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# Grafting an Islamic Sapling onto the Tree of Legal Dispute Resolution

## Alternative Approaches to Civil Disputes in Islamic Finance in the Gulf and Southeast Asia

Ai Kawamura

Asia-Japan Research Institute
Ritsumeikan University

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# Author's Profile

Ai Kawamura graduated from the College of Law at Ritsumeikan University in 2005, specializing in International Comparative Law. She obtained a Ph.D. in Area Studies at the Graduate School of Asian and African Area Studies (ASAFAS), Kyoto University, Japan, in 2014. She served as a Special Researcher (DC1) at the Japan Society for the Promotion of Science from 2011 to 2014, and as a Special Researcher (PD) from 2015 to 2018. She also served as an Associated Research Fellow at ASAFAS from 2014 to 2015, and 2018 to 2019. She is currently an Assistant Professor at the Faculty of Business Sciences, Tsukuba University, Japan, since 2018. Her specialty is: Area Studies, Islamic Law and Society, Islamic Economics, and Civil Dispute Resolution. Among her publications: "Dubai Approach as a New Resolution System for Islamic Finance Dispute Case," *Asian and African Area Studies*, 13(1), 2013, pp.1-23; "Comparison of Malaysia-Dubai Approach for the Islamic Dispute Resolution System in Islamic Finance", *Jurnal Hadhari*, 2017 Special Issue, pp.57-66; and "New Dispute Resolution Approach and Models for Islamic Finance," *Arab Law Quarterly*, 34(2), pp.141-166.

# Preface by the Author

In the recent decades, Islamic economics, Islamic banking, and other related terms have become rooted in academic literature on the Islamic world and global economy. When I started my research on dispute resolution in Islamic economic transactions a decade ago, despite the steady growth of the Islamic financial industry and the academic disciplines corresponding to that industry, civil disputes and their resolutions were not a common theme, and the literature was scarce. I was confident, however, that any successful economic field would face, sooner or later, civil disputes among those who were engaged in such a field. Subsequently, I started to observe separate cases to study.

However, I soon realized that, before going into individual case studies, the very question of the system of dispute resolution was waiting for our decoding. As I started to research on Islam, its legal system, modern civil disputes, Islamic economics, and Islamic ethics as well as the Gulf Arab countries and Muslim countries in Southeast Asia, I found myself caught in a deep complex forest, finding something new at every step.

The Islamic world has had its own legal system, under the name of Shari'ah, since its inception in the 7th century C.E. The success of the global expansion of the Islamic trade network from its center in the Middle East, connecting China in the east and Europe in the west, from the 8th to 14th centuries, must have been facilitated by legal systems that were convenient and useful for world trade and the conflict resolutions of those days.

However, after the advent of modernity brought through the expansion of Western powers, Islamic countries came under their influence and, where accompanying Western legal systems gradually penetrated, adopted the Western economic system. Usually, modern reform of legal systems in Muslim countries is considered as a process of the modernization of law. Subsequently, after undergoing a long process of westernization/modernization and/or de-Islamization for a

century or so, in the middle of the 20th century, a reversal started to emerge. The so-called Islamic revival brought calls for the reinstitution of Shari'ah. In the most dramatic cases, such as the Islamic Revolution of Iran in 1979, a return to Shari'ah was strongly demanded. In more subtle cases, such as the advent of Islamic finance, the theme of this book, Shari'ah issues were coming back only gradually and in pieces.

Once engaged in research on dispute resolution in Islamic economics, I found a complex economic and legal state of affairs, where we ought to take a quite new approach. I have coined a few concepts, such as duality of law, legal hybridity, Dubai approach, Malaysia model and uneven Islamization, to describe and analyze the structural complexity of dispute resolution in Islamic economics.

I am extremely happy to sum up my research findings in this book. I am very grateful to Asia-Japan Research Institute of Ritsumeikan University to offer me this opportunity.

