

Research Article

Shariah Contracts in Malaysian Islamic Banking: Regulatory Framework, Applications, and Contemporary Challenges

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Abstract. Islamic banking in Malaysia has experienced significant growth over the past four decades, positioning the country as a global leader in Islamic finance. This development is supported by the implementation of Shariah-compliant contracts as fundamental legal and ethical instruments governing financial transactions. This study aims to examine the regulatory framework of Shariah contracts in Malaysian Islamic banking, including the roles of Bank Negara Malaysia (BNM) and the Shariah Advisory Council (SAC) in ensuring compliance and standardization. The study also analyzes the application of key contracts, such as Murabahah, Ijarah, Mudarabah, Musharakah, and Wa'd, in various Islamic banking products and services. Using a qualitative research approach, data were collected through a systematic review of literature, regulatory frameworks, and official documents issued by Malaysian financial authorities. The findings reveal that Malaysia has established a strong Shariah governance framework; however, several challenges remain, including differences in Shariah interpretation, limited application of equity-based contracts, fintech regulatory issues, and tensions between commercial objectives and Maqasid al-Shariah principles. This study concludes that strengthening Shariah governance, enhancing cooperation between scholars and practitioners, and developing adaptive regulations are essential to ensuring the sustainability and competitiveness of Islamic banking in Malaysia.

Keywords: Islamic Banking; Malaysia; Maqasid al-Shariah; Regulatory Framework; Shariah Contracts.

Received: May 21, 2026

Revised: May 30, 2026

Accepted: June 20, 2026

Published: June 30, 2026

Curr. Ver.: June 30, 2026



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1. Introduction

Background of Study

The emergence of Islamic banking as a globally significant financial system represents one of the most consequential developments in the contemporary history of finance. Rooted in the ethical and jurisprudential principles of Shariah, Islamic banking offers an alternative to the conventional interest-based system by promoting equity, risk-sharing, and the prohibition of *riba* (usury), *gharar* (excessive uncertainty), and *maysir* (speculation) (Iqbal & Mirakhor, 2011). Since the establishment of the first modern Islamic bank in Egypt in the 1960s, the industry has grown exponentially, with global Islamic finance assets surpassing USD 4 trillion and operating across more than 80 jurisdictions worldwide (Islamic Financial Services Board [IFSB], 2023). This growth reflects not only the rising demand among Muslim-majority populations for faith-compliant financial services but also a growing global recognition of Islamic finance as an ethical and socially responsible alternative.

Within this global landscape, Malaysia occupies an unrivalled position as a pioneer and leading hub of Islamic banking. The country's Islamic finance journey commenced formally with the enactment of the Islamic Banking Act 1983, which provided the legal foundation for the establishment of Bank Islam Malaysia Berhad - the nation's first full-fledged Islamic bank (Bank Negara Malaysia [BNM], 2020). This milestone inaugurated Malaysia's distinctive dual banking system, wherein Islamic and conventional banks operate in parallel under a unified

regulatory architecture. The subsequent introduction of the Islamic Financial Services Act 2013 (IFSA) further consolidated and modernized the regulatory framework, integrating prudential oversight, Shariah governance requirements, and consumer protection within a single legislative instrument. Today, Malaysia consistently ranks among the top global destinations for Islamic finance, contributing substantially to international sukuk markets, Islamic fund management, and takaful industries (IFSB, 2023).

At the foundation of Malaysia's Islamic banking system lies a diverse array of Shariah-compliant contracts that serve as the legal and ethical instruments through which financial products and services are structured. Contracts such as Murabahah (cost-plus sale), Tawarruq (commodity murabahah), Ijarah (leasing), Mudarabah (profit-sharing), and Musharakah (partnership) each represent distinct modes of financial intermediation that are anchored in classical Islamic jurisprudence (Abdul Ghafar & Nor Hayati, 2020). These contracts are more than procedural formalities; they embody the higher objectives of Islamic law - Maqasid al-Shariah - which seeks to protect and promote human welfare through the preservation of religion, life, intellect, lineage, and wealth (Chapra, 2008). The degree to which modern banking practice faithfully reflects these objectives remains a central concern for scholars, regulators, and practitioners alike, underscoring the enduring relevance of Shariah contracts as both a scholarly and practical subject of inquiry.

Problem Statement

Notwithstanding Malaysia's achievements in Islamic banking, a critical examination of the field reveals persistent and deepening tensions between classical Shariah contract theory and its modern banking implementation. The most pressing of these concerns relates to the growing reliance on structured products, particularly Tawarruq, which has attracted significant scholarly criticism for its proximity to the very interest-based transactions that Islamic banking was designed to replace (Rosly & Bakar, 2003). While Tawarruq has been conditionally sanctioned by the SAC in Malaysia, its widespread application in personal financing and liquidity management products has reignited debates about whether the form of contractual compliance is being prioritized over its substance and spirit (Dusuki & Abozaid, 2007). This tension between legal permissibility and Maqasid al-Shariah alignment constitutes a fundamental unresolved challenge within the discipline.

