

# Challenges in Securing Shariah Compliance Issues among Islamic Financial Institutions: A Malaysian Perspective

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*Received: June 21, 2016*

*Accepted: August 4, 2016*

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## ABSTRACT

This paper aims to examine the extent of the implementation of muamalat legal provisions in Islamic banking institutions in Malaysia. It seeks to ensure whether the operation and management of Islamic banks in this country comply with the Shariah requirement. Besides, it also aims to examine the extent of the laws' effectiveness in overcoming encountered issues and problems. The author will use the qualitative method in analysing the data. This research will utilise the purposive sampling method to conduct the interview because the author will select the best group to be studied, comprising officers who are involved either directly or indirectly in Islamic banking. The case study method will be used to collect recorded data that are related to Islamic banking case reports. Therefore, to propose the future works about several approaches to appropriate solutions to responsible parties or bodies to ensure that Malaysia's Islamic banking system can be implemented in a more comprehensive manner in line with Shariah requirements. This paper will provide a detailed overview of how far the currently applied legal provisions are able to resolve several issues that have long been acknowledged and whether there are new issues which may emerge.

**KEYWORDS:** Muamalat Laws, Islamic Banking, Challenges, Shariah Compliance.

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## INTRODUCTION

Muamalat includes laws which are related to all human transactions and acts such as contracts of buying and selling, rental, mortgage and so forth. It aims to regulate the relationship between the parties involved in a fair and equitable manner. Islamic laws encompass the whole principle of social justice including the aspects of law, practice, rules and procedures which are in line with the Shariah requirements. This includes the Muamalat transactions which have to be in line with the Shariah law. Every element that contradicts Shariah law must be evaded. Implementation of Muamalat laws in Islamic banking institution have been reviewed by many scholars[9,20]. The financial system in Malaysia practices a dual-system approach. The applicable law in Malaysia within the financial context is the civil or conventional law. However, there is a special law or provision which is enacted under the civil law in order to govern Islamic banking and financial system. The growth and development of Islamic banking industry are dependent on the presence of a comprehensive legal framework. The success implementation of Islamic banking relies on the correct legal approach adopted by its facilities. In Malaysia, Islamic banking institutions do not only have to be sharia compliant but they also need to fulfil other statutory requirements either substantive or procedural laws. They also need to comply with Bank Negara Malaysia and Securities Commission's Directive[2].

The study will present a general overview of the effectiveness of the legal, regulatory and judicial framework in the implementation of Islamic Banking Institutions in Malaysia. Generally, it is submitted that the existing legal framework makes valuable contributions towards the development of Islamic banking. In order to ensure the credibility of the Islamic banking industry, the government should develop a legal framework keeping in view the fact that financial credibility may be one of the many reasons that retained the confidence of clients of any banks. However, in the case of an Islamic bank, Shariah compliance is a matter of equal importance. Financial Service Act (FSA) and Islamic Financial Service Act (IFSA) combine several separate laws to regulate the financial sector under each law's single framework for conventional and Islamic financial sectors. A few previous studies have analysed the development and features of cases involving Islamic banking disputes and the courts' viewpoints towards them. There is a need for a critical study of the trends and patterns of cases that had been on trial and decided by the courts in Malaysia. This study aims to provide a critical analysis of the reported cases in Malaysia involving Islamic banking disputes in the period from 2011 to 2016 with a particular focus on the trend and patterns in them. The

study that discusses the impact of those cases on the Islamic finance industry and recommends possible immediate legal redress and remedies for stakeholders, particularly the regulator and banking institutions and the consumers

In order to ensure the continuous growth of the industry domestically and globally, there is a need to back it with a strong and viable regulatory framework. The appropriate studies and research should be done to identify the issues that are often repetitive and ambiguities that continue to occur in the financing agreement, the smooth running of Islamic banking activities without any obstacles and the solutions that should be considered by those responsible and who have expertise in the field. As Islamic banking is still at the infancy stage, the industry is facing numerous obstacles and legal hurdles all over the globe, including in Malaysia. The Malaysian courts have decided a substantial number of cases involving Islamic finance matters. The decisions made in the reported cases stirred controversy and debates in the market, among the regulators, market players, academics and they had even caught the attention of end consumers. Some decisions in the reported cases involving Islamic financial transactions have had an undeniably adverse impact on market confidence and stability. The statistical information on cases was only recorded starting from July 2013 until August 2015 involving the high court, session court and magistrate court[15].