I owe a lot to many people who helped me during my research. Though there are many individuals who contributed their valuable suggestions for particular sections of this book, I here suggest some special acknowledgments. Firstly, I am most grateful to Professor Yasushi Kosugi of the Asia-Japan Research Institute of Ritsumeikan University for encouraging me, supporting me, and giving me constructive advice on publishing this book. I should also like to express my appreciation to Professor Anthony Brewer of the Institute, for making this book possible to publish and for suggesting modifications. I am also very grateful to Professor Mehmet Asutay of Durham University for giving me opportunities to brush up the theories and guiding me to understand the ideal of Islamic social justice. I am also very grateful to Professor Shinsuke Nagaoka of the Graduate School of Asian and African Area Studies in Kyoto University (ASAFAS). In addition, I want to express my appreciation for the cooperation and assistance I received from the members and staff of the Faculty of Business in Tsukuba University, and to Leiden University Library, and the Research Center for Islamic Economics and Finance in the National University of Malaysia.

The Japan Society of Promotion of Science was extremely generous in giving me financial support and lending their prestige to my research. Its grants include Grant-in-Aid for Early-Career Scientists [JSPS KAKENHI Grant Number JP20K20055], Grant-in-Aid for Scientific Research [JSPS KAKENHI Grant Number 11J02988] and Grant-in-Aid for Scientific Research [JSPS KAKENHI Grant Number 15J09218].

I also want to express my appreciation to my husband Keiji and my son Haruki both of whom helped me to keep focused and patiently assisted me in completing this book.

Ai KAWAMURA

Chapter 1.

# Islamic Economics Activities and Civil Disputes: Theoretical and Empirical Issues

## 1. Introduction

In the beginning, since Islamic economics was a new category of knowledges for a new sector of economic activities, it had to establish itself with its ideals and theories, and then its application. Simply stated, the new economic sector of Islamic finance had to be established from scratch in the middle of the 20th century. Any economic sector will inevitably bring civil disputes if the volume of commerce increases, and the same applies to Islamic finance, where the volume of the industry has developed in five decades to a sizable quantity in the world economy. This is why this chapter has to start with the historical background leading to the advent of Islamic economics itself before dealing with the issues of civil disputes in Islamic Finance.

The emergence of Islamic economics theory is a recent phenomenon, and consequently it has had a relatively short history compared to conventional economics.[1] However, it has grown rapidly into an international academic field studied by various researchers around the world.

In actual economic activities, Islamic economic theory has been practiced in many parts of the world using newly crafted Islamic financial products. At the international level, the Islamic Development Bank (IsDB) has currently been taking the initiative on economic development and empowering the poor, not only in its fifty-seven

[1] Since the rise of "Islamic economics", it has become common in its literature to describe economics in general as "conventional", as opposed to what is "Islamic" by the definition of this emerging field of knowledge.

member states but also in non-member countries throughout the world. IsDB projects have not only prioritized its field of finance but also encouraged innovation in science and technology, developing infrastructures and supporting research on Islamic finance.

In addition, the International Monetary Fund (IMF) and the World Bank have been working on utilizing Islamic financial products in their projects. As the international society has shown an interest in Environmental, Social and Governance (ESG), and Socially Responsible Investing (SRI) has been receiving greater attention, some ESG or SRI products such as the Green bond have inspired the Islamic financial market to adopt similar schemes. The Islamic financial industry has integrated such products into Green Sukuk[2] and is also adapting some ESG or SRI scores into the financial market.

Some Islamic financial products or schemes such as Sukuk have become well known in the financial industry in the last two decades or so. Other Islamic traditional social schemes, such as Zakat and Waqf, have also been revived in the form of new financial products for Islamic finance.

While the diversification of Islamic financial products progresses, such diversification has caused legal conflicts. These conflicts occur because Islamic finance products face issues regarding ‘Sharī‘ah compliance’. ‘Sharī‘ah compliant’, in Islamic financial terms, primarily means that the financial transaction or the product itself does not conflict with the rules of Sharī‘ah. This sounds simple, but in reality, there are various issues to be tackled.

