

Muhammad bin Ibrahim: The polemics of governing law in Islamic finance – recent developments and the way forward

Keynote address by Mr Muhammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the International Shariah Research Academy for Islamic Finance–Institute of Islamic Banking and Insurance (ISRA-IIBI) 2nd Annual International Thematic Workshop 2010: “The Polemics of Governing Law in Islamic Finance”, London, 29 November 2010.

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Let me first thank the organizers for inviting me to speak at this ISRA-IIBI 2nd Annual International Thematic Workshop 2010. Although I very much regret not being able to be in London in person, I am thankful for the many advances of modern technology for the opportunity to briefly address all of you this morning. I am also happy to note that this event is a continuation of international collaboration between the organizers, the International Shariah Research Academy for Islamic Finance (ISRA), the Institute of Islamic Banking and Insurance (IIBI) and Thomson Reuters, following the success of the inaugural workshop held last year. The theme of this year’s workshop, “*The Polemics of Governing Law in Islamic Finance: Recent Developments and the Way Forward*”, is most apt. With the emergence of Islamic finance as a new growth area in the global financial landscape, this Workshop provides an excellent forum to exchange views and information on topical legal issues in Islamic finance. As Islamic financial activities are increasingly crossing national boundaries, it is critical for more such dialogues to take place at an international level, in order to gain wider perspectives that can contribute to the development of a legal framework for Islamic finance that is internationally facilitative.

Islamic finance today has become a major industry worldwide with over 300 institutions and an estimated asset size of more than USD1 trillion. Its continuing advances in the international financial landscape have recently been accompanied by several major efforts aimed at strengthening its international financial infrastructure. A key structural enhancement achieved recently was the establishment of the Islamic Financial Services Forum (IFSF) that serves as a platform for cross-border engagement among regulators to achieve financial stability in the Islamic financial system. Another important development achieved more recently was the establishment of the International Islamic Liquidity Management Corporation (IILM) as a mechanism for more efficient management of liquidity across borders for Islamic financial institutions. These continuing efforts to strengthen the foundations of Islamic finance have served to ensure its preparedness in meeting the challenges on the path of internationalisation. As we open a new chapter of global growth and development with the unfolding of a new decade, Islamic finance is in a position of strength to play a greater role in the global financial landscape.

Today, many jurisdictions are interested in Islamic finance and have taken initiatives to develop the industry. The increasing interest in Islamic finance is a positive development as a larger number of institutions can contribute to more rapid growth of the industry. An increasing number of jurisdictions are now taking steps to modify their legislations to cater for Islamic finance. Ireland earlier this year published its Finance Bill 2010 which introduced significant amendments that are aimed at facilitating Islamic finance. France has also taken significant steps to push through changes to their tax and legal codes. Australia, Jordan and Lebanon are all reportedly working towards reviewing their legislations to be accommodative to Islamic finance. Given the importance of developing a supportive legal system, these global moves augur well for sustainable global growth of Islamic finance. In light of this development, I would like to make some remarks on the evolving legal framework for Islamic finance. In sharing my thoughts, I will draw heavily on some of the strategies and initiatives undertaken by Malaysia.

One of the key determinants for successful development of Islamic finance in any jurisdiction is the existence of a conducive legal framework that supports the operations and growth of the industry. Given that the legal infrastructure in any jurisdiction has evolved over the centuries to cater for conventional finance, understandably, governing legislations of a country have typically required modifications to accommodate Islamic financial transactions and structures. It is therefore of no surprise that jurisdictions that are able to quickly amend their legal framework have managed to achieve significant growth in Islamic finance.

The starting point in revising laws is therefore to ensure that the governing laws allow for the conduct of Islamic finance business. A closely related goal is to consider removing elements in existing laws, including the non-regulatory laws, which may render the conduct of Islamic finance business uncompetitive or inefficient. Initial considerations would involve changes to ensure that Islamic finance is placed on a level playing field with conventional finance. The purposes and objectives of the governing laws for Islamic finance are known to be largely similar to conventional finance from the financial regulation standpoint. Notwithstanding this, an ideal approach is devising a legal framework for Islamic finance that sanctions the statutory obligations for Shariah compliance in the governing law. This approach however, may not be feasible as preference for religions concerns can be seen to be contradictory to the principles of secularism and parity of beliefs rights in certain jurisdictions. We may need alternative approaches. I will revisit and elaborate on these points in greater detail at a later part of this speech.

In Malaysia, the new Central Bank of Malaysia Act 2009 explicitly codifies the duality of the Malaysian financial system which shall consist of the conventional financial system and the Islamic financial system. In this regard, Malaysia has taken the approach to enact regulatory laws that are, at least for banking and *takaful* (Islamic insurance) industry, separate from conventional finance as the legal foundation for the conduct of Islamic finance business. This approach has proven to be successful and critical in instilling public confidence in the Shariah integrity of the industry. Whilst enacting a separate governing law avoids the trap of confining the scope and operation of Islamic finance within the mould of conventional finance, this approach has proven in Malaysia to be the most efficient way possible to regulate Islamic finance.