Further compounding this challenge is the complexity of regulatory compliance under the IFSA 2013, which imposes heightened standards of Shariah governance, disclosure, and accountability on Islamic financial institutions. While these standards represent a significant regulatory advancement, their implementation has revealed practical difficulties, including inconsistencies in Shariah interpretation across institutions, inadequate institutional capacity among smaller banks, and the persistent challenge of distinguishing Islamic corporate governance from its conventional counterpart (Ginena & Hamid, 2015). Additionally, the rapid proliferation of financial technology and digital banking platforms has introduced a new generation of challenges for which the existing regulatory and Shariah governance frameworks were not originally designed. The integration of peer-to-peer financing, digital tokens, robo-advisory services, and blockchain-based contracts into the Islamic finance ecosystem raises novel jurisprudential questions that demand urgent scholarly and regulatory attention (Laldin & Furqani, 2018). Collectively, these issues signal a significant gap in the existing literature and underscore the need for a comprehensive and contemporaneous study of Shariah contracts within the Malaysian Islamic banking context.

Research Objectives

The objectives of this study are to examine the regulatory framework governing Shariah contracts in Malaysian Islamic banking, with particular reference to the roles of Bank Negara Malaysia and the Shariah Advisory Council. This study also aims to analyze the practical applications of key Shariah contracts, including Murabahah, Tawarruq, Ijarah, Mudarabah, and Musharakah, across Islamic banking products and services in Malaysia. Furthermore, this study seeks to identify and critically assess the contemporary challenges confronting the implementation of Shariah contracts in the context of regulatory compliance, product structuring, and the emergence of fintech and digital banking.

Research Questions

RQ1. How are Shariah contracts regulated within the Malaysian Islamic banking industry, and what is the institutional role of BNM and the SAC in ensuring compliance and standardisation?

RQ2. How are key Shariah contracts applied in the structuring of Islamic banking products and services in Malaysia, and to what extent do these applications align with Maqasid al-Shariah?

RQ3. What are the principal challenges confronting the implementation of and compliance with Shariah contracts in Malaysian Islamic banking, particularly in the context of emerging financial technologies and regulatory developments?

Scope of Study

This study focuses specifically on Islamic banking institutions operating within Malaysia's dual banking system, with primary attention to institutions regulated under the Islamic Financial Services Act 2013. The regulatory scope is defined by the guidelines, Shariah standards, and rulings issued by Bank Negara Malaysia and its Shariah Advisory Council, which constitute the authoritative framework governing Shariah compliance in the country. In terms of contractual scope, the study concentrates on five foundational Shariah contracts that are most prevalent in Malaysian Islamic banking practice: Murabahah, Tawarruq, Mudarabah, Musharakah, and Ijarah. While the study acknowledges the broader global discourse on Islamic finance, its analytical focus remains firmly grounded in the Malaysian context, thereby ensuring depth, specificity, and practical relevance.

2. Literature Review

Concept of Shariah Contracts

In Islamic jurisprudence, a contract, referred to as *aqd* (plural: *uqud*), is defined as the conjunction of an offer (*ijab*) and an acceptance (*qabul*) in a manner that is legally recognized and that produces binding legal consequences upon the contracting parties (Al-Zuhayli, 2003). The term *aqd* is derived from the Arabic root meaning "to tie" or "to bind," reflecting the normative expectation that a validly constituted contract creates enforceable obligations grounded in mutual consent and good faith. Classical Islamic jurists from the four major schools of jurisprudence, Hanafi, Maliki, Shafi'i, and Hanbali, have extensively theorized the conditions of contractual validity, establishing a rich body of *fiqh al-muamalat* (Islamic commercial jurisprudence) that continues to inform contemporary Islamic banking practice (Qudama et al., 2007). The validity of a Shariah contract rests upon several foundational conditions.

First, there must be the free and informed consent (*taradi*) of all contracting parties, free from coercion, fraud, or misrepresentation, a principle that directly mirrors the modern legal concept of *consensus ad idem* (Ayub, 2007).

Second, Islamic contracts are governed by the principle of asset-backing, which requires that every financial transaction be linked to a tangible, identifiable, and permissible underlying asset or usufruct. This requirement fundamentally distinguishes Islamic finance from conventional finance, where financial instruments can be created and traded independently of real economic activity (Iqbal & Mirakhor, 2011).