Firstly, to function effectively, Islamic finance must be compliant with the existing financial system which sometimes conflicts with the Sharī‘ah, such as when a financial transaction involves charging interest, Ribā, which the Sharī‘ah regards as prohibited. Islamic finance transactions were developed to avoid such conflicts. In some cases, an Islamic financial transaction would be seen as a commercial transaction

[2] Sukuk is often translated as ‘Islamic bonds’. Please refer to page 42 for details.

rather than a financial transaction, which could cause it to be illegal under conventional law, as the arrangements would be different from a conventional financial transaction.[3]

Secondly, Islamic finance has developed diversified financial products with complex schemes. In this regard, there are some discussions on whether these new Islamic financial products are Sharīʻah compliant or not. For example, there is an ongoing discussion on Tawarruq and Īna'h products which have been categorized as Sharīʻah compliant in some countries but not in others. In some court cases, the legitimacy of an Islamic financial product has been challenged.

However, most existing dispute resolution systems are not equipped to deal with Islamic financial dispute resolution. This is because up until now, the Sharīʻah court has only been dealing with family law or some legal issues related to Muslim property law and inheritance law. Financial transactions on the other hand, are under the jurisdiction of the "conventional" courts, who deal with the cases based on the conventional western law. Most Muslim countries' legislation was adopted from western countries' civil law and common law systems before modern Islamic finance was crafted. As a result, Islamic finance has faced complex legal issues, especially when disputes have occurred. There are even more issues related to Sharīʻah compliance contradicting conventional finance, and Islamic finance is facing a struggle to be Sharīʻah compliant in a non- Sharīʻah environment.

On the other hand, Islamic finance is sometimes shown to have some similarities with conventional finance in its schemes and practices, and this has raised some debates on the identity of Islamic finance. Recognizing the gap between the practice and theory has led to the emergence of the Islamic Moral Economy. This will be discussed in the fourth section of this chapter.

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3 The term "Conventional finance" mentioned in this book refers to the general western-law based finance system in use in the majority of countries. Usually this term is used to differentiate it from Islamic finance.

More disputes have emerged in the Islamic financial industry because financial activities increase as the market expands, while the diversification of financial products has also created complex contracts that have caused legal conflicts. Modern economies are complex, so both conventional and Islamic finance have forms of contract with varying complexities. However, Islamic finance has an additional feature to consider, namely, the aspect of Sharīʻah compliance. Thus, even Muslim countries, where the majority of the population is Muslim, have been facing legal issues with Islamic finance.

At the same time, Islamic finance has become a global phenomenon. The expansion of Islamic banking and finance has reached out to non-Islamic states such as the western countries and some Asian countries where Muslims are a minority. Therefore, the author considers it important to clarify such issues in order to discover solutions for maintaining sustainable Islamic financial markets.

## 2. The Development of Islamic Economics and Practice of Islamic Finance

The Islamic world experienced its golden age from the 7th century up to the end of the 17th century. Its history started in the Arabian Peninsula, a place where there were no records of major civilizations, at the time when the Sassanid dynasty and Byzantine Empire were clashing with each other. Islam literally emerged "suddenly from a blank space" [Kosugi 1994:14]. While polytheism, Zoroastrianism, Judaism and Christianity had been scattered around the Arabian Peninsula, Islam had not only conquered the "blank space" including large territories of the adjacent empires but was also destined to become one of the largest religions in the world.

Once there was a misconception that Islam had sprung from the desert where only nomadic Bedouins resided. It is well known by this time that Islam was born in the flourishing merchant city of Makkah

(Mecca). It is quite important to recognize that Islam encourages commerce and economic activities, as is clearly shown in several verses of the Qur'an, the sacred book of Islam, which Prophet Muhammad had brought as the Divine Word when he established the Islamic community in Makkah and Madinah. In fact, after his death, the Islamic world expanded its territories from North Africa to Central Asia, establishing a merchant empire. The importance of this specific area will be discussed in the next chapter.

