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## Appraising Legal and Regulatory Framework for Personal Financing Offering by Islamic Banks and Non-bank Institutions in Malaysia

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### Abstract

Islamic personal financing is one of the well-received financing products. It is crucial to ensure a strict compliance with the requirements prescribed by Shariah. However, Islamic personal financing is offered not only by Islamic banks but by other non-bank credit providers as well. This study attempts to appraise the divergent legal and regulatory framework for the offering of personal financing by both Islamic banks and selected non-bank institutions in Malaysia. Doctrinal legal research methodology and content analysis have been employed whereby relevant primary and secondary sources of law were appraised on the various legal and regulatory framework in respect of Shari'ah-compliant personal financing offered by different types of credit providers in Malaysia. The findings disclose that while Islamic banks and prescribed development financial institutions are subjected to the extensive regime, concerted efforts need to be directed towards strengthening the current legal and regulatory framework for community credit companies to ensure end-to-end Shari'ah compliance in the offering of Islamic personal financing. The study's findings act as a guide for relevant regulators in developing an overarching legal and regulatory framework for personal financing products that fall under their purview. This step is vital in ensuring that every process involved in offering Islamic personal financing is aligned with Shari'ah principles.

**Keywords:** Law and Regulation, Shariah Compliance, Financial Regulations, Governance, Money and Banking, Riba

### Introduction

Personal financing is a form of credit facility obtained to satisfy various consumer needs. Unlike home financing which is sought for house acquisition, or hire purchase which is commonly needed to finance vehicle acquisition, personal financing is not attached to any specific purpose. In most cases, applicants are not required to disclose the purpose of their applications for personal financing. Generally, consumers apply personal financing for various personal consumptions, including house renovation, payment of education fees, funding wedding expenses, performing umrah and even settling their existing debt.

In response to the growing demands of personal financing, credit providers, including Islamic banks and some prescribed development financial institutions (PDFIs) grasp this opportunity to offer Shari'ah-compliant personal financing to meet the consumers' financial needs. The yearly growth in the performance of personal financing products shows that this product has become an essential source of funds for consumers, albeit for diverse purposes. Data on personal financing in Islamic banking institutions from 2018 to 2020 shows that the approved financing had nearly doubled in two years. In 2018, there is RM30,090 million (7,202,011,410 USD) worth of approved Islamic personal financing. This number reached RM52,516 million (12,569,652,084 USD) in 2019 and RM56,729 million (13,578,029,421 USD) in 2020 (Bank Negara Malaysia, 2020). Non-bank credit providers such as community credit companies and cooperatives have also shown interest in this lucrative personal financing market. Access to the products by community credit companies and cooperatives have thus become the alternative options for consumer funds.

While the legal and regulatory framework in respect of the offering of personal financing by Islamic banks is comprehensive, a different scenario is observed in respect of non-banks institutions particularly community credit companies. Cooperatives, on the other hand, have made considerable improvements over the years. The absence of a comprehensive legal and regulatory framework may entice Shari'ah non-compliance issues since the prevalent underlying contract utilised itself is surrounded by numerous issues requiring close observation by the regulators. Thus, the primary aim of this study is to evaluate the existing legal and regulatory framework concerning the offering of personal financing by selected institutions and to evaluate the extent to which they safeguard end-to-end Shari'ah compliance. Although vast studies have been conducted on Islamic personal financing, to the best of researchers' knowledge, none has rigorously appraised the legal and regulatory framework in offering personal financing among Islamic banks and non-bank institutions in Malaysia. The findings may serve as a valuable guide to the relevant regulators in developing a comprehensive legal and regulatory framework governing Shari'ah-compliant personal financing.

Against this backdrop, this paper is structured as follows: the next part reviews past literature, followed by a discussion on the institutions offering Islamic personal financing in Malaysia. The subsequent section appraises the divergent legal, regulatory and governance framework currently in place to govern the offering of Islamic personal financing. The following discussion presents a comparative analysis together with some recommendations and the final section concludes the study.

### **Literature Review**

In the history of Islamic personal financing in Malaysia, Islamic banks have played a significant role as the pioneer of Shari'ah-based financing. As opposed to the conventional personal loans, Islamic personal financing is not a straightforward loan transaction with interest. Since obtaining personal financing is not directly linked with property acquisition, the structuring of personal financing using selling and buying transactions is problematic and, in many instances, involves controversial issues and disagreements among different scholars. For example, Shari'ah non-compliance issues related to the use of *bay' al-'inah* (sale and buyback) as the underlying contract include the element of legal trick, usury, inter-conditionality

element, sequence of contract and the argument that modern application does not represent the spirit of *bay' al-'inah* as outlined by al-Shafi'e's legal theory (Rosly, 2010).

Thus, to iron out these conundrums and allow greater acceptance of personal financing products offered by Islamic banks in Malaysia, an effort has been made to structure the products using the *tawarruq* principle. *Tawarruq* is extensively practised by Islamic finance institutions in Malaysia as an alternative to *bay' al-'inah* in structuring financing and deposit products (Mohamad and Ab Rahman, 2014). Nevertheless, this shift is not void of a debate as to the permissibility of *tawarruq* especially *tawarruq munazzam* (organised *tawarruq*). While the application of classical *tawarruq* has been widely recognised as Shari'ah-compliant, the modern practice adopted by the Islamic banks in offering pre-arranged *tawarruq* has been highly criticised by scholars due to the Shari'ah issues surrounding its application. Among the frequently highlighted issues are the motive and purpose behind organised *tawarruq*, legal stratagem, double agency, improper sequence of sale contracts and possibility of non-existent commodities (Ab Rahman, Mohammad, 2010; Ahmed, 2016; Aljamos, *et al.*, 2018; Roslan *et al.*, 2020; Asni, 2022). One of the clear deviations of organised *tawarruq* from the classical *tawarruq* is the involvement and interference of the bank in the second sale whereby purchase and sale transactions are carried out simultaneously in exchange for a financial obligation.

