the LIBOR rates.<sup>221</sup> If an *ijarah* transaction fulfils the conditions of Islamic transactions, the use of the interest rate is considered to be a benchmark for determining the mark-up. This is also known as the cost of fund. Thus, up till now, the use of LIBOR rates<sup>222</sup> are considered as a viable option to evaluate the rates of return on financing until a standard Islamic alternative that satisfies the *Shari'ah* ban on interest is developed, and become available for IFSI. Be that as it may, this study further notes that in the future, LIBOR may cease to operate, and it is unknown what will replace LIBOR, as a new benchmarking system for global banking and finance.

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<sup>219</sup> Sh. Yusuf DeLorenzo, 'The Use of LIBOR By Islamic Banks' (2009) 1 *Opalogue Islamic Finance Intelligence* 2-27.

<sup>220</sup> *Ibid.*

<sup>221</sup> *Ibid.*

<sup>222</sup> Aldohni (n 140). Aldohni underscored that, "the significance of LIBOR stems from a number of facts. First, it sets the borrowing rate for 10 currencies and 15 maturities. Second, it is used as a reference rate of a wide range of financial instruments. Third, the LIBOR is also used as a benchmark rate, which indicates the overall financial health of the market and relatively measures performance, with regard to investment return and funding cost. In addition to these factors, there is one last crucial element, that is, the virtue of trust, and how it is embedded in the very concept of the LIBOR."

### 2.3.4 IMF

In so far as the international framework for Islamic finance is concerned, the IMF has played a key role in the establishment of the IFSB as the IMF recognises the long-term effects of Islamic finance in the global banking and financial regulation, including the implications on the macroeconomic and financial stability of Islamic banks.<sup>223</sup> The recent demand for Islamic finance has called for the IMF to form an Interdepartmental Working Group (IDWGIF) that has an institutional overview on the development of Islamic finance and the current discussion on the regulation, supervision, and scope of Islamic finance and IFSI, in light of its potential and contribution to the global financial system.<sup>224</sup> On 9<sup>th</sup> October 2014, in Washington, D.C, the IDWGIF held its first meeting with its External Advisory Group (EAG) to discuss issues related to Islamic banking and the development of *sukuk* markets. The EAG identified policy challenges facing IFSI, and facilitated coordination with international institutions involved in developing standards for IFSI.<sup>225</sup> The IDWGIF and the EAG also discussed the implications of Basel III requirements for capital adequacy and liquidity requirements on IFIs, *Shari'ah*-compliance requirements, and corporate governance.<sup>226</sup>

### 2.3.5. The World Bank

In line with the World Bank's works and efforts on poverty alleviation and increasing access to finance, the Islamic finance focus under the World Bank is related to these endeavours.<sup>227</sup> By augmenting the use of *Shari'ah*-compliant approaches of financing in the World Bank Group's operations, three areas become the key focus, i.e.:

- (i) Sustainable development of Islamic finance for economic growth and poverty alleviation, given the use of PLS arrangements, and the emphasis on tangible assets that serve a real purpose, and discourages financial speculation;<sup>228</sup>

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<sup>223</sup> IMF < <http://www.imf.org/external/themes/islamicfinance/> > accessed 15 March 2017.

<sup>224</sup> Ibid.

<sup>225</sup> IMF < <http://www.imf.org/external/themes/islamicfinance/> > accessed 15 March 2017.

<sup>226</sup> Ibid.

<sup>227</sup> The World Bank < <http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance> > accessed 15 March 2017.

<sup>228</sup> Ibid.

- (ii) Promotion of financial sector development and financial inclusion, through an emphasis on partnership-style financing and expansion of the range and reach of financial products which help improve access to finance for the poor and small businesses,<sup>229</sup> and
- (iii) Strengthening financial stability, whereby efforts are geared towards protecting Islamic finance institutions and IFSI through avoidance of speculative financial products and excessive leverage. Through the risk-sharing principles, *Shari'ah*-compliant financing instruments are developed and used. Returns are tied to an asset, or risk-taking in a joint enterprise which dilutes the potential risk of a pure debt security vis-à-vis an asset-linked security in Islamic finance. This is as a result of the implications of banning interests where a pure debt security is indirectly prohibited.<sup>230</sup>

The World Bank Group is also engaged in assisting governments to formulate *Shari'ah*-compliant financing frameworks for small and medium scale enterprises.<sup>231</sup> In July 2015, a Memorandum of Understanding was signed between the World Bank and the CIBAFI to help foster the development of Islamic finance globally, including in non-Muslim countries.<sup>232</sup>

#### **2.4. Other Institutions, Centres, Actors, and Forum on Islamic Finance**

Other institutions, centres, actors, and forum that promulgate Islamic finance and contribute towards the international framework for Islamic finance encompass, the World Islamic Economic Forum (WIEF), the World Islamic Banking Conference (WIBC) organised by the Middle East Global Advisors, the Amanie Global Advisors, the UKIFC, various higher learning institutions such as Durham University, International Islamic University Malaysia (IIUM), IIUM Global *Waqf* Centre, Harvard Islamic Finance Project, Cambridge Islamic Finance Leadership Programme (CIFLP), Oxford Centre for Islamic Studies, the International *Shari'ah* Research Academy for Islamic Finance (ISRA), the International Centre for Education in

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<sup>229</sup> Ibid.

<sup>230</sup> Ibid.

<sup>231</sup> Ibid.

<sup>232</sup> The World Bank <<http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>> accessed 15 March 2017

Islamic Finance (INCEIF), and various training centres and chartered institutes like the Chartered Bankers' Institute, the Chartered Institute of Islamic Finance Professionals (CIIFP) Malaysia, Asian Banking School (ABS), Asian Institute of Chartered Bankers (AICB), Dubai International Financial Centre (DIFC), and state actors and non-state actors such as, Islamic finance practitioners and publishers, encompassing the Islamic Finance News (IFN), Thomson-Reuters on Islamic finance, as well as non-governmental organisations (NGOs), industry experts, scholars, corporations, investment banks, etc.

## 2.5. Mapping the international Framework for Islamic Finance

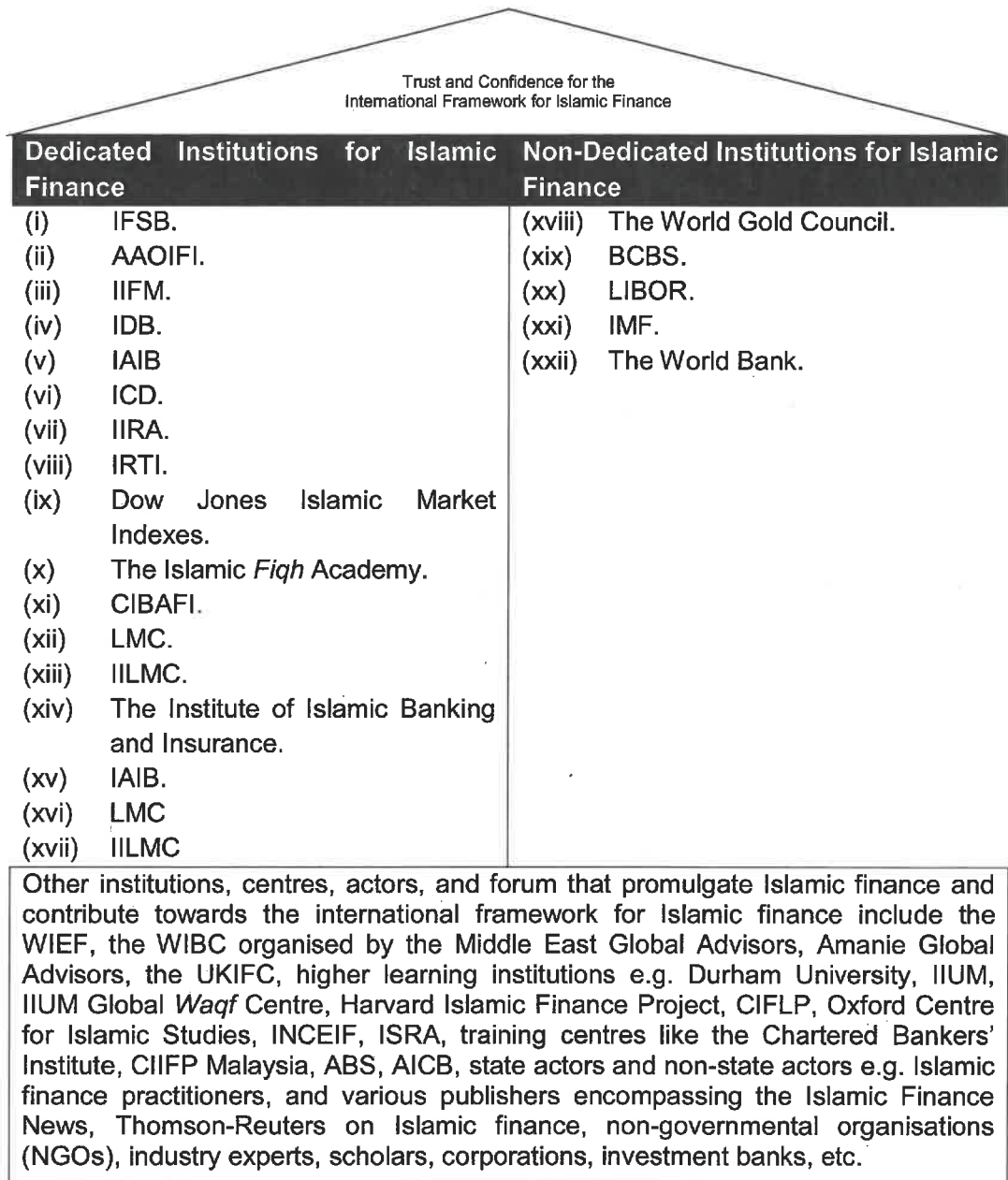
In light of the preceding examination on the international institutions that are categorised as the dedicated and the non-dedicated institutions for Islamic finance, **Figure C** maps out the international framework for Islamic finance.<sup>233</sup> **Figure C** can be used to examine the interactive relationship that has been fostered in the international framework for Islamic finance. The way the non-dedicated institutions map onto the non-dedicated institutions for Islamic finance is examined in this study to be a harmonious co-existence side-by-side. Thus, Islamic banking system operates alongside the conventional banking system, and both the dedicated and non-dedicated institutions take guidance from each other with regard to the promulgation, issuance, and dissemination of various standards, guidelines, and principles in relation to Islamic finance, particularly those that pertain to *Shari'ah*-compliant discourse, rulings, technical industry guidance, and mechanism.

Thus, although the dedicated institutions for Islamic finance are specifically focused on Islamic finance, the reality is that, the Islamic banking and finance ecosystem still largely follows and/or mimics the conventional banking system, except for the *Shari'ah*-compliant requirements, and this includes the adoption and incorporation of certain best practices, standards, and benchmarks as set out by the non-dedicated institutions for Islamic finance, such as LIBOR, IMF, World Bank, BCBS, and the World Gold Council.

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<sup>233</sup> This is author's own construction of a diagram to map out and examine the international framework for Islamic finance. For the purposes of further analytical examination of the international framework for Islamic finance, **Figure D** and **Figure E** are developed in this study, as appended in Appendix I.

**Figure C**



Based on **Figure C**, it is underscored that, the way the non-dedicated institutions map onto the non-dedicated institutions for Islamic finance is examined in this study to be a harmonious co-existence, operating side-by-side. Yet, although the dedicated institutions on Islamic finance have also stepped onto the map of the international framework of global finance, developing its interactive global governance structure that is also modelled by the conventional banking system, it is examined that, the conventional framework of finance still claims the lion's share of

the operational aspect of the global financial framework and regulatory regime.<sup>234</sup> In light of these dynamics, the two international frameworks, as they both currently exist, showcase that predominantly, the conventional framework is leading in terms of shaping international rules, standards, guidelines, principles, and soft-law instruments, to which the international framework for Islamic finance resorts to, as and where appropriate, although not holistically, due to the need to devise a *Sharī'ah*-compliant framework to operationalise the modern Islamic banking and finance,<sup>235</sup> and this includes the need to factor the issue of cost that will be incurred in any Islamic finance transactions or deals. Nonetheless, on a more integrated and conjunctive outlook of the international framework for Islamic finance, it does not suggest that the framework operates disjointedly from that of the conventional finance framework.<sup>236</sup> The only delineation between the conventional framework of banking and finance vis-à-vis Islamic finance is the application of *Sharī'ah*-compliance requirements by IFIs for the purposes of legitimising Islamic banking products, such as *musyarakah*, *murabahah*, *ijarah*, etc. in accordance with the *Sharī'ah*.<sup>237</sup> This includes placing the trust and confidence in the international framework for Islamic finance to operate and co-exist side-by-side with the conventional banking system. But more trust is entailed for Islamic finance to satisfy the *Sharī'ah*-compliant requirements, which primarily source their references from the *Quranic* worldview, *Hadiths/Sunnahs* and *Usul Fiqh* (Islamic jurisprudence and methodologies). Hence, the interactions between these two systems are becoming more interoperable due to the demand for Islamic financial products and related cross-border inter-bank activities, whilst the conventional banking system steadily adopts Islamic banking windows that require *Sharī'ah*-compliant framework and mechanism to be developed and operationalised.

Whilst trust and confidence characteristics constitute the overarching archetype for the international framework of Islamic finance, the relationships that exist and operate within the architectural paradigm of **Figure C** are further examined critically in Chapter Three, which analyses the philosophical foundation for the international framework of Islamic finance. In Chapter Three, **Figure D** and **Figure E** (as enclosed in Appendix I) will further expound and examine the foundation of trust

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<sup>234</sup> Davies and Green, *Global Financial Regulation, The Essential Guide* (n 36) 32-154.

<sup>235</sup> See further discussion and examination in Chapters Three, Four, and Five.

<sup>236</sup> Siddiqi, *Banking Without Interest* (n 38) 19-37.

<sup>237</sup> Alfred Kammer, Mohamed Norat, Marco Pinon, Ananthakrishnan Prasad, Christopher Towe, Zeine Zeidane, and IMF Staff Team, 'Islamic Finance: Opportunities, Challenges, And Policy Options' (2015) Staff Discussion Notes No. 15/5 <<https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf>>, accessed 15 March 2017.

and confidence from the analytical tool of 'meta-dependence' and 'meta-non-dependence' trust and confidence analysis, as espoused and enshrined by the *Quranic* worldview for the international framework for Islamic finance.

## 2.6. Conclusion

In light of the interdependent framework of international banking and finance, the study has examined and recognised that both the dedicated and the non-dedicated international institutions closely coordinate in mutual collaborative synergies to address various banking issues, including varying challenges facing Islamic finance and the global financial system. The Islamic banking and finance operations therefore cannot be examined solely in its *de jure* framework as it also mimics, follows, and takes its guidance from the good banking practices, as espoused in the conventional banking framework. In the *de facto* context of the international framework for Islamic finance, the study examines that the non-dedicated institutions have paved various collaborative relationships with the dedicated institutions that promulgate Islamic finance, including heeding serious institutional consideration towards the roles of *Sharī'ah*-compliant requirements for Islamic financing instruments. Thus, the way the non-dedicated institutions map onto the non-dedicated institutions for Islamic finance is examined in this study to be a harmonious co-existence side-by-side. Hence, Islamic banking system operates alongside the conventional banking system, and both the dedicated and non-dedicated institutions take guidance from each other with regard to the promulgation and dissemination of various standards, guidelines, and principles in relation to Islamic finance, particularly those that pertain to *Sharī'ah*-compliant discourses, rulings, guidance, and *Sharī'ah*-compliant mechanism.

Thus, having regard to the universal context of ethical-based financing that is inherent in Islamic banking and finance, the only delineation between the conventional finance and Islamic finance lies in the *Sharī'ah* promulgation, in which the non-dedicated institutions also heed this requirement carefully, when examining Islamic banking and finance issues. These projected synergies require further examination on the key determinants that enhance and/or impede the development of the international framework for Islamic finance. The *Shari'ah* and *Quranic* worldviews are critically examined in Chapter Three to analyse and ascertain their guidance for the international framework for Islamic finance.

## Chapter Three: Philosophical Foundation for the International Framework of Islamic Finance

*“On one thing, I remain gloomily clear. Without **trust** in financial institutions themselves, or those who work in them, or the media who cover them, the next crisis could be far more deadly than the last. Just ask JP Morgan” – John Authers<sup>238</sup>*

### 3.1. Fundamental Philosophy for the International Framework of Finance

As banking and finance become increasingly interconnected, this study identifies that the most important factor that is considered as the key determinant in constituting the philosophical foundation of the international framework for Islamic finance derives its essential promulgation from the core characteristic of basic commerce and mercantilism that was true ever since the collapse of the Bretton Woods system, and it still remains relevant until Bank 4.0 today, and that is ‘trust and confidence’.<sup>239</sup> The trust and confidence characteristics, as espoused in the global financial system, and carried out professionally through the professionalisation of the banking and finance sector,<sup>240</sup> including IFSI, and the trust in the *Shari’ah*-compliant system constitutes the key determinants for the international framework for Islamic finance to be developed, and accordingly for the trajectory course for the conventional banking framework, operating Islamic finance.

As the study investigates these key determinants, the answer which follows from the above-mentioned philosophical underpinning of trust and confidence affirms that Islamic banking and finance has been operationalising, in the *de jure* and the *de facto* contexts based on the characteristics of trust and confidence.<sup>241</sup> In the *de jure* context, Islamic finance has been carried out on the basis of trusting an enabling legal framework, which provides for a professional mechanism of ensuring *Shari’ah*-compliant transactions. In the *de facto* context, Islamic finance has been

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<sup>238</sup> John Authers, ‘In Banking We Trust’ *Financial Times* (London, 6 October 2018) 15-19.

<sup>239</sup> *Ibid.*

<sup>240</sup> Carney (n 66).

<sup>241</sup> Adam Ng., Mansor H. Ibrahim, Abbas Mirakhor, ‘Does Trust Contribute to Stock Development?’ (2016) 52 *Economic Modelling* 239-250. Ng and Mirakhor concluded that, “trust is a robust and positive determinant of stock market depth and liquidity, and that trust is the most relevant component of social capital in market development. Macroeconomic instability in the form of inflationary changes has a dampening effect on trust in the trading of stock. Further, social capital and its components, particularly trust, are more relevant to stock market development in countries with weak rule of law, non-OECD and OIC countries that are generally characterised by lower formal institutional quality.”

espoused to gain broader acceptance through various Islamic financial products that are created and reduced in the form of a restructured *Shari'ah*-compliant contract. The contract is restructured in such a manner that does not explicitly attract *riba* (interest), but the form in which such a contract is restructured would attract a profit.<sup>242</sup> This is referred to as BFR or a BR, depending on the jurisdictional usage of the terms.<sup>243</sup> Hence, the trust and confidence in the *Shari'ah*-compliant system constitute the key determinant for the international framework for Islamic finance to be developed, as well as the professional trust towards IFSI, and the banking sector.

### 3.2. A Critical Examination of the *Quranic* Worldview of Islamic Finance

As the characteristics of trust and confidence are necessitated for the conventional finance, the case is likewise similar for Islamic finance. The latter contemporary operational context is modelled largely from the already established conventional banking and finance model.<sup>244</sup> In this regard, the trust and confidence characteristics are enshrined in verse 275 of *Surah Al-Baqarah* of the *Quran*,<sup>245</sup> being the primary source of reference for any types of Islamic banking and finance operations. The essence of the aforementioned verse underscores a permissible ruling towards conducting the affairs of sale and trade (*ba'y*), but the prohibition against imposing an interest (*riba*) rate is absolutely prohibited.<sup>246</sup> In this regard, trade (*ba'y*) is contrasted against interest (*riba*), in a way that trade (*ba'y*) also constitutes a contract of sale, which Islamic finance requires the roles of labour and efforts in the generation of profits, instead of merely exploiting the roles of money to gain more income, or to make a speculation out of it. Thus, money is treated as an actual capital in the trade (*ba'y*) or sale transactions, involving the role of labour, which is contrasted against interest (*riba*), in which the profit gathered thereof is made without any labour, but rather due to an increased amount of repayment due to penalty for delayed repayment of debt, and/or default. The role of labour in the generation of profits exemplifies the stature of Islamic finance to be in stark contrast

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<sup>242</sup> Siddiqi, *Banking Without Interest* (n 38) 19-37. Even if explicitly interest-based transactions were not utilised, the *Fiqh Muamalat* used *hiyal* as 'legal stratagems', designed to achieve purposes fundamentally contrary to the spirit of the *Shari'ah*.

<sup>243</sup> *Ibid.*

<sup>244</sup> Carney (n 66).

<sup>245</sup> *Quran, Surah Al-Baqarah: (2), Verse 275; Quranic translations are referred to The Qur'an (trs) MAS Haleem (2<sup>nd</sup> edn OUP, 2010): "... That is because they say, 'trade is [just] like interest. And Allah has permitted trade and has forbidden interest (riba)..."*

<sup>246</sup> El-Gamal (n 165) 1-19.

against the affairs of interest (*riba*) in the conventional banking system. Thus, whilst the trust and confidence characteristic is not explicitly revealed in the said verse, but the essence in which the conduct of trade is differentiated from the forbidden interest (*riba*) rate signifies that trade is a commercial affair that is based on trust and confidence between and amongst the contracting parties.<sup>247</sup> This would involve a transcription of the terms of sales, the contracts, the covenants, and the provisions on the contracting parties' obligations, the payment schedule, the method of payment, and the legal treatment of debt repayment in the event of default.<sup>248</sup>

In the event of default, the interest (*riba*) is absolutely prohibited to be charged for penalising delayed payment as the argument posits against imposing an additional burden, but rather to ease the shoulder of the borrower to repay the entire sum owed to the lender.<sup>249</sup> The traditional Islamic finance position advocates for the contractual term to be restructured, or re-negotiated in such a manner that will enable the borrower to have a longer period of repayment of debt, so long as the interest (*riba*) is not charged for the said delay in repayment. It is not just about an injustice or repression that the interest (*riba*) could cause. But rather, through a sharp contrast of the permissible ruling of trade (*ba'y*) against interest (*riba*), as enshrined by the *Quranic* worldview of verse 275 of *Surah Al-Baqarah*, trade (*ba'y*), or sale (*bay'*) as a more all-encompassing concept in Islamic finance, it fundamentally requires the essential roles of labour and efforts in the generation of profits, instead of merely exploiting the roles of money to gain more income by extorting an interest (*riba*), and/or to make a speculation out of it. Thus, the trust and confidence elements should be placed on the trade/sale (*bay'*) terms as prescribed in a given contract, which should be able to be invoked as legal protection for both lenders and borrowers, and thereby protecting them against any abuse or exploitation. Further, the role of labour, which is inherent in the character trade (*ba'y*) or sale transactions, is contrasted against interest (*riba*). Accordingly, the contractual method of safeguarding both the lenders' and borrowers' interests is not only relevant in the context formalising a legal relationship, but is commanded by the *Quranic* injunctions which are translated to read as follows:

*"You who believe, fulfil contracts"*<sup>250</sup>

*"You who believe, be faithful to your contracts"*<sup>251</sup>

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<sup>247</sup> Siddiqi, *Banking Without Interest* (n 38) 19-37.

<sup>248</sup> *Quran*, *Surah Al-Baqarah*: (2), Verse 282; "O you who have believed, when you contract a debt for a specified term, write it down..."

<sup>249</sup> Siddiqi, *Banking Without Interest* (n 38) 19-37.

<sup>250</sup> *Quran*, *Surah Al-Maidah*: (2), Verse 1.

*"Fulfil the covenant of God when you have entered into it, and break not your oaths after you have confirmed them"*<sup>252</sup>

Based on the above-mentioned verses, the fulfilment of contractual obligations is enshrined and ordained not only in one verse of the *Quran*, but through the repetitive commandments to honour the trust and confidence fostered between and amongst the contracting parties. It should be acknowledged that trade (*bay*) is trade per se, and it is permissible under the *Shari'ah*, whereas interest (*riba*) is not, in and of itself, a conduct of trade or sale with a labour characteristic, but rather regarded as a penalty of an unjust treatment for a repayment, particularly, in the event of delayed payment.<sup>253</sup> It is not desirable that a delayed payment should be tolerated, but the essence of verse 275 of *Surah Al-Baqarah* and the above-mentioned verses have enshrined that, even before embarking into any kind of trade (*bay*) transactions which necessarily entails a term of contract, particularly formalised into a written form, should first be conscious of the trust and confidence that the contracting parties are made cognisant of, lest the lack thereof should warn the contracting parties to embark into any types of contractual and legal relationships. This includes the role of labour, which is inherent in the character trade (*ba'y*) or sale transactions, and it is contrasted against interest (*riba*) that is devoid of any labour. Without the trust and confidence, a simple sale transaction could not transpire, let alone to do banking, and trade activities, and to operate a global scale of business operations within the international framework for Islamic finance. In one of Prophet Muhammad's famous hadith regarding *riba* (interest), the Prophet Muhammad PBUH was quoted to have said the following:

*"(Exchange) gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt – equal for equal, like for like, hand to hand. He who gives or takes more incurs riba, the giver and the taker are equal (usurers)." Narrated by Muslim and Ahmad.*<sup>254</sup>

In another narration by Muslim, it was added:

*"Should the kinds (of commodities) differ, then exchange as you wish provided that the exchange is hand to hand"*<sup>255</sup>

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<sup>251</sup> *Quran, Surah An-Nisa': (4), Verse 33.*

<sup>252</sup> *Quran, Surah An-Nahl: (16), Verse 91.*

<sup>253</sup> It is to be noted as well that socialist thinkers and reformers like Robert Owen (1858) of Britain, Rodbertus (1875) of Germany had denounced interest, and called for its abolition.

<sup>254</sup> This hadith is narrated by Muslim as reported by Abu Hurairah; Muslim bin Hajjaj, *Sahih Muslim* (Dar al-Fikr, 2003) no 3959 778.

<sup>255</sup> M.Sultana, Syed Alwi, and Hassan, Aznan, *Islamic Derivatives: A Primer Towards Islamic FX Forwards, Profit Rate Swaps And Options* (CERT, 2012) 23.

In the above-mentioned hadith, the six kinds of commodities have been identified, where a violation of *riba* (interest) may be triggered in the event that the exchange of such goods is done in an unequal quality, volume, or weight. The traditional position for the six kinds of commodities that have the potential to carry *riba* (interest)-based transactions is still relevant until today, and it can be examined to be operationalised in the domain of exchange of currencies. The *Sharī'ah* jurists have come to an agreement that the reference to the gold and silver in the said hadith could be broadened in scope to include the currencies of exchange. The words 'hand to hand' gives rise to the connotation that the exchange of interest-based commodities is encouraged to be made on spot, and instantaneously, without any delay, in the time of payment or exchange.

Such a concept is also expounded by the *Hadith*, stressing that 'indeed the *Riba* is in the *nasee'ah* – i.e. because the increase for delay in payment.'<sup>256</sup> This injunction is transposed into the practical realm of Islamic banking and finance operations through the promulgation of AAOIFI's *Sharī'ah* Standard No.1-Trading in Currencies.<sup>257</sup> Its Clause 2 stipulates that, it is allowable to conduct trading in currencies provided that it is done in compliance with a strict set of circumstances, including the condition that both parties must take possession of the counter-values, upon concluding the contract. In another words, a contract of exchanging currencies can only be deemed to be *Sharī'ah*-compliant, if such an exchange is transacted on spot with both currencies being exchanged without any deferment. This is because, any deferment to any one of the counter-values will consequently result in attracting interest-like circumstance, culminating in *Riba An-Nasee'ah*,<sup>258</sup> which is as the result of the increase for delay, and this invalidates the exchange entirely. Whilst this type of exchange is risky as it has the potential to attract *riba* (interest), the traditional *Sharī'ah* position is resorted to, when dealing with any types of Islamic banking transactions that are contractual in nature, but devoid of an uncertainty (*gharar*) element in treating money as the actual capital, and not merely a potential capital.

Therefore, the prohibition against *riba* (interest) is absolute.<sup>259</sup> This explicates the core characteristics of labour inherent trade, sale, and finance for the international framework for Islamic finance to derive its source from the Islamic revealed knowledge, as enshrined in the *Quran*. Today, the *Quranic* guidance are

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<sup>256</sup> Ibid.

<sup>257</sup> Ibid.

<sup>258</sup> Wahbah al-Zuhayli, *Al-Tafsir al-Munir* (3<sup>rd</sup> edn Dar al-Fikr, 2003) Vol 4 82.

<sup>259</sup> *Quran*, *Surah Al-Baqarah*: (2), Verse 275.

being operationalised in such a manner that can accommodate the contemporary model of IFIs. Indeed, there is trust and confidence characteristic that needs to be examined when restructuring certain Islamic financial products in the market.

For instance, in an *ijarah* (Islamic leasing), the profit gathered from the lease arrangement should not induce *riba* (interest), but instead a profit will be gathered from the *ijarah* contract.<sup>260</sup> In this example, when one wishes to buy a house, and chooses an Islamic banking product such as *ijarah*, the deal will be reduced into contractual terms. The terms will stipulate that the bank will first purchase the house on behalf of the home purchaser, and as a result of the purchase, the bank will become the owner, which will then lease the house under the concept of *ijarah*. The purchaser, will then become a lessee who will pay the rent at a profit rate, or also known as the cost of fund, referred to as BFR, or BR, as indicated by the bank. Thus, the lessee who is also the purchaser, will pay the rent of the house to the bank, being the owner, at a profit rate (BFR or BR), as per the agreed terms and payment schedules, as prescribed in the *ijarah* contract. The loan is therefore restructured as an Islamic leasing contract. In this regard, the *Quranic* guidance has been operationalised to enable the *ijarah* transaction (which is a form of *bay'* (trade or sale)) to transpire, through which labour is also factored in that sale, not only on the basis of it being *Shari'ah*-compliant, but also features the trust in the sale (*bay'*).

In terms of the legal operationalisation that underpins the *ijarah* deal in practice, there are two modes in which the transfer of legal ownership can transpire, i.e. from the bank being the first owner and lessor, to the lessee being the borrower. The first option is through the structure of an *ijarah muntahia bittamleek* (lease to own), and second, through the structure of an *ijarah* with the transfer of ownership to be effected by a concept of *musyarakah mutanakisah* (diminishing partnership). In the first option, the *ijarah muntahia bittamleek* (lease to own), the bank finances the property against mutually agreed rental instalments, where profit (BR or BFR) is stipulated, and at the end of the lease period, ownership of the property will be legally transferred to the borrower with the last payment, and hence, the legal effect of '*bittamleek*' (to own) is undertaken.

In the second option, the *ijarah* (lease) and the legal effect of *musyarakah mutanakisah* (diminishing partnership) will be structured in a way that the bank finances the property against mutually agreed rental instalments, where profit (BR or

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<sup>260</sup> Siddiqi, *Banking Without Interest* (n 38) 19-37.

BFR) is stipulated, but the bank, besides being the lessor, also assumes the position of a partner with the borrower, who is also the other partner and a lessee. By paying the rent by instalments, the bank's position as a partner will be gradually diminished. Hence, it is known as *musyarakah mutanakisah* (diminishing partnership), whilst the legal ownership of the borrower as another partner is gradually being transferred through the increase of the percentage of share by continuous repayment by instalment to the bank. Hence, at the end of the lease period, the ownership of the property will be legally transferred to the borrower completely with the last payment, through the legal effect of *musyarakah mutanakisah* (diminishing partnership), in which the percentage share of partnership by the bank is completely diminished.

### **3.3. Islamic Finance: A Critical Examination of Trust and Confidence within the Value-Based Intermediation (VBI)**

Islamic finance places great importance on the greater good (*maslahah*) of the society, and this requires the translation of an intermediation function of Islamic banking into a VBI<sup>261</sup> function to facilitate financial inclusivity including the daily transfer of funds, cash withdrawals, and provision of liquidity in the payment sector. From the financial sector functions, the banking sector is espoused to bring a VBI function into the real sector of economy by carrying out its function to financialise the real economy in order to spur growth, and churn out the *maslahah*.<sup>262</sup> Islamic banks as financial intermediaries create another facet of a value-based function in the facilitation of a VBI relationship across various sectors of the economy. This VBI function signifies the trust and confidence vested in the banking institutions and the international framework for Islamic finance. The VBI function is espoused so that the benefits of financialisation into the real economy<sup>263</sup> can be made widespread for the greater utilitarian benefits (*maslahah*) of the masses, and to enable the masses to be more financially inclusive, and not excluded from the translated effects of banking and finance in the real economy. Islamic banking and finance included. Both the cashless and cash-based environments require great trust and confidence, and the case is likewise similar for the international framework of Islamic banking

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<sup>261</sup>BNM, 'Implementation Guide for Value-based Intermediation' (2008), <http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=735&bb=file>.> accessed 26 December 2018. "VBI is defined as an intermediation that aims to deliver the intended outcomes of *Shariah* through practices, conduct, and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests."

<sup>262</sup> Ibid.

<sup>263</sup> Ibid.

and finance. For the purposes of examining the VBI actualisation, the study identifies the examples of the range of services and products offered by IFIs in the existing design of the international framework for Islamic finance. In the operational dimension of Islamic banking transactions, the *Shari'ah*-compliant services and products<sup>264</sup> are highlighted in **Table 2** as follows:

**Table 2**

Deposit		
1.	<i>Wadiah / Mudharabah</i> <sup>265</sup>	Savings account-Islamic
2.	<i>Wadiah / Mudharabah</i> <sup>266</sup>	Current account-Islamic
3.	<i>Mudharabah</i>	General investment account-Islamic
4.	<i>Mudharabah</i>	Special investment account-Islamic
5.	<i>Mudharabah</i>	Specific investment account-Islamic
Banking Services		
1.	<i>Ujr</i>	Stock broking services
2.	<i>Ujr</i>	Telegraphic Transfer / Funds Transfer
3.	<i>Ujr</i>	Travellers' Cheques
4.	<i>Ujr</i>	Demand Draft
5.	<i>Ujr</i>	Cashiers' Order
6.	<i>Ujr</i>	Standing Instruction
7.	<i>Ujr</i>	ATM Service
8.	<i>Ujr</i>	Telebanking
Card Services		
10.	<i>Qardul Hasan</i>	Charge card-Islamic
11.	<i>Bay' al-Inah</i>	Credit card-Islamic
Retail Financing		
1.	<i>Al-Ijarah Thumma Al-Bay'</i>	Hire-Purchase-Islamic
2.	<i>Bay' Bithaman Ajil</i>	Home / House financing-Islamic
3.	<i>Ijarah</i>	Islamic Leasing
4.	<i>Ar-Rahnu</i>	Pawn-broking-Islamic
5.	<i>Bay' Bithaman Ajil / Bay' al-Inah / Murabahah</i>	Personal financing-Islamic
6.	<i>Bay' Bithaman Ajil</i>	Project financing-Islamic
7.	<i>Bay' Bithaman Ajil</i>	Property financing-Islamic

<sup>264</sup> Ibid.

<sup>265</sup> Demand deposits and saving deposits are structured under the *Wadi'ah* concept, in which a bank guarantees the repayment of the depositor's money, when demanded. The depositors of the *Wadi'ah* accounts are not entitled to any share of the bank's profits, but the bank may, at its absolute discretion, provide returns or gifts (*hibah*) to the depositors periodically as a token of appreciation.

<sup>266</sup> Islamic deposits are not necessarily interest-free, since on the asset side of Islamic banking, only a negligible portion of financing is based on the PLS mode of financing, whereas on the liability side, the PLS is used for the purposes of structuring Islamic deposits.

Through the incorporation of VBI, IFIs can get to the heart of people's relationship with money by better anticipating their customer's needs, or as the slogan says, 'Know Your Customer (KYC)'. Banking is humanised. Thence, IFIs may realise that they need to go beyond simple transactional relationships, and move to a lifestyle-based banking model,<sup>267</sup> or a VBI approach. The financial inclusion is on the rise globally, but account ownership varies dramatically, from 9% in South Sudan to 100% in countries such as Sweden. In reality, people do not wake up in the morning wanting to get banked. They have real, practical needs that require solutions. Hence, the underlying issue for VBI is also trust and confidence. Without trust and confidence, there is little hope for those outside the system.<sup>268</sup>

### **3.4. The *Quranic* Worldview of Islamic Finance: A Critical Examination of Trust in the Professionalisation of IFSI**

The *Quranic* worldview, enshrined in verse 275 of *Surah Al-Baqarah* has been operationalised in the modern context of actualising the roles of trust and confidence in the trade (*bay'*) and financing transactions, particularly in the banking services as set out in **Table 2**, and where the interest (*riba*) imposition is concerned, it is prohibited.<sup>269</sup> At present, the modern Islamic banking operations mimic largely the conventional banking model, except that profits (BFR or BR) are garnered instead of interest in the sense of *riba*.<sup>270</sup> To actualise the *Quranic* worldview of Islamic finance, the IFIs have been constituted and equipped by a group of banking and finance experts, legal experts, and qualified *Shari'ah* scholars, sitting on the SSB of banks, whose expertise can be tapped to examine various Islamic financial products before placing them in the market for consumers' preferences. Hence, the Islamic banking and finance framework is equipped with qualified professionals in their endeavours not only to carry out the roles in maintaining the banking standards, but also to espouse the *Quranic* worldview of Islamic finance, through professionalising IFSI's professionals and training them, in chartered institutions.<sup>271</sup>

Any impediment that is induced by the lack of professional training, education, and industrial experience can be problematic as it could risk the trust and confidence in the market, and affect the systemic risk caused by professional

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<sup>267</sup> \_\_\_\_, 'Personalisation: from novelty to necessity' *Chartered Banker* (October/November 2018) 18-19.

<sup>268</sup> \_\_\_\_, 'All inclusive?' *Chartered Banker* (October/November 2018) 25-27.

<sup>269</sup> Mohd. Daud Bakar, *Shari'ah Minds in Islamic Finance* (Amanie Media, 2016) 25 -108.

<sup>270</sup> Khan (n 138) 805-820.

<sup>271</sup> Bakar, *Shari'ah Minds in Islamic Finance* (n 269) 25 -108.

negligence in the sector. This endeavour of professionalising IFSI is pivotal so that IFIs are not deprived of certain professional standards<sup>272</sup> that need to be maintained to hold the trust and confidence in the IFSI and the international framework for Islamic finance. Due to the existing banking model, creativity is required to enable a professional business model of Islamic banking system be upheld in consonance with the *Shari'ah*-compliant requirements, professional banking standards, and the actualisation of verse 275 of *Surah Al-Baqarah*. A rigid approach for rejecting a creatively restructured *ijarah* for instance is costly and unattractive to the Muslims and non-Muslims, global market players, IFSI, and banking institutions, operating Islamic banking windows. Further, the question of *riba* (interest) is not completely obliterated in the modern context of the international framework and national framework for Islamic finance.<sup>273</sup> But careful examination should be given towards the form in which the Islamic financial products have been restructured and reformatted, where the question of *riba* (interest) in a restructured Islamic financial product would need to be addressed upfront, in the said restructured contract.<sup>274</sup>

Thus, although the contemporary banking and finance may not be able to escape the question of *riba* (interest) completely, it should not lead the Islamic banking sector to dwell on the rigid fundamentalist approach to reject outright the restructuring process, and purification approaches of Islamic financial products, as being creatively developed within the international framework for Islamic finance, espousing also various standards, guidelines, and principles that account for *Shari'ah*-compliance.<sup>275</sup> In actualising the *Quranic* worldview, the restructured

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<sup>272</sup> Ibid.

<sup>273</sup> Hadith by Prophet Muhammad PBUH received from Abu Hurairah, "There will come a time, he said, when you will not be able to find a single person in the world who will not be consuming *riba*, And if anyone claims that he is not consuming *riba*, then surely the vapour of *riba* (In another text the dust of *riba*)." *Sunan Abi Daud* (1999), Riyad, Dar al-Salam, "Kitab al-Buyu", Hadith No: 3331 485.

<sup>274</sup> In an Islamic Partnership (*Mudharabah*) contract for instance, there is a provider or supplier of a financial capital (*Rabbul Mal*) and the entrepreneur (*Mudharib*) who will carry out mostly the business part of the transactions. Through the Partnership (*Mudharabah*) contract, the supplier of the financial capital (*Rabbul Mal*) would be a passive partner, who would enjoy the benefit of profit i.e. BFR or BR from the business transaction activities of the entrepreneur (*Mudharib*), and such a profit cannot be regarded as an interest, charged as a result of providing the financial capital. The form, in which this product is restructured, has been transformed from the traditional form of a loan transaction into the Islamic Partnership (*Mudharabah*) contract, which translates the legal relationship to be reformatted as a contractual deal, between the provider of the financial capital (*Rabbul Mal*), and the entrepreneur (*Mudharib*). Therefore, no longer that the deal is considered to be between a borrower and a lender in the traditional context of a loan arrangement.

<sup>275</sup> Beng Soon Chong and Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based?' (2009) 17 *Pacific-Basin Finance Journal* 125-144. Chong and Liu noted that, "in theory, a unique feature that differentiates Islamic banking from conventional banking is the PLS approach. In practice, Islamic banking is not dissimilar from the conventional banking counterpart. On the asset side of Islamic banking, only a negligible portion of financing is based on the PLS approach. A large majority of Islamic

Islamic financial products, at present, will attract profit as the cost of fund, and not *riba* (interest).<sup>276</sup> Without the fundamental characteristics of the trust and confidence, any transactions, commercial, and financial activities cannot be materialised, let alone to conduct a more complex legal relationship, and bring into fore the multi-billion Islamic financial investments that would give rise to varying legal implications.

Therein lies the roles of IFSI's professionals in actualising, and espousing the *Quranic* worldview, for the international framework of Islamic finance to operate with a cautious heed towards riskier financing activities.<sup>277</sup> Whatever the future holds, IFIs still need banks and bankers, with the latter needs to consistently demonstrate high ethical, professional, and technical standards.<sup>278</sup> Apart from that, it has been emphasised by former BNM Governor Muhammad Ibrahim that, the Chartered Banker qualification reflects the aspirations of the BNM, which prompts IFIs to professionalise the banking workforce, and hold it to standards of conduct that will inspire confidence in the financial system.<sup>279</sup> Further, it is the duty of the bankers in IFIs to uphold the high standards expected of the profession. IFIs are in the business where trust is pivotal in the relationship between banks and customers. People count on bankers to help them achieve goals and secure their livelihood.<sup>280</sup>

### **3.5. A Critical Examination of Trust and Confidence as a Dependent-Interdependent Relationship**

As the Islamic banking model is modelled largely from the conventional banking system, which fundamentally, at its core relies on the trust and confidence to enable the banking environment to operate, Islamic banking in its contemporary form and structure, also cannot escape this dependent-interdependent<sup>281</sup> relationship of trust and confidence, vested in the established banking model. In one dimension, the Islamic banking model mimics and follows the conventional banking model in terms of basic banking structures, operations, and general guidelines, except that IFIs need to have an additional layer of *Shari'ah*-compliant mechanism,

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financing in Malaysia is still based on non-PLS modes that are permissible under the *Shari'ah*. On the liability side, the PLS approach is more widely adopted in structuring Islamic deposits."

<sup>276</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-20.

<sup>277</sup> *Ibid.*

<sup>278</sup> \_\_\_\_\_, 'Life After Brexit' *Chartered Banker* (August/September 2016) 22-23.

<sup>279</sup> \_\_\_\_\_, 'The Foundations of Trust' *Chartered Banker* (UK April/May 2017) 24-27.

<sup>280</sup> Asian Institute of Chartered Banker (AICB) Report, 'Empowering Bankers, Honouring the Trust', (Kuala Lumpur, 2018) 16-17.

<sup>281</sup> Adam Smith, 'The Theory of Moral Sentiments' (MetaLibri, 1970) 106-107. Adam Smith drew on the interdependent relation between one's own interest and the preservation of society.

and an SSB<sup>282</sup> to discuss, examine, administer, and approve Islamic financial products. In another dimension, the Islamic banking model is interdependent with the conventional banking model through its dealing in the inter-bank market activities, particularly, where the conventional banking model adopts an Islamic banking window, through which IFSI can interface. The international framework for Islamic finance, vested with the trust and confidence in the Islamic banking sector, has created a co-existence regime that interfaces the conventional banking system. That notwithstanding, market intuition should not be underestimated as it possess its own rationality to trust, be dependent, interdependent, and independent, and sometimes, where irrational exuberance strikes, panics are triggered, causing bank runs, and contagious effects, which will cascade and spiral to the entire banking ecosystem. As the global banking environment and financial systems are backed by trust and confidence, there is no empirical evidence to suggest that the positive promulgation of the law will enhance the trust and confidence in the conventional and Islamic banking system. The law is necessary, but not sufficient. The backbone of the global banking, including the international framework for Islamic finance, is the trust and confidence characteristics that are vested in the established design of the global financial system, ever since the collapse of the Bretton Woods system.<sup>283</sup>

### **3.6. A Critical Examination of the Vulnerabilities of Trust and Confidence for the International Framework for Islamic Finance**

On one hand, the conventional financial system depends on trust and confidence, as vested in the existing framework, which is supervised and regulated by the central bank. On the other hand, the day-to-day cross-border banking activities, such as inter-bank loans, payment, lending, and financing, produce the environment of trust and confidence to be more seamlessly dependent-interdependent, since one bank needs to trust the other bank, and vice-versa, in the network of highly interactive financial markets.<sup>284</sup> Contagions and bank failures are forewarned. The dependant-interdependent framework of banking systems could have domino effects in posing systemic and cataclysmic risks. Too interconnected to fail as the reality prognosticates, warrants the need for the GFSN, particularly the *Shari'ah*-compliant GFSN, which are examined later in Chapter Four of this study.

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<sup>282</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-30.

<sup>283</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 12-35.

<sup>284</sup> Authers (n 238) 15-19.

Although the Islamic banking sector is seen less prone to these risks due to its small market size and lesser exposure to riskier investment activities and financial innovations,<sup>285</sup> the vulnerability of the systemic risks caused by other banking institutions could spiral contagiously to the Islamic banking sector, if not heeded and forewarned. The Islamic banking model is still a corporate structure that requires sufficient liquidity and adequate capital to function, just like the conventional bank, except for the restructuring method of interest-rates (*riba*) in Islamic financial transactions. Yet, the extent to which Islamic bank is exposed to the interconnected market failures, inevitable economic recessions, and downward spiral of the aggregate demand can cause a chilling effect to consumers, depositors, and public to take a precaution in safeguarding their cash.<sup>286</sup> The erosion of trust and confidence may stem from the conventional banking sector, but its contagious effect has cascading effects to the global financial system, including towards the IFIs.<sup>287</sup>

In certain parts of the world like Sweden and Dubai, a cashless society is gradually becoming a normative environment, in which the market participants are enjoying a cashless or cardless environment of conducting transactions legally, without having had to bring the cash around. Whether it is a credit card, a debit card, a top-up card, a cashless mobile banking or an open banking system, such a cashless society has within their disposal an amount of money saved and deposited in a bank. This underscores the high level of trust and confidence that the market has vested, in terms of their choice for an electronic banking, daily financing options, and cross-border payment methods. Be that as it may, the trust and confidence in banking and finance are prone to vulnerabilities, if the market runs afoul causing bank runs, due to financial panics and crashes, propelling cash withdrawals, which prompt a sudden financial trauma in the banking and financial sector.

Therein lies various efforts to safeguard the GFSN, which should be able to address such vulnerabilities, and restore the trust and confidence. The GFSN measures, including the *Shari'ah*-compliant GFSN<sup>288</sup> are examined in Chapter Four of this study. Further, where a cashless environment is concerned, there is increasing evidence to suggest that customers are willing to have their data shared,

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<sup>285</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 12-35.

<sup>286</sup> Campbell and Singh, *Deposit Insurance* (Palgrave Macmillan, 2007) 40-61.

<sup>287</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8 – 20.

<sup>288</sup> IFSB, 'Strengthening the Financial Safety Net: The Role of SLOLR Facilities as an Emergency Financing Mechanism' (2014) IFSB Working Paper Series 1-97.

if it results in more relevant and valuable services.<sup>289</sup> But trust will be a critical element in ensuring that customers allow their banks to access their data.<sup>290</sup> Against this backdrop, winners in the market will be those who can persuade customers to share their data, and then use this data to make customers' lives better.<sup>291</sup>

### **3.7. A Critical Examination of the Trust and Confidence: The Realm of Choices for the International Framework of Islamic Finance**

Market is hypothesised to be rational, and at times can be, irrational. That notwithstanding, market has a choice. To vest the trust and confidence in the banking sector, or orchestrate a bank run, as has happened in Argentina due to the *corralito* economic measure, adopted by the Argentinian Government. The *corralito* measure, almost froze all the bank accounts. It was originally intended to stop capital flight, but the measure backfired. Bank runs occurred due to panic, resulted from the restriction of cash withdrawals by the *corralito* measure. Against this cautious context, Islamic finance has once been postulated as an alternative to the conventional banking model. But such an alternative should not be obscured from the *de facto* context, within which the Islamic banking environment fosters a dependent-interdependent relationship of trust with the conventional banking system. Therefore, whilst the choice to transact in an Islamic banking environment is available and accessible, the *de jure* context of the Islamic banking ecosystem unveils that it mimics the conventional banking model. Islamic bank is a commercial legal vehicle aiming to make profits,<sup>292</sup> and to the extent practicable, they uphold the *Shari'ah*-compliant requirements for the issuance of Islamic financial products. The capitalistic environment, within which Islamic banks are involved, heeds the fact that Islamic bank is an alternative choice, but is not necessarily dissimilar to other commercial banks, except on the aspect of the *Shari'ah*-compliant mechanism.<sup>293</sup>

This brings the critical examination towards the realm of choice, regarding the type of a banking model that the market wishes to elect. Such a choice is discretionary, but it is still the trust and confidence characteristics that constitute the

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<sup>289</sup> \_\_\_\_\_, 'Caring About Sharing' *Chartered Banker* (August/September 2016) 14-15.

<sup>290</sup> *Ibid.*

<sup>291</sup> *Ibid.*

<sup>292</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-20.

<sup>293</sup> Emily Sarah Hersh, 'Islamic Finance and International Regulation' (2011) *Journal of International Service* 51-63.

key determinants. Due to information asymmetries and irrational exuberance, market does not have a perfect understanding and is prone to an adverse selection and uncertainties,<sup>294</sup> and at times, can be extremely volatile. Thus, the choice for the most stable regime of a banking ecosystem may be elected by market participants, particularly, by depositors and consumers.<sup>295</sup> The rational choice theory posits that, a stable and resilient bank with a high level of capital adequacy and liquidity could be more trusted. Such a choice may seem rational. Investors also make a choice as they are wary of uncertain risks that are exposed in banking, particularly if the bank is not able to make returns, and not a going-concern. The trust for an open banking regime is also disputed as a matter of choice, and likewise, the use of an electronic payment, and digital financing activities. Simon Thompson underscored that “[w]ith so much talk about data and technology, it is easy to lose focus when it comes to banking fundamentals. For me, banking remains fundamentally about money, and about people—our customers, colleagues, and communities. Technology is shaping the way that banking products and services are delivered, but it is crucial that the digital tools we use, must be put to the service of banking, not banking put at the service of technology.”<sup>296</sup> Likewise, the introduction of the EU General Data Protection Regulation (GDPR), and open banking may seem to have caused a data dilemma, or probably presented an opportunity for banks, and their customers. The answer to this dilemma is all about trust. No trust, no engagement.<sup>297</sup> Further, digital finance is not an activity in its own right, and it is today integrated into human lives. In this regard, machine learning is effective at identifying patterns in customer data. But AI has no real understanding of what these patterns mean, nor of the wider context within which customers are using financial services.<sup>298</sup> Thus, the choice to do banking and operate its services still lies on human wisdom and oversight.<sup>299</sup>

For the international framework for Islamic finance, it has been examined that as long as the framework mimics largely the conventional banking model, except for the aspect of *Shari`ah*-compliant mechanism in Islamic banking, its exposure and interface with the intertwined global financial ecosystems are unavoidable.<sup>300</sup> Hence, the election of an Islamic banking and finance framework

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<sup>294</sup> Akerloff (n 166) 488-500.

<sup>295</sup> Campbell and Singh, *Deposit Insurance* (n 286) 40-61.

<sup>296</sup> Simon Thompson, 'The future of banking' *Chartered Banker* (October/November 2018) 14-15.

<sup>297</sup> \_\_\_\_\_, 'Power to the People' *Chartered Banker* (October/November 2018) 14-15.

<sup>298</sup> Brett King, *Bank 4.0: Banking Everywhere, Never At A Bank* (Marshall Cavendish International (Asia) Pte Ltd, 2018) 5-50.

<sup>299</sup> *Ibid.*

<sup>300</sup> Hersh (n 293) 51-63.

may not necessarily abdicate the said ecosystem from the issue of an erosion of trust and confidence, if being experienced by the conventional banking and finance sector. The nature of the dependent-interdependent relationship and the interconnectedness of the global financial system makes the systemic risk, and the GFSN pivotal, even for Islamic finance. One notable feature for Islamic finance is that it is still at its developmental stage, and is less prone to financial innovations and riskier investment portfolios,<sup>301</sup> as opposed to its conventional banking counterpart. Where the conventional banking ecosystem has steadily been learning about Islamic finance, its establishment of Islamic banking windows and certain joint venture efforts to create new Islamic banking products pave the way for an operational interface between the two banking sectors. This brings the dependent-interdependent relationships to be inextricably more linked and interoperable.<sup>302</sup> Thus, trust and confidence are key for the international framework for Islamic finance to operate alongside the conventional banking system. This relationship is examined in this study as being 'dependent-interdependent'.

### **3.8. A Critical Examination of Trust and Confidence: From Dependent-Interdependent Relationship to the Idea of Meta-economics and Meta-dependence for the International Framework of Islamic Finance**

From the dependent-interdependent relationship to the realm of choice by the market, the issue remains, to what extent that the trust and confidence characteristics constitute the key determinants for the global financial system, and the international framework for Islamic finance. The preceding discussion has examined the various facets of relationships, vulnerabilities, and the rational choice theory for the market to vest their trust and confidence. Nevertheless, in the wake of the 2008 global financial crisis, its residual effects are still lingering, as the global economy is faced with various issues of sovereign debts, balance of payment, bond maturities, and potential systemic risks, putting the trust and confidence in jeopardy. The uncertainties of Brexit, China and the US trade war, the rising call of populism and ethno-nationalism and the return to sovereignty, the global market environment operates in the age of uncertainty, instability, and insecurity. Insecurity is the manifestation of the lack of trust and confidence. To restore the trust and confidence, the GFSN are developed, including promulgating measures to provide

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<sup>301</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-30.

<sup>302</sup> Ibid.

for depositors' protection, LOLR, ring-fencing mechanism,<sup>303</sup> and to avail a higher level of capital adequacy, and a stable liquidity regime by banks. At the heart of these rising concerns lies a greater sense of consciousness, in examining whether, the trust and confidence are merely a manifestation of the rational choice behaviour, or there exists a greater sense of proportion that can be examined to be beyond the rational choice proposition for the global financial framework to operate. Simon Thompson articulated that, "[t]hrough this period of uncertainty, banks and bankers can guide businesses, individuals, and communities by demonstrating professionalism. There's a sense at least in some quarters, that it's time to batten down the hatches, and see what emerges once the storm has passed."<sup>304</sup>

The global financial crisis is often replete with various economic measures adopted and promulgated after having considered various data in a given economy. The Keynesian approach has been argued to have been able to solve it all whenever the discourse of Depression economics emerges. With a given data, the Keynesian approach for an *ex-post* intervention in the market, including the use of LOLR<sup>305</sup> could be adopted. That notwithstanding, in light of the rising uncertainties and insecurities in the global economic environment, the market becomes agitated, rather than being seen to operate in a prolonged period of stability. The irrational exuberance and 'tulip mania'<sup>306</sup> may not necessarily be able to explain the rationality of the market to be responded with the likewise rationally calculated economic interventions. The market, due to their bounded rationality, and while vesting their confidence on the economic consideration also desires to have a greater sense of trust and confidence, which is a phenomenon that instigates a greater proportion of consciousness that this study would like to critically focus, analyse, and examine. The greater proportion of consciousness appears to recognise a bigger reality that the market begins to grasp. In grasping this bigger reality, there is a phenomenon that will emerge to be introduced, and examined in this study, as the emergence of 'meta-economics',<sup>307</sup> particularly in this age of uncertainty today.

The introduction of 'meta-economics' is aimed at examining it as an emerging phenomenon which is examined to arise, when the market begins to reap greater consciousness of the issues, dealing with a reality far beyond and bigger

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<sup>303</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-30.

<sup>304</sup> \_\_\_\_\_, 'Navigating Stormy Waters' *Chartered Banker* (August/September 2016) 3.

<sup>305</sup> Charles Goodhart, Gerhard Illing, *Financial Crises, Contagion, and the Lender of Last Resort*, (OUP, 2002) 1-127.

<sup>306</sup> *Ibid.*

<sup>307</sup> Muhammad Arif Zakauallah, *The Cross And The Crescent*, (TOP, 2004) 5-18.

than the ordinary economic thinking, and the myriad of established economic phenomenon and solutions. The ordinary economic thinking, which accounts for the market rationality, albeit constrained with data, would logically respond to resolve the issues with an economic solution. For the 'meta-economics', the phenomenon is examined to deal with a bigger reality, and this bigger reality can be understood to have appeared beyond the existing economic knowledge or traditional knowledge of the market, being influenced by the rational choice proposition, and the conventional economic thinking. Therefore, in essence, the phenomenon of 'meta-economics' is concerned with the supra-economic perspectives of the bigger reality, dealing with the issues beyond and above the economic reality, such as a greater sense of trust and confidence in the age of 'unknown-unknown'<sup>308</sup> or uncertainty surrounding the global financial environment.

Further, as a general principle, it is noted that the market is influenced by the economic reality, which determines individual and collective rational decisions influencing many aspects of life, including vesting the trust and confidence, when the economic realities are known to be functioning. But, as the global financial crisis hits, the systemic risks pose a threat, and this phenomenon has brought a greater consciousness of a bigger reality, which at times, can change the equation from the traditional economic thinking into a realisation that a new sense of proportion may have emerged. This new sense of proportion does not refute the importance of the economic reality. But the realisation that ensues is, as far as the greater reality of things is concerned, and in the final analysis, it leads towards recognising that the bigger reality may surpass the economic reality.

Likewise, the trust and confidence in the global financial system, including the international framework for Islamic finance may emerge to be examined as a phenomenon of 'meta-economics' in light of the age of the 'unknown-unknown'<sup>309</sup> today. As the market deals with a bigger reality, the issue is whether the trust and confidence shall continuously be vested in the existing global financial system. The economics discipline may be able to avail an economic solution, but it does not always respond to the issues of bigger concerns dealing with the bigger reality, such as systemic and cataclysmic risks, facing the global financial system. Due to the information asymmetries and adverse selection,<sup>310</sup> market does not have the perfect

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<sup>308</sup> Nicholas Nassim Taleb, *The Black Swan*, (Penguin, 2008) 2-45.

<sup>309</sup> Ibid.

<sup>310</sup> Ibid.

understanding.<sup>311</sup> The bounded rationality further hampers that sense of an economic proportion and consequently, the continuation of trust and confidence towards the global financial system, and accordingly, the international framework for Islamic finance. As the bigger reality trails the economic reality, the philosophical sense that this study has introduced, and critically examined this consciousness of a bigger reality as the phenomenon of 'meta-economics'.<sup>312</sup> For the international framework for Islamic finance, the 'meta-economics' phenomenon is examined to be materialised when the consciousness of the bigger reality begins influencing the market choices or decisions, particularly to vest the continuous trust and confidence in the global financial system. This analysis examines that once the economy is running and bullish, and would not cause any major setbacks in the foreseeable future, the choice would generally be influenced by an economic consideration, particularly to trust the global financial system. But if the systemic risk is examined to disrupt the system, the market becomes agitated, less secure and unpredictable, and the rational choice may not dwell upon the economic consideration, but may be examined critically to give rise to the phenomenon of 'meta-economics'.

In this regard, the trust and confidence characteristics are not merely the economic rationale, but they are examined critically as being the 'meta-economics' phenomenon. It is re-emphasised that, the 'meta-economics' phenomenon is examined as a greater form of trust and confidence, which can be vested in the global financial system, as well as the international framework for Islamic finance. As Islamic finance is relatively small in size, the 'meta-economics' phenomenon may not necessarily impede the international framework for Islamic finance, albeit it may be affected in terms of contagious effects, when examining the long term stability of the interfaced systems between the conventional finance and the Islamic finance. It is acknowledged that the market would have their concerns and perspectives to vest the trust and confidence in the global financial system based on a host of factors and considerations. However, in this analysis, the study critically examines the analytical backdrop, surrounding the conventional wisdom of an economic thinking, the dependent-interdependent relationships vis-à-vis the 'meta-economics'

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<sup>311</sup> Ibid.

<sup>312</sup> As a matter of clarification, the introduction of the term 'meta-economics' is inspired in the philosophical tradition of the term metaphysics, where the law of physics may not necessarily be the sole determining factor towards a certain calculative postulation, but the metaphysical element is also implicit. However, this study does not dwell on such a metaphysical feature, but rather seeks its inspiration thereof, to examine the greater sense of proportion, when the 'unknown-unknown' might change, or affect the equation of trust and confidence, in the traditional economic reality of things, and where the global financial system is examined to be working and functioning, ever since the collapse of the Bretton Woods' system.

phenomenon, being the factors that can influence the market in the age of 'unknown-unknown' today. Therefore, for the international framework of Islamic finance, the *Quranic* worldview is adopted. This also constitutes a 'meta-economics' phenomenon, which applies in the sense that the *Quranic* worldview is an Islamic revealed knowledge<sup>313</sup> that is regarded to surpass the bounded rationality, information asymmetries, adverse selection, and the imperfect market understanding. To further examine this 'meta-economics' phenomenon, this study also introduces, and critically examines another idea of a 'meta-dependence' relationship. This 'meta-dependence' relationship culminates based on the relationship of dependent-interdependent that is also connected with the bigger reality of the 'meta-economics' phenomenon. The dependent-interdependent global banking environment, so interconnected and intertwined it is, has ushered a greater sense of consciousness of the 'meta-economics' phenomenon, which in the long run creates a 'meta-dependence' trust and confidence towards the global financial system, and accordingly, towards the international framework for Islamic finance. From the dependent-interdependent relationship to the critical examination of the roles of trust and confidence in the context of the 'meta-economics' phenomenon surrounding the age of uncertainty today, the word 'meta' is joined with the word 'dependence' to construct a 'meta-dependence' analysis of trust and confidence, which posits a greater reliance. Trust more. In the *Quranic* worldview, the 'meta-dependence' trust and confidence are espoused since the Islamic revealed knowledge<sup>314</sup> is heeded with greater reliance as the primary source of *Shari'ah*-compliant requirements for the international framework for Islamic finance. For Islamic finance, reliance on the *Quranic* worldview denotes a 'meta-dependence' trust, and such a trust is operationalised via the *Shari'ah*-compliant mechanism.

