

Coexistence of Conventional and Islamic Banking in Malaysia: Legal and Regulatory Challenges – A Literature Review

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DOI: <https://doi.org/10.47772/IJRISS.2026.100800629>

Received: 22 July 2026; Accepted: 27 July 2026; Published: 15 September 2026

ABSTRACT

Malaysia's dual banking system, which permits both conventional and Islamic financial institutions to operate side by side, represents the country's effort to accommodate financial inclusion and religious diversity. While this system has supported the rapid growth of Islamic finance, it also raises legal and regulatory challenges that require closer examination. This paper presents a structured literature review that explores how regulatory policies, governance frameworks, and court decisions influence the coexistence of these two banking models. It discusses key issues such as the overlap in jurisdiction between civil and Shariah courts, variations in Shariah interpretation, and the difficulties involved in resolving financial disputes. Drawing from academic studies, regulatory guidelines, and legal commentaries, this review identifies weaknesses in the current legal setup and offers suggestions for reform aimed at achieving greater legal certainty and coherence. The study contributes to ongoing discussions on how to strengthen dual financial systems in a legally pluralistic environment.

Keywords: Islamic banking, dual banking system, legal framework, Shariah governance, Malaysia.

INTRODUCTION

Malaysia's banking system is unique due to the coexistence of both conventional and Islamic banks, which are regulated under the supervision of Bank Negara Malaysia (BNM). This dual banking system caters to the country's diverse population by offering both interest-based and Shariah-compliant financial services. The foundation for Islamic banking was laid with the Islamic Banking Act 1983, which led to the establishment of Bank Islam Malaysia Berhad. Subsequent legislation, such as the Islamic Financial Services Act 2013 (IFSA), has reinforced the regulatory framework for Islamic financial institutions (Dusuki & Bouheraoua, 2011).

Despite these advancements, the coexistence of two different banking systems under one legal framework presents several challenges. A major issue is the potential conflict between civil law and Shariah principles when resolving disputes. Since civil courts have jurisdiction over both types of financial institutions, this can lead to inconsistencies, particularly when civil law does not fully align with Islamic financial principles (Ali, Oseni, Adeyemi, & Zain, 2016).

Additionally, the dual banking system requires a coordinated regulatory approach to ensure both banking models operate smoothly without conflicts. The Shariah Advisory Council (SAC), established under the Central Bank of Malaysia Act 2009, provides guidance on Shariah matters, but integrating these rulings with civil law can be challenging (Hasan, 2020). This article aims to explore the legal and regulatory issues surrounding Malaysia's dual banking system, identify areas of conflict, evaluate the effectiveness of existing regulations, and propose recommendations for improving the legal environment to better support both banking sectors.

LITERATURE REVIEW

Malaysia's dual banking system, where both Islamic and conventional banks operate under a shared legal and

regulatory framework, is a distinctive feature of its financial landscape. This model was institutionalized with the enactment of the Islamic Banking Act 1983, which laid the groundwork for the development of Islamic finance by establishing Bank Islam Malaysia Berhad as the country's first Islamic bank. Subsequent legislative instruments such as the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) were introduced to further consolidate the governance structures of both banking systems (Dusuki & Bouheraoua, 2011). These reforms were intended to delineate clearly the operational mandates of conventional and Islamic financial institutions, and to ensure systemic stability. However, despite this robust legal infrastructure, the coexistence of dual banking systems within a common law jurisdiction presents persistent challenges, particularly in the realms of legal interpretation, regulatory harmonization, and judicial capacity.

One of the core issues lies in the jurisdictional overlap between civil courts and the Shariah Advisory Council (SAC), the latter being the body authorized under the Central Bank of Malaysia Act 2009 to issue binding rulings on Shariah matters. While civil courts retain jurisdiction over all financial disputes—including those arising from Islamic finance—their reliance on conventional legal doctrines can conflict with Shariah principles embedded in Islamic contracts. This has led to notable inconsistencies in judicial decisions, particularly where civil courts interpret concepts like *riba* (interest), *gharar* (uncertainty), and *maslahah* (public interest) through a conventional lens, potentially undermining the ethical foundations of Islamic finance (Ali, Oseni, Adeyemi, & Zain, 2016). The courts' limited application of SAC guidance has raised concerns about legal certainty and the enforceability of Islamic financial instruments.

The effectiveness of the SAC in shaping legal outcomes is further constrained by the judiciary's limited exposure to Islamic legal reasoning. Despite SAC rulings being statutorily binding on courts concerning Islamic financial matters, the lack of specialized judicial training in Shariah law impairs consistent application (Oseni & Hassan, 2015). This disconnect not only affects the credibility of Islamic banking but also challenges the broader goal of legal pluralism that Malaysia aspires to uphold. Comparative studies indicate that while Malaysia has made commendable progress relative to other jurisdictions such as Indonesia or the UAE, its model of legal dualism still faces practical inefficiencies and conceptual ambiguity (Yaacob, 2012).