The science and technology of this period had nurtured new civilizations, and many scientific innovations developed in the Islamic world. Western Europe, or the West in a general sense, learnt a great deal from the Islamic civilization, and developed a modern civilization of their own in the later centuries. Unfortunately, the Western ascendency in the modern era brought about the downfall of the Islamic world, with the end of the Othman Empire in the early part of the 20th century marking the final period of its glorious days.

Most of the Islamic world was divided into colonies or protectorates governed by the British Empire or other European powers. Colonialism, or domination by the western powers fermented righteous indignation for the Islamic way of life among the Muslims. Beginning from the end of 19th century, the more westernization or modernization based on the western model was imposed, the more the Muslims increased their struggle to maintain their Islamic values and way of life.

In addition, poverty and other economic issues started to occur in the Muslim countries. Critics in the Muslim world started to discuss an Islamic way of economic development and tried to establish a platform for discussing an alternative economic system with more affinity to Islam. After a long period of various endeavors, this resulted in the "Islamic revival" in the 1970's, with its two major epoch-making events, namely, the establishment of the first commercial Islamic bank in 1975, and the Islamic Revolution of 1979.

Though the first of these two was not recognized as epoch-making in those days, it proved to be a watershed in the history of Islamic economics. In this sense, this author subscribes to the theory that the "Islamic revival" was a larger framework that delivered new economic theories, which soon developed as Islamic economics.

Islamic economics started to gain popularity during the early stages of the Islamic revival in the 20th century. Its academic history started from 1940 in South Asia under the British Empire. The first figure to introduce the concept of Islamic economics was Saiyid Abū al-A'lā Maudūdī, the Islamic thinker and historical figure who founded the Islamic religio-political organization, Jamaat-e-Islami. In his famous speech of 1941, Maudūdī criticized that the economic situation of the Muslim world had diverged from the philosophy of Islam and urged the need to establish an alternative economic system to free itself from Western domination.

His ideas were published in the Urudu language in 1945 and translated into English in 1947 as "The Economic Problem of Man and Its Islamic Solution". In his publication, the origin of Mudharaba (*Muḍāraba*) was mentioned. Therefore, Maudūdī is seen as the pioneer of Islamic economics [Nagaoka 2016: 54].[4]

After Maudūdī had sown the seeds of Islamic economics, a new academic field started to grow gradually. The strenuous efforts by the founding fathers of Islamic Economics accelerated after an economic developmental approach was adopted in the post-colonial countries in the Islamic world in the 1960s and 1970s.

These founding fathers had developed their economic theories from the 1960's. Muhammad 'Abdul Mannan, Muhammad Nejatullah Siddiqi, Muhammad Umer Chapra and Syed Nawab Naqvi are known to be among the founding fathers of Islamic Economics [Wilson 2004: 197]. They had their formal economic education in conventional economics while also being well versed in Islamic law. They criticized the

[4] There is an opinion that Muhammad Zaki Salih was the pioneer who brought up the topic of Islam and economics [Islahi 2005:4; 2008:1]. However, when we speak about "Islamic economics" from the aspect of Islamic revival, Maudūdī is generally regarded as the founder of the Islamic economics.

instruments of conventional economics for creating injustice in the Islamic society.

Another interesting aspect of the founding fathers of Islamic economics concerns the languages that they used for their publications. Previously, Urdu, the national language of the newly born Pakistan, and an Islamic language in South Asia[5], was the main language used for publications on Islamic economics by writers such as Maudūdī. However, these founding fathers mainly published their theories in English. After their works were published in English, they were translated into Arabic, Urdu or Turkish. For Islam, Arabic is the formal language; however, English is generally used as a common language.[6] Therefore, using English was beneficial for expanding Islamic economic thought globally.

