SUSTAINABILITY OF ISLAMIC FINANCE INDUSTRY: ARBITRATION AS FORUM FOR DISPUTE RESOLUTION

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Abstract

Islamic finance industry is one of the fastest growing components of the global finance. The sustainable growth of the Islamic finance industry cannot be achieved without a comprehensive legal and judicial framework. An efficient legal framework for Islamic finance in any jurisdiction would require three basic elements namely enabling laws and regulations, enforceability of Islamic financial contract and appropriate dispute resolution mechanism. The objective of this paper is to discuss the possibility of Islamic finance industry moving towards alternative dispute resolution mechanism in particular the arbitration as forum for disputes settlement. This is due to the growing concern among industry players and public consumers that dispute resolutions by way of reference to the civil court will result in less than satisfactory decisions in terms of Shariah compliance.

Introduction

One of the main challenges faced by the Islamic finance industry is the problem in dispute resolution of the Islamic financial contracts. This is due to the nature of Islamic financial contracts which must be Shariah compliant, commercially viable, valid and enforceable based on the prevailing governing laws. Therefore Islamic financial contracts have to be drafted in
such a way that they must comply with the Islamic as well as existing civil laws. Furthermore, it must be structured in such a way as to be enforceable in the civil courts (Engku Rabiah Adawiyah, 2008). Since Islamic financial matters are complex issues, the civil courts face great challenges in meeting with the requirements of civil law and Shariah principles.

In Malaysia, Islamic banking and finance matters comes under the jurisdiction of the civil courts as provided in List 1, the Federal List (Ninth Schedule) of the Federal Constitution which includes within its scope the mercantile law (banking and finance). On the other hand, there are several arguments why Shariah court are considered as not having jurisdiction over Islamic financial matters. Among others, the jurisdiction of Shariah courts only over matters pertaining to Islamic law, personal and family laws such as divorce, wakaf, succession, offences against the precepts of Islam and others as provided in List II- the State List (Ninth Schedule) of the Federal Constitution. Besides that, the Shariah courts shall have jurisdiction only over persons professing the religion of Islam.

One of the main questions arises from the above legal environment is the issue of the competency of civil courts in dealing with the complexity of Islamic financial contracts. A string of cases involving Islamic financial contracts which had been decided by the courts so far shows that the civil courts failed to appreciate the underlying principles of Islamic financial contracts.

In *Bank Kerjasama Rakyat Malaysia v Emcee Corporation Sdn. Bhd.* [2003] 1 CLJ 625, the court of appeal in this case held that even though the facility given to the respondent was an Islamic Banking Facility, it did not mean that the law applicable was different from the law applicable if the facility was given under conventional banking.

In *Tinta Press Sdn. Bhd v Bank Islam Malaysia Berhad* [1987] 1 CLJ 474, the disputes were dealt with by the civil court on the principles applicable to the common law of leasing even though the case is in relation to *ijarah* transaction.
In *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn. Bhd & 11 Ors* [2008] 5 MLJ 631, the judge held that BBA financing transactions, which comprise sale and buyback agreements between the bank and customers, are contrary to the Islamic Banking Act 1983 as it involves an element contrary to Shariah principles.

Decisions of these cases showed that the courts apply common law principles applicable to conventional banking and make no references to applicable underlying Shariah principles besides flawed judicial interpretations and applications of Islamic jurisprudential and *fiqh* principles by the judges leading to anomalies and conflicts between Shariah principles and the law. The judgments have led to legal uncertainty and debate among stakeholder and the consumer public, and erosion of confidence in the industry (Aida Othman, 2010).

These problems arise due certain factors such as non-recognition of the principle of Islamic law which resulted in the Islamic legal principles being marginalized or set-aside, non-existence of substantive Islamic law and lack of expertise in Islamic banking law among judges and counsels (Engku Rabiah Adawiyah, 2008).

Furthermore, the civil courts are also reluctant to refer to the Shariah Advisory Council when dealing with Syariah matters arising from Islamic banking and financial contracts that led to the unguided decisions which sometimes are contrary to the Shariah principles (Surianom Miskam, 2010). Shariah Advisory Council should be the highest authority for the ascertainment of Islamic law for the purpose of Islamic financial business.