Third, the principle of risk-sharing (*al-ghunm bil ghurm*) mandates that financial returns must be commensurate with the assumption of risk, thereby prohibiting arrangements that guarantee returns in the absence of genuine commercial exposure (Usmani, 2002). Together, these core principles, consent, asset-backing, and risk-sharing, constitute the ethical infrastructure upon which all Shariah-compliant financial contracts are constructed.

The broader conceptual framework for evaluating Shariah contracts is provided by *Maqasid al-Shariah*, the higher objectives of Islamic law. Chapra (2008) argues that Islamic financial contracts must not only satisfy formal Shariah requirements but must also demonstrably serve the welfare of individuals and society, a standard that transcends mere technical compliance. This distinction between the form and substance of contractual compliance has become a central axis of contemporary scholarly debate, particularly as the Islamic banking industry has grown more sophisticated and commercially driven. The alignment of contractual structures with the spirit of *Maqasid al-Shariah*, rather than merely its letter, remains one of the most enduring and contested questions in Islamic finance scholarship.

Types of Shariah Contracts in Islamic Banking

Islamic banking products are structured around three broad categories of Shariah contracts: exchange-based contracts, partnership-based contracts, and hybrid structures. Each category reflects a distinct mode of financial intermediation and carries its own set of jurisprudential conditions and regulatory implications.

Exchange-based contracts represent the most widely deployed category in contemporary Islamic banking.

Murabahah

A cost-plus-profit sale contract in which the seller discloses the cost of an asset and adds an agreed profit margin, is the most prevalent financing instrument in Malaysian Islamic banking, accounting for a significant proportion of total Islamic financing assets (BNM, 2022). Its widespread adoption is attributable to its simplicity, predictability of returns, and ease of regulatory compliance.

Ijarah (leasing)

Involves the transfer of usufruct, the right to use an asset, for an agreed consideration over a defined period, without transferring ownership of the asset itself (Al-Zuhayli, 2003). It is widely used in vehicle financing, home financing, and equipment leasing.

Salam

Is a forward sale contract in which full payment is made in advance for goods to be delivered at a future date, primarily applied in agricultural and commodity financing (Usmani, 2002).

Istisna'

A manufacturing contract in which a party commissions the production of a specified asset for delivery upon completion, is particularly relevant to project and infrastructure financing (Abdul Ghafar & Nor Hayati, 2020). These exchange contracts, while commercially effective, have been critiqued by scholars who argue that their application often mimics conventional loan structures, thereby undermining the risk-sharing ethos of Islamic finance (Dar & Presley, 2000).

Partnership-based contracts occupy a theoretically central, though practically marginalized, position in Islamic banking.

Musharakah

Is a joint venture or equity partnership contract in which two or more parties contribute capital and share profits and losses in proportion to their respective contributions (Usmani, 2002). It most closely approximates the ideal of risk-sharing envisioned by Islamic finance scholars and is considered the most authentic expression of Maqasid al-Shariah in the financial domain.

Mudarabah

Is a profit-sharing arrangement in which one party provides capital (rabb al-mal) and the other provides managerial expertise and labor (mudarib), with profits shared according to a pre-agreed ratio and losses borne exclusively by the capital provider (Al-Zuhayli, 2003). Despite their theoretical primacy, both Musharakah and Mudarabah remain significantly underutilised in Malaysian Islamic banking practice, owing to concerns about high risk, information asymmetry, moral hazard, and the absence of adequate regulatory incentives (Dar & Presley, 2000; Rosly & Bakar, 2003).

Hybrid structures represent an increasingly prominent feature of the Malaysian Islamic banking landscape.

Tawarruq

Also known as commodity murabahah, is a tripartite arrangement in which a customer purchases a commodity on a deferred payment basis and immediately sells it to a third party for immediate cash, effectively generating a cash loan without explicit interest (Dusuki & Abozaid, 2007). While conditionally permitted by the SAC in Malaysia, Tawarruq has been subject to mounting scholarly criticism because it is functionally indistinguishable from a conventional interest-bearing loan and contravenes the substance of Shariah prohibition.

Diminishing Musharakah (Musharakah Mutanaqisah)

Is a hybrid partnership-leasing structure in which the bank and customer jointly own an asset, with the customer progressively acquiring the bank's share over time through scheduled payments while simultaneously paying rent on the bank's remaining portion (BNM, 2022). It is widely regarded as a more authentic alternative to conventional mortgage financing and has gained considerable traction in Malaysian home financing products.

Malaysian Regulatory Framework

The regulatory architecture governing Shariah contracts in Malaysia is among the most comprehensive and institutionally developed in the global Islamic finance industry. Its cornerstone is the Islamic Financial Services Act 2013 (IFSA), which replaced the Islamic Banking Act 1983 and the Takaful Act 1984, consolidating the regulatory oversight of Islamic banking, takaful, and Islamic financial markets under a single legislative framework. IFSA 2013 introduces several landmark provisions, including mandatory Shariah compliance obligations for all licensed Islamic financial institutions, enhanced powers for BNM to issue Shariah standards, and strengthened governance requirements that explicitly distinguish Islamic corporate governance from its conventional counterpart (BNM, 2013). The Act

represents a paradigm shift from a reactive, product-approval-based regulatory model to a proactive, principle-based governance framework that holds institutions accountable for the entirety of their Shariah compliance posture.