Irrespective of these contentions, Shari'ah Advisory Council of the Central Bank of Malaysia (SAC) has ruled that financing products structured using the concept of *tawarruq* is permissible in its 51<sup>st</sup> meeting dated 28 July 2005 but subject to stringent conditions (Bank Negara Malaysia, 2010). Acceptability is determined by the overall meaning of Surah al-Baqarah verse 275, which allows for trade but forbids *riba* (interest). In other words, *tawarruq* is a trade activity, regardless of whether the goal is to make cash or not or whether there is a disclosure on the objective of acquiring the money.

SAC also maintains that *tawarruq* can be carried out if there is a critical need or if specific persons or institutions have a widespread practice. Furthermore, the argument is supplemented with the renowned *fiqh* (Islamic jurisprudence) maxim: "According to the original method of ruling, *mu'amalat* (transaction) is permissible, except when there is a provision prohibiting it." (Ahmad *et al.*, 2010) In addition, the juristic opinions of Hanafi, Hanbali and Shafi'e which permit *tawarruq* are likewise relied on to support their views. It is extremely essential to ensure that the *tawarruq* transactions abide by the fundamentals of selling and buying contract prescribed by Islamic commercial law because the permissibility of *tawarruq* by the SAC relies on the general allowability of selling and buying contract. In this regard, it is submitted that an all-embracing legal, regulatory and governance framework is requisite to guarantee conclusive Shari'ah conformity.

Several previous studies evaluated the practice of Islamic personal financing in Malaysia from different perspectives. The most recent literature investigated the differences in the practice of *tawarruq munazzam* contracts based on personal financing products in several Islamic banks in Malaysia (Asni, 2022). The researcher analysed the said differences based on the potential for risk to occur and risk from a Shariah perspective. The results show that there are differences in the practice of *tawarruq munazzam* contracts based on personal financing products practised by the Islamic banks studied. These differences have brought significant

influence in determining the level of Shariah risk potentials and Shariah risks, respectively. While this study is significant in highlighting potential risks such as customer engagement, *wa'd* (promise), commodity asset, *gharar* (uncertainty), *wakalah* (agency), *ta'wid* (compensation) and *gharamah* (penalty), the scope is limited to Islamic banks and there is no extensive discussion of legal, regulatory and governance framework regulating Islamic personal financing offered by Islamic banks and other institutions. Lee (2020) analysed regulatory framework and Shari'ah requirements applicable to financial and non-financial institutions offering Islamic banking products and services in Malaysia. The former includes commercial banks and Islamic banks while the latter refers to PDFIs, cooperative societies and moneylenders. While it offers useful source to understand the general regulatory framework between these different industries, the study did not carefully discuss with specific reference to Islamic personal financing. No in-depth comparative analysis was made particularly in respect of the applicable policy document, guidelines and governance between these two distinct institutions offering Islamic personal financing.

Yusoff *et al* (2016) examined the underlying concepts used to structure personal financing products in the Malaysian Islamic banking industries, including *bay al-inah*, organised *tawarruq*, *qard* (loan) with service charge and *rahn*-based *qard* (pledged-based loan). The authors also evaluated the factors which trigger Shari'ah non-compliance issues in the application of these instruments such as legal device to circumvent *riba*. Alternative mechanisms were proposed namely *hibah* (gift)-sale based financing, *hibah* for a reward, *salam* (forward sale) but merely from the theoretical perspective. Its practicality, marketability and perhaps potential Shari'ah issues still require further examination. The study was *Shari'ah*-based, and no reference was made to contemporary legal provisions.

A qualitative study by Ali and Hassan (2020) investigated the Shari'ah non-compliance phenomena in the practice of *tawarruq* in Malaysia. A self-administered questionnaire was distributed to 16 Malaysian Islamic banks to uncover the Shari'ah non-compliance issues in the application of *tawarruq* in Islamic banks in Malaysia. One of the major findings was that some practices of *tawarruq* in Malaysia might not comply with the Shari'ah, mainly due to the improper sequencing of contracts. It is submitted that this finding is critical in highlighting that the risk of Shari'ah non-compliance exists despite the presence of comprehensive regulatory framework, what more if such framework is not available in the first place.

As far as legal and regulatory framework is concerned, Ali and Oseni (2017) examines major policy initiatives by and legal reforms introduced by the Central Bank of Malaysia (BNM) to promote both local and cross-border transactions that seek to project Malaysia as a hub for Islamic financial transactions. Confining the parameter to the efforts undertaken by BNM, the study finds that the importance of law reforms in strengthening the financial system cannot be overemphasized, particularly when it comes to the need for an end-to-end Shari'ah compliance framework and consumer protection. Additionally, a study by Ahmad and Ishak (2021) explores Shari'ah governance practices among selected Islamic non-bank financial institutions in Malaysia. The finding discloses that while a comprehensive Shari'ah governance is in place in banking institutions, the opposite situation is present in non-bank institutions. Non-bank financial institutions differ in their Shari'ah governance processes due to the magnitude and complexity of their products. While the non-bank financial institutions may profit from this flexibility, the study recommends that their respective regulators should

improve the Sharī'ah governance aspects by developing a comprehensive policy and increasing its enforcement, especially from a check and balance standpoint. The research also proposes that these institutions establish an association among their members in order to increase coordination, better governance, and share opinions, particularly on Sharī'ah elements.

The majority of past studies discuss the underlying Sharī'ah concept of *tawarruq* which are widely utilised to structure Islamic financing products, including Islamic personal financing focusing on Sharī'ah non-compliance issues (Ahmed and Aleshaikh, 2014; Aljamos et al., 2018; Sharaiyra and Haswa, 2019; Ali and Hassan, 2020; Asni, 2022). In a nutshell, the review of previous literature divulges paucity in the existing literature that meticulously examine the legal, regulatory and governance framework of Islamic personal financing in banks and non-bank institutions.