The Kuala Lumpur High Court in the case of *Tahan Steel Corporation Sdn. Bhd. v Bank Islam Malaysia Bhd* [2004] 6 CLJ 25 observed that the ruling of the Shariah Advisory Council was not sought after in that case because the parties knew that the whole banking transaction in the present case was Islamic in nature.
In the case of *Affin Bank Bhd v. Zulkifli Abdullah* [2006] 1 CLJ 438, the court of the view that reference to Shariah Advisory Council is not necessary in the following observation:

“Since the question before the court is the interpretation and application of the terms of the contractual documents between the parties and of the decisions of the courts, thus reference of this case to another forum for a decision would be an indefensible abdication by this court of its function and duty to apply established principles to the question before it. It is not a question of Syariah law.”

Based on the above observation we can say that in certain cases, the principle of Islamic law well embedded in the Islamic financial documents were frustrated during the litigation process at civil courts. Most of the litigation cases so far involved Al-Bai-Bithaman Ajil contract. It is expected that a wide range of cases involving different types of Islamic financial contract will be brought to court in the near future. Definitely, this will bring another challenge to the court in interpreting and adjudicating the related documents involved. Premised on the current scenario, it is very important for the Islamic finance industry to opt for alternative disputes resolution in addressing legal redresses involving Islamic financial contracts. Tan Sri Dr Zeti Akhtar Aziz, Bank Negara of Malaysia Governor was quoted as saying

“to complement the court system, disputes may also be referred to the arbitration centre for resolution. In this regard, the Kuala Lumpur Regional Centre for arbitration will be enhanced to serve as a platform to deal with cases involving Islamic banking and finance, and to extend these services beyond our borders”.

(StarrBiz, 26th August 2004)
An Overview of Arbitration

Arbitration in essence is an avenue by which parties looked towards a third party, someone who understood the nature of their disputes, to resolve the issue in a fair and just manner. The parties depended on the knowledge, skill and experience of the arbitrator to solve their disputes. Technically, arbitration is a procedure in which a dispute is submitted by agreement of the parties, to one or more arbitrators who make a binding decision on dispute. In choosing arbitration the parties choose for a private dispute resolution procedure instead of going to court.

There are three essential elements of arbitration. First, there must be an agreement to refer the disputes to arbitration, Second, the arbitral tribunal must reach a decision based on the facts and third, arbitration award is binding on the parties and enforceable in court. Arbitration is the only dispute resolution mechanism that provides for enforceability of awards, provided the award is procured in a fair and impartial manner, without misconduct on the part of arbitrator or misconduct of the proceedings (Grace Xavier, 2001).

There are several advantages of arbitration procedure compared to litigation process in court. Among others, the court litigation involves multiple proceedings under different laws with risk of conflicting results. In contrast arbitration involves a single proceeding under the law determined by the parties. The court proceedings involved a long process as against arbitration where arbitrator and parties can expedite the procedures. Furthermore, in court proceedings the decision maker might not have relevant expertise compared to arbitration process where the parties can select arbitrators with relevant expertise (Sundra Rajoo, 2003).

Autonomy to select arbitrators with relevant expertise will benefit parties in Islamic finance disputes because the arbitrator is already familiar with the subject matter of the dispute. The arbitrator can be among scholars in Islamic banking and finance matter. This can address the issue of lack of expertise in Islamic banking and finance law among judges and counsels at civil courts.
Bingham J in Saleh Farid v Mackinon Mackenzie & Co (1983) 2 Lloyd’s Rep 500 opined, ‘In electing to have disputes tried by the process of arbitration, litigants achieve various obvious advantages. For example, they invest themselves with the luxury of choosing their own tribunal and no doubt take advantage of that opportunity in order to select a tribunal fitted by experience and knowledge to solve the dispute in question. They can also protect themselves against the risk of a tribunal whose judgment is liable to be perverted by excessive legalism. Litigants further achieve the benefit of conducting their proceedings in private and of avoiding certain formalities such as giving of evidence on oath, which ordinarily attend the conduct of Court proceedings. There are other advantages such as speed and the saving of expenses which may or may not be achieved depending upon the will of the parties and the arrangements which they choose to make. But those are additional advantages which are certainly capable of achievement as a result of the arbitration process’.

Arbitration is appropriate in the following circumstances and for the following reasons. First, where the parties are from different countries and neither wish to submit to jurisdiction of some foreign court. Second, the parties want to exercise some degree of control over the constitution of the tribunal. Third, the parties may chose arbitrator who is expert in the relevant trade. Fourth, the matter is private and awards are not as a general rule published. Fifth, the parties chose to have some degree of informality (Sundra Rajoo; 2003).