In this regard, the 'meta-dependence' trust and confidence is an analytical tool that can be used to critically examine a phenomenon of greater reliance and dependability towards the 'meta-economics' consideration in the global banking and financial system. Thus, in the age of an 'unknown-unknown', and due to the information asymmetries, and imperfect understanding of the market, the 'meta-dependence' trust and confidence may have culminated out of a greater sense of dependence over the 'meta-economics' phenomenon, and that is to vest greater reliance and confidence with the issues, dealing with the 'unknown-unknown'. This supra-economic perspectives include, the creative disruption towards the centralised

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<sup>313</sup> Rosly, *Critical Issues on Islamic Banking And Financial Markets* (n 149) 8-60.

<sup>314</sup> *Ibid.*

banking model, which has been abstracted by the emergence of various banking options and revolutions. Therefore, the 'meta-dependence' trust and confidence are the manifestation of an inward belief, which is introduced outward, as being reliant over a greater sense of consciousness, or meta-consciousness that are seen to be above, and beyond the rational economic proportion. As the market depends, or significantly depends on the global financial system to work, it is likewise the case when such a greater dependence is examined in the context of the international framework for Islamic finance. It denotes that the market is forged to have a meta-dependence trust and confidence. The *Quranic* worldview, as enshrined by verse 275 of *Surah Al-Baqarah*, and many other verses in the *Quran* can also be examined as an archetype of the 'meta-dependence' trust and confidence, which has been operationalised in the modern banking and finance context, espousing the roles of trust and confidence in the international framework for Islamic finance. But where *riba* (interest) imposition is concerned, it is clearly prohibited.<sup>315</sup> The emergence of an open banking platform will also induce a 'meta-dependence' trust and confidence that should be placed upon such a banking option. For the purposes of consultation tool of analysis, **Figure D** in Appendix I illustrates the 'meta-dependence' trust and confidence in a diagram format. It explains that, trust and confidence constitute the overarching feature for both the conventional and Islamic banking frameworks to operate, and it is more pertinent to be the case for Islamic banking system which fundamentally relies on the *Quran* as an archetype of the 'meta-dependence' trust and confidence, followed by *Sunnah/Hadiths* in terms of providing further technical guidance and explication of the *Shari'ah*.

Thus, **Figure D** in Appendix I serves as a diagram for an analytical tool to examine the 'meta-dependence' trust and confidence in this study. Critically speaking, this study examines that the 'meta-dependence' trust and confidence will emerge out of a greater sense of 'meta-dependence' belief. Notwithstanding the potential systemic risk or creative disruption due to various technological emergence, the nature in which the market has vested their trust and confidence is of a 'meta-dependence' relationship, as examined in **Figure D** in Appendix I. From the 'meta-economics' phenomenon dealing with the issues of bigger reality, and the age of 'unknown-unknown' today, the reliance on the *Quranic* worldview for Islamic finance are critically examined to espouse a 'meta-dependence' trust and confidence, which is an archetype of a 'meta-dependence' framework to espouse

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<sup>315</sup> Abu A'la al-Maududi, *First Principles of Islamic Economics* trs. AS Hashemi eds K Ahmad (The Islamic Foundation, 2011) 144.

Islamic finance, which derives its primary source of promulgation from the *Quranic* worldview, and *Hadith/Sunnah*.<sup>316</sup> The international framework for Islamic finance, comprising the dedicated and the non-dedicated international institutions for Islamic finance also require this 'meta-dependence' trust and confidence to operate a *Shari'ah*-compliant financial ecosystem that sources their main references from the *Quranic* worldview. In this regard, the 'meta-dependence' trust and confidence may not emerge solely from the manifestation of the 'meta-economics' phenomenon, but the market is examined to be more prone towards being more 'meta-dependent', when the 'meta-economics' phenomenon arises. This explains that the 'meta-dependence' trust and confidence is examined to be more critical, when the trust and confidence towards the global financial system is at risk. The market can elect to continue forging this 'meta-dependence' trust and confidence relationship. In this regard, the dependent-interdependent relationship is necessary, but not sufficient to critically analyse the emergence of 'meta-economics' phenomenon in the age of uncertainty and 'unknown-unknown' today.

The preceding analysis attests that the GFSN is also vital to enhance the trust and confidence in the global financial system as the GFSN can contribute towards the 'meta-dependence' trust and confidence to ensure the well-functioning global financial system. **Figure D** in Appendix I underscores that the conventional banking system and the international framework for Islamic finance operate on the basis of a dependent-interdependent relationship, and the 'meta-dependence' trust and confidence that the global financial system is working and functioning. This study underscores that the 'meta-dependence' trust and confidence can also turn into a 'meta-non-dependence' relationship. The market may decide to reject trusting the existing global financial system due to various reasons, such as the emergence of various banking revolutions. These new financing and banking realities can be deprived of being the alternatives to the existing banking model, if the trust and confidence are lacking, let alone to vest the 'meta-dependence' trust and confidence towards the new virtual environment of conducting the affairs of banking, trade/sale (*bay'*), and finance within the international framework for Islamic finance.

Apart from **Figure D** in Appendix I, **Figure E** in Appendix I illustrates this 'meta-non-dependence' trust and confidence in contrast to the 'meta-dependence' trust and confidence analysis in **Figure D** in Appendix I. This means that, as much

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<sup>316</sup> This is based on the 'meta-dependence trust and confidence' diagram, which is presented in this thesis as a tool of analysis and contribution to the study of the international framework for Islamic finance.

as there is a need for the 'meta-dependence' trust and confidence, there can also arise the phenomenon of 'meta-non-dependence' trust and confidence. As the global financial system is prone to a global systemic risk, and hence, the trust and confidence may be eroded. But when the trust and confidence have totally collapsed, it may trigger a 'meta-non-dependence' trust and confidence phenomenon. The existing archetype of the global banking and finance relies on this trust and confidence. Likewise, the international framework for Islamic finance relies on this trust and confidence, and in its operational context, a 'meta-dependence' trust and confidence are vested in the *Quranic* worldview, and the *Shari'ah*-compliant requirements to guide and implement the Islamic finance.

### **3.9. 'Meta-dependent' Fiat-Based Banking and the *Quranic* Worldview of Trust and Confidence in the International Framework of Islamic Finance**

The *Quranic* worldview as enshrined in verse 275 of *Surah Al-Baqarah* has been critically examined as an archetype of a 'meta-dependence' trust and confidence which has been operationalised in the modern banking and finance context, especially in espousing the roles of trust and confidence, vested in the international framework for Islamic finance. For the Muslims, the *Quranic* worldview, particularly verse 275 of *Surah Al-Baqarah* has been underscored as the main source, where this archetype of a 'meta-dependence' trust and confidence is referred to. This includes the *Quranic* injunctions on the prohibition of *riba* (interest).<sup>317</sup> As examined in the preceding analysis, the international framework for Islamic finance largely mimics the conventional banking framework, in terms of regulating and supervising financial institutions. Likewise, the guidelines and standards issued by the BCBS are referred to, adopted, and incorporated by the IFSB, as appropriate, to cater to the archetype of the 'meta-dependence' trust and confidence,<sup>318</sup> so as to operate Islamic banking and finance. Thus, the IFSI has modernised, adopted, and approved various Islamic financial products, such as *ijarah* for instance, by tackling the issue of *riba* (interest) through the modern method of restructuring the said products. The Islamic financial products are restructured so

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<sup>317</sup> AR al-Jazairi, *Kitab al-Fiqh ala al-Mazhab al-Aba'ah* (eds 2 Dar al-Kutub al-Ilmiyah, 2003) Vol. 2 222.

<sup>318</sup> This is based author's own construction of a diagram for 'meta-non-dependence trust and confidence', which is presented in this thesis as a tool of analysis and contribution to the study of the international framework for Islamic finance. See Appendix I for further examination.

that the profit gathered from the *ijarah* arrangement would not attract *riba* (interest), but instead a profit known as the cost of fund, from the restructured *ijarah* deal.

The 'meta-dependence' trust and confidence in the global banking system currently operates on the basis of trusting the fiat-money based system, where the responsibility for supplying such money and suppressing counterfeits has fallen to the responsibilities of the central bank. Although the printing of money is exposed to the temptation of quantitative easing (an unconventional monetary policy in which a central bank buys securities from the market in order to increase the money supply) to provide liquidity, undertake payments and financing activities, historically one way to limit such an ability to print up more money was to put money on a metallic standard. Under such a system, money cannot be printed without backing them with a precious metal, such as gold. This is prior to the collapse of the Bretton Woods system. For the purposes of monetary policy, the supply of the fiat money cannot be arbitrarily increased, because historically, there was a high cost of buying gold, which limited the money supply. Such a system had been able to prevent inflation, since the printing of a huge amount of new money will only cause its widespread circulation in the market, which compels the prices to drive up. Whilst preventing inflation is a strategic monetary plan, but the metallic standard benchmark could cause the supply of money to be fixed over time. Even if the economy could use a little bit more, or a little bit less money to make it work better, the supply of money is fixed by the amount of gold that is reserved. Thus, if a recession hits, the metallic standard would imply that the monetary policy cannot be used to stimulate the economy since the supply of money is fixed by the amount of gold that is reserved. Hence, ever since the collapse of the Bretton Woods system, the gold standard was abandoned, and trust as well as the 'meta-dependence' trust and confidence has since been vested continuously in the existing design of the fiat-money<sup>319</sup> system, which is supplied by the central bank of each jurisdiction.

The monetary policy operates by manipulating the supply of money in order to alter the price of borrowing money i.e. the interest rates. As the interest rates can adjust quickly, the money can be printed, upon knowing that the interest rates will adjust according to market equilibrium.<sup>320</sup> Hence, the appropriate amount of money can be printed, supposing that the interest rates will adjust in order to get the market holds the amount of money that the central bank decides to print. The interest rates

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<sup>319</sup> Howells and Bain, *Financial Markets And Institutions* (n 56) 4-88.

<sup>320</sup> *Ibid.*

react in a way similar to other prices. If the money supply suddenly increases, the price of money falls, and vice versa. Islamic banking operation is also not averse to the interest rate's fluctuations, and it is guided by the central bank through the benchmarking rate against the LIBOR rate to price their restructured Islamic banking products. However, an expansionary monetary policy can cause inflation to rise, pushing nominal interest rates up, whilst domestic currency can depreciate sharply.

On one hand, the contemporary operational aspect of Islamic finance today shares their similar commercial characteristics with that of the conventional banking model. The other side of the discourse examines that the 'meta-dependence' trust and confidence on Islamic sources of *fiqh muamalat* i.e. mainly the *Quran*, *Hadiths*, and *Sunnah* make the reliance towards the 'meta-dependence' trust and confidence even greater, and more deferential. This is because, Islamic finance operates on the archetype, which is based principally on the *Quranic* worldview, as the international framework for Islamic finance must be, *Shari'ah*-compliant. The *hadiths* and *Sunnah* facilitate a further technical explication of *Quranic* injunctions, particularly where certain details for the implementation are required. Thus, the 'meta-dependence' trust and analysis for the international framework for Islamic finance derives its core philosophical archetype from verse 275 of *Surah Al-Baqarah*, and it has been operationalised in the form of restructured Islamic financial products in the modern banking environment, and the international framework for Islamic finance.<sup>321</sup>

### **3.10. The International Framework for Islamic Finance: A 'Meta-Dependence' and 'Meta-non-dependence' Analysis**

At this juncture of history and time, ever since the collapse of the Bretton Woods system, the global trust and confidence are vested in the fiat-based currency, and to a significant extent, the electronic banking, and the digital financing environment, within which the same legal recognition for various national currencies are accorded to. Thus, in general, the *Quranic* worldview which espouses verse 275 of *Surah Al-Baqarah* has been examined to explicate the roles of trust and confidence in trade (*bay'*) and financing transactions, and where *riba* (*interest*) imposition is concerned, it is prohibited.<sup>322</sup> Thus, confided by the existing design of the framework for banking and finance, where the trust and confidence are vested,

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<sup>321</sup> Omar, Md. Noor, Mydin Meera, Abdul Manap, Abdul Majid, Syed Zain, Sarif, Sukmana, Muhammad Bashir (n 160).

<sup>322</sup> *Ibid.*

the international framework for Islamic finance also enjoys similar protection of trust and confidence, as the two banking systems inter-operate with each other. It has been examined that, post the collapse of the Bretton Woods system, the fiat-money is still used as the only asset that is universally accepted as a means of payment for goods and services, and this reality-check consciousness is examined to give effect to the 'meta-dependence' trust and confidence since 1945 until today. Without such a 'meta-dependence' trust and confidence, no sale transactions in the contemporary banking, including the international framework for Islamic finance can operate.

The 'meta-dependence' trust and confidence in the existing design of the fiat-money ecosystem contributes towards efficiency as it eliminates the need to engage in a barter trade, at least. Currently, the basis of the Islamic banking operation is largely modelled by the conventional banking and finance system, which is regulated and supervised by the central banking framework. But in terms of adhering to the *Sharī'ah*-compliant requirements, it is still the trust and confidence, as enshrined by the *Quranic* worldview, and verse 275 of *Surah Al-Baqarah* that have been examined to constitute the key determinants for the functionality of the existing design and characteristics of the international framework for Islamic finance. In the present discourse, it is the 'meta-dependence' trust and confidence, as enshrined in verse 275 of *Surah Al-Baqarah* that should guide, and navigate the trajectory development of the international framework for Islamic finance. The *Sharī'ah*-compliant requirements in Islamic finance are the manifestation of the practice of the 'meta-dependence' trust and confidence, which derives its core source of promulgation from the *Quranic* worldview. In essence, trust is something that only comes from being trustworthy.<sup>323</sup>

But the extent to which the full-blown implementation of Islamic finance, aiming to eliminate the influence of interest (*riba*) completely in Islamic banking products is examined, this may not appear to reflect level of a higher degree of 'meta-dependence' trust and confidence i.e. to undertake a full literal implementation of verse 275 of *Surah Al-Baqarah*. Because still, interest (*riba*) is restructured in such a manner that the form of contract creatively does not attract interest (*riba*), but instead, a profit in the form of BR or BFR is gathered in the sense of cost of fund. However, this creative operationalisation of Islamic finance should not be construed to augur a 'meta-non-dependence' analysis, or a hindrance towards garnering greater deference towards the *Quranic* archetype of the 'meta-dependence' trust

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<sup>323</sup> \_\_\_\_, 'Innovation With Impact' *Chartered Banker* (UK April/May 2017) 21-23.

and confidence, but rather, it can be examined as a creative contemporary approach to operate Islamic finance in a modern banking context.

### 3.11. Conclusion

This Chapter has critically examined that the most important feature that is considered to be the key determinant for the philosophical foundation of the international framework for Islamic finance is the 'trust and confidence'.<sup>324</sup> In the context of the emergence of the 'meta-economics' phenomenon, the 'meta-dependence' trust and confidence are espoused for the global banking environment to function and operate, and this has been critically examined as the key determinants for both the conventional banking framework, and the international framework for Islamic finance. Even to tap into a new frontier of technological revolution in banking and finance, it is the trust and confidence, as well as the 'meta-dependence' trust and confidence that constitute the key characteristics and determinants that need to be realised, actualised, and deferred to, for any banking and financing environment to work, function, and operate.

The trust and confidence, as well as the 'meta-dependence' trust and confidence, based on the *Quranic* worldview, and the *Shari'ah* standpoints have been critically examined as constituting the core philosophical foundation within which the international framework for Islamic finance operates. The *Quranic* worldview, enshrined in verse 275 of *Surah Al-Baqarah*, has also been examined to have been operationalised in the modern context of actualising the roles of trust and confidence in the international framework for Islamic finance, particularly in Islamic banking activities. But where *riba* (interest) is concerned, it is absolutely prohibited, as the position of Islamic finance has starkly contrasted *riba* (interest) with trade/sale (*bay'*), in which the latter fundamentally entails and involves the roles of labour.

Following the examination on the roles of trust and confidence in this Chapter, Chapter Four critically examines the roles of trust and confidence in the context of banking and financial crisis, the GFSN, and the ability of the international framework for Islamic finance to prepare *ex ante*, for such a crisis, and when the crisis hits, an *ex-post* intervention that is in accordance with the *Shari'ah* is required.

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<sup>324</sup> Ng., Ibrahim, and Mirakhor (n 241) 239-250.

## **Chapter Four: The Global Financial Crisis, the GFSN, And The Context of the International Framework for Islamic Finance**

*"It is my guiding confession that I believe the greatest error in economics is in seeing the economy as a stable, immutable structure" - John Kenneth Galbraith.<sup>325</sup>*

### **4.1. An Examination of the Global Financial and Banking Crisis**

In a *laissez-faire* economy, the erosion of trust and confidence in the banking sector is a serious issue that can lead to the triggering of a financial crisis, leading to a period of economic instability, the effect of which can spread contagiously to the neighbouring region, and the entire banking sector. The cause of the financial crisis is attributed to factors, among others, the failure of one, or more major financial institutions in conducting their banking operations, which would result in the loss of trust, and the erosion of confidence by the market, consumers, and depositors.<sup>326</sup> Islamic banks and IFIs, although they were not severely affected by the previous financial crisis due to the embryonic stage of their development, had stumbled upon distressed market in their banking operations. The Kuwait Finance House (KFH) was founded in 1977, i.e. four years before the *Souk al-Manakh* crisis<sup>327</sup> that resulted in the catastrophic fall in stock market prices. The *Souk al-Manakh* crisis had caused the real estate market collapse, and insolvency of Kuwaitis, including the KFH's clients. Kuwaitis' banks still survived, despite being exposed heavily to the real estate market. Nonetheless, *mudharabah* depositors were not paid their profit shares for a two-year period, although they were loyal to the bank, while the bank's books were rebalanced during the crisis.

In this regard, although that the global financial crisis of 2008 had only a limited effect to Islamic banks, the global financial crisis has heeded that the market economies go through alternating periods, during which the total output of goods and services, expands and contracts. The alternating pattern of economic expansion

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<sup>325</sup> John Kenneth Galbraith, 'Economics'

<<http://www.greatthoughtstreasury.com/economics/quotes?page=1>> accessed 20 October 2017.

<sup>326</sup> Campbell and Singh, *Deposit Insurance* (n 286) 40-61.

<sup>327</sup> Habib Ahmed, Mehmet Asutay and Rodney Wilson, 'Reflecting on Islamic Banking And Financial Crisis: Risks, Reputation And Stability' in Habib Ahmed, Mehmet Asutay and Rodney Wilson (eds.), *Islamic Banking and Financial Crisis*, (Edinburgh University Press, 2014) 13-39.

and contraction is often called the business cycle, because businesses are affected by the changes in output, produced in a given economy. Likewise, the banking and financial crisis is also affected by the external market environment, during which a recession occurs. **Figure F** in Appendix II depicts an alternating pattern of banking and financial crisis from 1900 to 2010, a study of which was conducted by Rogoff and Reinhart.<sup>328</sup>

As studied by Rogoff and Reinhart, it is examined that thus far, the worst economic downturn was in the 1930s, when the Great Depression occurred. This has led to the study of the Keynesian economics. Since the 2008-2010 recession, the impact has not yet seen to be withered yet, until today. The economic depression is a not normal economic downturn. The Great Depression started with a lingering recession from 1929 to 1933, to which the US did not see its output return to its 1929 to 1933 level, until after entering the World War II in 1941, the output fell sharply, and the unemployment had mounted significantly. In a recession, the Keynesian approach underscores that, it is important to increase the aggregate demand, and this is often done directly through direct fiscal policy measures, such as reducing taxes.<sup>329</sup> This is aimed at allowing the consumers to have greater purchasing power parity, by having a bigger after-tax incomes. But this direct fiscal intervention could also backfire as it contributes towards increasing government budget deficit. An indirect fiscal policy could be proposed, where the government spending is increased in times of recession, including to increase the aggregate demand by purchasing more goods and services from the market. But caution is exercised, when this measure is adopted, there is a prospect of contributing towards more debt in the economy, thus causing larger deficits, which will constrain the magnitude of various fiscal policy initiatives.

#### **4.2. An Examination of Measures Adopted To Weather The Global Financial And Banking Crisis**

Following the previous examination on the fiscal measures to weather the economic recession, this section examines various measures that have been adopted previously, by states. These include the efforts to contain the inflation,

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<sup>328</sup> Carmen M. Reinhart, and Kenneth S. Rogoff, 'Is the 2007 US Sub-prime financial crisis so different? An International Historical Comparison' (2008)98(2) American Economic Review: Paper & Proceedings 339.

<sup>329</sup> John Maynard Keynes, *The General Theory Of Employment, Interest, And Money*, (Snowball Publishing, 2012) 4-29.

encourage imports of only high priced commodities, discourage borrowings if inflation rules high, encourage savings and tax reduction, excessive government expenditure is reduced, focus towards infrastructure development is given, interest rate is reduced and cut, and if there is a greater demand towards acquiring mortgage the access to credit will be made stricter with the interest rate being increased in order to curb 'irrational exuberance'. Further, the conventional solution via the Keynesian economics suggests that taxes should be cut, whilst the government spending should be increased in times of recession so as to stimulate the aggregate demand, and cause gross domestic product (GDP) to rise.<sup>330</sup> Recognising such a need for a state intervention, **Table 3**<sup>331</sup> in Appendix III illustrates an examination of the various types of intervention undertaken by selected financial authorities. Whilst the list of measures described therein is not exhaustive, it is sufficient for a comparative examination in this study.

In so far as Malaysia's positions are concerned with regard to the intervention measures during financial crisis, which had been adopted in the past, prior to the year 2019, the range of measures vary. In terms of stimulus package, the Malaysian Government announced in 2008, an economic stimulus package of RM7billion. In terms of liquidity injections and debt guarantees, Malaysia's domestic financial sector had negligible exposure to both sub-prime related securities during the 2008 financial crisis. In this regard, foreign market intermediaries in Malaysia were locally incorporated, and they had a high level of capital, committed to support their operations. The BNM also undertook interest rate cuts. For instance, the OPR was cut by 25 basis points to 3.25%, in November 2008, in the midst of the financial crisis. Malaysia introduced a deposit guarantee through the establishment of Malaysia Depositor Insurance Corporation (MDIC) in 2005 to protect bank's depositors. In this regard, the Government guaranteed 100% of bank deposit until 2010. The roles of MDIC are further examined in Chapter Six. There was also ample liquidity in the domestic financial system to facilitate the orderly functioning of economic and financing activities. In terms of bank recapitalisation and asset purchase, the domestic banks in 2008 remain resilient on stronger balance sheets, and risks management standards. In relation to market closures, due to the 2008 financial crisis, Malaysia had introduced price limits on individual stocks, and

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<sup>330</sup> Ibid.

<sup>331</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 154 -156.

adopted a market-wide trading halt (circuit breakers) in order to maintain fair and orderly trading.

### **4.3. The Asian Financial Crisis of 1997-1998: Malaysia's Approach to Weather the Economic Recession and the Growth of Islamic Finance**

This section further examines the Malaysia's approach towards combating the contagious effects of the Asian financial crisis of 1997-98. A large amount of debt denominated in foreign currency was a notable feature of the institutional edifice in Chilean financial markets before its financial crisis in 1982, in Mexico in 1994, and in Southeast Asia in 1997. When the Asian financial crisis eventually hit the Malaysian economy, the attack against the Thai Baht, and the Indonesian Rupiah, had contagiously affected the Malaysian currency i.e. Ringgit which had plummeted from RM 2.50 per US dollar to RM 4.80 per dollar. In a matter of weeks, the depreciation of the Malaysian Ringgit had driven close to a hundred per cent. In a period of five months, almost half of the value of the Kuala Lumpur Stock Exchange (KLSE) composite index had lost. The KLSE benchmark composite index was at 1077 points in June 1997. Then the value had almost halved by November of 1997. The Malaysian economy experienced a sudden drop of the real estate prices, where the commercial property prices fell by almost 50 percent, and in 1998 GDP contracted by 7.5 percent. The KLSE was at 303 points, the lowest monthly average during the crisis, by August 1998. There were many options that had been made available to the Malaysian Government in 1997-98 to weather the economic crisis including the standard prescriptions by the IMF, i.e. increase liberalisation, tighten government spending, and raise interest rates.<sup>332</sup> Despite all these proposed measures, the Malaysian Government had opted the most unconventional approach.<sup>333</sup> In order to immediately address the economic crisis, there was a direct and speedy government intervention in the economy by introducing capital control<sup>334</sup>

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<sup>332</sup> Miskin (n 142) 3-20. It is noted that higher interest rates can be one of the factors that precipitates financial instability, because lenders realise that higher interest rates mean a dilution in the quality of potential borrowers, and they are likely to react by taking a step back from their business. Banking business operating on 'borrowing short and lending long' i.e. taking deposit which can be withdrawn on demand, and making loans that is to be repaid over a period of years will be affected, in terms of their bank balance sheets. The increase of interest rates will cause decline in net worth in the present value terms, whilst the interest rate rise lowers the value of assets with their longer duration, more than it raises the value of liabilities with their shorter duration.

<sup>333</sup> Ruzita Azmi and Adilah Abd Razak, 'The Role of Danaharta in Managing and Rehabilitating Financially Troubled Companies in Malaysia – Part Two' in Mark Fennessy (ed.), *International Corporate Rescue*, (Chase Cambria Company (Publishing), 2015) 23-28.

<sup>334</sup> Ibid.

to further regulate the outflow of the Malaysian Ringgit, increase government spending, lower the interest rates, and the Malaysian Ringgit was pegged<sup>335</sup> to the US dollar to enhance the currency stability and predictability.

The Malaysian approach was not free from severe criticisms particularly from foreign investors, economists and financial analysts. Nevertheless, the unconventional approach worked, and the economy recovered. Short selling by speculators was able to be checked and curbed as a result of the capital control. Liquidity was injected in ailing corporations through an *ex-post* but quick government intervention of investing RM60 billion to buy shares in the local bourse, and this had helped checked the retrenchment figures and boosted employment. There were many large-scale projects that were deferred, and corporate tax was reduced by 2 percent i.e. from 30 percent to 28 percent. There was a serious rationalisation of the financial sector, where the government spending was cut by a mere 2 percent. In order to manage the financial crisis, the Malaysian Government was left with no other measure but to directly intervene in the economy through the introduction of the capital control, and the bail outs of ailing big companies from falling into the path of insolvency, causing further contraction in the Malaysian economy.

In order to facilitate the management of the financial crisis, the National Economic Action Council (NEAC)<sup>336</sup> was established to give recommendations to the Malaysian Government to resuscitate the economy. Accordingly, two companies were set up, i.e. the '*Danaharta*' which is an asset management company, and the '*Danamodal*', which is a bank-restructuring agency.<sup>337</sup> This was the Malaysian corporate rescue approach conducted at the scale of a national bail-out to prevent further contraction in the economy. The role of *Danaharta* was established pursuant to *Pengurusan Danaharta Nasional Berhad Act 1998 [Act 587]* to buy non-performing loans from banks. The role of *Danamodal*, established pursuant to *Pengurusan Danamodal Nasional Berhad Act 1998* was to act as a vehicle for the recapitalisation of Banks as they were badly hit by the recession. Furthermore, a Corporate Debt Restructuring Committee was also set up which had led to the amendment of section 176 of the Companies Act 1965 [Act 125].<sup>338</sup> The *Pengurusan Danaharta Nasional Berhad Act 1998* and the *Pengurusan Danamodal Nasional*

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<sup>335</sup> Ibid.

<sup>336</sup> Ibid.

<sup>337</sup> Ibid.

<sup>338</sup> Ibid.

*Berhad Act 1998* are the Acts of Parliament that were enacted in response to the 1997-98 crisis.

The main objective of establishing the *Danaharta* was to take away non-performing loans from the balance sheet of financial institutions at fair market value, and rehabilitate them speedily. The *Pengurusan Danaharta Nasional Berhad Act 1998* [Act 587] empowered the *Danaharta* to buy assets through statutory vesting, and to appoint Special Administrators (SAs) to manage ailing corporations. The powers conferred to the SAs were unrestricted, even by a court action. According to section 33(2), Second Schedule of the *Pengurusan Danaharta Nasional Berhad Act 1998*, the SAs are empowered to 'exercise all the functions of the board, and to remove and suspend from office any director, regardless of memorandum and articles of association, or any other law' including the Companies Act 1965 [Act 125] and all other corporate regulations. The sections of the SAs are monitored by an 'Oversight Committee' which is appointed by the Executive. This broad power has attracted legal challenges, such as in *Repco Holdings Sdn. Bhd. v. Pengurusan Danaharta Nasional Bhd. & Ors.*,<sup>339</sup> there was an injunction that was sought based on the oppression remedy under section 181 of the Companies Act 1965 [Act 125] to restrain the SA from acting.

In this legal challenge, validity of the SA's appointment was challenged alongside the question of the constitutionality of 'the *Pengurusan Danaharta Nasional Berhad Act 1998* [Act 587], and allegations of *mala fide* on the part of *Danaharta*. This legal challenge was eventually dismissed by the High Court. Following this legal challenge, section 72 of the *Pengurusan Danaharta Nasional Berhad Act 1998* was amended to overrule judicial oversight over the SA, and *Danaharta*, and the provision reads as follows:

"Notwithstanding any law, an order of a court cannot be granted –

- (a) which stays, restrains or affects the powers of the Corporation, Oversight Committee, Special Administrator or Independent Advisor under this Act;

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<sup>339</sup> *Repco Holdings Sdn. Bhd. v. Pengurusan Danaharta Nasional Bhd. & Ors.* (No.1) [2002] 5 MLJ 637.

- (b) which stays, restrains or affects any action taken, or proposed to be taken, by the Corporation, Oversight Committee, Special Administrator or Independent Advisor under this Act;
- (c) which compels the Corporation, Oversight Committee, Special Administrator or Independent Advisor to do or perform any Act, and any such order, if granted, shall be void and unenforceable and shall not be the subject of any process of execution whether for the purpose of compelling obedience of the order or otherwise.”

It thus appears that the SA may have an unrestricted power which could be seen to be beyond any act of judicial oversight, and thus the provision may serve as an ouster clause in that regard. Therefore, following the economic crisis resulted from the Asian financial crisis of 1997-98, the Malaysian Government had actively intervened in the economy, and introduced an unconventional measure of introducing the capital control, the currency pegging, and the establishment of the *Danaharta*, exercising its role as an asset management company, and the *Danamodal*, exercising its role as a bank-restructuring agency, both of which were measures implemented to manage and rehabilitate the economy.<sup>340</sup>

During this period, Islamic finance had also found its opportunity to grow and capitalise itself as a new alternative market,<sup>341</sup> despite that the trust and confidence towards the conventional financial system had been shaken. The Islamic finance offered itself as an alternative mode of banking and finance. Hence, whilst Malaysia was badly hit by the financial crisis, the Islamic finance market began to be tapped during this period as it was less prone to speculative outflows and external shocks, and thus, presented itself as an interesting option for the Malaysian market, at least.<sup>342</sup> To further examine the measures to weather banking and financial crisis, section 4.4 examines the roles of the GFSN, LOLR, ILOLR, and *Sharī'ah* LOLR (SLOLR).

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<sup>340</sup> Azmi and Abd Razak (n 333) 23-28.

<sup>341</sup> Ibid.

<sup>342</sup> Ibid.

#### 4.4. A Critical Examination on Strengthening the GFSN: The Need for an ILOLR?

Heeded by the lessons learnt from the Malaysia's experience in managing the 1997-98 financial crisis, particularly the need to intervene in the economy to facilitate economic recovery, this section examines the efforts to strengthen the GFSN.<sup>343</sup> As recessions are unavoidable, and the banking crisis might recur, the GFSN is heeded with a critical examination on a set of institutions, measures, and mechanisms which provide the financial support, or intervention measures to countries hit by financial crisis, which is either currency, banking, or sovereign-debt crisis.

In the context of the global financial architecture, and the international framework for Islamic finance, the GFSN is too crucial to be ignored, as financial integration is rapidly happening, and economies are becoming globalised, interdependent, and interconnected. The key features of the GFSN include, among others, LOLR,<sup>344</sup> deposit insurance protection scheme, ring-fencing mechanism, etc. As the economy is faced with uncertainties, there are negative externalities which require various measures to be adopted for crisis prevention, and effective resolution. The GFSN can be designed to prevent and manage the negative effects of these externalities from spreading and becoming contagious. Therefore, in order to internalise the effects of the financial crisis, the GFSN must be strengthened. The GFSN is more optimal in internalising such an incidence of recession, as opposed to a private solution, due to the scale of recession requires a more efficient solution through the GFSN.

The GFSN is also prone to be seen as an *ex-ante* form of moral hazard.<sup>345</sup> In this regard, the GFSN could be seen as imprudent and sub-optimal if it encourages bad policy-making, particularly where the GFSN induces an imprudent act of lending by creditors to vulnerable countries that are unable to repay their loans. The GFSN is important for the purposes of supporting regional and global cohesion as the financial support such as LOLR could be made available.<sup>346</sup> The contagious effects of the financial crisis require a good political understanding to be forged between

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<sup>343</sup> Goodhart and Illing, *Financial Crises, Contagion, and the Lender of Last Resort* (n 305) 5-60.

<sup>344</sup> Forrest Cappie, 'Can there be an International-Lender-of-Last-Resort?' in Charles Goodhart and Gerhard Illing (eds), *Financial Crises, Contagion, and the Lender of Last Resort* (OUP, 2002) 437-449.

<sup>345</sup> Andrew Campbell and Rossa M. Lastra, 'Revisiting the Lender of Last Resort' (2009) 24 *Banking and Financial Law Review* 453-498.

<sup>346</sup> *Ibid.*

neighbouring countries because containing financial contagion entails a political dialogue to address various issues regarding economic recessions.

LOLR is a GFSN measure that should prevent costly deleveraging by runs of financial intermediaries, and their short-term debt liabilities. The LOLR principle requires that the LOLR should be extended to 'illiquid but solvent' institutions in the event of financial distress suffered by banks.<sup>347</sup> In an economy, the central bank is entrusted to undertake and assume the role of LOLR because it is the main monetary authority of the country whose roles among others, are to monitor, and supervise all banks including to ensure the monetary stability in an economy. In executing this LOLR function, the Bagehotian principle has been espoused to lend freely against good collateral at a penalty rate (interest). It is reasonable to expect the central bank assumes and undertakes the LOLR's role in times of financial distress faced by domestic banks. However, for the purposes of the international framework for Islamic finance, there is no similar institution like the domestic central bank to assume the role of the LOLR or ILOLR except that the discourse on this has turned to the IMF,<sup>348</sup> whose role is availed only to assist financially during the balance of payment deficit situation as incurred by nation states. But such a role is not the same like the LOLR as the IMF's financial assistance is extended with conditions attached, including the implementation of structural adjustment programmes to be adopted by nation states in order to help the economic recovery.

It is important to recognise the fragility of financial intermediaries, and the presence of short-term debt on the liabilities side of the balance sheets in order to determine the domestic bank runs, as opposed to the balance of payment deficit, as experienced by an economy. Where the external liabilities are denominated in a foreign currency, the central bank would not have a deep pocket to provide the ILOLR,<sup>349</sup> as opposed to an institution which has a deep pocket with foreign currencies. In international context, enforcing the laws to those countries which receive any LOLR/financial assistance will be more difficult, in contrast to domestic financial institutions, where legal sanctions could be made more enforceable.<sup>350</sup> Further, the international context would also have to deal with hot money flowing in, and outside the market, and the volatile mobility of foreign investors, which can at any point of time induce a bank run. For the purposes of examining the GFSN at a

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<sup>347</sup> Ibid.

<sup>348</sup> Cappie, *Financial Crises, Contagion, and the Lender of Last Resort* (n 344) 437-449.

<sup>349</sup> Ibid.

<sup>350</sup> Ibid.

global level, including the international framework for Islamic finance, the role of an ILOLR as opposed to a domestic LOLR should heed the need to have an institution that can provide a high-powered money like the central bank in a domestic jurisdiction.<sup>351</sup> This critical feature is currently lacking, but the domestic central bank is capable of undertaking such a role. Until the global financial crisis, the IMF's role has often become the *de facto* ILOLR, but in the *de jure* context of its role, the IMF provides its financial assistance with the conditions of structural adjustment programmes attached to it.<sup>352</sup>

Due to the global financial crisis, there is a real concern of whether the IMF's pockets are enormous enough and sufficiently deep to assume the roles of an ILOLR.<sup>353</sup> At this juncture of time, the examination of the role of LOLR may be more effectively assumed and played by domestic central banks as opposed to the IMF which does not have the necessary balance sheet elasticity to be the ILOLR. Further, the IMF is still tainted with a perceived stigma of their loans' conditions which make the country to be prone towards over-insure or self-insure. The problem with the domestic central banks is that they do not possess the legal mandate, neither are they legally empowered to undertake the role of an ILOLR. Further, should the domestic central bank undertake the role of ILOLR, the question arises on the extent of their ability to prevent the scale of the financial crisis, plus the ability to override its own domestic interest for the sake of maintaining the global financial stability.<sup>354</sup> It is thus apparent that the central bank must have a global mandate to become the ILOLR, but even that is to be the case, the ILOLR could potentially cause excessive moral hazard in the *ex-ante* paradigm of managing financial crisis.

#### **4.5. A Critical Examination on The LOLR and *Sharī'ah*-LOLR (SLOLR)**

It is unsettled whether the ILOLR is necessitated to help address the global financial crisis. In the context of an international framework for Islamic finance, the critical issue is whether the LOLR facility is *Sharī'ah*-compliant so as to help the domestic Islamic banks in times of financial distress. Apart from the capital adequacy issues, it is the liquidity turbulence problems that had caused the global

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<sup>351</sup> Cappie, *Financial Crises, Contagion, and the Lender of Last Resort* (n 344) 437-449.

<sup>352</sup> *Ibid.*

<sup>353</sup> *Ibid.*

<sup>354</sup> *Ibid.*

financial crisis. As the global financial crisis of 2008 hit all the banking sectors including IFIs, the need for *Shari'ah*-compliant LOLR (SLOLR) facilities are critical and vital.<sup>355</sup> The support for both the micro level of the IFSI as well as the macro level of the IFSI requires a regulatory and supervisory framework that is designed legally to provide the *Shari'ah*-compliant GFSN infrastructure to accommodate the need of the IFSI, and to ensure the well-functioning financial system in situations of liquidity stress.

Although the conventional LOLR facility is available, the challenge faced by IFSI when facing financial distress would be the need to be available with the SLOLR facilities. This has led the IFSB to embark on a paper titled as "*Strengthening the Financial Safety Net: The Role of SLOLR Facilities as an Emergency Financing Mechanism*"<sup>356</sup> which examines the role of SLOLR, and GFSN. The key critical issues as discussed in the paper are critically examined in this study as the international framework for Islamic finance will grow and heed the need for the GFSN, ILOLR, and SLOLR. Any domestic financial institution holding a banking licence and legally authorised to operate in a particular jurisdiction should be able to enjoy the LOLR as available by the central banks. However, as domestic Islamic banks are also required to comply with the jurisdictional requirements of banking operations which is a treatment similar to other conventional banks, it is uncertain whether Islamic banks will enjoy the LOLR facility, because the Bagehotian principle posits imposing a penalty rate (interest), which is not *Shari'ah*-compliant.<sup>357</sup>

The inter-bank open market operations will be resorted to, for the purposes of an inter-bank lending and borrowing, and seldom the banks will resort to the LOLR of the central bank, as eventually, it is the facility of last resort. For IFIs, the LOLR must be *Shari'ah*-compliant, if at all to be resorted to, by domestic Islamic banks. In this regard, direct intervention in the times of crisis is an emergency situation which calls for an emergency liquidity assistance (ELA), being an instrument to be devised by the central banks, in exercising their roles, as LOLR. This is not an exercise of 'constructive ambiguity as the exercise of this role is highly discretionary'<sup>358</sup> which is extended in 'exceptional circumstances', provided that there is sufficient collateral. The problem with the existing design of the conventional

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<sup>355</sup> Ibid.

<sup>356</sup> IFSB (n 288) 1-97.

<sup>357</sup> Ibid.

<sup>358</sup> Campbell and Lastra (n 345) 453-498.

LOLR is the interest-based LOLR. Thus, a *Shari'ah*-compliant LOLR is necessitated to accommodate the international framework for Islamic finance, although the essence of the Bagehotian principle can still be maintained i.e. to extend the LOLR temporarily to 'illiquid but solvent' financial institutions.<sup>359</sup>

The recent global financial crisis of 2008 has been associated with the cause of the drying up of liquidity in the financial crisis. Although IFIs may seem to have been able to withstand such a crisis, it still does not absolve IFIs from the possibility of encountering the liquidity turbulence problems in the future. Therefore, where such a liquidity problem occurs, the SLOLR must be equipped to address the issues at the level of domestic IFIs, although not necessarily at the international framework for Islamic finance since the position of the ILOLR is still debatable. ELA is important and should be restructured into a *Shari'ah*-compliant ELA for the purposes of crisis management and maintaining the systemic stability of the financial system. The classical LOLR doctrine, developed by Henry Thornton (1802) and Walter Bagehot (1873) could still be applied, where the central banks can lend at their discretion the LOLR to 'illiquid but solvent banks'.<sup>360</sup> The hefty penalty rate (interest) in LOLR warrants a critical *Shari'ah* examination. The Bagehotian principle posits that the penalty rate (interest) is meant to discourage unnecessary applications of the LOLR by domestic banks.<sup>361</sup> Both Thornton and Bagehot underscored that, the LOLR should provide a temporary solution aiming at extending an emergency assistance only in times of banking panics.<sup>362</sup> The central bank, bears a responsibility for guaranteeing the liquidity of both the conventional and Islamic banking sector, and this includes the provision of the SLOLR. As the banking operations have become widely interconnected, and interdependent today, it is difficult not to save a particular institution so as not to affect the other institutions, and consequently, the entire banking system.

The LOLR and SLOLR are the remedies in times of emergencies. The provision of the LOLR is not mandatory, but rather discretionary.<sup>363</sup> The discretionary role to be exercised by the central bank in this regard includes the critical examination of whether IFIs could potentially trigger contagion by their failures to another banking and financial institutions. Apart from the central banks,

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<sup>359</sup> Ibid.

<sup>360</sup> Ibid.

<sup>361</sup> Ibid.

<sup>362</sup> Ibid.

<sup>363</sup> Ibid.

the ILMC plays a crucial role for the development of liquidity within IFSI because of the limitation of domestic Islamic financial products such as through the issuance of high-quality, liquid, short-term, and tradable *Sharī'ah*-compliant financial instruments such as *sukuk* (Islamic bonds). Thus, liquidity is important for the purposes of a well-functioning of the financial system. In addition, a ready *Sharī'ah*-compliant GFSN that accommodates the need of IFSI contribute towards crisis prevention strategies. The *Sharī'ah*-compliant GFSN complements the regulatory framework that needs to ensure a well-functioning financial system. The *Sharī'ah*-compliant requirements for the establishment of the SLOLR are critically examined in section 4.6.

#### **4.6. SLOLR for the International Framework for Islamic Finance: The *Sharī'ah* Standpoints**

In principle, the SLOLR should prevent temporarily liquid banks from short-term lending, and accordingly provide a certain level of predictability, stability, and readiness of the expectation by the market facing the economic recession and banking crisis. In principle, the SLOLR is to be extended to 'illiquid but solvent' banks.<sup>364</sup> In this regard, the *Quranic* worldview, as enshrined by verse 275 of *Surah Al-Baqarah* cannot be applied in a literal sense due to the involvement of the penalty rate (interest) imposed in the conventional LOLR.

The *Sharī'ah* posits that an interest-based LOLR is not in tandem with the Islamic concept of *Qardhul Hassan* (benevolent loan) which is a type of loan, which involves 'the transfer of ownership in fungible wealth to a person on whom it is binding to return the wealth similar to it.'<sup>365</sup> As the LOLR facility is extended for an extra repayment at a later date, this penalty is tantamount to *riba* (interest), and therefore is not *Sharī'ah*-compliant. Therefore, there is a need to restructure or reformat the LOLR facility to be a type of ELA that does not attract *riba* (interest). The AAOIFI *Sharī'ah* Standard No. 19 (4/1) states that, 'the stipulation of an excess for the lender of a loan is prohibited, and it amounts to *riba* (interest), whether the excess is in terms of quality or quantity, or whether the excess is a tangible thing or a benefit, and whether the excess is stipulated at the time of contract, or while determining the period of delay for satisfaction or during the period of delay, and further, whether the application is in writing or is part of customary practice.'<sup>366</sup> The

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<sup>364</sup> IFSB (n 288) 1-97.

<sup>365</sup> Ibid.

<sup>366</sup> Ibid.

AAOIFI further examines that “[i]t is not permitted to the borrower to offer tangible property or extend a benefit to the lender during the period of the *Qardh* when this is done for the sake of *Qardh*, unless the giving of such benefits is a practice continuing the parties from a time prior to the contract.”<sup>367</sup> Therefore, the LOLR falls squarely within the scope of *riba* in a loan contract, which is either known as *riba al-duyun* that is accrued because of debt, or *riba al-naseeah* that is accrued because of the increase of the repayment of loans.<sup>368</sup> Thus, the SLOLR must be restructured in such a manner that does not attract *riba* (interest) repayment.

From the *Sharī'ah* standpoint, the central bank acting as the SLOLR requires domestic banks to furnish a collateralised security, or eligible collateral, which can be in the form of a mortgage, or some kind of lien or charge, provided that the collateral is a *Sharī'ah*-compliant asset. The collaterals reduce the consequences of adverse selection or moral hazard because it reduces the lender's losses in the case of a default. In this regard, the *Sharī'ah* treats the legality mortgage (*rahn*) as permissible based on the *hadith*, where the Prophet Muhammad PBUH bought some food in a deferred payment from a Jewish person, and the Prophet had mortgaged an armour to him.<sup>369</sup> This is '*rahn*', referring to pawning, mortgage, collateral, charge, lien, and pledge, for the security of debt. For the SLOLR, the central bank may examine the provision of a collateral by an illiquid bank provided that the collateral is also a *Sharī'ah*-compliant asset, and a good collateral based on its marketability, rating, etc. The list of eligible collaterals to be used in Islamic banking and financial transactions as recognised by the central bank has been listed in IFSB-2 Guidelines.

Further, the issue of penalty rate (interest) can be addressed and examined for the purposes of SLOLR by replacing it with a restructured profit rate, pursuant to the restructured form of contract providing the collateral. The profit rate is justifiable under the *Sharī'ah* because the SLOLR also requires a good collateral that is *Sharī'ah*-compliant. In this scenario, the principle of mutual willing consent (*Taradhi*) in *Fiqh Muamalat* is fulfilled.<sup>370</sup> Such a *Taradhi* concept will avoid an element that could nullify the contract, including the acts of *Ghabn Fahish* (excessive

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<sup>367</sup> Ibid.

<sup>368</sup> *Riba* (interest) herein refers to any unjustified increment in borrowing, or lending money, whether in kind or in cash, over and above the principal amount, as a condition stipulated or agreed between the parties, and the high penalty rate in the LOLR facility is *riba* and thus, not *Sharī'ah*-compliant.

<sup>369</sup> Ibid.

<sup>370</sup> Ibid.

inequality)<sup>371</sup> and *Tahhrir* (deception).<sup>372</sup> As the *Sharī'ah*-compliant collateral is provided with the SLOLR facility, the profit rates in the SLOLR for Islamic banks need to be benchmarked against suitable rates that will not cause more harm (*dharar*) to the Islamic banks which are in need of an ELA, through the SLOLR.

#### 4.7. Moral Hazard, SLOLR, and Islamic Finance

Moral hazard is cautioned even for Islamic finance. Although that the SLOLR may be availed in times of financial crisis, it does not absolve the SLOLR from the dilemma of moral hazard. The SLOLR, extended to save the 'illiquid but solvent Islamic bank' has the potential to also make the Islamic bank to be less heedful in managing their liquidity risks. The debate is whether the SLOLR should still be developed in light of the moral hazard caution, or to let the Islamic banks manage their own liquidity issues through seeking liquidity from the IILMC, for instance.

In general, the position towards developing the SLOLR for salvaging illiquid Islamic banks should also be based on the discretionary principle. Hence, such an extension is made on the basis that it is a temporary liquidity assistance. Further, the SLOLR facility is *Sharī'ah*-compliant, based on *taradhi* (mutual willing consent) in *fiqh muamalat*, and hence, this avoids *ghabn fahish* (excessive inequality), *tahhrir* (deception), and *dharar* (harm) to Islamic banks, when the SLOLR is availed and extended. There is an overriding *maslahah* (greater good) that needs to be upheld, when the SLOLR facility is availed and extended, and that is to maintain the well-functioning system of financial stability as the top priority to avoid Islamic bank runs, causing social and widespread economic repercussions. Moral hazard is a dilemma, but it can be mitigated through promulgation of self-based regulatory disciplines, as espoused by international standard-setting organisations, and the supervision by central banks.

The *Quranic* worldview has also espoused the enjoinder of good (*birr*) and acts of piety (*taqwa*), and the prohibition of bad deeds.<sup>373</sup> To avoid *gharar* (uncertainty), the discretionary role, espoused for the SLOLR does not need to be constructively ambiguous, as the terms and principles can be explicitly prescribed

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<sup>371</sup> Ibid.

<sup>372</sup> Ibid.

<sup>373</sup> *Quran, Surah Al-Maidah: (5), Verse 2; "...And cooperate in righteousness and piety, but do not cooperate in sin and aggression..."*.

for the *Shari'ah*-compliant collateral, and the determination of profit rates.<sup>374</sup> In times of banking crisis, prevention of contagion is extremely crucial for the central bank to consider providing the SLOLR to Islamic banks, and this should appropriately be exercised to save the Islamic financial market and safeguard the banking sector, rather than to be faithful only to one particular Islamic bank.

#### **4.8. A Critical Examination of the Restoration of Trust and Confidence through the Risk Management**

Following the critical examination of GFSN, ILOLR, LOLR, and SLOLR, the recent financial crisis of 2008 has witnessed that Islamic banks are generally not exposed to the shocks and contagious effects of the 2008 financial crisis. No Islamic banks had failed in the recent 2008 crisis, and its aftermath. Nevertheless, as the global financial system is not entirely absolved from the systemic risk, the Islamic banks which mimic the operational aspect of the conventional banking system should not be left heedless to prognosticate various risks facing the banking sector. The PLS mode of financing is one of the fundamental tenets of Islamic finance, endeavoured to manage various types of risks, and not simply to gain short-term profits.<sup>375</sup> The recent 2008 financial crisis has witnessed risky financial investments and innovations, taking in the form of complex collateralised debt instruments and credit default swaps, contributing towards the behaviour that is akin to *maysir* (gambling).<sup>376</sup> Islamic banks are seen as price takers rather than price makers in the overall context, where the conventional banking sector is dominating the financial market. Further, both the conventional and Islamic banks are at an active competition with each other as they are both commercial entities, aiming to make profits.<sup>377</sup> But the competition is more about the quality of products, rather than mere pricing which can be negotiated. In a financial crisis, the value of financial contracts can be futile as the ambiguities in the contracts contribute towards *gharar* (uncertainty) when the legal drafting of the financial contracts do not have the quality of addressing the risk of uncertainties.<sup>378</sup>

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<sup>374</sup> IFSB (n 288).

<sup>375</sup> Khan (n 138) 805-820. Khan examined that, "despite the promulgation of the PLS mode, it is noted that the IDB's asset portfolio for 1976-2004 showed that 91% of its financial transactions were non-PLS, and 92% of its income was till derived from non-PLS sources."

<sup>376</sup> Mohamed Sultan and Hassan, *Islamic Derivatives* (n 255) 23.

<sup>377</sup> Bianchi (n 33) 569-580.

<sup>378</sup> Mohamed Sultan and Hassan, *Islamic Derivatives* (n 255) 23.

Recapitalising banks that are trapped in financial distress will cost a burden on the government and to a certain extent, the taxpayers to rehabilitate the banks. Ever since the 2008 financial crisis, banks in debt-ridden countries such as Greece, Iceland, and Ireland had become almost insolvent, but no Islamic bank had to be bailed out yet, although the specialist real estate financier Amlak had to be recapitalised by the Dubai government, where it is based.<sup>379</sup> In light of the 2008 financial crisis, there is a need to solidify an effective risk management mechanism in order to manage the negative effects of cycles on banks, and magnitude of an economic downturn. The risk management and the risks faced by Islamic banks are categorised as follows:

- (a) Credit Risk;
- (b) Liquidity Risk;
- (c) Market Risk;
- (d) Operational Risk;
- (e) Investment Risk; and
- (f) Rate of Return Risk.

It should be noted that the IFSB provides dedicated guidelines on risk management of IFIs in its IFSB-1 (Guiding Principles of Risk Management for institutions (other than Insurance Institutions) Offering Only Islamic Financial Services). IFSB-1 is one of the many IFSB guidelines issued to be used by IFIs. Basically, IFSB-1 provides specific guidance for each set category of risk, particularly credit risk, equity investment risk, market risk, liquidity risk, rate of return risk, and operational risk. The IFSB standards will be adapted and adopted by IFIs according to their needs, as well as to suit the local practices. Comprehensive risk management and reporting process are the general requirements for risk management in IFIs. In this regard, the Board and senior management shall ensure that a proper identification, measurement, monitoring, reporting, and controlling of categories of risk are carried out so that adequate capital is held against these risks. Further, the process of risk management must be *Shari'ah*-compliant, as examined in Principle 1 of the IFSB Guidelines. The next discussion examines various IFSB Principles, as set out in sub-section (a) to sub-section (f) as below.

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<sup>379</sup> Mustafa Mohd. Haneefah, Zurina Shafii, Supiah Sallah, Nurazalia Zakaria, *Governance And Shari'ah Audit in Islamic Financial Institutions*, (USIM, 2012), 51-77.

**(a) Credit Risk**

In the IFSB-1 Guideline,<sup>380</sup> the credit risk is defined as the probability that a counterparty fails to meet its obligations in accordance with agreed terms. Managing credit risk is important, as Islamic banks are exposed to manage their receivables and leases, such as the *murabahah* contracts, diminishing *musharakah* and *ijarah*, and the working capital financing transactions/projects, such as *salam*, *istisnaa'*, or *mudharabah*. There is a great need for the IFIs to be able to manage their credit risks, as they conduct their financings and investment portfolios relating to default and losses, including the risks arising from the settlement and clearing transactions. According to the IFSB-1 Guidelines, credit risk mitigation is divided into the following principles, as explained in IFSB Principle 2.1 to IFSB Principle 2.4.

With respect to Principle 2.1, IFIs should have a strategy for financing. The instruments used must be in compliance with *Sharī'ah*, whereby it recognises the potential credit exposures that may arise at different stages of various financing agreements. Thus, in order to ensure that instruments used for financing are *Sharī'ah*-complaint, IFIs shall keep a list of all types of applicable and approved transactions, and financings. The approved list shall need to be kept up-to-date, and communicated to the relevant personnel within the IFIs.

With regard to Principle 2.2, IFIs shall carry out a due diligence review to the prospect counterparties before deciding on the choice of an appropriate Islamic financing instrument. Therefore, creditworthiness of the counter party should be performed. The counterparty reviews should focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash-flows.

In relation to Principle 2.3, IFIs should have appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument. Thus, depending on the modes of financing, appropriate methodologies to measure, and report counterparty risk should be adopted. The risk may arise at different contract stages (including counterparty performance risk in *Salam* and *Istisna'* contract).

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<sup>380</sup> Ibid.

In respect of Principle 2.4, IFIs shall have in place *Shari'ah*-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument. Thus, measures to mitigate credit or counter-party risk are, among others, (i) limits from relying too much on collateral and guarantees; (ii) devise policies to define the action to be taken by IFIs, when a customer cancels a non-binding purchase order; (iii) devise appropriate credit management systems and administrative procedures in place, to undertake early remedial action for managing problem of credits, potential, and defaulting counterparties. In this regard, remedial action include both administrative and financial measures. The administrative measures include negotiating and following-up with the counterparty through maintaining frequent contact with the counterparty, setting an allowable timeframe for payment, or to offer debt-rescheduling, or restructuring arrangements, or using a debt-collection agency. The financial measures may include, among others, imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with *Shari'ah*, as decided by the IFIs' *Shari'ah* Advisor, and establishing the enforceability of collateral, or third party guarantees. Further, IFIs shall set appropriate measures for early settlements, which are permissible under their *Shari'ah* rules and principles for each Islamic financing instrument. In this regard, IFIs shall assess and establish appropriate policies and procedures pertaining to the risks associated with their own exposures in parallel transactions. For instance, in the case of *Istisna'* transaction, IFIs enter into *Istisna'* contract as sellers to provide manufactured goods or a building to a customer. The IFIs will then enter into a (parallel) *Istisna'* contract as buyers with a supplier (manufacturer or builder), using the specifications drawn up for the original contract. If the supplier fails to deliver the manufactured goods or the building according to the agreed specifications, IFIs would equally be in default of their obligation. If necessary, an external expert may be engaged to evaluate, approve, and monitor the technical aspects.

**(b) Liquidity Risk**

Liquidity risk occurs when there is a potential loss to IFIs arising from their inability to fulfil their obligations as they may be due, without incurring unacceptable costs or losses. In light of the unanticipated events of liquidity crisis, there is a need for IFIs to manage the possibility of liquidity shortages. The closure of *Ihlas Finance* in Turkey during the period of financial crisis in 2000-2001 was due to severe liquidity problems. Although ILMC has been established to address the issue of liquidity, the liquidity management still poses a real challenge to the IFIs. For

instance, the shortage of liquid instruments should prompt IFIs to be more liquid than their conventional peers, and have more non-earning assets on their books. However, it is noted that most of the instruments used for liquidity management purposes are also interest-based, and this makes it difficult for a range of liquid instruments to be availed when Islamic banks need to place their surplus cash. The Islamic banks tend to put their excess cash reserves into short-term interbank *murabahah*<sup>381</sup> at a cost compared to their conventional banks. As opposed to the conventional money market instruments, the cost for managing liquidity using short-term *murabahah* is higher. This is because the involvement of commodity brokers drives the costs for managing liquidity to be high. IFSB Principles 5.1 to 5.2 below explicate the IFSB Principles 5 on Liquidity Risk.<sup>382</sup>

With regard to Principle 5.1, IFIs shall have in place a liquidity management framework, (including reporting) taking into account separately, and on an overall basis their liquidity exposures, in respect of each category of current accounts, unrestricted, and restricted investment accounts. IFIs may have their own criteria for classifying cash-flows, including behavioural methods, and may consider differentiating the types of cash-flows. When calculating net funding requirements (NFR),<sup>383</sup> a substantial influence on the liquidity situation of IFIs relates to their management of PLS depositor holders' expectations. While the basis of NFR calculation is to assume that the funds are repaid at the contractual maturity date, it may not be realistic to assume that all PLS deposit holders will maintain their funds at IFIs until maturity. Therefore, an internal assessment of their expectations and incentives will be part of the NFR calculations. Due to IFIs' dual role in meeting their obligations to current account holders, and managing their expectations of their PLS deposit holders, the IFIs should make periodical cash-flow analysis under various market scenarios and conditions.

The scenarios may vary, depending on local market conditions, and may be based on (i) a 'normal' operating environment (for example) a steady state condition); and (ii) scenarios of adverse circumstances (for example non-linear events and chaotic conditions). IFIs shall establish the maximum amounts of cumulative liquidity mismatches, which they consider acceptable (within the regulatory requirements), and manageable for different time bands, as a percentage

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<sup>381</sup> Ibid.

<sup>382</sup> Ibid.

<sup>383</sup> Ibid.

of total funds available. The effect of liquidity shortages may vary according to the fund providers' liquidity preferences, and hence, separate limits on liquidity mismatches should be set up accordingly. These limits shall be regularly reviewed, taking into account the IFIs' liquidity situation, economic climate, and market conditions.

With respect to Principle 5.2, IFIs shall carry out a due diligence review to the prospect counterparties before deciding on the choice of an appropriate Islamic financing instrument. IFIs' liquidity management policies shall include some form of contractually agreed orderly liquidation procedures, to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the PLS deposit holders' capital and damage to the IFIs' reputation and viability. IFIs must have a liquidity contingency plan addressing various stages of a liquidity crisis. Where appropriate, IFIs shall include in their contingency plans the following factors, and define appropriate action points at each stage:

- (i) Holdings of tradable high quality liquid assets, which may be readily disposed of in sizeable amounts in deep markets, taking into account the likelihood that it will not be possible to realise full book value;
- (ii) Profile of other assets, and the degree of liquidity of these assets;
- (iii) Assessment of *Sharī'ah*-compliant and available funding products in the market, including possible cooperation agreements with either other IFIs, or conventional institutions on an interest-free basis, for accessing temporary funding, or sale and leaseback arrangements for longer term funding;
- (iv) Possible liquidity managements with the central bank (on an interest-free basis);
- (v) Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and
- (vi) Notification procedures for communication with IFIs' head office and/or supervisory authorities.

