



A CRITICAL ANALYSIS OF THE DISPUTE
RESOLUTION MECHANISMS IN THE ISLAMIC
FINANCE INDUSTRY IN MALAYSIA

BY

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ABSTRACT

With the increasing boost to the Malaysian Islamic finance industry and the sophistication experienced in the industry with regards to product development, there is a consequential downside of such enviable achievements, which is the gradual surge in the number of disputes involving *Shari'ah* compliant transactions. In order to propose a consolidated framework for dispute resolution in the Islamic finance industry in Malaysia, it is important to critically analyse the existing dispute resolution mechanisms in the Islamic finance industry in Malaysia. There seems to be over-dependence on civil law institutions, no thanks to the Malaysian colonial heritage, in issues involving Islamic finance law and regulation. It thus appears that there is a systematic neglect of some important principles of Islamic dispute resolution. Thus, even as other mechanisms have been identified by many researchers and efforts are being geared currently towards standardising these mechanisms, their use is still very much at the minimal level. This has led to the belief in some quarters that litigation is the only model of dispute resolution in the Islamic finance industry in Malaysia. This study adopts a doctrinal legal method in examining the relevant Islamic dispute resolution mechanisms that are unique to Islamic finance disputes as well as a SWOT analysis in analysing the strengths, weaknesses, opportunities and threats of the existing mechanisms for dispute resolution in the Islamic finance industry in Malaysia. Finally, the research proposes for the consolidation of the mechanisms for a sustainable industry that will make Malaysia a choice forum for dispute resolution. The findings of this research reveal that the preference of Malaysian Islamic financial institutions for litigation as a means of dispute resolution has relegated other sustainable processes of dispute resolution to the background and made them irrelevant in the Islamic finance industry. This is in line with the hypothesis of the research that the continued preference for litigation as a means of settling disputes in Islamic finance industry is not sustainable due to the paradigm shift in dispute resolution involving financial matters globally. The research is therefore unique in its content value because although a lot of research has been conducted on the different dispute resolution mechanisms available in the Islamic finance industry in Malaysia; none has conducted a SWOT analysis on any of the mechanisms. It is believed that the SWOT model will help the Islamic finance industry understand the relative relevance of other ADR processes and make them relevant as mechanisms for resolving Islamic finance disputes. In the end a consolidated dispute resolution mechanism model is proposed for a better handling of Islamic finance disputes.

خلاصة البحث

مع زيادة دفعة لصناعة التمويل الإسلامي الماليزي والتطور من ذوي الخبرة في هذه الصناعة فيما يتعلق تطوير المنتجات، و هناك الجانب السلبي لاحقة من هذه الإنجازات، والتي هي زيادة تدريجية في عدد المنازعات التي تنطوي على المعاملات المتوافقة مع الشريعة الإسلامية. من أجل اقتراح إطار موحد لتسوية المنازعات في صناعة التمويل الإسلامي في ماليزيا، فمن المهم تحليل دقيق لآليات تسوية المنازعات القائمة في صناعة التمويل الإسلامي في ماليزيا. يبدو أن هناك أكثر من الاعتماد على مؤسسات القانون المدني، لا بفضل التراث الاستعماري الماليزي، في القضايا التي تنطوي على قانون التمويل الإسلامي والتنظيمي. وبالتالي يبدو أن هناك إهمال منهجي لبعض المبادئ الهامة لتسوية المنازعات الإسلامية. وهكذا، حتى تم التعرف على آليات أخرى من قبل العديد من الباحثين ويجري توجيه الجهود نحو توحيد هذه الآليات، واستخدامها ما زال في الحد الأدنى. وقد أدى ذلك إلى الاعتقاد في بعض الأوساط أن التقاضي هو النموذج الوحيد لتسوية المنازعات في صناعة التمويل الإسلامي في ماليزيا. ولذلك يسعى هذا البحث إلى دراسة آليات تسوية المنازعات الإسلامية ذات الصلة التي هي فريدة من نوعها للمنازعات التمويل الإسلامي، ودراسة و إجراء تحليل SWOT، في تحليل الآليات القائمة لتسوية المنازعات في صناعة التمويل الإسلامي في ماليزيا، وأخيرا افترح هذا البحث تعزيز آليات لصناعة مستدامة من شأنها أن تجعل ماليزيا منتدى المفضل لتسوية المنازعات. تكشف نتائج هذا البحث أن تفضيل المؤسسات المالية الإسلامية الماليزية للتقاضي كوسيلة لتسوية المنازعات. قد هبطت العمليات المستدامة الأخرى لتسوية المنازعات إلى الخلفية وجعلها غير ذات صلة في صناعة التمويل الإسلامي. كما تبين أن تفضيل يستمر لمدة التقاضي كوسيلة لتسوية المنازعات في الصناعة المالية الإسلامية، ليست مستدامة بسبب النقلة النوعية في تسوية المنازعات التي تنطوي على مسائل التمويل الإسلامي. إن هذا البحث هو فريد في حد ذاته في قيمة مضمونه أنه على الرغم من الكثير من البحوث قد أجريت على آليات مختلفة لتسوية المنازعات المتاحة في صناعة التمويل الإسلامي في ماليزيا؛ لم يجر أي تحليل SWOT، على أي من الآليات. ويعتقد أن نموذج SWOT، سوف يساعد صناعة التمويل الإسلامي لفهم الجاذبية النسبية للعمليات ADR الأخرى وجعلها ذات الصلة و آليات لتسوية المنازعات المالية الإسلامية. في النهاية تقترح تسوية المنازعات نموذج آلية موحدة لأفضل التعامل مع المنازعات المالية الإسلامية.

