

Legal Protection of Islamic Banks, Challenges and Solutions

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Abstract

The Islamic banking industry is an important part of the financial system in any country that has this type of banking. Islamic banking institutions are regulated by several laws and regulations as same as conventional banks. The Islamic banking Act and general banking law, financial laws, and other related laws are the main piece of law for organizing the Islamic banking system. One of the main challenges that facing Islamic banking institutions is the lack of a legal framework to protect Islamic banking and manage these banks. The legal framework of the Islamic banking industry includes special Islamic banking law and other laws that have relation to Islamic banks such as finance law and company law. The two main legal challenges of Islamic banking institutions is lack of legal framework and lack of Sharia court to deal with disputes and issues relating to Islamic banking cases. thus, it is necessary for Islamic banking institutions to have special Islamic banking law and provisions in other law that they regulate Islamic banking institutions. Therefore, enacting Islamic banking law and amending some other laws to include the Islamic banking industry is needed. Furthermore, establishing a Sharia court to settle Islamic banking cases when there are disputes. Alternatively, appointing Shariah experts and professionals in Islamic banking issues in civil court can be an alternative solution for dealing with Islamic banking cases. **Purpose of The Paper:** The purpose of this study is to find out the legal challenges that face Islamic banks, and then find proper solutions for these challenges. **Methodology and Approach:** The qualitative method-based is applied for this study as qualitative research is a proper method for conducting this type of research. The study uses various documents and content analysis approach to understand and analyse the nature of legal challenges of Islamic banking institutions. In this paper, both primary and secondary materials are part of the data collection. Thus, Acts, books, academic journals are used for collecting data for the purpose of this research. **Findings:** It is found that the current legal framework of the Islamic banking industry needs to be reformed to be a proper legal framework. Therefore, related laws and regulations to Islamic banks should be amended to cover Islamic banking institutions. In addition. Islamic banking Act is necessary to be enacted for regulation Islamic banks. Furthermore, establishing a Sharia court or appointing qualified Shariah scholars in civil court is necessary for resolving legal challenges that face Islamic banking institutions.

Keywords: Islamic Banking, Legal Issues, Shariah Court, Civil Court

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Introduction

Islamic banking sector needs to be regulated as other industries and sectors.¹ Therefore, an adequate legal framework is necessary for the entire Islamic banking system. In order to have a proper legal framework for the Islamic banking industry is vital to look at possible legal challenges of the Islamic banking system. Many challenges are facing Islamic banks in the world, some of these challenges are legal while some others are Shariah challenges. The legal challenges back to the laws and regulations that rule Islamic banks industry, such as Acts, Instructions and court cases, while the Shariah challenges back to the Shariah principles that applied by Islamic banks, such as Shariah boards of Islamic banks and Sharia scholars.

One of the main legal challenges for the Islamic banking sector is the lack of legal protection for the Islamic banks. This challenge arises from a lack of proper Islamic banking law and legal framework. Due to the fact that Islamic banks are regulated by several laws and rules in any country, these laws and rules should contain some provisions for regulating Islamic banks. However, these Acts do not protect Islamic banks from the legal point of view. Like conventional banks, Islamic banks need to be protected from losses that occurred through interest which is prohibited under Sharia law to be practiced by Islamic banks. In many countries, company laws do not

¹ Zainab Belal and Rusni Hassan, LEGAL AND REGULATORY FRAMEWORK OF ISLAMIC BANKING IN LIBYA, Al Mashalih – Journal Of Islamic Law 1 (2018) 2.

mention Islamic banks as a company to be protected as same as other companies.¹ Furthermore, lack of the Sharia courts to deal with Islamic banking cases is another challenge for the Islamic banking institutions in the world. Thus, due to the lack of a special court to deal with Sharia issues and Islamic banking cases, civil courts have this responsibility.² In this context, this paper will focus on Islamic legal challenges to find a proper solution for them.

Fundamental Principles of Islamic Banking System

The main source of the Islamic banking system is the Quran and Hadith which prohibit the payment and receipt of interest (*riba*). Furthermore, the sharing of profit and loss is the fundamental principle of the Islamic banking system. The theoretical basis of the Islamic finance system goes beyond the interaction of factors in production and economic behaviour. Whereas the conventional banking system focuses principally on the economic and financial aspects of transactions, which is based on interest. Hence, receiving and paying interest is allowed under the conventional banking system or it can be said that interest is a main part of the conventional banking system. The Islamic system places equal emphasis on the ethical, social, and religious dimensions, to boost justice for the good for the entire humanity. As a result, this is a crucial reason that Islamic banks today have attracted significant attention worldwide. Nevertheless, both the Islamic and the conventional banking institutions have a commercial basis, and they work for making profits. The point that differentiates conventional banks from Islamic banks is that philosophies in the Islamic financial system focus on social justice and equality.³