**(c) Market Risk**

Market risk is set out in Principle 4 in IFSB-1 Guiding Principles which refers to the potential impact of adverse price movements such as benchmark rates, foreign exchange rates, equity prices, and commodity prices, on the economic

value of an asset.<sup>384</sup> Where there exists the risk of losses in assets arising from movements in market prices, the market risk causes the risk of fluctuations of values in tradable, marketable assets (including *sukuk*), and in off-balance sheet specific portfolios, for example, the restricted investment accounts. The market risks refer to the current and future volatility of market values of specific assets. For instance, the commodity price of a *salam* asset, the market value of a *sukuk*, the market value of *murabahah* assets purchased to be delivered over a specific period, and adopted the foreign exchange rates, which are subjected to market risk volatility. IFSB Principle 4.1 in relation to market risk explicates that, in respect of all aspects held, IFIs shall have in place an appropriate framework for market risk management (including reporting), and also for those that do not have a ready market and/or are exposed to high price volatility.<sup>385</sup>

In respect of Principle 4.1, it can be examined that for the purposes of operating *ijarah*, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease of the lessees terminates the lease earlier (by defaulting), during the contract. In *ijarah muntahia bittamleek*,<sup>386</sup> a lessor is exposed to market risk on the carrying value of the leased asset (collateral) in the event that the lessee defaults on the lease obligations. In a *salam* contract, IFIs are exposed to commodity price fluctuations on a long position, after entering into a contract, and while holding the subject matter, until it is disposed of. In the case of parallel *salam*, there is also the risk that a failure of delivery of the subject matter would leave the IFIs to be exposed to commodity price risk, as a result of the need to purchase similar asset in the spot market, in order to honour the parallel *salam* contract. When IFIs are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to changes in liquidity of the markets, in which the assets are traded, and which give rise to greater market risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets. IFIs are also exposed to foreign exchange fluctuations arising from general foreign exchange spot rate changes in both cross-border transactions, and the resultant foreign currency receivables and payables. These exposures may be hedged using *Shari'ah* compliant methods.

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<sup>384</sup> Ibid.

<sup>385</sup> Ibid.

<sup>386</sup> See the definition at 'List of Arabic Terms and Glossary of Islamic Banking and Finance', at page xii - xiv.

**(d) Operational Risk**

Operational risk is about the management of the Islamic banks that need to ensure that there are adequate systems and controls to ensure *Shari'ah*-compliance. Operational risks may include various inter-related risks, such as the risk related to the failure of system, processes, people, internal, and external systems.<sup>387</sup> *Shari'ah* non-compliance risk is regarded as a sub-category of the operational risks in managing the operations of IFIs. *Shari'ah* audit in IFIs is also intended to reduce the *Shari'ah* non-compliance risk as it acknowledges the operational issues in IFIs that comply with the *Shari'ah*. For IFIs, *Shari'ah*-compliance is important because such compliance requirements must operationally be dispersed throughout the entire the organisation of IFIs, and their products and activities. For the international framework for Islamic finance to operate, managing *Shari'ah*-compliant operation is important. Not only that the perception regarding IFIs is nurtured, the compliance with *Shari'ah* is also key to feature the long-term reliability and sustainability of the *Shari'ah*-compliance framework in IFIs. Thus, *Shari'ah*-compliance is one of the most important aspects for the development of the international framework for Islamic finance. The IFSB-Principles 7.1 and 7.2 are examined below in relation to Operational Risk.<sup>388</sup>

With respect to Principle 7.1, IFIs should have in place adequate systems and controls, including *Shari'ah* Board or Advisor, to ensure compliance with *Shari'ah* rules and principles. Thus, IFIs shall ensure that they comply with the *Shari'ah* rules and principles, as advised by the *Shari'ah* Committee, SSB, and the SAC of central bank, where applicable, with respect to their products and activities. This means that *Shari'ah*-compliance considerations are taken into account, whenever IFIs accept deposits and investment funds, provide finance, and carry out investment services for their customers. IFIs shall ensure that their contract documentation complies with *Shari'ah* rules and principles, with regard to the formation, termination, and elements, possibly affecting contract performance, such as fraud, misrepresentation, duress, or any other rights, and obligations. IFIs shall undertake a *Shari'ah* compliance review, at least annually, performed either by a separate *Shari'ah* audit department, or as part of the existing internal audit function by persons, having the required knowledge, and expertise, for the purpose. The objective is to ensure that:

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<sup>387</sup> Ibid.

<sup>388</sup> Ibid.

- (a) the nature of the IFIs' financing and equity investment; and
- (b) their operations are executed in compliance with the *Sharī'ah*, as per the fatwa, policies, and procedures, approved by IFIs' *Sharī'ah* Committee. Also, IFIs shall keep track of income, not recognised arising out of *Sharī'ah* non-compliance, and assess the probability of similar cases arising in the future. Based on historical reviews, and potential areas of *Sharī'ah* non-compliance, the IFIs may assess potential profits that cannot be recognised as eligible IFIs' profits.

In relation to Principle 7.2, IFIs shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Hence, there is a need to identify investing activities that contribute to investment returns, and take reasonable steps to carry out those activities, in accordance with IFIs' fiduciary and agency duties, and to treat all their fund providers appropriately, and in accordance with the terms and conditions of their investment agreements. Allocation of assets and profits between the IFIs, and their PLS deposit holders, will be managed and applied appropriately to PLS deposit holders, having funds invested over different investment periods. Limiting the risk transmission between current and investment accounts. IFIs shall adequately disclose information on a timely basis, on their PLS deposit holders, and the markets, in order to provide a reliable basis for assessing their risk profiles, and investment performance.

**(e) Investment Risk**

According to Principle 3 in IFSB-1 Guiding Principles, it is examined that the principles pertaining to the management of risks inherent in the holding of equity instruments for investment process. There exists an investment risk, whenever there is an act of entering into a partnership for the purposes of undertaking or participating in a particular financing or general business activity.<sup>389</sup> Investment by way of *mudharabah* and *musharakah* instruments will risk its earnings by IFIs which would also face other types of risks, including credit and liquidity that are subjected to volatility in earnings and capital. The capital invested by the provider of finance does not have a fixed return as the *musharakah* and *mudharabah* instruments are

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<sup>389</sup> Nabil Maghrebi and Abbas Mirakhor, 'Risk Sharing and Shared Property in Islamic Finance' (2015) 23 (2) Islamic Economic Studies 85. Maghrebi and Mirakhor examined that, "the conventional risk mitigation techniques are not compatible with the *Shariah*-compliant requirements due to the PLS model. Instead of transferring the risk to borrowers, the depositors of the IFIs are investors, and they share the risk of their investment with the institutions as the agents."

profit-sharing financings. That notwithstanding, an investment risk can be mitigated by appraising the risk profiles of potential partners (*mudharib* or *musharakah* partner). *Mudharabah* is a partnership in profit between the provider of capital (*rabbul maal*), and the entrepreneur (*mudharib*) provides the labour. These risk profiles include the past record of the management team and quality of the business plan, and human resources involved in the proposed *mudharabah* or *musharakah*. Further, the management should appraise the legal and regulatory environment that influences the equity investment performance such as policies on tariffs, quotas, taxation, or subsidies, and any sudden policy change, affecting the quality and viability of an investment. In the light of the emergence of various financial innovations, the risks of change in technology and risk of substitution should also be examined in the context of investment risks. The principles under Principle 3 in relation to investment risks in IFSB-1 Guiding Principle contain Principles 3.1 to 3.3.<sup>390</sup>

With respect to Principle 3.1, IFIs should have appropriate strategies in place for risk management, and reporting processes in respect of the risk characteristics of equity investments, including *mudharabah* and *musharakah* investments. Thus, it requires an adoption of an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and existing from profit sharing investments. In this regard, IFIs shall ensure proper infrastructure and capacity are in place, to monitor continuously the performance and operations of the entity, in which IFIs invest, as partners. These should include the evaluation of *Shari'ah*-compliance, adequate financial reporting by, and periodical meetings with partners, and proper recordkeeping of these meetings. The principle also necessitates identification and monitoring the transformation of risks at various stages of investments lifecycles. Further, possible factors affecting the expected volume and timing of cash-flows for both returns and capital gains, arising from equity investments, should be analysed and determined. In this regard, using *Shari'ah*-compliant risk-mitigating techniques, the impact of possible capital impairment of an investment can be reduced. This may include the use of *Shari'ah* permissible security from the partner.

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<sup>390</sup> Mohd. Haneefah, Shafii, Sallah, Zakaria, *Governance And Shariah Audit in Islamic Financial Institutions* (n 379) 51-77.

With regard to Principle 3.2, IFIs must ensure their valuation methodologies are appropriate and consistent, and they should conduct the assessment on the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IFIs and the *mudharib* and/or *musharakah* partners. Hence, in order for IFIs to conduct the assessment on the potential impacts of the methods on profit calculations and allocation, the following measures could be taken. First, an agreement with the *rabbul mal* (provider of financial capital), and *mudharib* (entrepreneur), and/or *musharakah* partners, before entering into any agreement on the appropriate valuation methods, and periods for which the profit is to be calculated, and allocated taking into account market practices and liquidity features. Second, determination of the profit of the investment by the *mudharabah* or *musharakah* business. In the case of a change of the partnership's shares in a *musharakah* (for example in a diminishing *musharakah*), the shares changing hands shall be valued at a fair value or on some other mutually agreed basis. Third, assessment of the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings. Fourth, engagement of independent parties to carry out audits and valuations of the investment. This will help to ensure transparency, and objectivity in valuation and in the distribution of profits and the determination of amounts to be redeemed. Fifth, establishment of a middle office to perform market risk management function, and to independently monitor, measure, and analyse risk inherent in treasury operations of Islamic Banks.

In relation to Principle 3.1, IFIs shall, in respect of their equity investment activities, including extension and redemption conditions for *mudharabah* and *musharakah* investments, exit strategies should be defined and established and must subject to the approval of IFIs' *Shari'ah* Board. In this regard, examples of exit strategies are, redemption of equity investments and the divestiture of under-performing investments. The criteria may include alternative exit routes, and the timing of exit, and agreement on the methods for the treatment of retained profits by the investee to mitigate the risk of the investee, having cash problems to make profit distributions.

**(f) Rate of Return Risk**

As Basel II provides the rate of return risk, this risk is stipulated in Principle 6 in IFSB-1 Guiding Principle as the risk is associated with the overall balance sheet

exposures, where mismatches arise between assets and balances from fund providers. The net income and the Return on Assets (ROA) of the IFIs will be affected, when there are changes in the market rates and relevant benchmark rates. The PLS deposit holders will have expectations of a higher rate of return when there is an increase in the benchmark rates. When the return on assets is under-performing in contrast to the competitors' rates, IFIs will be put under market pressure to pay a return that exceeds the rate that has been earned on assets financed by the PLS deposit holders.

The IFIs would also suffer a Displaced Commercial Risks (DCR) as a result of the mismatch between the assets and balances from fund providers.<sup>391</sup> The DCR can be understood as the level of risk that are transferred to shareholders in order to cushion the Investment Account Holders (IAH) from bearing some, or all of the risk (credit risk and market risk), as they are contractually exposed in a *mudharabah* contract. Thus, the PLS mode is constrained by competition from conventional banking practices. IFIs may even face withdrawal risk which can manifest from the competitive conventional banking practices due the lower rate of return or at times, the non-availability of the rate to the depositors.<sup>392</sup> IFSB Principles 6.1 and 6.2 were developed in relation to the rate of return risk, and its measures to mitigate the risk.<sup>393</sup>

With respect to Principle 6.1, a comprehensive risk management and reporting process should be established by IFIs in order to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for IAH.<sup>394</sup> Thus, IFIs shall have in place competent staff to undertake the analysis of risk exposures arising from their consolidated balance

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<sup>391</sup> DCR is the risk accrued to the IFIs due to the commercial pressure of having to pay a rate of return equivalent to a competitive rate of return, and absorb a portion of losses, which normally would have been borne by IAH in order to avoid massive withdrawal of funds. See also Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank 2008) 175.

<sup>392</sup> Chong and Liu (n 275) 125-144. It is noted that, at the 2<sup>nd</sup> International Conference on Islamic Banking on 15<sup>th</sup> February 2006, former BNM Governor, Tan Sri Zeti Akhtar Aziz, stressed that "PLS places a higher degree of fiduciary risk on IFIs in ensuring that the investment deposit funds are managed in the most effective and efficient manner. This is further compounded by competition in managing the liquidity in the system. The profit share distributed needs to be competitive relative to that earned and paid by the conventional banks. Given the dual banking environment, the ability to maximise risk-adjusted returns on investment and sustain stable and competitive returns is an important element in ensuring the competitiveness of the Islamic banking system."

<sup>393</sup> Mohd. Haneefah, Shafii, Sallah, Zakaria, *Governance And Shari'ah Audit in Islamic Financial Institutions* (n 379) 51-77.

<sup>394</sup> IFIs are allowed to predetermine the profit ratio, but the rate of return of the investment is the subject to be determined only after the end of the investment period.

sheet activities. These include the process of identification, measurement, monitoring, reporting, and control of the rate of return risk. In this regard, IFIs shall be aware of the factors that give rise to the rate of return risk. The primary form of rate of return risk to which the IFIs are exposed, comprises increasing long-term fixed rates, in the market. In general, profit rates earned on assets reflect the benchmark of the previous period, and do not correspond immediately to changes in increased benchmark rates. Further, IFIs shall assess the effect of the level of their dependency on current account holders' funds. Although no returns are expected by the current account holders, the sudden withdrawal of these funds would have an adverse impact on the overall potential rate of return for IFIs.

With regard to Principle 6.2, IFIs must ensure that an appropriate framework for managing DCR in place, where applicable. Thus, in order to mitigate the adverse impact of income smoothing for Profit Sharing Investment Account (PSIA) on shareholders' returns, and meet potential but unexpected losses that would be borne by IAH, the IFIs can set up prudential reserves, such as Profit equalisation reserve (PER), and Investment Risk Reserve (IRR). Policies on PER and IRR used to smooth or enhance periodic pay-outs to IAH, and to mitigate DCR. PER is the amount appropriated out of gross income of *murabahah* income, before allocating the *mudharib's* share in order to smooth returns paid to the IAH and the shareholders. IRR is the amount appropriated out of IAH's income, after deduction of the *mudharib's* share of income in order to cover any future losses on investments financed by PSIA.

Thus, in essence, risk management must be heeded with serious attention particularly in managing liquidity risk, and the need for provision of the rate of return which should be adequate, and existent. The IFSB guidelines serve as persuasive soft-law instruments. They are not always adhered to. As Islamic banks and IFIs are prone to these risks, the risk management mechanism and strategies should be adequate. This should prompt the Islamic banks to stay out from the complacency zone by undertaking risk mitigation measures.<sup>395</sup>

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<sup>395</sup> Mahmoud A El-Gamal, 'Islamic Bank Corporate Governance and Regulation: A Call for Mutualisation' <http://www.ruf.rice.edu/~elgamal/files/IBCGR.pdf>, accessed 20 April 2018. El-Gamal examined that, 'depositors of the IFIs are not the creditors and the institutions are not the borrowers. They are in fact investors to the IFIs who will fairly share the rate-of-return risk with the institutions. In Malaysia, IFIs' depositors are protected by the government, up-to RM250,000 saving's deposit.'

The recent financial crisis was in part, also triggered by credit risk, especially in the home loan market, where the sub-prime lending was allowed in the US mortgage sector. Most Islamic banks are retail institutions and hence, their main concern will be on liquidity risks in order to meet their obligations towards depositors who need to withdraw cash. Another critical risk facing Islamic banks is the *Sharī'ah* risk. This can be seen in the promulgation of fatwa or *Sharī'ah* rulings by international standard-setting body such as the Islamic *Fiqh* Academy of *Fatwa*, which proclaimed that *Tawarruq* is prohibited due its involvement with *riba*. Malaysia manages this *Sharī'ah* risk through the establishment of a two-tier *Sharī'ah* governance mechanism, consisting the SSB at the level of IFIs, and the SAC at the level of BNM. In this regard, Zulkifli Hassan suggested that 'best practice' in *Sharī'ah* governance has not yet reached the level of efficiency and sophistication expected from IFIs.<sup>396</sup>

Thus, for the international framework of Islamic finance to operate and flourish, there is a need to heed IFSB guidelines in risk management, particularly to ensure an *ex-ante* preparation to face financial crisis and liquidity turbulence, apart from recognising the need for an *ex-post* government intervention, and GFSN such as LOLR, ILOLR, and SLOLR facilities.

#### **4.9. A Critical Examination of the Restoration of Trust and Confidence through Basel III, and Managing the Liquidity Risk**

Following the aftermath of the recent global financial crisis, Basel III was developed to solidify the regulatory regime for the banking sector. As liquidity turbulence problem became one of the main factors that had caused the recent financial crisis, Liquidity Coverage Ratio (LCR) in relation to reinforcing the capital requirements had been re-examined in Basel III. Liquidity is understood as the ability of a bank to fund increases in assets and meet its obligations as they become due, without incurring unnecessary losses. For the purposes of Basel III, the LCR<sup>397</sup> is a newly introduced technique, aimed at ensuring that the liquidity in banks in the

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<sup>396</sup> Zulkifli Hassan, 'A Survey on *Sharī'ah* governance practices in Malaysia, GCC countries and the UK critical appraisal,' (2011) 4 (1) International Journal of Islamic and Middle Eastern Finance and Management 30-51.

<sup>397</sup> LCR will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors, BCBS <<https://www.bis.org/bcbs/>> accessed 23 July 2018.

short term, while a Net Stable Funding Ratio (NSFR)<sup>398</sup> has been espoused to ensure the medium and long term resilience against liquidity shocks.

That notwithstanding, the international framework for Islamic finance consisting of the Islamic banking sector will be restrained in order to meet fully the Basel III liquidity requirements. It is undeniable that the significant level of liquidity is a must to ensure the proper functioning of the banking sector and financial markets as evidenced by the recent global financial crisis. The Islamic banks may have an adequate level of capital. Yet, they are not necessarily liquid. Thus, the liquidity requirements are aimed to promote a regime that will facilitate IFIs to withstand liquidity shocks. Basel III has been proposed and recommended by the BCBS to solidify the regulatory framework which will enhance the overall financial stability, and to improve the capital adequacy standards.<sup>399</sup> For the Islamic banks to remain liquid during normal times, liquidity funding could be sought by obtaining credit from other IFIs or financial institutions. Further, the sale of assets in financial markets can also be obtained through market liquidity. Last but not least, the central bank could also provide an acceptable collateral through which central bank liquidity in the form of credit can be obtained. In light of these liquidity scenarios, where an Islamic bank is faced with the difficulties to obtain cash at reasonable cost from borrowings, this can cause a situation of funding liquidity risk, and where the difficulty involves the sale of assets, market liquidity risk is triggered.<sup>400</sup>

The funding liquidity shortfall requires the Islamic banks to source from the private source, such as other financial institutions, IFIs, or from inter-bank money markets, in order to increase its liquidity level. This has not been necessarily easy for IFIs which are technically constrained by its own business model, which requires the ascertainment of liquidity from the sources that are *Shari'ah*-compliant.<sup>401</sup> Further, market failures may impede access to liquidity from private sources and opaque bank assets can create information-related problems, whereby financial institutions may be unable to screen and monitor the prospective borrowers

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<sup>398</sup> NSFR is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding, BCBS <<https://www.bis.org/bcbs/>> accessed 23 July 2018.

<sup>399</sup> Habib Ahmed, 'Basel III liquidity requirement ratios and Islamic banking' (2015) 16 (4) *Journal of Banking Regulation* 251-264.

<sup>400</sup> Beebee Salma Sairally, Marjan Muhammad, Madaa Munjid Mustafa, 'Instruments for Meeting Capital Adequacy Requirements Under Basel III: A *Shari'ah* Perspective' (ISRA Research Paper No. 52/2013) 9-16.

<sup>401</sup> Ahmed (n 399) 251-264.

adequately.<sup>402</sup> Hence, Islamic banks cannot simply borrow funds to meet the liquidity requirements in case of need, when the interest-based loans are clearly prohibited by the *Shari'ah*. Thus, even in the case of sales of debt, the Islamic banks are restricted to undertake the sale of their debt-based assets in order to secure market liquidity. The lack of an organised Islamic money markets in most jurisdictions curtails the ability of most Islamic banks to seek liquidity in times of real need. IFIs carry 40 percent more liquidity than their conventional counterparts, and commit about 95 percent of their funds to short-term *Ijarah*, *Murabahah*, and *Musharakah* instruments.<sup>403</sup>

For Malaysia, the Islamic Interbank Money Market has been developed, where the *mudharabah*-based interbank investments<sup>404</sup> are used to enable the liquidity funding. Further, the use of *mudharabah*-based interbank investment certificate, and placing the excess liquidity with the central bank under the *wadiah* (deposit and safe-keeping) certificates have been instrumental towards the development of the domestic inter-bank *Shari'ah* financial market in Indonesia.<sup>405</sup> The sale of assets in the securities market also allows the market liquidity to be sought. If the assets are mostly debt-based, the *Shari'ah*-compliant requirements on the sale of debt must be observed, and this potentially constrains the efforts to raise funds by selling debt-based assets to Islamic banks. Romzie Osman and Abdul Rahim Abdul Rahman examined that the overall risk management was given serious attention by IFIs, but the liquidity risk was a real challenge, particularly, the provision of the rate return, which was insufficient, or almost non-existent.<sup>406</sup>

Another option that can be availed to navigate the liquidity management of IFIs is the issuance of a short-term *sukuk* (Islamic bonds) in order to raise funds. The Central Bank of Bahrain has issued a short-term *salam*-based *sukuk* to raise the liquidity funding. But it should be noted that the nature of *salam*-based *sukuk* is debt-based, and should not be tradable, as opposed to an *ijarah*-based *sukuk*, which is an asset-based Islamic bond which is tradable.<sup>407</sup> The lack of secondary markets for *sukuk* prevents the sale at suitable prices. IFIs are also constrained by

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<sup>402</sup> Ibid.

<sup>403</sup> Maher Hassan and Jemma Dridi, 'The Core Principles for Islamic Finance Regulations, And Assessment Methodology' (IMF Working Paper, 24 May 2018) <<https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/05/24/pp040618the-core-principles-for-islamic-finance-regulations-and-assessment-methodology>> accessed 25 July 2018.

<sup>404</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>405</sup> Ibid.

<sup>406</sup> Ahmed, Asutay and Wilson, *Islamic Banking and Financial Crisis* (n 327) 13-39.

<sup>407</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

the private sources of liquidity, because of the non-adherence to the *Sharī'ah*-compliant instruments and markets. This limitation is likewise applicable when the IFIs elect to seek liquidity funding from the public bodies, which cannot facilitate the ready provision of liquidity in times of need, due to the lack of *Sharī'ah*-compliant instruments and markets. As discussed and examined in the preceding sections, the SLOLR may present itself as an available financial safety-net in the event where the emergency funds are required by IFIs, provided that the issue of penalty rate (interest) could be addressed. Most of the existing LOLR facilities are interest-based, and it is a continuous effort to be undertaken by the central bank of each jurisdiction to develop the SLOLR facilities.

Apart from the possibility of developing the SLOLR facilities, the issue of the acceptability of Islamic securities has also surmised. In this regard, the IIFM was established in Bahrain in 2002 as a global standard-setting body for the Islamic capital and money markets. The IIFM's role is to provide the standardisation of documentation and processes of ICM-related financial products.<sup>408</sup> The LMC based in Bahrain was instituted to develop short-and medium-term financial instruments for Islamic banks to use for the purposes of managing their liquidity risks.<sup>409</sup> Notwithstanding this progressive development, the international framework for Islamic finance still suffers from the small-scale operation of the LMC which is more focused on the GCC region, and rather limited to Bahraini banking sector.<sup>410</sup> But the establishment of the IILMC in Kuala Lumpur has enabled *sukuk* to be traded in the international financial markets. For liquidity management purposes, the IILMC can be sourced globally by any Islamic banks and IFIs.

As the liquidity issue becomes critical during the recent financial crisis, the need for IFIs to meet the Basel III liquidity requirements warrant a sufficient supply of liquid *Sharī'ah*-compliant instruments to enable trading in the active markets. Having fewer assets that are liquid cause the Islamic banks to hold more reserves and cash,<sup>411</sup> but in the absence of high quality assets, the maturity of assets would need to be shortened by the Islamic banks, and their liabilities would be increased, and more capital will be required to be raised in order to meet the liquidity requirements. For the purposes of the international framework for Islamic finance, IFIs are prone to lose out in terms of their comparative advantage against the

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<sup>408</sup> Ibid.

<sup>409</sup> LMC, available at <https://www.lmcbahrain.com/>, accessible on 23 July 2019.

<sup>410</sup> Ibid.

<sup>411</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

conventional banks due to the obstacles to meet the *Shari'ah*-compliant instruments for the purposes of the liquidity requirements as stipulated by Basel III.<sup>412</sup> The international framework for Islamic finance should be more proactive to resolve this crucial issue of liquidity needs. Recognising this liquidity necessity, the Central Bank of Sudan has steered an arrangement to manage liquidity at the private level, where IFIs are prompted to create 'alliance groups' to meet the liquidity requirement.<sup>413</sup> In this regard, the liquidity pools are gathered which may be used in case of need among the participating IFIs. But this kind of arrangement may only address the short-term liquidity problems, but not the large-scale liquidity problems that can be triggered in the event of economy-wide shocks. The SLOLR may then need to be devised and developed<sup>414</sup> so that such a wide liquidity shock can be responded to by the central bank through an *ex-post* intervention in the financial market. Further, as the *sukuk* markets are still growing and gaining acceptance, the central bank may purchase any illiquid *sukuk* at discounted prices, and accordingly avail the Islamic banks with sufficient liquidity, as needed.

Without sufficient liquidity instruments and infrastructure, the international framework for Islamic finance will be impeded in terms of its growth, and this could also raise the issue of trust and confidence in the said banking sector in the long run.<sup>415</sup> Further, the scarcity of *Shari'ah*-compliant liquid asset has also prompted IFIs to hold more reserves and reserves. The central bank's role is also constrained by the SLOLR in order to avail IFIs with *Shari'ah*-compliant tradable instruments to meet the short-term liquidity needs. Therefore, there will be a serious hurdle for IFIs to fulfil Basel III liquidity requirements, if the *Shari'ah*-compliant tradable and liquidity instruments and infrastructures are not adequately developed. Therefore, as the international framework for Islamic finance relies on trust and confidence, there should be a robust liquidity infrastructure for IFIs to operate to ensure the well-functioning Islamic banking and financial system, and accordingly satisfy Basel III's regulatory liquidity requirements. Noraini Mohd. Ariffin and Salina Hj. Kassim had examined that during the period of 2006 to 2008, there was no clear increase in liquidity risk for the leading six Malaysian Islamic banks, but the return on equity declined as a consequence of the financial crisis.<sup>416</sup> Thus, it should not be underestimated that a sound liquidity infrastructure for the international framework

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<sup>412</sup> Ahmed (n 399) 251-264.

<sup>413</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>414</sup> IFSB (n 288) 1-97.

<sup>415</sup> Ahmed (n 399) 251-264.

<sup>416</sup> Ahmed, Asutay and Wilson, *Islamic Banking and Financial Crisis* (n 327) 13-39.

for Islamic finance is extremely vital in the long run.<sup>417</sup> This framework should adequately encompass various sources of liquidity funding, including the role of the SLOLR as a financial safety-net and GFSN in times of emergency and wide-scale liquidity shocks. Thus, a robust liquidity infrastructure for the Islamic financial sector is required for the smooth-functioning of IFIs and to fulfil the regulatory liquidity requirements of Basel III in the immediate term.<sup>418</sup>

#### **4.10. Global Financial Crisis from Ethical Finance, Behavioural Finance, and the *Quranic* Worldview as Novel Scholarly Contributions**

Following the critical examination of the various types of risk management principles, guidelines, liquidity risk management, and the important roles of the SLOLR, this section examines the global financial crisis from an ethical finance,<sup>419</sup> behavioural finance, and the *Quranic* worldviews as novel scholarly contributions in this study. From the 1930s to the recent 2008 financial meltdown, the discussion on the factors that have caused the economic recession attracts debates and analysis from various viewpoints, such as the failure of corporate governance, liquidity-turbulence, failure in the risk-management and early warning mechanism, excessive leverage and risk-taking,<sup>420</sup> undercapitalised banking system, and recent theorisation of behavioural economics and finance. Centering the focus on the theories of behavioural finance, this section examines the roles of economics in sub-section 4.10.1, particularly the behavioural economics and finance, the roles of *Quranic* ethics<sup>421</sup> in in sub-section 4.10.2, and the roles of law in sub-section 4.10.13, as an eventual propagation of ethical-based finance in the context of financial crisis.<sup>422</sup> Factors triggering the financial crisis vary. These factors have been examined

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<sup>417</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>418</sup> Ahmed (n 399) 251-264.

<sup>419</sup> Valentino Cattelan, 'Legal Pluralism, Property Rights and the Paradigm of Islamic Economics' (2017) 30 (1) Journal of King Aziz University 21-35. Cattelan concludes that, "the focus of Islamic economics paradigm on real (instead of financial) economy may represent a fundamental guideline for the promotion of a social impact model of development, whose outcomes should be judged in the light of the effective contribution of financial instruments to the (economic/social) wealth of a given community, in terms of real growth of entrepreneurship, economic empowerment, and financial inclusion (and not simply in terms of nominal value)."

<sup>420</sup> Miskin (n 142) 3-20.

<sup>421</sup> Mirakhor, *State of Islamic Finance* (n 21) 29-32.

<sup>422</sup> The author of this thesis has presented his research on the topic of "The Roles of Ethical Finance in the Context of Financial Crisis: Integrating Economics with Quranic Ethics and Law" at the Ethical Finance and Governance in Emerging Markets Conference at Edinburgh Napier University on 2-3 May 2018 (Unpublished).

earlier, from the historical analysis of the 1930s Great Crash as examined by John Kenneth Galbraith<sup>423</sup> to the study of banking crisis by Rogoff and Reinhart, to the propagation on the return to Depression Economics as re-examined by Paul Krugman.<sup>424</sup> These analytical contributions have been rigorous in examining multi-faceted issues surrounding the financial crisis, including the roles of the LOLR.<sup>425</sup> This section examines another aspect of novel scholarly contributions to guide the perspectives regarding the roles of ethical finance, behavioural finance, and the *Quranic* worldview in the context of financial crisis.

Behavioural finance<sup>426</sup> is juxtaposed between two disciplines, i.e. psychology and finance, although it is largely examined as part of the subset of the financial discipline as well. Catering to the psychological dimension of the financial discipline, financial actors are composed of banking industries, namely banks and corporations, government, bankers as professional actors, institutional investors, consumers, depositors, lawyers, law makers, economists, IFIs, other institutional financial institutions, taxpayers, etc. These actors are the drivers of the financial and real economy operating within the international framework for Islamic finance, which is driven by capitalism and the *laissez-faire* pursuit of self-interests. Psychological safety over fear. In this regard, the financial crisis, and other scandals which featured the banking industry of a decade ago have also witnessed a corresponding decline in trust. The question is whether the trust and confidence are still solid, and whether the culture of the bank can be trusted. As banks work to embed advanced analytics in their banking culture, and leverage the value of customer data, a healthy and ethical banking culture in the digital age becomes more crucial than ever before.<sup>427</sup> Organisational culture is set by the board and senior management team, and it is spread throughout the entire workforce within the organisation.<sup>428</sup>

As banks are driven by profit-making agenda, capitalism breeds greed which is pervasive in the market. Capitalism has shaped the mind-set and psychological underpinning of financial market actors, and has been seen to be operationalised as

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<sup>423</sup> John Kenneth Galbraith, *The Great Crash* (Penguin, 2009) 2-35.

<sup>424</sup> Paul Krugman, *The Return to Depression Economics* (Allen Lane 2008) 2-15.

<sup>425</sup> The author has presented his research on this topic titled as "Will the Banking Crisis Recur When the only thing that is Certain is Uncertainty and Are We Returning to Depression Economics with Legal Responses?" at the Society of Legal Scholars' Conference, Banking and Finance Law Section on 4 September 2018 (Unpublished).

<sup>426</sup> Richard H. Thaler, *Misbehaving* (Penguin 2016) 1- 80.

<sup>427</sup> \_\_\_\_\_, 'Tone from the Top' *Chartered Banker* (October/November 2018) 16-17.

<sup>428</sup> *Ibid.*

the main catalyst that mobilises these actors in the financial and real economy.<sup>429</sup> Their actions of financing, lending, borrowing, taking and managing risks are influenced by capitalism and greed.<sup>430</sup> Capitalism shapes the mind-set, influences the psychological behaviour of the market actors towards greater accumulation of capital and profit maximisation, which subsequently develops a propensity towards excessiveness. To put it more contextually, excessive capitalism. More plainly, excessive greed in the psychological sense of moral dimension. Where excessive greed permeates the banking sector, the exuberance rises high, irrationality spurs, rationality becomes bounded, and the rational economics' responses become futile as the issue turns to be behaviourally-oriented.<sup>431</sup> Excessive propensity for greed and capitalism may be curbed, if not curtailed. The ethical and behavioural finance command that capitalism is positive, when it is exploited towards inducing active motivation to reap prosperity which can spill over to financialise the real economy.<sup>432</sup>

But the negative acts of excessive risk-taking<sup>433</sup> and speculative behaviours are admonished. From the perspective of behavioural finance, the response is not certain as financial actors do not always derive their conclusion rationally, but from the herding mood, and the psychological propensity that echoes the mantra of capitalism that 'greed is right and good'.<sup>434</sup> According to Anjan Thakor, Professor of finance at the Washington University in St. Louis, a healthy banking culture is one that is based on a clearly articulated higher purpose for the bank i.e. a prosocial contribution goal that transcends usual business goal, but intersects with the social contributory aspect. High capital in the bank and its financial safety value should be emphasised over 'reckless' growth.<sup>435</sup>

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<sup>429</sup> Thaler, *Misbehaving* (n 426) 1- 80.

<sup>430</sup> John Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (n 28) 5-60. According to John Kay, "[t]he financial sector has grown too large, detached itself from ordinary business and everyday life, and has become an industry that mostly trades with itself, talks to itself, and judges itself by reference to standards which it has itself generated. And the outside world has itself adopted those standards, bailing out financial institutions that have failed all of us through greed and mismanagement."

<sup>431</sup> *Quran, Surah Al-An'Am: (6), Verse 50* is one of the verses which articulates the need to use intellectual reasoning, but beyond that, there still exists knowledge asymmetries due to bounded rationality, and the predicament of an imperfect understanding. "Say, [O Muhammad], "I do not tell you that I have the depositories [containing the provision] of Allah or that I know the unseen, nor do I tell you that I am an angel. I only follow what is revealed to me." Say, "Is the blind equivalent to the seeing? Then will you not give thought?"

<sup>432</sup> Mirakhor, *State of Islamic Finance* (n 21) 29-32.

<sup>433</sup> Miskin (n 142) 3-20.

<sup>434</sup> 'Greed is good' is a catchphrase by Gordon Gekko from the 1987 film 'Wall Street'.

<sup>435</sup> \_\_\_\_\_, 'Tone from the Top' *Chartered Banker* (October/November 2018) 16-17.

From the perspective of finance, the financial rules and accounting principles are devised with great precision and empirical data that take into account the discounted cash flow and balance sheet test to examine whether a risk should be undertaken before certain financial investments are made. Whilst this discipline has developed its esoteric sophistication through rigorous mathematical formulas and the institutionalisation of accounting and financial principles, the financial safeguard is therefore ideal, but it still lacks the coherent interaction from the psychological dimension of financial actors,<sup>436</sup> which is complex, if not perplexing to discern. Discounted cash flow may be able to assist the corporate finance, but an assumption would still have to be made on the consideration of interest rates, which require a verification test, lest the cash flow analysis will be prone to several variables of fluctuating propositions. Therein lies the necessity to integrate the behavioural aspects of financial actors with the financial aspects of the discipline.<sup>437</sup>

As novel scholarly contributions, this study critically examines a new analytical perspective, enshrined in the *Quranic* worldview by undertaking a critical analysis with the aspects of behavioural finance and ethical finance in the context of financial crisis. The roles of economics, *Quranic* ethics,<sup>438</sup> and the roles of law are critically examined in turn in the following sub-sections 4.10.1, 4.10.2, and 4.10.3.

#### **4.10.1. The Roles of Economics**

The notion of ethics from the economics' standpoint is examined with a focus on the notion of bounded rationality. The behaviour of market participants is not always in consonance with the rational choice theory, but at times, influenced by the Animal Spirits as examined by George A. Akerloff and Robert J. Schiller.<sup>439</sup> The Animal Spirits articulate greed and capitalism influence the decisions of the market actors and the financial sector in their activities and decisions. John Kenneth Galbraith examined that, following the 1930s Great Crash and Depression, there must be a recommendation of good knowledge of what happened in 1929 to serve as the best safeguard against its recurrence.<sup>440</sup> Galbraith had made a sharp observation on the human behaviour during the speculative stock market bubble

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<sup>436</sup> Thaler, *Misbehaving* (n 426) 1-80.

<sup>437</sup> Ibid.

<sup>438</sup> Mirakhor, *State of Islamic Finance* (n 21) 29-32.

<sup>439</sup> George A. Akerloff and Robert J. Schiller, *Animal Spirits* (Princeton University Press, 2010) 2-20

<sup>440</sup> Galbraith, *The Great Crash* (n 423) 2-15.

and subsequent crash. The market was induced to speculate to get rich without labour.<sup>441</sup>This issue falls squarely within the domain of behavioural finance analysis.

The financial crisis, when examined in the paradigm of Adam Smith, postulates that economics is about the study of the nature and causes of nation's wealth, or a study of wealth through the economic freedom in the *laissez-faire* system.<sup>442</sup> Adam Smith examined that the unobservable market force will boost the demand and supply of goods and services in a free market and the market will eventually reach an equilibrium.<sup>443</sup> Capitalism underpinned, it is the pursuit of the individual self-interests that will bring greater benefit for all, since the *laissez-faire* system creates more competitions and profit maximisation efforts. The *laissez-faire* induces the market to its inherent ability to perfect itself through the 'invisible hand', which will set the prices and quantity, as well as the demand and supply. In the context of financial crisis, Adam Smith's approach heralds that the government spending should not constitute a major market force since the market is capable of perfecting itself. Thus, government intervention in the market can be detrimental to the market, and it is the supply that will create its own demand.

While Adam Smith has garnered significant influence for his study of 'The Wealth of Nations',<sup>444</sup> John Maynard Keynes expounded that economics is a study of market that is not perfect but yet stable, and at times, can be potentially unstable due to shocks and booms that could impact the market and the economy.<sup>445</sup> Thus, Keynes rejects that market can self-perfect itself through what Adam Smith examined as a method of self-correction mechanism or the invisible hand. It is Keynes' belief that market is not self-sustaining.<sup>446</sup> Hence, government intervention is needed through increasing government expenditure, stimulating government spending, and formulating fiscal and monetary policy (fiscal stimulus) to boost

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<sup>441</sup> Ibid.

<sup>442</sup> Adam Smith, *The Wealth of Nations* (CreateSpace Independent Publishing Forum, 2014) 5-28. Adam Smith (1776) gave birth to Economics as a social science, followed by significant contributions by Jeremy Bentham (1832), J.S.Mill (1873), Ricardo (1832), and Malthus (1834) to enrich economics as a pure social science. The rapid industrialisation fostered a new worldview on social and religious conundrum. The legal prohibition against usury was repealed, which had led to the widespread *laissez-faire* in the 19<sup>th</sup> century Britain to remove the statutory ceiling on the rate of interest and the legal penalty for violating the maximum limit.

<sup>443</sup> Smith, *The Wealth of Nations* (n 442), 5-28.

<sup>444</sup> Ibid.

<sup>445</sup> John Maynard Keynes, *The General Theory Of Employment, Interest, And Money* (Snowball Publishing, 2012) 4-29.

<sup>446</sup> Ibid.

economic growth.<sup>447</sup> In times of recession, there is a need to have an expansionary fiscal policy. More sovereign borrowing can be used to offset fall in private spending. Demand is spurred by consumers' consumption, whilst lowering taxes can boost domestic consumption, and pull the economy out of recession.<sup>448</sup>

Whilst these economics' approaches shed some light as to how the financial crisis can be dealt with, it is also Galbraith's recommendation of good knowledge of what happened in 1929 that heeds for the best safeguard against financial crisis' recurrence.<sup>449</sup> Particularly, there was a need to observe the behavioural aspect of the market during the speculative stock market bubble, and its subsequent crash. Thus, in this section, the Smith's and Keynes's economics have been examined alongside the contribution of behavioural finance theories, as augmented by Akerloff and Schiller, and Galbraith's study of the Great Crash of 1930s, in order to further explain the roles of behavioural and ethical finance, in the context of financial crisis.

#### **4.10.2. The Roles of *Quranic* Ethics**

To complement the examination of the international framework for Islamic finance, particularly in the context of managing the financial crisis, the behavioural finance aspect requires a critical examination of ethics<sup>450</sup> which could be inspired in terms of its further elucidation from the enshrinement of *Quranic* ethics. Whilst *Quranic* ethics may not be mutually exclusive from the ethical underpinnings, as theorised by Akerloff and Schiller for the purposes of analysing behavioural finance, the key distinction lies in the 'meta-dependence' analysis for the *Quranic* ethics, which gives deference to the Islamic revealed knowledge and non-material wisdom, as enshrined in the *Quranic* worldview.<sup>451</sup>

The fact is that the international framework for Islamic finance is 'meta-dependent' towards the *Quranic* worldview, when operationalising the *Shari'ah*-compliant requirements in Islamic finance. The 'meta-dependence' analysis of the

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<sup>447</sup> Ibid.

<sup>448</sup> Ibid.

<sup>449</sup> Galbraith (n 423) 2-15

<sup>450</sup> Abdul Karim Aldohni, 'Book Review, Hillel Gamoran, *Jewish Law in Transition: How Economic Forces Overcame the Prohibition Against Lending on Interest*' (*Ecclesiastical Law Journal*, (2012) 14 (1) 121-122. It is noted that historically, Judaism, Christianity, and Islam share a similar firm position with regards to usury. In relation to commerce and business, religious rulings, in general, are more concerned with the question of morality of any business transaction, and one of the main shared grounds between most religions is the prohibition of interest (*riba*).

<sup>451</sup> Abbas Mirakhor, *State of Islamic Finance* (n 21) 29-32.

*Quranic* worldview, espoused throughout the international framework for Islamic finance is not only guided by an Islamic revealed knowledge,<sup>452</sup> but also a wisdom to examine the psychological<sup>453</sup> aspect of the market. These economic actors are prone to the material forces of the market, whilst the *Quranic* worldview<sup>454</sup> has balanced such a profit maximising behaviour with the *Quranic* ethics in order to curb riskier investment appetites and the harmful effects of an excessive capitalism, including the prohibition of *riba*, *maysir*, and *gharar* activities. Ethics' discourse may take hundreds of civilisations<sup>455</sup> to bring them into the form of an agreed universal principle of ethics. But the basic characteristics of banking and Islamic finance have been critically examined to derive from the characteristics of trust and confidence, vested in trade (*bay*).<sup>456</sup> This role of trust and confidence for the international framework for Islamic finance has been enshrined in verse 275 of *Surah Al-Baqarah*, forming the core archetype for the Islamic finance operation. The recent financial crisis may have shaken the trust and confidence. But the 'meta-dependence' connexion to the *Quranic* ethics espoused within the international framework for Islamic finance have not been unheeded in the context of fulfilling the *Shar'ah*-compliant requirements. The *Quranic* ethics of trust and confidence, enshrined in verse 275 of *Surah Al-Baqarah* should remain operational for the long-term 'meta-dependence' characteristics of trust and confidence for the international framework for Islamic finance. The *Quranic* ethics of trust and confidence in contracting and financing are enshrined in the *Quran*, systematically, repetitively,

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<sup>452</sup> Ibid.

<sup>453</sup> Richard H. Thaler, *Misbehaving* (n 426) 1- 80

<sup>454</sup> *Quran, Surah Ar-Rum*: (30), Verse 39; stipulates that *riba* (interest) does not increase other people's wealth but charity does manifold. *Quran, Surah An-Nisa*: (4), Verse 161; stipulates that the taking of *riba* (interest) and the wrongful appropriation of other people's property is forbidden as this can be seen as devouring of one's wealth. *Quran, Surah Al-Imran*: (3), Verse 130-132; prohibits the doubling and redoubling of *riba* (interest). Finally, in *Quran, Surah Al-Baqarah*: (2), Verse 275-281; sealed all doors towards *riba* (interest) and in this regard, trade (*bay*) is permitted but *riba* (interest) is prohibited.

<sup>455</sup> Marianne M. Jennings, 'Ethics and Financial Markets: The Role of the Analyst (a summary)' (2013) The Research Foundation of Chartered Financial Analyst 1-7. Jennings articulated that, "[t]he ethical issues financial analysts face today are no different from the ethical issues financial advisers, fund managers, and analysts have faced over the decades and centuries that financial markets have existed. Ethics in the market place is not a new concept. In fact, fraud has been and always will be with us. The Code of Hammurabi covered everything from adultery to business trade, with the basic goal of the code being to impose harm on the perpetrator equal to the harm done to the customer/client." Further, it is noted that "the ancient Babylonia Hammurabi (2000 BC) regulated the rate of usury by disapproving such a practice, and the new King declared the cancellation of all debts at the time of his coronation. Judaism prohibited usury in the strongest terms, and did not distinguish between distress loans, and loans for any other purpose, but permitted the Jews to charge usury from non-Jews. Thomas Aquinas (1274) distinguished between distress and commercial loans, but the law was not amended, but the prohibition was carried out conspicuously. John Calvin (1564) pleaded that usury was morally repugnant while interest on commercial and development loans served social needs."

<sup>456</sup> *Quran, Surah Al-Baqarah*: (2), Verse 275.

consciously, and to a certain extent, descriptively, as the main ethical underpinning that will foster the *maslahah* (greater good) and justice (*'adl*) of the masses, and for the inter-civilisational utilitarianism, as the spill-over effects from the trust-building exercise. The *Quranic* ethics are enshrined explicitly in the following *Quranic* verses, and in times of financial crisis, the *Quranic* guidance is enshrined through verses 47-49 of *Surah Yusuf*, where the management of the economy is guided by the *Quran*. The relevant verses are translated as follows:

*"But seek, through that which Allah has given you, the home of the Hereafter; and [yet], do not forget your share of the world. And do good as Allah has done good to you. And desire not corruption in the land. Indeed, Allah does not like corrupters."<sup>457</sup>*

*"You will surely be tested in your possessions and in yourselves. And you will surely hear from those who were given the Scripture before you and from those who associate others with Allah much abuse. But if you are patient and fear Allah - indeed, that is of the matters [worthy] of determination."<sup>458</sup>*

*"Those who do not spend their wealth that has been given to them by Allah must not think that it is good for them; indeed it is bad for them."<sup>459</sup>*

*"And [they are] those who, when they spend, do so not excessively or sparingly but are ever, between that, [justly] moderate"<sup>460</sup> .*

*"Who are stingy and enjoin upon [other] people stinginess and conceal what Allah has given them of His bounty - and We have prepared for the disbelievers a humiliating punishment."<sup>461</sup>*

*"O you who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. .... And do not be [too] weary to write it, whether it is small or large, for its [specified] term. That is more just in the sight of Allah and stronger as evidence and more likely to prevent doubt between you, except when it is an immediate transaction which you conduct among yourselves. For [then] there is no*

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<sup>457</sup> *Quran, Surah Al-Qasas: (28), Verse 77.*

<sup>458</sup> *Quran, Surah Al-Imran: (30), Verse 186.*

<sup>459</sup> *Quran, Surah Al-Imran: (3), Verse 180.*

<sup>460</sup> *Quran, Surah Al-Furqan: (250), Verse 67.*

<sup>461</sup> *Quran, Surah Al-Nisa: 94), Verse 37.*

*blame upon you if you do not write it. And take witnesses when you conclude a contract. Let no scribe be harmed or any witness. For if you do so, indeed, it is [grave] disobedience in you. And fear Allah. And Allah teaches you. And Allah is Knowing of all things*<sup>462</sup>.

*"[Joseph] said, "You will plant for seven years consecutively, and what you harvest leave it in its spikes, except a little from which you will eat. Then will come after that seven difficult [years] which will consume what you saved for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes]."*<sup>463</sup>

Based on the above-mentioned verses, the *Quranic* worldviews do not only emphasise the importance of the ethics of trust in the trust-building exercise in contracting and financing, but also ordains in verses 47-49 of *Surah Yusuf* that, in times of high economic growth, the government spending should be reduced to allow reserves and cash to be saved, but in times of an economic recession, the government spending should be increased to boost economic growth. Thus, the *Quranic* worldview enjoins capitalism to drive economic growth by spending to stimulate demand and growth, but simultaneously heeding caution against excessive capitalism. Excessive greed and risk-taking behaviours are to be curbed. Capitalism is espoused in a manner, enshrined in *Surah Al-Qasas*, verse 77, where men as economic actors are asked to seek what lies the Hereafter, and yet, they should not forget their share of the world. This capitalism and trust-building exercise is moderated by *Surah Al-Imran*, verse 186, where through capitalism and profit maximisation efforts, the economic actors will be tested what are in their possessions and within themselves, and this underscores the need to be ethical in the behavioural financial undertakings. The test of capitalism is further examined by verse 180 of the same *Surah*, where the attitude of spending must be balanced with the attitude of charity so as to curb excessive greed and capitalism. Therefore, wealth spending may seem to be good, but is bad if the moderation and balance are not observed in consonance with the exercise of the *Quranic* worldviews of ethical finance. Where greed and capitalism become pervasive in life, *Surah Al-Nisa*, verse 37, has warned against parsimony and thriftiness as a result of an excessive

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<sup>462</sup> *Quran*, *Surah Al-Baqarah*: (2), Verse 282.

<sup>463</sup> *Quran*, *Surah Yusuf*: (12), Verse 47-49

capitalism, but the *Quranic* worldview has balanced the injunction through the need for moderation, via a moderate spending policy in *Surah Al-Nisa*, verse 67.

To further maintain the essence of trust and confidence in the international framework for Islamic finance, a detailed inscription is elucidated in *Surah Al-Baqarah*, verse 282. A formalisation of a legal relationship must be undertaken in the context of financing and contracting an obligation so as to foster a mutual trust and a legal enforcement mechanism. As economic crisis is a recurring phenomenon that is subjected to the alternating cyclical patterns, the *Quranic* worldview through *Surah Yusuf*, verses 47-49 has guided the policy making strategies to control financing growth in the event of an economic expansion, so that during the period of an economic crisis, reserves from the period of an economic expansion can be used to amplify the financing activities. This policy strategy is also akin to an adage of wisdom to 'save during sunny days, but spend during rainy days'.<sup>464</sup> Therefore, increasing government spending may help alleviate the impact of a recession because during the recession, the government could effectively exercise its role to purchase more goods and services. This will in turn stimulate the aggregate demand in an economy, which will influence the businesses to employ many workers in order to optimise the full production of output to meet the increasing trends of demand in an economy. Fiscal stimulus is important in this regard as it can help in boosting the domestic demand. The increase in domestic demand is a positive sign towards speedy economic recovery rather than seeing the economy being stagnant due to its lack of economic growth. The government spending in times of crisis helps in rehabilitating the economy which later on, will be gradually self-sustaining. This will eventually absolve the government from its role to spend indefinitely. The examination of the *Quranic* worldview in this study should be heeded with utmost importance to guide the international framework for Islamic finance, in addition to treat the *Quranic* worldview as novel scholarly contributions towards guiding the understanding on the roles of economics, behavioural finance, ethical finance, and the *Quranic* ethics of finance. In essence, the *Quranic* worldview is the Islamic revealed knowledge, incorporating both the material and the non-material wisdom,<sup>465</sup> which is examined beyond the lenses of a capitalist postulation. The *Quranic* worldview provides reading lenses for the analysis of 'meta-dependence' trust and confidence which enshrine the *Quranic* ethics for the international framework of Islamic finance, and guide its future trajectory development.

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<sup>464</sup> Eduardo Cavallo, Tomás Serebrisky, *Saving for Development, How Latin America and the Caribbean Can Save More and Better* (Palgrave Macmillan, 2016) 4-80.

<sup>465</sup> Cattelan (n 419) 21-35.

In light of the ethical-finance analysis, a corporate code of ethics in reaction to the financial crisis may appear to be a good idea. But the question is whether it is really worth the investment since the *Quranic* worldview can guide the international framework for Islamic finance. Further, as ethical behaviour is highly reliant on the integrity of individuals, it is impossible for a code to capture everyday situation that is encountered in everyday banking. This study is conscious of the actions taken towards bankers who have acted unethically during the global financial crisis, some were sacked, and some had lost their membership of professional bodies.<sup>466</sup> In the aftermath of the financial crisis, ethical standards are important to ensure not only the proficiency of banking services, but also its integrity. Ethical and professional conduct starts with a well-founded understanding of an ethical behaviour, which is developed and shared across the bank's organisation. The future of banking might be different from what is now, given the rapid emergence of disruptive technologies. But it is imperative that bankers reinvent themselves to embrace these changes. Yet, certain things about bankers will remain, whether they are bankers of today or tomorrow, a clear moral compass for an ethical behaviour of trust is a must.<sup>467</sup>

#### 4.10.3. The Roles of Law

The roles of economics, behavioural economics, behavioural finance, ethical finance, and *Quranic* ethics must not be considered in isolation but rather, they are to be harmoniously integrated with the appropriate consideration of the roles of law, particularly the *lex specialis* regime for a *Shari'ah*-compliant GFSN to manage financial crisis.<sup>468</sup> The law is an avenue to integrate the economics (including the behavioural economics and finance) with the ethical finance principles, which among others, are enshrined by the *Quranic* worldview. This will enforce a fused framework of the *Quranic* ethics and finance, which can be translated into a legal framework that provides a workable *Shari'ah*-compliant GFSN to manage the financial crisis. The financial crisis, when examined in the paradigm of the Smith's and Keynesian's economics, postulates two completely different approaches. Smith was prone to the *laissez-faire* approach, whilst the Keynesian economics posits the imperfect market system that is unstable due to shocks and booms. It is J.K. Galbraith's examination of the market behaviour during the 1930s Great Crash that had clarified that it was the speculative behaviour that was induced by the excessive greed to make money

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<sup>466</sup> Nikolopoulos and Thomakos (n 55) 47-48.

<sup>467</sup> \_\_\_\_\_, 'The Foundations of Trust' *Chartered Banker* (UK April/May 2017) 24-27.

<sup>468</sup> IFSB (n 288) 1-97.

without labour that had caused the Great Depression.<sup>469</sup> In a recession, it is the *ex-post* paradigm that requires a critical examination of the market, as according to Keynes, the market cannot perfect itself. Hence, an *ex-post* government intervention is required through increasing government expenditure, plus extending the LOLR and SLOLR to the banking sector facing liquidity-turbulence problems.<sup>470</sup> In the context of banking crisis, the *ex-post* intervention is gullible towards moral hazard.<sup>471</sup> This brings the policy analysis to examine whether it is the moral hazard that the intervention seeks to prevent, or the greater *maslahah* (greater good) to maintain the well-functioning financial system that should become the priority.

The LOLR and SLOLR are the *lex specialis* mechanism which may be accused of contributing to the propensity of financial crisis, as it induces moral hazard, and encourages excessive risk-taking. But without the GFSN such as the LOLR and the SLOLR, such an *ex-post* government intervention may not help facilitate the economy towards fast recovery from the financial crisis, and resuscitate the economy towards financial stability as an overriding *maslahah* (greater good) goal. Thus, the legal framework should be able to accommodate the need to have a ready LOLR, and the SLOLR for the purposes of the international framework for Islamic finance. Andrew Campbell and Rosa M. Lastra, critically examined, when revisiting the LOLR, in times of extreme uncertainty and volatility, market participants “seek little ambiguity from their central bank”.<sup>472</sup> Thence, through the legal mechanism taking its course via “the introduction of Special Liquidity Scheme by the Bank of England was examined to be a non-permanent scheme, aiming to provide a temporary solution to the continuing problems associated with the lack of liquidity in the financial markets, which had to be extended and expanded.”<sup>473</sup> Therefore, the legal framework on the SLOLR should be developed as a financial safety-net, heeding the *Quranic* worldview to intervene in the economy in times of a recession to boost the economy, and increase government spending to stimulate the economic growth. As Islamic banking becomes highly inter-connected, the need to maintain the well-functioning global financial system also becomes more imperative.

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<sup>469</sup> Galbraith (n 423) 2-55.

<sup>470</sup> Campbell and Lastra (n 345) 453-498.

<sup>471</sup> *Ibid.*

<sup>472</sup> *Ibid.*

<sup>473</sup> *Ibid.*

#### 4.11. The *Quranic* Worldview of Islamic Finance: A Critical Examination of Depositor's Protection, and Ring-Fencing Mechanism of Islamic Banks

Following from the roles of *Quranic* ethics for Islamic finance and financial crisis, this section examines depositor's protection<sup>474</sup> and ring-fencing mechanism adopted by Islamic banks. Trust and confidence by depositors should not be taken lightly in the wake of the recent financial crisis. The crisis in Cyprus, Greece, and Italy suggest that depositors do not always trust their governments to honour their depositor protection commitments. Whilst Islamic banks are also incentivised by profit-making agenda, Islamic banks are engaged in activities that may at times pose a risk of return, and this hampers rewarding the depositors with dividends and profits (*hibah*). Besides, the lack of a separation between the investment part of the bank and the deposit-taking function of the bank can be problematic. The depositors, upon expecting a guarantee of their deposited money may face sudden panic, when the bank fails to honour its promise to avail the needed liquidity.

Hence, learning this lesson from the previous banking panics and bank runs such as in Argentina, Islamic banks particularly in Malaysia have begun to delineate between the accounts that are solely purported for the investment part of the bank, which is geared towards relatively risky business, and the saving account (*wadi'ah*) that is solely purported for the performance of the deposit-taking function of the bank. The creation of the saving account (*wadi'ah*) has also been considered to be ring-fenced against the riskier investment channel of the bank, through which the two segments of the banking functions are not mixed in their operational aspects of banking, finance, and payment activities.<sup>475</sup> Thus, the saving's account (*wadi'ah*) is ring-fenced,<sup>476</sup> and safeguarded against any unnecessary risk, posed by the investment channel of the banking function, which is more prone to vulnerable market condition and volatile trading environment. Riskier investment activities can result in the loss of return. But through the separation of the saving account

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<sup>474</sup> Campbell and Singh, *Deposit Insurance* (n 286) 40-61. The deposit insurance protection is aimed at protecting depositor's cash in a bank up-to a certain threshold in order to increase the public confidence.

<sup>475</sup> Andrew Campbell and Paula Mofatt, 'The Introduction of Ring-fencing Mechanism in the UK: An Example to be Followed?', *The Journal of Business Law* (Issue 4 2019), 241-261. Campbell and Mofatt examined that, "[t]he Vickers Report determined that the purpose of ring-fencing (also known as structural separation) was to isolate retail banking activities from wholesale and investment banking activities to insulate them from shocks within the financial system. In this way, essential banking services could be maintained in a financial crisis."

<sup>476</sup> Ariff (n 15) 68.

(*wadi'ah*) and the investment channel of the bank, depositor's protection is assured which can arguably bring about the general feeling of trust and confidence amongst the depositors.<sup>477</sup> In Malaysia, the Malaysia Depositor Insurance Corporation (MDIC) was established to provide depositor's protection in both the Islamic and conventional banks up-to RM250,000 limit, which is a very high threshold for a regulatory guarantee.<sup>478</sup> Andrew Campbell and Paula Mofatt argued that 'ring-fencing may have a role to play in overcoming the depositor protection trust deficit in some jurisdictions, but the better option must be to consolidate the depositor protection arrangements, rather than adopt ring-fencing.'<sup>479</sup>

Thus, such a ring-fencing mechanism may not necessarily be the sole factor in contributing towards the trust and confidence building exercise. It is one of the GFSN measures in which the deposit-taking function of the bank can be safeguarded and ring-fenced, regardless of the risk of loss-making operated by the investment channel of the bank. In short, there has been no absolute empirical evidence as yet to attest that such a ring-fencing mechanism would indefinitely contribute towards solidifying the trust and confidence in banking and finance.<sup>480</sup> In order to conduct the business function of the deposit-taking by Islamic banks, the trust and confidence are necessitated, particularly by depositors. The *Quranic* worldview, as enshrined in verses 47-49 of *Surah Yusuf* can be examined to have been translated into the modern context of developing a ring-fencing mechanism, so that in times of financial crisis, the deposit channel of the bank is saved from the sudden shock of the economic crisis as it is not exposed to the riskier part of the investment portfolio. The extent of the height of the fence<sup>481</sup> to be raised remains a mootable area of examination, but suffice to underscore that in times of financial crisis, the deposit channel of the bank has been saved, *ex-ante*.<sup>482</sup> The fact that the saving account (*wadi'ah*) is ring-fenced and safeguarded in terms of depositors' protection<sup>483</sup> will indirectly enable the investment function of the bank to take its own

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<sup>477</sup> Campbell and Singh, *Deposit Insurance* (n 286) 40-61.

<sup>478</sup> The roles of the MDIC is examined in Chapter Six.

<sup>479</sup> Campbell and Mofatt (n 475) 241-261. Campbell and Mofatt examined that, "ring-fencing has a role to play in enhancing depositor protection, where depositors do not trust governments to honour their deposit guarantee schemes, but beyond this it may add little of real value to financial stability."

<sup>480</sup> *Ibid.* Campbell and Mofatt examined that, "[i]t is significant that ring-fencing has not been identified by the FSB as a 'must have' item in its list of key attributes. Whilst banks need to meet safety and soundness objectives set by regulators, it is also important to remember that money tied up in regulatory initiatives is money that is taken out of the real economy."

<sup>481</sup> *Ibid.*

<sup>482</sup> *Ibid.*

<sup>483</sup> *Ibid.*

course of business judgement in creating more investment opportunities by generating maximum profits to the banks through its returns.

