

**Review Article****How important is it to have a special law governing Islamic banking?****Oluwaseun S. Saidu<sup>a,\*</sup>**<sup>a</sup> University of Manchester, United Kingdom\* [sulaimanibnsaidu@alumni.manchester.ac.uk](mailto:sulaimanibnsaidu@alumni.manchester.ac.uk)

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**ABSTRACT**

The ascendancy of Islamic finance particularly its offshoot, Islamic banking has been aggressive considering its spate of development. A salient factor responsible for this is the governing law for such financing paradigm. It is however contestable whether the workability of Islamic banking hinges on dedicated governing laws, amended subsisting laws or existing laws. In other words, is the existing legal (conventional) infrastructure adequate for any Islamic finance jurisdiction, or is there a need for a separate governing law? It is evident that this question is pertinent, vexed and has far-reaching implications. This article seeks to attend to this question in a very concise manner. Thus, the author forms an opinion common-sensibly resorting to comparative analysis, with or without judgements as well as real world country case studies.

**Keywords:** Islamic banking, comparative analysis, governing law, shariah, with or without, compatibility

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**Introduction**

Laws are a sine-qua-non for any institution as it oils the wheel for smooth operation, continued existence as well as growth and development of such institution. However, the question of the importance of having a special law for Islamic banking is not a direct one. Seeking an answer requires an understanding of Islamic banks and the mainstream banks; whether or not there exist ideological and/or scientific distinctions between them; if there are such differences, then a case for a dedicated law becomes plausible, but if it is a situation of “old wine in new bottle,” having a separate law becomes less cogent. Furthermore, it might also be useful to put into consideration the existing inherited law system and the “religio-politico” ambience cum spread in determining the suitability of additional law as this might mitigate duplicative tendencies, cost implications and bureaucratic bottlenecks.

Therefore, implicatively, three possibilities abound: the need for outright Islamic banking law, an amendment of the existing banking law, and the “need” for no new Islamic banking law at all. Against this backdrop, the study will define what law is, explain the meaning of Islamic banking, juxtapose Islamic banking and its conventional counterpart to expose the differences and to what degree if any, present brief case studies of countries with Islamic banks, the nature of their laws and achievements owing to those laws. The

study concludes with a specific statement of how important it is to have a special law for Islamic banking.

### **Law and governing law for Islamic banking defined**

“Laws” are commands issued by the uncommanded commander, i.e. the sovereign; such commands are enforced by sanctions and a sovereign is one who is obeyed by the majority.<sup>1</sup> These are the tenets of legal positivism. The theory of legal positivism was championed by Jeremy Bentham (1748-1832), John Austin (1790-1859), and Herbert Hart (1907-1992). Not without variations, the theory tries to explain that the legal validity and acceptability of a norm in any system rests not on its merits but on its sources.<sup>2</sup>

Complementing the theory of legal positivism is the definition by Hutchins who sees Law as a body of principles and rules developed in the light of the rational sciences of Ethics and Politics.<sup>3</sup> He further opined that the aim of politics and ethics is good life and likewise the aim of law. The above might help us understand the importance of laws, its sources, objective, compliance as well as enforcement. Against this backdrop, we can define a governing law for Islamic banking as those laws enacted by the relevant authority aimed at strengthening the foundation as well as facilitating the sustainable growth and development of Islamic banking which might consist of regulatory and non-regulatory aspects cutting across areas such as adjudication, functionings, legal documentation, tax and legal codes, enforcement and penalty mechanisms keeping in mind the Shariah objectives.

### **Islamic banking versus conventional banking: Where do we draw the line?**

As the name implies, Islamic banking simply refers to banking that is based on Islamic principles. Čihák and Hesse defined “Islamic or Shariah compliant banking as the provision and use of financial services and products that conform to Islamic religious practices and laws.”<sup>4</sup>

More rigorously, Islamic banking is a system that is embodied with the following criteria:<sup>5</sup>

a) Risk-sharing: the terms of financial transactions need to reflect a symmetrical risk/return distribution each participant to the transaction may face;

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<sup>1</sup> Austin, J., *Lectures on Jurisprudence; or, The Philosophy of Positive Law*. (London: J. Murray, 1875). Available at: <https://archive.org/details/lecturesonjuris02austgoog>.