Bank Negara Malaysia plays the dual role of prudential regulator and Shariah governance overseer for Islamic financial institutions. Through its issuance of policy documents, exposure drafts, and Shariah standards, such as those governing Murabahah, Ijarah, Mudarabah, Musharakah, and Tawarruq, BNM provides detailed operational requirements that Islamic banks must adhere to in structuring their products and conducting their business (BNM, 2020). These standards are designed to harmonize practice across institutions, reduce the risk of Shariah non-compliance events, and ensure that the application of Shariah contracts is consistent with the underlying principles of Islamic jurisprudence. BNM's regulatory approach is notable for its emphasis on substance over form, a principle that directly addresses the concern that banks may achieve technical Shariah compliance while deviating from the spirit of Maqasid al-Shariah.

The Shariah Advisory Council of Bank Negara Malaysia (SAC) occupies a uniquely authoritative position in the Malaysian Islamic finance regulatory framework. Established under the Central Bank of Malaysia Act 2009, the SAC serves as the sole authoritative body for the ascertainment of Islamic law for Islamic financial business in Malaysia (BNM, 2020). Its rulings are legally binding on all Islamic financial institutions, Shariah committees, and significantly, on the civil courts and arbitration bodies adjudicating Islamic finance disputes. This binding authority distinguishes Malaysia's model from most other jurisdictions, where Shariah advisory bodies typically serve in an advisory or consultative capacity only (Ginena & Hamid, 2015). The SAC's binding status has been credited with reducing jurisprudential fragmentation and enhancing legal certainty in Malaysian Islamic banking, though it has also attracted scholarly debate regarding the appropriate balance between regulatory authority and independent scholarly *ijtihad* (Laldin & Furqani, 2018).

Previous Studies

The academic literature on Shariah contracts in Malaysian Islamic banking has grown considerably over the past two decades, with scholars examining a range of issues from contractual theory to regulatory practice. A prominent strand of this literature focuses on the dominance of Tawarruq in Malaysian Islamic banking products. Dusuki & Abozaid (2007) conducted a critical assessment of Tawarruq's application in Malaysian Islamic banks, concluding that the contract's widespread use represents a circumvention of the *riba* prohibition rather than a genuine compliance with it. Their study found that most Tawarruq transactions in Malaysia are structured in a manner that renders the underlying commodity sale a mere legal fiction, thereby failing the Maqasid al-Shariah test. This critique was subsequently reinforced by Mohamad & Ab Rahman (2014), who documented the near-total dominance of debt-based and quasi-debt instruments, including Tawarruq and Murabahah, in Malaysian Islamic bank financing portfolios, and argued for systemic policy interventions to incentivize the adoption of equity-based instruments.

A second significant body of literature examines the effectiveness of Shariah governance mechanisms within Malaysian Islamic banking institutions. Ginena & Hamid (2015) provided a comprehensive theoretical and empirical analysis of Shariah governance frameworks across multiple jurisdictions, identifying Malaysia as a model of regulatory sophistication while noting persistent challenges related to the shortage of qualified Shariah scholars, the concentration of scholar appointments across multiple institutions, and the risk of governance capture. Hasan (2014) similarly highlighted structural weaknesses in the internal Shariah compliance functions of Malaysian Islamic banks, including inadequate Shariah audit capabilities, insufficient training of compliance personnel, and the absence of standardized methodologies for Shariah risk assessment. These findings collectively suggest that while Malaysia's institutional framework is robust at the macro-regulatory level, implementation gaps remain at the institutional level.

A third area of scholarly inquiry addresses the legal duality arising from the parallel operation of civil and Shariah law in Malaysia's judicial system. Islamic financial disputes in Malaysia may be adjudicated by civil courts applying civil law principles, or, since the enactment of the Central Bank of Malaysia Act 2009, referred to the SAC for Shariah determinations that are binding on the courts. Oseni and Ahmad (2012) examined the jurisdictional tensions inherent in this dual legal framework, noting that the application of civil law principles to Islamic finance contracts occasionally produces outcomes that are inconsistent with Shariah requirements. Their study called for greater integration between civil and Shariah legal principles in the resolution of Islamic finance disputes, and recommended the development of a specialized Islamic finance court or tribunal equipped

with sufficient expertise in both domains. Taken together, these streams of literature converge on a shared conclusion: that while Malaysia has made remarkable strides in institutionalizing Islamic banking, the gap between regulatory aspiration and operational reality, particularly in the domains of contract authenticity, governance effectiveness, and legal coherence, remains a critical area requiring continued scholarly and policy attention.