It is the trust and confidence as enshrined by the *Quranic* worldview in verse 275 of *Surah Al-Baqarah* that has guided the international framework for Islamic finance, and for the purposes of financial crisis management, verses 47-49 of *Surah Yusuf* provide the necessary *Quranic* guidance. The Islamic banks, operating a ring-fencing mechanism for its saving account (*wadi'ah*) will not only guard the Islamic banks from being exposed to the riskier part of the bank, but it ensures that the depositors' cash is protected.

#### 4.12. Conclusion

In conclusion, managing the financial crisis is important as the international framework for Islamic finance heeds the lessons from its conventional banking counterpart, including the risk management, the GFSN that is more *Shariah*-compliant, Basel III's recommendations on liquidity management, the roles of behavioural finance, the ethical finance, the *Quranic* ethics, the *Quranic* worldview, and the *lex specialis* regime for the SLOLR. The notion of ethics from the economics' standpoint, particularly the notion of bounded rationality explicates that the behaviour of market participants is not always in line with the rational choice theory, but at times, influenced by excessive greed and capitalism, herding mood, and reckless risk-taking behaviours.

The international framework for Islamic finance also heeds not only the Smiths' and Keynesian's approaches in managing the financial crisis, but also the behavioural finance, the ethical finance, and the *Quranic* worldview, as enshrined in *Surah Yusuf*, verses 47-49, *Surah Al-Baqarah*, verses 282, and many other verses, enshrined by the Islamic revealed knowledge. The *Quranic* ethics may not be mutually exclusive from the present ethical underpinnings for good banking practices. But the distinction lies in the analysis of the 'meta-dependence' trust and confidence, which makes a direct reference to the *Quranic* worldview which is found to be scarce in modern banking and finance literatures, but it is examined to be relevant in this study for the purposes of guiding the international framework for Islamic finance.<sup>484</sup> Market confidence is espoused as a matter of trust for the well-

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<sup>484</sup> Cattelan (n 419) 21-35.

functioning of the global financial system as well as the need to establish a more *Shari'ah*-compliant GFSN, such as the SLOLR, the depositor's protection, and the ring-fencing mechanism.

Whilst the modern banking characteristics of trust and confidence, behavioural finance, and *Quranic* ethics may seem to have found their overlapping interactions in the propagation of trust and confidence, an enabling legal framework to accommodate the GFSN, complemented by the *Shari'ah*-compliant GFSN, SLOLR, and the *Quranic* worldview of managing the financial crisis should also be developed.<sup>485</sup> To sum up this Chapter, it is suited to refer to the words of Christine Lagarde, which emphasise that "moral hazard has to be dealt with later... Maintaining the functioning of our markets is the top priority."<sup>486</sup>

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<sup>485</sup> IFSB (n 288) 1-97.

<sup>486</sup> Christine Lagarde, *Financial Times* (London, 11 October 2008).

## Chapter Five: The Roles of International Law in the Global Financial System and the International Framework for Islamic Finance

*"I can predict the motion of heavenly bodies but not the madness of crowds" –  
Sir Isaac Newton<sup>487</sup>*

### 5.1. An Examination of International Law as a Backdrop for the International Framework of Islamic finance

The discourse on international law is often undertaken with a critical examination of its real significance at the international setting. As the formation of international law is not necessarily codified, and even if it is codified, it only binds the state actors if they are state parties in the true sense of honouring *pacta sunt servanda*,<sup>488</sup> and not merely observing the object and purpose of the treaties.<sup>489</sup> There are public international law and private international law. For the purposes of international framework for Islamic finance, both the public and private international laws apply as the interaction involves states and non-state actors. The public international law is concerned with governing international law in the context of states' relations inter-se, including the stipulation of, among others, the host State's obligations in hosting any international organisations and institutions which should be granted with privileges and immunities, particularly where the professional carriage of the institutional functions are conducted in that host state. The private international law governs the relations of private sector participants at the international setting, such as non-state actors like banks, corporations, financial institutions, and persons, which either interact between and/or amongst them, or with the central bank in a particular jurisdiction, and relevant government agencies.

These interactions attract the legal application of public international law, but only to the extent of examining sovereign states' obligations under a binding treaty. The public international law derives its main sources from Article 38(1) of the Statute of the International Court of Justice (ICJ), which provides the primary sources to be:

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<sup>487</sup> Sir Isaac Newton was originally reported as saying that he could 'calculate the motions of erratic bodies but not the madness of a multitude', in Francis, J., 1850, "Chronicles and Characters of the Stock Exchange", *The Church of England Quarterly Review*, 27 (6), pp. 128-55.

<sup>488</sup> Article 26 of the VCLT reads "[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith. A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty." Article 27 of the VCLT states that, "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."

<sup>489</sup> Article 18 of the VCLT states that, "[a] state which has signed or ratified a treaty has the obligation to refrain from acts which would defeat the object and purpose of that treaty prior to its entry into force."

(a) treaties; and (b) customary international law, as established through the formation of states' practices and *opinio juris*;<sup>490</sup> and the secondary sources which include: (c) the general principles of law as recognised by civilised nations; (d) scholarly works and judicial decisions; and (e) other general principles of law, and legal maxims. There is no particular hierarchy to rank these sources<sup>491</sup> as each source is unique in contributing towards the doctrinal and theoretical development of international law. The *Quran* and *Sunnah/Hadiths*, which constitute the main sources for Islamic finance is a set of legal sources of their own reference, as the *Quran* is the Islamic revealed knowledge, whilst the *Sunnah/Hadiths* have their own methodological verification of authenticity. If at all relevant for the purposes of public international law, the legal opinions, rulings, writings and decisions of *Sharī'ah* jurists and scholars can fall under Article 38 (1) (d) and (e) of the ICJ Statute.

As the international framework for Islamic finance develops, the Islamic finance sector is not constrained in one jurisdiction. Islamic finance activities move beyond borders. This requires an enabling legal framework to be developed both at the international level and the domestic level in order to provide a legal coverage for the cross-border operation of global banking and financial activities. To this end, the international framework for Islamic finance is faced with regulatory and supervisory challenges. IFIs, whilst operating in a particular jurisdiction, will be supervised, monitored, and regulated by a central bank in that jurisdiction. But when the financial activities undertaken by IFIs are extra-territorial, the financial activities are subjected to the other countries' jurisdictional requirements, and legal coverage.<sup>492</sup> To address this discrepancy, the international framework for Islamic finance has adopted a likewise similar model like the conventional banking model in order to encourage the harmonisation of law, international standards, guidelines, principles, and best practices to mitigate the risk of legal discrepancies, and the fragmentation of standards, when applied domestically, and internationally.<sup>493</sup>

The IFSB, the AAOIFI, the IIRA Rating, the Islamic *Fiqh* Academy, and the DJMI, among others, have been instituted to address these gaps that cause the fragmented implementation of various international standards, principles, and

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<sup>490</sup> '*Opinio juris sive necessitates*', or simply '*opinio juris*' is the belief that an action was carried out as a legal obligation. See also James Crawford, *The Chance, Order, Change: The Course of International Law* (The Hague Academy for International Law 2013) 27-55.

<sup>491</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

<sup>492</sup> Ibid.

<sup>493</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 'Regulating Islamic Financial Institutions: The Nature of the Regulated' (2004) World Bank Policy Research Working Paper 1-48.

guidelines faced by domestic IFIs, when conducting their banking and financial activities, internationally. Since nation states are sovereign actors of international law, they cannot be compelled to adhere to treaties, or international instruments, except when they are legally bound by the treaties as contracting parties. In the absence of a clear *pacta sunt servanda* regime<sup>494</sup> which is required to constitute a hard-law obligation, the international framework for Islamic finance espouses its regulatory and supervisory mechanism through soft-law<sup>495</sup> regulation and supervision. The abstract nature of the soft-law regulation in the international framework for Islamic finance has a persuasive effect, and it is reckoned to have a force of its own right as it does not trigger a legally binding obligation.<sup>496</sup>

International institutions within the international framework for Islamic finance such as the IFSB and the AAOFI have the legal mandate to develop various soft-law instruments as they cannot compel sovereign states to adopt them, but only to encourage voluntary adoption through persuasive dissemination of best international standards, guiding principles, recommendations, and rulings. The legal application of the soft-law instruments is an act of voluntary<sup>497</sup> self-regulation should IFIs align themselves with the international standard-setting regime. Through the dissemination soft-law instruments by the international institutions, operating within the international framework for Islamic finance, the level of harmonisation between financial markets is improved. Internationally accepted standards are established through the soft-law dissemination, which accordingly invites voluntary participation by IFIs for the purposes of streamlining international compliance of best practices, standards, rules, guidelines, and guiding principles.<sup>498</sup>

In some jurisdictions like Malaysia, the application of international law operates on the basis of a dualism<sup>499</sup> regime. This dualism regime underscores that international law obligations must be translated into a domestic law framework so that the international law in question can operate domestically, and be made legally enforceable in that jurisdiction. Apart from the dualism regime, a monism<sup>500</sup> regime of international law does not require the translation of the treaty obligations into the

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<sup>494</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

<sup>495</sup> Abdul Karim Aldohni, 'Soft law, self-regulation and cultural sensitivity: The case of regulating Islamic banking in the UK' (2014) 5 (2) *Journal of Banking Regulation* 164-179.

<sup>496</sup> Aldohni (n 495) 164-179.

<sup>497</sup> *Ibid.*

<sup>498</sup> El-Hawary, Grais and Iqbal (n 493) 1-48.

<sup>499</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

<sup>500</sup> *Ibid.*

domestic legal framework. It only requires the state actors to treat the treaty obligation, in and of itself, as legally sufficient to be executed, domestically. Therefore, the treaty obligation does not need to be translated into the domestic law because the monism regime treats the treaty as a hard-law obligation that is *ipso facto* legally binding, self-executing, and enforceable towards the sovereign state.<sup>501</sup>

Because of the abstract and voluntary nature of the soft-law instruments, it gives discretion to IFIs to implement them. This voluntariness leads to the fragmentation of the international law in the context of the operation of the international framework for Islamic finance.<sup>502</sup> Further, where the international adjudication and judicial decisions are concerned, the lack of applicability of the doctrine of *stare decisis*<sup>503</sup> does not legally bind sovereign states with a binding legal precedent, as decided in previous cases. There are no hierarchy of courts in the international framework for Islamic finance, and hence, the lack of the *stare decisis* application, and the binding precedent.<sup>504</sup> But when a legal dispute arises, the disputing parties may choose various available forum for the settlement of disputes, either prescribed in financial contracts, or elect an arbitral procedure in accordance with the parties' choice, or the DIFC court, or London as juridical seats for arbitration and venue for the settlement of legal disputes concerning Islamic finance.

This lack of legal consistency in the application of international law through the non-binding judicial decisions at the international level is one of the legal impediments to harmonise and apply the international rules, and soft law, consistently.<sup>505</sup> States' behaviour in international law also creates a normative conduct in applying the international law which is either the hard-law, or the soft-law as the state actors can wield their stature of soft power, smart power, sharp power, or hard power in bargaining their way to comply, or reject the application of international law.<sup>506</sup> Therefore, the international framework for Islamic finance does not merely operate within the domain of hard-law and soft-law framework, but also at times interacts with various poles of power structures, as well as internal and external variables that exist at the international law regime.<sup>507</sup>

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<sup>501</sup> Ibid.

<sup>502</sup> Ibid.

<sup>503</sup> Ibid.

<sup>504</sup> Ibid.

<sup>505</sup> Ibid.

<sup>506</sup> Ibid.

<sup>507</sup> Ibid.

One of the modes through which international law is promulgated is by way of a legally binding treaty, specifically a multilateral treaty establishing an international organisation.<sup>508</sup> This creation of international institutions such as the IMF, the World Bank, the IFSB, and the AAOIFI, are backed legally by their respective constituent treaties. Although the more participation of state actors and non-state actors in these multilateral treaties is an indication of well-accepted practices at the international setting, caution is heeded as the application of these treaties is not a straight-forward testament of the formation of well-accepted states' practices that could constitute the crystallisation of customary international law (CIL), as the CIL requires the presence of an *opinio juris*.<sup>509</sup> The problem can transpire in the circumstance where 'Baxter paradox' is identified, which refers to a situation where the more agreement there is, the less law.<sup>510</sup> The 'Baxter paradox' was articulated by Judge Richard Baxter, who was the ICJ Judge in 1970.<sup>511</sup> When commenting on the North Sea Continental Shelf Cases, Judge Baxter examined that "*...it is only fair to observe the proof of a non-consistent pattern of conduct by non-parties becomes more difficult as the number of parties to the instrument increases. The number of participants in the process of creating CIL become so small that the evidence of their practice will be minimal or altogether lacking. Hence, the paradox is that as the number of parties to a treaty increases, it becomes more difficult to demonstrate what is the state of CIL that dehors the treaty*".

In this regard, the rules as provided in treaties cannot be a conclusive evidence of CIL which is formed through the formation of widespread states' practices and *opinio juris*. Thus, the 'Baxter paradox' draws on the basic rules of consent under international law, where it is not always the case that the more support there was for a proposition to a treaty, the more likely it becomes one of CIL.<sup>512</sup> The 'Baxter paradox' articulates that the more agreement, the less law, and a mere acceptance of a particular treaty is not a conclusive evidence of a CIL, attributing towards widespread states' practice and *opinio juris*. Where the international framework for Islamic finance operates, the 'Baxter paradox' is applicable to the extent of comparing sovereign states' *de jure* legal obligations vis-à-vis their *de facto* states' practices with regard to the adoption of soft-law obligations. As these soft-law obligations are not *ipso-facto* adopted by sovereign

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<sup>508</sup> Ibid.

<sup>509</sup> Ibid.

<sup>510</sup> North Sea Continental Shelf (Federal Republic of Germany v. Denmark; Federal Republic of Germany v. The Netherlands), Judgment, ICJ Reports 1969, 43 (Para 76).

<sup>511</sup> Ibid.

<sup>512</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

states, it is the 'Baxter Paradox' that follows the analysis i.e. the more agreement there is, the less law, due to the difficulty to ascertain the *opinio juris* for the CIL.

## 5.2. Enabling Legal Environment for the International Framework of Islamic Finance

The creation of an enabling legal environment for the international framework for Islamic finance is vital. This includes the adoption of the Basel Principles, its recommendations and standards, as well as various soft-law instruments as issued by other standard setting bodies, like the IFSB, the AAOIFI, the IIRA Rating, the Islamic *Fiqh* Academy of *Fatwa*, and the DJMI. One of the important endeavours to develop the framework for global banking is the dissemination of the '*Basel Core Principles for Effective Banking Supervision*' (the Basel Core Principles), as reintroduced and revised by the BCBS in September 2012. The Basel Core Principles set the *de facto* minimum standard for the sound prudential regulation and supervision of the banking sector which applies to all banks, and it does not separate its application towards the systemically important banks (SIBs). The primary objective for the banking supervision is to ensure the safety and soundness of banks and the banking system. The Basel Core Principles contain 29 Core Principles which aim to accommodate a diverse range of banking sectors and cover a broad spectrum of banks.<sup>513</sup>

The Basel Core Principles are aimed to equip the regulators with international standards for an effective risk-based supervision of the banking sector, early intervention, and timely supervisory actions. The banking and financial regulators are guided by the Basel Core Principles to ensure sound and sustainable macroeconomic policies, effective market discipline, and an appropriate level of

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<sup>513</sup> BCBS, <<https://www.bis.org/publ/bcbs213.pdf>> accessed 20 May 2018. The 29 Basel Core Principles include Principle 1 (responsibilities, objectives, and powers); Principle 2 (independence, accountability, resourcing and legal protection for supervisors); Principle 3 (co-operation and collaboration); Principle 4 (permissible activities); Principle 5 (licensing criteria); Principle 6 (transfer of significant ownership); Principle 7 (major acquisitions); Principle 8 (supervisory approach); Principle 9 (supervisory techniques and tools); Principle 10 (supervisory reporting); Principle 11 (corrective and sanctioning powers of supervisors); Principle 12 (consolidated supervision); Principle 13 (home-host relationships); Principle 14 (corporate governance); Principle 15 (risk management process); Principle 16 (capital adequacy); Principle 17 (credit risk); Principle 18 (problem assets, provisions and reserves); Principle 19 (concentration risk and large exposure limits); Principle 20 (transactions with related parties); Principle 21 (country and transfer risks); Principle 22 (market risks); Principle 23 (interest rate risks in the banking book); Principle 24 (liquidity risk), Principle 25 (operational risk); Principle 26 (international control and audit); Principle 27 (financial reporting and external audit); Principle 28 (disclosure and transparency); and Principle 29 (abuse of financial services).

systemic protection, and the financial safety-net.<sup>514</sup> Through the adoption of these Basel Core Principles, both the conventional and the Islamic banks will be supervised and regulated in line with the same principles. Thus, to be part of the global banking ecosystem, the Islamic banks shall heed and accept the Basel Core Principles, which incorporate international best recommendations for IFIs. Although the Basel Core Principles are not designed to cater for every needs of the banking sector and IFIs, the overarching objective is for the regulator to develop a thorough understanding of the operations of all individual banks operating in its jurisdiction for an effective banking supervisory system. The Basel Core Principles are generic, and do not cater for a one-fit-for-all solution, because the main responsibility still lies on the financial regulator in each jurisdiction to undertake a comprehensive examination and supervision of its domestic banking sector's health and stability. Amongst the aspirations for the effective banking supervision include, ensuring the sound and sustainable macro-economic policies, the well-established framework for financial stability and policy formulation, a clear framework for crisis management, the recovery and resolution, an appropriate level of public safety-net, and an effective market discipline. In order to further examine the international dissemination of the soft law instruments within the international framework for Islamic finance,<sup>515</sup> this study examines six key international institutions, namely the dedicated institutions for Islamic finance such as the IFSB, the AAOIFI, the IIRA Rating, the Islamic *Fiqh* Academy of *Fatwa*, the DJMI, and the non-dedicated institutions for Islamic finance such as the IMF.

### 5.2.1 IFSB

As an international standard-setting institution that upholds and augments the soundness and stability of IFSI, the IFSB has issued various global prudential standards and guiding principles for the IFSI to operate within the international framework for Islamic finance. The IFSB's core aspiration is to ensure the soundness and stability of the IFSI.<sup>516</sup> To actualise this aspiration, the IFSB carries out various research and initiatives on IFSI-related issues, and organises roundtables, seminars, and conferences for the regulators, and IFSI's stakeholders. To this end, the IFSB promotes the development of a prudent and transparent IFSI by introducing new or adapting the existing international standards consistent with

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<sup>514</sup> Campbell and Lastra (n 345) 453-498.

<sup>515</sup> Aldohni (n 495) 164-179.

<sup>516</sup> IFSB, <<https://www.ifsb.org/>> accessed 20 May 2018.

the *Shari'ah*, and recommend them for the adoption. In a larger global banking context, the IFSB's roles complements those works undertaken by the BCBS, IOSCO, the IAIS, etc. Hosted in Malaysia, the IFSB Act 2002 [Act 623] has been enacted which legally provides the IFSB with immunities and privileges that are usually granted to international organisations and diplomatic missions. Since 2002 until today, the IFSB has been guiding and developing the international framework for Islamic finance. It has published many standards, guiding principles and technical notes which are stipulated in IFSB-1 to IFSB-22.<sup>517</sup>

In December 2005, IFSB published IFSB-1 (Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IFS)), and IFSB-2 (Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only IFS). In December 2006, IFSB published IFSB-3 (Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds). In December 2007, IFSB published IFSB-4 (Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds), and IFSB-5 (Guidance on Key Elements in the Supervisory Review Process of Institutions offering IFS (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds). In December 2008, IFSB published IFSB-6 (Guiding Principles on Corporate Governance for Islamic Collective Investment Schemes). In January 2009, IFSB published IFSB-7 (Capital Adequacy Requirements for *Sukuk*, Securitisations and Real Estate Investments). In December 2009, IFSB published IFSB-8 (Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings), IFSB-9 (Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings), and IFSB-10 (Guiding Principles on *Shari'ah* Governance Systems for Institutions offering IFS). In December 2010, IFSB published IFSB-11 (Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings). In March 2012, IFSB published IFSB-12 (Guiding Principles on Liquidity Risk Management for Institutions offering IFS). In December 2013, IFSB published IFSB-14 (Standard on Risk Management for Takaful (Islamic Insurance) Undertakings), and IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes).

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<sup>517</sup> IFSB, <<https://www.ifs.org/>> accessed 20 May 2018.

In March 2014, IFSB published IFSB-16 (Revised Guidance on Key Elements in The Supervisory Review Process of Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes). In April 2015, IFSB published IFSB-17 (Core Principles for Islamic Finance Regulation (Banking Segment). In April 2016, IFSB published IFSB-18 (Guiding Principles for *Retakaful* (Islamic Reinsurance). In April 2017, IFSB published IFSB-19 (Guiding Principles on Disclosure Requirements for ICM Products (*Sukuk* and Islamic Collective Investment Schemes). In December 2018, IFSB published IFSB-20 (Key Elements in the Supervisory Review Process of Takaful/*Retakaful* Undertakings), IFSB-21 (Core Principles for Islamic Finance Regulation (ICM Segment), and IFSB-22 (Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering IFS (Banking Segment)). To date, there are 22 IFSB Guiding Principles published by the IFSB.

Based on the above, it is noted that the IFSB has promulgated IFSB Core Principles for Islamic Finance Regulation (CPIFR) as prescribed under IFSB-17. The CPIFR represents a landmark effort towards attaining common international regulatory standards. The CPIFR, which can be used by both developed and developing market jurisdictions, will permit national authorities to detect the gaps in their regulatory framework, and the measures needed to fill these gaps in a manner that are internationally consistent. The CPIFR are benchmarked against the new global regulatory framework, which enabled the integration of Islamic finance into the global surveillance framework. Further, the CPIFR has been reflected by the IMF in its Staff Discussion Note, titled as '*Islamic Finance: Opportunities, Challenges, and Policy Options*' in April 2015.

Further, in terms of capital adequacy requirements, IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes) was published in December 2013 by the IFSB to guide IFSI. It was primarily aimed to serve banking institutions offering IFS, including but not limited to fully-fledged Islamic commercial banks, Islamic investment banks/companies, Islamic banking subsidiaries of conventional banks, Islamic banking branches/divisions/units of conventional banks, and such other financial institutions as may be determined by the respective supervisory authority. Supervisory authorities were expected to commence the implementation of IFSB-15 in their jurisdictions by 1 January 2015, although earlier implementation may be feasible, having regard to an adequate period for the IFSB-

15 to be transcended into national supervisory regulations and guidelines for IFSI, as well as transitional arrangements to enhance the quality and quantity of capital, and the introduction of new capital and leverage requirements. It is also emphasised in the IFSB-15 that such implementation should be undertaken in compliance with the *Sharī'ah* and within the legal and regulatory framework applicable in the jurisdiction.

Other than the guiding principles, the IFSB has also issued the Guidance Notes (GN) as stipulated in GN-1 to GN-6. In March 2008, IFSB published GN-1 (Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions on *Sharī'ah*-compliant Financial Instruments). In December 2010, IFSB published GN-2 (Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity *Murabahah* Transactions), and GN-3 (Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders). In March 2011, IFSB published GN-4 (Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only IFS), and GN-5 (Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions on *Takaful* and *Retakaful* Undertakings). In April 2015, IFSB published GN-6 (Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering IFS [Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes.]). To date, IFSB published 6 GNs in order to guide IFSI. All these GNs are meant for guidance towards IFSI, to which the implementation should be undertaken in compliance with the *Sharī'ah* and within the legal and regulatory framework applicable in the jurisdiction.<sup>518</sup>

In addition to the guiding principles and the GNs, the IFSB has also issued the Technical Notes (TN) as stipulated in TN-1 and TN-2.<sup>519</sup> In March 2008, IFSB published TN-1 (Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering IFS: The Development of Islamic Money Markets). In December 2016, IFSB published Technical Note on Stress Testing for Institutions Offering IFS. These TN are meant for technical guidance for IFSI.

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<sup>518</sup> Ibid.

<sup>519</sup> Ibid.

As the study examines in Chapter Six the development of a *Shari'ah* Governance Framework, this Chapter has identified that IFSB-3 and IFSB-10 are of particular relevance as they deal with the corporate governance, and Guiding Principles on *Shari'ah* Governance System, respectively. The IFSB-3 on Corporate Governance stipulates seven guiding principles of prudential requirements in the area of corporate governance for institutions offering IFS. This guiding principle carves out its application to Islamic mutual funds and *takaful* (Islamic insurance) institutions. IFSB-3 examines seven guiding principles on corporate governance.<sup>520</sup> In terms of General governance approach of IFIs, Principle 1.1 stipulates that IFIs shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing the IFIs' accountabilities to various stakeholders. Further, Principle 1.1 stipulates that IFIs shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognised accounting standards, which are in compliance with *Sharī'ah* rules and principles, and are applicable to IFIs, as recognised by the supervisory authorities of the country.

In terms of Rights of IAH, Principle 2.1 stipulates that IFIs shall acknowledge IAH's right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised. Further, Principle 2.2 stipulates that IFIs shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns. In terms of compliance with Islamic *Sharī'ah* rules and principles, Principle 3.1 stipulates that IFIs shall have in place an appropriate mechanism for obtaining rulings from *Sharī'ah* scholars, applying fatwa and monitoring *Sharī'ah*-compliance in all aspects of their products, operations and activities. Further, Principle 3.2 stipulates that IFIs shall comply with the *Sharī'ah* rules and principles as expressed in the rulings of the IFIs' *Sharī'ah* scholars. IFIs shall make these rulings available to the public. In terms of Transparency of financial reporting in respect of investment accounts, Principle 4 stipulates that IFIs shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

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<sup>520</sup> Ibid.

### 5.2.2. AAOIFI

Hosted in Bahrain and supported by over 200 institutional members from over 45 countries comprising central banks, regulatory authorities, financial institutions, accounting and auditing firms, legal firms, etc., the AAOIFI is tasked to develop and issue standards for IFSI. The AAOIFI has issued and promulgated AAOIFI standards, including *Shari'ah* standards, accounting standards, auditing standards, governance standards, and codes of ethics.<sup>521</sup> In addition, the new standards are often being developed, while the existing standards are reviewed to accommodate to the present IFSI's condition. In the context of an adoption of standards at the international setting, the AAOIFI standards are followed voluntarily as part of the regulatory requirement which forms the basis of internal guidelines in various jurisdictions that offer Islamic finance across the world. Consequently, the AAOIFI standards have also promulgated better harmonisation of international Islamic finance practices. Among others, the AAOIFI has issued the AAOIFI *Shari'ah* Standard on investment *sukuk*, certificates of ownership in leased assets, *istisna'* certificates, *musharakah* certificates, and *mudharabah* certificates.<sup>522</sup>

Further, the AAOIFI has issued the AAOIFI Governance Standards which espouses the adoption of accounting standards. The AAOIFI accounting standards have been incorporated as mandatory regulatory requirement in jurisdictions, such as Bahrain, Jordan, Oman, Qatar, Qatar Financial Centre, Sudan, and Syria. In addition, the AAOIFI accounting standards have been implemented by the IDB Group, which is a multilateral institution, dedicated for the development and research for Islamic finance. In jurisdictions such as Indonesia and Pakistan, the AAOIFI accounting standards have been adopted as a basis of national accounting standards. In other jurisdictions such as Brunei, Egypt, France, Kuwait, Lebanon, Malaysia, Saudi Arabia, South Africa, the United Arab Emirates, the DIFC, the United Kingdom, Africa and Central Asia, the AAOIFI accounting standards have been used voluntarily as a basis for internal guidelines by leading IFIs.<sup>523</sup> To keep abreast with the growing market need, the AAOIFI standards are continuously being developed, and revised by promulgating new *Shari'ah* standards relating to *sukuk*, and the new accounting standard on the issuance of *sukuk* in order to give

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<sup>521</sup> AAOIFI, <<http://aaoifi.com/?lang=en>> accessed 25 May 2018.

<sup>522</sup> Ibid.

<sup>523</sup> Ibid.

extensive and comprehensive guidance to IFIs.<sup>524</sup> As IFIs require an SSB to check on the *Sharī'ah* compliance, the revised governance standards relating to SSB stipulates the governance standards in Governance Standard for IFIs No.1 (GSIFI-1) to GSIFI-5. To date, there are five GSIFIs that have been published by the AAOIFI, which consist of GSIFI-1 (SSB: Appointment, Composition and Report), GSIFI-2 (*Sharī'ah* Review), GSIFI-3 (Internal *Sharī'ah* Review), GSIFI-4 (Audit and Governance Committee for IFIs), and GSIFI-5 (Independence of SSB).<sup>525</sup>

In general, the International Financial Reporting Standards (IFRS) are applicable to IFIs. In Malaysia, the Malaysian Accounting Standards Board (MASB) agree that IFRS should be applicable to IFIs as well, although it is noted that the IFRS do not adhere to the *Sharī'ah*.<sup>526</sup> The Deloitte Islamic Finance Knowledge Centre (IFKC) finds that 79% of the industry leaders surveyed were in support of a convergence initiative of the AAOIFI standards with the IFRS, while 7% were against it because to have a separate set of accounting standards would be costly and redundant.<sup>527</sup> Although there have been accounting standards developed by the AAOIFI, the real challenge lies in the enforcement of these standards by IFIs, whilst at the same time adhering to the IFRS.

The reality is that the IFRS is recognised in the global financial system. IFIs operating in western-based jurisdictions also need to comply with the IFRS. The IFRS is the *lingua franca* of financial reporting, whilst AAOIFI accounting standards have not been fully accepted. This contributes towards the lack of power by AAOIFI to enforce their standards.<sup>528</sup> Further, the accounting standards as issued by the AAOIFI have been examined to be compatible with the IFRS, except in few circumstances that require *Sharī'ah*-compliance. The MASB takes the view that the IFRS is also *Sharī'ah*-compliant, and hence applicable to IFIs.<sup>529</sup> It thus appears that it is impossible that AAOIFI's standard can stand within its own sphere of exclusivity without applying the IFRS.

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<sup>524</sup> Nor Farizal Mohamed, Asyaari Elmiza Ahmad, and Fadzlina Mohd Fahmi, 'Accounting Standards and Islamic Financial Institutions: the Malaysian Experience' (2016) 4 (1) Journal of Islamic Banking and Finance 33-38.

<sup>525</sup> AAOIFI (n 521).

<sup>526</sup> Mohamed, Ahmad, and Mohd Fahmi (n 524) 33-38.

<sup>527</sup> *Ibid.*

<sup>528</sup> *Ibid.*

<sup>529</sup> *Ibid.*

### 5.2.3. The Islamic *Fiqh* Academy of Fatwa

Pursuant to a resolution adopted by the Third Islamic Summit Conference of the OIC in Makkah in January 25-28, 1981, the Islamic *Fiqh* Academy of *Fatwa* was established, and ever since its inception in 1981, the Islamic *Fiqh* Academy of *Fatwa* has passed several resolutions for Islamic finance. Selected resolutions that deal with the various concepts of Islamic finance are highlighted herein for the purposes of elucidating the roles played by the Islamic *Fiqh* Academy of *Fatwa* in respect of issuing and disseminating various pertinent resolutions on Islamic finance.<sup>530</sup>

Resolution No. 136 (2/15) is concerned with *musharakah mutanaqisah* (diminishing partnership) and its *Sharī'ah* rules. This resolution deals with the concept of *musharakah mutanaqisah*, its formation and features, as well as the *Sharī'ah* rules on the lawfulness of *musharakah mutanaqisah* and the permissibility for partners to lease their portion of shareholding in the *musharakah mutanaqisah*. Resolution No. 137 (3/15) is concerned with *sukuk al-ijarah*. This resolution deals with among others with the concept and features of *sukuk al-ijarah* underlying assets for the *sukuk*, trading of *sukuk* in the secondary market, *sukuk al-ijarah* involving sub-leases as well as liability of the *sukuk* issuer. Resolution No 139 (5/15) is concerned with credit cards. This resolution deals with the permissibility of credit cards which have underlying accounts without an interest element, provision on fees and cash drawings for such cards, purchase of gold, silver and currencies using such cards as well as permissibility of privileges for such card holders. Resolution No 140 (6/15) is concerned with investment *waqf* (endowment) and its profits and returns. This resolution deals with matters relating to the rules concerning investment in properties of *waqf* assets as well as the permissibility of cash *waqf*. Resolution No 147 (5/16) is concerned with international commodities and its principles of dealings. This resolution deals with the various modes for commodity transactions in organised markets and the permissibility of such modes from the perspectives of the *Sharī'ah*. Resolution No. 157 (6/17) is concerned with concerning mutual promise (*muwa'adah*) and mutual covenant (*muwata'ah*) in contracts. This resolution deals with the *Sharī'ah* rules relating to mutual promise in various situations as well as the implications of an enforcement of such mutual promise. Resolution No 158 (7/17) is concerned with debt sales. This resolution deals with certain situations involving revocation of debt by another debt which is not permissible under the *Sharī'ah* as well as the permissibility of certain forms of debt

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<sup>530</sup> Islamic *Fiqh* Academy of *Fatwa*, <<http://www.iifa-aifi.org/>> accessed 27 May 2018.

sales. Resolution No 177 (3/19) is concerned with the role of *Sharī'ah* supervision in regulating the operations of Islamic banks, its importance, stipulations and the manner it operates. This resolution deals with the purpose of *Sharī'ah* supervision and specifies three major components of *Sharī'ah* supervision relating to a *Sharī'ah* board, internal administration for *Sharī'ah* supervision, and a central *Sharī'ah* authority. Resolution No 178 (4/19) is concerned with *Sukuk*, its contemporary applications and its circulation. This resolution deals with, among others the meaning of *sukuk*, the characteristics of *sukuk*, and *Sharī'ah* rulings on *sukuk*. Resolution No. 179 (5/19) is concerned with *tawarruq* (monetisation), its meaning and types (classical applications and organised *tawarruq*). This resolution deals with the types of *tawarruq* and its juristic rulings and the impermissibility of organised and reverse *tawarruq*.<sup>531</sup>

The resolutions passed by the Islamic *Fiqh* Academy of Fatwa are aimed at ensuring that IFIs adopt the financing and investment techniques that are *Sharī'ah*-compliant, and thus removes all kind of dubious and prohibited financial techniques.<sup>532</sup> Further, the resolutions cater for the conformity to the *Sharī'ah* so that the adopted techniques will safeguard the actualisation of the *Maqasid of Sharī'ah* (*Sharī'ah* objectives).<sup>533</sup> In addition, these fatwa resolutions are aimed at harmonising the various views on a particular Islamic financial product, although the room for an *ijtihad* (independent scholarly opinion based on *Shari'ah*) is still open to be exercised. The overarching objective in these resolutions is to ensure that the actualisation of the socio-economic objectives of the Muslims is enhanced, and not fragmented and distracted by differing *fatwa* rulings and/or *fatwa* shopping.

#### 5.2.4. IIRA Rating

IIRA is an important agency that is tasked to issue a rating based on the *Sharī'ah* compliance.<sup>534</sup> Established in 2005 by shareholders from eleven countries, IIRA has grown to encompass multilateral development institutions, banks, financial institutions, and rating agencies. IIRA's main aspiration is to provide a credit rating

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<sup>531</sup> '*Tawarruq*' replicates a loan contract by using multiple sales and agency contract, whereby the client gets cash and owes the bank the amount financed plus a return. The Islamic *Fiqh* Academy, in its 19<sup>th</sup> session, held in Sharjah UAE, during 26-30 April 2009 ruled that the use of '*Tawarruq*' was illegal on the grounds that it involves *riba*.

<sup>532</sup> Islamic *Fiqh* Academy of Fatwa (n 554).

<sup>533</sup> Ibid.

<sup>534</sup> IIRA, 'Corporate Profile' <<http://www.iirating.com/CorporateProfile.aspx>> accessed 2 June 2018.

for IFIs<sup>535</sup> by offering specialised ratings such as *Shari'ah* quality ratings, fiduciary ratings, and corporate governance ratings. IIRA offers investors an independent assessment of the *Shari'ah*-compliance of either IFIs, or Islamic finance products such as *sukuk*, as provided for, in its methodology for *Shari'ah* quality ratings.<sup>536</sup> In this regard, IIRA has emerged as a reliable source of reference for the international framework of Islamic finance to pursue a certain level of quality on the *Shari'ah*-compliance. Through the *Shari'ah*-Compliance rating tool, IFIs are able to compete in a legally enabling environment to achieve the highest rating, and this subsequently increases the level of *Shari'ah*-compliance. A Board of specialised *Shari'ah* scholars supervises and monitors these quality ratings.<sup>537</sup> For a rating assignment, a team of three scholars reviews the finding of the rating specialists, but they must not have any relation with the audited entity. The team is chosen by the secretariat of the SSB. IIRA's role in this regard is to offer technical support to the board, and facilitate in obtaining the required information for the rating of the IFIs, such as the financial statements of the last five years, *fatwas*, and product structure. In terms of rating methodology,<sup>538</sup> IIRA provides services to investors from various schools of thought and sects. IIRA does not issue a *fatwa* or comment on the decision of SSB. IIRA's main task is to examine IFI's compliance with the decisions issued by its SSB. That notwithstanding, IIRA still conducts a thorough review of the decisions by the SSB of IFIs. An objective evaluation is made towards any reservations on *fatwas* as articulated by *Shari'ah* scholars. Such an evaluation also needs to have regard to the power and the resources available to the SSB to carry out its role. Each IFI will have its own internal mechanism for ensuring *Shari'ah*-compliance, particularly a dedicated *Shari'ah* unit to review compliance with the decisions issued by the SSB, and how it deals with issues on income derives from non-*Shari'ah* compliance activities.<sup>539</sup>

Further, IIRA's methodology also includes assessing the structure of assets and liabilities in a product, the credibility, and the independence of the SSB members who approve a product, and the IFI's process of *Shari'ah* authentication of

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<sup>535</sup>IIRA, 'Rating', <<http://www.iirating.com/RatingNavigations.aspx>> accessed 2 June 2018.

<sup>536</sup>IIRA, 'Methodology for *Shari'ah* Quality Rating,' <[http://www.iirating.com/Documents/ReserachReports/sharia\\_methd\\_eng\\_.pdf](http://www.iirating.com/Documents/ReserachReports/sharia_methd_eng_.pdf)>accessed 2 June 2018.

<sup>537</sup>IIRA, 'Methodology for *Shari'ah* Quality Rating,' <[http://www.iirating.com/Documents/ReserachReports/sharia\\_methd\\_eng\\_.pdf](http://www.iirating.com/Documents/ReserachReports/sharia_methd_eng_.pdf)>accessed 2 June 2018.

<sup>538</sup> Ibid.

<sup>539</sup> Ibid.

an Islamic financial product.<sup>540</sup> Other factors, such as disclosure of business activities to clients, the *Shari'ah*-compliance of its ethics code, the disclosure of its profit and loss calculation method, and IFIs' compliance with international standards in Islamic finance, such as the *Shari'ah* standards of AAOFI would also influence the *Shari'ah* quality rating.<sup>541</sup> To ensure that *Shari'ah*-compliant and conventional funds are not commingled, IIRA reviews the procedures taken on the rating of Islamic windows offered by conventional financial institutions.<sup>542</sup> As the IIRA's rating is valid for one year, IIRA continuously monitors and obtains relevant information from the rated IFIs. Modification of the rating result might ensue, following the information gathered during that one year validity period. IIRA's rating will be publicly withdrawn, if IFIs elect not to renew its agreement.

In terms of procedural flow for *Shari'ah* Quality Ratings<sup>543</sup>, the issuer/client will first sign agreement for rating with IIRA, then submits preliminary information materials to IIRA. IIRA then will tell the secretariat of the *Shari'ah* Board to formulate the *Shari'ah* Quality Rating Committee, and conduct a preliminary study and send the preliminary information to the *Shari'ah* Quality Rating Committee. The *Shari'ah* Quality Rating Committee liaises with IIRA to submit a detailed questionnaire to the issuer/client. Then, the issuer/client provides detailed information in response to detailed questionnaire. IIRA will establish with the *Shari'ah* Quality Rating Committee the points to be covered during due diligence, conduct pre-due diligence meeting analysis, conduct due diligence meeting analysis, conduct post-due diligence meeting analysis, submit report to *Shari'ah* Quality Rating Committee, and then it decides the preliminary/initial rating. Then, IIRA notifies issuer/client of the preliminary/initial rating, and discusses the rating rationale and issues with issuer/client. The issuer/client may appeal based on any new facts or information. The *Shari'ah* Quality Rating Committee will deliberate on appeals by issuer/client and gives decision. Then, IIRA will communicate the decision of the *Shari'ah* Quality Rating Committee to the issuer/client. The issuer/client will have to give consent to release of the rating to the public. Then eventually and finally, IIRA will release the rating to media.

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<sup>540</sup> Ibid.

<sup>541</sup> Ibid.

<sup>542</sup> Ibid. Other factors have been stated in the IIRA methodology of *Shari'ah*-quality rating, but they are not directly related to *Shari'ah*-compliance. For example, the IIRA reviews IFSI accounting policies, and practices, and its presentation of financial statements, as well as its compliance with IFRS.

<sup>543</sup> Ibid.

As IIRA conducts *Shari'ah*-compliance rating at the request of an IFI and does not avail the result without IFIs' permission, it does not follow that the *Shari'ah*-compliance rating as conducted by IIRA will improve the level of *Shari'ah*-compliance in the IFIs.<sup>544</sup>No IFIs would consent to publish a negative rating and only the good ratings are made available. An approval of IFIs must be sought prior to the issuance of its *Shari'ah*-compliance rating because it is not in the interest of IIRA to inflict a negative impact on IFIs. The international framework for Islamic finance can be further enhanced through the balancing act of increasing the *Shari'ah*-compliance level, and at the same time, protecting consumers whilst promoting the affairs of business by IFIs so that the *Shari'ah*-compliance rating can be actualised to churn out more trust and confidence by the market towards Islamic finance.

It is examined and noted that IIRA Rating<sup>545</sup> consists of six types. Firstly, type 'AAA (SQR)', which means, in IIRA's opinion, an entity/instrument rated AAA (SQR) conforms to the highest level of standards of *Shari'ah* requirements in all aspects of *Shari'ah* quality analysis. Secondly, type 'AA (SQR)', which means, in IIRA's opinion, an entity/instrument rated AA (SQR) conforms to very high level of standards of *Shari'ah* requirements in all aspects of *Shari'ah* quality analysis. Thirdly, type 'A (SQR)', which means, in IIRA's opinion, an entity/instrument rated 'A (SQR)' conforms to high level of standards of *Shari'ah* requirements and has very few weaknesses in some areas of *Shari'ah* analysis. Fourthly, type 'BBB (SQR)', which means, in IIRA's opinion, an entity/instrument rated BBB (SQR) conforms to moderately high level of standards of *Shari'ah* requirements and has few weaknesses in some areas of *Shari'ah* analysis. Fifthly, type 'BB (SQR)', which means, in IIRA's opinion, an entity/instrument rated BB (SQR) conforms to satisfactory level of standards of *Shari'ah* requirements and has some weaknesses in some areas of *Shari'ah* analysis. Sixth and last but not least, type 'B (SQR)', which means, in IIRA's opinion, an entity/instrument rated BBB (SQR) conforms to adequate high level of standards of *Shari'ah* requirements, and has weaknesses in some areas of *Shari'ah* analysis.

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<sup>544</sup> IIRA, 'Rating' <<http://www.iirating.com/RatingNavigations.aspx>> accessed 2 June 2018.

<sup>545</sup> Ibid.

### 5.2.5. Dow Jones Islamic Market Index (DJMI)

Another tool to increase the level of *Shari'ah*-compliance is through the Dow Jones *Shari'ah* indices, which were developed in the beginning for *Shari'ah*-compliant investment in stock markets. Following thereof, the international framework for Islamic finance comprising the *Shari'ah* scholars, IFIs, and credit rating agencies would be able to benefit a great deal by the systematic reference to the Dow Jones *Shari'ah* indices. Established in 1999 in Bahrain to aid Muslim investors who sought to invest in the Dow Jones stock market, the DJMI was one of the first attempts to create a *Shari'ah*-compliant index.<sup>546</sup> Having its own SSB, the DJMI is rendered with an advisory *Shari'ah* assistance and recommendations as submitted to the DJMI steering committee which issues final business decisions.<sup>547</sup>

Other than DJMI, the Standard & Poor's, the Russell-Jadwa *Shari'ah* Index,<sup>548</sup> the Thomson Reuter Islamic Indices, and the FTSE-*Shari'ah*, the Global *Shari'ah* Global Equity Index are also the entities that issue various *Shari'ah*-compliant indices.<sup>549</sup> Apart from those indices, unofficial *Shari'ah* indices have also been issued by *Shari'ah* scholars particularly with regard to the percentages of non-*Shari'ah* income which investors have to purify by paying it to charity. The business activities and the debt structure of the listed companies will be examined, and calculated, as part of the basic methodologies to assess the *Shari'ah*-compliant indices. Any activities that are involved with the *Shari'ah* prohibitions will be excluded from the index, and these are the prohibited activities such as gambling, alcohol, pork-related products, tobacco, etc.<sup>550</sup>

A screening will also be conducted towards the listed companies in order to examine their capital structure, and the debt level should be less than 33% of company capital. Companies will be more encouraged to use *Shari'ah*-compliant

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<sup>546</sup> M. Fahim Khan and Mario Porzo, *Islamic Banking and Finance in the European Union: A Challenge* (Edward Elgar Ltd, 2010) 137.

<sup>547</sup> CME Group Index Services, 'Guide to the Dow Jones Islamic Market Indexes' <<https://uaelaws.files.wordpress.com/2012/05/dow-jones-islamic-market-indexes-rulebook1.pdf>> accessed 15 July 2018.

<sup>548</sup> Jadwa, 'Launch of the Russel-Jadwa *Shari'ah* Indexes', <<http://www.iadwa.com/en/news/news/news-2009/launch-of-the-russell-iadwa-shariah-indexes.html>> accessed 15 July 2018.

<sup>549</sup> FTSE Group, 'FTSE *Shari'ah* Global Equity Index Series' <<https://www.ftserussell.com/products/indices/Global-Shariah>> accessed 15 July 2018.

<sup>550</sup> The DJMI SSB does not allow investing in companies involved in these activities, where impure sources exceed 5% of their revenue. See CME Group Index Services, 'Guide to the Dow Jones Islamic Market Indexes' 5.

financing methods, rather than the conventional ones, as these *Sharī'ah*-compliant indices help increase *Sharī'ah*-compliance in Muslim countries, such as Saudi Arabia. But the limitation exists as *Sharī'ah*-compliant indices are confined to the capital market, enticing certain types of investors, and thus, they appear inadequate to deal with the bigger issue of *Sharī'ah*-compliance, let alone to completely replace the roles of the *Sharī'ah*-compliance rating agencies. Composing *Sharī'ah*-compliant indices is not free from controversies.<sup>551</sup> As the room for *ijtihad* is open, there is not always a clear agreement amongst *Sharī'ah* scholars regarding the accepted level of debt, or the percentage of non-halal income of a corporation to be included in *Sharī'ah*-compliant indices.<sup>552</sup> It is also unsettled whether the calculation of the debt structure should be based on the book value, or the market value of the company for the purposes of appraising the *Sharī'ah*-compliant indices.<sup>553</sup> Another issue is whether financial statements can represent a reliable account for the screening of non-*Sharī'ah* compliant assets and liability. It appears that whilst the international framework for Islamic finance has thus far enjoyed the abundance of *Sharī'ah*-compliance ratings, the methodology in which the *Sharī'ah*-compliance rating is undertaken remains to be improved, assessed, and critically examined.

### 5.2.6. IMF

The IMF has issued various working papers and policy papers which are not limited to the affairs of conventional banking and finance, but also issues pertaining to Islamic finance. Among others, the IMF has issued a Policy Paper on '*The Core Principles for Islamic Finance Regulations (Banking Sector) (CPIFR), And Assessment Methodology*',<sup>554</sup> '*the Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study*',<sup>555</sup> '*Islamic Finance: Opportunities,*

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<sup>551</sup> Grais and Pellegrini, 'Corporate Governance and *Sharī'ah* Compliance in Institutions Offering Islamic Financial Services' 17 <<https://openknowledge.worldbank.org/handle/10986/8901>> accessed 17 July 2018.

<sup>552</sup> Ibrahim al-Sakran, *al-Ashum al-Mukhtalifah* (Wahaj al-hayah Lim-Lam, 2005); salih al-Isaymi, *al-Ashum al-Mukhtalifah fi Mizan al-Shariah* (al-Tadmuriyyah, 2008) 20-81.

<sup>553</sup> Abdul Rahman, *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking* (Wiley Finance 2010) 365.

<sup>554</sup> IMF, 'The Core Principles for Islamic Finance Regulations, And Assessment Methodology' (IMF Working Paper, 24 May 2018) <<https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/05/24/pp040618the-core-principles-for-islamic-finance-regulations-and-assessment-methodology>> accessed 25 July 2018.

<sup>555</sup> Hassan and Dridi (n 403).

*Challenges, and Policy Options*,<sup>556</sup> and several other papers through which the options for financial reform, and a review of existing IMF policies are examined.

The CPIFR was issued by the IFSB as part of the standards used in assessing the banking regulatory and supervisory regimes of relevant member jurisdictions under the Financial Sector Assessment Program (FSAP), and the Reports on Observance of Standards and Codes (ROSCs). The CPIFR reflects the order of the Basel Core Principles with five additional principles that are specific to Islamic banking operations.<sup>557</sup> Thus, for countries that have systemically significant Islamic banking sector, the assessment of the banking regulation and supervision regime of the jurisdiction would be against the CPIFR (for fully Islamic banking systems), or the Basel Core Principles, and the five additional core principles under the CPIFR (for dual banking systems). Besides that, the IMF's transparency policy permits for deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in staff reports and other IMF documents. In essence, the IMF papers and reports help to shape, contribute, and develop the international framework for Islamic finance, as the gathered data and information, findings, and recommendations can be evaluated objectively by IFIs, and nation states.

### **5.3. A Critical Examination of the Capital Adequacy Requirement: Basel III Standpoints, and *Sharī'ah*-Compliant Issues**

Each bank is required to have a good quality capital, in times of financial stability and economic crisis. Thus, regulatory capital is crucial for the banks to maintain to fund their activities. The regulatory capital constitutes a buffer to absorb the losses that the bank incurs, and this is not at the expense of the banks having to default on its liabilities, or adversely jeopardising the depositors, bondholders, and other senior creditors. The dissemination of Basel III is intended to ensure adequate regulatory capital to be established by banks including Islamic banks to fulfil their obligations in the event of losses, and prevent costly national bail-out. This section critically examines the issue of regulatory capital, and its requirement under Basel

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<sup>556</sup> Kammer, Norat, Pinon, Prasad, Towe, Zeidane (n 39).

<sup>557</sup> The five additional principles are: (i) Treatment of PSIA/IAHs (CPIFR 14); (ii) *Sharī'ah* Governance Framework (CPIFR 16); (iii) Equity Investment Risk (CPIFR 24); (iv) Rate-of-Return Risk (CPIFR 26); and (v) Islamic "Windows" Operations (CPIFR 32). Islamic Banks are also exposed to credit, market, and operational risks; but these risks could be heightened by the complexity of the way the products are structured.

III, including Basel III's classification of instruments under Tier 1 (T1), and Tier 2 (T2) capital, and the type of instruments that are in compliance with the *Shari'ah*, and could potentially meet the Basel III criteria for T1, and T2 capital.

A delineation is made between going-concern and gone-concern capital for the purposes of determining the regulatory capital under Basel III.<sup>558</sup> The regulatory capital is aimed at maintaining the overall trust and confidence in the financial system, and prevent potential bank run by the depositors as the losses are absorbed when the bank reaches the point of non-viability, and in the event of winding up (gone-concern scenario), the depositors will be protected.

Basel III elucidates the 'gone concern' to be beyond the meaning of 'insolvency and liquidation' and it 'includes situations in which the public sector provides support to distressed banks that would otherwise have failed'. Besides the 'bail-out' situation, a 'bail-in' feature of capital instruments is stipulated under Basel III,<sup>559</sup> where the elements of write-off, or conversion to common equity upon the occurrence of the trigger events to ensure that the regulatory capital absorbs the losses before the national bail-out is resorted to.

To strengthen the banking sector's ability to absorb shocks from the financial stress, the Basel III regulatory framework stipulates new regulatory capital requirements for banking institutions. Under Basel III, the bank's minimum capital requirement level has been increased, and the criteria for qualifying regulatory capital requirements has been redefined. By the end of 2019, the total regulatory capital under Basel III should be increased to 10.5%, as opposed to the current 8% of risk-weighted assets (RWA) under Basel II.<sup>560</sup> Further, Basel III has also abolished Tier 3 (T3) capital, whilst the components of regulatory capital have been reclassified as Tier 1, and Tier 2. Thus, the redefined criteria for qualifying regulatory capital under Basel III will impact the forms of capital instruments, particularly the *Shari'ah*-compliant instruments to be issued as T1, Additional Tier-1 (AT1), and T2 capital. **Figure G** below examines the changes to the capital structure under Basel III, and Basel II.

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<sup>558</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>559</sup> Ibid.

<sup>560</sup> Kahf (n 135).

Figure G <sup>561</sup>

Capital Adequacy Requirements	Basel III	Basel II
Significant increase in CET1 to improve quality of capital base. RWA has been increased to <b>10.5%</b> .	Capital Conservation Buffer CET 1 ( <b>2.5%</b> by 2019)	Tier 3 (*abolished)
Basel III (Loss absorption Concern.)	Tier 2 ( <b>2%</b> )	Tier 2 ( <b>8%</b> ) Tier 2 ( <b>8%</b> ) (Maximum 100% of Tier 1)
Basel III (Loss Going Concern ( <b>6%</b> ))	Additional T1 ( <b>1.5%</b> )	Tier 2 (Subordinated term debt). Maximum 50% of Tier1. Tier 2 ( <b>4%</b> ) (Maximum 100% of Tier 1)
	Common Equity T1 ( <b>4.5%</b> )	Innovative T1 ( <b>2%</b> ) Common Equity T1 ( <b>2%</b> with at least 50% of Tier 1) Tier 1 ( <b>4%</b> )

The total regulatory capital is to be maintained at 8% of risk-weighted assets (RWA) at all times under Basel III, which is similar under Basel II.<sup>562</sup> Tier 3 under Basel II has been abolished, and the components of T1 and T2 have also been adjusted from 4% each under Basel II to T1 being 6%, and T2 being 2% under Basel III. In order to improve the quality of the capital base, Common-Equity Tier 1 (CET1) under Basel III has been increased from 2% under Basel II to 4.5% as examined under **Figure G** above. Following the Basel III's distinction between going-concern (where the bank is still solvent, and continuing its operation), and gone-concern (where the bank is facing financial distress) scenarios, the subordination principle is to be applied to the capital requirements such as that there is a ranking of Common Equity Tier 1 (CET1), AT 1, and T2 instruments under Basel III. In this regard, T1 capital, comprising CET1, and AT1 could be used to absorb losses under a going-concern scenario, while the T2 instruments can be used to absorb further losses when the bank reaches the point of gone-concern. Whilst the

<sup>561</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>562</sup> Davies and Green, *Global Financial Regulation: The Essential Guide* (n 36) 7-19. Davies and Green outlined that, "Basel II has three main pillars. Pillar I established minimum capital requirements based on the risk of banks' assets. Pillar II stipulates a system of supervisory review to assess a bank's systems, controls, and risk management that can further influence the minimum capital requirement. Pillar III enforced market discipline by increasing information through rules of promoting disclosure and transparency."

regulatory capital level of conventional banks will be affected by Basel III, the impact also spills towards the capital-raising exercise by IFIs. This will attract *Sharī'ah*-compliant concerns as IFIs are regulated, supervised, and monitored to meet Basel III capital requirements. Although the noble objective is to further strengthen the resilience of IFIs in the event of economic and financial stress, *Sharī'ah*-compliant concerns remain alive. Therefore, to meet Basel III regulatory capital requirements, regulatory banking and finance authorities have promulgated guidelines for IFIs. The IFSB and BNM have examined the issue of qualifying *Sharī'ah*-compliant instruments that the Islamic banks can issue for the purposes of meeting the scope of regulatory capital. The debates remain unsettled about the suitable instruments that could satisfy the *Sharī'ah* requirements and the overarching objectives of Basel III.<sup>563</sup>

One of the key *Sharī'ah* concerns is the subordination of the capital instruments<sup>564</sup> that are structured using equity-based and exchange-based contracts to meet the regulatory capital requirements. This is because, through the subordination of the capital instruments, the instruments will only receive repayment in liquidation if all depositors and senior creditors are repaid in full,<sup>565</sup> and this will help achieve the loss absorbency during a gone-concern scenario. But as the equity-based and exchange-based contracts are structured in the form of *mudharabah* (investor-manager/entrepreneur) contract, the relationship is formed between investors as providers of capital (*rabbul-mal*), and Islamic banks as managers (*mudharib*) of the capital. However, at times, in practice, the *mudharabah* funds cannot necessarily be distinguished from the Islamic banks' assets, and this will manifestly alter the *mudharabah* relationship into a *musharakah* (partnership) relationship due to the fact that the assets have been used by IFIs for their general obligations.<sup>566</sup> Hence, notwithstanding that initially, the structure of the instrument takes in the form of *mudharabah*, but where the assets have been used by IFIs, the *Sharī'ah* rulings of a *musharakah* deal shall apply. Thus, it is not possible for a partner in *musharakah* (partnership) contract to be merely subordinated vis-à-vis the other partner so that the other partner could enjoy priority over payments.

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<sup>563</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>564</sup> Ibid.

<sup>565</sup> Ibid.

<sup>566</sup> Ibid.

Apart from that, in times of financial crisis, banks may be rescued by the injections of capital from the public sector,<sup>567</sup> whilst holders of subordinated instruments (mainly T2 capital) could not absorb any loss. Thus, Basel III treats that a mere subordination of capital is inadequate, notwithstanding that these instruments are ranked above ordinary shareholders, and subordinated to all other creditors. This is because, such a capital could not absorb the losses. The holders of these instruments would instead enjoy a status of being ahead of taxpayers when it comes to absorbing the losses.<sup>568</sup> Thus, the 'bail-in' feature has been articulated for capital requirements under Basel III so that the regulatory capital can absorb the losses by construct, before the taxpayers' money is used for public bail-out.

#### **5.4. A Critical Examination of the Capital Adequacy Requirements for IFIs**

Basel III standards will have to be fully implemented by the end of 2019. This has prompted the G-20 countries to adopt Basel III. The Islamic banks have complied with Basel II. But Basel III remains a significant challenge as the standards designed are seen to be more suited to the conventional banks as opposed to the Islamic banks that must consider the *Shari'ah*-compliant issues.<sup>569</sup> For the purposes of meeting the 2% regulatory capital requirement under Basel II, the Islamic banks may be well-capitalised as opposed to meeting the Basel III's standard set at 4.5% of the common equity in relation to RWA. Nevertheless, the investment *mudharabah* account does not account as common equity as these accounts are treated as bank liabilities, and not assets.<sup>570</sup> In theory, these accounts may have the ability to absorb losses, but this is not the case in practice. There must be a minimum of 6% of RWA accounted for by Tier 1 capital, which includes 4.5% common equity and an additional 1.5% as retained earnings. For Islamic banks, PER is maintained to enable payments to investment *mudharabah* depositors, and they can receive a profit even when the bank suffers losses. The question is whether these reserves are also determined as retained earnings. On one hand, the PER may be considered as the benefit of investment only, and therefore cannot be counted as retained earnings.<sup>571</sup> Hence, the issue of retained earnings are to be resolved as the regulators may argue that because the PERs are earmarked for the benefit of

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<sup>567</sup> Ibid.

<sup>568</sup> Ibid.

<sup>569</sup> Ibid.

<sup>570</sup> Ibid.

<sup>571</sup> Ibid.

investment depositors, they cannot be counted as retained earnings, although this position may not be agreeable to Islamic banks.<sup>572</sup>

Under Basel III, the mandatory capital conservation buffer of 2.5% constitutes an additional buffer. But if the PER is not allowed to count as retained earnings, then, the Islamic banks may need to rely on capital conservation buffers which are aimed to reduce the need to call on equity investors for an additional capital in the event of a financial crisis. The capital conservation buffers constitutes the reserves for the purposes of protecting depositors. The second buffer is the discretionary counter-cyclical buffer, and it applies to both conventional and Islamic banks with high credit growth. The banks are more vulnerable to a cyclical downturn, and this should be a concern for banks when financing new customers, and they may not be able to meet repayment obligations. If the two buffers and the regulatory capital adequacy requirements under Basel III are adopted by Islamic banks, the capital ratio will increase to 9.5% of RWA, plus the 1.5% retained earnings requirement for Tier 1 capital.

In addition, Basel III has also increased the liquidity requirements, where a net funding ratio of 30 days' coverage has been introduced. Therefore, Islamic banks should calculate their net funding outflows, so that the banks will have adequate liquidity to meet the depositor demands.<sup>573</sup> But if the major assets are interest payable such as the treasury bills, it would be difficult for the Islamic banks to manage its liquidity since major liquidity managed by the Islamic banks are through the deposits with the central bank. This means, no return is earned by the Islamic banks. Further, Islamic banks also manage their liquidity by holding inter-bank deposits that are subject to *murabahah* contracts, involving commodity trades on the London Metal Exchange. Further, Islamic banks are required to maintain the NSFR for long-term assets and liabilities under Basel III. The sum of a stable funding divided by the sum of long-term assets should exceed 100%. A stable funding includes customer deposits, long-term wholesale funding, usually through time deposits from other equity and banks. Short term wholesale funding of the sort that evaporates during the financial crisis is excluded. But the overnight and short-term *murabahah* deposits of Islamic banks are also included into a stable funding regime.<sup>574</sup> The most stable funding for Islamic banks is mainly from investment *mudharabah* deposits, which are subjected to periods of notice for withdrawals from

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<sup>572</sup> Ahmed, Asutay and Wilson, *Islamic Banking and Financial Crisis* (n 327) 13-39.