Amicable dispute resolution is encouraged in Islam as provided in the Al-Quran and hadith. There are several recognized process of dispute resolution namely Sulh (good faith negotiation), Tahkim (arbitration), Med-Arb (a combination of Sulh and Tahkim), Muhtasib (ombudsman), Wali al-Mazalim (informal justice or chancellor) and Fatawa al Muftis (expert determination or non-binding evaluative assessment)(Umar A. Oseni, 2010). The following verses support the appointment of arbitrator in the settlement of disputes.
If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from her's; if they both wish for peace, Allah will cause their reconciliation. Indeed, Allah is Ever All-Knower, Well-Acquainted with all things”.

(Al-Nisa' : 35)

“But no, by your Lord, they can have no faith, until they make you judge in all disputes between them, and find in themselves no resistance against your decisions, and accept (them) with full submission.”

(Al-Nisa' : 65)

Legislative Framework for Arbitration in Islamic Banking and Finance

Latest development of Malaysian legal infrastructure of Islamic finance has further strengthen the position of Shariah Advisory Council as the highest and sole authority to be referred to by the civil courts or arbitrators. Prior to the enactment of the Central Bank Act 2009, the ruling by the Shariah Advisory Council is only binding on the arbitrator.

Nevertheless, by virtue of the amendment to the Central Bank Act 1953 any ruling made by the Shariah Advisory Council shall be binding on both the court and arbitrator.

Section 56 (1) of the Central Bank of Malaysia Act 2009 provides :

"Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Shariah matter, the court or the arbitrator, as the case may be shall
a. take into consideration any published rulings of the Shariah Advisory Council;
b. refer such question to the Syariah Advisory Council for its ruling.”
By virtue of these amendments, the civil court and arbitration tribunal shall take into consideration any published rulings relating to Islamic financial business issued by the Shariah Advisory Council and refer such question to the Council for any ruling pertaining to that matter. The referral mechanism provided under the abovementioned Section 56 (1) will assist the court or arbitration tribunal to come to the satisfactory decisions in terms of Shariah compliance and furthermore preserves the sanctity of Shariah rulings issued by the Shariah Advisory Council.

Besides that, Malaysia had enacted specific arbitration rules for Islamic banking and financial services to compliment the court system and enable disputes relating to Islamic finance to be dealt with by the Kuala Lumpur Regional Centre of Arbitration (KLRCA). KLRCA is a neutral and autonomous organization independent of the government of Malaysia. KLRCA was established in 1978 under the auspices of the Asian-African Legal Consultative Organization (AALCO) which is an international legal organization comprising of 48 member states.

The Rules for arbitration of KLRCA (Islamic Banking ad Financial Services) 2007 (“IBFS Arbitration Rules”) are applicable for the purposes of arbitrating any commercial contract, business arrangement or transaction that is based on Shariah Principles. Rule 1 of IBFS Arbitration Rules provide that where the parties to any contract, business arrangement or transaction which are premised on the principles of Shariah, where the parties to any contract have agreed in writing* that disputes arising or clarification required there from shall be settled by arbitration in accordance with the Rules of Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial services) (hereinafter referred to as “Rules”) then such disputes shall be settled in accordance with these Rules.

The KLRCA Model Arbitration Clause for IBFS Arbitration Rules is adapted from the UNCITRAL Model Arbitration Clause with the appropriate modifications. It reads:

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* Footnote: The requirement of writing is to ensure that the parties have a clear understanding of their obligations and rights under the contract.
“Any dispute, controversy or claim arising from Islamic banking business, Takaful business, Islamic Financial business, Islamic development financial business, Islamic capital market product or services or any other transaction business which is based on Shariah principles out of this agreement or contract shall be decided by arbitration in accordance with the Rules of Arbitration of Kuala Lumpur Regional Centre for arbitration (Islamic Banking and Financial services).”

Rule 48 of the IBFS Arbitration Rules state that in the event that IBFS Arbitration Rules are silent on any matter, the UNCITRAL Rules for Arbitration shall be applicable, provided they are consistent with the Shariah principles. This alternative dispute resolution system helps to create an environment where industry players and consumers are able to execute financial transaction efficiently, with sufficient certainty and enforceability.

Conclusion

One of the key factors in maintaining the sustainable growth of Islamic finance industry locally or globally is an effective adjudication forum to undertake legal redresses arising from disputes revolving around Islamic financial transactions. It is also one of the critical elements in instilling and maintaining the public confidence in the system. Most importantly, the alternative forum to court adjudication should be able to appreciate the underlying principles of Islamic financial contract in eliminating *riba* and propagating social justice in the society.
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