<sup>2</sup> Gardner, J., “Legal Positivism: 5½ Myths,” *The American Journal of Jurisprudence* 46(1) (2001): 199-227, doi: 10.1093/ajj/46.1.199.

<sup>3</sup> Hutchins, R.M., “The Autobiography of an Ex-Law Student,” *The University of Chicago Law Review* 1(4) (1934): 511-518.

<sup>4</sup> Čihák, M. and Hesse, H., “Islamic Banks and Financial Stability: An Empirical Analysis,” *Journal of Financial Services Research* 38(2) (2010): 95-113.

<sup>5</sup> El-Hawary, D., Grais, W. and Iqbal, Z., “Regulating Islamic Financial Institutions: The Nature of the Regulated,” World Bank Policy Research Working Paper, WPS322 (2004). World Bank.

b) Materiality: all financial transaction must have “material finality,” that is it is directly or indirectly linked to a real economic transaction; thus options and most other derivatives are banned;

c) No exploitation: a financial transaction should not lead to the exploitation of any party to the transaction; and,

d) No financing of sinful activities such as alcoholic beverages.

In other words, it ideally is a banking paradigm that is in line with the tenets and application of Shariah. It therefore adopts all that is normally allowed in banking except where expressly prohibited under the Shariah. On the other hand, all non-Islamic banks could be conveniently referred to as conventional banks.

It is however contentious whether the Islamic banks differ significantly from the conventional banks. Several theoretical and empirical studies have tried to expose the variations in the structure, operations as well as functionality of these two banking systems. One study using a sample of 141 countries and 2,956 banks whilst controlling for time-variant country-fixed effects and bank factors came to a conclusion that Islamic banks and commercial banks do not have different business models and that there are no significant differences in their business orientation.<sup>6</sup>

Another study sought to establish if there are indeed structural differences between the financial characteristics of 15 Islamic banks and 15 commercial banks. Using logit, probit and discriminant analysis, he concluded that the duo is not distinguishable in terms of profitability, returns and efficiency but is distinct when liquidity, leverage and credit risk are considered.<sup>7</sup>

Contrastingly, some similar studies using non-parametric approaches have shown that they are indistinguishable as far as liquidity and non-performing loans are concerned. For example, a study argued that Islamic banks digress from the profit or loss sharing paradigm and that this is at least true of the Malaysia prototype. They contend that Islamic banks are not too different from conventional ones, and therefore suggested that the two banking systems should be treated similarly under financial related parlances.<sup>8</sup>

Another study looked at costs, revenue and profit efficiency of 43 Islamic banks and 37 conventional banks for a 15 year period suggest that there are no significant differences between the overall efficiency outcomes of conventional and Islamic banks.<sup>9</sup>

Meanwhile, Bourkhin and Nabi tried to see if the effect of the financial crisis of 2007-2008 on the financial soundness of Islamic banks and conventional banks will help show significant differences in both models. Utilizing a sample of 34 Islamic banks and

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<sup>6</sup> Beck, T., Demirgüç-Kunt, A. and Merrouche, O., “Islamic vs. Conventional Banking: Business Model, Efficiency and Stability.” *Journal of Banking & Finance*, 37(2) (2013): 433–447.

<sup>7</sup> Metwally, M.M., “Differences between the Financial Characteristics of Interest-Free Banks and Conventional Banks,” *European Business Review* 97(2) (1997): 92-98.

<sup>8</sup> Chong, B. S. and Liu, M. H., “Islamic Banking: Interest-Free or Interest-Based?” *Pacific-Basin Finance Journal* 17(1) (2009): 125-144.