Ongoing reforms have aimed to address these gaps, focusing on enhancing judicial competence through targeted training programs, refining regulatory processes, and proposing institutional innovations such as specialized financial courts (Hasan, 2020). These efforts seek to harmonize the application of Shariah and civil law, thereby fostering greater predictability and investor confidence. Nonetheless, literature emphasizes that structural adjustments alone are insufficient; a deeper integration of Shariah principles into the mainstream legal framework is essential for the long-term viability of the dual system. This includes developing mechanisms for dynamic jurisprudential dialogue between civil and Shariah authorities, and embedding Islamic financial literacy within the legal education curriculum.

In sum, the literature underscores that while Malaysia's dual banking framework is supported by a sophisticated regulatory apparatus, its efficacy is impeded by unresolved legal dualities and institutional fragmentation. Addressing these challenges requires not only legislative reforms but also the political and scholarly will to reconceptualize the interface between Shariah and civil legal norms within a unified judicial context.

RESEARCH METHODOLOGY

This study adopts a qualitative research methodology grounded in doctrinal legal research and systematic literature review. The research does not involve any primary data collection such as surveys, interviews, or field observations. Instead, it relies on secondary sources including academic journal articles, statutory provisions, regulatory frameworks, court judgments, and authoritative commentaries relevant to the legal and regulatory aspects of conventional and Islamic banking in Malaysia. A doctrinal approach is employed to examine statutory instruments such as the Islamic Banking Act 1983, the Financial Services Act 2013, and the Islamic Financial Services Act 2013, alongside judicial interpretations that highlight the interaction between civil law and Shariah principles. The literature review is conducted using databases such as Scopus, JSTOR, Google Scholar, and official publications by Bank Negara Malaysia and the Shariah Advisory Council.

Sources are selected based on their relevance, credibility, and contribution to scholarly discourse on Malaysia's dual banking system. This methodology enables a critical and comparative analysis of the current regulatory landscape, identifies legal ambiguities, and highlights areas requiring reform for improved integration between the two banking systems.

FINDINGS AND DISCUSSION

Jurisdictional Tension Between Civil and Shariah Legal Frameworks

A central challenge arising from Malaysia's dual banking system is the jurisdictional tension between civil law and Shariah law, especially in adjudicating Islamic finance disputes. While Islamic financial institutions operate based on contracts governed by Shariah principles—such as the prohibition of *riba*, *gharar*, and speculative elements—the enforcement of these contracts falls within the purview of civil courts under Malaysia's common law system. Ali et al. (2016) emphasize that this overlap often results in Islamic contracts being interpreted through conventional legal frameworks, thereby undermining the distinctiveness and integrity of Islamic legal norms. For instance, courts may prioritize established principles of contract law, such as consideration and enforceability, over Shariah doctrines such as *maslahah* (public interest) or *istihsan* (juridical preference), leading to outcomes that diverge from the intentions behind Shariah-compliant transactions.

Moreover, while the Central Bank of Malaysia Act 2009 grants the Shariah Advisory Council (SAC) legal authority to issue binding rulings on Shariah matters, in practice, civil court judges retain discretion in how these rulings are applied. Oseni and Hassan (2015) note that the practical integration of SAC rulings into judicial reasoning remains inconsistent, partly due to varying levels of understanding of Islamic jurisprudence among judges.

This discrepancy reflects a broader systemic issue: the parallel operation of two legal logics within a single judiciary that lacks a unified interpretative framework. Consequently, Islamic banking disputes may be resolved in ways that satisfy procedural civil law requirements but compromise the ethical and jurisprudential aims of Islamic finance.

Fragmentation and Overlaps in Regulatory Authority

Another critical issue is the fragmented nature of regulatory oversight in Malaysia's dual banking system. Despite Bank Negara Malaysia's central role in supervising both conventional and Islamic financial institutions, the legislative environment comprising the Financial Services Act 2013 (FSA), the Islamic Financial Services Act 2013 (IFSA), and the Central Bank of Malaysia Act 2009 often results in overlapping mandates and regulatory uncertainty.

Yaacob (2012) argues that such fragmentation creates inefficiencies in compliance and oversight, particularly when financial products exhibit hybrid characteristics that blur the line between conventional and Islamic finance.

The regulatory challenge is exacerbated by differing interpretations of key concepts such as risk-sharing, profit-loss arrangements, and the permissibility of certain contract structures (e.g., *bay' bithaman ajil* or *murabahah*). While the SAC serves as the authoritative body on Shariah matters, its guidance must be implemented through operational regulations that align with the broader legal and financial systems.