Hence, Islamic banking propounds the central philosophies of profitable risk-sharing and not unfair risk-transfer, with its elementary doctrines being the prohibition against interest and *gharar* (uncertainty). In Islam, interest is considered illegal regardless of the amount involved and there is no such thing as an acceptable amount of interest. As conventional banking is mostly interest-based, an alternative is given. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)⁴ has formally recognized numbers of Islamic financial tools, four of these tools are most commonly used in the world by Islamic financial institutions, are *Murabaha* (mark-up), *Ijarah* (leasing), *Musharakah* (partnership) and *Sukuk* (Islamic bonds).⁵

Therefore, the Islamic banking system is different from the conventional banking system in the risk-sharing principle. As in a conventional banking system, the risk remains to the bank while in an Islamic banking system, the risk is shared between both the Islamic bank and the client. In that context, one of the aforementioned transactions is applied between the Islamic banks and their clients. According to the profit and loss sharing principle, Islamic banks and their clients share in profits and losses which is the way that Islamic banking transactions are conducted under Sharia law. Besides the Shariah principle, Islamic banking institutions are regulated by several laws and regulations. The main law for Islamic banking institutions is Islamic Banking Law, which exists in some countries while in others not.

Laws and Regulations of Islamic Banking Industry

Some several laws and regulations regulate Islamic banking institutions in different ways. Some of these laws are special for the Islamic banking system while some other laws regulate the financial sector in general. Islamic Banking Law is a special Act for regulating Islamic banks while general banking law, company law, and investment law are general Acts. Having special Islamic banking law in any country can be a good reason for developing Islamic banks in that country. For instance, Malaysia has a supportive Islamic banking Act for the regulation and supervision of Islamic banks. Islamic Financial Services Act 2013 in Malaysia is the main Act for regulation Islamic banks in this country.⁶ As stated in the PART II of the Act:

“The principal regulatory objectives of this Act are to promote financial stability and compliance with Shariah and in pursuing these objectives, the Bank shall— (a) foster— (i) the safety and soundness of Islamic financial institutions; (ii) the integrity and orderly functioning

¹ For instance, looking at Iraqi Company Law No. 21 of 1997 (as amended in 2004), does not refer to Islamic banking industry.

² Shamim Njeri Kinyanjui, Challenges Facing the Development of Islamic Banking. Lessons from the Kenyan Experience, European Journal of Business and Management 5 (2013) 97.

³ Reyadh Mohamed Seyadi, Legal Aspect of Islamic Finance, ARAB LAW QUARTERLY 29 (2015) 2.

⁴ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a Bahrain based not-for-profit organization that was established to maintain and promote Shariah standards for Islamic financial institutions, participants and the overall industry. AAOIFI, About AAOIFI, <https://aaoifi.com/about-aaoifi/?lang=en> Accessed 27 February 2021.

⁵ MOHD YAZID BIN ZUL KEPLI, ISLAMIC FINANCE IN SINGAPORE: LEGAL AND REGULATORY CHALLENGES, Singapore Law Review 31 (2013) 280-281.

⁶ Mohamad Akram Laldin and Hafas Furqani, Islamic Financial Services Act (IFSA) 2013 and the Sharī'ah-compliance requirement of the Islamic finance industry in Malaysia, ISRA International Journal of Islamic Finance 10 (2018) 97.

of the Islamic money market and Islamic foreign exchange market; (iii) safe, efficient and reliable payment systems and Islamic payment instruments; and (iv) fair, responsible and professional business conduct of Islamic financial institutions; and (b) strive to protect the rights and interests of consumers of Islamic financial services and products”¹

Furthermore, the Philippines Islamic Banking Act No. 11439, 2019 is a special Islamic banking law for regulation Islamic banks in this country.²

In contrast, some countries do not have special Islamic banking law, and Islamic banks are regulated by general banking law which regulates both Islamic banks and conventional banks such as in Kuwait. The Islamic banking institutions in Kuwait are regulated by the Central Bank of Kuwait (CBK). the Central Bank of Kuwait and the Organization of Banking Business.³ CBK Law is the same piece of legislation that provides for the Islamic banking regulatory and supervisory framework and sets the requirement for the Shariah Governance framework.⁴ Thus, the CBK Law comprises 4 chapters wherein Islamic banking provisions which were part of the amendment in 2003, are placed under section 10 of Chapter III.⁵ The Chapter deals with the organization of the banking business in general.