### **Institutions Offering Islamic Personal Financing in Malaysia**

This section highlights the key consumer credit institutions which offer Islamic personal financing as one of their financing products namely Islamic banks established under the Islamic Financial Services Act 2013 (IFSA), PDFIs under the Development Financial Institutions Act 2002 (DFIA), community credit companies licensed under the Moneylenders Act 1951, and cooperatives registered under the Co-operatives Societies Act 1993.

#### ***Islamic banks***

Since its inception in 1983, Islamic banks in Malaysia continue to demonstrate remarkable development with enhanced infrastructure and innovative products. From one full-fledged Islamic bank, the number of industry players has expanded to 16, comprising ten local and six foreign Islamic banks altogether (Bank Negara Malaysia, 2022). As of 2020, 37% of the growth in the banking system was attributed to Islamic financing, with Islamic financing predominantly propelling this expansion through household financing, among other things (FitchRatings, 2021). Islamic personal financing is a must-have product by the majority of Islamic banks in Malaysia as depicted in Table I.

Table I

*List of Islamic Personal Financing Offered by Islamic Banks in Malaysia*

ISLAMIC BANKS	CONTRACT	ISLAMIC PERSONAL FINANCING
Affin Islamic Bank Berhad	<i>Tawarruq</i>	Affin Islamic Personal Financing-i
Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	<i>Bay' Bithaman Ajil*</i>	Al-Rajhi Personal Financing-i
Alliance Islamic Bank Berhad	Commodity <i>Murabahah</i> Contract	Cash Vantage Financing-i
AmBank Islamic Berhad	<i>Murabahah Tawarruq</i>	AmBank Islamic Personal Financing-i
Bank Islam Malaysia Berhad	<i>Tawarruq</i>	Bank Islam Personal Financing-i 1. Personal Financing-i Package 2. Personal Financing-i Non-Package 3. Personal Financing For Professional Program
Bank Muamalat Malaysia Berhad	<i>Tawarruq</i>	Muamalat Personal Financing-i ( <i>Tawarruq</i> ) 1. Structured Personal Financing-i 2. Personal Financing-i Programme
CIMB Islamic Bank Berhad	Commodity <i>Murabahah</i>	Xpress Cash Financing-i
Hong Leong Islamic Bank Berhad	<i>Tawarruq</i>	Personal Financing-i
HSBC Amanah Malaysia Berhad	Commodity <i>Murabahah</i>	HSBC Amanah Personal Financing-i
Kuwait Finance House (Malaysia) Berhad	<i>Tawarruq</i>	KFH <i>Murabahah</i> Personal Financing-i Generic
Maybank Islamic Berhad	<i>Tawarruq</i>	Maybank Islamic Personal Financing-i
MBSB Bank Berhad	<i>Tawarruq</i>	Personal Financing-i 1. Mumtaz-i 2. Afdhal-i 3. Private Sector-i
OCBC Al-Amin Bank Berhad	NIL	Not offered
Public Islamic Bank Berhad	<i>Bay' al-Inah Wa'd</i>	BAE Personal Financing-i BAE AG Personal Financing-i PLUS BAE Personal Financing-i Solar Plus BAE Personal Financing-i
RHB Islamic Bank Berhad	Commodity	Personal Financing-i for Civil Sector Personal Financing-i for Private Sector

			<i>Murabahah</i> via <i>Tawarruq</i> arrangement	Personal Financing-i for Pensioners
Standard Chartered Berhad		Saadiq	NIL	Currently not available

\*The concept of financing is by way of commodity trading. However, instead of *tawarruq*, product disclosure sheet explains that the underlying contract is *bay' bithaman ajil*.

Source: Respective Islamic Banks' Websites as of June 2021

### **Prescribed Development Financial Institutions**

The development financial institutions (DFIs) have played a pivotal role in the growth and development of the targeted industries such as agriculture, small-medium enterprises, infrastructure, maritime, export-oriented sectors, and capital-intensive and high-tech industries are some of the strategic sectors. To meet the specific needs of the selected key sectors, DFIs offer a specific range of financial products and services. Currently, there are six DFI's established under the DFIA namely Bank Pembangunan Malaysia Berhad, Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank), Export-Import Bank of Malaysia Berhad (EXIM Bank), Bank Kerjasama Rakyat Malaysia Berhad, Bank Simpanan Nasional and Bank Pertanian Malaysia Berhad (Agrobank). These institutions are known as PDFIs. PDFIs which offer Islamic personal financing to individual consumers are depicted in Table II:-

Table II

*List of Islamic Personal Financing Offered by PDFIs*

PDFIs	CONTRACT	ISLAMIC PERSONAL FINANCING
Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat)	<i>Tawarruq</i>	Personal Financing-i for Public Sector Personal Financing-i for Private Sector Personal Financing-i for Pensioners
Bank Pertanian Malaysia Berhad (Agrobank)	<i>Tawarruq</i>	AgroCash-i Financing
Bank Simpanan Nasional	<i>Tawarruq</i>	BSN MyRinggit-i (Public Sector) BSN MyRinggit-i (Executive-1) BSN MyRinggit-i (Professional)

### **Community Credit Companies**

Community credit companies (previously known as moneylenders) is another important source of consumer credit access. This age-old industry is believed to begin in Malaysia in the middle of the 19<sup>th</sup> century when a group of banking sub-caste community known as Nattukotai Chettiar arrived in the then Malaya and commenced their business in Penang, Malacca and Singapore (Singh, 2003). As at August 2020, there are 4,425 community credit companies nationwide licensed under the Ministry of Housing and Local Government (Bahagian Kawalan Kredit Komuniti, 2020). Nevertheless, the credit given by these companies is based on conventional loan transaction whereby interest charged for a secured loan must not exceed 12% per annum, and for an unsecured financing the maximum interest chargeable is 18% per annum. However, to fulfil the rising demand of Shari'ah-compliant financing, some community credit companies have made an initiative to offer a Shari'ah-compliant version of



“credit granting” which has the same connotation with Islamic personal financing (Lim, personal communication, 2020).