Hasan (2020) highlights that this alignment is not always seamless, resulting in institutions facing uncertainty over whether certain financial innovations will be deemed both Shariah-compliant and legally enforceable. The lack of a cohesive mechanism for integrating Shariah rulings with regulatory enforcement undermines the coherence of the legal system and creates operational risks for Islamic financial institutions.

Legal Aspect	Civil Law Perspective	Shariah Law Perspective
Interest (Riba)	Permitted under contractual agreement	Strictly prohibited
Uncertainty (Gharar)	Permitted unless clearly deceptive	Prohibited in transactions
Jurisdiction	Adjudicated by civil courts	Subject to Shariah Advisory Council advice
Binding Authority	Based on statute and precedent	Based on Qur'an, Hadith, Ijma'

Table 1: Key Differences Between Civil Law and Shariah Law in Financial Contract Enforcement, adapted from Dusuki & Bouheraoua (2011)

The Imperative for Judicial and Institutional Reform

The third major finding concerns the need for judicial and institutional reform to ensure the effective implementation of dual banking regulations. The literature reveals that one of the key barriers to legal coherence in Islamic finance is the insufficient capacity of civil courts to adjudicate disputes grounded in Shariah jurisprudence. Oseni and Hassan (2015) and Hasan (2020) both advocate for the creation of specialized financial courts or tribunals, staffed by judges trained in both civil and Islamic law, as a solution to this problem. Such a move would enhance judicial competence, ensure doctrinal fidelity, and reduce inconsistencies in rulings on Islamic banking contracts.

Institutional reform must also involve clarifying the hierarchy of legal authorities in matters involving Islamic finance. Although SAC rulings are deemed binding, their integration into the judiciary's reasoning process must be better codified through procedural guidelines and statutory amendments. Furthermore, the development of a legal taxonomy that categorizes Islamic financial contracts according to both Shariah principles and enforceable civil obligations could provide clearer interpretative tools for courts. In the absence of such systemic reforms, Malaysia risks perpetuating a form of legal dualism that dilutes the objectives of Islamic finance and undermines investor confidence, both domestically and internationally.

In summary, while Malaysia has made considerable progress in establishing a robust legal and institutional framework for its dual banking system, the literature underscores three key areas where challenges persist: jurisdictional conflict between legal systems, fragmentation of regulatory authority, and insufficient judicial capacity. Addressing these issues requires not only legal reforms but also a paradigm shift in how Malaysia conceptualizes and operationalizes the integration of Shariah and civil law.

CONCLUSION AND RECOMMENDATIONS

The dual banking system in Malaysia, which includes both conventional and Islamic banking, faces some important challenges. This study identifies three main issues. First, there are jurisdictional conflicts between civil law and Shariah law. When Islamic banking disputes are handled in civil courts, they may not fully consider Shariah principles, leading to inconsistent legal rulings and undermining the reliability of Islamic financial contracts. Second, regulatory oversight is fragmented. Although Malaysia has strong institutions like Bank Negara Malaysia (BNM) and the Shariah Advisory Council (SAC), their roles are not always well-coordinated, causing confusion and inefficiencies. Finally, there is a lack of specialized knowledge about Islamic finance among judges and regulatory officials, making it hard to apply Shariah principles consistently. These issues suggest the need for reforms to help both banking systems function better together.

To address these problems, it is recommended to create a specialized court or tribunal for Islamic finance. This court would have judges trained in both civil law and Shariah law, ensuring that Islamic finance disputes are handled more accurately and consistently. This would reduce the confusion caused by civil courts unfamiliar with Islamic law and help build trust in the legal system for both Islamic banks and their clients.

Better coordination between regulatory bodies, such as BNM and SAC, is also needed. These institutions should work together more closely to streamline regulations and avoid overlap between the two legal systems. A unified regulatory framework would help provide clearer guidelines for Islamic banks, making the environment more predictable and reducing uncertainty. In addition, there should be more training for judges and legal professionals on Islamic finance. This would help ensure that they understand both Shariah law and civil law, leading to more accurate and consistent rulings in Islamic finance cases. Specialized education for the judiciary would also reduce legal confusion and make the system work more smoothly.

Lastly, the role of the Shariah Advisory Council (SAC) should be strengthened. SAC rulings should be given more authority and consistently applied within the legal system. This would help align Shariah principles with civil law, reducing legal friction and providing clearer guidance for Islamic financial institutions. If these steps are taken, Malaysia's dual banking system could become more efficient and effective, addressing the challenges it faces today.

In conclusion, Malaysia has made progress in developing its dual banking system, but resolving the issues identified in this study is essential for its future success. By setting up a specialized tribunal, improving regulatory coordination, enhancing training for legal professionals, and strengthening the role of SAC, Malaysia can create a more cohesive legal framework that supports both conventional and Islamic banking.

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