APPROVAL PAGE

I certify that I have supervised and read this study and that, in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Comparative Laws.

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Supervisor

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Aishat Abdul-Qadir Zubair

Signature

Date

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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For
“To Allah belongs everything I call my own”
&
My Parents.

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LIST OF ABBREVIATIONS

ADR	Alternative Dispute Resolution
BBA	<i>Bay' Bithamin Ajil</i>
BNM	Bank Negara Malaysia
CBMA	Central Bank of Malaysia Act
DAP	Dispute Avoidance Processes
FMB	Financial Mediation Bureau
FSP	Financial Service Provider
FOS	Financial Ombudsman Scheme
FSO	Financial Service Ombudsman
IBF	Islamic Banking and Finance
IDR	Islamic Dispute Resolution
IFSA	Islamic Financial Services Act
KLCMC	Kuala Lumpur Court Mediation Centre
KLRCA	Kuala Lumpur Regional Centre for Arbitration
MMC	Malaysian Mediation Centre
SWOT	Strengths, Weaknesses, Opportunities and Threats
SAC	Shari'ah Advisory Council
SAW	<i>Şallallahu 'Alayhi Wasallam</i> (Peace Be Upon Him)

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND TO THE RESEARCH

Of late there have been series of reforms in the legal framework for Islamic finance in Malaysia including the dispute resolution. The latest of these reforms is the Islamic Financial Services Act (IFSA) 2013, which is the new legislation that provides a comprehensive framework for Islamic finance industry. The new Act which has some salient provisions like sections 133 and 138 that deal with Financial Ombudsman Scheme (FOS) is therefore seen as a right step in the right direction by the stakeholders in the industry.¹ The Deputy Governor of the Central Bank of Malaysia, Muhammad bin Ibrahim had earlier made some remarkable statements on the evolving legal framework for Islamic finance by focusing heavily on some of the strategies and initiatives undertaken by the Malaysian government. Malaysia is said to have taken the approach to enact regulatory laws that are for banking and *takāful* (Islamic insurance) industry, separate from the conventional finance, as the legal foundation for the conduct of Islamic finance business. Furthermore, the country had established a Law Harmonisation Committee with the main objectives being to review existing Malaysian laws which are applicable to Islamic financial transactions and to propose necessary amendments to give legal recognition to Islamic financial transactions under the law. It is imperative to note that the essential element in

¹ See Engku Rabiah Adawiah Engku Ali, “Shariah Harmonisation and Regulatory Consolidation: BNM Experience”, paper presented at the International Sharī‘ah Scholars’ Forum, organised by ISRA and IRTI, Kuala Lumpur. (2013) at 4; and Mohamad Akram Laidin, “IFSA 2013 Prospects and Future”, paper presented at the International Conference on Commercial Law, organised by Ahmad Ibrahim Kulliyah of Laws, IIUM, Malaysia. (2013) at 5.