### Cooperatives

Cooperatives are regarded as non-bank financial institutions (Ahmad and Ishak, 2021). The cooperative sector has witnessed the emergence of Islamic cooperative which has undeniably enhanced the position of cooperatives in providing Islamic financial services. According to Cooperative Statistics 2020, there are 14,629 cooperatives ranging from banking cooperatives, credit cooperatives, agricultural cooperatives, housing cooperatives, industrial cooperatives, transportation cooperatives, consumer cooperatives, construction cooperatives and services cooperatives (Malaysia Co-operative Societies Commission, 2020). As of 2020, there are 572 credit cooperatives which principal business is offering various credit facilities, including personal financing (Malaysia Co-operative Societies Commission, 2020). In tandem with the awareness of Shari’ah-compliant financing, the majority of these cooperatives have offered Islamic personal financing which are mostly structured using the *tawarruq* concept. Examples of the cooperatives which offer Islamic personal financing are listed in Table III.

Table III

*Examples of Cooperatives Offering Islamic Personal Financing*

COOPERATIVES	CONTRACT	ISLAMIC FINANCING	PERSONAL FINANCING
Koperasi Bank Persatuan Malaysia Berhad (Coop Bank Pertama)	<i>Tawarruq</i>	Pembiayaan Lestari Co-opbank Pertama	Persendirian-i
Koperasi Tentera	<i>Bay’ al-’Inah</i>	Pembiayaan Ekspres Koperasi Tentera	
Koperasi Putri Terbilang	<i>Tawarruq</i>	KOPUTRI Tawarruq	Pembiayaan
Koperasi Bersatu Tenaga Malaysia Berhad	<i>Tawarruq</i>	KOBETA Speed-i KOBETA Cash-i	
Koperasi Kumpulan Johor Corporation	<i>Tawarruq</i>	Pembiayaan Peribadi-i Pembiayaan Peribadi-i (Khas)	
Koperasi NUCW Berhad	<i>Tawarruq</i>	Personal (Government Sector) Personal Financing (Private Sector)	Financing

Source: Respective Cooperatives Websites as of June 2021

### Appraising Divergent Legal and Regulatory Framework

This section analyses the applicable laws and regulatory instruments in relation to the offering of Islamic personal financing by the abovementioned institutions.

### ***Islamic Banks***

The sustainable and dynamic progress of Islamic banks in Malaysia is largely attributed to the presence of robust legal and regulatory framework. BNM plays a pivotal role to spearhead advancement of Islamic financial institutions in Malaysia and accorded strengthened regulatory powers pursuant to the Central Bank of Malaysia Act 2009 (CBMA) and the IFSA.

#### *Establishment of the apex authority to ascertain Shari'ah issues*

One of the distinguishing features of Islamic banking legal and regulatory framework is the establishment of the SAC as the apex authority to address issues related to Shari'ah under section 51 of the CBMA. Sections 55(1) and 55(2) of the CBMA mandate BNM and Islamic financial institutions to consult the SAC when conducting Islamic banking and financial activity and when conducting their affairs in general. Additionally, sections 56(1), 57 and 58 of the CBMA provide that the decisions and advice of the SAC bind Islamic financial institutions, BNM, the Shari'ah Committee, courts of law and arbitrators in issues relating to Islamic financial concerns. Thus, if there are any Shari'ah issues related to Islamic personal financing, the matter will be referred to the SAC for determination, for instance, the permissibility of *tawarruq* in structuring financing products in Malaysia as highlighted earlier.

#### *Legislation emphasising Shari'ah compliance*

The enactment of the IFSA, overarching legislation governing Islamic banks, is a critical component of Islamic bank's legal and regulatory framework. Section 28 of the IFSA obliges Islamic banks to conform with Shari'ah throughout their operation, including product development. Section 28(1) of the IFSA emphasises that an institution must always ensure that its goals and operations, commercial affairs and activities align with Shari'ah. It is worth pointing out that the IFSA's regulatory goal is to ensure Shari'ah compliance (Section 6 of the IFSA). The scope of Shari'ah compliance involves complying with the SAC of BNM's rulings (Section 28(2) of the IFSA). In accomplishing this regulatory objective, BNM has been vested with broader regulatory power to ensure Islamic banks' adherence with Shari'ah principles. Consistent with the present discussion, the relevant power is to specify standards on Shari'ah matters as stipulated in section 29 of the IFSA. However, the content of the policy document is classified as either a standard or guidance. Only non-compliance with the standard may result in enforcement action. Moreover, to promote better compliance, BNM has also been granted powers to pursue administrative, civil and criminal action in the event of contravention not only with the IFSA but also standards issued pursuant to the IFSA. This enforcement power is stated in sections 245 and 250 of the IFSA for administrative and civil actions, respectively.

#### *Issuance of Tawarruq Policy Document (2018)*

Pursuant to the authority to issue standards, BNM has issued policy documents based on different underlying contracts commonly used to structure Islamic financial products. As of now, there are 14 Shari'ah policy documents issued by BNM which serve as substantial guidance for internal Shari'ah compliance functions.

Pertaining to Islamic personal financing product, the applicable Shari'ah policy document is *Tawarruq* Policy Document. Section 15(1)(a) of the IFSA permits Islamic banks that have been granted permission to conduct Islamic banking activity to implement this policy document, which became effective on December 28, 2018. To ensure the legality of *tawarruq*, Part B

contains both compulsory Shari'ah criteria and optional procedures that are acceptable. This part enumerates numerous components that must be considered in order to overcome non-compliance issues with the use of *tawarruq* as the contract underpinning personal financing. For example, regarding the issue of unidentifiable asset, this policy document spells out the requirement that the asset must be acknowledged by Shari'ah as valuable, identifiable and deliverable. It is also mandatory for the seller to specify a detailed description of the item to the buyer if the asset is not available at the *majlis al-'aqd* (contract session).