3. Method

Research Design

This study adopts a qualitative research approach employing a conceptual and doctrinal legal analysis to examine the regulatory framework, practical applications, and contemporary challenges of Shariah contracts in Malaysian Islamic banking. Qualitative research is particularly suitable for studies that seek to understand legal principles, regulatory structures, and institutional practices through the interpretation of textual and documentary evidence rather than through statistical measurement (Creswell & Creswell, 2018).

The doctrinal legal analysis method is widely used in legal and Islamic finance research because it enables a systematic examination of laws, regulations, policy documents, and jurisprudential sources governing specific financial practices (Hutchinson & Duncan, 2012). In the context of Islamic banking, this approach facilitates an in-depth assessment of how Shariah contracts are regulated, interpreted, and implemented within Malaysia's dual banking system. The study focuses on major Shariah contracts commonly applied in Islamic banking products, including *murābahah*, *tawarruq*, *mushārah*, *muḍārah*, *ijārah*, and *wakālah*.

Furthermore, the study adopts a conceptual analytical framework by integrating regulatory analysis with Islamic jurisprudential perspectives. This allows for an examination of both the legal validity and practical implications of Shariah contracts within contemporary banking operations. The approach is particularly relevant given the dynamic nature of Islamic financial innovation and the continuous evolution of regulatory standards governing Islamic banking institutions in Malaysia.

Data Collection

The study relies exclusively on secondary data obtained from authoritative and credible sources relevant to Islamic banking regulation and practice. Secondary data are appropriate for doctrinal and conceptual research because they provide comprehensive information regarding legal frameworks, institutional policies, and scholarly interpretations (Johnston, 2017).

The primary sources of data include regulatory publications issued by Bank Negara Malaysia (BNM), particularly the Islamic Financial Services Act 2013 (IFSA 2013), policy documents on Shariah governance, and standards governing Islamic banking operations. These documents provide the legal and regulatory foundation for the implementation of Shariah contracts within Malaysian financial institutions.

In addition, resolutions and policy decisions issued by the Shariah Advisory Council (SAC) of Bank Negara Malaysia serve as important sources for understanding official Shariah interpretations and rulings relating to Islamic banking products and contractual structures. SAC resolutions are particularly significant because they function as the highest authority on Shariah matters in Islamic finance within Malaysia.

The study also draws upon academic journal articles, books, conference proceedings, and scholarly publications on Islamic banking, Shariah contracts, and financial regulation. These sources provide theoretical perspectives and empirical discussions concerning the application and challenges of Islamic financial contracts. Furthermore, annual reports and sustainability reports published by Islamic banking institutions operating in Malaysia are reviewed to examine practical implementations of Shariah contracts and product offerings within the industry.

Collectively, these sources provide a comprehensive foundation for evaluating the interaction between regulatory requirements, Shariah principles, and operational practices in Malaysian Islamic banking.

Data Analysis

The collected data are analyzed using content analysis and thematic analysis techniques. Content analysis is a systematic method for examining textual materials in order to identify patterns, meanings, and relationships within documents (Krippendorff, 2018). This method is particularly suitable for analyzing legal texts, regulatory documents, policy frameworks, and scholarly literature related to Islamic banking.

The analysis begins with a detailed review of regulatory and institutional documents to identify the legal and Shariah requirements governing Islamic banking contracts in Malaysia. Relevant provisions from IFSA 2013, Bank Negara Malaysia policy documents, and SAC

resolutions are examined to determine the regulatory framework supporting the application of Shariah contracts.

Subsequently, thematic analysis is employed to categorize findings into key themes that emerge from the literature and regulatory documents. According to Braun & Clarke (2006), thematic analysis enables researchers to identify recurring patterns and organize qualitative data into meaningful analytical categories. For the purpose of this study, three major themes guide the analysis.

The first theme focuses on regulatory frameworks, examining the role of Bank Negara Malaysia, the Islamic Financial Services Act 2013, Shariah governance requirements, and regulatory oversight mechanisms that govern Islamic banking operations.

The second theme explores product applications, particularly the implementation of Shariah contracts in Islamic banking products and services. This includes examining how contracts such as *murābahah*, *tawarruq*, *mushārakah*, *muḍārabah*, *ijārah*, and *wakālah* are structured and utilized by Islamic financial institutions.

The third theme addresses contemporary challenges affecting the implementation of Shariah contracts. These challenges include regulatory compliance issues, product standardization, Shariah governance concerns, legal documentation complexities, differing juristic interpretations, and the ongoing debate regarding the authenticity of certain Islamic banking products.