Due to the court decisions, the regulator has amended the existing laws to enhance its regulatory framework in the attempt to maintain market stability. Yet market players remain uneasy about the trend in legal decisions and stakeholders have realised the urgent need for a stronger legal backbone for the Islamic finance industry[7]. This is in line with the increase in the number of cases registered in the high court from year to year. The phenomenal increase in cases involving Islamic banking and finance in the High Court Kuala Lumpur can be seen from the statistics of cases recorded at the Commercial (Muamalat) Division. Based on the mentioned report, there is an urgent need to view this matter seriously and extensive research is needed to identify the issues that are often repetitive and ambiguities that exist in the legislation on Islamic banking, the need for the efficient operation of Islamic banking activities without any obstacles and solutions that needed to be considered by those who are responsible and those who have expertise in the matter. A few previous studies have analysed the development and features of cases involving Islamic banking disputes and the courts' attitude towards them. However, the need remains for a critical study of the trend and pattern of those decided cases in Malaysia.

Hence, this study aims to provide a critical analysis of the reported cases in Malaysia involving Islamic banking disputes in the period from 2011 to October 2016 with a particular focus on the trend and patterns in them. The study discusses the impact of those cases on the Islamic finance industry and recommends the possible immediate legal redress and remedies to its stakeholders, particularly the regulator, banking institutions and the consumers in order to ensure the continuous growth of the industry domestically and globally by backing it with a strong and viable regulatory framework. The appropriate studies and research should be conducted to identify the issues that are often repetitive and ambiguous in the financing agreement and to ensure the smooth running of the Islamic banking activities. In relation to this context, studies are therefore needed to investigate how far the adopted legal provisions are appropriate in relation to the concept of Islamic banking. This is consistent with the current situation considering the amount of attention given by many Islamic law scholars and lawmakers in Malaysia. Furthermore, Islam is currently beginning to regain attention from not only Malaysians but also outsiders. Therefore, it feels that explanations about laws in Islamic banking institutions are required to enable those interested in Islam to discover that Islam also has what other conventional laws possess. Moreover, everything in Islam can also be aligned to any setting regardless of the situation, time and place.

## **ISSUES AND CHALLENGES IN THE IMPLEMENTATION OF MUAMALAT LAW**

Among the issues and challenges faced by the Islamic Banking Institutions in Malaysia is firstly, the level of consumer understanding about the instruments offered by Islamic banking. According to the study conducted by [10] reviews of previous studies related to the knowledge about Islamic banking among non-Muslim respondents reveal that their understanding of Islamic banking is relatively low. The findings of their pilot study indicated that non-Muslims have yet to fully accept Islamic banking as an alternative to conventional banking. Their study also found that the non-Muslims' level of understanding about *riba* or usury is still very low even if they know the meaning of *riba*. For those who have used Islamic banking, the most popular product is the savings account and the factors that influence their choice of bank is the high interest offered by the Islamic savings accounts and the overall quality of service. This means that Islamic banking can also be well received by non-Muslims if the criteria required by them can be provided by Islamic banks. Thus, the researcher wants to conduct in-depth examination of how the level of understanding and awareness of the Muslims or non-Muslims about the benefits of Islamic banking institutions can be enhanced.