As Islamic economics theories expanded and spread among the Muslim countries, it was only a matter of time before they were put into practice. The rise in oil prices was the trigger for developing the financial markets in the Gulf countries. At the same time, the Gulf countries were seeking a way to diversify their industries. Banking and finance were seen as good options.

The practice of Islamic finance was in fact made possible due to the large amount of oil income in the Gulf countries. In the 1960s, the discussion with the Seven Sisters[7] had led to an increase in the oil price in the Middle East. OPEC had started to unite on developing the oil industry after the third Arab-Israeli War in 1968. After their independence in 1971, the Gulf countries were gaining benefits from the increase in oil prices. They were also working to diversifying their industries, and the financial sector was seen as a promising alternative.

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5 Languages with a long cultural association with Islamic cultures may be called Islamic languages, such as Arabic, Persian, Turkish, Urdu, and Malay, among others.

6 The OIC, the Organization of Islamic Conference at its inception, and the Organization of Islamic Cooperation currently, uses Arabic and English as its main media of communication.

7 Common term for the seven transnational oil companies of the "Consortium for Iran" oligopoly or cartel, which dominated the global petroleum industry from the mid-1940s to the mid-1970s.

As the impetus for the introduction of Islamic finance, it is important to consider the "Islamic Revival" during the 1970s. The experience of the "western impact" in the Middle East and the Gulf countries during the 19th and 20th centuries had triggered the Islamic world to seek to restore an Islamic way of life. This movement for an Islamic way of life started to be visualized in social life, where the phenomena of establishing Islamic banks was one of its manifestations [Kosugi 2006: 730-731]. In addition, when Bahrain, Qatar and the United Arab Emirates became independent in 1971, these countries' political systems were "monarchies that had a high affinity with Islam" [Kosugi 2006: 291-292]. Soon after the establishment of the first Islamic bank, several other Islamic banks were founded.[8]

Thus, in developing finance as an alternative to the oil industry in the Gulf, there was a need to reach out to the general Muslim population, and so the commercial sector aimed to practice Islamic economics. Thus, Islamic finance was able to start developing its industry from the Gulf region.

There were some historical events related to the emergence of Islamic finance in the 1960s and 1970s. Resolution No.15/4, the "need to set up a Muslim economy" was raised during discussions at the Fourth Islamic Conference of Foreign Ministers meeting in Benghazi, from March 24-26, 1973. The Conference of Finance Ministers of Muslim countries was held in Jeddah in December of the same year. During this conference, the "Declaration of Intent" to establish the Islamic Development Bank (IDB) was issued, and the bank was subsequently established in 1975.

At the same time, the first commercial Islamic bank, the Dubai Islamic Bank, was established in Dubai as the first bank to legally practice Islamic financial services, partly due to the fact that the rulers in

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[8] The Kuwait Finance House was incorporated in 1977. The Faysal Islamic Banks of Sudan were established in 1977, and Jordan Islamic Bank was established in 1978. Then, in 1979, Bahrain Islamic Bank began its operation as the first fully commercial Islamic bank in Bahrain.

the Gulf countries were comparatively supportive of Islamic banking [Wilson 2009:6].

Prior to these two Islamic financial institutions, there were some Islamic social welfare institutions in Egypt and Malaysia. In order to support the poor in Mīt Ghamr, in the Nile Delta of Lower Egypt, the Bank Mīt Ghamr li-l-Tawfīr, a savings bank utilizing the zakat fund was established in Egypt in 1963. The intention was to establish it as a bank; however, the Egyptian government during that time was cracking down on the Islamic movement. Therefore, Mīt Ghamr faced a lock-down but was reopened as Nasir Social Bank in the 1970s. Although, the Mīt Ghamr experiment in Egypt had faced setbacks, the establishment of the Bank Fayṣal al-Islāmī al-Miṣrī (Faisal Islamic Bank of Egypt) was achieved in 1979. It was first licensed as an "economic and social institution taking the form of an Egyptian Joint-Stock Company operating in compliance with Islamic Sharia principles".[9] The founder of the Faisal Islamic Bank was Mohammed Al-Faisal Al-Saud, a son of King Faisal, who was the driving figure of modernization in the Saudi Arabian Kingdom.