<sup>573</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>574</sup> Ahmed, Asutay and Wilson, *Islamic Banking and Financial Crisis* (n 327) 13-39.

30 to 180 days.<sup>575</sup> Funding from the wholesale market cannot be sought as it attracts *riba* (interest).<sup>576</sup> Therefore, from the *Shari'ah*-compliant standpoint, in addition to the need to satisfy the regulatory capital requirement under Basel III, the liquidity requirement such as the net funding ratio of 30 days' coverage and the NSFR would have to be adhered to by Islamic banks.<sup>577</sup>

Further, in terms of revised capital adequacy requirements, IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes) was published in December 2013 by the IFSB to guide IFSI. It was primarily aimed to serve banking institutions offering IFS, including but not limited to fully-fledged Islamic commercial banks, Islamic investment banks/companies, Islamic banking subsidiaries of conventional banks, Islamic banking branches/ divisions/units of conventional banks, and such other financial institutions as may be determined by the respective supervisory authority. The risk-weighting methodology stipulated in IFSB-15 may be applied to *Shari'ah*-compliant financing assets held by Islamic 'window' operations that are not self-contained, or by other institutions, holding such assets. The IFSB-15 is applicable to any IFS that falls within the scope as stated in IFSB-15, on a fully consolidated basis at the holding company level, within a group or sub-group of IFS, or on a solo basis, or on both fully consolidated and solo bases, as ascertained by the respective supervisory authority. The IFSB-15 was not intended to be applied at the consolidated level to a group or sub-group that comprises entities other than IFS, as enumerated in the said IFSB-15. Its application by supervisory authorities should also be commensurate with the size, nature, complexity, and type of products of the IFS in the jurisdiction. Whilst IFSB-15 may have been issued to guide IFSI, yet in terms of capital adequacy requirements, Basel III framework is still being referred to, even for Islamic banks, with the necessary supervision and regulation by the Central Bank in a particular jurisdiction.

## **5.5. International Framework for Islamic Finance: Interdependence, and the Clash of Civilisations**

The international framework for Islamic finance involves the interaction between the Islamic and the non-Islamic worlds that are interconnected and

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<sup>575</sup> Ibid.

<sup>576</sup> Ibid.

<sup>577</sup> Ibid.

interdependent through globalisation, international trade, cross-border banking, and businesses. Islamic banks invest in foreign assets so that they can boost yield and diversify the risks. This underscores the potential areas of interdependent financial relationships that are forged between the Islamic world and the non-Islamic world. For the international framework of Islamic finance, there is no systemic risk regulator to monitor the counterparty risk of dealing with cross-religious boundaries.<sup>578</sup> The existing international institutions, such as the IFSB, the AAOIFI, the IIRA Rating, are each assigned the roles according to their specific sector's objectives. The realist response to the international framework for Islamic finance is that international law is frail to be any good.<sup>579</sup> The clash of civilisations, as being provoked, exacerbates Islamophobia which accentuates the realist response towards the international law-making process, including the development of the international framework for Islamic finance. This study has critically examined in Chapter Three that, whilst the trust and confidence are espoused, uncertainties should be responded with greater consciousness of a 'meta-dependence' trust and confidence, instead of the clash of civilisations.<sup>580</sup> Thus, the value system that the international framework for Islamic finance operates should be approached beyond the realist response of propagating the clash of civilisations.<sup>581</sup>

Further, as the nature of the operation of international law accords deference to the sovereignty of states since all states are equal under international law, no single international regulator can be established to compel a regulated behaviour of state actors.<sup>582</sup> But with increasing interdependence between borrowers and lenders in Islamic finance, the Islamic and the non-Islamic worlds could internalise the

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<sup>578</sup> Bakar, *Shari'ah Minds in Islamic Finance* (n 269) 25-108.

<sup>579</sup> Thucydides, *The History of the Peloponnesian War* (trans. R. Crawley and R.C. Feetham, Avon, Connecticut, Cardavon Press, revd., 1974), Bk V, pp.293-299. It is noted that, "[t]he strong do what they can and the weak suffer what they must". That is the lesson of the Melian Dialogue, events of 416 B.C., written down by Thucydides soon after, in almost the earliest moments of the written record of human history, a bleak and satisfying narrative.

<sup>580</sup> Huntington, *The Clash of Civilizations and The Remaking of a New World Order* (n 111) 212. Huntington states, "... [t]hus lie in fundamental questions of power and culture. *Kto? Kvo? Who is to rule? Who is to be ruled?* The central issue of politics defined by Lenin is the root of the contest between...". In the use of the Huntingtonian methodology is the to draw the conclusion that the Islamic world and non-Islamic world will always pole apart, and will always have 'clash' with each other. The methodology negates any form of constructive dialogue and cross-civilisational understanding which will hamper further progress.

<sup>581</sup> Huntington, *The Clash of Civilizations and The Remaking of a New World Order* (n 111) 212. Huntington states that, "...[s]o long as Islam remains Islam (which it will) and the West remains the West (which is more dubious), this fundamental conflict between two great civilisations and ways of life will continue to define their relations in the future even as it has defined them for the past fourteen centuries."

<sup>582</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

effects of causing harm to the other, including the acts of war and aggression. Globalisation suggests that two McDonalds do not fight and go to war, and this creates the macdonalisation of societies.<sup>583</sup> Further, as IFSI grows, the non-Islamic world could embrace the potential market of Islamic finance. The General Electric (GE), Shell, and Tesco of the UK are amongst those major non-Islamic issuers of Islamic securities. The GE's \$500 million Islamic bond sold at just 155 basis points over US treasuries, claiming itself to be the first US corporate issuer of Islamic bonds that has broadened the list of sizeable assets.<sup>584</sup> The state of Sachsen-Anhalt in Germany also issued €100 million *sukuk* in February 2005.<sup>585</sup> Despite this wider acceptance of Islamic finance, the Islamic world has also been brought to bear the unresolved regional conflicts as well as sanctions, which could impede further development of Islamic finance. Further, there is also a regional competition to be the global financial authority. The IFSB for instance, is composed of a broad number of non-GCC Islamic financial regulators including Korea, Singapore, Hong Kong, as well as the OIC as the GCC-dominated equivalent group. The emergence of various international standard setting bodies within the international framework for Islamic finance are also in competitive race in creating internationally acceptable forms of securitisation that are *Shari'ah*-compliant. The Dar Al-Maal Al-Islami (DMI) trust, and the Al-Baraka Banking Group are the two major Gulf-based multi-banking conglomerates that have often competed since 1970s in order to establish substantial presence in global markets.<sup>586</sup> A number of gulf-based Islamic banks are also leaders in their home markets. But due to the rapid growth of Islamic finance, the Al-Rajhi Bank of Saudi Arabia has expanded into Malaysia. Also, the Kuwait Finance House has expanded strongly into Malaysia. Tapping into the employment and trade flows between the UAE and Pakistan, the Dubai Islamic Bank has established its great presence in Pakistan. The expansion of these multimarket conglomerates has the potential to achieve the scale needed for the purposes of attaining the efficiency and profitability levels, and will likely induce change in the international framework for Islamic finance through acquisitions, and pan-regional strategies to enhance Islamic finance.<sup>587</sup>

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<sup>583</sup> Thomas L. Friedman, *The Lexus and the Olive Tree: Understanding Globalization*, (Farrar, Straus and Giroux 1999) 4-30.

<sup>584</sup> Rachna Uppal, Stanley Carvalho, 'GE Capital raises \$500 million in debut Islamic bond' <<https://www.reuters.com/article/us-gccapital-bonds-idUSTRE5A130I20091119>> accessed 28 July 2018.

<sup>585</sup> Banker Editor, Germany launches Europe's first Sukuk, 2/09/2004, available at <https://www.thebanker.com/Comment-Profiles/Germany-launches-Europe-s-first-Sukuk?ct=true>, accessed on 28 July 2018.

<sup>586</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>587</sup> Bakar, *Shari'ah Minds in Islamic Finance* (n 269) 25-108.

Citi-Islamic investment bank, as established by Citigroup in 1990s has brought within it a dedicated business unit and teams dedicated to *Shari'ah*-compliant products and services. The HSBC Amanah, as founded by the HSBC Group in 1998 further marked a major breakthrough on the evolution of the international framework for Islamic finance landscape. Islamic windows that are *Shari'ah*-compliant have been established to cater for the need of the clients. As Islamic finance grows, it is not free from issues emanating intra- and cross-religious divisions, as well as the factions of Islamic legal thoughts, and the adherence to Islam. In the wake of varying standards in Islamic finance, the harmonisation and standardisation of these standards have been espoused,<sup>588</sup> as though they are also negotiable issues under international law. Nevertheless, the bargaining and negotiation cannot run contrary to the *Shari'ah*, but the differentiation is permitted only on the extent of further interpretation, application, and implementation of the *Shari'ah*. Rather than being embroiled in the clash of civilisations and unnecessary divergence, there is more of a shared interest in economic prosperity, rather than the cultural divide between the Islamic and the non-Islamic worlds which have become increasingly interdependent. In addition, Islamic finance offers a range of *Shari'ah*-compliant Islamic financial solutions from the retail to the wealth management sector, which makes it a growing financial sub-system within the global financial system. That being said, money market instruments such as hedging and derivative mechanisms are still peculiar to Islamic finance, although it may appear important in the context of managing risks and hedging,<sup>589</sup> and could be the next potential frontier for the development of international framework for Islamic finance.

## **5.6. The Creative Evolution in the International Framework for Islamic Finance: A Critical Examination of Islamic Derivatives<sup>590</sup>**

In the wake of the 2008 financial crisis, derivative is one such instrument that has been debated to have caused many investors losing their money. For Islamic finance, the issue is whether derivative instruments could be the next step of the

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<sup>588</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>589</sup> Mohamed Sultan and Hassan, *Islamic Derivatives* (n 255) 23.

<sup>590</sup> In section 2 of IFSA 2013 [Act 759], the term 'Islamic derivative' means 'any agreement, including an option, a swap, futures or forward contract, made in accordance with *Shari'ah*, whose market price, value, delivery or payment obligations is derived from, referenced to or based on, but not limited to, Islamic securities, commodities, assets, rates (including profit rates or exchange rates) or indices.'

evolutionary phase of the sector,<sup>591</sup> particularly in managing the risks inherent in the financial system. *Shari'ah* scholars have broadly rejected the traditional notion of derivatives since derivatives are types of investments where investors do not own the underlying asset.<sup>592</sup> It is an act of betting (*maysir*) against the direction of the price movement of the underlying asset vide a contractual agreement. Thus, derivatives are financial instruments that have no value of their own. Instead, the derivatives derive the value from the value of some other assets. By this construct, derivatives are broadly rejected as they contravene the *Shari'ah* which prohibits opaque contractual agreements that are speculative and akin to gambling (*maysir*). Issues and challenges faced by Islamic derivatives encompass the *Shari'ah* issues (product structuring and the use of product), legal issues (lack of standardisation and enforceability of *wa'ad* (fulfilment of promise), regulatory issues (lack of regulatory framework), ethical and moral issues (speculation (*gharar*) and gambling (*maysir*), and the legacy conventional mindset of derivatives banker. There are several *muamalat* contracts that have the features which resemble the derivatives. They can be used for hedging such as *salam* and *istisna'*. The *muamalat* contracts that are used to create products which have features similar to forwards, futures, options, and swaps are commodity *murabahah*, *musawamah*, *bay' al-inah*, and *wa'ad*. In addition to these requirements for financial instruments, the *Shari'ah* has some basic conditions with regard to the sale of an asset (in this case, a real asset, as opposed to financial assets). According to the *Shari'ah*, for a sale to be valid, the commodity, or the underlying asset must currently exist in its physical sellable form, and the seller should have legal ownership of the asset in its final form. These conditions for the validity of a sale would render the trading of derivatives impossible. However, the *Shari'ah* provides exceptions to these general principles to enable a deferred sale, where needed. A contemporary juristic opinion has been offered by Hashim Kamali<sup>593</sup> with regard to the validity of derivative products such as futures, and futures trading. His juristic opinion is examined as the foregoing.

First, the counter-values in the two sides of the transaction could both be absent at the time of contract i.e. no good is delivered and no price is paid. In order to validate a sale, the *Shari'ah* has ordained that it is essential that at least one of the counter-values should be present and delivered at the time of the contract.<sup>594</sup>

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<sup>591</sup> Karim Ulah, 'Evolutionary Islamic Banking Service' (2015) 3 (2) Journal of Islamic Banking and Finance 91-96.

<sup>592</sup> Mohamed Sultan and Hassan, *Islamic Derivatives* (n 255) 23.

<sup>593</sup> Ibid.

<sup>594</sup> Ibid.

Second, the trading in futures and derivatives is banned because the *Sharī'ah* prohibits short-selling in the event where the seller neither owns, nor possesses the underlying assets being sold. The *Sharī'ah* requires that any sale contract must involve an exchange and transfer of ownership of the object of sale. Hence, it is imperative that the seller owns the object of sale, and in this vein, the short-selling is prohibited.<sup>595</sup>

Thirdly, the '*Qabdh*' requirement which refers to the 'taking and holding something in one's hands' must be satisfied in a derivative instrument. The *Sharī'ah* ordains that the '*Qabdh*' requirement constitutes the legal possession of the subject matter of a contract, and this accordingly formalises a valid contract of sale, where the buyer cannot sell the goods that he has bought, except when the goods are in his legal possession. The AAOIIFI further stipulates that the '*Qabdh*' requirement is crucial since the *Sharī'ah* restricts the sale of one debt for another (*bay' al kali bil kali*), as may be triggered in a derivative transaction. Therefore, the actual holding of the subject matter should qualify as a valid mode of taking possession, and not any kind of legal substitutes. The *Sharī'ah*'s position is, a debt is disallowed to be the subject matter of a sale, except it is at par value, and settled for cash at spot. A sale of debt cannot be sold for another debt (*bay al kali bil kali*). Further, the derivative transaction is prone to excessive uncertainty (*gharar*) surrounding the entire trade. Uncertainty (*gharar*) that is triggered will nullify the contract.<sup>596</sup>

Further, the Islamic *Fiqh* Academy, in 1992, had adopted a decision on the definition of 'company share', which stated that the subject matter in the sale of company shares is an 'undivided portion of company assets'. This definition could be aligned to the accounting definition of 'owners' equity', which refers to 'the residual interest in the assets of an entity that remains after deducting its liabilities'. Nevertheless, a clear demarcation is made to the definition offered by the Islamic *Fiqh* Academy from the conventional legal definition of 'company share', which represents a residual claim to future cash-flows (dividends and liquidation proceeds). Following the decision by the Islamic *Fiqh* Academy, it has spurred evolutionary growth of Islamic fund management, investment and equities, and *sukuk* as another asset class within the Islamic capital market. Selective approval is

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<sup>595</sup> Ibid.

<sup>596</sup> Ibid.

accorded after reviewing the necessity of these products and the mechanics of the structure on the basis of *maslahah* (greater benefit of the people).<sup>597</sup>

The creative evolution of the international framework for Islamic finance has also experienced a process of standardisation of legal documentations led by the IIFM. As the global standardisation body for the Islamic capital and money market segment of the IFSI, the IIFM has focussed on the standardisation of Islamic financial products, documentations, and related processes. A memorandum of understanding was established in 2006 between the IIFM and the International Swaps and Derivatives Association (ISDA) with the objective of establishing a new market standard master agreement for Islamic financial hedging instruments. The collaboration has formalised an IIFM *Tahawwut* Master Agreement (TMA), which forms a framework document for hedging transactions, specially developed for IFSI, including Islamic banking window-based operations. The TMA covered the relationship framework, events of early termination, early termination netting mechanisms, representations, etc. Further, the TMA stipulates that for the purpose of *Sharī'ah*-compliance, the following conditions must be met:<sup>598</sup>

- (a) Transactions entered into should only be for the purpose of hedging actual risks of the relevant parties;
- (b) Transactions should not be entered into for speculation purposes;
- (c) Transactions must be real transactions, involving the actual transfer of ownership or real assets, actual risk and real settlement;
- (d) The underlying asset must be *Halal* (Islamically permissible); and
- (e) Interest (*riba*) must not be chargeable under the transaction.

That notwithstanding, there are still contemporary Muslim jurists who opine that derivatives in their conventional stature and practices are not in compliance with the *Sharī'ah*. This disapproval is due to the fact that the structure of derivative, in and of itself, contradicts the *Sharī'ah*, let alone to examine the actual practice of the derivatives. Hence, derivatives are denounced outright in its conventional context by some jurists. In general, the jurists may acknowledge that the underlying purpose of derivatives to hedge and manage adverse risks related to the business enterprise should be acceptable by the *Sharī'ah*. But where the Islamic derivative takes the course of a more exotic instrument, the derivative at issue morphs into a highly

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<sup>597</sup> Ibid.

<sup>598</sup> Ibid.

speculative (*gharar*) structure that is prohibited by the *Shari'ah*. Caution has been exercised to avoid misleading the restructuring process of Islamic derivatives' agreement, which has brought the TMA into fruition. The reference of 'derivatives' in the name is avoided, but the word '*Tahawwut*' is used instead.<sup>599</sup> Thus, for the purposes of entering into such a TMA contract, it shall only be used for hedging purposes. Speculating or arbitraging are strictly prohibited. In this regard, the investment bank (supported by the Islamic structures) must ensure that the actual requirement of the client (the counterparty of the solution) and the client's acceptance towards accepting hedging and risk management mechanism are fully *Shari'ah*-compliant. The investment bank, providing the TMA or Islamic derivative mechanism, should develop a proper internal *Shari'ah*-compliant governance mechanism to ensure the full observance of the criteria,<sup>600</sup> such as:

- (i) the agreements in the structure shall be real and not fictitious (*ghayr al-surriyyah*);
- (i) the agreement shall deliver its effect (*athuraha*);
- (ii) the agreements must be separate and independent; and
- (iii) the agreements shall not be made conditional, one upon the other.

Abu Sulayman of the OIC *Fiqh* Academy considers 'options' to have been detached and independent of the underlying asset and hence, are not acceptable.<sup>601</sup> Mufti Taqi Usmani of the OIC Islamic Fiqh Academy had opined that promises that are part of a contract are acceptable in the *Shari'ah*, however the trading and charging of a premium for the promise is not acceptable.<sup>602</sup> The profits from the options also may be unearned, and hence, can be regarded as *maysir* (gambling). In a nutshell, the creative evolution of the international framework for Islamic finance recognises the overall stance of Islamic jurists i.e. the conventional derivative instrument is one that should be treated with apprehension and suspicion, because these instruments can be used for speculation. In this regard, the basis of Islamic derivative, originally purported for risk management may have been lost.

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<sup>599</sup> Ibid.

<sup>600</sup> Ibid.

<sup>601</sup> Ibid.

<sup>602</sup> Ibid.

## 5.7. A Critical Examination of the International Framework for Islamic Finance in the Context of Brexit, And UK As Islamic Finance Hub

UK is the western leading jurisdiction for Islamic finance. Although UK is faced with the on-going negotiation towards the full effect of Brexit, this section examines whether the UK will remain the Islamic finance hub for both the non-Islamic world and the Islamic world. On 23<sup>rd</sup> June, 2016, a referendum decision was announced for the UK to leave the European Union (EU).<sup>603</sup> The referendum saw the vote to leave was won by 51.9% to 48.1%. The referendum turnout was 71.8%, with more than 30 million people voting. On 26<sup>th</sup> January, 2017, the UK Government introduced a brief bill called The EU (Notification of Withdrawal) Act 2017.<sup>604</sup> The future arrangement between the UK and the EU is being negotiated. To date, the UK is faced with the deadline by the end of October 2019 to leave the European Union (EU), either with a deal or no-deal Brexit.

The UK has considered her options to leave the EU. The first option was for the UK to emerge as a third-sovereign state to like the Norwegian or the Singapore models,<sup>605</sup> and the second option was for the UK to remain as a beneficiary state, enjoying a favourable treatment accorded within the Customs Union (CU)<sup>606</sup> of the EU market. This has caused considerable negotiations and disagreements on the extent to which such a favourable treatment could still be accorded, as applicable. The third-sovereign state model did not yield itself as a preferred model for the UK.<sup>607</sup> The Brexit negotiation solicits benefits that can be afforded to the UK by remaining in the CU. <sup>608</sup> A CU is a trade-liberalisation phase that follows from the formation of an FTA between and amongst the EU Members. It sets a common external tariffs, allowing goods and services to travel freely between the EU Members. The CU, covering Europe was created in 1958 as part of the European Economic Community (EEC), which had evolved into the EU, i.e. a supranational entity that pools the sovereignty of all EU Members, including the UK (pre-Brexit).

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<sup>603</sup> John Armour and Horst Eidenmüller, *Negotiating Brexit* (Blackwell's 2017 2-35).

<sup>604</sup> Niamh Moloney, 'Financial Services, the EU, and Brexit: An Uncertain Future for the City?' (2016) 17 *German Law Journal* 75-81.

<sup>605</sup> *Ibid.*

<sup>606</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35. See also Piet Eeckhout, Oliver Patel, *Prolonging the Acquis Is A Blueprint for the Brexit Transition*, (2017), available at LSE Blog <<https://blogs.lse.ac.uk/brexit/2018/02/07/prolonging-the-acquis-is-a-blueprint-for-the-brexit-transition/>> accessed 23 July 2019.

<sup>607</sup> Moloney (n 604) 75-81.

<sup>608</sup> *Ibid.*

The full *EU-acquis* is to be observed during the Brexit negotiations, whilst the final Brexit deal being debated and negotiated. The options remain for the UK, either to land on a hard-Brexit deal, or a soft-Brexit deal, or a no deal Brexit. The international law requires the observance of full *EU-acquis*.<sup>609</sup> To fulfil the *EU-acquis*, the UK should not defy the object and purpose of all EU treaties that the UK is a signatory party to.<sup>610</sup> Although Brexit is affected by the unknown-unknown, this section critically examines the position of the UK to remain as an Islamic finance hub from the prospect of optimism, despite the creeping Euro-scepticism may hamper the final Brexit deal for the future UK-EU relationship.<sup>611</sup>

The financial services sector in the UK is amongst the most important sector for the facilitation of market access, and the liberalisation of financial services for the UK and the EU. Despite that the UK is not part of the Eurozone, the position of pound sterling is reinforced through its day-to-day usage within the UK.<sup>612</sup> The use of Euro is widespread as one of the freely usable currencies in the world. Due to Brexit, a cheaper pound sterling may well garner considerable opportunities for international investors from the Islamic world, and elsewhere. The UK and Eurozone currency markets are highly liquid, transferable, usable, and exchangeable due to the increasing interdependence and the inter-market flow of currency exchange that is freely taking place on a day-to-day basis.<sup>613</sup> Clearing and payment systems within the inter-market flows have been facilitated through the favourable treatments accorded to the UK, being part of the EU. Brexit yields a different value proposition for these financial markets to freely operate in cross-border context, particularly from the UK financial services sector into the EU market, and vice versa.<sup>614</sup> Before Brexit, the UK has enjoyed tremendous stature of being a thriving hub for the financial services sector. The Bank of England, being the central bank of the UK, supervises and regulates the overall financial services sector in the UK. The ECB supervises and regulates the financial sector within the Eurozone. The integrated nature of these two markets, and the substantial inter-bank operations pave the way for an interdependent network of banking and capital markets within the EU, and the UK.

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<sup>609</sup> Moloney (n 604) 75-81.

<sup>610</sup> McCormack G, Anderson H., 'Brexit and its implication for restructuring and corporate insolvency in the UK' (2017) *Journal of Business Law* 7.

<sup>611</sup> Moloney (n 604) 75-81.

<sup>612</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35

<sup>613</sup> *Ibid.*

<sup>614</sup> Moloney (n 604) 75-81. Moloney argued that the regulated nature of financial services involve some sort of 'equivalence' agreement, with the UK seeking access as a 'third country' to the EU single market. Equivalence under current EU financial law is not simply a matter of regulatory equivalence as it involves an assessment of supervisory/enforcement equivalence.

### 5.7.1 A Critical Examination of the Islamic Financial Services in the UK

Post-2008 financial crisis, the UK's financial regulatory structure was redesigned to enable better supervision and regulation, where the then Financial Services Authority (FSA) was replaced by two new regulatory bodies i.e. the Financial Conduct Authority and the Prudential Regulatory Authority, with the latter established as a subsidiary of the Bank of England. In 2019, the CityUK reported that the UK is the top western centre for Islamic finance, with 5 fully *Shariah*-compliant banks licensed in the UK with banking assets of around £4.1 billion in 2018, and assets of UK-based institutions that offer Islamic financial services totalled around \$6 billion in 2017.<sup>615</sup> This placed UK at the top position in the hierarchy of the EU countries, fourth place among the non-Muslim majority of countries (after Singapore, Sri Lanka, and South Africa).<sup>616</sup> In 2016, the total assets of UK-based Islamic finance institutions were estimated to be more than \$5 billion in 2016. Islamic finance in the UK are also examined in the context of infrastructure development that used Islamic finance facilities such as the development of The Shard, Battersea Power Station regeneration, the redevelopment of Chelsea Barracks, London Gateway, and the Olympic Village.<sup>617</sup> Further, the Gatehouse Bank, a *Shari'ah*-compliant bank has managed to finance over 6,500 homes through its £700 million investment in the North West and the Midlands.<sup>618</sup> The *raison d'être* for this growth is attributed to the depth and breadth of established conventional financial and related professional services in the UK.

In terms of legal framework, the UK provides one of the most attractive legal, regulatory, and tax systems for Islamic finance to flourish. In 2009, the GE Capital issued its *sukuk*, and it has become the first listed *sukuk* in the London Stock Exchange (LSE) by a US Corporation. The Kuveyt Turk *sukuk* was the first Islamic bond issued by the EU Bank. In 2010, it was the International Innovative Technologies that had issued the first UK corporate *sukuk* on the LSE. The IDB based in Jeddah also joined these *sukuk* issuances on the LSE by raising \$1.2 billion. In 2014, the UK issued its sovereign *sukuk* on the LSE. These developments

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<sup>615</sup>The CityUK The CityUK, (Global Trends in Islamic Finance and the UK Market 2019) <<https://www.thecityuk.com/research/global-trends-in-islamic-finance-and-the-uk-market-2019/>>accessed 10 September 2019.

<sup>616</sup> Ibid.

<sup>617</sup> Ibid.

<sup>618</sup> Ibid.

have brought Islamic finance to the mainstream of conventional finance, and underscored the acceptance of *sukuk* as an asset class by global investors.<sup>619</sup>

The existing financial landscape of the UK has also witnessed that, there are over 20 banks located in the UK that offer Islamic finance services. Five of which are fully *Shari'ah*-compliant, and mainly retail-focused. In 2016, there was a \$4.5 billion total *Shari'ah*-compliant banking assets. The Al-Rayyan Bank, which is a retail bank is the only Islamic bank, has high street presence with five branches across the UK.<sup>620</sup> The Bank of London and The Middle East (BLME) is an independent wholesale *Shari'ah*-compliant UK bank based in London. The Qatar Islamic Bank (QIB) is a UK subsidiary of QIB, which offers a diverse range of *Shari'ah*-compliant products for both financing and investments such as private equity and asset management to their clients. The Gatehouse Bank, a *Shari'ah*-compliant wholesale investment bank, operates in capital markets and its asset finance is managing \$1.2 billion real estate assets, globally.<sup>621</sup> The Abu Dhabi Islamic Bank UK Limited has emerged as the only country outside the Middle East, which operates a large network of its banking operations in Egypt, Iran, Saudi Arabia, Qatar, and the Middle East. With its headquarter in London, the IIB European Investment Bank, formerly known as the European Islamic Investment Bank, has now become part of Rasmala, which is known as an authorised investment firm instead of a bank.

The number of Islamic banking and financial services in the UK is higher than many other western jurisdictions. With this development, the UK becomes a friendly hub for Islamic finance that hosts many foreign banks and financial institutions, particularly through the access of London market, and the London-based teams for specific initiatives, such as property-finance, corporate financing, and Islamic finance lending. The corporations and issuers of financial products have enjoyed the depth and breadth of London's capital markets, which provide them with a wide access to a range of investors all around the world, and the secondary market liquidity.<sup>622</sup>

To enhance the LSE as a key global venue for the issuance of sovereign *sukuk*, the Islamic Finance Market Index was launched in 2013, which has

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<sup>619</sup> Ibid.

<sup>620</sup> Ahmed Belouafi, Abdelkadir Chaci, 'Islamic Finance in the United Kingdom: Factors Behind its Development and Growth' (2014) 22 (1) Islamic Economic Studies 37-77.

<sup>621</sup> The CityUK, (n. 615) 3-9.

<sup>622</sup> Belouafi and Chaci (n 620) 37-77.

witnessed that to date, over \$48 billion has been raised through 65 issues.<sup>623</sup> The dynamic and attractive market environment in the UK has also made London to emerge as an Islamic finance hub<sup>624</sup> that hosts over 200 international law firms, to which 25 of these law firms are estimated by the CityUK to have forged major global partnerships with IFSI and established dedicated Islamic finance units. This positive phenomenon is attributed to the fact that majority of the Islamic financial products are reducible into contractual issues that are governed by the English Common Law, although the legal disputes often arise on the issue of the choice of law, as a matter of substantive law or procedural law application, or even the determination of *lex arbitri*. The UK is also recognised as one of the largest accounting, consulting, and professional service firms, where these firms have Islamic finance departments which provide qualified advisory services to global clients.

### 5.7.2. Hard Brexit and Islamic Finance in the UK

The term of the art for the 'hard-Brexit' critically examines the position of UK as a third sovereign state as the UK's liberalisation approach will stem from the WTO General Agreement of Trade in Services (GATS). As a general rule, under the WTO multilateral trade framework, all WTO Member States shall enjoy the Most-Favoured-Nation (MFN) Treatment, as stipulated under Article II of GATS.<sup>625</sup> An exception to the MFN Treatment would be the preferential treatment accorded to a free trade area, a CU, a common market and the Economic Union.<sup>626</sup>

As hard-Brexit envisions that the UK will leave the EU completely, a legal consequence that follows therefrom will deny the UK a more favourable treatment that was previously accorded to her, by being an EU Member. This means, the UK

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<sup>623</sup> The CityUK, (n. 615).

<sup>624</sup> Belouafi and Chaci (n 620) 37-77.

<sup>625</sup> Article II(1) of GATS stipulates that, each WTO Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

<sup>626</sup> In Article V (1) of GATS, it reads that, "[t]his Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement:

- (a) has substantial sectoral coverage, and
- (b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:
  - (i) elimination of existing discriminatory measures, and/or
  - (ii) prohibition of new or more discriminatory measures,

either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIVbis.

will not be able to reap the benefits as envisaged by Article V of GATS which is a trade exceptionalism circumstance for a CU,<sup>627</sup> or an Economic Union which enjoys a better preferential treatment, as opposed to the *de facto* minimum threshold of the MFN treatment under Article II of GATS.<sup>628</sup> The UK will be prevented from enjoying a favourable treatment that one EU Member accords to another EU Member on the basis of the preferential regime of the EU treaties. That notwithstanding, paragraph 2 of GATS' Annex on Financial Services allows a broad 'prudential carve-out' in which a WTO Member may derogate from their commitments due to prudential reasons, provided that the measure at issue is not used as a means to avoid obligations under the WTO-GATS.<sup>629</sup> Where the financial services are concerned, it is basically covered under the WTO-GATS to which the MFN treatment applies. In the event of a hard-Brexit, the UK will have no choice but to fall back on the general rule of trade multilateralism by enjoying the *de facto* WTO-MFN regime.<sup>630</sup>

A hard-Brexit also defeats the UK of her 'passporting rights' which include the denial of UK's enjoyment on the freedom of establishment, as accorded under Article 49 of the Treaty on the Functioning of the European Union (TFEU)<sup>631</sup>, and the freedom to provide services as provided under Article 56 of the TFEU.<sup>632</sup> In essence, the EU 'passporting' system for banks and financial services companies constitute the foundation of the EU single market for financial services. This should enable the firms that are authorised in any EU Member to trade freely with minimal additional authorisation. In this regard, a 'passported' UK based bank has certain rights and preferential treatments within the EU, where banks' customers will be provided with a broad range of banking services across the UK, and all the 28 EU

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<sup>627</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35

<sup>628</sup> *Ibid.*

<sup>629</sup> *Ibid.*

<sup>630</sup> *Ibid.*

<sup>631</sup> Article 49 of TFEU reads: "[w]ithin the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."

<sup>632</sup> Article 56 of TFEU reads: "[w]ithin the framework of the provisions set out below, restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended. The European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may extend the provisions of the Chapter to nationals of a third country who provide services and who are established within the Union."

Member States. A 'passport' UK based bank could also enjoy establishing a branch in any other EU Member state, where its cross-border banking services could be offered across all other EU Member states, at a low cost and without duplication.<sup>633</sup> Likewise, the 'passporting rights' allows EU-based banks to sell their products and services across the EU borders, and easily establish branches in other EU Member States. The option of a hard-Brexit would put the UK-based bank at a disadvantage position, where such 'passporting rights' may no longer be available, but instead, a licence must be applied in each EU Member. Not only that the range of the licensed banking services is limited, a licence is not necessarily available in many EU Members. The licence will usually be limited to one country at a time with no cross-border rights. This denial of 'passporting rights' will result in duplication, and substantial additional costs.<sup>634</sup> The 'passporting rights' is of special favourable treatment to the UK, because the UK is the largest exporter of financial services inside the single market, exporting over £20 billion of services to customers in the EU in 2014, and facilitating hundreds of billions of euros.

Following the event of Brexit, the European Banking Authority, whose role is to ensure an effective and consistent prudential regulation and supervision across the European banking sector, had been moved from London to Paris in France.<sup>635</sup> Thus, the UK's status as a global financial hub appears to be put at risk due to the hard-Brexit consequences. London's lucrative euro-clearing market will also be affected as Paris may emerge as capitalising the euro-market. The UK may also be implicated by a haemorrhage of employees, trade, services, and investment due to the loss of her 'passporting rights'.<sup>636</sup> The situation is more implicating to the big banks and financial institutions which operate widely across the EU, where their relocation from the UK to the EU market becomes an option. The hard-Brexit may not necessarily impact much the Islamic banks based in the UK, having their own domestic appeal and localised demographic operations in the UK. Nevertheless, should a hard-Brexit deal persist, the commercial appetite of Islamic Banks may be diluted in terms of expanding its banking operations across the EU market, although this scenario remains to be examined within the realm of market uncertainties.

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<sup>633</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35

<sup>634</sup> *Ibid.*

<sup>635</sup> *Ibid.*

<sup>636</sup> *Ibid.*

### 5.7.3. Soft Brexit and Islamic Finance in the UK

A 'Soft-Brexit' is another term used for the categorical implication that suggests lesser impacts of Brexit to the UK. For the soft Brexit, it is examined that the UK could still enjoy the preferential treatments, as accorded within the CU of the 28 European Members.<sup>637</sup> Unlike the hard-Brexit which will subject the UK's liberalisation approach to stem from the WTO-MFN multilateralism, and the denial of a more favourable treatment within the EU such as the loss of UK of her 'passporting rights', a soft-Brexit will bargain the implications for the UK to find her comfort to rely on Article 63 of TFEU.<sup>638</sup> This is in relation to the free movement of capital, if able to be granted for the UK to enjoy the preferential treatments in the CU. This is important in order to mitigate the barriers to transfer capital, and repatriate profits within the EU from the UK, and vice versa. In principle, the free movement of capital, and the repatriation of profits, principally purport for an efficient allocation of production factor of capital by market participants within the EU Single Market. Hence, extending the free movement of capital to third countries widens the supply side considerably, in favour of the EU market. Therefore, it is highly dependent on the negotiations on the competing freedoms issue for the UK's market to access into the EU, whilst the enjoyment of the single market of a CU may either be granted to the UK after Brexit, or denied by Article 63 of TFEU.<sup>639</sup>

The implications of Brexit the Islamic finance in the UK may also be softened by the fact that the UK is the leading hub for Islamic finance in the western world. In July 2019, the UK Finance Minister Philip Hammond announced that the UK government has plans for its second *sukuk* (sterling-denominated), after her first issuance of *sukuk* in 2014. Further, the position to cement the UK's status as the leading western hub for Islamic finance was also attested by the Economic Secretary to the Treasury, Harriett Baldwin in April 2016, who had made it clear of the UK Government's commitment to make Islamic financing more accessible in the UK.<sup>640</sup> Further, the international banks such as Citi Bank, HSBC, JPMorgan, Deutsche Bank, and Standard Chartered which are based in London and offering

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<sup>637</sup> Ibid.

<sup>638</sup> Article 49 of TFEU reads: "1. [w]ithin the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

<sup>639</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35

<sup>640</sup> The CityUK, (n. 615) 3-9.

Islamic financial services are aimed at among others, attracting Middle East liquidity.<sup>641</sup> This kind of appeal for Islamic financial products and services offering may not necessarily be impacted by the Brexit. The liquidity in the overall UK financial sector could still be supported, as such a need arises.

In addition, the LSE has developed an enabling environment for the Islamic finance to thrive. The LSE has become a crucial avenue for the *sukuk* issuance totalling to 65 *sukuk* being listed on the LSE with a value of \$48 billion.<sup>642</sup> Not only that the UK through the LSE has become the first western country to issue a sovereign *sukuk*, the UK Government in 2014, has also managed to sell her \$200 million *sukuk*, expected to mature in 2019 to investors not merely based in the UK, but also to major global hubs for Islamic finance. Further, the soft-Brexit may not affect the established platforms for Islamic fundraising on the LSE i.e. the Main Market, and the Professional Securities Market.<sup>643</sup> The Professional Securities Market offers less strict regulatory requirements that allows the issuance of debt securities and *sukuk* to be more flexible, as opposed to the Main Markets. The domestic General Accepted Accounting Principles (GAAP) governing the *sukuk* issuances also need not follow the IFRS requirements.<sup>644</sup> The position of the LSE also remains attractive as the listing venue is not only competitive, but also cost-efficient since the LSE does not charge an annual fee to the issuers as compared to other major exchanges. With a total of seven *Shari'ah*-compliant exchange traded funds (ETFs) listed on the LSE, the net assets of Islamic funds in the UK has been reported to have reached US\$728million. The London market, through the LSE has emerged as the leading western hub, and more importantly, the Europe's gateway to global Islamic finance. The UK's first sovereign *sukuk* was also oversubscribed with a strong demand and orders totalling around £2.3 billion.<sup>645</sup> Further, the UK Government has removed double tax on Islamic mortgages, and tax relief extension on Islamic mortgages, to natural persons, and juridical persons (corporations).<sup>646</sup> Alongside these developments, the international capital markets are comfortable with London, and the LSE being exploited as the hub for Islamic finance. As promising this may be, it is unlikely that there would be a change of direction in the near future for the UK to lead, and remain the leading hub for Islamic finance.

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<sup>641</sup> Ibid.

<sup>642</sup> Ibid.

<sup>643</sup> Ibid.

<sup>644</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35.

<sup>645</sup> The CityUK, (n. 615) 3-9.

<sup>646</sup> Armour and Eidenmüller, *Negotiating Brexit* (n 603), 2-35

#### 5.7.4. Brexit and the UK as Islamic Finance Hub

Brexit speaks of uncertainties. Yet, the UK's leading position for Islamic finance in the western world may be unperturbed because of its strategic centrality, and the uniqueness of London as an efficient and attractive market, having established herself an enabling legal framework, and a conducive market environment for the international framework for Islamic finance to operate. Albeit that hard Brexit may cause the loss of the 'passporting rights' for the UK based banks, domestic Islamic banks in the UK have been operating their businesses within the UK, and thus, such 'passporting rights' would not affect the smaller segment of the Islamic finance industry. Whilst the soft Brexit may either grant or deny the UK, a frictionless access into the single market of the EU's CU, i.e. through the enjoyment of free movement of capital as enshrined under Article 63 of TFEU, the UK may still remain the western hub of Islamic finance. There are more localised operations of domestic Islamic banks in the UK, unless the inter-bank markets also operate across the EU. In that situation, the impact is unlikely to be any different from any other major banks in the UK that enjoy the benefits of Article 63 of TFEU, as may be granted in post-Brexit context. As the 2020 Brexit deadline approaches, the transition period is time and resource-consuming for the UK. Therefore, having no deal for Brexit suggests that a separate trade deal for the UK cannot be negotiated with one of the EU Member States. Likewise, a trade deal cannot be made by an individual EU Member State with a third country on their own. This is due to the fact that the UK can only sign formally her own individual trade deal with other countries, once the UK has officially exited the EU. If the hard Brexit follows, the UK shall fall-back on the WTO multilateral rules regime.<sup>647</sup>

That notwithstanding, the Gulf Times has noted, shortly before the UK's referendum, Middle Eastern banks have a particularly big exposure to the UK Islamic finance industry through their subsidiaries, namely the Qatar Islamic Bank, Abu Dhabi Islamic Bank, Mashreq (UAE), and ABC International Bank (Bahrain).<sup>648</sup>The UK Government's political commitment was also pronounced through the speech by former UK Prime Minister, Mr. David Cameron, who had announced during the World Islamic Economic Forum in 2013 that London shall "stand alongside Dubai as one of the great capitals of Islamic finance anywhere in

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<sup>647</sup> The CityUK, (n. 615) 3-9.

<sup>648</sup> Sohail Jaffer, 'Brexit and London's Role as an Islamic Banking Hub: Is the Glass Half Empty, or Half Full?', (*Gulf Times*, 2 August 2016) < <https://www.worldfinancialreview.com/brexit-and-londons-role-as-an-islamic-banking-hub-is-the-glass-half-empty-or-half-full/>>accessed on 23 July 2017.

the world.”<sup>649</sup> The UK, through London has become the western centre for Islamic finance with the establishment of *Shari’ah*-compliant financial services, a preferred venue for *sukuk* issuances, and the non-Islamic world’s premier centre for Islamic finance.<sup>650</sup> Although Luxembourg, Paris, and Germany may also contest for the leading western jurisdiction for Islamic finance, they are not at comparable statures against the UK. The UK has established an Islamic finance friendly environment, with the most legislations than any of the EU Members in order to facilitate the development Islamic finance from the political, legal, and tax perspectives. Further, the English Common Law is used widely as a preferred choice of law for dispute resolution in Islamic finance through the use of the UK courts, and London, as the juridical seat and venue for arbitration,<sup>651</sup> plus the ubiquitous usage of the English language in the Islamic financial contracts.<sup>652</sup> Hence, despite Brexit, there is still a case of potential optimism for the UK to remain the western hub for Islamic finance.

The UK’s depth and breadth of the financial market sector should reinforce this position, particularly through the issuance of sterling-denominated *sukuk*. In this regard, notwithstanding the ‘Islamic’ nomenclature in Islamic finance itself, the UK has established herself as the most-friendly hub for the issuance of *sukuk* to be listed on the LSE. The year 2016 saw monumental political change. But the Brexit and Trump-induced shockwaves should not dismantle the already established economic and regulatory landscape in the UK. Not immediately. Other financial centres like Paris, Frankfurt, and Dublin may consider the impact of deregulation, but they may still lack the resources, infrastructure, and motivation to compete with London.<sup>653</sup> London’s main advantage is that it is already established, and is a friendly environment in which to do business.<sup>654</sup> The uncertainty in EU politics could present an opportunity to the UK to remain the western hub for Islamic finance, because in general, the UK to date, still has a running economic environment with a consistently stable governance system.<sup>655</sup> The future is uncertain, but London is an attractive market that currently enjoys considerable market trust and confidence.<sup>656</sup>

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<sup>649</sup> The CityUK, (n. 615) 3-9.

<sup>650</sup> Ibid.

<sup>651</sup> Belouafi and Chaci (n 654) 37-77. The position of UK as an effective venue for the resolution of Islamic finance disputes is further examined in Chapter Seven.

<sup>652</sup> Yusuf Talal DeLorenzo and Michael J.T. McMillen, ‘Law and Islamic Finance: An Interactive Analysis’ in Simon Archer and Rifaat Ahmed Abdel Karim (eds.), *Law and Islamic Finance: An Interactive Analysis*, (Wiley, 2012) 136-200.

<sup>653</sup> \_\_\_\_\_, ‘London stands strong’ *Chartered Banker* (UK April/May 2017) 30-32.

<sup>654</sup> Ibid.

<sup>655</sup> Ibid.

<sup>656</sup> The CityUK, (n. 615) 3-9.

## 5.8. A Critical Examination of War and Peace, the *Quranic* Worldview for the International Law-Making Process for the International Framework of Islamic finance

The post-September 11<sup>th</sup>, 2001 attack on the New York Trade Centre and Washington D.C. had witnessed the US' launch on the 'War on Terror'. This had led to rigorous US anti-terrorist financing and money laundering regulatory enhancement framework including increasing surveillance of Islamic financial institutions and funds in the US.<sup>657</sup> These developments did not only target the shut-down of Islamic funds and institutions, but also prompted a reversal of capital flight for the Muslims to withdraw their funds and place them in a safer financial ecosystem.<sup>658</sup>

The international framework for Islamic finance has since enhanced its anti-money laundering and terrorist financing regulatory framework by keeping abreast with the FATF's development and recommendations including efforts to develop a regulatory infrastructure in the form of an Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities (AMLATFPUA) Act 2001 [Act 613], where Malaysia's legal regime is concerned. Hence, Malaysia has developed its Islamic finance framework alongside the efforts to counter money laundering and terrorist financing activities as promulgated by AMLATFUA. In addition, Islamic finance is exposed to ratings which are usually undertaken with an impartial exercise towards *Shari'ah*-compliance, but at times they are tampered with political externalities. For instance, when Iran issued her sovereign bond in 2005 to tap the international capital market since the 1979 Iranian Revolution, the US administration made Moody withdrew its rating in line with the US trade sanctions against Iran.<sup>659</sup> Thus, war, peace, and geo-political stability also play a role in the international framework for Islamic finance.

Following the World War II, the United Nations was established to maintain the world order and peace, and to promote peaceful resolution for the settlement of disputes, which include, among others, the establishment of the ICJ, the Permanent

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<sup>657</sup> Warde, *Islamic Finance in the Global Economy* (n 32) 70-111.

<sup>658</sup> Rushdi Siddiqui, Global Director of DJMI estimated that, nearly US\$20 billion have been repatriated in the wake of September 11 attack, and the large influx of funds to the Middle East led to a quadrupling of share prices on GCC's stock markets, between 2003 and 2005.

<sup>659</sup> Reuters, 'Moody's, Citing U.S. Concern, Cancels Ratings on Iran Debt', (*The New York Times*, 4 June 2002) <<https://www.nytimes.com/2002/06/04/business/moody-s-citing-us-concern-cancels-ratings-on-iran-debt.html>> accessed 2 November 2018.

Court of Arbitration (PCA), and many other dispute settlement forum.<sup>660</sup> In the spirit of espousing the peaceful mechanism for the settlement of international disputes, the international law has established various procedural and substantive legal frameworks, including for the settlement of international trade, commercial, financial, and Islamic finance disputes.<sup>661</sup>

As disputes could escalate into war, the peaceful mechanism of conflict resolution has been developed.<sup>662</sup> In this regard, the role of Islamic finance in the international law-making framework is relevant in the context of peaceful resolution of disputes. The ICJ, being the principal judicial organ of the UN, is an avenue for the state-to-state settlement of disputes, including for both the Muslim and the non-Muslims worlds. This will attract the application of public international law.<sup>663</sup> For Islamic finance, the law governing it constitutes a substantial part of world's legal system that is based on the *Shari'ah*-compliant requirements, or more specifically, whose official legal system is based on the *Quranic* worldview.

The *Shari'ah* and the *Quranic* worldview cater for a wide range of issues to guide the way of life, including to shape the global governance architecture, administering the states relations *inter se*, as well as the commercial and financial aspects of the law, and peaceful settlement of disputes.<sup>664</sup> Hence, as the international framework for Islamic finance is developed alongside the development of international law, there should not be over-reliance on domestic legal features for certain institutionalisation of an Islamic legal system, since the *Shari'ah* and the *Quranic* worldview are the cornerstones in guiding the international framework for Islamic finance. The law is organic. A living framework that can move across borders, and thus, a domestic legal system may change over time. But the fundamentals of the *Shari'ah* and the *Quranic* worldview remain steadfast.<sup>665</sup> The key determinants for the international framework for Islamic finance are the trust and confidence, and the 'meta-dependence' trust and confidence that are espoused for Islamic finance, based on the *Shari'ah* and the *Quranic* worldview.

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<sup>660</sup> Crawford, *The Chance, Order, Change* (n 490) 27-55.

<sup>661</sup> Ibid.

<sup>662</sup> Ibid.

<sup>663</sup> Ibid.

<sup>664</sup> *Quran, Surah Al-Hujurat: (2), Verse 275-81*; "O mankind, indeed, We have created you from male and female and made you peoples and tribes that you may know one another. Indeed, the most noble of you in the sight of Allah is the most righteous of you. Indeed, Allah is Knowing and Acquainted."

<sup>665</sup> Mirakhor, *State of Islamic Finance* (n 21) 29-32.

To cater for the evolving international law, and the international framework for Islamic finance that mimics the conventional banking system, Islamic finance today has creatively operationalised the *Shari'ah* and the *Quranic* worldview. Legal flexibility is allowed. The interpretation and application of the *Shari'ah* are carried out moderately,<sup>666</sup> acknowledging the socio-economic imperatives, and recognising that certain domains such as modern business transactions and legal matters of the non-Muslims also require a secular governance, including the involvement of public and private international law, common law, and civil law. The vast parts of the legal systems in the world are regulated by secular laws, and secular courts, constituting a vital part of the legal landscape including the international framework for Islamic finance.<sup>667</sup> For the peaceful settlement of legal disputes, the roles of the *Shari'ah* courts are clearly defined in countries like Malaysia, where their jurisdictional ambit is limited to personal cases, dealing with Muslims' inheritance and marriage.

The scope of the *Shari'ah* may be attenuated, but the international framework for Islamic finance still requires the *Shari'ah* and the *Quranic* worldview to guide its most crucial part of the *de jure* and *de facto* operations of Islamic finance. Currently, the application of Islamic law is internally diverse in different jurisdictions, especially at the level of doctrine, legal interpretation, and legal theory. The *Mazhabs* have historically offered varying legal interpretations of the *Shari'ah*, but the primary source remains the *Quran*, complemented by the *Sunnah/Hadiths*.<sup>668</sup> In this regard, the formal incorporation of the *Shari'ah* into Islamic finance differentiates the international framework for Islamic finance from the pure secular operation of the public and private international laws. The roles of *Shari'ah* and the *Quranic* worldview are important for the international framework for Islamic finance as they are interconnected in a tangible way, whether they operate in secular-based jurisdiction, partially-*Shari'ah* based jurisdiction, or *Shari'ah* based jurisdiction.<sup>669</sup> In this regard, although the Islamic ideals are practised differently by different actors of international law, the reality is that the *Shari'ah* and the *Quranic* worldview play a crucial role in the international framework for Islamic finance. As war is shunned, and peace is aspired through the peaceful mechanism of conflict resolution, the international law-making process under the international framework for Islamic finance plays a vital role in promoting trust and confidence. This will enable the globally interdependent markets interact harmoniously through the hard-law and

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<sup>666</sup> Ibid.

<sup>667</sup> Ibid.

<sup>668</sup> Ibid.

<sup>669</sup> Chong and Liu (n 275) 125-144.

soft-law mechanism in implementing international standards and principles, as promulgated by the dedicated and the non-dedicated institutions for Islamic finance. There is no one-fits-for all solution for the living framework for Islamic finance to operate, but the current framework can sustain the trust and confidence as long as it continues to work harmoniously with the conventional banking framework, including to develop a robust GFSN to safeguard the well-functioning financial system.

## 5.9. Conclusion

Given the paramount importance of the *Shari'ah* and the *Quranic* worldview in the development of the international framework for Islamic finance, the promulgation of international law through the persuasive dissemination of soft-law instruments<sup>670</sup> for IFSI has created an enabling international environment, fostering a dependent-Interdependent relationship between international law and domestic law, and the Common Law with the *Shari'ah*. These legal interactions have created an enabling legal environment that further espouses the trust and confidence in the international framework for Islamic finance. The roles of dedicated institutions for Islamic finance such as the IFSB, the AAOIFI, the IIRA Rating, the DJMI, and the non-dedicated institutions like the IMF, further contribute towards the promulgation of soft-law instruments for the international framework for Islamic finance. The role of the UK as the leading western hub for Islamic finance is prognosticated to remain the same due to the creation of an enabling environment for Islamic finance to operate.<sup>671</sup> Trust and confidence in the international framework for Islamic finance is vital.<sup>672</sup> In light of the crucial roles of international law, the development and dissemination of various standards, rules, guidelines, and principles have espoused the creative evolution of Islamic derivatives within the international framework for Islamic finance. Although war, Islamophobia, the clash of civilisations, and Brexit may appear to be the impediments, the international framework for Islamic finance is a system of trust and confidence, enshrined by the *Shari'ah* and the *Quranic* worldview as the 'meta-dependence' archetype of trust and confidence, underpinning the Islamic finance operation. In a nutshell, acknowledging these active roles of international law in developing the international framework of Islamic finance, Chapter Six critically examines Malaysia, as a case-study.

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<sup>670</sup> Aldohni (n 495) 164–179.

<sup>671</sup> The CityUK, (n 615) 3-9.

<sup>672</sup> Ng., Ibrahim and Mirakhor (n 241) 239-250.

## Chapter Six: Malaysia as a Case-Study

### 6.1. Introductory Examination of International Framework for Islamic Finance with Malaysia as a Case-Study

The choice of Malaysia as the main focus is due to its dual banking model, consisting of the conventional banking model and the Islamic banking model, and the centrality of its *Sharī'ah* governance mechanism, operating the international framework for Islamic finance, with much creativity, but is still guided by the central banking regime of the BNM, and the SAC of the BNM, playing a strong role to guide IFSI in Malaysia. Further, Malaysia is a progressive jurisdiction in terms of its legal and regulatory framework, providing an enabling legal environment that accommodates IFSI flexibly, in terms of aligning IFSI with the Basel standards, and with that of the IFSB, as well as the domestic banking requirements.<sup>673</sup> In addition, Malaysia's contemporary context of creatively implementing the international framework for Islamic finance also currently shapes the global governance of Islamic finance with the establishment of a proper domestic *Sharī'ah* governance framework as developed by Malaysia.<sup>674</sup> Further, Malaysia, being part of the Commonwealth countries, adopts the Common Law system for its legal and regulatory environment for banking and finance.<sup>675</sup> However, consideration of the *Sharī'ah* principles in Islamic banking and finance are still accorded to support IFSI, and for the purposes of ensuring *Sharī'ah*-compliance in product development.<sup>676</sup> The unique dual-banking model, as exemplified in Malaysia's legal and regulatory system demonstrates how the conventional and Islamic banking systems in Malaysia co-exist, and operate side-by-side, and it is likewise the case for the co-existence of the conventional and Islamic banking ecosystems at the global governance framework.<sup>677</sup> While embracing the edifice of the conventional banking and finance system, it is Malaysia's ability to adopt flexibly the international framework for Islamic finance, and interpret the *Sharī'ah*, using Islamic sources of jurisprudence, mainly the *Quran*, *Sunnah*, and *Hadiths* (Prophetic sayings and actions) in the contemporary context of modern banking and finance, alongside the operational

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<sup>673</sup> Malaysia has enacted its Financial Services Act 2013 [Act 758] and Islamic Financial Services Act 2013 [Act 759], which came into force on 30<sup>th</sup> June 2013.

<sup>674</sup> Chaudhury (n 13) 20-31.

<sup>675</sup> Hamzah and Bulan (n 14) 6.

<sup>676</sup> Ariff (n 15) 67-68.

<sup>677</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 101-116.

influence of the Common Law system makes the case-study relevant, significant, exploratory, yet contributory towards the international framework for Islamic finance.

While the scope of 'banking' falls under the 'Federal List' of Malaysia's Federal Constitution (FC), 'Islamic banking and finance' also falls within the Federal purview.<sup>678</sup> Pursuant to the promulgation of Bank Negara Act 2009 [Act 701], all *Shari'ah* issues pertaining to Islamic banking and finance shall be referred to the SAC of the BNM, as the highest *Shari'ah* authority and the sole authoritative body on *Shari'ah* matters pertaining to Islamic banking, *takaful* (Islamic insurance), and Islamic finance in Malaysia.<sup>679</sup> Thus, the rulings of the SAC shall be applicable to IFIs, and likewise to the courts and arbitrators, which are required to refer to the rulings of the SAC for any proceedings relating to Islamic finance, and such rulings are legally binding.<sup>680</sup> To further examine the background context of how Malaysia adopts and implements the international framework for Islamic finance, sections 6.2 to 6.16 below provide a comprehensive examination of how the international framework for Islamic finance transcends into the national level, including the role in which Malaysia plays towards developing its national framework for Islamic finance, and more particularly the roles of the BNM, towards promulgating Malaysia, as a model prognostication for the international framework for Islamic finance. This means affirming that, the international framework for Islamic finance operates alongside the conventional banking framework, and it is not a disjointed framework.

## **6.2. Malaysia: A Multi-Party Parliamentary Democratic System and a Constitutional Monarch Jurisdiction**

Malaysia's model of government is based on the UK-Westminster model. Malaysia is a multi-party parliamentary democracy, and a constitutional monarch country.<sup>681</sup> With a demography population, totalling up-to 32 million peoples, the Malay (including indigenous peoples) constitutes the majority race (61.7%), followed by Chinese (20.8%), Indian (6.2%), other races (0.9%), and non-citizens (10.4%). Muslims are the majority (61.3%), followed by Buddhist (19.8%), Christian (9.2%), Hindu (6.3%), Confucianism and Taoism (1.3%), none (0.8%), and unspecified (1%). Malaysia's FC proclaims that Islam is the religion of the federation, but other

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<sup>678</sup> FC, Ninth Schedule 'Legislative Lists', List I.

<sup>679</sup> Bank Negara Malaysia Act 2009 [Act 701], see sections 51-52

<sup>680</sup> Bank Negara Malaysia Act 2009 [Act 701], see section 57. Further analysis on the binding nature of SAC's resolutions is examined in Chapter Six.

<sup>681</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 1-43.

religions may be practised in peace and harmony in any part of the federation.<sup>682</sup> That notwithstanding, Malaysia's federalism structure recognises the role of Islamic law to be limited to certain matters, particularly those involving marriage, divorce, familial, custody, Islamic wills, and probate matters.<sup>683</sup> Article 74(2) of the FC provides that, without prejudice to any power to make laws conferred on it by the said Article, the legislature of a State may make laws with respect to any of the matters enumerated in the State List of the FC.<sup>684</sup>

In the State List (Second List, in the Ninth Schedule of FC), Islamic law and the family law of persons professing Islam are matters under the state's purview. Thus, the state legislature has power and jurisdiction, and is legally empowered to enact the laws.<sup>685</sup> This includes issues, such as inheritance, succession, betrothal, marriage, divorces, maintenance, adoption, legal guardianship, gifts, trusts, charities and charitable institutions, *zakat*, Islamic revenue, and mosques. This list explicitly provides that the state legislatures shall legislate, and apply Islamic law principles with regard to only these prescribed matters.

Regarding the offences or Islamic criminal law, the state legislatures are empowered with a very limited criminal legislative power only to those involving the Muslims. The criminal law is under the Federal purview. Article 74(2) of the FC has specified in the Ninth Schedule 'Legislative Lists' List II (I) of the State List, the power of the state legislatures to make law, for the creation and punishment of offences by persons, professing the religion of Islam against the percept of that religion, except in regard to matters included in the Federal List.

As Malaysia's legal system inherited the English Common Law since the independence of *Tanah Melayu* (later known as 'Malaya', then, 'Malaysia') in 1957, the English Common Law still has a great influence in the contemporary Malaysia. Section 5(1) of the Civil Law Act 1956<sup>686</sup> enables the application of the English

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<sup>682</sup> Ibid.

<sup>683</sup> Shad Saleem Faruqi, *Document of Destiny* (The Star, 2008) 2-50.

<sup>684</sup> (Second List, in the Ninth Schedule of Malaysia's FC).

<sup>685</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 1-43

<sup>686</sup> Section 5(1) of the Civil Law Act 1956 provides that, "[i]n all questions or issues which arise or which have to be decided in States of West Malaysia other than Malacca and Penang with respect to the law of partnership, corporations, banks and banking, principles and gent, carriers by air, land and sea, marine insurance, average life and fire insurance, and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in the like case of at the date of the coming into force of this Act, if such questions is or shall be arisen or had to be decided in England, unless any case other provision is or shall be made by any written law."

Common Law in commercial matters encompassing the law of partnership, insurance, etc. The UK Marine Act 1906 had been applied by the High Court of Malaya to determine the practice of marine insurance policies in the case of *Soon Hai Kee Shipping Sdn. Bhd. v. Tokio Marine Insurance*<sup>687</sup>

Further, Section 3(1) of the Civil Law Act 1956<sup>688</sup> states that the application of the Common Law and rules of equity is conditional, and subject to two limitations i.e. they are (i) applicable in the absence of statutes, covering the same issue; and (2) applicable to the extent permitted by the local circumstances and inhabitants. Lord Scarman, in Privy Council's decision of *Jamil bin Harun v. Camden*<sup>689</sup> held that "[t]heir Lordships do not doubt that it is for the courts of Malaysia to decide, subject always to the statute law of the federation, whether to follow English law. English authorities may be persuasive but are not binding." This underscores that the English Common Law post-1956, has been classified as persuasive materials, and are not legally binding to Malaysia.

### **6.3. An Examination of the Historical Background of Banking and Finance in Malaysia**

The contemporary development of banking and finance in Malaysia owes its significant contribution and influence from the beginning of the banking origins in Malaya, through the advent of British merchant communities in Penang (an island in the northern part of Malaysia), and Singapore in the 19<sup>th</sup> century. Penang and Singapore were the Straits Settlement, a standalone British colony, encompassing also Malacca. Penang is an island in the northern part of the then Malaya (now 'Malaysia') had become a strategic location and port facilities, which had spurred the growth of banks in the then Malaya, such as Mercantile Bank (later a subsidiary of the Hong Kong Bank, and now HSBC) with the set up office in Penang, Chartered Bank (now Standard Chartered) in 1875, and Hong Kong Bank in 1884.<sup>690</sup>

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<sup>687</sup> *Soon Hai Kee Shipping Sdn. Bhd. v. Tokio Marine Insurance* [2011] 1 CLJ 375.