Lack of Protection Law for Islamic Banking Institutions

The Islamic banking system is based on Sharia law which is prohibited to deal with interest as it is against religion. Besides Shariah law, man-made law regulates Islamic banking institutions. Therefore, there is a necessity for enacting laws and regulations to protect Islamic banks from being part of the conventional system. The current laws and regulations are enacted for the conventional system rather than the Islamic system. Thus, Islamic banks are not protected from being treated on an interest-based. Most of the laws were designed based on conventional banking systems before the commencement of Islamic banking and finance. however, there is no serious effort had been made to change these conventional systems to be suitable for Islamic banks, except few simple and basic changes introduced in some aspects in some states.⁶

In that context, Islamic banks are not protected from dealing with transactions that contain interest if there no changes to the current laws that apply to Islamic banks, such as company law, financial law, commercial law, and general banking law. In that sense, looking at the aforementioned laws and Acts, it can be noted that all these laws in many countries are designed for the conventional system. Therefore, for resolving the issue of the lack of protection law for Islamic banks, it is necessary to amend all laws and regulations that applied to the Islamic banking sector. In addition, enacting a special Islamic banking law and a special protection law for Islamic banks can be recommended as a good solution for protecting Islamic banks to be treated as same as conventional banks that is because as most Islamic countries’ existing banking regulations are based on the western system.⁷ the law should facilitate Islamic banking transactions in order to offer Islamic banking services to clients.⁸ Furthermore, central banks have to deal with Islamic banks in a different way as dealing with conventional banks, as these two banks have a different system and different laws and regulations. Furthermore, Islamic banking professionals should have their role in resolving legal challenges that faced the Islamic banking industry by suggesting a proper solution to the central banks and lawmakers. In general, the legal framework of the Islamic banking industry could be reformed to reduce the legal challenges of the Islamic banking system. The reform should cover all legal and Shariah aspects of the Islamic banking system.

¹ Act 759 Islamic Financial Services Act No 759- 2013, Part II, 6.

² Zico Law, Islamic banking Act passed in Philippines, 2019 <https://www.zicolaw.com/resources/alerts/islamic-banking-act> accessed 26 February 2021.

³ [Islamic Banking Law in Kuwait](https://www.zicolaw.com/resources/alerts/islamic-banking-act), Suapi Shaffai, < <https://islamicfinanceupdates.wordpress.com/islamic-banking-law-in-kuwait>> accessed 26 February 2021.

⁴ Central Bank of Kuwait, CBK Law, Islamic Banking, < <https://www.cbk.gov.kw/en/legislation-and-regulation/cbk-law/chapter-three>> accessed 26 February 2021.

⁵ CBK Law, Chapter Three, Section 10, Article 86 – 100.

⁶ Sekoni, Abiola, Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System, IIUM Institute of Islamic Banking and Finance (IiBF) Malaysia, Munich Personal RePEc Archive, (2015) 7.

⁷ Sekoni, Abiola, Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System, IIUM Institute of Islamic Banking and Finance (IiBF) Malaysia, Munich Personal RePEc Archive, (2015) 11.

⁸ Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (1st edn, Routledge 2011) 122.

Lack of Special Islamic Court for Islamic Banks

Courts have a significant role in settling disputes between different parties in society. Usually, civil courts come to mind when there is talking about disputes. In fact, the statement is true because the role of civil courts cannot be dined in resolving problems and disputes. However, when the matter is related to Islamic banking cases and disputes the Sharia court could be the best option. Even though Sharia court does not exist in many countries for settling down Islamic banking cases, then civil court interferes in this situation.

Therefore, the lack of a Shariah court is another challenge that faces Islamic banks when there is a dispute between Islamic banks and their clients. In most of the countries in the world, Islamic banking cases are referred to civil court. However, the judges who are appointed in this court are not specialized in Shariah-related matters¹ including Islamic banking and finance. Consequently, the challenge that faced Islamic banks in the court is a significant issue for Islamic banking institutions. This issue is general for Islamic banks in almost all countries in the world. However, in Malaysia is issue has been solved to some extent. Thus, in Malaysia when there is an Islamic banking case in the courts, the courts are to decide Shariah issues on Islamic banking, they are required to refer to the Sharia Advisory Council which is a central Sharia committee in Malaysia, rulings or resolutions to avoid counter-Shariah judgments.²

The member of the civil court usually judges from a civil background and most of them do not know about Islamic banking and finance. Therefore, the decision that is made by those judges may not be the right decision. The Malaysia approach could be a good example for resolving the issue. However, it is not the best solution as referring to the rules of the Sharia Advisory Council of Negara Malaysia is not compulsory.³ Thus, the court may not return to these documents of the Sharia Advisory Council. Therefore, there should be a better solution for this challenge.