Concerning the issue of the non-existence of assets at the time of trading and lack of observance of *aqad* sequence causing the sale of something not belonging to the seller, the *Tawarruq* Policy Document clearly accentuates the need for the underlying asset to be in existence and owned by the seller in each respective sale and purchase contracts. In addition, concerns on possession of the asset are also dealt with extensively. In brief, taking possession which can be either in the form of *qabd haqiqi* (physical possession) or *qabd hukmi* (constructive possession) must take place before the asset can be sold the third party. To reflect the actual effect of taking possession, the *Tawarruq* Policy Document provides that the possession shall take effect upon *takhliyah* (the seller releasing the asset to the purchaser) through any mechanism permitted by Shari'ah, including *'urf tijari* (customary business practice) in order for *tamkin* (the purchaser would have access to the asset) to take place and for the purchaser to assume its ownership risk. The seller is responsible for any loss or damage to the asset before the buyer takes control of it.

Another contentious issue associated with organised *tawarruq* is dual agency. The *Tawarruq* Policy Document expressly allows the execution of the sale and purchase. However, the contractual parties must mutually agree on the main aspects of the authorised work, such as price, tenure, and asset specification, and the transaction must be adequately backed by proper proof in the proper sequence. The correct sequence depends on the following types of dual agency:

- i) when a contracting party acts as an agent to buy an asset on behalf of another contracting party, he must then act as an agent for the sale of the asset on behalf of the same contracting party back to himself; or
- ii) when a party acts as an agent to buy an asset from himself on behalf of another contracting party, he must then act as an agent for sale on behalf of the same contracting party to a third party.

In the event the execution of the sale and purchase contracts in the *tawarruq* occurs on a date later than the date on which the funds are received from the principal; and the profit of the sale and purchase contract which is on a deferred basis is calculated from the day the funds are accepted, the agent must reveal the selling price to that party.

The operational standards for *tawarruq* in terms of governance and oversight, structuring, risk management, financial transparency, and market conduct are described in full in Part C. *Tawarruq* management and implementation are outlined in the following five key elements:

- i) Principle 1: Establishment of a robust governance and oversight framework to ensure that *tawarruq* is carried out according to Shari'ah-compliant practises;

- ii) Principle 2: Structuring and implementation of a *tawarruq* are facilitated by detailed policies, procedures, and processes, as well as a suitable infrastructure and extensive documentation;
- iii) Principle 3: Implementing an effective risk management system to manage risks throughout the life cycle of *tawarruq* in line with its risk appetite.
- iv) Principle 4: A *tawarruq* would be conducted fairly and transparently in accordance with Sharī'ah to safeguard the interests of stakeholders; and
- v) Principle 5: Provision of adequate disclosure and transparency to facilitate stakeholders' understanding and assessment of a *tawarruq*.

*Issuance of Policy Document on Introduction of New Product (2014)*

BNM also issued a Policy Document on Introduction of New Product which was effective on 7 March 2014. Other than Sharī'ah compliance, this policy document covers the aspect of risk management and consumer protection. However, the discussion here is restricted to the Sharī'ah compliance aspect only. This policy document applies to all licensed banks, licensed investment banks, licensed Islamic banks and PDIFs. In the said policy document, they are collectively referred to as financial institutions, but for the purpose of discussion in this section, reference is made to Islamic banks only.

Thus, Islamic banks must observe the requirements enumerated therein before introducing a new product, including any new Islamic personal financing product. A new product is defined as "a product which is being offered by a financial institution for the first time in Malaysia or a combination of a product and any existing or new product, or variation to an existing product being offered by a financial institution in Malaysia, that results in a material change to the structure, features or risk profile of the existing product".

There are several provisions in this policy document related to Sharī'ah compliance requirement. In essence, all new products must be approved by BNM before they can be launched. In respect of Sharī'ah-compliant products, it is mandatory for all new product proposals to get endorsement and validation from the Sharī'ah Committee, including the terms and conditions contained in proposal forms, offer letters, agreements and other legal documents used in the product transaction. Likewise, all product manuals, advertisement or marketing materials, product illustrations and brochures used to describe the new product shall be endorsed by the Sharī'ah Committee. In this regards, approval of new product applications by a majority of the Sharī'ah Committee is sufficient, even though all members are obliged to evaluate, validate, and approve them.

To facilitate the deliberation on all Sharī'ah issues by the Sharī'ah Committee, the Policy Document on Introduction of New Product also requires thorough research to be carried out before the discussion takes place. Furthermore, Sharī'ah Committee's certification must be supported by the relevant *fiqh* literature, evidence and reasoning. Apparently, the policy document does not only concern with compliance during the pre-approval stage but also post-approval. It underscores the importance of establishing an effective process for the purpose of monitoring constant Sharī'ah compliance of products. This process involves making sure that all product-related operational decisions are made in a Sharī'ah-compliant way, such as only accepting collaterals for Islamic financing products that are Sharī'ah-compliant.

In respect of the offering of new Shari'ah-compliant products, Islamic banks must establish the presence of a sound and robust Shari'ah governance framework that includes extensive Shari'ah-compliant product development and implementation process. Additionally, the new Shari'ah-compliant product must meet the following conditions:

- i) approval of the product and the relevant documentations by respective financial institution's Shari'ah Committee;
- ii) the product's underlying Shari'ah contract, structure and features must be similar to the products that have been approved by the SAC of the Bank; and
- iii) consistency of the product with the SAC resolutions.

The launch-and-file system is inapplicable for a product that employs a new Shari'ah contract in the Malaysian market. Likewise, a product that combines two or more products that have been previously approved on a stand-alone basis or that constitutes a variation in an existing Shari'ah-compliant product, may attract Shari'ah issues that have not been deliberated by the SAC. Launch-and-file system is a fast-track approval method by which Islamic banks can proceed to provide the new product to customers following submission of a comprehensive list of information as specified in Appendix 3 to BNM. Appendix 3 requires information requirements for new products which include:

- i) product description, including name and features;
- ii) product structure, including transaction flows;
- iii) types of Shari'ah contract used;
- iv) relevant SAC resolution that approved the new product structure; and
- v) verification statement by the Shari'ah Committee that the new product structure does not attract any Shari'ah issue that has not been deliberated by SAC. The statement must be signed off by the Chairman of the Shari'ah committee. Moreover, the statement must include any dissenting views from any Shari'ah Committee member and be accompanied by the deliberation and the rationale that support such views.