Recently, Malaysia has undertaken the initiative to establish a Law Harmonisation Committee with the main objectives to review existing Malaysian laws which are applicable to Islamic financial transactions and to propose necessary amendments to give legal recognition to Islamic financial transactions under the law. The mandate of the Committee extends beyond those that are regulatory in nature to include all laws relevant to execute the whole chain of Islamic finance practices. The desired outcome of the Committee's work is the creation of laws that are facilitative, contemporary, and easily enforceable. Another objective is to provide facilitative legal framework for the Islamic finance industry and develop Malaysian laws as the law of choice for international Islamic financial transactions. This initiative is consistent with our continuous effort to foster an efficient, innovative and competitive Islamic financial system, given the more globalised and liberal operating environment within which Islamic finance will operate.

The consideration for evolving the legal framework in Islamic finance would not be complete without extending due regard to the robustness of Shariah governance framework. This is inevitable given that Islamic finance has its roots in Shariah. The overarching requirement for an Islamic financial institution is to ensure that its objectives and operations are in accordance with Shariah. In Malaysia, our experience suggests that mandating this requirement in the laws governing Islamic finance is fundamental not only in the context of defining the business scope of an Islamic financial institution, but also in preserving the sanctity of Shariah in Islamic finance.

This legal mandate is also crucial for the Bank to take supervisory and regulatory remedy against an Islamic financial institution, which may include revocation of licence, in cases,

where a violation by the institution poses reputational risk that might cause an erosion of confidence and could threaten the systemic stability of the Islamic financial system. The integrity and credibility of Shariah governance framework in Malaysia is also fundamentally supported by the role of the Bank's Shariah Advisory Council (SAC), a centralized referral body for Islamic finance community, which is statutorily positioned as the highest authority in the determination of Shariah matters relating to Islamic finance. In preserving the sanctity of the Shariah, the SAC itself ensures the robustness of its rulings through a rigorous process before arriving at a decision.

Another essential element in developing an effective legal infrastructure is the role of an adjudication system. A supportive adjudication system in the context of Islamic finance is one which can authoritatively enforce the principles of Shariah in dispute settlements involving Islamic financial transactions. An efficient and authoritative adjudication system helps create certainty and establishes the legitimacy of Islamic financial contracts. Islam places great importance on contracts and on parties to a contract. The ability of parties to enforce a contract is thus critical as it constitutes the core of maintaining the confidence of the public at large. Therefore, there is a crucial need for a dispute settlement mechanism that is able and competent to dissect in a judicious manner Shariah matters in contracts, so that issues of dispute in Shariah interpretation could be resolved and enforced accordingly. Whilst it is neither practical nor desirable to change the entire court system, a potential solution is to create a special Islamic bench that deals with financial transactions undertaken in accordance with the Shariah. This could be a viable option particularly for Muslim majority countries, as is the case in Malaysia. The use of market discipline is another option to ensure the sanctity of Shariah via mandating sufficient check and balance in adherence to Shariah matters including a minimum disclosure requirement, certification by the Shariah committee or an external audit done on the Shariah compliance aspects of an institution's operations.

In Malaysia, we have taken the approach in ensuring that the sanctity of contracts is always paramount and enforceable in our court of law. For adjudication purposes, a dedicated judge in the commercial division of the High Court in Malaysia has been assigned to preside over litigations relating to Islamic banking and finance. The court's adjudication role in Islamic finance is reinforced by the support from the SAC in its capacity as a consultative body to the Malaysian judiciary system. Under the law, the Central Bank of Malaysia Act 2009 prevails, if a question concerning a Shariah matter arises in any proceedings relating to Islamic financial business, where the court or the arbitrator shall take into consideration any published rulings of the SAC or refer the matter to the SAC for its ruling. The SAC's rulings are binding on the courts and arbitrators. This referral system preserves and enhances the sanctity of Shariah rulings and the consistency in the interpretation and application of Shariah principles in Islamic financial transactions. To complement the court system, specific arbitration rules for Islamic banking and financial services have also been developed, enabling disputes for both domestic and international cases to be dealt with by the Kuala Lumpur Regional Centre for Arbitration (KLRCA).

Such comprehensive legal infrastructure for Islamic finance is unique to Malaysia and essentially reflects the support and dedication by the legal fraternity in keeping abreast with the development of Islamic finance. Adding to the strength of the institutional and legal framework in Malaysia is our continuing emphasis on human capital development. Various measures have been implemented to ensure that our market players, including the judges and lawyers, are well-trained in Islamic finance. Moving forward, with the existence of a dedicated court for Islamic finance, competent human capital and consistent legal precedents, Malaysia is well-placed to serve as a platform for adjudication and dispute settlement. The KLRCA in particular can be leveraged upon as an alternative dispute settlement mechanism for arbitrating international disputes relating to Islamic finance.