The second issue is concerned with the application or use of various denominations (*mahzab*) among the Syariah advisers. The process of identifying the obligations or compliance of a financial instrument according to the

Islamic law requires the ability of the scholars to understand these instruments in terms of concept and implementation. The strong understanding between market practitioners and these religious scholars should be the primary basis for assessing the compliance of any instrument to the Syariah principles. To safeguard the correct and effective implementation of Syariah decisions, the role of certain parties in coordinating and administering issues related to Syariah is crucial. This is to ensure the development of Islamic financial instruments run effectively and in an orderly manner. From a legal perspective, the regulator needs to ensure that the Islamic financial system should always be protected and secured. As far as product development is concerned, the regulatory authorities need to provide clear guidance on a product to be developed [14].

In addition to the regulatory body, the role played by the Syariah advisors is also very central. This is because the relationship between Islamic scholars and those who are experts in the field of modern finance cannot be separated, like two sides of a coin. Thus, the coupling of the two parties who are experts in their respective fields, in particular the economic experts and Syariah scholars is a necessity. Thus, Syariah advisers will be appointed by any financial institution that chooses Islam finance as their activities. The role played by the Syariah advisors is particularly important in ensuring that every instrument complies with the principles of Syariah. Similarly, the development of Islamic finance, particularly in terms of policy planning and product developments need to progress smoothly and in accordance with Syariah principles. To allow the Syariah advisers to fulfill their duties and functions, the institution must provide a task force or secretariat to assist in administrative matters and research. The secretariat should conduct a preliminary investigation on aspects of Syariah standpoint pertaining to issues raised so that the Syariah advisors can see the overall picture before making a decision. Research conducted by the secretariat will allow a broader discussion by the Syariah advisers on issues that were previously raised, which supported by the Syariah edicts. All financial institutions offering Islamic financial facilities are required to establish a Syariah Committee. Among the duties and responsibilities of the Syariah Committee is to advise the board on matters of law and to ensure that the bank's business operations comply with Syariah principles at all times, to approve Syariah Compliance Manual and to validate related documentation. This committee is also required to provide Syariah reviews or decisions in writing for the purpose of record and reference.

To ensure the duties of the Syariah committee can be executed efficiently, every Islamic financial institution has the responsibility to provide assistance to the Committee in carrying out its duties. Islamic financial institutions are required to refer all Syariah issues to the committee for advice and subsequently adopt the relevant advice. Islamic financial institutions are also required to ensure product documentations containing the Syariah issue are approved and endorsed by the Syariah committee, allowing the committee to examine all relevant records, transactions, handbooks or other related information to enable the Syariah committee members to perform their duties effectively.

In addressing the current issues concerning Muamalat, fiqh scholars seriously consider the subject matter contained in the *istinbat al-ahkam* tradition (legal formulation methods) such as the issue of halal and haram, usury or *riba*, *gharar*, *maslahah* and *maqasidsyar`iyyah*. However, in carrying out their responsibilities, the fiqh scholars have always taken a balanced approach between the theoretical and practical aspects and the compliance of Syariah principles with *`urf al-iqtisadiyyah* (the customary practice of economic activities). In this context, fiqh scholars normally apply the principle of required changes as well as changes based on the instructions of the Quran and al-Sunnah. Based on the explanation above, the combination of intellect with religious revelations renders Syariah law dynamic, flexible, and able to handle any life issues that occur in any occasion or era. However, understanding and the assessment of human reason should be consistent with the requirements of the religious revelation and must be conducted according to the general guidelines established. Thus, the researcher aims to investigate how the resolutions of the securities commission of the Syariah Advisory Council (SAC) are formulated.

The third issue is the extent to which the views of the Syariah advisory council can bind the judges' verdict in the trial of cases involving Islamic banking. It involves the intervention of the principle of division of power (Separation of Power). According to the Central Bank of Malaysia 2009 in Section 55, banks and financial institutions should consult the Syariah Advisory Council (SAC). In addition, Section 56 states that the court or the arbitrator should consult the Syariah Advisory Council (SAC) in Syariah issues. Section 57 states that the resolution of the Syariah Advisory Council (SAC) is binding on the Court of Justice and Arbitration. Section 58 of the Syariah Advisory Council (SAC) is higher than other Syariah committee and section 59 (3) states the failure to comply with the resolutions of the Syariah Advisory Council (SAC) is an offense and can be punished with a penalty. This is because the rapid development of the economy and Islamic banking will bring some new issues pertaining to the law. Even this situation has become increasingly complicated when a judge has the right to choose to follow or otherwise because the final result of the case will be decided by a judge. The researcher will examine what are the Muamalat cases which had to be referred first to the Syariah advisory council. The questions that need to be asked are whether to place a duty on the court to refer any matters concerning Syariah banking to the SAC, whether to make the rulings into binding court decisions and whether the provisions in question have no retrospective effects.