<sup>688</sup> Section 3(1) of the Civil Law Act 1956 provides that, "[t]he common law, rules of equity and statutes of general application shall be applied so far only as the circumstances of the states of Malaysia and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary."

<sup>689</sup> *Jamil bin Harun v. Camden* [1984] 1 MLJ 217-219.

<sup>690</sup> Muhammad Ridhwan Ab. Aziz, *Introduction to Islamic Institutions in Economics and Finance* (USIM, 2013) 13-39.

Deposit taking had become predominant amongst the populace as a result of increasing trade, commerce, and port activities. Banking halls had evolved in tandem with the growing number of customers and depositors. The 1960s witnessed the beginning era of computerising banking services. Then, the rapid advancement in automation in 1980s had spurred the banking services, from the basic deposit taking services to money markets. In 1981, Maybank, with its branch in Ampang Park in Kuala Lumpur, launched the first ATM in Malaysia.<sup>691</sup> The ATMs changed the banking and financial landscape in Malaysia with an increasing financial inclusion. In the contemporary banking system in Malaysia, the banking operation is trusted to be well-functioning without any serious issue of doubt.<sup>692</sup>

After the independence of *Tanah Melayu* in 1957, the Central Bank Ordinance 1958 created the central bank, known as *Bank Negara Tanah Melayu*, which is today known as 'Bank Negara Malaysia (BNM)'. It commenced its business operation on January 1<sup>st</sup>, 1959. Pursuant to the Central Bank Ordinance 1958, the *Bank Negara Tanah Melayu* was legally mandated with the sole authority to issue currency notes and coins in the country. But, the *Bank Negara Tanah Melayu* did not execute this legal authority.<sup>693</sup> The then Currency Board was allowed to continue exercising such an authority until in 1967, when the BNM undertook a 'currency split', which prompted the BNM to issue the Malaysian Ringgit on June 12<sup>th</sup>, 1967.<sup>694</sup> Following therefrom, the neighbouring countries within the ASEAN region like Singapore and Brunei, had instituted their own respective Boards of Commissioners of Currency for the issuance, management, and redemption of their respective currency notes and coins. In light of this landscape, the banking system has comprised the monetary and non-monetary institutions. The monetary institutions are those institutions whose principal liabilities are accepted as money, comprising the BNM, being the sole currency issuing authority in Malaysia, and the commercial banks (including Islamic banks) as the only institutions permitted to operate current accounts. The non-monetary institutions encompass those institutions, closely linked to the monetary institutions, whose liabilities are accepted as near money. These institutions, falling under the supervision of the BNM, are the discount houses, the finance companies, and the merchant banks. Malaysia's banking system also has undergone its own evolutionary process to cover foreign banks' representative offices, and the offshore banks in the Labuan International Offshore Business and

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<sup>691</sup> Ab. Aziz, *Introduction to Islamic Institutions in Economics and Finance* (n 690) 13-39.

<sup>692</sup> *Ibid.*

<sup>693</sup> *Ibid.*

<sup>694</sup> *Ibid.*

Financial Centre (Labuan IBC) in Labuan island of Malaysia. The non-financial intermediaries are monitored by various government departments and agencies. Those intermediaries cover the development finance institutions (DFIs), the savings institutions, the provident and the pension funds, the insurance companies, including the offshore insurance companies, and a group of financial intermediaries, comprising the building societies, the unit and property trusts, leasing companies, factoring companies, credit token companies, venture capital companies, special investment agencies, and several special financial institutions, such as the National Mortgage Corporation (*Cagamas*), and the Credit Guarantee Corporation.

#### **6.4. Early Development of Islamic Banking and Finance in Malaysia: A Dual Banking Model**

Established on 30<sup>th</sup> September 1963, the Pilgrimage Fund Board (*Tabung Haji*)<sup>695</sup> which was mooted by the Royal Professor Ungku Aziz, had pioneered the growth of Islamic banking and finance in Malaysia. *Tabung Haji* was instituted to allow Muslim depositors to save money for the purposes of meeting the cost of pilgrimage to Mecca in Saudi Arabia. The need arose to guarantee the savings of Muslims to be free from *riba* (interest), and that the banking and financing activities are to be *Shari'ah*-compliant. Amongst the early legislations governing Islamic banking and finance in Malaysia were, Islamic Banking Act 1983 (IBA 1983), Takaful Act 1984 (TA 1984), and the Banking and Financial Institutions Act 1989 (BAFIA 1989), enacted for the conventional banking sector. The IBA 1983 was enacted to provide an enabling legal environment for the Islamic banking system to operate side-by-side with the conventional banking system. IFIs, offering products similar to those of the conventional banks, still must comply with the regulations and supervision of the BNM. In 1983, Malaysia embarked on the establishment of *Bank Islam Malaysia Berhad* (BIMB), licensed under IBA Act 1983, and it was publicly listed on 17<sup>th</sup> January 1992.<sup>696</sup> The BIMB developed an Islamic banking system, by providing as many Islamic banking products to the Muslims, and the non-Muslims in Malaysia. *Syarikat Takaful Sdn. Bhd.*, a Malaysian Islamic insurance corporation was established in 1984, pursuant to the TA 1984.

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<sup>695</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 101-146.

<sup>696</sup> Sheraz Naughton and Bala Shanmugan, 'Interest-Free Banking: A Case Study of Malaysia' (1994) 7, 3 *Journal of Islamic Banking and Finance* 46.

Ten years after the establishment of the BIMB, the Malaysian Government introduced a dual banking system in 1993, called the Interest-Free Banking Scheme (*Skim Perbankan Tanpa Faedah* ("SPTF")).<sup>697</sup> This enabled the conventional banks in Malaysia to provide Islamic banking products, using the facilities of their conventional banking system. In 1996, legislative amendments were made to BAFIA 1989 to allow conventional banks in Malaysia to operate an Islamic banking window. Following the merger arrangement between *Bank Bumiputera Malaysia Berhad* (BBMB), and Bank of Commerce (Malaysia) Berhad (BOCB), *Bank Muamalat Malaysia Berhad* (BMMB) was established in 1999, which was a consequence of the Asian financial crisis in 1997-98. In 1998, the SPTF was upgraded to an Islamic Banking Scheme, setting up Islamic banking divisions, replacing Islamic banking units to be headed by senior level of management.<sup>698</sup> The BIMB and BBMB, serve as intermediaries between the savings surplus, and the deficit unit, or the households, and take the initiative to handle the financial instruments of interests since *riba* (interest) is prohibited. In this regard, services that were initially offered were: (i) those for a fee or a fixed charge, such as safe deposits, fund transfer, trade financing, property sales and purchases, or handling investments; and (ii) those that involve partnerships in investments, and the sharing of profits and losses. Thus, Islamic banks like any other conventional banks are also profit-making commercial entities, except that the profit-making activities are undertaken in a *Shari'ah*-compliant manner.

In other parts of the world, the early efforts began in the private sector, where the Dubai Islamic Bank was established in 1975 to allow the bank to engage in business enterprise, while accepting deposits into checking accounts. IFSI began further experimentation, which witnessed the establishment of a savings bank based on the PLS concept, in the Egyptian town of Mit Ghamr in 1963. Until 1971, the Naseer Social Bank was established in Egypt, and was declared an interest-free commercial bank, although its charter did not make any reference to the *Shari'ah*. Then, a rising number of Islamic banks spread across the Middle East, such as the Islamic Development Bank (1975), the Faisal Islamic Bank of Sudan (1977), the Faisal Bank of Egypt (1977), and the Bahrain Islamic Bank (1979). In 2002, the IFSB headquarter office was established in Malaysia.<sup>699</sup>

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<sup>697</sup> Norhashimah Mohammed Yasin, 'Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies' (2001) 9 1, *International Islamic University Malaysia Law Journal* 3.

<sup>698</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 101-146.

<sup>699</sup> *Ibid.*

As Malaysia's financial services sector was gradually being liberalised, foreign banks such as Kuwait Finance House, Al-Rajhi & Asian Finance (a consortium of Qatar Islamic Bank, RUSD Investment Bank Inc. & Global Investment House), BNP Paribas SA, PT Bank Mandiri, National Bank of Abu Dhabi, Mizuho Bank and Sumitomo-Mitsui Banking Corporation) had been given license to operate in Malaysia since 2005. For the purposes of further enhancing the *Shari'ah*-compliance aspects of Islamic banking and finance, Malaysia has established the National Council for *Fatwa* in 1970 under the National Council for Malaysian Islamic Affairs. Later, it was transferred to the Islamic Affairs Division at the Prime Minister's Department in 1984, and eventually known as the *Jabatan Kemajuan Islam* (JAKIM). JAKIM is the Islamic Development Department under the Prime Minister's Department, established in 1997. The National Council for *Fatwa* discusses and coordinates issues regarding *fatwa* at the national level, including *Shari'ah*-compliant issues on Islamic finance. Today, the promulgation of section 27 of the BNM Act 2009 has legally mandated the BNM to maintain a dual financial system.<sup>700</sup> It explicitly stipulates that the financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system. To further enhance the roles of *Shari'ah*-compliance requirement for Islamic finance in Malaysia, the SAC was established under the auspices of the BNM pursuant to sections 56-57 of the BNM Act 2009. The SAC plays a proactive and significant role in issuing specific *Shari'ah* rulings, decisions, and guidelines on *Shari'ah*-compliant issues on Islamic finance to IFIs, and their rulings are legally binding.

## 6.5. Islamic Capital Market and SAC

In addition to Islamic banking development, Islamic finance framework in Malaysia also caters for Islamic Capital Market (ICM). BNM is the central regulatory authority for the Islamic banking sector, whereas the Securities Commission (SC) of Malaysia is the central regulatory authority for the Malaysia's capital market and ICM.<sup>701</sup> The SC was first established on 1<sup>st</sup> March 1993 under the Securities Commission Act 1993 [Act 49]. Thereafter, the Capital Market and Services Act [Act 671] (CSMA 2007)<sup>702</sup> was enacted to consolidate the Securities Industry Act 1983 [Act 280] and Futures Industry Act 1993 [Act 499] to regulate and provide for matters relating to the activities, markets and intermediaries in the capital markets, and for matters consequential, and incidental thereto. The SC is a self-funding

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<sup>700</sup> Ibid.

<sup>701</sup> Ibid.

<sup>702</sup> The CSMA 2007 governs both the conventional capital market and the ICM in Malaysia.

statutory body that reports to the Minister of Finance Malaysia.<sup>703</sup> The SC has direct responsibility in monitoring the activities of market institutions, including the exchanges and clearing houses, as well as persons licensed under the CSMA 2007.<sup>704</sup> The SC of Malaysia has also established its own SAC, by virtue of section 316C of the CSMA 2007, whose role is to render *Shari'ah*-related advice on issues of Islamic finance in the ICM.<sup>705</sup> Under the CSMA 2007, the SAC of the SC will determine the application of *Shari'ah* on any matter pertaining to ICM business, or transaction, and to advise the SC on *Shari'ah* issues relating to ICM business, or transaction.<sup>706</sup> Further, the SAC of the SC is empowered to provide an advice to any person on *Shari'ah* issues relating to ICM business, or transaction.<sup>707</sup>

For the purposes of developing the ICM under section 316A of the CSMA 2007, the SAC of SC shall be established to ascertain the application of *Shari'ah* for the purposes of ICM business or transactions. Section 316A of the CSMA 2007 provides that an ICM product is a capital market product for the purposes of securities<sup>708</sup> laws, and the SC specify any model agreement or documentation relating to a transaction or arrangement in respect of Islamic capital market products and the duties and responsibilities of the different parties involved in a transaction or arrangement in respect of Islamic capital market products, as well as any other matter as may be deemed appropriate, in giving full effect to the principles of *Shari'ah* in relation to a transaction in respect of Islamic capital market products. Section 316G of the CSMA 2007 provides that any ruling made by the SAC of the SC shall be binding on (a) the licensed person, stock exchange, derivatives exchange, clearing house, central depository, listed corporation or any other person referred to in section 316E of the CSMA 2007, and (b) the court or arbitrator referred to in section 316F. Further, section 316H of the CSMA 2007 provides that, where a ruling given by a registered *Shari'ah* adviser<sup>709</sup> to a person engaging in any Islamic

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<sup>703</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 255-295.

<sup>704</sup> There have been several statutory amendments that took place to further clarify the CSMA 2007 such as the latest Capital Markets and Services (Amendment) Act 2015 [Act 1499].

<sup>705</sup> Mardiyah Shari and Madzlan Hussain, 'Financial Services Act 2013 [Act 758] and the Islamic Financial and Services Act 2013 [Act 759]' (ZICO, 2016)1-8.

<sup>706</sup> See section 316B - 316H of CSMA 2007.

<sup>707</sup> *Ibid.*

<sup>708</sup> Section 316B of CSMA 2007 defines 'Islamic securities' as securities for the purposes of securities laws, and any proposal, scheme, transaction, arrangement, activity, product or matter relating to Islamic securities shall comply with the relevant requirements under securities laws and guidelines issued by the SC.

<sup>709</sup> For the purpose of this section, "registered *Shari'ah* adviser" means a person who is registered under any guidelines issued by the Commission under section 377 of CSMA 2007 [Act A1370/2010].

capital market business or transaction is different from the ruling given by the SAC, the ruling of the SAC of SC shall prevail.

## **6.6. *Bursa Malaysia* and the Labuan Financial Services Authority (LFSA)**

Apart from the SC, *Bursa Malaysia*<sup>710</sup> is also one of the regulators responsible for regulating the financial market in Malaysia. The *Bursa Malaysia* is an exchange holding company, approved under section 15 of the CSMA 2007. It operates a fully-integrated exchange, offering the complete range of exchange-related services including trading, clearing, settlement, and depositary services. Islamic markets offered by the *Bursa Malaysia* including *Bursa Suq Al-Sial*, *Sharī'ah*-Compliant Securities, *sukuk*, Islamic Real Estate Investment Trust (iREITs), and *Sharī'ah*-Compliant Exchange Traded Funds (iETFs).

The other regulator is the Labuan Offshore Financial Services Authority.<sup>711</sup> The Labuan Financial Services Authority (LFSA) was instituted on 15<sup>th</sup> February 1996 as a corporate statutory body established under the Labuan Offshore Financial Services Authority Act 1996 [Act 545], which provides the functions and powers of LFSA as prescribed in section 3(2), and section 4, respectively. LFSA is the single regulatory authority in Labuan, with the responsibility of coordinating the development of the offshore financial industry and the Labuan IFC. In general, under the Labuan Financial Services and Securities Act 2010 [Act 704] ("LFSSA 2010"), the Labuan banking business encompasses the business of receiving deposits, Labuan investment banking business, Labuan financial business, Labuan Islamic financial business, and other business specified by the LFSA, with the approval of the Minister of Finance, subject to compliance with the applicable exchange control restrictions under the Financial Services Act 2013 [Act 758] (FSA 2013). In section 181 of the LFSSA 2010, it stipulates that 'a licensed entity who carries on or transacts, or holds himself out as carrying on or transacting any Islamic banking businesses, Islamic investment banking businesses, *takaful*, *retakaful*, or any other business under this Act which is *Sharī'ah*-compliant shall comply with the provisions of the Labuan Islamic Financial Services and Securities Act 2010 [Act 705] in matters, where such *Sharī'ah* compliance are concerned, subject to such modifications as may be made by the LFSA, pursuant to guidelines.' Thus, the LFSA

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<sup>710</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 255-295.

<sup>711</sup> Ibid.

has a key role to license and regulate licensed entities operating within Labuan, and ensure the entities remain in compliance with the internal and international best standards adopted by the jurisdiction, including the *Shari'ah*-compliant requirements as set out by the LFSSA 2010. The LFSA aims to develop policies for the orderly conduct of business and financial services in Labuan, and become the international business and finance centre.

## 6.7. Malaysia Deposit Insurance Corporation (MDIC)

As part of the endeavours to safeguard the financial safety-net, promote the financial stability, and boost consumer confidence,<sup>712</sup> the Malaysia Deposit Insurance Corporation (MDIC) has been established. MDIC is a Malaysian Government statutory body, established in 2005 pursuant to the Malaysia Deposit Insurance Corporation Act 2005 [Act 642] (MDIC Act 2005). In Malaysia, MDIC is known as '*Perbadanan Insurans Deposit Malaysia*', or PIDM, in short. Internationally, the PIDM is known as MDIC.<sup>713</sup> Recognising the need to protect depositors (individuals or businesses) against the loss of their deposits in the event of a bank failure, the Deposit Insurance System (DIS) is introduced, and it is currently being administered by the MDIC. The depositors shall not need to apply, or register to be guaranteed the deposit insurance protection by the MDIC. Deposit insurance protection is availed automatically for eligible deposit accounts placed with MDIC member banks. In Malaysia, MDIC provides coverage for the eligible deposits up to RM250,000, per depositor, per member bank.<sup>714</sup> The high threshold of RM250,000 is not only intended to enhance the level of trust and confidence in Malaysia's banking sector, but also covers both the principal amount of a deposit and the interest/return. Depositors in both the conventional and Islamic banks in Malaysia will be guaranteed the protection of this high threshold, except that the Islamic banks' depositors cannot get the payment of interest. MDIC's membership consists of member banks and insurer members. Hence, all commercial banks licensed under Financial Services Act 2013 [Act 758] (FSA 2013), and all Islamic banks licensed under Islamic Financial Services Act 2013 [Act 759] (IFSA 2013), including locally incorporated subsidiaries of foreign banks operating in Malaysia, are member banks of the MDIC. Insurer members are all *takaful* operators licensed under IFSA 2013,

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<sup>712</sup>MDIC, Annual Report 2005, 54, <<https://www.pidm.gov.my/PIDM/files/3c/3c48ed98-b325-4e54-83ff-4483aa74d404.pdf>> accessed 23 September 2018.

<sup>713</sup> MDIC, Annual Report 2005 (n 746) 54.

<sup>714</sup> Ibid.

which conduct family and/or general *takaful* business in Malaysia, as well as insurance companies licensed under the FSA 2013 to conduct life and/or general insurance business in Malaysia, including locally incorporated subsidiaries of foreign insurance companies, operating in Malaysia. Membership is compulsory pursuant to MDIC Act 2005. In this regard, commercial and Islamic banks which are member institutions of the MDIC, are referred to as 'member banks'. This membership sign is often displayed at the entrance of bank branches throughout Malaysia. Member banks and insurer members pay annual premiums and levies to the MDIC.

The statutory mandate<sup>715</sup> of the MDIC is to: (i) administer a deposit insurance system, and a *takaful* (Islamic insurance) and insurance benefits protection system; provide insurance against the loss of part, or all of deposits for which a deposit-taking member is liable; (ii) provide protection against the loss of part or all of *takaful* (Islamic insurance) or insurance benefits for which an insurer member is liable; (iii) provide incentives for sound risk management in the financial system; and (iv) promote or contribute to the stability of the financial system. Towards fulfilling the objectives of administering a deposit insurance system, and provide insurance against the losses, the MDIC will help alleviate the risk of failure of the financial system. In this regard, the MDIC has extended its protection to the DIS, the *takaful*, and the Insurance Benefits Protection System (TIPS) to protect bank depositors and owners of *takaful* certificates, and insurance policies in the event of an MDIC's member bank failure. The legal extension to the *takaful*, and TIPS began on 31<sup>st</sup> December, 2010. The MDIC is legally mandated to provide incentives for sound risk management in the financial system, as well as promote and contribute to the stability of the financial system.<sup>716</sup>

Not to be seen as an *ex-ante* moral hazard, the MDIC complements the existing BNM's regulatory and supervisory framework, by encouraging its member institutions to implement sound risk management practices. This is because, the MDIC is also the resolution authority in Malaysia for member banks and insurer members. The MDIC has a legislative power to make an early intervention in distressed member institutions to alleviate the potential of failure, which can be costly and contagious to the banking system in Malaysia.<sup>717</sup> The MDIC may even assume control over the institution, or take such an intervention in the member institution, if the situation is really necessary i.e. where the said institution is deemed

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<sup>715</sup> Ibid.

<sup>716</sup> Ibid.

<sup>717</sup> Ibid.

no longer viable by the BNM. This is again intended to minimise costs to the financial system by way of an early, or an *ex-ante* intervention. In light of this role, the MDIC complements the BNM's roles, and contributes to the stability of the financial system by managing the DIS and TIPS, and encouraging prudent risk management to avoid bank failures. This regulatory style corresponds to the discourse of depositors' protection in section 4.11, and may attest that Malaysia's model is quite a heavily regulated model, in terms of regulating and supervising the conventional and Islamic banking sector, including the *takafull*/insurance sector.

The current structure<sup>718</sup> of the MDIC is governed by its Board of Directors (BOD), appointed by the Minister of Finance from both the public and the private sectors. The BOD was headed by a non-executive Chairman, while other representatives are the BNM Governor, the Secretary General of Treasury, directors from the public sector, and directors from the private sector with relevant banking and financial sector background and experience. There are also institutions that are not member banks of the MDIC. They are, among others, investment banks, overseas branches of member banks, DFIs, cooperative banks, all non-bank financial intermediaries such as provident and pension funds, housing credit institutions, cooperative societies, and building societies which are not supervised, or regulated by the BNM. Nevertheless, the BNM's role remains as the primary regulator and supervisor of the Malaysia's financial system, and is responsible for maintaining the stability of the financial system. Again, Malaysia's regulatory style is aimed primarily to maintain the overall financial stability, and it is articulated to be a highly regulated approach, which can be prone towards over-regulation. In 2009, MDIC adopted a *Kafalah* (guarantee) scheme and donation (*Tabarru'*) to guarantee for a fee (*Kafalah bil ujr*).<sup>719</sup> The MDIC charged fees in return for the guarantee that is offered to member institutions. Although it appears that the nature of the *Tabarru'* contract is charitable, the imposition of the fees through *Kafalah bil ujr* is acceptable as long as it is not excessive, but necessary, to execute such a guarantee with a fee imposed.<sup>720</sup> Promoting the *maslahah* (greater good) is vital under the *Sharī'ah*, which includes protecting public resources and maintaining financial stability, which will elevate the financial hardship if depositors' protection is not guaranteed, and

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<sup>718</sup> Ibid.

<sup>719</sup> Ibid.

<sup>720</sup> Wahbah Al-Zuhayli (trans. by Mahmoud A El-Gamal and revised by Muhammad S.Eissa), *Financial Transaction in Islamic Jurisprudence, Vol.1* (Dar Al-Fikr Damascus, 2003) 39.

availed.<sup>721</sup> In the event of failure of a MDIC member institution, there will be no funds' transfer between Islamic and conventional funds. Also, MDIC is statutorily allowed to borrow from the government and for the purposes of a payout for Islamic bank's depositors, as long as the borrowing is *Sharīah*-compliant.<sup>722</sup>

## 6.8. Malaysia International Islamic Financial Centre (MIFC)

The establishment of MIFC<sup>723</sup> was founded on the launch of the MIFC initiative in 2006. As a framework community consisting the BNM, SC, LFSA, *Bursa Malaysia*, government ministries and agencies, industry players encompassing the Islamic banking, *takaful/re-takaful*, and ICM players, the MIFC has further developed Islamic banking and finance sector in Malaysia. Among the focus areas for MIFC are, international Islamic banking, international *takaful*, Islamic fund and wealth management, *sukuk* origination, and human capital development. In shaping the Islamic finance industry, MIFC has espoused various incentives that are made accessible to financial institutions, participating in the MIFC initiative, such as new licenses for conducting foreign currency businesses, attractive tax incentives, and facilitative immigration policies.

## 6.9. The International Centre for Education in Islamic Finance (INCEIF) and the International *Sharīah* Research Academy for Islamic Finance (ISRA)

In addition to the MIFC, Malaysia has established INCEIF,<sup>724</sup> based in Kuala Lumpur to serve as the global university for Islamic finance. Since its inception in 2005, INCEIF which was set up by the BNM has developed various programmes for education and training, such as Chartered Islamic Finance Professional (CIFP), Masters in Islamic Finance Practice (MIFP), Msc. in Islamic Finance, and Ph.D. in Islamic finance. To further enhance Islamic finance in Malaysia, ISRA<sup>725</sup> was established in 2008 by the BNM as an Islamic and *Sharīah*-related research

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<sup>721</sup> Jean Pierre Sabourin, "The Role of Islamic Deposit Insurance in Providing Stability to the Islamic Financial System" (FSB and BNM, 23<sup>rd</sup> November 2009, Kuala Lumpur, Malaysia, 3<sup>rd</sup> IFSB Public Lecture on Financial Policy and Stability) 9

<sup>722</sup> MDIC, Annual Report 2005, 'Building Strong Foundations', 57 <[www.pidm.gov.my/downloads/ar2005.pdf](http://www.pidm.gov.my/downloads/ar2005.pdf)> accessed 5 December 2018.

<sup>723</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>724</sup> Ibid.

<sup>725</sup> Ibid.

institution. Since its inception, ISRA has been promoting applied research in the area of *Shari'ah* and Islamic finance, where ISRA serves as a repository of knowledge for *fatwas*, and undertake studies on contemporary issues in Islamic finance. A certified *Shari'ah* Adviser and Auditor Programme is offered by ISRA to equip IFSI with the requisite technical understanding and professional skills on *Shari'ah*-compliance and review process.

## 6.10. BNM: A Centralised Banking Regime in Malaysia

Malaysia adopts a centralised banking regime under the regulation and supervision of BNM.<sup>726</sup> Notwithstanding the repeal of the Central Bank of Malaysia Act 1958 by section 99 of BNM Act 2009 [Act 701], the body corporate established under the repealed Act under the name '*Bank Negara Malaysia (BNM)*' or, in English, 'Central Bank of Malaysia' continues to be in existence under and subject to the provisions of BNM Act 2009 [Act 701]. Pursuant to section 5 of BNM Act 2009, the principal objects of BNM are to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy, whereas the primary functions of the Bank are as follows:

- (a) To formulate and conduct monetary policy in Malaysia;
- (b) To issue currency in Malaysia;
- (c) To regulate and supervise financial institutions which are subject to the laws enforced by the Bank;
- (d) To provide oversight over money and foreign exchange markets;
- (e) To exercise oversight over payment systems;
- (f) To promote a sound, progressive and inclusive financial system;
- (g) To hold and manage the foreign reserves of Malaysia;
- (h) To promote an exchange rate regime consistent with the fundamentals of the economy; and
- (i) To act as financial adviser, banker and financial agent of the Government.

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<sup>726</sup> BNM is legally empowered to act as the regulator of banking institutions under the BNM Act 2009, the FSA 2013, and the IFSA 2013. The BNM has broad powers of supervision and control over banking institutions in Malaysia, where the BNM adopts a risk-based supervision approach, under which financial institutions are monitored based on their risk profiles and adequacy of risk management systems. The Minister of Finance plays a role in the regulation of banks and Islamic banks, and is the approving authority for applications for banking licences, and has the power to revoke licences.

While the BNM has the powers necessary to give effect to its objects when carrying out its functions, the BNM shall have regard to the 'national interest'<sup>727</sup> as stipulated under section 5(4) and (5) of BNM Act 2009. With such comprehensive legal powers,<sup>728</sup> the BNM ensures the orderly and proper conduct and growth of banking, finance companies, merchant banking, discount houses, money brokering and insurance business in Malaysia.<sup>729</sup>

Further, the BNM ensures that the money supply in the country is flexible and adequate to sustain Malaysia's economic growth, and the credits are available and within control to meet the domestic demands.<sup>730</sup> Measures adopted by the BNM include regulating the volume of money and the generation of credit by the various institutions to ensure price stability, controlling the inflation, promoting savings, and providing funds for financing activities. To this end, the BNM imposes statutory reserve requirements (SRR), liquid asset requirement, discount operations, open market operations, interest-rates regulation, credit control, lending guidelines, and moral suasion. **Figure H** examines the financial institutions and markets, regulated and supervised by the BNM.

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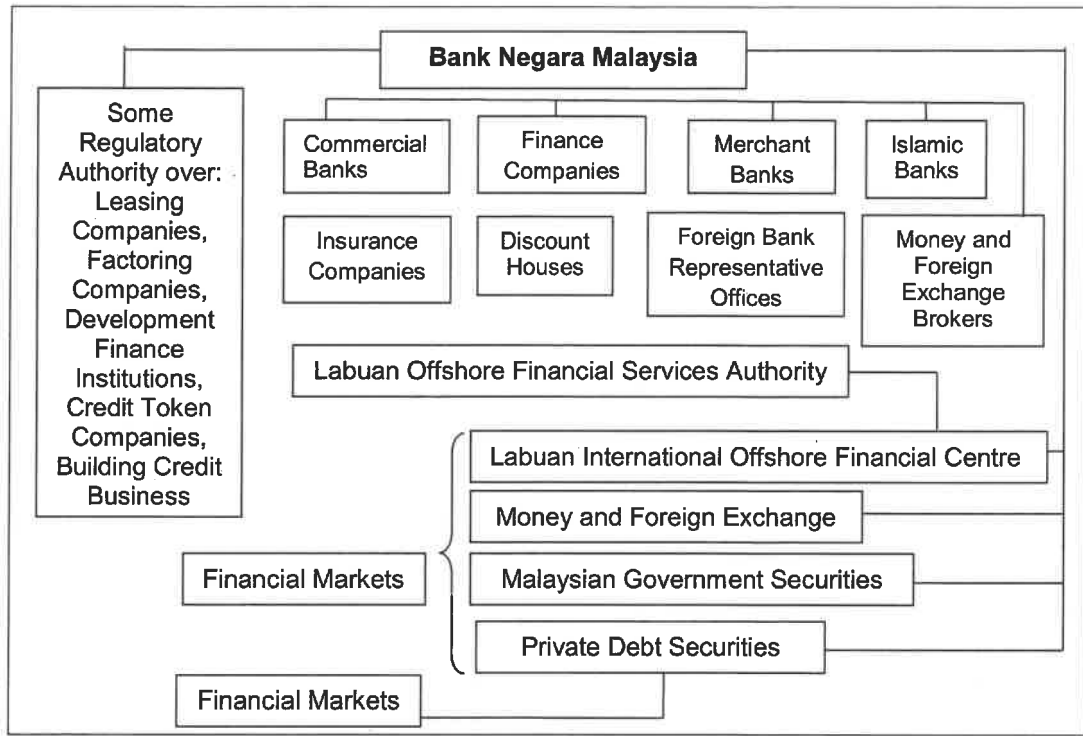
<sup>727</sup> The term 'national interest' is not defined under the BNM Act 2009, but it has been indirectly enshrined under section 22 regarding the promotion of monetary stability, where the BNM shall pursue a monetary policy, which serves the 'interests of the country' with the primary objective of maintaining price stability, giving due regard to the developments in the economy. Section 31 of the BNM Act 2009 refers to the 'interest of financial stability' and likewise, section 41 also refers to the 'interest of financial stability.'

<sup>728</sup> Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, 'Current Challenges in Central Banking – Legal Perspective', (2009) SEACEN-BNM Banking and Financial Law School, Lanai Kijang 1-4 <<https://www.bis.org/review/r090924a.pdf>> accessed 25 July 2019. It is noted that (i) in the area of financial stability, the BNM Act 2009 incorporates an explicit mandate of the BNM for financial stability, which includes risks that disrupts the financial intermediation process which affects public confidence. The BNM Act 2009 also provides comprehensive provisions for heightened surveillance, pre-emptive actions, and expanded resolution powers to facilitate the swift and orderly resolution of financial crisis. The BNM may take appropriate intervention actions to avert risks that stem from unregulated entities. (ii) In the area of comprehensive financial system safety net, the BNM Act 2009 provides for an effective regulatory and supervisory system to ensure the sound management of financial institutions, and the ability to deal with problems affecting financial stability, the LOLR facility that is provided by central banks to address liquidity stresses faced by financial institutions, and the deposit insurance scheme that provides a guarantee on deposits to protect the savings of depositors, and reduce the prospects for disruptions that could threaten the stability of the financial system.

<sup>729</sup> Ab. Aziz, *Introduction to Islamic Institutions in Economics and Finance* (n 724) 13-39.

<sup>730</sup> *Ibid.*

**Figure H**  
**Financial Institutions and Markets Regulated by BNM<sup>731</sup>**



The BNM Act 2009 provides the continued existence of the BNM for the administration, objects, functions, and powers of the BNM, and the centralised banking regime in Malaysia has also promulgated the following legislations:

- (a) FSA 2013 [Act 758] is aimed to provide for the regulation and supervision of financial institutions, payment systems, and other relevant entities, and the oversight of the money market, and foreign exchange market, to promote financial stability and for related, consequential or incidental matters;
- (b) IFSA 2013 [Act 759] is aimed to provide for the regulation and supervision of IFIs, payment systems, and other relevant entities, and the oversight of the Islamic money market, and Islamic foreign exchange market, to promote financial stability and compliance with *Shari'ah*, and for related, consequential, or incidental matters;
- (c) Development Financial Institutions Act 2002 [Act 618] is aimed to promote the development of effective and efficient DFIs to ensure that the roles, objectives, and activities of the DFIs are in tandem with the government

<sup>731</sup> Ibid.

policies, and that the roles are effectively and efficiently executed. Act 618 also emphasises on the efficient management and effective corporate governance, and provides a comprehensive supervision mechanism to strengthen the financial position of DFIs, through the specification of prudential requirements;

- (d) Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 [Act 613] is aimed to provide for the offence of money laundering, the measures to be taken for the prevention of money laundering and terrorism financing offences, investigation powers, and the forfeiture of property involved in, or derived from money laundering and terrorism financing offences, as well as terrorist property, proceeds of an unlawful activity, and instrumentalities of an offence;<sup>732</sup> and
- (e) Money Services Business Act 2011 [Act 731], which provides for the licensing, regulation, and supervision of the money services business, comprising money changing, remittance, and wholesale currency businesses.

The BNM has also increased its international cooperation,<sup>733</sup> particularly on the regional cooperation among central banks in East Asia. The focus of the regional cooperation has been in the areas of financial stability, financial markets, and payment and settlement systems.<sup>734</sup> In the 21st century, the contemporary Malaysia has evolved to adopt internet banking, and mobile banking services. Today, an open banking regime witnesses the emergence of Monzo, Revolut, and Starling banks, providing another alternative choice for consumers. The emergence of crypto-currency has also shaped the financial mind-set amongst the present generation to exploit and utilise an encrypted financing platform that rejects and bypasses a regime of a centralised regulatory and supervisory banking governance.

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<sup>732</sup> The First Schedule of Act 613 contains a list of the reporting institutions under the AMLATFPUAA i.e. financial institutions and designated non-financial businesses and professions, which are required to perform certain obligations, which are designed to prevent money laundering and terrorism financing offences. The Second Schedule of Act 613 lists serious offences from various legislation, which if committed, are likely to result in a person benefitting or deriving proceeds, from the offence. Act 613 promotes a collaborative and multi-agency approach by setting out the powers and functions of the competent authority, which is responsible to oversee the performance of obligations by the reporting institutions, facilitate the enforcement of Act 613, and co-operate with the foreign financial intelligence units, enforcement agencies which are responsible to investigate the offences under Act 613, and supervisory and regulatory authorities which are responsible to facilitate in the implementation of Act 613.

<sup>733</sup> See section 79 of BNM Act 2009 on 'International Cooperation'.

<sup>734</sup> Ab. Aziz, *Introduction to Islamic Institutions in Economics and Finance* (n 690) 13-39.

Currently, the BNM regulates crypto-currency under the legal and regulatory framework to combat money laundering and anti-terrorism financing.<sup>735</sup> Crypto-currency is not recognised as a legal tender in Malaysia.<sup>736</sup> The SC of Malaysia warned that, all cryptocurrency assets shall need prior approval before trading on any exchanges, and those who continue to operate unlicensed crypto exchange would risk RM10 million fine, and ten years of jail time, or both.<sup>737</sup> In this regard, the SC recognised only three exchanges, which are Luno Malaysia, Sinegy Technologies, and Tokenize Technology, whilst crypto exchanges that are not approved by the SC must cease all activities, and return all monies and assets collected from investors.<sup>738</sup> Irrespective of the developments on the crypto exchanges, Malaysia, with an increasing educated population, and the ubiquitous exposure and usage of smart-phones in daily activities, have also been at the forefront of creating the demand for innovative mobile and digital banking services. This includes the increasing usage of digital and mobile banking services in Islamic finance. In this vein, section 60 of BNM Act 2009 explicitly provides for BNM's power to promote and develop Malaysia as an international Islamic financial centre.

### **6.11. Liquidity and Capital Adequacy: BNM's Framework of Regulation and Supervision**

In general, the BNM implements the Basel Accords, and currently, Basel II capital framework including the Internal Ratings-Based approach for credit risk, and Pillar 2 and 3 components have been implemented. The 'gradual phase-in' of Basel III has been announced by the BNM for its implementation in Malaysia. For Islamic banks, the IFSB guides on the international prudential standard to ensure the soundness and stability of the IFSI. Further, FSA 2013 and IFSA 2013 provide that BNM may impose prudential standards on a bank relating to liquidity in order to promote the safety and soundness of the bank and its integrity. The promulgation of 'Liquidity Framework'<sup>739</sup> and 'SRR'<sup>740</sup> prescribing the liquidity requirements by the

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<sup>735</sup> BNM, Digital Currency, <[http://www.bnm.gov.my/index.php?ch=en\\_digital\\_currency&lang=en](http://www.bnm.gov.my/index.php?ch=en_digital_currency&lang=en)> accessed on 23 July 2019.

<sup>736</sup> Mathew Di Salvo, 'Cryptocurrency Still a Grey Area in Malaysia After Government Deems It 'Neither Legal nor Illegal' (Bitcoin.com, 2 August 2019) < <https://news.bitcoin.com/cryptocurrency-still-a-grey-area-in-malaysia-after-government-deems-it-neither-legal-nor-illegal/>> accessed 2 August 2019.

<sup>737</sup> \_\_\_\_\_, 'Strict Malaysian Regulator Approves Three Cryptocurrency Exchanges' (CCN, 13 January 2019) <<https://www.ccn.com/strict-malaysian-approves-first-3-cryptocurrency-exchanges/>> accessed 2 August 2019.

<sup>738</sup> Ibid.

<sup>739</sup> BNM, 'The Liquidity Framework' provides a standard measurement approach that focuses on the ability of a banking institution to manage its liquidity mismatches through the projection of a maturity

BNM are applicable to both the conventional and Islamic banks. The 'Liquidity Framework' does not underscore a rigid compliance with a particular ratio, but instead, banks are required to maintain adequate cash flows to cope with events of abnormally heavy withdrawals. As a minimum standard, the available cumulative mismatch to cater the liquidity shocks should not be less than the compliance requirement, as agreed with the BNM. Under the 'Liquidity Framework', the net compliance surplus should be positive for two maturity buckets.<sup>741</sup> For the capital adequacy requirement in Malaysia, domestic banks are required to maintain a minimum capital fund at RM2 billion, while the locally incorporated foreign bank to maintain RM300 billion, and a stand-alone investment bank to maintain a minimum of RM500million. Further, each bank within the banking group must adhere the minimum regulatory capital requirement, as prescribed under the Capital Adequacy Framework (Capital Components) and Capital Adequacy Framework for Islamic Banks (Capital Components), issued by the BNM based on Basel III Capital Adequacy Requirements.<sup>742</sup>

In this regard, in terms of capital adequacy requirements for Islamic banks in Malaysia, IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes) published by the IFSB was also referred to guide IFSI. Supervisory authorities, including BNM were expected to commence the implementation of IFSB-15 in their jurisdictions by 1 January 2015, although earlier implementation may be feasible, having regard to an adequate period for the IFSB-15 to be transcended into national supervisory regulations and guidelines for IFSI, as well as transitional arrangements to enhance the quality and quantity of capital, and the introduction of new capital and leverage requirements. It was also emphasised in the IFSB-15 that

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profile to its assets, liabilities, and off-balance sheet commitments, over a one-year span. Banks are expected to maintain adequate liquidity buffers, composed primarily of high quality marketable securities, to cushion the impact of liquidity shocks that may transpire from a banking crisis or market-wide stress scenario.<[http://www.bnm.gov.my/guidelines/01\\_banking/04\\_prudential\\_stds/03\\_liq\\_i.pdf](http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/03_liq_i.pdf)> accessed 24 April 2018.

<sup>740</sup> BNM, 'SRR'. The banks must maintain balances in their statutory reserve accounts that are at least equal to the prescribed ratio which is currently set at 4.0 per cent of total eligible liabilities.<<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=30&bb=file>> accessed 24 April 2018.

<sup>741</sup> For commercial/Islamic banks: (i) it is up-to one week; and (ii) one week to one month, and in the case of investment bank, it is up-to three days; and (ii) four days to one month.

<sup>742</sup> Under these requirements, all banks are required to maintain a minimum risk-weighted total capital ratio of 8 per cent at all times. For DFIs regulated by the BNM, they are required to maintain an absolute minimum capital of RM300 million at all times, and this is prescribed under the BNM Capital Adequacy Framework for DFIs, under which the RWA capital ratio are to be maintained at 8 per cent.

such implementation should be undertaken in compliance with the *Shari'ah* and within the legal and regulatory framework applicable in the jurisdiction.

## **6.12. Malaysia's Banking Resolution and Liquidation Framework**

In general, Malaysia's liquidation regime for all corporations, including banks are governed by the Companies Act 1965 [Act 125]. But for banks and Islamic banks, additional requirements are stipulated under FSA 2013 and IFSA 2013, respectively. For the purposes of IFSA 2013, sections 203-211 stipulate the general provisions on winding up concerning an institution.<sup>743</sup> In the event of winding up of the institution covered under section 203 of IFSA 2013, Companies Act 1965 [Act 125] shall apply. The BNM shall apply for the winding up, upon obtaining authorisation from the Minister of Finance, based on its recommendation to the Minister, and file the winding up application to the High Court under section 205 of IFSA 2013, subject also to restrictions on voluntary winding up under section 206 of Companies Act 1965. Sections 208-209 of IFSA 2013 provide for the appointment and remuneration of liquidator. Subject to the order of the High Court, the appointed liquidator shall carry out his functions under the direction and supervision of the BNM. Sections 212-221 of IFSA 2013 govern licensed *takaful* operators. These specific provisions under IFSA 2013 are intended to safeguard the interest of depositors, creditors, and the public, in the event that banks and Islamic banks are in crisis and faced with liquidation, and winding up. The BNM also has wide powers in relation to a bank that is insolvent, or likely to become unable to fulfil all, or any of its obligations. With the concurrence of the Minister of Finance, the BNM may prohibit a bank from extending credit facility, appoint certain persons as directors or advisors, and remove from office any director or officer of the licensed institution.

The bank's resolution regime in Malaysia is also governed by the MDIC Act 2005. The MDIC may be notified by the BNM regarding an MDIC member institution which has ceased to be viable, or is likely to cease to be viable. Pursuant to the notification, the MDIC is empowered to: (i) require its member institution to undertake steps to refrain from any act, including to cease soliciting, taking, or repaying deposits or carry on its business, or to restructure the whole, or part of its

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<sup>743</sup> Section 203 IFSA 2013 provides that, an 'institution' refers to a licensed person or an operator of a designated payment system. The same section also defines 'liquidator' to include a provisional liquidator, wherever applicable.

business; (ii) acquire or subscribe to the shares of its member institutions; (iii) assume control over its member institutions; and (iv) apply to the High Court to appoint receiver, manager, or receiver, and manager to manage the assets and liabilities of the member institutions; (v) present a petition for winding up, subject to the approval of the Minister of Finance; (vi) designate one of its subsidiaries as a 'bridge institutions'<sup>744</sup>; or (vii) transfer the assets and liabilities of the non-viable institutions to the bridge institutions. These bail-in/bail features in Malaysia's banking and resolution framework are developed to preserve the confidence in the financial system.

### 6.13. AAOIFI's Standards And IFRS in Malaysia

In essence, the International Financial Reporting Standards (IFRS) are applicable to IFIs. In Malaysia, the Malaysian Accounting Standards Board (MASB) affirms that IFRS should be applicable to IFIs as well, although it is noted that the IFRS do not adhere to the *Shari'ah*.<sup>745</sup> The Deloitte Islamic Finance Knowledge Centre (IFKC) finds that 79% of the industry leaders surveyed were in support of a convergence initiative of the AAOIFI standards with the IFRS, while 7% were against it because to have a separate set of accounting standards would be costly and redundant.<sup>746</sup> Although there have been accounting standards developed by the AAOIFI, the real challenge lies in the enforcement of these standards by IFIs, whilst at the same time adhering to the IFRS. The reality is that the IFRS is recognised in the global financial system. IFIs operating in western-based jurisdictions also need to comply with the IFRS. The IFRS is the *lingua franca* of financial reporting, whilst AAOIFI accounting standards have not been fully accepted. This contributes towards the lack of power by AAOIFI to enforce their standards.<sup>747</sup> Further, the accounting standards as issued by the AAOIFI have been examined to be compatible with the IFRS, except in few circumstances that require *Shari'ah*-compliance. The MASB takes the view that the IFRS is also *Shari'ah*-compliant, and

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<sup>744</sup> Where a subsidiary of MDIC has been designated as a 'bridge institution', the designation will expire two years after it is made, unless extended or earlier terminated, in accordance with the provisions of the MDIC Act 2005. The 'bridge institution' is authorised to carry on business as a bank of the non-viable bank during the designated bank period.

<sup>745</sup> Mohamed, Ahmad, and Mohd Fahmi (n 524) 33-38.

<sup>746</sup> Ibid.

<sup>747</sup> Ibid.

hence applicable to IFIs.<sup>748</sup> It thus appears that, it is impossible that AAOIFI's standard can stand within its own sphere of exclusivity without applying the IFRS.

#### **6.14. Contemporary Development of Islamic Banking and Finance in Malaysia, SAC, and SGF 2010**

With Islam as the official religion of the Federation, and the growing awareness and renaissance of Islamic values and principles, Malaysia has embarked on a dual banking model since early 1980s, pioneering the conventional banking system and Islamic banking system. Today, a structured adoption of a dual banking model consists of the conventional banking and Islamic banking models, operating side-by-side, and regulated and supervised by the BNM.<sup>749</sup> This framework is further enhanced by the promulgation of the FSA 2013 [Act 758], governing the conventional banking sector, and the IFSA 2013 [Act 759], governing the Islamic banking sector. This has led the IFIs in the contemporary Malaysia to adopt two types of regulatory framework, i.e. the governmental regulatory framework, and self-based regulatory framework. The government-based regulatory framework is in the form of legislations and guidelines imposed by the BNM upon IFIs.<sup>750</sup> The self-based regulations refer to regulations imposed by institutions upon themselves, based on standards issued by certain standard-setting bodies, such as the IFSB and the AAOIFI.<sup>751</sup> A major development took place in 2009. The BNM Act 2009 promulgated a dedicated provision in Part VII, establishing the *Sharī'ah* Advisory Council (SAC), as the highest authority for reference in Islamic banking and finance matters. The BNM Act 2009 provides the BNM the authority to supervise and regulate Islamic banks, as it does to other licensed banks. The centralised feature of an SAC is absent in the IBA 1983, which only requires the establishment of a *Sharī'ah* Advisory Board, in order for an institution to be licensed as an IFI.

Although constitutionally, 'Islamic finance' appears to be enshrined under the purview of 'Islamic' item in the FC, the legal position of the FC places the 'Islamic banking and finance' matters under the civil court's jurisdiction. This is due to the fact that Islamic banking falls under the item 'finance' in the FC. In this regard, a

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<sup>748</sup> Ibid.

<sup>749</sup> Section 27 of BNM Act 2009 provides that 'the financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system.'

<sup>750</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 101 - 146.

<sup>751</sup> Ibid.

special High Court in the Commercial Division known as the *Muamalat* bench was created.<sup>752</sup> Pursuant to Practice Direction No. 1/2003, paragraph 2, all cases under Code 22A filed in the High Court of Malaya will be registered, and heard in the High Court Commercial Division 4. Thus, the *Muamalat* bench of the High Court of Malaya will only hear cases relating to Islamic banking and finance matters. For the application of *Sharī'ah*, and Islamic law in Malaysia, a parallel system of *Sharī'ah* courts was developed.<sup>753</sup> Notwithstanding the establishment of the *Muamalat* bench, the SAC is the highest authority in Malaysia, for resolving all matters or disputes related to Islamic banking, finance, and *takaful*. This approach is more centralised, as the stability of *Sharī'ah* rulings on Islamic banking and finance matters are supervised under the central purview of the SAC of the BNM. The roles of the SAC, as enumerated in section 52(1) of the BNM Act 2009 include:

- (i) determination of *Sharī'ah* issues on any financial matter;
- (ii) issuance of a *Sharī'ah* ruling when reference is made to the SAC; and
- (iii) advise the BNM on issues relating to *Sharī'ah* matters in Islamic financial transactions.

Prior to 2009, the *Sharī'ah* advisors were regulated based on the Guidelines of *Sharī'ah* Committee in IFIs (BNM/GPS 1), which entered into force on 1<sup>st</sup> April 2005. Pursuant thereto, all IFIs, regulated and supervised by the BNM are required to conform to all the requirements, prescribed thereof. With the newly introduction of the '*Sharī'ah* Governance Framework for IFIs' (SGF 2010), having the objectives of ensuring *Sharī'ah*-compliance by IFIs, BNM/GPS1 was no longer applicable and replaced with, starting on 1<sup>st</sup> January 2011.<sup>754</sup> The SGF 2010 is aimed to instil public confidence in IFSI, IFIs, and promote financial stability within Malaysia. In the Financial Stability Report 2010, the former BNM Governor, Tan Sri Dr. Zeti Akhtar Aziz underscored the importance of the SGF 2010, in providing a comprehensive guidance on the roles and responsibilities of the SAC, boards of directors and management, in order to ensure *Sharī'ah*-compliance is observed by IFIs.<sup>755</sup> Due to the liberalisation of the financial services and Malaysia's exposure to the global trading environment, the Islamic banking system in Malaysia has been considered

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<sup>752</sup> Hassan (n 70) 82-115.

<sup>753</sup> Mohamed Dzaiddin Hj. Abdullah, 'Development of Islamic Law in Malaysia: An Overview' (2002) 101 *International Islamic University Malaysia Law Journal* 3. It is noted that the *Sharī'ah* court system is a hierarchy system that consists of three kinds of courts: first, *Sharī'ah* subordinate courts, then *Sharī'ah* High Court, and the top the *Sharī'ah* Appeal Court, which is headed by a chief *Sharī'ah* judge appointed by the Yang di-Pertuan Agong (Sultan).

<sup>754</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta (n 94) 4- 5.

<sup>755</sup> Ibid.

as more progressive, compared to other Muslim countries implementing the Islamic banking and finance framework.<sup>756</sup> The dual banking systems are actively being regulated and supervised by the BNM, being the main regulatory and supervisory authority for the Malaysian banking, finance, and *takaful* industries.

### **6.15. A Critical Examination on the Financial Services Act 2013 [Act 758] and the Islamic Financial And Services Act 2013 [Act 759]**

As the dual banking model continues to grow, the demand towards a more comprehensive legal framework to administer the growing conventional banking system and the Islamic banking system has also crystallised. Following an extensive policy research, the BNM issued the *Financial Sector Blueprint 2011-2020* (a 10-year Blueprint) that charted the future direction of the financial system in Malaysia, including to enhance the resilience of Islamic finance. This has led to the promulgation of the FSA 2013, and the IFSA 2013. The experience of the Asian financial crisis and the recent global financial crisis have tested the efficacy of prudential regulation in Malaysia to pre-emptively deal with disruptions to financial stability. In light of these lessons learnt from the two crisis, the BNM Act 2009 and the MDIC Act 2011 have been promulgated to empower the prudential regulators to be more pro-active and acquainted with the risks, and repercussions of macro-economic developments, for financial institutions and Malaysia's financial system. Further, the FSA 2013 and the IFSA 2013 made a complete overhaul of the legislative framework and the supervisory regime for financial institutions in Malaysia and develop a comprehensive financial safety net.<sup>757</sup>

The FSA 2013 is the main statute governing the conventional finance industry. It has replaced the Financial Services Act 1989, the Insurance Act 1996, the payment Systems Act 2003, and the Exchange Control Act 1953. The main objectives of the FSA 2013 are to: (i) promote financial stability, safety, and soundness of the financial institutions; (ii) promote integrity and orderly functioning of the money market and foreign exchange market; (iii) promote safe, efficient, and reliable payment systems and payment instruments; (iv) promote fair and

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<sup>756</sup> Hassan (n 70) 82-115.

<sup>757</sup> See section 77 of BNM Act 2009 in relation to measures to safeguard monetary and financial stability.

responsible business conduct of the financial institutions; and (v) protect the rights and interest of consumers.

The IFSA 2013 governs the Islamic finance sector. It replaced the IBA 1983 and the TA 1984. The main objectives of the IFSA 2013 are to: (i) promote financial stability, and compliance with the *Shari'ah*, including the safety, and soundness of IFIs; (ii) promote integrity and orderly functioning of the money market, and foreign exchange market; (iii) promote safe, efficient, and reliable payment systems, and payment instruments; (iv) promote fair and responsible business conduct of IFIs; and (v) protect the rights and interest of consumers. Both the FSA 2013 and the IFSA 2013 came into force on 30<sup>th</sup> June 2013. The IFSA 2013 is regarded as an omnibus legislation for the regulation and supervision of IFIs such as Islamic banks, *takaful* operators, international Islamic banks, international *takaful* operators, as well as operators of payment systems.

It is examined that the overarching main objectives of the FSA 2013 and IFSA 2013 are to legally empower the BNM with greater powers to counter future risks to financial stability in the financial sector, increase consumer protection, promote competition in the broader financial services sector, and undertake the step forward towards encountering global trends in the financial regulations. The strengthened legal powers of the BNM are vital to maintain the overall financial stability in Malaysia, and safeguard the well-functioning financial system.<sup>758</sup> Further, the transition policy for the IFSA 2013 has been promulgated by the BNM for the purposes of facilitating IFIs to adopt the legal framework of IFSA 2013.<sup>759</sup>

In addition, the scope of the IFSA 2013 has been broadened.<sup>760</sup> This can be examined mainly in the definitions of 'authorised person'. Section 2 of IFSA 2013 defines 'authorised person' as a person licensed under section 11 to carry on an 'authorised business'. Section 2 further defined 'authorised business' as a licensed business or an approved business. The IFSA 2013, through section 2 defines 'Islamic banking business' as the business of (i) accepting Islamic deposits on current account, deposit account, savings account, or other similar accounts, with or without the business of paying, or collecting cheques drawn by, or paid in by

<sup>758</sup>Mardhiyyah Sahri and Madzlan Hussain, 'Financial Services Act 2013 [Act 758] and the Islamic Financial and Services Act 2013 [Act 759]' (ZICO, 2016)1-8.

<sup>759</sup>BNM, 'Transition Policy under IFSA 2013' (2014), <<https://islamicbankers.files.wordpress.com/2013/12/20140214-transition-policy-under-islamic-financial-services-act-2013-ifsa.pdf>> accessed 2 December 2018.

<sup>760</sup> Sahri and Hussain (n 758).

customers; or (ii) accepting money under an investment account; and (iii) provision of finance; and (iv) such other business as prescribed under section 3.<sup>761</sup> The term 'Islamic deposit' is defined in section 2 of the IFSA 2013, but the chapeau explains the term as a sum of money, accepted or paid, in accordance with *Shari'ah*.<sup>762</sup>

The FSA 2013 and the IFSA 2013 also underscore a category of 'financial intermediation'. The activities of financial intermediation are listed under section 211 of the FSA 2013 and section 222 of the IFSA 2013. With regard to licensing, all persons undertaking banking business, investment banking, or insurance business, are legally required to hold valid licenses, granted by the Minister of Finance. The Minister thus plays an active role as the approving authority for the application of banking licenses, with the power to impose conditions on such licenses, including the power to revoke licenses, and direct investigations in prescribed circumstances. Businesses such as financial advisory, money-broking, and insurance broking will only require approvals from the BNM. Every authorised person is required to maintain, a minimum capital of funds, or a surplus of assets over liabilities, during the course of undertaking its authorised business.

The FSA 2013, governing the conventional banking sector, allows a person holding existing interest in a licensed person to increase its shareholding in that licensed person, without having to obtain prior approval, if such an increase does not exceed a multiple of 5%, and together, does not exceed the aggregate of 10%.<sup>763</sup> As for disposing shares, the condition to get approval of the Minister of Finance or the BNM no longer applies, except in cases where the shareholder proposes to dispose shares which results in the shareholder, ceasing to have

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<sup>761</sup> Section 3 of IFSA 2013 pertains to prescription by Minister of Finance of additional business or activity.

<sup>762</sup> Section 2 of IFSA 2013 defines 'Islamic deposit' as a sum of money accepted or paid in accordance with *Shari'ah*— (a) on terms under which it will be repaid in full, with or without any gains, return or any other consideration in money or money's worth, either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and person accepting it; or (b) under an arrangement, on terms whereby the proceeds under the arrangement to be paid to the person paying the sum of money shall not be less than such sum of money, but excludes money paid bona fide— (i) by way of an advance or a part payment under a contract for the sale, hire or other provision of property or services, and is repayable only in the event that the property or services are not in fact sold, hired or otherwise provided; (ii) by way of security for the performance of a contract or by way of security in respect of any loss which may result from the non-performance of a contract; (iii) without limiting paragraph (ii), by way of security for the delivery up or return of any property, whether in a particular state of repair or otherwise; and (iv) in such other circumstances, or to or by such other person, as set out in schedule 2 (Other Exclusions from Definition of 'Islamic Deposit').

<sup>763</sup> Mardhiyyah Shari and Madzlan Hussain, 'Financial Services Act 2013 [Act 758] and the Islamic Financial and Services Act 2013 [Act 759]' (ZICO, 2016)1-8.

control over the licensed person. For financial holding company (FHC), it must first obtain a written approval of the Minister of Finance, and require an approval by the BNM, if the company intends to become an FHC, holding more than 50% shares in a licensed person. An FHC of a licensed person is not permitted to operate any business, except financial services, or other services relating to financial services, and must comply with all prudential requirements.<sup>764</sup>

The *Shari'ah* governance framework is a key differentiating point, between the FSA 2013, and the IFSA 2013.<sup>765</sup> The new Part IV of the IFSA 2013 was introduced to strengthen and reinforce the *Shari'ah*-governance framework. In this regard, IFIs shall ensure an end-to-end *Shari'ah*-compliance with regard to their policies, procedures, and operations. For the purposes of corporate governance, a licensed person is required to obtain the approval of the BNM for the appointment, election, reappointment, and re-election of the chairman, director, chief executive officer, or a senior officer, and a notification to BNM of the appointment, election, reappointment and re-election of the chairman, director, chief executive officer, or a senior officer is enough in the case of an approved person, or an operator of a designated payment systems.

The FSA 2013 and the IFSA 2013 have further enhanced the duties of directors, and stipulated more stringent requirements on transparency on the part of directors of licensed persons, and the FHC. For insurance and *takaful*, the FSA 2013 stipulates that insurers who hold composite licenses are prohibited from operating both general and life insurance businesses. Likewise, under the IFSA 2013, the *takaful* operators who hold composite licenses are prohibited from operating both general and family *takaful* business. However, licensed professional reinsurers/*retakaful* operators are exempted from this prohibition. The BNM has granted a grace period of up to 5 years, or as specified by the Minister of Finance, on a recommendation by BNM, for composite insurers/*takaful* operators to de-merge into separate entities. Further, the FSA 2013 and the IFSA 2013 have streamlined the regulations and supervisions of licensed and approved persons. The criteria, by which any application to carry on payment systems business are assessed similarly as an application to carry on licensed business. For the purposes of regulating exchange control, no person shall undertake or engage in any transaction as stipulated Schedule 14 of IFSA 2013 (List of transactions regulated under section

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<sup>764</sup> The prudential requirements are prescribed under Part V of the FSA 2013, and Part VI of the IFSA 2013.

<sup>765</sup> Sahri and Hussain (n 758).

225(2)—measures relating to international and domestic transactions), unless he has obtained a written approval from the BNM. This will include any proposed transaction falling within the borrowing or lending of Ringgit Malaysia, between non-residents, retaining, or using Ringgit Malaysia by a non-resident, giving or obtaining any guarantee in respect of any debt or liability, importing into, or exporting from Malaysia in Ringgit Malaysia, foreign currency, gold, or other precious metals.

Further, the BNM is legally empowered under the FSA 2013 and the IFSA 2013 to assume control over the entire or part of business affairs, or property of the financial institution, to manage it, or appoint any person to manage it on behalf of the BNM, and to designate a bridge institution when certain circumstances arise.<sup>766</sup> Such circumstances are prescribed in section 177 of IFSA 2013, which among others, includes IFIs' breach of provisions under IFSA 2013, the assets of IFIs are not sufficient to give adequate protection to its depositors, IFIs have become, or are likely to become insolvent, or likely unable to meet their obligations, or the capital of IFIs has reached the level that may detrimentally affect the depositors, IAH, *takaful* participants, users, creditors, or the public, generally. Part XIV of IFSA 2013 provides for such an intervention and remedial remedy, where the BNM has the power to remove director, chief executive officer, or senior officer who no longer fulfils the fit and proper requirements under section 69 of the IFSA 2103, or has breached or failed to comply with the IFSA 2013. These developments signify a radical new basis for reorganising the financial regulation in Malaysia. The BNM can dictate what is appropriate for any bank, including IFIs and its FHC, in respect of its capital requirements, corporate governance, consumer protection, shareholding, and intervention. The Ministerial exemptions also require recommendation by the BNM, and be carried out in tandem with the objectives of the FSA 2013, and the IFSA 2013, and all related legislations. **Table 4** below examines the salient critical aspects of the IFSA 2013, and the FSA 2013.<sup>767</sup>

**Table 4**

Source	Aspects of IFSA 2013 and FSA 2013
BNM Guidelines.	Disclosure of material transactions, business conduct.
US Bank Holding Company Act 1956.	Regulation of financial holding companies.
UK Consumer Insurance	Insurance/ <i>takaful</i> -related provisions (example

<sup>766</sup> Ibid.