#### *Issuance of Policy Document on Shari'ah Governance (2019)*

Other than the *Tawarruq* Policy Document (2018) and Policy Document on Introduction of New Product (2014), BNM has also issued Shari'ah Governance 2019 in accordance with section 29(2) of the IFSA. Except for paragraph 12.5, which will take effect on 1 April 2023, this policy document took effect on 1 April 2020. It is applicable to licensed Islamic banks, licensed takaful operators, including professional takaful operators, licensed banks and licensed investment banks approved to carry on Islamic banking business, PDFIs approved to carry on Islamic financial business and Shari'ah Committee members.

To be more specific, this policy document outlines heightened accountability for Shari'ah governance implementation oversight on the Board, Shari'ah Committee, and other key organs involved in that process. This policy document also addresses the Shari'ah committee's objectivity in strengthening sound decision-making processes and the robustness of internal control mechanisms for managing Shari'ah non-compliance risks effectively. This policy paper highlights the Board's, Senior Management's, and the Shari'ah Committee's main duties in Shari'ah governance. Additionally, it emphasises the critical role of the Shari'ah Secretariat in

providing operational support to the Sharī'ah Committee in order for it to function correctly and efficiently.

There are three categories of control functions described in the policy document: Sharī'ah non-compliance risk management, Sharī'ah review and Sharī'ah audit. These three types of control functions must be undertaken constantly to ensure efficient management of Sharī'ah non-compliance risk. Thus, substantial resources must be reserved for control functions, such as recruiting enough officers with the necessary skills and training. Islamic personal financing based on *tawarruq* relies on the control functions to guarantee that the actual implementation of *tawarruq* transactions is in line with the provisions outlined in the *Tawarruq* Policy Document.

Thus, in addition to complying with the *Tawarruq* Policy Document and Policy Document on Introduction of New Product, the offering of Islamic personal financing is subject to adherence to Sharī'ah governance. It is indispensable to accentuate that Sharī'ah governance is a critical aspect in ensuring thorough compliance with Sharī'ah principles as depicted in numerous instruments introduced by BNM such as the *Tawarruq* Policy Document as well as Policy Document on Introduction of New Product.

The provisions on Sharī'ah governance are likewise spelt out under the IFSA. Division 2 stipulates that Sharī'ah governance encompasses, among other things, the establishment of the Sharī'ah Committee, the appointment of Sharī'ah Committee members, their duties and cessation as members. Division 3 provides the requirements for audit on Sharī'ah compliance.

### ***Prescribed Development Financial Institutions***

The enactment of the DFIA marks a significant milestone in providing a robust regulatory and supervisory framework for selected DFIs whereby these institutions have been placed under the regulatory purview of BNM. As part of the regulatory and supervisory framework, BNM monitors these institutions' activities and financial performance to ensure that they perform their mandated roles prudently, supported by strong corporate governance and best practices. However, the relevant stakeholder ministries of the respective PDFIs continue to be accorded the responsibility to provide broad policy direction on the strategic roles and targeted sectors supported by each institution. Section 33B of the DFIA permits PDFIs to carry out their entire business in accordance with Sharī'ah or in addition to its existing conventional business subject to prior written approval from BNM.

### ***Establishment of the apex authority to ascertain Sharī'ah issues***

BNM co-regulates PDFIs under the DFIA. Hence, the SAC of BNM is regarded as the highest authority in addressing any new arising Sharī'ah issues faced by PDFIs, similar to Islamic banks. Correspondingly, by virtue of sections 56(1), 57, and 58 of the CBMA, the rulings and advice of the SAC shall bind PDFIs as well on matters pertaining to Islamic financial matters.

### ***Legislation emphasising Sharī'ah compliance***

Division 2 of the DFIA is designated to detail out legal provisions on Sharī'ah compliance. Section 33 of the IFSA obliges PDFIs operating their business in accordance with Sharī'ah to ensure that the business, affairs and activities are aligned with Sharī'ah requirements. Section 33D(1) of the DFIA states that an institution shall at all times ensure that its aims and

operations, business, affairs and activities comply with Sharī'ah. Furthermore, compliance with the SAC ruling is deemed to be compliance with Sharī'ah (Section 33D(2) of the DFIA). To streamline the regulatory framework of Islamic banks and PDFIs, section 33(E)(1) of the DFIA echoes equivalent provision with section 29(1) of the IFSA which provides the power of BNM to specify standards on Sharī'ah matters. Moreover, section 33E(2) of the DFIA which provides for the power to specify standards on Sharī'ah governance is in pari materia with section 29(2)(a) of the IFSA. In order to strengthen compliance with the standards among PDFIs, BNM may also exercise its administrative, civil and criminal action in the event of contravention not only with the DFIA but also standards issued pursuant to the DFIA. This power is stated in sections 106A and 106E of the DFIA for administrative and civil actions, respectively.

#### *Issuance of Policy Documents*

In relation to the offering of Islamic personal financing, the relevant policy documents issued by BNM are the *Tawarruq* Policy Document (2018), Policy Document on Introduction of New Product (2014) and Policy Document on Sharī'ah Governance (2019). The scope of discussion of relevant parts of these policy documents are similar to those elaborated earlier in relation to Islamic banks.

Additionally, in respect of Sharī'ah governance, Division 3 of the DFIA stipulates Sharī'ah governance encompassing, inter alia, the establishment of Sharī'ah Committee, the appointment of Sharī'ah Committee members, their duties and cessation as members. Requirements on audit on Sharī'ah Compliance is specified in Division 4 of the DFIA.