To harmonize Syariah principles in the context of the civil court, more in-depth studies need to be conducted to improve and streamline them [11].

Islamic finance advisory bodies should be respected because it is responsible for safeguarding the implementation of the Islamic principles in financial affairs. The results and the clarifications of this committee should be obeyed to ensure that the principles of Islamic banking are protected. The view of the committee should not be questioned because its members are Islamic scholars and experts in Islamic banking. Based on the cases that have been decided, it is clear that only the civil court has the jurisdiction over matters concerning banking and Islamic finance. Although the amended act has been enforced, we can see the actual response to the opinions and information provided by the SAC to explain the principles of Islam in matters relating to Islamic banking and finance, which still remains under the jurisdiction of the civil court judge. Therefore, the suggestion to establish Islamic commercial courts which are preside by representatives of the civil and Syariah court judges must be expedited. In the interim, the initial step is to ensure that the judges and legal practitioners are trained in Islamic banking and finance. The next issue is what are the criteria and eligibility of the judge appointed to hear cases concerning Muamalat? How is this dealt with in terms of knowledge about the Syariah law? There need to be a paradigm shift in understanding and appreciating the principles and practice of Islamic banking based on the established standards or merit [11].

## LITERATURE REVIEW

In [12] focused on investigating the linkages between bank regulatory and supervisory structures associated with Basel III's pillars and various aspects of banks' efficiency and risk. The analysis focussed on dual banking system over the period of 2006-2010. Results suggested that regulation and strict monitoring of banking operation and higher supervisory power of the authorities, the increase of the technical efficiency of Islamic banks and the decrease in convention banks efficiency. We observe the opposite effect in the case of restrictions on bank activities, with higher restrictions causes a reduction in risk taking by Islamic banks but increasing the risk taking for conventional banks. Results also indicated that Islamic banks were better prepared for the implementation of Basel III guidelines compared to conventional counterparts. However, the work is not similar to the one proposed in this study because it did not consider much about banking cases as a reference. It also did not discuss issues about the application of Islamic laws in banking industry Malaysia.

In [1] argued that the flexibility of the legal set up in some jurisdictions of the conventional legal system gave room for the practice of Islamic banking, but Islamic scholars were not comfortable with this argument. They insisted on the fact that Shari'ah was unequivocal in its legal provisions on commercial and financial transactions. Demands by the Islamic scholars for a separate legal framework for Islamic financial system, which differ from the conventional law and takes Shari'ah requirements into consideration. It opined that the importance of institutionalizing an appropriate robust legal and regulatory framework for Islamic banks and other financial institutions could not be over emphasized. It argued that availability of an appropriate legal and regulatory framework could immensely enhance the soundness of these institutions and aids the regulators, especially Central Banks in regulating and supervising the financial institutions. It can also assist the central bank to be more effective in the execution and management of its credit and monetary policies. In a nutshell, it can be inferred that a robust legal and regulatory framework is required to create an enabling environment that supports the growth of Islamic financial services industry and as well fosters its stability. On the other hand, this paper focuses on the study of muamalat laws which are currently being applied in Islamic banking institutions as well as their current developments.