It can be said that establishing a special court for Islamic banking and finance cases or Shariah court is recommended for resolving the problem of lack of a special Islamic court that deals with matters in Shariah or matters related to Islamic finance. The special Islamic court can decide on cases within Islamic banking and Islamic finance. the best example is Indonesia as Islamic banking legal cases in Indonesia fall under the authority of the Religious Courts. Law No. 3 of 2006 the amendment of Law No. 7 of 1989 renewed by Law No. 50 of 2009, dispute resolution through litigation is under the purview of the Religious Courts.⁴ Hence, the Sharia court in Indonesia is an important part of the development of Islamic finance.⁵ Any Islamic banking cases and disputes in Islamic finance will be referred to the religious court in Indonesia. The member of the Shariah court should be judges and experts in Islamic finance. They should know about both Shariah and legal aspects. They should have basic knowledge in modern finance as most of the Islamic cases are related to modern finance.

Another solution for the Islamic banking court challenge is appointing financial experts in the civil court. Hence, any Islamic banking case that goes to the civil court can be dealt with by those experts who are knowledgeable in Islamic banking and finance. The appointed member should be qualified in resolving Islamic banking cases. These members should have knowledge in legal, Sharia, finance, and banking system.

Conclusion

Islamic banking institutions facing several challenges that affect this development and slow down the development of the industry and these challenges are legal and Shariah in their nature. The two main challenges faced by Islamic banking institutions are first, lack of a legal framework for the Islamic banking industry and second is lack of a special Sharia court for resolving the issue related to Islamic banking cases. lack of special Islamic banking law is the main problem for Islamic banks. In addition, other laws and regulations such as

¹ Zulkifli Hasan* and Mehmet Asutay, AN ANALYSIS OF THE COURTS' DECISIONS ON ISLAMIC FINANCE DISPUTES ISRA International Journal of Islamic Finance 3 (2011) 50.

² Ishaq El-Mubarak, A. M. O, Zakariya Mustapha, Abdul Majid Tahir Bin Mohamed and Garba Ibrahim, Laws of Islamic Banking in Nigeria: Critical Review and Best Practice Proposal, International Journal of Academic Research in Business and Social Sciences 10 (2020) 40.

³ Hakimah Yaacob, 'The New Central Bank of Malaysia Act, 2009': Enhancing The Integrity and Role of the Shariah Advisory Council (SAC) in Islamic Finance' 2010, Research paper, International Shari'ah Research Academy for Islamic Finance (ISRA), 1, 8.

⁴ Atharyanshah Puneri, Ilhamiddin Ikramovich Nazarov, Moustapha Chora Ahmat and Muhamad Ikhwan Arif, The Litigation Process in Handling Murabahah Cases: A Comparative Study between Malaysia and Indonesia, *International Journal of Management and Applied Research* 6 (2019) 307

⁵ Nuha Qonita, THE EMERGENCE OF LEGAL SYSTEM IN ISLAMIC FINANCE, *Jurisdictie: Jurnal Hukum dan Syariah* 9 (2018) 79.

company law, finance law, and general banking law do not refer to Islamic banks in their provisions. Therefore, Islamic banking institutions have the problem of an adequate legal framework to regulate the Islamic banking industry. Another challenge facing Islamic banking institutions is the lack of a special Sharia court to deal with Islamic banking cases. In most countries, civil courts deal with Islamic banking cases when there is a dispute. However, judges in civil courts to some extent do not have knowledge of Sharia-related issues and Islamic banking cases. Judges in civil court have a legal background in manmade-law rather than Shariah law. In this context, when a civil court makes a decision on any Islamic banking case maybe not an accurate and not right decision.

For resolving the legal challenge of Islamic banking institutions, this study recommends that enacting a special law for protecting the Islamic banking industry is necessary. Furthermore, the laws and regulations that have relation to the Islamic banking system should be amended to cover Islamic banks. It is the responsibility of the central bank to have its role in resolving challenges facing Islamic banking institutions. Establishing a special Sharia court for dealing with Islamic banking cases could be a possible solution for the lack of a Sharia court. The members of this court should be qualified members and scholars who have knowledge in Shariah, legal and fiqh. Another recommendation is to appointing some qualified members in the civil court to deal with Shariah issues and Islamic banking cases when there is a dispute.

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