<sup>767</sup> Ibid.

Source	Aspects of IFSA 2013 and FSA 2013
(Disclosure and Representations) Act 2012/ <i>Sharī'ah</i> Advisory Council Resolutions.	consumer insurance contract, duty to take reasonable care not to make a misrepresentation, insurer's remedies, and abolishment of 'basis of contract' clauses.
Basel III.	Prudential requirements (capital adequacy requirements, liquidity requirements, and risk management).

In order to further illustrate and critically examine the salient distinguishing features between the FSA 2013 and the IFSA 2013,<sup>768</sup> **Table 5** below examines the salient critical aspects that distinguish the IFSA 2013 and the FSA 2013.

**Table 5**

Aspects	FSA 2013	IFSA 2013
Scope of Activities	No provision regarding permission for conventional institutions to carry on Islamic businesses.	Section 14 allows conventional institutions to carry on Islamic businesses.
Grounds for revocation of authorisation	There is no such ground as per section 18(1)(a) of IFSA 2013.	Section 18(1)(a) includes non-compliance with <i>Sharī'ah</i> .
<i>Sharī'ah</i> requirements	No equivalent provision of Part IV of IFSA 2013.	Part IV (ss.27-38) stipulates the requirements in full details. Section 66(e) explicitly requires Board of Directors to observe standards applicable in this respect.
Related Party	No such inclusion of section 57 (3) (b) of IFSA 2013.	Section 57(3)(b) includes members of <i>Sharī'ah</i> Committee as related party.
Monetary penalty	Schedule 15 relates to only 72 types of breaches.	Schedules 15 relates to 81 types of breaches.
Circumstances for exercising power to issue directions	No equivalent provision of section 167 of IFSA 2013.	Section 167(a) includes non-compliance with the <i>Sharī'ah</i> .
Giving priority to Takaful participants instead of shareholders.	Section 56 only states that Board of Directors must have regard to policy holders.	Section 65 explicitly impose this on Board of Directors.

<sup>768</sup> Ibid.

Further, as Bank Negara's regulatory oversight also encompasses *takaful* and insurance, **Table 6** below illustrates and critically examines the salient critical aspects that distinguish the IFSA 2013 and the FSA 2013, vis-à-vis the TA 1984/Insurance Act 1996,<sup>769</sup> which have been repealed with the coming into force the FSA 2013 and the IFSA 2013, on 30<sup>th</sup> June 2013.

**Table 6**

IFSA 2013 and FSA 2013	Takaful Act 1984/Insurance Act 1996
BNM can assume control of an institution with an approval from the Minister of Finance, and can suspend powers of the Board. BNM is also allowed under the law to order the sale of the business or assets, or parts of the business.	There is no direct predecessor. Previously, parties to a transaction could apply to the High Court for an approval with regard to any act of assuming control over any financial institutions.
BNM may appoint a receiver to the financial institution.	No previous power. Other parties could apply to the High Court for such an order.
Approval by the Minister of Finance is required on advice by the BNM for charges of share control over a financial institution.	Changes of control are not directly regulated, but was regulated via requiring changes to holdings of more than 5% to be approved.
BNM can order that another company in a corporate group be designated as the group's FHC, requiring a corporate rearrangement.	BNM has no power to dictate precisely the corporate structures.
BNM requires a licensed person to hold at all times or part of its assets in Malaysia.	BNM has a limited power to dictate the transfer of assets.
BNM can specify standards on prudential requirements, including standards relating to capital adequacy, liquidity and risk management.	BNM has a very general power and less prescriptive.

In addition, for the purposes of discussing the Islamic finance framework, **Table 7** below illustrates and critically examines the salient critical aspects that distinguish the IFSA 2013 and the TA 1984 (which has been repealed with the coming into force the IFSA 2013, on 30 June 2013).<sup>770</sup>

<sup>769</sup> Ibid.

<sup>770</sup> Ibid.

Table 7

Operations	Takaful Act 1984	IFSA 2013
Permissible <i>takaful</i> interest.	It is not explicitly required for family <i>takaful</i> at the time of payment of contribution and when certificate is effected.	It is explicitly required for family <i>takaful</i> at the time of payment of contribution and when certificate is effected.
Surplus of asset over liabilities.	This aspect has consistently been a requirement for licensing and can be a cause for the revocation of license, as set out in section 2 (definition of 'statutory balance sheet'), section 4 (2)(b), section 11(1)(d), section 16 (3).	The issue of surplus assets seems to be dealt with only in these sections 12 and 218 in the event of winding up.  By virtue of <i>Takaful</i> (Surplus of Assets over Liabilities) (Revocation) Regulations 2013, gazetted as PU(A) 197, the Minister of Finance has revoked the <i>Takaful</i> (Surplus of Assets over Liabilities) Regulations 1985.
Levy.	Section 21(3) imposes that levy not exceeding 1 % of the annual actual contribution of an operator in any one year assessable on the general business, and in the case of family solidarity business on any new business, carried out by the operator in the previous year.	Levy is no longer provided for under the IFSA 2013.
Consumer Takaful Contract.	There is no provision governing the consumer <i>takaful</i> contracts.	IFSA 2013 has introduced provisions governing consumer <i>takaful</i> contracts.
Pre-contractual duty of disclosure.	More onerous duty on consumer to disclose all relevant information.	There is less onerous pre-contractual duty of disclosure for consumers with greater responsibility on insurers to guide relevant disclosures.  For consumer insurance contracts, IFSA 2013 eradicates the insurer's ability to rely on the basis clause (in proposal, reinstatement forms, health warranties) to repudiate claims on the basis of material

Operations	Takaful Act 1984	IFSA 2013
Prohibited conducts	Prohibited products are provided under section 28 (any statement, promises or forecasts which is misleading, false, or deceptive, or by any fraudulent concealment of a material fact, or by the reckless making (fraudulently or otherwise) of such statement are offences.	non-disclosure. Prohibited conducts are extensively listed out in Schedule 7 of IFSA 2013. It includes among others, demanding payments for unsolicited products and services, exerting undue pressure, influence, or using or threatening to use harassment, coercion or physical force in relation to the provision of payment for products and services.
Investible assets.	Section 17(2)(a) and (b) of TA 1984 imposes requirement as to the assets of <i>Takaful</i> fund.	All investment limits must be in accordance with the Risk-Based Capital Framework for <i>Takaful</i> Operators (BNM/RH/GL004-23).
Assumption of risk.	It is provided under section 25 of TA 1984, where the risk is assumed at the point when – (a) the contribution payable is received by the operator or is guaranteed to be paid by such person; or (b) deposit of such amount as may be prescribed is made in advance.	It is provided under section 96, where the risk is assumed at the point when the <i>takaful</i> contribution payable is received by the licensed <i>takaful</i> operator in such manner, and within such time, as may be prescribed by the Bank i.e. any third party collection channel.
Cessation Notice.	Cessation notice is stipulated under section 32 of TA 1984, where the <i>takaful</i> operator shall notify BNM in writing within 14 days that a person has ceased to be its Chairman, director, CEO or senior officer and the reasons.	The notification for the cessation notice to the BNM is reduced to 7 days.
Age Capacity	Section 64 provides that a <i>takaful</i> agent is a person under the age of 18 years old shall not have the capacity to enter into a contract of <i>takaful</i> .	The age capacity has been reduced to 16 years old.

## 6.16. *Sharī'ah* Governance Model in Malaysia

The BNM underscores the paramount importance for the Islamic financial system to operate in compliance with the *Sharī'ah*. Thus, a two-tier *Sharī'ah* governance model<sup>771</sup> was developed comprising a centralised SAC at the BNM level, and an internal *Sharī'ah* Committee, or SSB established in each IFI in Malaysia. The SAC consists of prominent *Sharī'ah* scholars, jurists, and market practitioners. The members of the SAC are qualified individuals, and have vast experience in banking, finance, economics, laws, and the application of *Sharī'ah*, particularly in the area of Islamic economics, banking, and finance.<sup>772</sup> The SAC is legally empowered under the BNM Act 2009, to issue *Sharī'ah* rulings for the purposes of Islamic banking business, *takaful* business, Islamic financial business, Islamic development financial business, or any other businesses which operate Islamic finance.

As the reference body and *Sharī'ah* advisor to the BNM, the SAC is responsible for validating all Islamic banking and *takaful* products, to ensure their *Sharī'ah*-compliance, and accordingly be used by IFSI in Malaysia. In addition, the SAC advises BNM on any *Sharī'ah* issues relating to Islamic financial businesses or transactions of BNM, and other related entities. Hence, the role and functions of the SAC was further reinforced vide the promulgation of the BNM Act 2009. The SAC was accorded the status of the sole authoritative body on *Sharī'ah* matters pertaining to Islamic banking, *takaful*, and Islamic finance. The rulings of the SAC shall prevail over any contradictory ruling given by a *Sharī'ah* body or committee constituted in Malaysia. Additionally, the rulings of the SAC also apply to the court and arbitrator for any proceedings relating to Islamic financial business, and such rulings shall be binding. In the recent decision by the Federal Court in Malaysia, in the case of *JRI Resources v. Kuwait Finance House*<sup>773</sup>, this legal position has been reaffirmed by the highest apex court in Malaysia, which held that the rulings of the SAC shall prevail over any contradictory ruling given by any *Sharī'ah* body or *Sharī'ah* committee constituted in Malaysia, and such binding rulings do not violate Malaysia's FC with regard to the power vested in the judiciary vis-à-vis the SAC.

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<sup>771</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta (n 94) 5-43.

<sup>772</sup> Section 53 (1) of BNM Act 2009 provides that 53. (1) The Yang di-Pertuan Agong may, on the advice of the Minister after consultation with the Bank, appoint from amongst persons who are qualified in the *Sharī'ah* or who have knowledge or experience in the *Sharī'ah* and in banking, finance, law, or such other related disciplines as members of the SAC.

<sup>773</sup> *JRI Resources v. Kuwait Finance House* [2009] MLJU 275.

The *Shari'ah* Governance framework 2010 (SGF 2010), issued by the BNM promulgates the primary objective of enhancing the roles of the board, the *Shari'ah* Committee, the SSB, and the management in relation to *Shari'ah* matters. This includes enhancing the relevant key organs, having the responsibility to implement the *Shari'ah*-compliance and research functions to achieve a *Shari'ah*-based operating ecosystem. The SGF 2010 stipulates the following main objectives, i.e.:

- (i) to set out the expectations of the BNM on an IFIs' *Shari'ah* governance structures, process, and arrangements to ensure that all its operations and business activities are in accordance with the *Shari'ah*;
- (ii) to provide a comprehensive guidance to the board, *Shari'ah* Committee and management of the IFIs in discharging its duties in matters relating to *Shari'ah*; and
- (iii) to outline the functions relating to *Shari'ah* review, *Shari'ah* audit, *Shari'ah*-risk management and *Shari'ah* research.

Figure I below illustrates the SGF 2010.<sup>774</sup>

Figure I

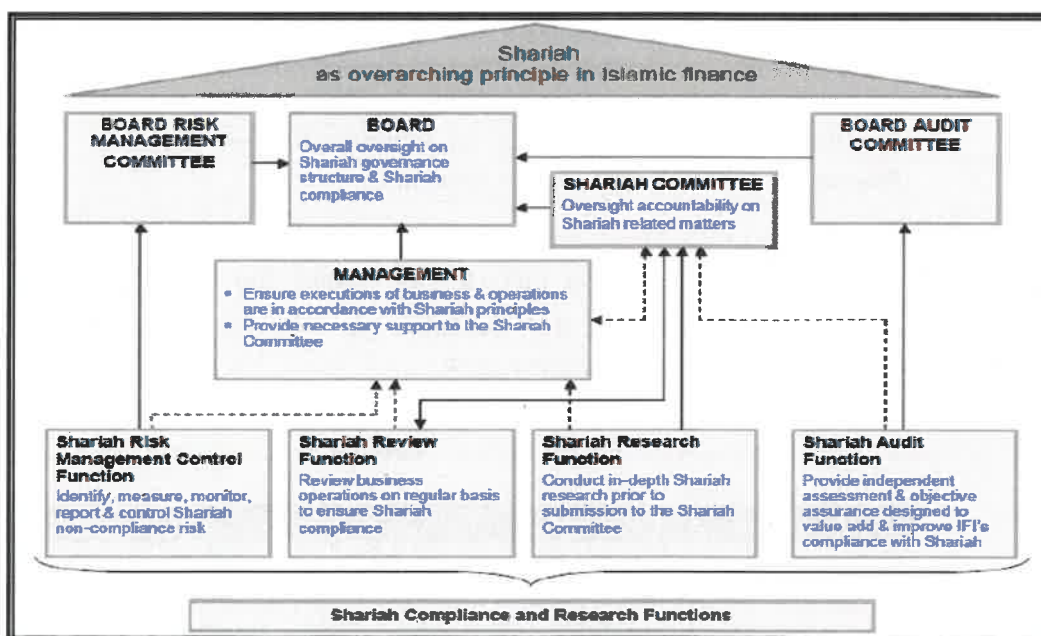


Table 8 below further illustrates and examines the key organs and functions in the operation of the *Shari'ah* Governance Framework.<sup>775</sup>

<sup>774</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta (n 94) 5-43.

**Table 8**

Key Organs		Functions
Board of Directors.	of	Oversee on <i>Shari'ah</i> compliance aspect of the IFIs' overall operations. Here, the board is ultimately responsible for establishing an appropriate <i>Shari'ah</i> governance framework for the IFIs. The board is expected to understand the <i>Shari'ah</i> non-compliance risk associated with Islamic finance business and its implications to the IFIs.
<i>Shari'ah</i> Committee or SSB.	or	Consist of qualified members with <i>Shari'ah</i> background who are able to deliberate Islamic finance issues and provide sound <i>Shari'ah</i> decisions.
Management.		Responsible to provide adequate resources and capable manpower to support every function involved in the implementation of <i>Shari'ah</i> governance. This is to ensure that the business operations are executed in accordance with the <i>Shari'ah</i> .
<i>Shari'ah</i> Review.		This practice should be conducted on a continuous basis. This review should cover processes and deliverables as well as determining that they satisfy the needs of the <i>Shari'ah</i> .
<i>Shari'ah</i> Audit.		This audit should be done on an annual basis to verify that the IFIs' key functions and business operations comply with the <i>Shari'ah</i> .
<i>Shari'ah</i> Risk Management.	Risk	To practise <i>Shari'ah</i> risk management process to identify all possible <i>Shari'ah</i> non-compliance risks and take remedial measures to reduce the risk.
<i>Shari'ah</i> Research.		To develop an internal <i>Shari'ah</i> research team to conduct research on <i>Shari'ah</i> .

In addition, for the purposes of guiding the IFSI, **Table 9** below further illustrates and examines the 'Guideline on Corporate Governance for Licenses Islamic Bank (Revised BNM/GP-i)'.<sup>776</sup>

**Table 9**

Principles	Explanation
Principle 1	Every Islamic bank should be headed by an effective board, which assumes specific responsibilities. The vision, strategy, and corporate values of the Islamic bank should be clearly specified and understood.
Principle 2	There should be an effective board composition, with a strong

<sup>775</sup> Ibid.

<sup>776</sup> Ibid.

Principles	Explanation
	independent element, where no individual or small group of individuals should be allowed to dominate the board's decision making.
Principle 3	There should be a clear division of responsibilities at the helm of an Islamic bank, which will ensure a balanced and clear lines of role, responsibility, authority, and accountability throughout the Islamic bank.
Principle 4	There should be a formal and transparent process for the appointment of directors to the board, and the appointment of Chief Executive Officer.
Principle 5	Directors must be persons of calibre, credibility and integrity with the necessary skills and experience and be able to devote time and commitment.
Principle 6	Board should meet regularly and be duly furnished with complete and timely information.
Principle 7	There should be a formal and ongoing assessment of the effectiveness of the board as a whole, the directors, and the Chief Executive Officer.
Principle 8	There should be a formal and transparent procedure for fixing the remuneration packages of board members, Chief Executive Officer, and senior management and the remuneration policies and practices should be in line with the Islamic bank's ethical values, objectives, and cultures.
Principle 9	Persons empowered with decision making authority (including directors) should exercise care to avoid situations that may give rise to a conflict of interest situation.
Principle 10	There should be clear separation between shareholders and management so as not to impede sound corporate governance.
Principle 11	There should be robust auditing requirements and the auditor, board and management need to maintain professional and objective relationship.
Principle 12	Islamic bank should engage in regular, effective and fair communication with shareholders/stakeholders.
Principle 13	Conducting corporate governance in a transparent manner can reinforce sound corporate governance.
Principle 14	Board is collectively responsible and accountable for the veracity of disclosures and management of risk.

Further, the *Shari'ah* review and *Shari'ah* audit functions<sup>777</sup> are critically examined and distinguished in **Table 10** below.

<sup>777</sup> Ibid.

Table 10

	<i>Shari'ah</i> Review	<i>Shari'ah</i> Audit
Scope.	Covers IFIs' overall business operations, including end-to-end product development process – from pre-product approval (i.e. products restructuring before introducing to market) to post-product approval process (i.e. products offering process).	Audit of financial statements of IFIs' Compliance audit on organisational structure, people and information technology application system. Review adequacy of <i>Shari'ah</i> governance process.
Process.	<p>Planning the review programme (objectives, scope, reporting rectification, and follow up actions).</p> <p>Documentation of process involved in review. Communicate the outcome of review and highlight any non-compliance to senior management and <i>Shari'ah</i> Committee.</p> <p>Rectify any non-compliance in <i>Shari'ah</i> and prevent recurrence. Communicate results of review to the <i>Shari'ah</i> Committee.</p>	<p>Understand business activities (i.e. auditability and relevance of activities). Develop comprehensive internal audit programme or plan (objective, scope, personnel assignment, sampling, control and duration, establish proper audit process). Obtain and make reference to relevant references (SAC rulings, <i>Shari'ah</i> Committee decisions, fatwas, guidelines, <i>Shari'ah</i> audit results and internal <i>Shari'ah</i> checklist). Communicate results of any assessment of findings to <i>Shari'ah</i> Committee and Audit Committee. Provide recommendations and follow up on rectification measures taken by IFIs.</p>
Reference.	Regular assessment on <i>Shari'ah</i> compliance in activities and operations of IFIs by qualified <i>Shari'ah</i> officers (i.e. having knowledge in <i>Shari'ah- Usul Fiqh</i> and <i>Muamalat</i> ).	Periodical assessment to provide independent assessment and objective assurance to add value and improve IFIs compliance in ensuring sound and effective internal control system for <i>Shari'ah</i> compliance.
Roles and responsibility.	Examine and evaluate IFIs level of compliance to <i>Shari'ah</i> , remedial rectification to resolve non-compliance and control	Performed by internal auditors – trained and have adequate knowledge of <i>Shari'ah</i> . The internal auditors may engage

Shari'ah Review	Shari'ah Audit
mechanism to avoid recurrence.	expertise of <i>Shari'ah</i> officers in performing the audit.

Further distinction is also critically examined between the *Shari'ah* audit and statutory audit,<sup>778</sup> as distinguished in **Table 11** below.

**Table 11**

	<i>Shari'ah</i> Audit	Statutory Audit
Framework.	No proper framework.	Conventional Audit regime.
Definition.	<i>Shari'ah</i> Audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for <i>Shari'ah</i> compliance.	Statutory Audit process provides assurance on the reality and fairness of an IFI's financial information, advice on controls and processing system weaknesses and confirmation of accounting treatments on complex transactions.
Scope.	Audit of financial statements of the IFI. Compliance audit on organisational structure, people process and information technology application systems, and review of adequacy of the <i>Shari'ah</i> governance process.	Financial Statements and related control pertaining to the financial operations.
Duties of the Auditor.	Outlined in SGF 2010.	Outlined in Companies Act of Malaysia 1965.
Audit Report.	Through <i>Shari'ah</i> Committee Report.	Standard Audit Report.
Responsibility.	Internal Auditor.	External Audit.
Reporting Structure.	Shareholders and Stakeholders (external parties).	Audit Committee and <i>Shari'ah</i> Committee (internal parties).

Whilst the BNM provides the general requirements of the *Shari'ah* governance framework in Malaysia, the AAOIFI and the IFSB also promulgate their respective *Shari'ah* governance framework, the area that appears to require further

<sup>778</sup> Ibid.

improvement lies on the issue of *Shari'ah* risk management and research functions which require further examination and explication for IFSI.<sup>779</sup> **Table 12** below makes a comparative analysis among *Shari'ah* governance framework and guidelines.<sup>780</sup>

**Table 12**

No.	Discussion	AAOIFI	IFSB	BNM
1.	Definition of <i>Shari'ah</i> governance.	Not provided.	Provided.	Not provided.
2.	Independence, competence, responsibility of SSB.	Discussed.	Discussed.	Discussed.
3.	<i>Shari'ah</i> review and <i>Shari'ah</i> audit.	Discussed.	Discussed.	Discussed.
4.	Risk Management.	Not discussed.	Not discussed.	Discussed.
5.	Research Function.	Not discussed.	Not discussed.	Discussed.

In Malaysia, the *Shari'ah* scholars sitting on the SSB are prohibited from serving more than one *Shari'ah* board at a time, and this is to avoid them being stigmatised as merely rubber-stumps in approving *Shari'ah*-compliant products.<sup>781</sup> The Persian Gulf countries adopt a virtually unregulated approach, where their *Shari'ah* scholars have resisted any attempt towards a more regulated approach of the *Shari'ah* governance framework.<sup>782</sup> IFSI is a very demanding industry, whilst its profit-making aspiration is important for the sustainability of the business, and hence, the selection of *Shari'ah* scholars to sit on the SSB of a particular bank is critical.<sup>783</sup> Banks are looking for *Shari'ah* scholars who can certify their *de facto* conventional financial instruments as *Shari'ah*-compliant, as opposed to conservative *Shari'ah* scholars who regularly denounce the contemporary Islamic banking and finance practice as being un-Islamic, despite that there exists today an international framework for Islamic finance consisting of various international institutions that promulgate various standards, principles, rulings, and guidelines that cater for the *Shari'ah*-compliant requirements.<sup>784</sup>

<sup>779</sup> Nawal Kasim, Sheila Nu Htay, Syed Ahmed Salman, 'Comparative Analysis on AAOIFI, IFSB, and BNM *Shari'ah* Governance Guidelines.' (2013) 4 (15) International Journal of Business and Social Science 220-227.

<sup>780</sup> Ibid.

<sup>781</sup> Khan (n 138) 805-820.

<sup>782</sup> Ibid.

<sup>783</sup> Ibid.

<sup>784</sup> Ibid.

Further, a punitive measure is prescribed under section 28 of IFSA 2013. It stipulates that IFIs shall at all times ensure that its aims and operations, business, affairs and activities, are in compliance with the *Sharī'ah*.<sup>785</sup> Any person who contravenes section 28 of IFSA 2013 commits an offence, and shall, on conviction, be liable to imprisonment for a term not exceeding eight years, or to a fine not exceeding twenty-five million ringgit, or both.<sup>786</sup> This onerous duty may create a backlash, and hamper the development of IFSI, because potential entrants may feel apprehensive of the punitive criminalisation measure prescribed by IFSA 2013. The *de jure* legal position stipulates that any person, including a financial institution or its directors, controllers or officers, is considered to have committed a criminal offence if he contravenes section 28 of IFSA 2013, and this may reduce the number of experts wanting to serve IFIs as directors, chief executive officers, and auditors.<sup>787</sup>

### **6.17. Critiques, and Challenges towards the Centrality of the SAC's Model of *Sharī'ah*-Governance**

On 10<sup>th</sup> April 2019, the Federal Court of Malaysia delivered a landmark decision in the case of *JRI Resources v. Kuwait Finance House*.<sup>788</sup> It decided in favour of the SAC, affirming the roles of the SAC as the sole authoritative body on *Sharī'ah* matters pertaining to Islamic banking, *takaful*, and Islamic finance in Malaysia. The decision by the Malaysia's highest court has provided IFSI in Malaysia with legal certainty<sup>789</sup> on *Sharī'ah*-compliance issues. This also reaffirmed the core objectives of establishing the centralised SAC under the BNM. It was a split decision with a 5-4 majority, decided in favour of the SAC. Thus, Malaysia's style of regulating and supervising the *Sharī'ah*-compliance issues in Islamic finance in Malaysia is thus seen being reinforced by this decision. Accordingly, it ensures continuous uniformity, standardisation, harmonisation, stability, and predictability of *Sharī'ah* rulings.

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<sup>785</sup> Section 28 (2) of IFSA 2013 provides that 'for the purposes of this Act, a compliance with any ruling of the SAC of BNM in respect of any particular aim and operation, business, affair or activity shall be deemed to be a compliance with *Sharī'ah* in respect of that aims and operations, business, affair or activity.'

<sup>786</sup> Section 28 (5) of IFSA 2013.

<sup>787</sup> Sheila Aion Yussof, 'The Islamic Financial Services Act, 2013 Malaysia's Model Framework for *Sharī'ah*-Compliance and Stability' (2013) *Islamic and Civilisational Renewal* 391-406 <[file:///C:/Users/lwwmaw/Downloads/335-Article%20Text-1312-1-10-20130909%20\(1\).pdf](file:///C:/Users/lwwmaw/Downloads/335-Article%20Text-1312-1-10-20130909%20(1).pdf)> accessed 25 June 2019.

<sup>788</sup> *JRI Resources v. Kuwait Finance House* [2009] MLJU 275.

<sup>789</sup> *Ibid.*

In the case of *JRI Resources v. Kuwait Finance House (KFH)*,<sup>790</sup> the issue before the Federal Court was whether sections 56 and 57 of BNM the Act 2009 violated Malaysia's FC. The provisions were argued to usurp the judicial power of the court. Hence, the SAC cannot issue a binding legal ruling. The majority judgement decided that issues raised were of 'great public importance, especially to the Islamic banking and finance industry in Malaysia.'<sup>791</sup> The Federal Court Judge, Justice Datuk Mohd Zawawi Mohd. Salleh held that, in his majority written judgment, the SAC's ruling under sections 56 and 57 of the BNM Act 2009 does not conclude or settle the dispute between the parties arising from the Islamic financing facility at hand. In the judgement, Justice Datuk Mohd Zawawi opined that "[i]t does not 'determine' the liability of the borrower under the Islamic facility. The determination of a borrower's liability under any banking facility is decided by the presiding judge, and not the SAC."<sup>792</sup> The majority judgement was supported by the Court of Appeal president, Justice Tan Sri Ahmad Maarop, and Federal Court judges, Justices Tan Sri Ramly Ali, Tan Sri Azahar Mohamed, and Datuk Alizatul Khair Othman Khairuddin. The dissenting judges were, Chief Justice Tan Sri Richard Malanjum, Chief Judge of Malaya Justice Tan Sri Zaharah Ibrahim, Chief Judge of Sabah and Sarawak Justice Datuk David Wong Dak Wah, and Federal Court judge Justice Tan Sri Idrus Harun.

This was in response to JRI counsel's submission that it was impermissible for the legislature to divest the core judicial functions, traditionally vested with the High Court, and to confer, or vest the same in the SAC. The SAC was argued to lack the basic legal standing of a superior court like the High Court. Thus, sections 56 and 57 impugned the doctrine of separation of powers.<sup>793</sup> In this case, the Association of Islamic Banking Institutions Malaysia, and the BNM appeared as interveners. The Federal Court also deliberated on the binding nature of the SAC rulings and expert evidence. The factual matrix of the case pertains to vessels, financing facilities, and the roles of the SAC. In this case, KFH granted JRI Islamic facilities, including an *ijarah* facility, in 2008, and 2009. KFH had purchased the vessels at JRI's request. The Islamic bank funded the purchase and then, became the owner of the vessels which were later leased to JRI. The issue was, who should foot the bill for the vessel's major maintenance works. KFH filed a civil action against JRI and its guarantors, on 2<sup>nd</sup> September 2013, to recover the amounts due under

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<sup>790</sup> Ibid.

<sup>791</sup> Ibid.

<sup>792</sup> Ibid.

<sup>793</sup> Ibid.

the facilities. The High Court, in October 2014, granted KFH a summary judgement for RM118.3 million, which was outstanding as at November 2013, together with compensation fees. JRI appealed to the Court of Appeal against the summary judgement.

In September 2015, JRI argued that its failure to derive income from the charter proceeds from leasing of the vessels was due to KFH's failure to undertake major maintenance works on the vessels. JRI alleged that the carrying out of the major maintenance works on the vessels was the responsibility of the respondent, as the owner of the vessels. JRI also submitted that the High Court had erred in not seeking a ruling on a *Shari'ah* issue in relation to the *Shari'ah* compliance of a clause in the facility agreement, which states that the customer (JRI) shall undertake all of the major maintenance, and bear all the costs, charges, and expenses. Therefore, on the direction of the Court of Appeal, the SAC was referred the *Shari'ah*-compliance position of the *ijarah* agreement clause. The SAC reverted to the High Court, on 30<sup>th</sup> June 2016. Negotiation to determine the party that will bear the maintenance cost of the asset was allowed, as long as it was agreed by the parties. It was at this juncture, JRI had submitted to challenge the constitutionality of sections 56 and 57 of Act 2009, which legally empowers the SAC to give its ruling. The issue was whether, sections 56 and 57 of the BNM Act 2009 were unconstitutional, as they contravened Part IX of the FC, particularly Article 121 of the FC on the judicial power, and that the said sections have the effect of vesting judicial power in the SAC of the BNM.

Section 57 of the BNM Act 2009 provides, "[a]ny ruling made by the SAC pursuant to a reference made under this Part shall be binding on the IFIs under section 55 of BNM Act 2009, and court or arbitrator making a reference under section 56." On this part, section 56 of BNM Act 2009 states, "[w]here 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." The majority 5-4 decision upheld that the duty to ascertain Islamic law was conferred on the legislature, and the SAC was the legislature's machinery to assist in resolving disputes in Islamic banking. Thus, Justice Datuk Mohd Zawawi opined that the "[SAC] does not exercise judicial power at all."<sup>794</sup> The SAC has been harmonising the proliferation of *Shari'ah* opinions in

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<sup>794</sup> Ibid.

IFSI since its inception. In this regard, Justice Datuk Mohd Zawawi opined that the “[SAC] has already accustomed to the practical considerations at hand, and the need for certainty in the industry on Islamic banking principles. Therefore, the binding nature of the ruling of the SAC is justified as section 56 of the 2009 Act was enacted on the reason of conserving and protecting the public interest.”<sup>795</sup> Regarding the issue of expert evidence, Justice Datuk Mohd Zawawi opined that its use would not be helpful to a civil court judge. Ultimately, the civil court judge still must make a decision. The judge would have to choose which expert opinion to rely on. This could be further complicated if each expert based his or her opinion on different schools of jurisprudence. Further, Justice Datuk Mohd Zawawi opined that “[w]e are of the firm opinion that it is for a body of eminent jurists, properly qualified in Islamic jurisprudence and/or Islamic finance, to be the ones dealing with questions of validity of a contract under Islamic law and in Malaysia that special body would be the SAC.”<sup>796</sup>

On one hand, the recent judgement augurs well for the legal certainty and predictability of the *Shari'ah* governance framework for IFSI in Malaysia. But future challenge could still arise. The legal position may be revisited and re-examined from a different constitutional standpoint, or from another legal stance. The legal angle on which these sections can be questioned could become narrower. In light of this case, the Chief Executive Officer of CIMB Islamic Bank Bhd., Mr. Mohamed Rafe Mohamed Haneef opined that there will always be differences of opinion among those expert witnesses, which make the process of ascertaining the right interpretation complex for the civil courts.<sup>797</sup> Hence, this legal uncertainty was addressed by making the SAC's decision binding on the civil courts. But the main overriding consideration still remains that the courts cannot abdicate the final decision to outsiders, even to the experts. Thus, the decision appears quite an unsettling judgement.<sup>798</sup> It can be critiqued that the Federal Court may have ceded part of its judicial jurisdiction and powers to the SAC, albeit with regard to Islamic law, or the *Shari'ah* ruling, as decided by the SAC. In the context of upholding the doctrine of separation of powers, the judgment of the *JRI Resources v. Kuwait Finance House* appears to be unprecedented in that regard.<sup>799</sup> Further, the

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<sup>795</sup> Ibid.

<sup>796</sup> Ibid.

<sup>797</sup> Habhajan Singh, 'Federal Court leans once more towards BNM's *Shari'ah* Advisory Council', 15 April 2019, available at <https://themalaysianreserve.com/2019/04/15/federal-court-leans-once-more-towards-bnms-shariah-advisory-council/>, accessed on 23 July 2019.

<sup>798</sup> Ibid.

<sup>799</sup> Ibid.

centralised style of the SAC's governance structure, whilst providing certainty, predictability, stability, and uniformity of *Shari'ah* rulings, may be prone towards a heavy regulatory style of espousing *Shari'ah* governance. To a certain extent, the IFSI and in this case, the judiciary body in Malaysia may seem to be regulated in one way, for the sake of ensuring a *Shari'ah*-compliance regime.

## **6.18. *Shari'ah* Governance Model in Other Jurisdictions**

IFIs must undertake to implement best practices of corporate governance, including to enhance the *Shari'ah* governance structure, consisted of highly qualified *Shari'ah* advisors. For Malaysia, the SGF 2010 was promulgated with the SAC being the central authority under the BNM to ensure *Shari'ah*-compliance of IFIs. There are different approaches that are adopted in different jurisdictions with regard to the *Shari'ah* governance framework. These approaches define varying structures, roles, and responsibilities of an SSB, as well as the legal effects of their decisions. As a comparison to Malaysia's *Shari'ah* governance framework, this study examines the selected *Shari'ah* governance frameworks in three types of jurisdictions, namely:

- 6.18.1. *Shari'ah*-based jurisdictions;
- 6.18.2. Partially-*Shari'ah* based jurisdictions; and
- 6.18.3. Secular-based jurisdictions.

### **6.18.1. *Shari'ah*-Based Jurisdiction**

Bahrain is chosen as a *Shari'ah*-based jurisdiction. It is averse towards regulator's intervention, or over-regulation. Hence, it adopts a minimalist approach, enabling the market to develop its own *Shari'ah* governance system.<sup>800</sup> The Central Bank of Bahrain is the sole regulator of the Bahraini financial sector, regulating and supervising all financial institutions, the insurance sector, and the capital market. The CBB Rule Book (2010), Volume 2, Islamic Banks, High Level Controls, HC 9.2, provides that "[i]slamic bank licensees, which refer to themselves as Islamic, are subject to additional governance requirements and disclosures to provide assurance to stakeholders that they are following *Shari'ah* principles." In ensuring compliance with *Shari'ah* principles, each Islamic bank licensee must establish an independent SSB, consisting of at least three *Shari'ah* scholars, and complying with AAOIFI's Governance Standards for IFIs No. 1 and No.2. Under HC 9.2.6., it stipulated that

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<sup>800</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta.(n 94) 5-43.

“all Islamic Banks must comply with all AAOIFI issued accounting standards as well as applicable *Sharī`ah* pronouncements issued by the *Sharī`ah* Board of AAOIFI.” In terms of regulatory framework, the Islamic financial sector in Bahrain is subject to the same supervisory regulations as conventional banks. The “Prudential Information and Regulatory Framework” (PIRI) is a comprehensive framework created specifically to deal with Islamic banks. It covers corporate governance, liquidity management, capital adequacy, asset quality, management of investment accounts. At the Bahraini national level, the National *Sharī`ah* Advisory Board of the CBB is established with an objective to serve and verify *Sharī`ah* compliance of its own products only. This *Sharī`ah* Advisory Board however does not have the authority over other IFIs, and hence, the minimalist<sup>801</sup> approach adopted by Bahrain.

#### **6.18.2. Partially-*Sharī`ah* Based Jurisdiction**

Indonesia is another partially *Sharī`ah*-based jurisdiction, which has enhanced the development of *Sharī`ah* governance within Indonesia’s Islamic banking industry with the promulgation of Act No. 21 of 2008 on *Sharī`ah* Banking (“Act No.21 of 2008”).<sup>802</sup> Act No. 21 of 2008 provides various aspects and procedures for Islamic banking products and operations, including the provisions for the licensing, prudential supervision, *Sharī`ah*-compliance supervision, management, conversion of conventional banks into Islamic banks, and sanctions in cases of violation.

To augment IFSI, Indonesia launched the Blueprint of Islamic Banking in Indonesia (2002). Three main stages were introduced to achieve the *Sharī`ah* governance. Stage One (2002 to 2004) was focused on promoting a better understanding of the concept of *Sharī`ah*-based finance, supporting and facilitating the formulation of the *Sharī`ah* financial norms, and conducting studies to develop an integrated regulatory and supervisory mechanism. Stage two (2004 to 2008) was aimed to develop three components i.e.: (i) supporting more efficient *Sharī`ah* supervisory activities; (ii) developing incentives to improved compliance with *Sharī`ah* principles; and (ii) complying with international standards for financial products and services. Last but not least, stage three (2008 to 2011) was the phase in towards developing an integrated rating system that accommodates *Sharī`ah* and financial aspects. Pursuant to the Blueprint, the Bank Indonesia Regulation (BIR)

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<sup>801</sup> Ibid.

<sup>802</sup> Ibid.

No. 7/46/PBI/2005 was issued as a step towards gaining compliance with international standards on *Shari'ah*. The regulation constitutes part of the initiatives to meet the targets stipulated by the Blueprint of Islamic Banking in Indonesia.<sup>803</sup> The provisions of Act No.21 of 2008 pertaining to *Shari'ah* governance are relatively general. Section 32 of Act No.21 stipulates that the industry must establish an SSB. The *Shari'ah* governance regulatory framework in Indonesia comprises two supervisory bodies. The first is the *Shari'ah* Board in Islamic banks, and also in conventional banks, conducting Islamic banking business in Indonesia. The second is the National *Shari'ah* Council (NSC), which is Indonesia's national-level *Shari'ah* supervisory body. The NSC's main duty is to analyse and formulate *Shari'ah* principles, through the issuance of fatwas to guide the IFSI.

The NSC issued Decision No. 01/2000. It serves as basic guidelines and reference to the duties of the NSC. It also elucidates the NSC's duties, including: (i) issuing *fatwas* relating to Islamic financial matters, which are binding on SSBs within the financial institutions; (ii) issuing *fatwas* which are to be considered as a basis for the proposed regulations, issued by relevant authorities, such as the Department of Finance of the Republic of Indonesia and the Central Bank of Indonesia; (iii) delivering opinions for the appointment or revocation of appointment of any person for the membership of an SSB within the financial industry; (iv) proposing the involvement of the experts and officials of any government bodies in the areas related to *Shari'ah* issues, in which fatwas must be issued; (v) issuing letters of reminder to any IFIs for any non-compliance with fatwas of the NSC; and (vi) proposing that governmental authorities take the necessary legal action, when the letter of reminder is not heeded.

The NSC and SSB's duties include: (i) conducting supervision and advisory duties towards the board of directors, the *Shari'ah* division and branch managers in numerous banking activities from the perspective of the *Shari'ah*; (ii) acting as the mediating body between the bank, and the NSC, in the implementation of *fatwas* and decisions of the NSC; and (iii) providing periodic reports on their supervisory activities to the NSC since the appointment of the members in any bank is determined partly by the NSC. Indonesia's approach towards *Shari'ah* governance is a gradual development approach to prepare IFSI and IFIs to be *Shari'ah*-compliant, whilst the Blueprint gives ample development space for the *Shari'ah* governance framework to be further improved for IFSI in Indonesia.

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<sup>803</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta (n 94) 5-43.

### 6.18.3. Secular-Based Jurisdiction

As the first country in the EU to declare the intention to adopt Islamic finance, the United Kingdom (UK) has been supportive towards the practice of Islamic banking and finance. In 2008, the UK Financial Services Authority (FSA) and the HM Treasury introduced various regulations in order to mitigate legislative hurdles that can prevent Islamic finance to be developed in the UK. The FSA, being the sole financial regulator in the UK, has been highlighted by Michael Ainley, Ali Mashayekhi, Robert Hicks, et.al<sup>804</sup> to have contributed towards the development of Islamic finance in the UK.

Michael Ainley, Ali Mashayekhi, Robert Hicks et.al<sup>805</sup> stated that all financial institutions have to comply with the Financial Services and Markets Act 2000 (FSMA), and some other finance acts. The FSMA deals with the regulation of financial services in the UK. Section 19 of the FSMA provides that any person who carries out regulated activities in the UK must be permitted and authorised by the FSA, including, *inter alia*, accepting deposits. All financial institutions, including IFIs shall be subjected to the same rules and supervisory framework in the UK. Thus, the FSA regulates all financial institutions, including IFIs, according to the same standards. The FSA's approach was articulated by its then Chairman, Sir Howard Davies,<sup>806</sup> where he underscored that the FSA's approach can be concluded as "no obstacles, but no special favours". Michael Ainley concurred that, under the FSMA, there is no discrimination for, or against a particular sector, such as Islamic banking.<sup>807</sup>

IFIs shall be required to meet the five main thresholds, provided under the FSMA. The five thresholds are: (i) the firm must have the right legal status for the activities it wishes to undertake; (ii) for a firm incorporated in the UK, its head office and management must also be in the UK; (iii) if the person or firm has "close links" with another person or firm, these are not likely to prevent the effective supervision of the firm; (iv) the firm must have adequate resources financially, and non-financially, for the activities it seeks to carry out; and (v) the firm including its people and activities, must be 'fit and proper'.

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<sup>804</sup> Michael Ainley, Ali Mashayekhi, Robert Hicks et. Al (2007) '*Islamic Finance in the UK: Regulations and Challenges in the UK*' Financial Services Authority 31.

<sup>805</sup> Ibid.

<sup>806</sup> Ibid.

<sup>807</sup> Ibid.

The UK was regarded by Seni Mohamed Mohamed Nafees as a country which does not have an exclusive legislation on Islamic banking.<sup>808</sup> Matters relating to *Sharī'ah* advisory are left to the respective Islamic banks. Further, the FSMA does not provide any reference with regard to the central and sole authoritative body akin to Malaysia's SAC, or anybody of such kind. That notwithstanding, the financial and operational perspective of Islamic financial activities and the *Sharī'ah* governance supervision still need to be critically examined.<sup>809</sup> Where the decision of the *Sharī'ah* scholars is not legally binding, it may create a potential impediment for the sustainability of the IFSI. In this regard, the UK model of *Sharī'ah* governance is examined as a reactive approach, as argued and examined by Zulkifli Hassan.<sup>810</sup> The UK regulators will only react and intervene in the *Sharī'ah* governance matters when any significant issue arises. IFIs operating within UK's jurisdiction are free to be independent in developing their own *Sharī'ah* governance standards, without being required to comply with any national, or higher level *Sharī'ah* Council like the SAC of the BNM. The UK's regulatory style is a self-regulation approach, decentralised, and self-initiative, instituted by the respective IFIs. The FSA does not provide any specific legal ruling or policy on *Sharī'ah* governance framework. This flexibility has enabled IFSI in the UK to manage its own *Sharī'ah* governance, and this gives rise to different styles, experimentation, and practices.

Further, the rise of rise of *Sharī'ah* firms globally, providing *Sharī'ah* advice to IFIs, can be seen as constituting an independent body, or an ad-hoc authority which is decentralised in terms of providing their respective *Sharī'ah* advice and opinions to IFIs.<sup>811</sup> This connotes a decentralised regime of *Sharī'ah* governance.

### **6.19. The Prognosis of Malaysia's Model: An Exploratory Case Study for the *Sharī'ah* Governance Framework**

This study examines that Malaysia is an exploratory case-study. It is not a confirmatory one. This is because the SGF 2010 is still experimental, and relatively

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<sup>808</sup> Mohamed Nafees, Seni Mohamed (2011), *'Evolution, Legal and Regulatory Issues, and Dispute Resolution in the Modern Islamic Banking Industry in Sri Lanka'*; Dissertation, Ahmad Ibrahim Kulliyah of Laws, International Islamic University Malaysia.

<sup>809</sup> There has been a rise of *Sharī'ah* firms globally, providing *Sharī'ah* advice to IFIs. The *Sharī'ah* firms consist of *Sharī'ah* experts whose roles are similar to external auditors who undertake their duty independently. See also, Karim Ginena and Azhar Hamid, *Foundations of Sharī'ah Governance of Islamic Banks: The Role of Sharī'ah Supervisory Boards, Internal Audit and Advisory Forms* (John Wiley and Sons 2015) 363.

<sup>810</sup> Hassan (n 70) 82-115

<sup>811</sup> See also, Mushtak Parket, *Practices of Sharī'ah Governance in the Islamic Capital Market in ISRA & Thomson Reuters* (Islamic Commercial Law Report 2017) 56-59.

new. Further, heeded by the majority decision in the case of *JRI Resources v. Kuwait Finance House*,<sup>812</sup> Malaysia's central regime of *Shari'ah* governance framework should be espoused as a normative case-study and proposition for the Islamic finance framework, which can be critically examined herein. In this regard, Zulkifli Hassan argued and suggested that 'best practice' in *Shari'ah* governance has not reached the level of efficiency and sophistication expected from IFIs.<sup>813</sup>

In favouring for a more reactive approach i.e. a self-based and self-initiative regulation, this regulatory style will accommodate the local differences in the market, by allowing varying experimentation and creativity in IFSI with regard to *Shari'ah*-compliant decisions on Islamic finance products. This will induce greater accountability on the IFIs with regard to the establishment of SSB, and the provision of *Shari'ah* advice to the IFIs. However, the lack of a centralised supervision of the *Shari'ah* governance framework may cause discrepancy or inconsistency of *fatwa* and *Shari'ah* rulings. In certain circumstances, the situation is also prone towards *fatwa*-shopping, causing further fragmentation of the *Shari'ah* rulings. In the case of *bay' al-'inah* for instance, the SAC of the BNM has considered it to be *Shari'ah*-compliant.<sup>814</sup> Hence, it is implemented in accordance with the juristic view of the *Shafi'e Mazhab*. This has enabled Malaysia to issue *sukuk* based on the *bay' al-'inah* structure. But this position is rejected by the Middle Eastern *Shari'ah* scholars whose *Shari'ah* opinions are based on the majority of other *Mazhabs*.<sup>815</sup>

On the other hand, should a centralised-style of regulation be favoured, the *Shari'ah* governance framework like the SAC of the BNM and the SGF 2010 would enable a better standardisation,<sup>816</sup> harmonisation, stability, predictability, and certainty on *Shari'ah*-compliant rulings.<sup>817</sup> This standardisation will minimise major fragmentation in the *Shari'ah*-compliance issues and rulings pertaining to Islamic finance products.<sup>818</sup> Accordingly, it will bring spill-over effects to allow an optimal regulation to be adopted for the certainty and predictability in the IFSI. As the

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<sup>812</sup> *JRI Resources v. Kuwait Finance House* [2009] MLJU 275.

<sup>813</sup> Hassan (n 430) 30-51.

<sup>814</sup> Saiful Azhar Rosly and Mohd Sanusi, 'Some Issues of *Bay' al-'Inah* in Malaysian Islamic Financial Markets' (2001) 16 (3) Arab Law Quarterly 262.

<sup>815</sup> *Ibid*.

<sup>816</sup> Edib Smolo and Abbas Mirakhor, 'The Global Financial Crisis and Its Implications for the Islamic Financial Industry' (2010) 3 (4) International Journal of Islamic and Middle Eastern Finance and Management 372, 373. Smolo and Mirakhor argued that the lack of a standard framework is also regarded as one of the factors that exacerbate the risk exposure to the IFIs.

<sup>817</sup> Hassan, Abdullah, Hassan, Ibrahim, Md.Sawari, Abd. Aziz, Triyanta (n 94) 5-43.

<sup>818</sup> Hakimah Yaacob, Marjan Mohammad and Edib Smolo, 'International Convention for Islamic Finance: Towards Standardisation' (2011) 29 ISRA Research Paper 1-54.

centralised *Sharī'ah* governance framework is intended to enable better harmonisation of *Sharī'ah* rulings, the centralised regime will be able to absorb a large regulatory scale of IFSI's *Sharī'ah* governance issues when it comes to the adoption *Sharī'ah*-standards, as opposed to the segmented self-based regulatory style. Further, the standardisation of *Sharī'ah* rulings may prevent the race to the bottom. IFSI will try to adopt and adhere to the optimal standard, being standardised by the centralised *Sharī'ah* governance framework. IFIs do not have to continuously experiment with various *Sharī'ah*-compliant products which may attract legal discrepancies in the *Sharī'ah*-compliance views on Islamic finance products.<sup>819</sup>

Further, the centralised regime of the *Sharī'ah* governance framework meets the regulatory-scale objectives by maximising efficiency values and the governance values in the *Sharī'ah*-compatibility aspect. It will internalise the costs for un-standardised *Sharī'ah*-rulings in IFSI through allowing a uniform interpretation of the *Sharī'ah*. Inter-industry *Sharī'ah* externalities can be addressed and internalised through the centralised *Sharī'ah* governance framework. IFIs which are prone to under-regulate can be supervised and regulated by the central SAC, which can be seen to assume jurisdictional neutrality, impartiality, and independence to eliminate spill-over effects of lax *Sharī'ah*-standards produced by IFIs. Thus, where a single jurisdictional neutrality is institutionalised, many of the inconsistent *Sharī'ah* rulings and decisions by IFIs can be effectively addressed, and mitigated. A better regulatory scale can also be achieved through the centralised SAC's model, as opposed a decentralised self-based initiative. Also, different IFIs, operating *Sharī'ah* rulings differently are prone to the regulatory capture, where IFIs, being commercial entities are also driven to maximise shareholders' value in the corporation. The duplication of *Sharī'ah* rulings can be better managed, and responded to, through the SAC's centralised model. That notwithstanding, the recent majority decision in the case of *JRI Resources v. Kuwait Finance House*<sup>820</sup> should prognosticate that Malaysia's model is not confirmatory, but exploratory. The *Sharī'ah* governance framework, espoused by the BNM Act 2009 and the SGF 2010, is still a living framework, which can prone to further improvement. As IFSI continues to grow and

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<sup>819</sup> Shanmugam, B. and Zahari, Z.R., *A Primer on Islamic Finance*, (Charlottesville, VA: Research Foundation of CFA Institute, 2009) 93. Shanmugam and Zahari argued that, "the lack of standardised religious decisions leads to uncertainty, confusion, and unease among scholars and investors. This situation restricts the industry from reaching its potential because a number of inefficiencies arise from the lack of standardisation. For example, different interpretations of *Sharī'ah* mean that, one Islamic bank may not be able to accept or use as a model for another Islamic bank's products, which can hamper the integration of Islamic finance at both the national, and international levels."

<sup>820</sup> *JRI Resources v. Kuwait Finance House* [2009] MLJU 275.

develop a higher level of expertise and maturity, IFIs may develop their own strategic dependence towards highly qualified *Sharī'ah* experts of their own, who are well verse in every technical aspects of the law, *Sharī'ah*, banking, and Islamic finance operations. This dependence may deny the 'meta-dependence' deference towards the centralised SAC regime, which does not comport to the demand for IFI's unique circumstances, diversity, experimentation, and specific peculiarities that are inherent in each IFI. Diversity in the implementation and experimentation will provide opportunities for IFIs to learn, experiment, and improve, so that the industry can operate with sufficient flexibility to provide heterogeneity of consumer preferences, rather than be held back against certain fixed standards. This will be of great advantage to the IFSI. It can benefit from the percolation of varying approaches first, before the international framework for Islamic finance, including a certain style of *Sharī'ah* governance frameworks, can be decisively affirmed, and confirmed.

Malaysia's model is examined to adopt and impose a heavy regulatory style due to its centralised *Sharī'ah* governance framework, and robust legal powers accorded to the BNM. Be that as it may, Malaysia still, has managed to lead and contribute enormously to the IFSI through this standardisation regime of the SAC, harnessing certainty, predictability, and uniformity of the *Sharī'ah* rulings. Whilst these harmonisation efforts are needed for the stability of the *Sharī'ah* rulings within Malaysia, this study examines that Malaysia is an exploratory case-study to be compared with other regulatory styles like the UK's, and Bahrain's approaches.

## **6.20. The Prognosis of Malaysia's Model: An Exploratory Case Study for the Legal and Regulatory Framework**

As an exploratory case-study, Malaysia's legal and regulatory framework can be further examined through the following characteristics:<sup>821</sup>

- 6.20.1. The creation of an enabling legal environment;
- 6.20.2. The effective mechanism of dispute resolution; and
- 6.20.3. The enforceability of Islamic financial products.

The examination of these characteristics also incorporate a discussion on how the international framework for Islamic finance attracts various international cases and disputes, and the jurisdiction in which such a settlement of dispute is

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<sup>821</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

preferred at the international forum. Thus, the examination of the above-mentioned characteristics are not confined only within the Malaysia's domain, but also the international domain, within which the operation of the international framework for Islamic finance is espoused, and examined in this study.

#### **6.20.1. An Enabling Legal Environment: Malaysia's Experience**

Malaysia has created an enabling legal environment for the development and growth of Islamic finance. The enabling legal environment has been shaped by a clear policy decision and direction as supported by the legal and regulatory framework on Islamic finance.<sup>822</sup> Further, the legal environment is enhanced by the licensing and supervision of IFIs, and the establishment of the *Sharī'ah* governance structure and mechanism to ensure a systemic-*Sharī'ah* compliance. IFSI will further grow and flourish if a friendly and neutral taxation system is also created to enable *Sharī'ah*-compliant products stand parallel and competitive with the conventional ones.<sup>823</sup> Supporting infrastructures, accounting standard, human resource, and professional development, participation in global initiatives such as the IFSB, the AAOIFI, and any other necessary non-fiscal measures are vital for the long-term sustainability of IFSI. The standardisation of *Sharī'ah* rulings by the SAC of the BNM also provides a stable regime for an enabling legal framework for Islamic finance in Malaysia. In terms of taxation regime, there are three Acts that directly affect the operation of IFSI in Malaysia. They are, among others, Stamp Act 1949 [Act 378], Real Property Gains Tax Act 1976 [Act 169] (RPGT Act 1976), and Income Tax Act 1967 [Act 53] (ITA 1967).<sup>824</sup>

Due to the restructured contractual relationship between IFIs and customer, and the prohibition of *riba* (interest) under the *Sharī'ah*, the Stamp Act 1949 was amended as Act A723 of 1989, through the promulgation of a new section 14A. Section 14A provides that, "where it is shown that a principal or primary security secures the repayment of moneys provided under a scheme of financing made according to the *Sharī'ah*, duty chargeable thereon shall be calculated on the principal amount provided by the financier or financing body." Pursuant to that section, if the bank grants financing to purchase a mortgage, the amount of the stamp duty chargeable on the contract will be calculated, based on the amount

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<sup>822</sup> Sayyid Tahir, 'Fiscal and Monetary Policies in Islamic Economics: Contours of an Institutional Framework' (2013) 21 (2) 1-22.

<sup>823</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>824</sup> *Ibid.*

provided the bank. Further, to ensure a tax-friendly and neutrality regime between Islamic and conventional financing products, the additional instruments that are required to be implemented in tandem with the *Sharī'ah* are exempted from duty so that the legal position on stamp duty exemption stands parallel to that of the conventional financing product. Section 35 of the Stamp Act 1949 provides, the instruments under the heading of General Exceptions in the First Schedule shall not be chargeable with duty. Also, the scope of the stamp duty exemption is extended to the *sukuk* issuance on behalf of the issuer and investors, provided that the SAC of the SC Malaysia has approved the *sukuk* in question.<sup>825</sup>

In April 2007, a blanket exemption for the real property gains tax (RPGT) was provided by the government. This also applies to disposal of assets from 31<sup>st</sup> March 2007. In the Malaysian Budget for 2010, the blanket exemption has been lifted. The RPGT was set at a fixed rate of 5%, based on the formula provided in the order for all categories of property owners and shareholders. The RPGT imposition did not apply to the first time disposal of residential property in a lifetime, as well as to the transfer between parent and child, husband and wife, grandparent, and grandchildren. Despite the RPGT imposition on 1<sup>st</sup> January 2010, "the disposal of any chargeable asset pursuant to a scheme of financing approved by the BNM, or the Securities Commission as a scheme which is in accordance with the principles of *Sharī'ah*, where such disposal is strictly required for the purpose of compliance with those principles, but which will not be required for any other schemes of financing", under paragraph 3(g) of Schedule 2 of the RPGT Act 1976, are exempted from the Act.

As the prohibition of *riba* (interest) is clear under the *Sharī'ah*,<sup>826</sup> the ITA 1967 makes reference to 'interest' in its various provisions, be it in the computation of taxable income for interest received, or outgoings, and expenses allowed, (during a certain period) including sum payable by way of interest, upon any money borrowed. The ITA 1967 does not contain provisions in respect of profits or gains, and financial expenses pertaining to Islamic banking. The ITA 1967 was amended by inserting a new section 2(7) "any reference to this Act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of

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<sup>825</sup> General Exceptions in the First Schedule include: 6. An instrument executed pursuant to a scheme financing approved by the Central Bank, the Labuan Offshore Financial Services Authority, or the Securities Commission, as a scheme which is in accordance with the principles of *Sharī'ah*, where such instrument is an additional instrument strictly required for the purpose of compliance with those principles, but which will not be required for any other schemes of financing.

<sup>826</sup> *Quran, Surah Al-Baqarah: (2), Verse 275-81.*

interest, in transactions conducted in accordance with the principles of *Sharī'ah*." With this amendment, Islamic banks' customers can enjoy similar benefits in respect of profits or gains, as enjoyed by conventional banks' customers.<sup>827</sup>

#### **6.20.2. The Effective Mechanism for Dispute Resolution: Malaysia's Experience**

To complement the enabling legal framework, an effective mechanism for dispute resolution in IFSI was created. As Malaysia has adopted the dual banking regime, the Malaysia's judiciary system has also undergone an evolutionary phase of its courts' systems, comprising the civil court, and the *Sharī'ah* court. The *Sharī'ah* court's jurisdiction is stipulated under paragraph 1 of the State List in the Ninth Schedule of the FC. In this regard, the *Sharī'ah* Court shall have jurisdiction only over persons professing the religion of Islam, and in respect of any of the matters prescribed under paragraph 1 of the State List. The Ninth Schedule of the Federal List (List I) of the FC also includes, inter alia, item 7, which includes 'banking, money lending, pawnbrokers, control of credit, bills of exchange, cheques, promissory notes, and other similar instruments.' As such, there have been a number of cases involving Islamic banking, as held by the civil court in Malaysia. In the case of *Bank Islam v. Adnan Omar*,<sup>828</sup> BIMB has filed a suit in the High Court for recovery of money pursuant to a guarantee. The defendant raised a preliminary issue that the civil court had no jurisdiction to hear the case on the ground that the plaintiff was an Islamic bank. This is in view of Article 121(1A) of the FC, which provides that the High Court does not have jurisdiction in respect of any matter within the jurisdiction of the *Sharī'ah* Court. The preliminary objection was overruled. The matter of banking comes within the Federal List of the Ninth Schedule of the FC. Bank Islam is a body corporate, possessing no religion, and cannot not be subjected to the *Sharī'ah* courts' jurisdiction.<sup>829</sup> It thus connotes, only the civil court has the jurisdiction to hear cases involving Islamic banking transactions. The *Sharī'ah* court is not an adequate forum to decide over Islamic banking cases.

In *Tinta Press Sdn. Bhd. v. Bank Islam Malaysia Bhd*<sup>830</sup>, *Dato' Hj. Nik Mahmud bin Daud v. Bank Islam Malaysia*<sup>831</sup>, and *Arab-Malaysian Finance Bhd. v.*

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<sup>827</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>828</sup> *Bank Islam v. Adnan Omar* [1994] 3 CLJ 735.

<sup>829</sup> *Ibid.*

<sup>830</sup> *Tinta Press Sdn. Bhd. v. Bank Islam Malaysia Bhd.* [1987] 1 CLJ 474.

<sup>831</sup> *Dato' Hj. Nik Mahmud bin Daud v. Bank Islam Malaysia Bhd.* [1996] 4 MLJ 295.

*Taman Ihsan Jaya Sdn. Bhd. & Ors*,<sup>832</sup> the civil court made their decisions, based on the Common Law principles of contract. Although references were made to *ijarah*, *qardul hassan*, *bait bithaman ajil*, there was no discussion of such concepts from the point of view of the *Sharī'ah*. This denotes, during that juncture of history, the Islamic finance maturity was still gaining its momentum, and had not reached the level of readiness to be dealt comprehensively, with the standpoint of the *Sharī'ah*, banking, and the Common Law principles of contract. As the civil courts assumed their jurisdiction, it would not be feasible to transfer Islamic finance cases to the *Sharī'ah* courts. This will necessitate legislative amendments, and the statutory elevation of the *Sharī'ah* courts, and their jurisdictions. Disputes over Islamic banking transactions which have arisen thus far, do not involve Islamic law only, but involve the application of other statutes under the civil law, such as the National Land Code 1965 [Act 56], the Contracts Act 1950 [Act 136], of which the *Sharī'ah* court has no jurisdiction, plus that the *Sharī'ah* court judges are not trained in and not familiar with. The power of enforcement and remedies available in the *Sharī'ah* courts are very limited. Islamic banking customers are not just the Muslims, but also the non-Muslims. The *Sharī'ah* court does not have the jurisdiction over the non-Muslims, and neither can the non-Muslim lawyers appear in the *Sharī'ah* courts.