In [18] addresses the implications of the recent global financial crisis on the regulation of Islamic financial services. The book, dealt with the relevant regulatory issues in a timely manner. It described further clarity and understanding on the multi-dimensional goals of policy makers and regulators in ensuring that the resilience of the Islamic financial system and its core tenets are aligned with the evolving global regulatory developments. In domestic Islamic financial systems to become more inter connected and with the consequence that are integrated, risks are more rapidly transmitted across the financial system. However, the study differs from the proposed study because the author will study the benefits contained in the new acts compared to the previous ones. This includes forms of offense and penalty being imposed for the offenses due to violation or failure to comply with specified muamalat law procedures or provisions.

In [5] explained the Islamic finance system had become an accepted phenomenon in the international financial system. The recent unprecedented rapid growth of Islamic financial system was gradually changing the status of the Islamic banking system as an alternative to the conventional counterpart to a mainstream contender. Due to its universal growing acceptance and popularity, many countries were embarking on legal and regulatory reforms to

sustain the global development of the system. This has generated a lot of issues and challenges for sustainable growth of the financial system. Despite this, a supportive uniform regulatory and legal framework to enhance global integration of the system has yet to be developed. Therefore, considering the critical role of sound and robust legal and regulatory framework in the sustainable development of Islamic banking system, it is imperative to align the regulatory and legal framework in line with the development. The focus of this paper is premised on these issues and the challenges posed to the growth and sustainability of Islamic banking system. Hence, there are significant differences in comparison to the current research (my research) because the scope of the current research is more focused on cases involving Islamic banking and the results are parallel with the current laws.

In [6] presented a legal adjustment, one among some key determinants which affects the rapid or slow development of Islamic banking in a particular region. Though sometimes this was neglected at the beginning of the initiation of Islamic banking but in turn, it would significantly affect the long run of the progress of Islamic banking. Finally, it will discover how the legal adjustment correlates with the speed of the development of Islamic banking. These three countries were selected since the each was different from the others in the legal situation, Malaysia is an Islamic state by constitution, Indonesia is a Muslim country and Singapore is a totally secular country and hence the development of Islamic banking is also dissimilar. It is of a particularly interesting to discover the way these three different countries respond to the development of Islamic banking in their respective countries from a legal perspective. Therefore, there are significant differences in comparison to the current research because the scope of the current research is more focused on cases involving Islamic banking in court and identifies the problems that occurred in the performance of the banking system in Malaysia.

In [16] tried to extract quotations from traditional books as well as resolutions from various fiqh councils, especially from the shariah standard developed by AAOIFI. It also provided readers with various types of generic diagrams of the products including selected issues on each product. There were also attempts to address some common questions regarding Islamic banking practices. Therefore, it was not similar to the one proposed in this study because it did not consider much about the banking cases as the main reference. It also did not discuss issues about the application of Islamic laws in banking industry Malaysia.

In [8] addressed the framework and principles of Islamic banking, explored the nature and growth of the major international Islamic financial organisations, institutions and examined some important theoretical considerations relating to Islamic banking. This book explained the level and growth of assets, capital structure and profitability together with some indication of likely future developments. It examined in more detail the process of Islamisation of the financial system in both Pakistan and Iran. It also included a survey of the major Islamic banking laws which had been introduced in Iran, Pakistan, Malaysia and Turkey. In comparison, this paper focuses on study cases and muamalat laws which are currently being applied in Islamic banking institutions as well as their current developments.

In [19] explained about the views of Islamic scholars, especially Shafi'i scholars in relation to funding on offer in Islamic banking. There is some of the arguments from Al-Quran and Hadith to strengthen the descriptions of each type of financing and product. It examined a considerable amount of references and it translated the classical Arabic language to make it modern and easy to understand, in accordance with the current muamalat @ fiqhu al-hayah. In comparison, the current study shall focus only on the Islamic banking institutions and will not be making comparisons with conventional banks.

In [3] thoroughly explains property and its ownership, and different types of contracts in shariah legislation. Besides emphasis on those, it also discusses banking products, debts exemption and bankruptcy in shariah perspective. In overall, it discussion highlights the religious scholars' thought and the sacred book of Thurath. On the contrary, this paper is directed towards discussing the implementation of muamalat law and analyzing its related cases which have occurred in Malaysia.