#### **Community Credit Companies**

The community credit in Malaysia is governed by the Moneylenders Act 1951. This industry is under the regulatory purview of the Ministry of Housing and Local Government. Some community credit companies offer Islamic personal financing in order to meet the demands of the consumers (Lim, personal communication, September 24, 2020). However, as of now, there is no specific legal, regulatory or governance framework to regulate Islamic personal financing by this group of companies.

#### **Cooperatives**

Malaysia Cooperative Societies Commission (MCSC) or Suruhanjaya Koperasi Malaysia, a statutory body under the Ministry of Domestic Trade and Consumer Affairs, has been mandated as the regulatory authority to oversee and coordinate activities carried out by cooperatives in Malaysia. To enable the development of Islamic cooperatives, the issuance of the Sharī'ah Governance Framework by MCSC in 2015 is integral in addressing the issue of Sharī'ah compliance by cooperatives.

#### *Establishment of the apex authority to address Sharī'ah issues*

One of the primary features in the Sharī'ah Governance Framework is the requirement of establishing a Sharī'ah Committee to ensure the compliance of Sharī'ah principles by the cooperatives. Therefore, observing this requirement, Islamic cooperatives set up Sharī'ah Committees at the internal level (Issyam et al., 2016). This body is responsible for monitoring the business activities conducted by the respective cooperative and consequently ensuring Sharī'ah principles are being adhered to (Suruhanjaya Koperasi Malaysia, n.d.). Sharī'ah

Committee in the Islamic cooperative sector may be established as an internal Shari'ah Committee, an external Shari'ah Committee or a Shari'ah Committee for the group of cooperatives (Ahmad and Ishak, 2021).

In contrast, a centralised Shari'ah Advisory Body is absent at the national level as the Shari'ah Committee is only established at the institutional level. Pursuant to section 26 of the Malaysia Co-operative Societies Commission Act 2007, MCSC as the regulatory body is obligated to consult the SAC of BNM with regard to any Shari'ah issue and issue a written directive based on consultation with SAC. This fact indicates that the highest authority is absent in ascertaining Shari'ah issues at the MCSC level as the principal regulator for cooperatives in Malaysia. Some authors have acknowledged that there is a need for the establishment of a Shari'ah Advisory Body at the national level, as clearly exemplified by the Islamic banking industry, to resolve the issue of suitability of the application of the SAC of BNM in the context of cooperative businesses (Issyam et al., 2016).

#### *Legislation emphasizing Shari'ah compliance*

Since Islamic cooperative is regarded as one of the providers for Islamic financial services, legislation is perceived as one of the most significant mechanisms in monitoring Shari'ah compliance. The primary legislation for the cooperatives is the Co-operative Societies Act 1993 with the objective of advocating the value of trustworthiness, transparency and honesty within the cooperative implementation (Intan Waheedah, Maslinawati and Azizah, 2013). It is pertinent to note that there is no specific act governing the operation of business activities conducted by Islamic cooperatives to date. Although there is no specific legislation governing Islamic cooperatives, section 84A (1) of the Co-operative Societies Act 1993 addresses the importance of Shari'ah compliance as the provisions require cooperative institutions carrying Shari'ah-based activities to ensure Shari'ah compliance by seeking advice from the SAC. Concerning this matter, based on section 84A(2) of the same Act, it is compulsory for Islamic cooperatives to comply with the written directions issued by the MCSC after consultation with the SAC of BNM.

#### *Issuance of guidelines by Malaysia Cooperative Societies Commission*

There is a list of related guidelines issued by MCSC relating to the operation of cooperatives. MCSC derived its power to issue guidelines pertaining to Islamic cooperatives from section 86B(1) of Co-operative Societies Act 1993 which allows MCSC to issue any directive, guidelines, circulars or notices to give full effect to the implementation of Shari'ah compliance by cooperative institutions. For instance, MCSC has issued GP07, Guidelines on Islamic Financing by Co-operatives, which came into force on 16 November 2009. Pursuant to this guideline, it is necessary for the MCSC to monitor and control the business activities conducted by Islamic cooperatives which provide Islamic financing services or facility. Under this guideline, all cooperatives offering Shari'ah-based services need to adhere to Shari'ah principles such as the prohibition of *riba*, oppression and fraud. The guideline issued by MCSC is relative to the values of Islam as the guideline also gives utmost attention to the principles of Islamic economy and Islamic commercial transaction by emphasizing on halal-based activities (Hassan et al., 2018). Apart from this guideline, there are several other guidelines on Shari'ah compliance such as GP07A, Guidelines on Giving Control Financing Prudently and GP07B, the Guidelines for Giving *Ibra'*(rebate) for Share-based Islamic Financing Purchase. These guidelines need to be read together with GP07, Guidelines on Islamic Financing by Co-



operatives. The financings referred to by these guidelines are credit facility and Islamic financing offered by cooperatives.

#### *Issuance of Guideline on Shari'ah Governance*

Rapid growth and emerging market of the cooperatives sector shows dire need for good Shari'ah governance. Evidently, MCSC as the main regulator for cooperatives has taken a significant step in adopting the practice of Shari'ah governance by the issuance of GP28, Shari'ah Governance Guidelines in July 2015. These guidelines are applicable for the cooperatives which engage in financial intermediation activities based on the Shari'ah principle, including banking functions, credit function, financing and *ar-rahn* (Islamic pawnbroking) (Issyam et al., 2016).

Shari'ah Governance Guidelines provide for the requirement of the establishment of the Shari'ah Committee at the cooperative institutions. The role of the Shari'ah Committee is not only limited to overseeing the operation of the business but to provide advice on Shari'ah matters. Apart from the Shari'ah Committee, internal audit and management committees are vital parts of the cooperative governance components in order to enhance Shari'ah compliance and consequently and promote competitive cooperatives guided by integrity (Hassan et al., 2018). Although the guidelines provide for the responsibility of the Internal Audit Committee in providing control mechanisms for cooperative institutions, the Shari'ah control functions such as Shari'ah Review, Shari'ah Audit and Shari'ah Risk are not explicitly mentioned in the said Guidelines (Ahmad and Ishak, 2021). In terms of contravention with Shari'ah principles, Shari'ah Governance Guidelines highlights that MCSC has the authority to impose corrective measures on the cooperative. There is no penalty provided under the Guideline in the event of non-compliance with Shari'ah principles (Issyam et al., 2016).