In this regard, Zulkifli Hassan and Mehmet Asutay categorised Islamic finance cases in Malaysia into three phases of evolution.<sup>833</sup> The first phase covered a period between 1979-2002, where it was examined that in that phase, the courts decided in favour of Islamic banks, as they were more concerned with the application of Common Law, emphasising the civil and technical aspects, and did not tackle the actual *Sharī'ah* issues.<sup>834</sup> The second phase covered a period of 2003-2007. The courts indicated their intention to examine critically, the underlying principles and financing facility offered by the IFIs.<sup>835</sup> The third phase covered a

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<sup>832</sup> *Arab-Malaysian Finance Bhd. v. Taman Ihsan Jaya Sdn. Bhd. & Ors* [2008] 5 MLJ 632. In this case, Justice Abdul Wahab Patail explained that "... [t]he civil court's function, in this case, to render a judicially considered decision before it according to law and not apply Islamic law as if it were a *Sharī'ah* court. Its function is to examine the application of the Islamic concepts and to ensure that the transactions in the cases before it do not involve any element not approved in Islam."

<sup>833</sup> Zulkifli Hasan and Mehmet Asutay, 'An analysis of the Courts decisions on Islamic finance disputes' (2011) 3 (2) *ISRA International journal of Islamic finance* 41-71.

<sup>834</sup> Hasan and Asutay (n 853). The main cases that were referred to were: (i) *Tinta Press Sdn Berhad v BIMB* (1987) 1 MLJ 474; 1 CLJ 474 (ii) *Bank Islam Malaysia Berhad v Adnan Omar* [1994] 3 CLJ 735; [1994] 3 AMR 44; [1994] 4 BLJ 372 (iii) *Dato' Nik Mahmud Bin Daud v Bank Islam Malaysia Berhad* [1996] 4 MLJ 295 (iv) *Bank Islam Malaysia Bhd v Shamsuddin Bin Haji Ahmad* [1999] 1 LNS 275; [1999] MLJ 450 (v) *Bank Kerjasama Rakyat Malaysia Bhd v Nesaretnam Samyveloo* [2002] 8 CLJ 95; [2002] 7 MLJ 103.

<sup>835</sup> *Ibid.* The cases that were referred to were: (i) *Bank Kerjasama Rakyat Malaysia Berhad v Emcee Corporation Sdn. Bhd.* [2003] 2 MLJ 408; 1 CLJ 625 (ii) *Sea Oil Mill (1979) Sdn Bhd & Anor v Bank*

period of 2008-2010 had witnessed the legal reality of the High Court ruling in the case of *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*, where the judgment marked the beginning of a proactive attitude of the civil courts in examining the validity of Islamic banking practices, and determining the issues involved in Islamic banking cases.<sup>836</sup>

Taking into account these phases of evolution in Islamic finance disputes, the BNM issued a Recommendation 5.10 of the BNM's Master Plan, proposing the establishment of a committee to establish a *Sharī'ah* Commercial Court, dedicated to deal with legal matters on Islamic banking, and *takaful*. The Recommendation proposed training programmes for judges and lawyers on Islamic banking and *takaful*. To facilitate the litigation process at this *Sharī'ah* commercial court, a comprehensive Islamic Commercial Code was proposed to be introduced to lend support to existing regulatory laws, governing Islamic finance. This has brought to the establishment of a dedicated High Court to adjudicate all *muamalat* cases in the Commercial Division of High Court in Kuala Lumpur. Practice Direction No. 1 of 2003 was issued by the Chief Judge of Malaya to all legal practitioners in Malaysia to register Islamic banking and finance cases at both the High Courts, and the lower courts, using a special code number. These initiatives raised the bar of legal and Islamic finance maturity in IFSI, and legal fraternity including the judiciary, legal professionals, bankers, and IFSI's professionals, as well as simultaneously increasing the public confidence in Islamic banking and finance in Malaysia.

In addition to the effective mechanism for resolution of disputes availed through the court system, IFSI can stand to benefit from the available arbitration procedures for the alternative dispute resolution mechanism. To reduce the court process, cases involving the high scale financing facilities can be adjudicated, and

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*Kerjasama Rakyat Malaysia Berhad* [2003] MLJ 207 / [2003] 1 LNS 718 (iii) *Bank Islam Malaysia Berhad v Pasaraya Peladang Sdn Berhad* [2004] 7 MLJ 355; (iv) *Tahan Steel Corporation Sdn Bhd v Bank Islam Malaysia Berhad* [2004] 6 CLJ 25; [2004] 6 MLJ 1 (v) *Arab Malaysian Merchant Bank Berhad v Silver Concept Sdn Bhd* [2005] 5 MLJ 210 (vi) *Malayan Banking Berhad v Marilyn Ho Siok Lin* [2006] 7 MLJ 249; 3 CLJ 796 (vii) *Affin Bank Berhad v Zulkifli Abdullah* [2006] 3 MLJ 67 (viii) *Malayan Banking Berhad v Yakup bin Oje & Anor* [2007] 6 MLJ 398.

<sup>836</sup> *Ibid*. The cases that were referred to were: (i) *Bank Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd* [2008] 1 CLJ 784; [2007] MLJ 722 (ii) *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631; [2009] 1 CLJ 419 (iii) *Light Style Sdn Bhd v KFH Ijarah House (Malaysia) Sdn Bhd* [2009] CLJ 370; [2009] 1 LNS 193 (iv) *Majlis Amanah Rakyat v Bass bin Lai* [2009] 2 CLJ 433 (v) *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor And Other Appeals* [2009] 6 CLJ 22; [2009] 6 MLJ 839 (vi) *Tan Sri Khalid Ibrahim v Bank Islam Malaysia Berhad* [2009] 6 MLJ 416 (vii) *Bank Islam Malaysia Bhd v Azhar Osman & Other Cases* [2010] 5 CLJ 54 [2010] 1 LNS 251.

decided in an arbitral forum. To that end, the international and domestic legal framework must be enhanced, and well-equipped, to cater for such a scale in IFSI. Mediation or reconciliation are also enshrined by the *Quranic* worldview as well as the practice of the Prophet Muhammad PBUH. Today, conciliation (*sulh*), mediation (*wasta*), and arbitration (*tahkim*) have been widely implemented in the Muslim world. As the *Sharī'ah* enjoins good (*amr bil maruf*) and prevent wrongdoing (*munkar*), access to justice (*'adl*) is not merely about the existence of the courts alone to resolve disputes, but also the informal dispute resolution mechanisms in Islamic banking and finance.<sup>837</sup> Arbitration in Malaysia is regulated under Arbitration Act 2005 [Act 646], which applies to arbitration proceedings that arise out of a written agreement, unless the arbitration agreement is contrary to public policy.

Although Malaysia currently adopts the centrality regime of *Sharī'ah* supervision in Islamic finance under the purview of the SAC of the BNM, it is not a clear-cut confirmatory case-study that IFSI would eternally bind themselves to the authority of a sole panel of *Sharī'ah* scholars, especially when faced with disputes worth millions and billions of dollars. To further provide various options for an efficient mechanism to resolve Islamic finance disputes at the national, regional, and international levels, IFIs can bring their disputes to be adjudicated under the auspices of the International Islamic Centre for Reconciliation and Commercial Arbitration of Abu Dhabi,<sup>838</sup> established in 2005 by the Islamic Development Bank and the Government of UAE, and the Kuala Lumpur Regional Centre for Arbitration (today known as the "Asian International Arbitration Centre AIAC", with its Rules of Arbitration for Islamic Banking and Finance Services 2007).<sup>839</sup> In addition to the contract-specific solutions in Islamic financial contracts, a planned agenda that ensures continuous improvement in competency of Islamic finance professionals, bankers, lawyers, and judges are necessitated so that the level of Islamic finance maturity can be raised in IFSI, alongside the transparency, certainty, and predictability of *Sharī'ah* rulings, and court decisions. Alternative methods of dispute resolution such as mediation, conciliation, and arbitration should be enhanced for the effective dispute resolution in Islamic finance.

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<sup>837</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 43.

<sup>838</sup> Islamic Centre for Reconciliation and Commercial Arbitration of Abu Dhabi, <<https://government.ae/en/information-and-services/justice-safety-and-the-law/litigation-procedures/alternative-methods-to-settle-disputes/-key-arbitration-institutions>> accessed 23 October 2018.

<sup>839</sup> AIAC Rules of Arbitration for Islamic Banking and Finance Services 2007 <[https://arbitrationlaw.com/sites/default/files/free\\_pdfs/KLRCA%20Arbitration%20Rules%20%28Banking%20%26%20Financial%20Services%29.pdf](https://arbitrationlaw.com/sites/default/files/free_pdfs/KLRCA%20Arbitration%20Rules%20%28Banking%20%26%20Financial%20Services%29.pdf)> accessed 23 October 2018.

### 6.20.3. The Enforceability of Islamic Financial Products

It has been examined that the Malaysian High Courts had often made their decisions based on the Common Law principles of contract, although there had been some positive developments that took into account the *Sharī'ah* application in Islamic financial contracts, through the promulgation of the SAC's role, and the SGF 2010. In this regard, the role and stature of the English Common Law as an important legal reference cannot be overlooked for the continuous operation of the international framework for Islamic finance, and the enforceability of the Islamic financial products, nationally, and globally. The English courts have been chosen as a proper forum to deal with various transactional matters, particularly those pertaining to the enforcement of contracts. The roles of the English courts have often been called for, to deal with issues arising under Islamic financial contracts. The English Common Law is often applied and referred to, instead of implementing a pure application of the *Sharī'ah*.<sup>840</sup> The reference to the *Sharī'ah* in Islamic financial contracts has raised legal difficulties in the past, concerning the interpretation, application, and implementation of Islamic financial contracts in various jurisdictions. When the *Sharī'ah* is applied into an alien environment, the English Common law, or any other law governing the interpretation, application, implementation, and enforcement of Islamic financial contracts, the *Sharī'ah* standpoints may be overlooked, although the contracts are restructured to morph into a different contractual form to make it *Sharī'ah*-compliant.<sup>841</sup> It is a fallacy to assume that the *Sharī'ah* can stand on its own, within the existing legal and procedural environments that incorporate both the practice of the English Common Law principles of contract and the *Sharī'ah* in Malaysia's legal framework, as well as the international framework for Islamic finance. Further, it would be impractical to incorporate, interpret, and implement all the *Sharī'ah* rules in Islamic financial contracts, without having to understand, and apply the legal enforceability regime of Islamic financial contracts, nationally, and internationally.

For the purposes of the enforceability of the Islamic financial contracts, the documents and instruments adopted in Islamic financial products must not only be *Sharī'ah*-compliant, but also legally-compliant and viable with the existing procedural law in force, so that the restructured Islamic financial products can be made legally enforceable in the civil courts. Regardless whether the SSB or the SAC

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<sup>840</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>841</sup> *Ibid.*

may have approved the Islamic financial products, the hybrid nature of these enforcement proceedings may culminate into legal conflicts between the Common Law principles of contract versus the *Shari'ah*.<sup>842</sup> Such legal conflicts will be further exposed to various legal challenge. The judges, although may refer the matter to the SAC for a binding authority on *Shari'ah*-related issues in Islamic financial contracts, they may also apply the Common Law, or Malaysia's law of contracts to decide the matter, holistically, and legally.<sup>843</sup> This is unavoidable because, notwithstanding the SAC's *Shari'ah* rulings, the procedure within which the Islamic financial contracts are made legally enforceable are applied by the mechanism of a civil procedure code. Where a case involves the cross-border enforceability of Islamic financial contracts, the international procedural rules should be resorted to, such as the 2010 UNCITRAL Rules of Arbitration (the UNCITRAL Rules), and the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the 'New York Convention').

At the international level, the application of the English Common Law becomes more crucial with regard to the issue of enforceability of Islamic financial contracts. In *Dana Gas PJSC v Dana Gas Sukuk Ltd*<sup>844</sup> case, a legal challenge was made to the validity and enforceability of \$700million Islamic bonds (*sukuk*) under the English law. The legal challenge was made on the grounds of interpretation, mistake, and public policy, in which the claimant's payment obligations were unfounded. It was held by the English High Court that, the English Common Law governing the undertaking was valid, and enforceable, in accordance with its terms, even if all relevant obligations were unlawful and unenforceable under the UAE law, including on the grounds of an alleged *Shari'ah* non-compliance. In *Musawi v RE International*,<sup>845</sup> it was held that the Rome Convention does not apply to arbitration agreements. The English Common Law requires the governing law of an arbitration agreement to be the law of a country. Although section 46(1)(b) Arbitration Act 1996 enables the disputing parties to elect principles other than the law of a country (for example, *Shari'ah*) for resolution of a dispute, its provisions do not extend to the governing law of the arbitration agreement. In *Beximco Pharmaceuticals v Shamil Bank of Bahrain*,<sup>846</sup> the Rome Convention limits the governing law of a contract to the law of a country. In this regard, the disputing parties may incorporate into the 'governing law' clause a specifically identified provision of a foreign law, such as the

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<sup>842</sup> Ibid.

<sup>843</sup> Ibid.

<sup>844</sup> *Dana Gas PJSC v Dana Gas Sukuk Ltd* [2017] EWHC 2928 (Comm).

<sup>845</sup> *Musawi v RE International* [2007] All ER (D) 222 (Dec).

<sup>846</sup> *Beximco Pharmaceuticals v Shamil Bank of Bahrain* [2004] EWCA Civ.19.

*Sharī'ah*. But the general reference to *Sharī'ah* without reference to, or identification of, any specific aspects of the *Sharī'ah* was not adequate, for the incorporation. In *Al Midani v. Al Midani*,<sup>847</sup> it was held that a judgment of the Islamic *Sharī'ah* Council was not binding on parties who did not consent to its authority and jurisdiction. The Islamic *Sharī'ah* Council, described itself as 'extra-judicial', was not a national court, an arbitral tribunal, or a judicial body.

Thus, in a nutshell, for the international framework for Islamic finance to be made legally viable, it is important that the characteristics for (i) an enabling legal environment; (ii) effective dispute resolution mechanism; and (iii) the enforceability of Islamic financial contracts, be developed and made apprised of the interaction with the English Common Law, the Civil Law, and even the public and private international law application, governing the substantive and procedural issues of disputes. Malaysia's legal and regulatory framework encompassing the above-mentioned characteristics could be exemplified as an exploratory case-study.

## **6.21. International Framework for Islamic Finance: 'Meta-dependence' Trust and Confidence Re-examined**

As critically examined in the case-study of Malaysia, the characteristics of an enabling legal environment, effective dispute resolution mechanism, and the enforceability of Islamic financial products are vital for the IFSI to operate in a legally viable ecosystem of banking and finance.<sup>848</sup> These legal characteristics are also vital for the viable development of the international framework for Islamic finance.

Further, on a more global scale, trust and confidence have been critically examined as the key determinants for the global economic and financial system of governance, without which the entire global banking operation, its payment system, cross-border finance, and the flow of capital cannot confidently operate. From the dependent-interdependent relationship to the meta-dependence analysis of trust and confidence, the dedicated and the non-dedicated institutions that promulgate IFSI comprise a body of professionals from diverse cultural backgrounds and multi-verse legal systems, who have been working to develop and cater the overall development of the international framework for Islamic finance. Their endeavours

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<sup>847</sup> *Al Midani v. Al Midani* [1999] All ER (D) 188.

<sup>848</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

contribute to enhance the trust and confidence<sup>849</sup> for the international framework for Islamic finance. At the global financial governance level, the conventional banking framework is seen to be supervised and monitored by the BCBS, particularly the recommendations to increase capital adequacy and liquidity requirements for banks. For the international framework for Islamic finance, Islamic banks have been recommended to comply with Basel II and III,<sup>850</sup> whilst the IFSB, modelled by the BCBS, provides guidance to the IFSI. This conscious reality depicts an enabling international environment for the co-existence of both the conventional and Islamic banking systems to operate in a highly dependent-interdependent relationship, and 'meta-dependence' trust and confidence.

At this juncture of history, the fact remains that the Islamic banking and finance is still at its embryonic stage of development.<sup>851</sup> Islamic finance is still being developed with a cautiously optimistic outlook towards a more innovative development with respect to various Islamic banking products. In this vein, Islamic banking and finance are seen as not being progressive enough to venture into exciting innovations in modern banking and finance. Efforts towards a more innovative product origination, innovation, and development have been carried out, but the core of the execution endeavours must be made in compliance with the *Sharī'ah*. There is no perfect solution to develop the international framework for Islamic finance, as IFSI continues to grow and the market is experiencing various experimentations and ways to promulgate an enabling legal environment, effective mechanism of dispute resolution, and enforceability of Islamic financial products.<sup>852</sup> It is indeed a living framework, based on trust and confidence,<sup>853</sup> which is continuously being nurtured and augmented.

As a matter of global governance system underpinned by the international legal framework, the establishment, development, and promulgation of various international standards, guidelines, rulings, rules, and principles for the global implementation of Islamic finance by various international institutions should be able to create an enabling legal environment within which the global governance for Islamic banking and finance could viably operate. The global governance structure consisting of the dedicated and the non-dedicated institutions for Islamic finance has

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<sup>849</sup> Carney (n 66).

<sup>850</sup> Sairally, Muhammad, Munjid Mustafa (n 400) 9-16.

<sup>851</sup> Wilson (n 122) 35-59.

<sup>852</sup> Thani, Abdullah, Hassan, *Legal Aspects of the Malaysian Financial System* (n 16) 134.

<sup>853</sup> Carney (n 66).

engendered trust and confidence amongst IFSI, and other market players. In this regard, the sustainability of the global governance architecture of the international framework for Islamic finance does not dwell merely on the basis of an institutionalist' argumentation, or a liberalist stance, or a realist paradigm to usher for the sustainability of the framework. As examined, trust and confidence are the key determinants for the well-functioning global banking and financial system.<sup>854</sup>

The institutionalists' argumentation propagates for the strength and sustainability of the international institutions, the quality of the international principles, rules-based guidelines, international best practices, hard-law and soft-laws, and various regulatory standards. The realists posit a structural division of power and hegemonic interests to propel for the survivability of the international framework for Islamic finance. A strong power structure and hegemonic political base could usher the long-term trajectory development of the international framework for Islamic finance. The liberalists with a more inward-looking approach would heed the domestic liberalist stance of sovereignty to be maintained in projecting Islamic finance as a vital national development agenda and master plan.

That notwithstanding, the perspectives from the institutionalists, the liberalists, and the realists cannot critically explain and examine a holistic picture as to why and how the international framework for Islamic finance could be sustained, enhanced, or even impeded, in the short-term, and the long-term. The holistic picture should heed the most important and fundamental requirement for the international framework of Islamic finance, which is fundamentally based and enshrined by the *Quranic* worldview of verse 275 of *Surah Al-Baqarah*, which underscores the importance of trade (*bay'*) and the prohibition of *riba* (interest). Whilst trade (*bay'*) is contrasted against *riba* (interest) in terms of the role of labour, this characteristic also recognises the roles of trust and confidence in banking and finance.<sup>855</sup> Since the international framework for Islamic finance is modelled and exemplified in part by the conventional banking model, the key characteristics of trust and confidence, emanating from the bigger share of the conventional banking regime should be able to usher a viable Islamic finance framework, which operates within the broader spectrum of a well-functioning global financial system.

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<sup>854</sup> Authers (n 238) 15-19.

<sup>855</sup> *Quran, Surah Al-Baqarah: (2), Verse 275-81.*

Hence, the characteristics of trust and confidence in the global governance architecture for Islamic finance are of paramount importance.<sup>856</sup> It should be instilled, nurtured, espoused, and embedded alongside the enabling legal framework to back and support the overall banking and finance sector. The approach towards over-regulation and over-supervision is debatable. Hence, in light of these differing approaches, trust and 'meta-dependence trust and confidence' characteristics are to be vested in IFIs, operating their self-based initiative to conduct their professional *Sharī'ah*-compliant mechanism. Accordingly, a more regulated regime of Islamic finance framework could be developed with more trust and confidence in IFIs.

Further, it is also the trust and confidence of the public, market players, and the entire banking and finance industry participants that must be garnered in order to ensure that any form of banking and financing activities, trade (*bay'*), business, and commercial transactions that take place do not run afoul of the trust and confidence vested in respective IFIs in developing their *Sharī'ah*-compliant products.<sup>857</sup> It will be cataclysmic if banking and finance operate without the trust and confidence. In the age of uncertainty, the 'meta-dependence' trust and confidence should be instilled, lest a panic-stricken environment is triggered, it can cause contagious bank runs, leading to massive withdrawal by depositors, and thereby eroding the trust and confidence vested in the existing system and financial architecture.<sup>858</sup> Likewise, it is the trust and confidence in the international framework for Islamic finance that are examined to be key characteristics for the framework. Last but not least, the basis upon which the *Quranic* worldview is espoused for Islamic finance, and the promulgation of numerous *Sharī'ah*-compliant standards and principles for the international framework contribute to the analysis of 'meta-dependence' trust and confidence in the international framework for Islamic finance.

## 6.22. Conclusion

The paramount importance of trust and confidence in the international framework for Islamic finance has been critically examined throughout the thesis. This Chapter further reinforces such a role. The *Quranic* worldview, as enshrined by verse 275 of *Surah Al-Baqarah* can be seen to have been translated into the modern context of espousing the roles of trust and confidence in the contemporary

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<sup>856</sup> Carney (n 66).

<sup>857</sup> Ng., Ibrahim and Mirakhor (n 241) 239-250

<sup>858</sup> Carney (n 66).

professionalisation of modern banking practices in IFSI, but where the interest (*riba*) imposition is concerned, it is prohibited. In this regard, although the international framework for Islamic finance is largely modelled by the conventional banking structure, the global market still vests the trust and confidence in both the conventional and Islamic banking and finance frameworks.<sup>859</sup>

The dual banking and financial systems in Malaysia are mutually reinforcing. Trust and confidence are vested in the well-functioning conventional banking system, and accordingly, the development of Islamic banking framework through a dual banking system in Malaysia. The room for improvement and innovation is still vast for the IFSI and the international framework for Islamic finance such as the innovation of Islamic derivatives in the market. To that end, the creative evolution of the international framework for Islamic finance should be enhanced with the trust and confidence, or 'meta-dependence' trust and confidence.

The *Quranic* worldview enjoins trade (*bay'*), but prohibits the engagement with *riba* (*interest*), and the two affairs are contrasted in terms of the roles of labour in Islamic finance.<sup>860</sup> Thus, the wider utilitarian benefit (*maslahah*) geared towards better financial inclusion, VBI, and financial stability that IFSI could bring, propels the international framework for Islamic finance to operate on the basis trust and confidence, and 'meta-dependence' trust and confidence including the deference towards the *Sharī'ah*, and the *Quranic* worldview, complemented and supported by an enabling legal environment, an effective dispute resolution mechanism, and a viable mechanism for the enforceability of Islamic financial contracts.

Further, Malaysia's active dual banking system, comprising two recent legislations i.e. the FSA 2013 and the IFSA 2013, and the promulgation of the SGF 2010 serve as an exploratory case-study. Malaysia is a heavily regulated model for the promulgation of the international framework for Islamic finance. The centralised SAC's model, espoused by sections 56-57 of BNM Act 2009 and the SGF 2010 has enabled better standardisation, harmonisation, and certainty with respect to *Sharī'ah*-compliance. It also creates spill-over effects to allow an optimal regulation, and prevents the race to the bottom through the adoption of an optimal *Sharī'ah*-compliance standard, issued at the central level of the SAC.

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<sup>859</sup> Authers (n 238) 15-19.

<sup>860</sup> *Quran, Surah Al-Baqarah: (2), Verse 275-81.*

Be that as it may, the lack of a centralised *Sharī'ah* governance framework will accommodate the local differences, allow varying experimentation and creativity in IFSI, and induce greater accountability on the IFIs. In light of the landmark decision in the case of *JRI Resources v. Kuwait Finance House*<sup>861</sup>, regarding the constitutionality of the SAC under the BNM, this Chapter concludes that Malaysia is an exploratory case-study for espousing the international framework for Islamic finance, either in the context of its promulgation of the FSA 2013 and the IFSA 2013, or its two-tier *Sharī'ah*-governance model, which tends to prominently accentuate the roles of the SAC of the BNM.

The way the international framework filters into Malaysia's national framework for Islamic finance can be examined in the manner that IFSB-15 (Revised Capital Adequacy Standard for Institutions Offering IFS (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes) published by the IFSB was expected to commence the implementation in compliance with the *Sharī'ah*, and within the legal and regulatory framework in which Malaysia implements its Islamic finance, and this includes the compliance with the Basel requirements on capital adequacy. Further, in terms of accounting standards, the MASB agreed that IFRS should be applicable to IFIs as well, although it was noted that the IFRS did not adhere to the *Sharī'ah*.<sup>862</sup> It has been examined that to have a separate set of accounting standards would be costly and redundant.<sup>863</sup> Thus, although there have been accounting standards developed by the AAOIFI, the reality is that the IFRS is recognised in the global financial system. IFIs operating in western-based jurisdictions also need to comply with the IFRS. The IFRS is the *lingua franca* of financial reporting, whilst AAOIFI accounting standards have not been fully accepted, even in the context of MASB in Malaysia.

In light of these analysis, this Chapter concludes its critical examination of Malaysia as an exploratory case-study by recognising the greater roles and powers of the BNM, emerging as a stronger regulator to safeguard and maintain the overall financial stability in Malaysia, conventional and Islamic banking included, as the BNM has been legally mandated, and statutorily empowered by the present Malaysia's legal and regulatory framework to implement both the conventional and Islamic banking systems and frameworks.

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<sup>861</sup> *JRI Resources v. Kuwait Finance House*<sup>861</sup> [2009] MLJU 275

<sup>862</sup> Mohamed, Ahmad, and Mohd Fahmi (n 524) 33-38.

<sup>863</sup> *Ibid.*

## **Chapter Seven: Conclusion and Recommendations**

### **7.1. Introduction**

This Chapter is the final chapter of this study. This Chapter summarises the entire issues, research areas, and salient topics of critical examination, as analysed in each Chapter of this study. Further, this Chapter provides the justification and the examination of research originality, research findings, a summarised version of the international framework for Islamic finance, recommendations to academia, IFSI, professionals, and regulators. This Chapter also highlights areas of future research, and provides the overall final conclusion.

### **7.2. Research Originality**

This research is original, significant, and contributory towards novel scholarly works on Islamic banking and finance, focusing on, and examining the international framework for Islamic finance. The above-mentioned characteristics of research originality are underscored as the foregoing.

First, this is a pioneering study based on an inter-disciplinary research approach. It examines the international framework for Islamic finance, consisting of the dedicated and the non-dedicated international institutions for Islamic finance. This research undertakes a multi-dimensional analysis to examine the international framework for Islamic finance. The study and examination, as carried out in each chapter are critical, and to the extent possible, guidance-driven to develop and theorise the international framework for Islamic finance, and also, to actualise it within the conscious reality of the present global financial system. The existing research on the international framework for Islamic finance lacks the coherent and comprehensive study in explicating a holistic examination of the international framework for Islamic finance. If at all, the studies on the international framework for Islamic finance are conducted, they are sector-oriented, polarised, and segmented in their respective areas of research. Further, this study of the international framework for Islamic finance has made a critical examination of the past, present, and future issues facing the global financial system, as well as the Islamic financial system. This interdisciplinary study is also examined in a scholarly context by

tackling *Shari'ah*-compliant requirements and their issues in the most pragmatic way possible, having regard to the conscious reality of IFSI and IFIs that are exposed to the evolving financial regulatory landscape, global financial crisis, and the regime of international law-making dynamics.

Second, as this study is pioneering to map out the international framework for Islamic finance (see **Figure C**), the study does not undertake a dogmatic approach of conducting a theological-based research. But the *Quranic* worldview is examined as an active archetype towards the development of the international framework for Islamic finance. Various verses, and *Surahs* from the *Quran*, being the primary source of the *Shari'ah*, and for the international framework for Islamic finance have been examined, and deliberated in this study. This integrated research heeds the divine injunctions of the *Quranic* worldview, and examines the manner in which the *Quranic* worldview, contributes as a 'meta-dependence' analysis, for the trajectory development of the international framework for Islamic finance.

Third, following from the *Quranic* worldview, this study has identified and examined the key determinates that contribute towards the development of the international framework for Islamic finance, i.e. the trust and confidence. In the age of uncertainty and 'unknown-unknown', the characteristics of trust and confidence are analysed and examined together with another tool of analysis. It is introduced and examined by this study as the 'meta-dependence' trust and confidence. The trust and confidence, the 'meta-dependence' trust and confidence analysis, and the *Quranic* worldview contribute to the scholarly works of this study. This analytical contribution heeds the modern banking context, and the operation of Islamic finance, and examines the trajectory trust and confidence, within the international framework for Islamic finance. Further, the trust and confidence, the 'meta-dependence' trust and confidence analysis, and the *Quranic* worldview are examined within the modern international framework for Islamic finance, which has been legally supported by the creation of an enabling legal environment, an effective dispute resolution mechanism, and the need for an enforceability of Islamic financial products. The GFSN, including ILOLR, SLOLR, depositor's protection, and ring-fencing mechanism have been examined to complement and augment the international framework for Islamic finance, alongside the roles of the key institutions such as the IFSB, the AAOIFI, the IIRA Rating, the Islamic *Fiqh* Academy of *Fatwa*, and Basel III, for the purposes of *Shari'ah*-compliance and implementation by IFIs.

Fourth, and last but not least, Malaysia has been examined and concluded in this research as an exploratory case-study. This partially *Shari'ah*-based jurisdiction is examined in terms of its dual banking system, regulated by the BNM Act 2009, the IFSA 2013, the FSA 2013, and the promulgation of the SGF 2010. This examination is contributory towards an exploratory case-study for the international framework for Islamic finance. Although the study on the SGF 2010 has been commented by various literatures, this study has made a critical examination on the implications of the SGF 2010, and the centralised SAC's model under the BNM. The regulatory implications for the centralised model may contribute towards better standardisation, harmonisation, and certainty with respect to *Shari'ah* rulings' compliance, create spill-over effects to allow an optimal regulation, and prevent the race to the bottom through the adoption of an optimal *Shari'ah*-compliance standard. The lack of a centralised *Shari'ah* governance framework, using a self-based regulation would accommodate the local differences, allow varying experimentation and creativity in IFIs, and induce greater accountability on the IFIs. The FSA 2013 and the IFSA 2013 have also been examined and compared. The implication of the case of *JRI Resources v. Kuwait Finance House* with respect to the constitutionality of the SAC's roles were examined to be unprecedented. Hence, the *Shari'ah* Governance model in Malaysia is not a yet stable regime as future new legal challenges may still arise. This constitutes another new dimension for this thesis, which concludes that Malaysia is an exploratory case-study. To examine the larger context of the international framework for Islamic finance, the *Shari'ah* governance framework in the *Shari'ah*-based jurisdiction, and the secular-based jurisdiction are examined. The UK, as an Islamic finance hub is prognosticated to remain the leading western jurisdiction despite Brexit, because of the ubiquitous use of the English language in Islamic financial contracts, the use of Common Law in Islamic financial disputes, and the juridical seat of London for an international dispute settlement forum.

### **7.3. Research Findings**

Having regard to the *de jure* and the *de facto* implementation of the international framework for Islamic finance, this study which aims to answer two questions, has gathered its research findings, as the foregoing. First, the study has examined and answered its main research objective, which is to identify the key determinants that enhance, or impede the international framework for Islamic finance. The study has answered this question, by examining the roles of trust and confidence as the key determinants that contribute and enhance the international

framework for Islamic finance. The characteristics of trust and confidence are further examined alongside the 'meta-dependence' analysis of trust and confidence, and the *Quranic* worldview, as novel scholarly contributions. This has answered the question that the existing international framework for Islamic finance is not impeded by the current global financial architecture, but rather enhanced by the characteristics of trust and confidence. In the age of uncertainty, a 'meta-dependence' analysis of trust and confidence are provided as an analytical tool within which, the international framework for Islamic finance can rely on. Further, the impediments towards further progress for the international framework of Islamic finance are identified and examined, such as Islamophobia, the clash of civilisations, war, and the lack of a supportive legal environment that constitute hindrance towards the adoption of Islamic finance. This study does not offer a perfect-solution, but is conscious of the enhancing and impeding factors that can affect the international framework for Islamic finance. Thus, the 'meta-dependence' trust and analysis, and the *Quranic* worldview are examined in light of the 'meta non-dependence' trust and confidence, owing to the reasons of the 'unknown-unknown'.

Secondly, and related to the first objective, the study has answered the question of whether Malaysia can be used as a model for Islamic finance. To this end, this study has analysed and examined that Malaysia can be used as an exploratory case-study, instead of a confirmatory one. This is due to several reasons, highlighted as follows.

First, the choice of Malaysia as the main focus is due to its dual banking model, consisting of the conventional banking model and the Islamic banking model, and the centrality of its *Shari'ah* governance mechanism, operating the international framework for Islamic finance, with much creativity, but is still guided by the central banking regime of the BNM and the SAC of the BNM, playing a strong role to guide IFSI in Malaysia. Further, Malaysia is a progressive jurisdiction in terms of its legal and regulatory framework, providing an enabling legal environment that accommodates IFSI flexibly, in terms of aligning IFSI with the Basel standards with that of the IFSB, as well as the domestic banking requirements. Further, Malaysia is a partially *Shari'ah*-based jurisdiction with a unique historical background of its own, having its own written FC as the supreme law of the land. Where its dual banking systems are concerned, the conventional banking system and the Islamic banking system are governed by the FSA 2013, and the IFSA 2013, respectively. The SGF 2010 has also been examined as part of the critical analysis in this study. This study

has examined and found that the FSA 2013, the IFSA 2013, and the SGF 2010 are still experimental, and no empirical evidence can be provided at this juncture to affirm that this framework as a confirmed model for the case-study, and for the international framework for Islamic finance. Malaysia's model is an exploratory case-study, but it is also exemplary in light of its initiatives and endeavours to develop the Islamic finance framework, such as the *Sharī'ah* governance framework, the creation of an enabling legal environment, the creation of an effective mechanism for dispute resolution as well as the enforceability of Islamic financial products.

Second, Malaysia's model is exploratory because it is a progressive partially-*Sharī'ah* based jurisdiction that has managed to interpret the *Quranic* worldview, and the *Sharī'ah*, in the contemporary context of Islamic banking and finance, nationally, and internationally. Such a progressive stance is examined through Malaysia's active promulgation of *Sharī'ah*-compliance requirements for IFSI via a statute-based framework like the BNM Act 2009, the FSA 2013, the IFSA 2013, soft-law framework such as the SGF 2010, and active encouragement of the adoption of international standards and principles as issued by Basel, IFSB, AAOIFI, IIRA Rating, etc. Thus, Malaysia's framework is not yet a confirmatory model.

Third, as an exploratory model, Malaysia's framework is critically examined to be a heavily-regulated model, which is prone to over-regulation and over-supervision by the SAC and the BNM. This heavily regulated model has its own legal and *Sharī'ah*-compliance implications. The SAC model can enable better standardisation, harmonisation, and certainty in IFSI with respect to *Sharī'ah*-compliance requirements, create spill-over effects to allow an optimal *Sharī'ah*-compliance regulation, and prevent the race to the bottom through the adoption of an optimal *Sharī'ah*-compliance standard. The lack of a centralised *Sharī'ah* governance framework such as self-based initiative and regulation would allow IFSI to accommodate the local differences, allow varying experimentation and creativity in IFSI, and induce greater accountability on the IFIs, instead of being heavily regulated and supervised by the sole SAC in a jurisdiction.

#### **7.4. International Framework for Islamic Finance**

This research is a study of the international framework for Islamic finance, spanning across its global governance structure, consisting of various international

institutions with a focus of Malaysia as an exploratory case-study. The international framework for Islamic finance has been analysed, and critically examined as follows.

First, the historical examination of the global financial system was deliberated in Chapter One, analysing the institutional standpoints of the global financial system, systemic and regulatory paradigms of the global financial framework, the Bretton Woods system, the fiat-based system, and the LIBOR system. This Chapter concluded that capitalism survived as the prevailing paradigm that prompted the development, and progress of global banking and finance. For Islamic finance, it co-exists with the conventional banking model, as it is modelled largely therefrom. Thus, within the global financial system, Islamic finance can be construed to operate side-by-side with the conventional banking system as Islamic banking system and its structure follows largely the conventional banking ecosystem, with an additional requirement of the *Shari'ah*-compliant mechanism.

Second, the international framework for Islamic finance was further examined in Chapter Two. The dedicated institutions for Islamic finance, and the non-dedicated institutions for Islamic finance were identified, examined, and mapped out. The list in **Figure C** was not exhaustive, but sufficient for the purposes of the critical examination of this study. This Chapter examined the regime of the international law-making dynamics, focusing on the key dedicated institutions and the non-dedicated institutions for Islamic finance. The dedicated institutions that were examined were, IFSB, IIFM, AAOFI, IDB, IAIB, ICD, IIRA, Dow Jones Market Index, the Islamic *Fiqh* Academy, and CIBAFI. The non-dedicated institutions were the World Gold Council, BCBS, LIBOR, IMF, and the World Bank. The synergies between these institutions were mutually reinforcing in promoting the stability and the inter-operability of the global financial system.

Third, the philosophical foundation for the international framework for Islamic finance is critically analysed and examined in Chapter Three. Trust and confidence characteristics have been examined as the key determinants that contribute and enhance the international framework for Islamic finance. Further, the *Quranic* worldview and the 'meta-dependence' analysis of trust and confidence, as well as the 'meta non-dependence' analysis of trust and confidence were examined for the purposes of novel scholarly contributions in this study. Also, it was examined and concluded that the trust and confidence characteristics were not only vital for the

conventional banking system, but also crucial towards further professionalising IFSI, and the international framework for Islamic finance.

Fourth, as IFIs are prone to the global financial crisis, the international framework for Islamic finance should be equipped to identify measures that can withstand the global banking and financial crisis. Chapter Four critically examined this recurring phenomenon in the context of Islamic finance and *Shari'ah*. As the study by Rogoff/Reinhart has demonstrated the cyclical patterns of banking and financial crisis since the 1930s' Depression to 2010, the international framework for Islamic finance heeds the lessons learnt from the various measures adopted by sovereign countries to weather the economic recessions, including measures adopted by Malaysia to manage the Asian financial crisis in 1997-98. The GFSN measures such as the LOLR, the SLOLR or the potential ILOLR, alongside the ring-fencing mechanism, and the deposit protection scheme, were critically examined for the purposes of availing the international framework for Islamic finance with the GFSN that is *Shari'ah*-compliant to manage the financial crisis and IFIs facing financial distress. Whilst moral hazard was cautioned, Basel III's recommendations on liquidity, and IFSB's risk management mechanism were examined so that the financial crisis could be responded to *ex-ante*, and where the financial crisis hit, an *ex-post* intervention was justified to safeguard and maintain the well-functioning financial system. The ethical finance, the behavioural finance, and the *Quranic* worldview were also examined in Chapter Four to justify the need for an intervention in the market as the overarching purpose was to safeguard and maintain the financial stability. In relation to liquidity risks faced by IFIs in the event of financial crisis, the monetary and regulatory authorities' role was to ensure that the liquidity infrastructure was neutral and strong enough to address the challenges of the global financial crisis. In the context of Islamic finance, the impact of the proposed Basel III requirement to maintain sufficient cushion of high quality liquid assets had been carefully considered, as the infrastructure and tools for liquidity risk management by Islamic banks was still in its infancy in many jurisdictions. A very narrow definition of liquid assets could unnecessarily exacerbate liquidity risks in many Islamic financial markets, in which Islamic banks were to compete with conventional counterparts, for the limited stock of *Shari'ah*-compliant government securities. As a consequence, IFIs could incur more compliance costs, as the market could be rendered illiquid when the demand exceeded the supply, placing IFIs at disadvantage.<sup>864</sup> Thus, the

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<sup>864</sup> Tan Sri Zeti Akhtar Aziz, former BNM Governor, 'Enhancing the Resilience and Stability of the Islamic Financial System' Regulators Forum, Global Islamic Finance Forum: Special Session on

international framework for Islamic finance shall equip itself with sufficient liquidity regime to facilitate the development of IFIs, and to withstand the financial crisis.

Fifth, as the international framework for Islamic finance operates within the operative rules of international law, it was underscored in Chapter Five that international law has served as a backdrop for the purposes of development of the international framework for Islamic finance. Thus, having regard to the status of international law in treaty-making exercises, and the promulgation of soft-law framework, an enabling international legal environment was created to develop various principles, standards, guidelines, and international ratings, as developed by the IFSB, the AAOIFI, the Islamic *Fiqh* Academy of Fatwa, the IIRA Rating, the Dow Jones *Shari'ah* Indices, the IMF, and the Basel III on Capital Adequacy Requirement. As the UK has emerged as the leading western hub for Islamic finance, her position might remain unchanged, despite Brexit. Further, the international law making process is dynamic. It has required a conscious examination of negative externalities such as war, Islamophobia, and the clash of civilisations. In spite of these negative externalities, the creative evolution for Islamic derivative has taken place in the international framework for Islamic finance.

Sixth and last but not least, the international framework for Islamic finance was studied in Chapter Six, by examining Malaysia as the case-study. Malaysia, as a partially *Shari'ah*-based jurisdiction was critically examined as an exploratory and exemplary case-study. The way international framework for Islamic finance filters into the national framework is by adoption of the Basel standards, compared to voluntary IFSB standards, IFRS instead of the AAOIFI's standards. Further, the exploratory dual banking regime, as regulated and supervised by the IFSA 2013 for Islamic banking and finance sector, and the FSA 2013 for the conventional banking and finance sector, were examined alongside the critical examination of the roles of the SAC under the BNM. The SAC is the sole authoritative body on *Shari'ah* issues in Islamic banking and finance in Malaysia. This heavily regulated model was critically compared with other jurisdictions, adopting a self-based regulatory mechanism. The regulatory implications were critically examined. The SAC regime has created better standardisation, harmonisation, stability, and certainty for *Shari'ah*-compliance, but the lack thereof, created a flexible experimentation of *Shari'ah*-compliance products by IFIs. In light of the recent case of *JRI Resources v.*

*Kuwait Finance House*, in relation to the constitutional challenge on the SAC's roles, the prognosis that this study concluded was, Malaysia's model was an exploratory model, and not a confirmatory one, to prognosticate a model for the international framework for Islamic finance. The essence of the international framework for Islamic finance lies in the characteristics of trust and confidence. Where the legal and regulatory framework is concerned, the creation of an enabling legal environment, the effective dispute resolution mechanism, and the enforceability of Islamic financial products are necessitated. Further, the *Quraniq* worldview, as well as the 'meta-dependence' analysis have contributed as novel scholarly contributions for the trajectory development of the international framework for Islamic finance.

## 7.5. Recommendations

Islamic finance has not yet reached its full potential. Within the next decade, the savings of the world's then 1.6 billion Muslims may be placed in Islamic banks. The global *takaful* market is estimated to reach USD14.4 billion, by 2020. Currently, most IFIs are highly liquid, but this does not prevent IFIs to continuously experiment diversifying their new asset classes and markets to embark, and diversify in project finance. Therefore, the study recommends that there should be a clear policy direction and market demand, and the requisite legal measures that can be implemented to establish an enabling legal environment that facilitates a harmonious interface between the *Shari'ah*, the international law, and the respective national legal frameworks. This will ensure transparency, stability, predictability, and minimise commercial risks, and legal uncertainties. Malaysia's heavily regulated model is recommended as an exploratory case-study. The international framework for Islamic finance should be enhanced by efforts undertaken at the international and national levels. This includes the enhancement efforts and initiatives undertaken by the AAOIFI in setting the benchmark of Islamic accounting standards by enhancing clarity, transparency, and harmonisation. The IIFM, in developing global Islamic capital and money market, and promoting active and regulated trading and capital flows. The CIBAFI, in promoting Islamic finance in theory and practice by disseminating *Shari'ah*-compliance concepts, improving IFIs' practices, cooperation, professionalism, and transparency. The IFSB, in complementing Basel's recommendation on capital adequacy, risk management, liquidity, and corporate governance. The LMC, in creating an active inter-bank market by creating secondary market for short-term *Shari'ah*-compliant treasury products, and Islamic liquidity research. The IIRA, as a reference point for IFIs' ratings, *Shari'ah* and credit

quality ratings, and corporate governance ratings, in providing effective tool for informed investment decision-making. A closer collaboration should be developed by these institutions to ensure the well-functioning Islamic financial system. It is also recommended that the international framework for Islamic finance continuously promotes and promulgates consistent commitment and inclusive participation of diverse actors of the international framework for Islamic finance, be it from the secular based-jurisdiction countries, partially *Shari'ah*-based jurisdiction and *Shari'ah*-based jurisdiction countries. This continuous promulgation should not be hampered by any impeding internal and external factors facing the IFSI, but rather be enhanced through active contribution towards reifying an enabling legal environment for IFSI, an effective mechanism for dispute resolution in Islamic finance, and a viable regime for an enforceability of Islamic financial contracts. There is a need to have a committed sponsorship through academic input to formulate a visionary framework and capital sponsorship to further develop the international framework for Islamic finance. Also, there is a need to have a change in mind-set, from the *Shari'ah*-compliant to a more holistic understanding of the *Shari'ah* within the operative banking context, legal and regulatory framework (international and domestic), and future banking landscape. Continuous education and training to all stakeholders should be undertaken to build better understanding, holistic awareness, and constructive engagement between regulators, practitioners, academics, and *Shari'ah* scholars to set a common agenda for the international framework for Islamic finance. It is imperative to build an enabling legal framework for IFSI through the concerted efforts and collaboration between IFIs, industry institutions, regulators, and a wider participation of the critical mass of the society.

## **7.6. Future Research**

As underscored at the outset in the introduction part of this study, the international framework for Islamic finance is a living framework that is responsive to the global financial system landscape and the evolving trends in the global banking and financial ecosystem. The living framework is organic and dynamic, and cannot be a fixed framework that remains stagnant within the existing operative framework. As it currently stands, although the international framework for Islamic finance mimics the conventional banking model, the framework has creatively interpreted and applied the prohibition of *riba* (interest) and the *Shari'ah* within the modern banking and financing ecosystem that is restructured in a manner that Islamic financial products have morphed into different forms that are regarded as *Shari'ah*-

compliant, as compared to their original versions of the conventional contracts. In light of this living framework, this study identifies there are other research areas that can be undertaken in the future to complement the analysis and study of the international framework for Islamic finance. In decades to come, as IFSI continues to grow and develop, future research can be undertaken in the areas focusing on the legal and regulatory framework, dealing with Islamic banks' insolvency regime, cross-border Islamic banks' insolvency and resolutions, types of dispute resolution mechanism, enforceability of Islamic financial contracts, comparative future roles of the UK and Malaysia as Islamic finance hubs, improvisation of the *Shari'ah*-governance mechanism, and other important components of Islamic finance such as *waqf* (Islamic endowment) models, and *zakat* (alms giving) funds system within the international framework for Islamic finance, a cross-border taxation regime for Islamic finance, the depositor's protection regime and the ring-fencing mechanism for Islamic banks, the *Shari'ah*-compliant GFSN, the *Shari'ah*-compliant ILOLR, open banking including the use of mobile and digital banking in Islamic finance, and various other Islamic financial innovations. This study is a pioneering study that is aimed to examine the key determinants that contribute to the development of the international framework for Islamic finance. Trust and confidence, the 'meta-dependence' trust and confidence, and the *Quranic* worldviews constitute the key determinants for this living framework. Other identified areas of research as highlighted above can contribute towards a further study in post-doctoral research in order to complement this study, or constitute a stand-alone topical research.

## 7.7. Overall Conclusion

This study has conducted an examination of the international framework for Islamic finance, encompassing the dedicated and the non-dedicated institutions for Islamic finance, the financial crisis, and the GFSN that must be *Shari'ah*-compliant, and the international law-making dynamics espoused by the IFSB, the AAOIFI, the IIRA Rating, the Islamic *Fiqh* Academy, and the IMF, in promulgating international standards and soft-law instruments for IFSI, and last but not least, Malaysia as a case-study. Although Islamic finance is still relatively small in size, compared to the global financial system, its international operation necessitates a strong and viable framework to ensure a harmonisation of universally accepted standards. At present, the international framework for Islamic finance largely mimics the conventional finance framework, and this makes the conventional rules' framework such as Basel I, II and III, as an appropriate starting point. As the international framework for

Islamic finance is vulnerable to periods of instability, the financial regulation and supervision are vital at the level of international framework for Islamic finance.

Islamic finance continues to function due to the trust and confidence, the 'meta-dependence' trust and confidence, and the *Quranic* worldview, sustaining the international framework for Islamic finance. It is supported by an enabling legal environment for IFSI, an effective mechanism for dispute resolution, and a regime for an enforceability of Islamic financial contracts. The centralised *Sharī'ah* governance and the self-regulatory styles remain as an exploratory research area as the living framework for Islamic finance continues to develop and experiment itself. Malaysia is an exploratory case-study for the prognostication of the international framework for Islamic finance. With an increasing bankable population, linking IFSI to non-IFSI sector, and the real economy, Islamic finance market is growing. This requires robust efforts to safeguard the GFSN to ensure the well-functioning global financial system, and to maintain the global financial stability. IFSI and non-IFSI included. In the future, Islamic finance may no longer be regarded as an alternative source of funding for the purposes of meeting the *Sharī'ah*-compliance requirements, but may be integrated as the mainstream model, as the maturity of legal, banking, financial, and *Sharī'ah* minds are enhanced. Therefore, the efforts towards developing the international framework for Islamic finance are not meant to be exclusively devoted towards Islam and the Muslims, but to safeguard the global financial stability, and ensure the well-functioning financial system in the long run. Last but not least, the findings of this study have further contributed in terms of its examination and finding that, the international framework for Islamic finance is a living framework based on trust and confidence, the 'meta-dependence' trust and confidence, the *Sharī'ah*, the legal and regulatory framework, and the *Quranic* worldview. Indeed, trust and confidence are the key determinants to conduct the affairs of trade (*bay'*), banking, and finance. The *Quranic* worldview has enshrined this fundamental principle within which the international framework for Islamic finance should operate. However, as a living framework, the international framework for Islamic finance should not remain faithful to one particular operational model, but allow its architecture to be improved, enhanced, changed, and developed, except for the *Quranic* worldview of *Surah Al-Baqarah*, verse 275, regarding the enjoinder of the affairs of trade (*bay'*), and the prohibition of *riba* (interest). Indeed, "[v]erily, Allah will not change the fate of people until they change it themselves."<sup>865</sup>

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<sup>865</sup> *Quran*, *Surah Ar-Ra'd*: (13), Verse 11.

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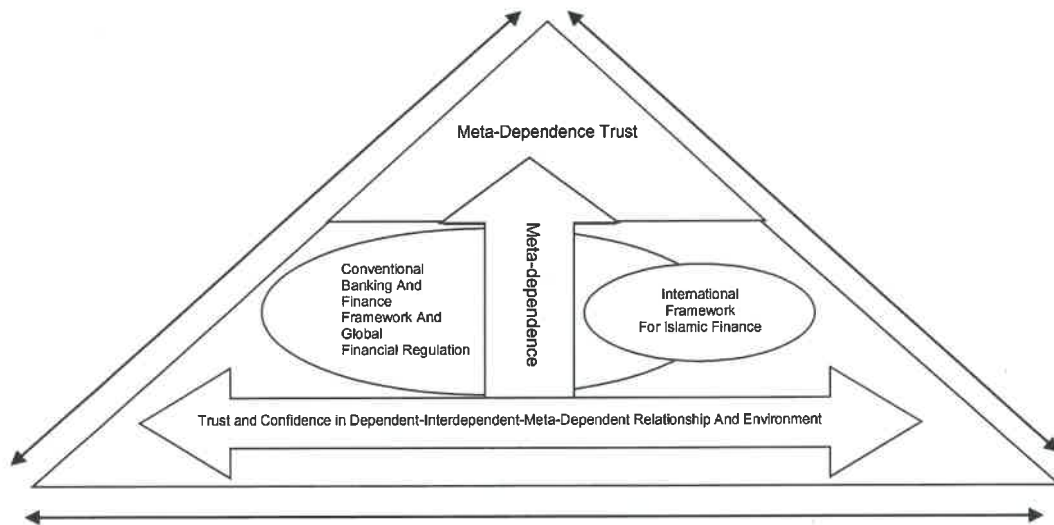
- (1) Charter of the United Nations.
- (2) Statute of the International Court of Justice.
- (3) Vienna Convention on the Law of Treaties 1969.
- (4) Basel Core Principles for Effective Banking Supervision, Basel II, Basel III.
- (5) IFSB Published Standards, Guidance Notes, Technical Notes,
- (6) AAOIFI Governance Standards for IFIs.
- (7) Resolutions by the Islamic *Fiqh* Academy of *Fatwa*.
- (8) IIRA.
- (9) DJMI.

### **Other Cases:**

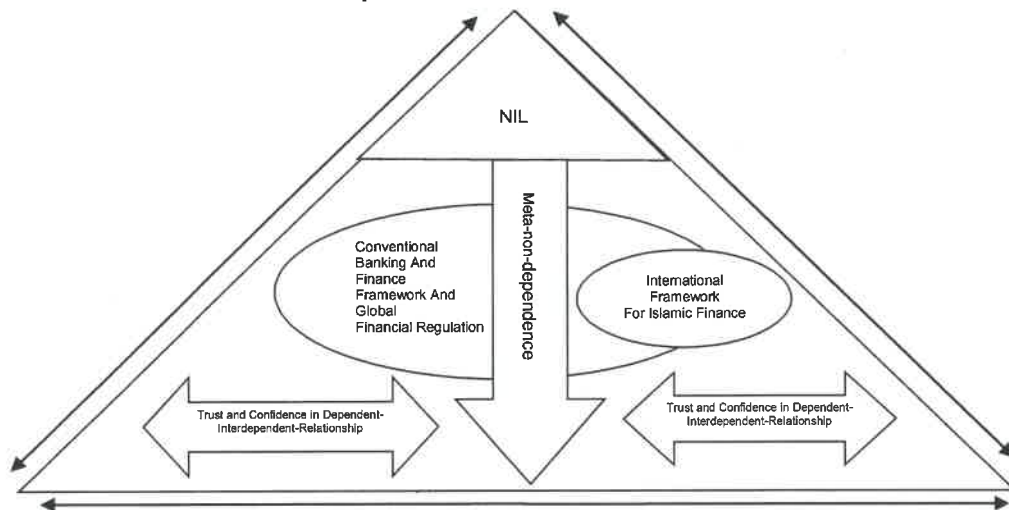
- (1) Al Midani v Al Midani [1999] All ER (D) 188.
- (2) Beximco Pharmaceuticals v. Shamil Bank of Bahrain [2004] EWCA Civ. 19.
- (3) Dana Gas PJSC v Dana Gas *Sukuk* Ltd [2017] EWHC 2928 (Comm).
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- (5) North Sea Continental Shelf (Federal Republic of Germany v. Denmark; Federal Republic of Germany v. The Netherlands), Judgment, ICJ Reports 1969.

## Appendix I

**Figure D<sup>866</sup>**  
**Meta-Dependence Trust and Confidence**



**Figure E<sup>867</sup>**  
**Meta-Non-Dependence Trust and Confidence**

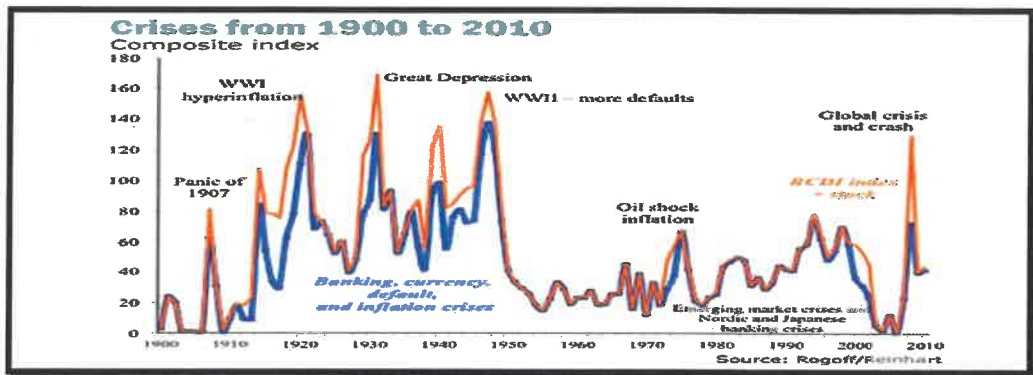


<sup>866</sup> This is author's own construction of a diagram for 'meta-dependence trust and confidence', which is presented in this thesis as a tool of analysis and contribution to the study of the international framework for Islamic finance. **Figure D** shows that international framework for Islamic finance is a system that co-exists and operates side-by-side with the conventional banking system, yet it is still smaller compared to the former, but still relies on the trust and confidence in the overall system of banking and financial stability. Due to the dependent-interdependent relationship in the current age of uncertainty, a 'meta-dependence' trust may be instilled, and espoused for the well-functioning global financial system.

<sup>867</sup> **Figure E** is based author's own construction of a diagram for 'meta-non-dependence trust and confidence', which is presented in this thesis as a tool of analysis and contribution to the study of the international framework for Islamic finance. No trust, no engagement. This can eventually lead to the collapse of trust and confidence in the banking sector, bringing about the 'meta-non-dependence' trust towards the uncertain course of a functional global financial system. Islamic finance too can be affected as its system is dependent-interdependent with the conventional banking system.

## Appendix II

Figure F  
Rogoff/Reinhart Banking Crisis Patterns (1900 to 2010)<sup>868</sup>



It is examined that, thus far, the worst economic downturn was in the 1930s, when the Great Depression occurred. This has led to the study of the Keynesian economics. Since the 2008-2010 recession, the impact has not yet seen to be withered yet, until today. The economic depression is a not normal economic downturn. The Great Depression started with a lingering recession from 1929 to 1933, to which the US did not see its output return to its 1929 to 1933 level, until after entering the World War II in 1941, the output fell sharply, and the unemployment had mounted significantly. In a recession, the Keynesian approach underscores that, it is important to increase the aggregate demand, and this is often done directly through direct fiscal policy measures, such as reducing taxes.<sup>869</sup>

<sup>868</sup> Carmen M. Reinhart, and Kenneth S. Rogoff, 'Is the 2007 US Sub-prime financial crisis so different? An International Historical Comparison' (2008)98(2) American Economic Review: Paper & Proceedings 339.

<sup>869</sup> John Maynard Keynes, *The General Theory Of Employment, Interest, And Money*, (Snowball Publishing, 2012) 4-29.

## Appendix III

**Table 3**  
**Intervention by Financial Authorities in the market.**

No.	Types of Measures and Intervention Approaches	The Global Financial Crisis and Responses
1.	Stimulus Package.	<ul style="list-style-type: none"> <li>(a) The UK Government launched a £35 billion bank rescue plan in October 2008.</li> <li>(b) The US Government approved a US\$162 billion economic packages in February 2008, and subsequently another rescue package worth US\$200 billion in March 2008.</li> <li>(c) China unveiled its economic stimulus package of US\$586 billion in November 2008.</li> <li>(d) The Euro Commission revealed 200 billion Euro economic recovery.</li> <li>(e) Japan unveiled a 5 trillion yen spending package.</li> </ul>
2.	Liquidity Injections/debt guarantees.	<ul style="list-style-type: none"> <li>(a) Japan, Australia, India injected US\$27 billion into money markets in September 2008.</li> <li>(b) The Bank of Japan provided US dollars at fixed interest rates for an unlimited amount against pooled collateral.</li> <li>(c) The US Federal Reserve injected US\$70 billion into the US money market to ease the credit squeeze.</li> <li>(d) The US Federal Reserve announced US\$5 billion rescue package for AIG.</li> <li>(e) Six EU States pledged US\$2.3 trillion in guarantees and other emergency measures.</li> <li>(f) The Hong Kong Monetary Authority pumped HK\$15.5 billion into the banking system in October 2008.</li> <li>(g) The European Central Bank injected 70 billion Euro into money market.</li> <li>(h) European Central banks injected US\$180 billion into the crisis hit markets.</li> </ul>
3.	Interest rate cuts.	<ul style="list-style-type: none"> <li>(a) In Asian economies, the Hong Kong Central Banks lowered its base rate by 525 basis points; China (-216 basis points) and India (-225 basis points).</li> <li>(b) Co-ordinated interest rate cuts by the US and EU by 50 basis points on October 7, 2008.</li> </ul>

No.	Types of Measures and Intervention Approaches	The Global Financial Crisis and Responses
		(c) The US Central Bank lowered interest rate by 425 basis points from 2007 to 2008; the Bank of England (-275 basis points); the European Central Bank (-150 basis points).
4.	Deposit guarantee.	<p>(a) In Asian economies, the Hong Kong Central Banks lowered its base rate by 525 basis points; China (-216 basis points) and India (-225 basis points).</p> <p>(b) Co-ordinated interest rate cuts by the US and EU by 50 basis points on October 7, 2008.</p> <p>(c) The US Central Bank lowered interest rate by 425 basis points from 2007 to 2008; the Bank of England (-275 basis points); the European Central Bank (-150 basis points).</p>
5.	Bank recapitalisation /asset purchase.	<p>(a) The Royal Bank of Scotland, HBOS and Lloyd's received unprecedented £37 billion bail-out from the UK Government.</p> <p>(b) The Bank of England unveiled £50 billion to swap bank risky mortgage debt.</p> <p>(c) Belgium injected €4.7 billion in Fortis bank for a 49% stake.</p> <p>(d) The US unveiled a US\$700 billion Troubled Asset Relief Program.</p> <p>(e) The UK Government injected US\$63 billion into three of the biggest British banks.</p> <p>(f) Malaysia regulated short-selling framework already in place unlike many other markets.</p>
6.	Short-selling ban.	<p>(a) South Korea banned short-selling for local stocks and allowed listed firms to buy back 10 times more of their own shares than previously they could.</p> <p>(b) US temporarily banned short selling in 900 financial institutions. The ban was lifted on 8<sup>th</sup> October 2008.</p> <p>(c) UK banned short-selling in 34 financial institutions stocks until January 16, 2009.</p>
7.	Market closures.	<p>(a) The Russian Stock Exchange halted trading three times since mid-September and delayed trading on 10<sup>th</sup> October 2008.</p> <p>(b) Indonesia suspended trading on the Jakarta Stock Exchange for three days.</p>