developing an effective legal infrastructure is the role of an adjudication system. The adjudication system within the context of Islamic finance must therefore be one which can authoritatively enforce the principles of *Sharī'ah* in dispute settlements involving Islamic financial transactions. Therefore there is a crucial need for a dispute settlement mechanism that is able and competent to dissect in a judicious manner, *Sharī'ah* matters in contracts, so that issues of dispute in *Sharī'ah* interpretation could be resolved and enforced accordingly.²

It is to be noted that for a successful development of Islamic finance in any jurisdiction, the most important and key determinant is the existence of a favourable dispute resolution system that supports the operations and growth of the industry. Malaysia's legal infrastructure as well as the court system which evolved over the centuries catered for conventional finance; it is therefore understandable that the governing legislations in place typically require modifications to accommodate Islamic financial transactions and structures. A quick amendment to the legal framework in Malaysia will thus result in the achievement of a significant growth in Islamic finance.³ This in a way extends to having a robust *Sharī'ah* governance framework since Islamic finance has its roots in *Sharī'ah* and also the overarching requirement of Islamic finance is to ensure that its objectives and operations are in accordance with *Sharī'ah*. More so with the emergence of Islamic finance as a new growth area in the global financial landscape, there is the increase in the legal issues in Islamic finance which are to a very large extent topical in nature. Therefore, as Islamic

² Muhammad bin Ibrahim, "The polemics of governing law in Islamic finance – recent developments and the way forward", paper presented at the International Sharī'ah Research Academy for Islamic Finance-Institute of Islamic Banking and Insurance (ISRA-IIBI) 2nd Annual International Thematic Workshop, organised by ISRA-IIBI, London. (2010) at 2-3.

³ This is because Malaysia is well-placed to serve as a platform for adjudication and dispute settlement and thus any further delay in putting all the necessary tools in achieving this may be of dire consequence.

financial activities are increasingly crossing national boundaries, there is the need for more researches to be conducted with a wider perspective that can positively contribute to the development of a legal framework for Islamic finance. Such a legal framework needs to be both nationally and internationally facilitative especially on the dispute resolution framework that will be beneficial to all parties concerned.

At present, apart from the widely known litigation process at the Muamalat Bench of the Commercial Division in the High Court of Malaysia, there are other alternatives which are less formal in terms of procedural issues and legal technicalities. Such alternative mechanisms include the recently established Kuala Lumpur Court Mediation Centre (KLCMC) annexed to the High Court, Islamic finance arbitration under the i-Arbitration Rules 2013 of the Kuala Lumpur Regional Centre for Arbitration (KLRCA), Financial Mediation Bureau (FMB) set up by Bank Negara Malaysia (BNM), Malaysian Mediation Centre (MMC) and the recently established Securities Industry Dispute Resolution Centre (SIDREC) which is relevant for the resolution of disputes involving *Shari'ah*-compliant securities. It is observed that for the effective overcoming of the challenge of adequate access to justice as is presently witnessed in the industry, putting in place the necessary legal and regulatory framework is highly imperative.

The roles of the *Shari'ah* Advisory Council (SAC) in its capacity as a consultative body to the Malaysian judiciary system is sometimes overblown. This is where whenever a question concerning a *Shari'ah* matter arises in any proceedings relating to Islamic financial business, the judge or the arbitrator is expected to refer the matter to SAC for its ruling which are binding on the courts and arbitrators. It is with great humility and respect to these efforts of the Malaysian government that I think this has not solved the main problem of access to justice of Islamic finance

dispute in the country. This is because there are presently conflicts on certain constitutional issues with regards to sections 56 and 57 of the Central Bank of Malaysia Act (CBMA) 2009. It is because of these conflicts that the Chief Justice of Malaysia is of the view that a specialist tribunal should be established for Islamic finance matters.⁴ Also KLRCA can only boast of arbitrating very few cases of Islamic finance since 2007 when the centre was identified to hear Islamic banking and finance matters.

It is against this background that this research intends to analyse the different mechanisms of resolving disputes in the Islamic finance industry in Malaysia. The subject of this research is therefore very important as it is evident that despite the current diverse options available to the parties in Islamic finance issues, the challenge of adequate access to justice still lingers on. The research intends to come up with new findings as well as add to the web of knowledge on this subject that will help in developing and improving the aspect of dispute resolution in Malaysia's Islamic finance industry for Malaysia has the potential to serve as a platform for resolving cross-border Islamic finance disputes.