Malaysia had also developed a savings bank for Hajj in the 1960s. Tabung Haji was established in 1962 to help Muslims to save traveling expenses for Haj without conflicting with the Islamic economic tenets. Malaysia's first commercial Islamic bank was established in the 1980s.

During the 1980s, Islamic banking and finance progressed to form multinational groups sponsored by wealthy Saudis. The first was Dar al-Māl al-Islami (DMI) Trust Group which was established in 1981. The founding of the DMI international network was also initiated by Mohammed Al-Faisal Al-Saud, the founder of the Faisal Islamic Bank.

The DMI Trust established its headquarters for investment banking in the Bahamas. The DMI Group expanded its business into banking, real estate investments, mortgage finance, asset management and

[9] HP of the Faisal Islamic Bank of Egypt "Incorporation & History" Retrieved on May 11, 2020, from < https://www.faisalbank.com.eg/FIB/english/about- us/incorporation-history.html>.

management services incorporated in Bahrain, Pakistan, Switzerland, and the Cayman Islands [DMI 2018:100].

Another was the Majmū‘a al-Baraka al-Muṣrifī, known as Albaraka Banking Group (ABG). This group was developed from the Dallah Albaraka Group that was established in 1969 from several single organizations to form a conglomerate.

The Albaraka Investment and Development Company started its sales including Islamic financial transactions in 1982 as the financial sector of the Dallah Albaraka. The Islamic financial sector was separated from the company and became the Al Baraka Banking Group in 1984.

From the 1990s, western financial institutions started to compete in Islamic financial services. Some western conventional banks started to provide a so-called Islamic window (or Sharī‘ah window) where they offered Islamic financial services. An Islamic window is a bureau or banking sector of a conventional bank separated from its conventional financial services that provides Islamic financial services.

Accordingly, western banking groups started to open their own Islamic windows, which also brought up the issue of the conventional non-Islamic banks for dealing Islamic assets. The Citi Corp Banking Corporation, which was incorporated in 1977, started its involvement in Islamic banking by opening its Islamic windows. The Faysal Islamic Banks of Sudan were established in 1977, and Jordan Islamic Bank was established in 1978. Then, in 1979, Bahrain Islamic Bank began its operations as the first fully commercial Islamic bank in Bahrain in 1996. The Citi Islamic Investment Bank E.C. was a 100% subsidiary of the Citi Corp Banking Corporation. Then the HSBS Amanah, which is the Islamic window of the HSBC Group, was established in 1998.

In addition, in the 1990s, governments started to be proactive in developing the Islamic financial market. For instance, WAWASAN 2020 (Vision 2020) by the Malaysian government included its initiative in 1991 to develop Islamic finance.

In the 2000s, Islamic financial services started to expand their businesses into the western countries. The UK and France began improving their legal environments to nurture the Islamic banking sector. A fully-fledged Islamic bank was established in the UK as the Islamic Bank of Britain in 2004, and in 2006, Gordon Brown, the Chancellor of the Exchequer at that time, announced that the UK would become "a gateway for Islamic trade and finance".[10] The Islamic finance market had become not only a medium for financial transactions for Muslim countries but also an international financial market.

## 3. Expansion of Islamic Finance and Increase of Civil Disputes

When the Financial Crisis occurred in 2008, triggered by the sub-prime loan issues in the United States, it expanded globally, and eventually affected the Islamic financial industry. Islamic finance had first been seen as an alternative solution that could avoid the effects of the 2008 financial crisis [SESRIC Monthly Report 2009]. However, while the current situation of Islamic finance seemed to be stable, when the financial crisis occurred, due its global scale it was clear that the Islamic financial industry had been affected negatively from 2008 till 2009, and the Gulf region in particular was strongly affected.[11] From the empirical studies, it is also known that in the Gulf region, the Islamic banking sector has more risk and faces a higher failure hazard than the conventional banking sector [Alandejan 2013].