<sup>9</sup> Bader, M.K.I., Mohamad, S., Ariff, M. and Hassan, T. “Cost, Revenue and Profit Efficiency of Islamic versus Conventional Banks: International Evidence Using Data Envelopment Analysis,” *Islamic Economic Studies* 15(2) (2008): 23-76.

conventional banks covering 16 countries, they found no significant differences in both models.<sup>10</sup> They inferred that “the Islamic banks are diverging from their theoretical business model which would have allowed them to keep the same level of soundness even during the crisis”.

On the basis of financial ratios alone, Olson and Zoubi assert that conventional banks are different from Islamic banks.<sup>11</sup> In fact, a panoramic analysis of both systems reveals that both Islamic and conventional banks are strikingly similar in many respects, and it is indeed “an inefficient replication of conventional finance, always one step behind (conventional) development.”<sup>12</sup>

From the foregoing, it is quite clear that the differences between the two relate more to ideology rather than functionality. Therefore, it is not difficult to see that the degree of importance for a special law governing Islamic banking rests strangely on the ideals of the paradigm. Whether or not ideological difference alone gives credence to a special governing law suggesting preferential treatment of Islamic banks poses an ethical question which confronts the moralist worldview of the religion of Islam itself. In spite of this, a special governing law justified through ideological differences still requires some scrutiny, perhaps a “With or Without” approach requiring an examination of some country scenarios might further our understanding and help reach a conclusion as to how important a separate legislation is.

### **Selected countries scenarios**

The Malaysian experience provides a legitimate example of a country with a separate Islamic banking law; the Islamic Banking Act of 1983.<sup>13</sup> For informational sake, it is noteworthy that the Islamic Financial Services Act (IFSA) 2013 became operational relatively recently. It came into force on the 30 June 2013, and repeals the Islamic Banking Act. The IFSA legislates on areas of regulation and supervision with respect to Islamic financial institutions and operation of payment systems. It also rules on oversight functions of Islamic money market and Islamic foreign exchange market.<sup>14</sup> However, the developments of the Malaysia market trace back to the past thirty years when the 1983 law was in force. Thus, the IFSA is not pertinent to this discussion, as the future might provide an alternative effective thesis.

Somewhat politically motivated, the 1983 law is deficient in terms of regulations, and to a large extent unspecific. It touches on licensing issues cum operational requirement and Shariah membership, but does not spell out clearly on how this is to be carried out. It also

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<sup>10</sup> Bourkhis, K. and Nabi, M.S., “Islamic and Conventional banks’ Soundness during the 2007-2008 Financial Crisis. *Review of Financial Economics* 22(2) (2013): 68-77.

<sup>11</sup> Olson, D. and Zoubi, T.A., “Using Accounting Ratios to Distinguish between Islamic and Conventional Banks in the GCC region,” *The International Journal of Accounting* 43(1) (2008): 45-65.

<sup>12</sup> El Gamal, M.A., *Islamic Finance: Law, Economics and Practice*. (New York: Cambridge University Press, 2006), p. 25.

<sup>13</sup> Islamic Banking Act, 1983. Laws of Malaysia. Act 276. Available at: [http://www.bnm.gov.my/documents/act/en\\_ib\\_act.pdf](http://www.bnm.gov.my/documents/act/en_ib_act.pdf).

<sup>14</sup> Islamic Financial Services Act, 2013. Available at: [http://www.bnm.gov.my/documents/act/en\\_ifsa.pdf](http://www.bnm.gov.my/documents/act/en_ifsa.pdf).

talks about reserve requirements, foreign bank entrant operational policies as well as business restrictions. A close look at this banking law reveals that most of its provisions supposedly for Islamic banking especially in areas of licensing, financial requirements, reserve requirements, and business restrictions are analogous to its conventional counterpart. This casts serious doubt on the need for this special Law in the first place. This becomes clear when one considers the progress Malaysia has made in the industry for considerable number of years which cannot be directly attributable to this dedicated act.