In sum, this research is timely since the government of Malaysia has as one of its objectives highlighted in the 2013 Malaysian Budget, to make Malaysia a global leader in Islamic finance and a major Islamic finance hub⁵ which this study believes is only possible if there is a sound and robust dispute resolution framework in Malaysia. Therefore, the need to analyse the options in place now and suggest the way forward is most timely.

⁴ Arifin Bin Zakaria. "Recent Reforms in the Legal Framework of Islamic Finance in Malaysia: Court's Perspective", paper presented at the 14th Professor Emeritus Ahmad Ibrahim lecture, organised by Ahmad Ibrahim Kulliyah of Laws IIUM, Malaysia. (2013) at 39.

⁵ Mohd Najib Haji Abdul Razak, *The 2013 Budget Speech*, at [16:30], <<http://www.pmo.gov.my/?menu=page&page=2038>> viewed on 10 October 2013.

1.2 STATEMENT OF THE PROBLEM

The challenge of adequate access to justice facing parties in Islamic finance matters despite the current diverse options available is what this research aims at finding solution to. This is caused among other reasons by the civil court jurisdiction accorded to Islamic finance matters as well as its adjudication by judges who are not originally trained in Islamic commercial matters. The declaration of some *ḥarām* (forbidden) practices as *ḥalāl* (permissible) or vice versa and the application of the English law of contract as well as its principles to Islamic finance cases are some of the numerous examples of such anomalies that permeate the Islamic finance industry. This has in most of the cases left both parties in the dispute dissatisfied as it is only in rare cases that we have one of the disputants partially satisfied with the outcome of the decision.⁶ Also, the Muamalat Bench of the Commercial Division in the High Court of Malaysia that was established to ameliorate the hardship faced by parties cannot be said to have lived up to the expectation of many in the industry as the judge manning the bench is still an English trained judge who applied the principles of English contract law to Islamic finance cases. Therefore the same problem faced in the earlier cases before the Muamalat bench was established is still seen in the subsequent cases handled by the judge.⁷ In the end what we have is a robust industry with no standardised dispute resolution mechanism which may result in the loss of interest in the entire industry and may lead to asking questions such as what then is the relevance of having such a robust industry in the first place. It will only be like the proverbial case of a big and

⁶ See the cases of *Bank Islam Malaysia Berhad v Adnan bin Omar* [1994] 3 CLJ 735; and *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors* [2008] 5 MLJ 631; [2009] 1 CLJ 419.

⁷ See the cases of *BIMB v Dato' Nik Haji Mahmud* [1996]. 4 MLJ 295; and *Affin Bank v Zulkifli* (2006) 3 MLJ 67.

beautiful house built on a weak foundation, there is no use for such beauty if there is no guarantee of it withstanding the wind and rain.

In trying to address this problem in this study answers to some important questions will be given. Some of the questions are: what are the strength and weaknesses of the existing dispute resolution mechanisms available to the stakeholders in the Islamic finance industry in Malaysia? What are the relevant Islamic Dispute Resolution (IDR) mechanisms that are unique to Islamic finance matters? Will a consolidated model which seeks to integrate the existing mechanisms for dispute resolution engender sustainable practices in the Islamic finance industry?

Therefore, the existing options or alternatives available in the Islamic finance industry for dispute resolution are analysed to build on the strengths of the mechanisms in place, reduce or eliminate weaknesses, minimize threats and take advantage of opportunities available. Thus the study provides the strategies that will help in adopting the IDR that will best suit the Islamic finance industry in Malaysia and also that of the world as a whole. The findings of this research are expected to add to the web of knowledge in this field and will as well be of tremendous help to law reforms in the dispute resolution sector of the Islamic finance industry of some other countries around the globe. In the end the research proposes for the consolidation of the mechanisms for a sustainable industry that will make Malaysia a forum of choice for dispute resolution.

1.3 OBJECTIVES OF THE STUDY

This dissertation arises out of the need to come up with a sustainable mechanism for the resolution of dispute in the Malaysia's Islamic finance industry that would integrate the existing process into a comprehensive multi-tiered framework that will benefit both the consumers and the Islamic financial institutions.