Another important legal aspect in the conduct of Islamic finance is in ensuring good documentation of contracts underlying Islamic financial transactions. Legal documentation forms an integral part of Islamic finance sector as it provides a critical "bridge" between

Shariah and Islamic finance practices. There are two major considerations in ensuring good legal documentation of Islamic financial transactions. Firstly, there is a need to ensure that the documentation conforms to Shariah in such a way that it enables the operationalisation of Shariah principles into legally enforceable Islamic finance contracts. This is crucial to avoid legal and reputational risks arising from the failure to faithfully reflect the principles of Shariah which could undermine public confidence in the industry. It also underscores the importance of legal advisors, Shariah advisors, and other key organs such as the compliance and internal audit functions, as well as the board in performing their obligations towards ensuring Shariah compliance. The importance of these various components is reflected in the newly revised guidelines on Shariah governance framework that was issued recently.

The second consideration relates to the importance of moving towards greater standardization in the legal documentation of Islamic financial transactions. A more standardized contract creates greater certainty and predictability about the characteristics of the financial contracts. When the parties involved are better able to understand their rights and obligations, stakeholders' confidence in the market would correspondingly improve. In essence, standardization of documentation, products and practices are essential to ensure that the markets are fair, efficient and transparent. Whilst contract and product standardization is encouraged to the greatest extent possible, we also need to be mindful not to let it stifle innovation. As a nascent industry, the need for innovation and competition in Islamic finance is so important that its absence might impede its growth. One important area is the need to appreciate and subscribe to the value of diversity in Shariah. I believe that diversity in Shariah interpretation is the seed to harness innovation in Islamic finance. Diversity in opinions and practices generate wider options for consumers and practitioners. I believe that this is very fundamental. It is also for this reason that Malaysia subscribes to the concept of mutual recognition of the interpretations and decision of Shariah principles reached by a recognized Shariah body across countries. We believe in the need for diversity as it is an impetus for sustainable global growth of Islamic finance.

While diversity would create a conducive environment for Islamic finance to prosper, varying interpretations of Shariah within a country can add to the complexity of the operating framework of Islamic financial institutions. The progressive harmonisation of Shariah interpretations, in this particular respect, can be viewed as an important driver towards greater acceptance and avoid possible confusion by the public. Malaysia had addressed the issue through a centralised SAC, which through collective wealth of experience and expertise of its members, its independence and its rigorous process of rule-making, has ensured the credibility of Shariah ruling on Islamic finance transactions. But at another level, facilitating the internationalisation of Islamic finance would involve a delicate balancing act in nurturing innovation and pushing for greater Shariah convergence, harmonization and acceptance. One option is to standardize contracts for mature and widely acceptable concepts and structures as it leads to consistency and efficiency and in some instances promote inter-jurisdiction transactions. Given that majority of Shariah interpretations are actually very similar, more attention needs to be given to translate these rulings that are commonly practised into documentation, products and services in a unified manner. However, this could only happen if there is common understanding on the issues or fatwas involved. To contribute towards this process, Bank Negara Malaysia has taken the initiative to enhance the transparency on juristic reasoning in Islamic finance through the publication of Shariah resolutions by the SAC. We have also been issuing a series of "Shariah Parameters" for several major Shariah contracts which are aimed at promoting consistent application of these contracts in Islamic finance. By leading these various efforts, we hope it can pave the way towards greater understanding and contributes towards international convergence on Shariah matters across jurisdictions.

Before I end my remarks, I would like to take this opportunity to highlight the importance of continuing a close and effective partnership in Islamic finance between Malaysia and the UK. Collaboration between financial centres in Islamic finance is an important part of the process

that would contribute towards expanding global development of the industry. With London's keen ambition to establish itself as the center in Islamic finance in Europe, there is certainly much room for cooperation between Kuala Lumpur and London. The importance of our relationship has been cemented not long ago with the signing of the Memorandum of Understanding between Bank Negara Malaysia and the UK Trade and Investment. Our strong collaborative endeavors are already visible in the area of education and capacity building, evidenced by the growing number of strategic alliances between several Malaysian and the UK education and training institutions in recent years. Several UK financial institutions have also successfully established presence through joint-venture with local partners in our takaful market. I am most hopeful that there will be more collaborative endeavors going forward to exploit the strength and synergies between the two centers, particularly in areas that will lead to enhancing the efficiency of Islamic finance and greater cross-border transactions.

On that note, I wish all of you a successful Workshop. Thank you.