The Kuwaiti account provides us with an example of a country which has amended its banking laws with additions so as to accommodate Islamic banking. The Kuwait Central Bank Law of 1968 along with Section 10 Amendment of 2003 is one of the most comprehensive banking laws catering for Islamic banking in the world. It touches on areas such as local and foreign entrant requirements cum restrictions for Islamic banks, Islamic banking products, investment allowances and modalities, capital requirements, Shariah board establishment and operational guideline, issues of rights of customers and deposit guarantees in detail.<sup>15</sup> Therefore, owing to the comprehensiveness and workability of this amended legislation coupled with the continued existence of the Kuwait Finance House (KFH), Boubyan Bank and Kuwait International Bank, not much is left to be desired of a dedicated Islamic bank law.

An outstanding example of a country which has successfully accommodated Islamic banking (alternative banking) practices without a special law and with little or no amendment is the United Kingdom. Much of the activities of banks and financial service operators including the Islamic banks are overseen by the Financial Services Authority (FSA). Again for informational diffusion, FSA relinquished its powers as prudential and conduct regulator in the UK to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), and hence ceased to exist on 1 April 2013.<sup>16</sup> The PRA under the Bank of England became responsible for banks while the FCA now handles consumer protection and misconduct. However, not much has been done differently since the authority split.

For discursive relevance, the Financial Services and Market Act of 2000 provides for issues on regulations; licensing, registration, organizational and management set up, financial requirements, product offering, deposit protection cum guarantee, Shariah supervision guidelines, advertisement guidelines and so on. The finance acts of 2004 and 2007 provide for what could be more or less considered as tax concession in the form of stamp duty; to be paid once as far as double staged transactions such as Murabaha financed residential contracts, Ijara underlined home purchase plans as well as diminishing Musharaka based mortgages are concerned.<sup>17</sup> Overall, amidst obvious shortcomings of deposit protection which raises Shariah legitimacy concerns, the UK experience still provides a level playing ground for the development of Islamic banks such as Islamic Bank (al-Rayan) of Britain, Bank of London and Middle East, and Ahli United Bank alongside its

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<sup>15</sup> Central Bank of Kuwait Law 1968. CBK Law 32/ 1968, Section 10. Text as Amended as per stipulations of decree law number 130/1977 (25 October 1977) and Law number 30/2003 (25 May 2003). Available at: <http://www.cbk.gov.kw/www/law.html>.

<sup>16</sup> See Prudential Regulation Authority (PRA).

<sup>17</sup> See Finance Act 2004; and Finance Act 2007.

conventional counterparts, and gives us a clear indication that we need not have a special governing law for Islamic banking to materialize.

More so, the “compatibility” of common law with the Shariah law, and the prevalence of secularism (the religio-politico ambience) in most countries with Islamic banks further weaken the case for a special governing law.

## Conclusion

By and large, the article has attempted to examine why and to what extent a special law is necessary for Islamic banking. It is quite obvious and undisputable that it is possible to have Islamic banking without a separate legislation such as in the United Kingdom, or with amendments such as in Kuwait. Therefore, a dedicated governing law is less important. At best, deductively, regulatory attempts as opposed to separate legislation might be useful. It is also worthy of mention that the disconnectedness between the ideals of Islamic banking and its functionality remains a conundrum. As theory informs the practical, the theory informing Islamic banking practice might be defective. This is not to say that the dictates of the Creator as given in the established sources; the *Quran* and *Hadith* is suspect, but the situation might not be unconnected with the excessive, uncouth and unrestricted exegesis of these sources by the self-imposed and self-acclaimed scholars as well as overzealous academicians, theologians and theorizers. After all, it is the correct understanding of the revealed and received knowledge that matters, not necessarily the quantum of knowledge acquired, and “*Allah is the Light of the heavens and the earth. The example of His light is like a niche within which is a lamp, the lamp is within glass, the glass as if it were a pearly [white] star lit from [the oil of] a blessed olive tree, neither of the east nor of the west, whose oil would almost glow even if untouched by fire. Light upon light. Allah guides to His light whom He wills. And Allah presents examples for the people, and Allah is Knowing of all things*” (emphasis by author; Quran 24:35).

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