#### **Comparative Analysis**

The preceding discussion reveals different legal and regulatory framework available to regulate the offering of Islamic personal financing in Malaysia, as illustrated in Table IV below. The said table shows an apparent discrepancy between Islamic banks' legal and regulatory framework and the PDFI'S and community credit companies. Cooperatives, on the other hand, have gradually reinforced their legal and regulatory framework.

Table IV

*Legal and Regulatory Framework Governing the Offering of Islamic Personal Financing in Malaysia among Different Institutions*

Legal and Regulatory Framework	Islamic banks	PDFIs	Community Credit Companies	Cooperatives
The establishment of apex authority to determine Shari'ah issues under specific legislation	√ SAC	√ SAC	Nil	Nil However, reference may be made to the SAC of BNM on any Shari'ah issues.
The establishment of an internal Shari'ah Committee pursuant to specific legislation	√ Internal Shari'ah Committee	√ Internal Shari'ah Committee	Nil	√ Internal, external or a group Shari'ah Committee
The existence of legislation prescribing Shari'ah compliance by the institutions	√ IFSA	√ DFIA	Nil	√ Co-operative Societies Act 1993
The existence of regulators with powers to ensure Shari'ah compliance	√ BNM	√ BNM	Nil	√ MCSC
The issuance of a policy document on underlying contract to ensure Shari'ah compliance and other operational aspects	√ <i>Tawarruq</i> Policy Document	√ <i>Tawarruq</i> Policy Document	Nil	√ GP07: Guidelines on Islamic Financing by Co-operatives
The issuance of a policy document to introduce new products	√ Policy Document on Introduction of New Product	√ Policy Document on Introduction of New Product	Nil	Nil
The issuance of a policy document on Shari'ah governance	√ • IFSA	√ • DFIA	Nil	√ GP28, Shari'ah

<ul style="list-style-type: none"> <li>• Role of the Board of Directors</li> <li>• Role of Senior Management</li> <li>• Sharī'ah Committee</li> <li>• Sharī'ah Secretariat</li> <li>• Sharī'ah Risk Management</li> <li>• Sharī'ah Compliance</li> <li>• Sharī'ah Audit</li> </ul>	<ul style="list-style-type: none"> <li>• Policy Document on Sharī'ah Governance</li> </ul>	<ul style="list-style-type: none"> <li>• Policy Document on Sharī'ah Governance</li> </ul>		<p>Governance Guidelines (However, Sharī'ah control functions such as Sharī'ah Review, Sharī'ah Audit and Sharī'ah Risk are not specifically mentioned in the Guidelines)</p>
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It is submitted that in the absence of an embrasive legal and regulatory framework, there is uncertainty as to whether the offering of Islamic personal financing is coherent with Sharī'ah provisions. The worrying part is that all the allegations raised in the literature about Sharī'ah non-compliance issues occur in reality. This loophole regrettably defeats the objective of introducing Islamic personal financing products which are intended to avoid *riba*-based transactions.

Thus, it is suggested that overarching legal and regulatory framework must be in place for all institutions that aspire to offer Sharī'ah-compliant products, including Islamic personal financing. In addition, it is proposed that there should be a centralised Shariah Advisory Council at the apex authority and Shariah Committee in each of the non-bank institutions. Collaboration among various regulators is imperative to streamline the legal and regulatory framework for offering Islamic personal financing in Malaysia especially in the issuance of policy document for on underlying contract, introduction of new product and Sharī'ah governance. The presence of support and control functions such as Sharī'ah secretariat, Sharī'ah risk management, Sharī'ah compliance and Sharī'ah audit must be seriously considered too. In this regard, it is viewed that BNM has developed a constructive model for reference, albeit with necessary modification in view of different business model, capital structure and human resources. This strategy will enhance consumer confidence and concurrently eliminate confusion among the public on the precise mechanism in offering Islamic personal financing products. It is likewise submitted that this approach will eventually foster an optimistic outlook on the role of Malaysia as one of the leaders in Islamic finance.

### Conclusion

The offering of personal financing by Islamic banks and certain PDFIs is subject to a strict legal and regulatory framework under BNM. This regime aims to ensure that every aspect related to Islamic personal financing is parallel with Sharī'ah requirements encompassing product structure, modus operandi, legal documentation, operational aspects as well as promotional materials. There are commendable efforts implemented by cooperative industry's regulator to establish some regulatory control to ensure conformity with Sharī'ah principles.

Unfortunately, a comprehensive framework is not comparatively available to regulate Islamic personal financing offered by community credit companies. This shortcoming may create doubts as to the legitimacy of Islamic personal financing offered by these institutions. It is hoped that the respective regulator will attempt to establish an inclusive legal and regulatory framework to preserve overall Shari'ah compliance in offering Islamic personal financing by community credit companies. The framework established by BNM provides a valuable model for reference. This study, however, acknowledges some limitations which provide more room for future research. Future research may explore empirical research on the viable legal and regulatory framework to be adopted by different regulators due to the different natures of the credit providers and business settings. Further research may also be conducted to elicit views and opinions of industry players in establishing a feasible legal and regulatory framework. The research may adopt different methodologies to arrive at more objective and in-depth findings.

Undeniably, this study serve as an extensive study on different legal and regulatory framework in relation to Shari'ah-compliant personal financing among Islamic banks and non-bank institutions in Malaysia and constitutes as the first of its kind in the existing literature. As such, the study's finding act as a guide for relevant regulators in developing an overarching legal and regulatory framework for personal financing products that fall under their purview. This step is vital in ensuring that every process involved in offering Islamic personal financing is aligned with Shari'ah principles.

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