In [17] and several other corresponding authors the issue on muamalat in Malaysia centered on the point of view of lawyers, Shariah judges and Shariah advisors Islamic banking institutions in Malaysia. The article identifies the civil laws, which are applicable to Islamic banking and examines whether they are in accordance with the Shariah or not. It also scrutinizes complications which occur upon the execution of Shariah structures in Malaysia in fostering Shariah concepts in the Islamic banking legislation frameworks. This showcases the existence of significance difference in the study to be conducted, which emphasizes the implementation and effectiveness of current muamalat law in overcoming Islamic banking predicaments in Malaysia.

In [13] discusses several legal issues related to Islamic banking legal provisions. It discusses numbers of opinions and recommendations in overcoming the limitations which will permit the Islamic banking transactions and innovations to be perfectly executed. In addition, it presents analysis on the provisions of law for banking institutions in Malaysia and United Arab Emirates (UAE). The study focused on how guidelines and methods of

implementation, procedures and rules, legal provisions, arbitration, direction by the trial judge or court and civil action.

In [4] discusses the legal description and classification of Islamic banks under the English law. It concisely reviews legal analysis of the English legal system in comparison to the Islamic legal system. It also describes the impact of the UK conventional legal framework on Islamic banking and the impact on the prosperity of the Islamic banking sector. In comparison, this paper focuses on the provisions of the law which prevail in Malaysia through the civil courts.

In [9] puts forward a new and thought provoking approach to Islamic finance, particularly in relation to securitisations. It provides an analysis of the fundamental principles underlying the Islamic law of contract and commercial practice in comparison with their equivalents in common law in the English speaking world. It seeks to draw similarities and differences where appropriate to facilitate the growth and development of Islamic commercial and financial law globally. It explained about structuring a securitization to be compatible with both the Shariah and common laws. It also testified about Islamic finance in Malaysia as a model to emulate. In comparison, this paper focuses on the in-depth examination of the problems and issues that are related to muamalat laws and the increase in cases of Islamic banking in Malaysia.