This study therefore embarks on the following specific objectives:

1. To study the relevant Islamic dispute resolution mechanisms that is unique to Islamic commercial law.
2. To examine the existing dispute resolution mechanisms in the Islamic finance industry in Malaysia.
3. To conduct a SWOT analysis on the existing mechanisms of dispute resolution in the Islamic finance industry.
4. To propose for the consolidation of the mechanisms for a sustainable industry that will make Malaysia a forum of choice for dispute resolution.

1.4 HYPOTHESIS

This research hypothesizes that

1. The preference of Malaysian Islamic financial institutions for litigation as a means of dispute resolution has relegated other sustainable processes of dispute resolution to the background and made them irrelevant in the Islamic finance industry.
2. The continued preference for litigation as a means of settling disputes in Islamic finance industry is not sustainable due to the paradigm shift in dispute resolution involving Islamic finance matters.

1.5 LITERATURE REVIEW

This study primarily relates to three major blocs of literature on dispute resolution in Islamic finance. These include literature on mechanisms of dispute resolution in Islamic commercial law, the mechanisms of dispute resolution specific to Islamic finance, and the litigation of Islamic finance cases by civil courts in Malaysia.

Firstly, the literatures on dispute resolution in Islamic commercial law are quiet few in number and most are usually in a comparative manner, outlining the substantive and procedural distinctions between the modern Alternative Dispute Resolution (ADR) and the classical Islamic dispute resolution mechanisms otherwise known as IDR. For example, Oseni⁸ examined the classical ADR under Islamic law and highlighted the contentious issues facing the modern ADR. By modern ADR he meant the conventional ADR framework. He examined the daunting challenges posed by the conventional mechanisms as proposed by some researchers for the resolution of disputes in the Islamic finance industry by unravelling the limitations of the conventional ADR framework. Therefore in a bid to propose IDR he highlighted the major defects inherent in ADR and therefore called for the avoidance and repetition of same in the formalised model for dispute resolution in Islamic banking and finance which he proposed. However, his proposal for a workable model for dispute resolution having regards to the classical means and formalising them in the light of modern situation without violating any fundamental provision of *Fiqh al-Mu'amalāt* (Islamic commercial law), by not suggesting the way and method to achieve this requires practical reforms in the industry.

⁸ Umar A. Oseni, "Islamic Banking and Finance Disputes: Between the Classical and Modern Mechanisms of Dispute Resolution" in *Islamic Banking & Finance: Principles, Instruments and Operations*, edited by Adnan Trakic and Hanifah Tajuddin, *Current Law Journal*, 2012, at 351-370.

According to White⁹ IDR does not only provide desperately needed subject matter expertise in Islamic finance dispute resolution, but at the same time accommodates Islamic legal values and traditions in resolving the disputes that inevitably arise in the context of Islamic finance. He further stressed that IDR is necessary to support the growth of Islamic finance because while the Western-style of ADR may be adversarial,¹⁰ IDR on the other hand utilizes a much more directive approach where the arbitrator rather than being an impartial facilitator with no real stake in resolving a dispute, has more hands on approach to resolving a dispute. This approach which is less formal and far less adversarial than the court proceedings is far less likely to damage business relations. In examining how IDR differs from conventional ADR, he looked specifically at how the whole mechanism is utilized in industries such as construction and labour disputes alone without touching Islamic finance. This is after he has agreed that the *Shari'ah*-based form of ADR not only provides desperately needed subject matter expertise in Islamic finance dispute resolution, but at the same time accommodates Islamic legal values and traditions in resolving the disputes that inevitably arise in the context of Islamic finance. While identifying that IDR is necessary to support the growth of Islamic finance,¹¹ he only stated this in so far as to show the distinct feature and potentials of the mechanisms as compared to ADR and not to show how this can be put in place to serve the many identified objectives that IDR can achieve.

⁹ Andrew White, "Dispute Resolution and Specialized ADR for Islamic Finance" in *Islamic Finance Law and Practice*, edited by Craig R. Nethercott and David M. Eisenberg, Oxford University Press, 2012, at 306-333.

¹⁰ Arbitration under the western-style of ADR is generally characterized as a form of private adjudication, based on a well-entrenched tradition of highly adversarial dispute resolution where an arbitrator is seen as dispassionately neutral and impartial, following the Western notion of 'blind justice'.

¹¹ The identified ways that IDR can be used in supporting the growth of Islamic finance are that it is a legitimate model for Islamic finance dispute resolution and that it provides unique expertise and procedural approach to resolving Islamic finance disputes.