Through these analytical procedures, the study develops a comprehensive understanding of the relationship between regulatory requirements, contractual applications, and emerging challenges within the Malaysian Islamic banking industry. The findings are subsequently interpreted within the broader context of Islamic finance development and Shariah compliance, allowing for a balanced assessment of current practices and future directions for the industry.

4. Results and Discussion

Regulatory Framework of Shariah Contracts in Malaysia

Malaysia is widely recognized as one of the leading jurisdictions in the development and regulation of Islamic finance (Islamic Financial Services Board [IFSB], 2022). The success of Malaysian Islamic banking can largely be attributed to its comprehensive regulatory framework, which ensures that Islamic financial institutions operate in accordance with Shariah principles while maintaining financial stability and consumer protection (Bank Negara Malaysia, 2010).

The primary legislation governing Islamic banking in Malaysia is the Islamic Financial Services Act (IFSA) 2013. The Act was introduced to strengthen the legal and regulatory framework of Islamic financial institutions by providing clear guidelines on Shariah compliance, risk management, governance, and consumer protection (Islamic Financial Services Act 2013). IFSA 2013 emphasizes that all Islamic financial products and services must comply with Shariah principles at all times. Failure to comply with Shariah requirements may result in regulatory actions and penalties.

A significant feature of Malaysia's Islamic finance framework is the role of the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM). The SAC serves as the highest authority on Shariah matters relating to Islamic finance in Malaysia. Established under the Central Bank of Malaysia Act 2009, the SAC is responsible for issuing rulings and resolutions regarding Shariah issues arising in Islamic financial transactions (Central Bank of Malaysia Act 2009). The decisions of the SAC are legally binding on Islamic financial institutions, arbitrators, and courts whenever Shariah-related matters are involved. This legal recognition enhances consistency in the interpretation and application of Shariah principles across the industry (Central Bank of Malaysia Act 2009). It also minimizes disputes and uncertainties that may arise due to differing scholarly opinions.

In addition to the SAC, Bank Negara Malaysia issues various policy documents and Shariah standards to guide financial institutions in implementing specific contracts (Bank Negara Malaysia, 2010). These standards provide detailed operational requirements, legal structures, risk management procedures, and governance expectations for Islamic banking products. The standardization of Shariah contracts has contributed significantly to the growth of Islamic banking in Malaysia. Customers and investors have greater confidence in Islamic financial products because of the robust regulatory oversight (IFSB, 2022). Furthermore, Malaysia's regulatory model has become a reference point for many countries seeking to develop their own Islamic finance industries. However, despite the strengths of the framework, regulatory compliance remains challenging. Islamic banks must continuously monitor their products and operations to ensure alignment with evolving regulatory

requirements and Shariah standards. This requires substantial investment in compliance systems, training, and governance structures (Bank Negara Malaysia, 2010).

Application of Shariah Contracts in Malaysian Banking Products

Murabaha

Murabaha is one of the most commonly used contracts in Islamic banking. It is a cost-plus sale agreement where the bank purchases an asset requested by a customer and subsequently sells it to the customer at an agreed price that includes a disclosed profit margin (Usmani, 2002). Murabaha is widely used in asset financing, trade financing, equipment financing, and vehicle financing. The contract provides transparency because both the acquisition cost and profit margin are disclosed to the customer (Rosly, 2005).

The popularity of Murabaha can be attributed to its simplicity and predictability. Customers know exactly how much they are required to pay throughout the financing period. From the bank's perspective, Murabaha offers lower risk compared to partnership-based contracts because the profit is predetermined. Despite its widespread use, some scholars argue that Murabaha resembles conventional lending because the profit margin is fixed (Hanif, 2016). Nevertheless, the transaction remains Shariah-compliant because it is based on a genuine sale of an underlying asset rather than the lending of money with interest (Usmani, 2002).

Tawarruq

Tawarruq has emerged as the dominant financing structure in Malaysia's Islamic banking industry (Bank Negara Malaysia, 2019). The contract involves a series of commodity transactions that ultimately provide cash liquidity to customers. In a typical Tawarruq arrangement, the bank purchases a commodity from a supplier and sells it to the customer on a deferred payment basis. The customer subsequently sells the commodity to a third party for cash. Through this process, the customer obtains financing while maintaining compliance with Shariah principles. Tawarruq is extensively used in personal financing, home financing, credit facilities, and deposit products. Malaysian Islamic banks favor Tawarruq because of its operational flexibility and ability to meet diverse customer financing needs (Bank Negara Malaysia, 2019).

However, the extensive reliance on Tawarruq has generated considerable debate among scholars. Critics argue that the structure may replicate the economic effects of conventional loans despite complying with legal Shariah requirements (Hanif, 2016). This issue remains one of the most discussed topics in contemporary Islamic finance.