**CONCEPTUAL FRAMEWORK**

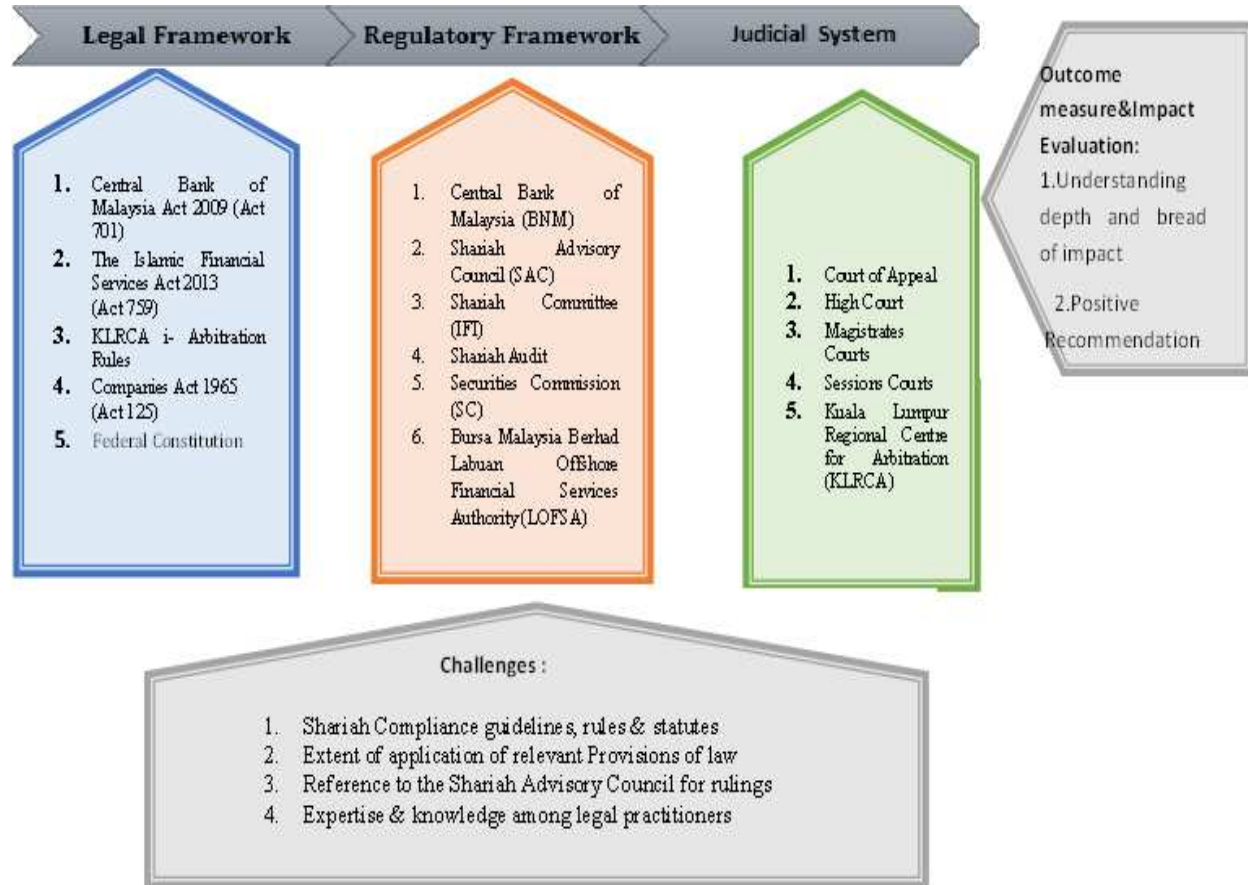


Figure 1: The conceptual framework of the study showing how the main variables are theorized to relate to each other

The framework will conduct and show the flow of legal and regulatory framework and judicial system in Malaysia. The jurisdiction of any bodiesthat be appointed and the provisions of the existing law, which have an influence on the implementation of Muamalat laws and services provided by Islamic banking Institutions in Malaysia. The conceptual framework in the figure above will use methods of qualitative research, descriptive and the data is collected from secondary data which is library literature. Through this research, it intends to showcase a qualitative research design where it will systematically organise how studies on regulatory, legality and challenges

were conducted. This paper will analyze the documents and the information obtained to explain the phenomenon that is taking place on the basis of relevant documents. Conceptual frameworks often include a visual representation, depicting the chronology of the study or expected relationships between each of the parties responsible for compliance with the provisions of the law Muamalat in the study landscape. The theoretical analysis is limited to the goal of assessing the suitability of the application of laws in the governance of Islamic banks. More specifically, this study aims to build a model.

The framework for this research in the form based on how the regulatory and governance framework and the application of the provisions of the statute or law muamalat may influence the implementation of the structural model law on Islamic banking institutions. The study also examines whether the internal and external challenges that had to be faced and the factors that are a barrier to compliance and the smooth implementation of Muamalat laws in Islamic banks. The study focused on how guidelines and methods of implementation, procedures and rules, legal provisions, arbitration, direction by the trial judge or court and civil action. Under implementation of the Muamalat laws, the convergence of the most important in this study is that its implementation structures.

## CONCLUSION

The legal and regulatory bodies' are very important roles in ensuring good Shariah governance. An effective Shariah governance framework requires the involvement of the Shariah committee as the key players, the government as the regulatory body, the Islamic financial Institutions as the implementers and also to other persons relevant to the business such as auditors, accountants and lawyers. This study is vital to prove that localization of muamalat laws and management could be implemented in Malaysia. The perceptions of the regulatory are very important. Their voice should be heard by the policy makers as well as Islamic banking institutions. The views of the regulators are also important because they will implement this suggestion if these findings are significant to the Islamic banking institutions to take the first step to ensure that the Shariah compliance aspect in Islamic banks is more efficient and complete.

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