Mudarabah

Mudarabah is a profit-sharing contract involving two parties: the capital provider (rabb al-mal) and the entrepreneur or manager (mudarib). In Malaysian Islamic banking, Mudarabah is commonly used in investment accounts. Customers provide capital while the bank manages the investments. Any profits generated are distributed according to a pre-agreed profit-sharing ratio. One of the main advantages of Mudarabah is that it promotes risk-sharing, which is a core principle of Islamic finance (Laldin & Furqani, 2013). Unlike conventional fixed-interest investments, returns are linked to the actual performance of the investment.

However, Mudarabah also presents challenges. Customers may be reluctant to accept investment losses, while banks face difficulties in managing investment risks and ensuring transparency. Consequently, many Islamic banks have reduced their reliance on Mudarabah in favor of more predictable financing structures (Mokhtar et al., 2008).

Ijarah

Ijarah refers to an Islamic leasing contract where the bank retains ownership of an asset and leases it to a customer in exchange for rental payments (Usmani, 2002). The contract is commonly applied in vehicle leasing, equipment financing, and property leasing. During the lease period, ownership remains with the bank while the customer enjoys the right to use the asset. Ijarah provides flexibility because customers can access valuable assets without making a large upfront payment. Additionally, the contract clearly defines the rights and responsibilities of both parties.

The popularity of Ijarah reflects its practical applicability in modern financial markets. Nevertheless, banks must carefully manage ownership-related risks such as maintenance obligations and asset depreciation (Rosly, 2005).

Musharakah

Musharakah is a partnership contract in which two or more parties contribute capital to a joint venture and share profits and losses according to agreed terms (Usmani, 2002). In Malaysia, the most common form is Diminishing Musharakah, particularly in home financing. Under this arrangement, both the bank and the customer jointly own the property. The

customer gradually purchases the bank's ownership share through periodic payments until full ownership is achieved.

Diminishing Musharakah is often regarded as one of the most authentic Islamic financing structures because it embodies the principles of risk-sharing and partnership (Shaharuddin, 2011). Nevertheless, its implementation can be more complex than debt-based financing structures, resulting in higher administrative costs and operational challenges.

Contemporary Challenges

Over-Reliance on Tawarruq

One of the most significant challenges facing Malaysia's Islamic banking industry is the heavy dependence on Tawarruq-based financing (Bank Negara Malaysia, 2019).

Although Tawarruq provides practical solutions for customers and banks, excessive reliance on this contract has raised concerns regarding the authenticity of Islamic finance. Critics argue that the widespread use of Tawarruq shifts Islamic banking away from its original objective of promoting risk-sharing and equitable wealth distribution (Hanif, 2016; Shaharuddin, 2011). The dominance of Tawarruq may also limit innovation by discouraging the development of alternative Shariah-compliant financing structures (Laldin & Furqani, 2013).

Shariah Governance Complexity

Islamic banks operate within a highly regulated environment that requires compliance with multiple governance mechanisms. These mechanisms include regulations issued by Bank Negara Malaysia, rulings from the Shariah Advisory Council, internal Shariah Committees, external audits, and risk management frameworks (Bank Negara Malaysia, 2010). While these governance mechanisms strengthen accountability and enhance public confidence in Islamic banking operations, they also increase operational complexity and compliance costs. Smaller Islamic financial institutions may face particular challenges in maintaining the necessary expertise, resources, and capabilities required to fulfill these regulatory and governance requirements (Bank Negara Malaysia, 2010).

Legal Duality

Malaysia operates under a dual legal system consisting of civil law and Shariah law.

Although Islamic financial contracts are governed by Shariah principles, disputes are generally resolved within the civil court system. This situation may create tensions when judges must interpret complex Shariah concepts without specialized expertise (Central Bank of Malaysia Act 2009).

Differences between legal and Shariah perspectives may lead to uncertainties in contract enforcement and dispute resolution (Rosly, 2005).

Fintech Disruption

The rapid growth of financial technology (fintech) presents both opportunities and challenges for Islamic banking. Innovations such as digital banking, blockchain technology, artificial intelligence, peer-to-peer financing, and smart contracts are transforming financial services worldwide (IFSB, 2022).

While these technologies offer efficiency and accessibility, they also raise new Shariah issues that may not be fully addressed by existing regulatory frameworks. Regulators must therefore develop new guidelines that ensure technological innovation remains consistent with Islamic principles (IFSB, 2022).

Standardization versus Innovation Trade-Off

Standardization promotes consistency, transparency, and regulatory certainty. However, excessive standardization may reduce flexibility and limit innovation (Bank Negara Malaysia, 2010). Islamic banks must balance regulatory compliance with the need to develop innovative products that meet evolving customer expectations. Achieving this balance remains a critical challenge for the future growth of Islamic finance (Laldin & Furqani, 2013).

Discussion

Malaysia has achieved remarkable success in establishing a globally respected Islamic banking system. Strong regulatory institutions, comprehensive Shariah governance structures, and continuous regulatory development have contributed significantly to industry growth (IFSB, 2022; Bank Negara Malaysia, 2010).

However, a critical examination reveals a gap between the theoretical foundations of Islamic finance and practical implementation. Islamic finance was originally envisioned as a system promoting justice, risk-sharing, entrepreneurship, and socio-economic development (Laldin & Furqani, 2013). In practice, many Islamic banking products continue to rely heavily on debt-based structures. The dominance of Tawarruq and Murabaha indicates that Islamic banks often prioritize operational efficiency and profitability over equity-based financing.

Although these contracts comply with legal Shariah requirements, they may not fully realize the broader objectives of Maqasid al-Shariah (Shaharuddin, 2011; Hanif, 2016).

From a Maqasid al-Shariah perspective, Islamic finance should contribute to wealth circulation, social welfare, economic justice, and sustainable development (Laldin & Furqani, 2013). Greater utilization of Musharakah and Mudarabah financing could help achieve these objectives more effectively.

Furthermore, research has shown that customers often choose Islamic banks not only because of religious considerations but also due to service quality, reputation, and product competitiveness (Dusuki & Abdullah, 2007). Therefore, Islamic banks must balance Shariah compliance with commercial viability in an increasingly competitive financial environment.

Overall, Malaysia's regulatory framework remains highly effective in ensuring compliance and market stability. Nevertheless, continuous reforms are necessary to encourage innovation, enhance financial inclusion, and strengthen the alignment between Islamic banking practices and the ethical foundations of Shariah (IFSB, 2022; Laldin & Furqani, 2013).

5. Conclusion and Suggestions

Based on the findings of this study, several policies, institutional, and industry-level recommendations are proposed to enhance the effectiveness and sustainability of Shariah contracts within the Malaysian Islamic banking system.

First, regulatory authorities and industry stakeholders should gradually reduce over-reliance on Tawarruq-based structures and encourage greater diversification of Shariah contracts such as Musharakah, Mudarabah, and Ijarah-based financing. This would strengthen the authenticity of Islamic banking products and better align industry practices with the risk-sharing principles of Shariah.

Second, Bank Negara Malaysia and the Shariah Advisory Council (SAC) should continue to enhance regulatory clarity and harmonization of Shariah interpretations across financial institutions. Strengthening standardization efforts while preserving scholarly flexibility is essential to reduce legal uncertainty and improving consistency in product structuring and implementation.

Third, Islamic financial institutions should invest in simplifying product structures and improving transparency in documentation. Clearer disclosure of contract mechanisms would improve consumer understanding, enhance trust, and increase accessibility, particularly among retail customers who may lack technical financial literacy.

Fourth, continuous capacity building and professional training for practitioners, Shariah officers, and legal advisors should be prioritized. Strengthening expertise in both Shariah jurisprudence and modern financial engineering will improve product innovation while ensuring compliance with Islamic principles.

Fifth, policymakers and regulators should actively support technological innovation, including Islamic fintech solutions, while ensuring that digital transformation remains aligned with Shariah governance requirements. This includes developing clear regulatory frameworks for digital Islamic banking products and platforms.

Sixth, public awareness and financial literacy programmes should be expanded to improve understanding of Islamic banking principles and Shariah-compliant financial products. Greater awareness can enhance informed decision-making and strengthen public confidence in Islamic financial systems.

Finally, future research should adopt empirical approaches to evaluate the performance, efficiency, and risk characteristics of different Shariah contracts in practice. Comparative studies between conventional and Islamic financial instruments would also provide valuable insights for policy formulation and industry development.

This study examined the regulatory framework, practical applications, and contemporary challenges associated with Shariah contracts in Malaysian Islamic banking. The findings demonstrate that Malaysia has established one of the most advanced Islamic finance ecosystems globally. Through the implementation of IFSA 2013, the guidance of Bank Negara Malaysia, and the authority of the Shariah Advisory Council, the country has developed a robust framework that promotes Shariah compliance, consumer protection, and financial stability.

The study also found that contracts such as Murabaha, Tawarruq, Mudarabah, Ijarah, and Musharakah play a significant role in facilitating Islamic banking operations. These contracts provide customers with Shariah-compliant alternatives to conventional financial products. Despite these achievements, several challenges continue to affect the industry.

These include over-reliance on Tawarruq, governance complexity, legal duality, technological disruption, and the tension between standardization and innovation.

Therefore, while Malaysia has made substantial progress in Islamic finance development, further efforts are required to strengthen the industry's contribution toward achieving the broader objectives of Islamic economic principles and Maqasid al-Shariah.

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