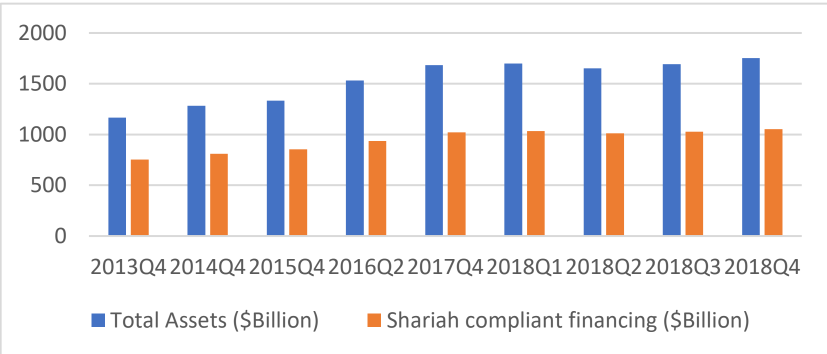
Islamic finance has been expanding its market dramatically since the 2000s as we saw in the previous section. It is said that the global Islamic finance assets increased to $1.46 trillion by the end of 2012 and reached

10 BBC News (June 13, 2006). "UK's Brown Backs Islamic Finance". Retrieved on May 11, 2020, from <http://news.bbc.co.uk/2/hi/business/5074068.stm >.

11 The Gulf region, for the scope of this study, includes six countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.

$2 trillion by 2014 [TheCityUK 2013].[12] It was estimated that the global assets of Islamic finance would reach $1.8 trillion in 2013 [Ernst & Young 2012]. Although the global economy had faced some challenges, by the year 2018, the Islamic financial market's global assets had exceeded $2.5 trillion [Salaam Gateway 2019: 2]. Therefore, the Islamic financial market had expanded more than it was expected to.

Nowadays, Islamic finance has spread globally and is practiced not only in Muslim majority countries but also in minority areas like Europe, the UK, and others. The UK had been recognized as the western center for Islamic finance and was reported to have $6 billion in Sharīʻah assets in 2017.[13] Although the Islamic financial market was affected negatively by the financial crisis and the Dubai Shock, the market has kept on growing, as shown in Figure 1.




[12] In most cases, global assets of Islamic finance are those that are used in Islamic financial transactions. Therefore, Islamic financial institutions generally consider that all of their assets are based on Sharīʻah. When conventional banks or other financial institutions deal in Islamic finance, they will open an Islamic window to separate its transactions from conventional transactions. However, this does not mean that they totally separate their Islamic and the conventional assets. Therefore, it is difficult to totally differentiate the assets which are only used for Islamic finance.

[13] theCityUK. 2019. "Global Trends in Islamic Finance and the UK Market 2019". Retrieved on May 11, 2020, from < https://www.thecityuk.com/research/global-trends-in-islamic-finance-and-the-uk-market-2019/>.

Figure 1. Total Selected Aggregated Structural Islamic Financial Indicators

Source: Created by the author based on "Prudential and Structural Islamic Finance Indicators (PSIFIs) 2019" Retrieved on May 11, 2020, from
< https://www.ifsb.org/psifi_05.php >

The Islamic financial market was also affected by the negative effect of Brexit and the decrease in crude oil prices on global finance in 2018. Despite the difficult global economic situation, the three main Islamic financial sectors, which are banking, capital markets and Takaful (Islamic insurance), were estimated at $2.19 trillion in 2018 [IFSB 2019: 9].

## (1) Issues of Islamic Finance Civil Disputes

Islamic finance has been expanding its market across the globe. More actors, including non-Muslims, are getting involved in Islamic financial transactions. Islamic financial products are developing, and the contracts are becoming complicated as some financial transactions may sometimes be combined. For instance, the Sukuk structure has developed hybrid types that underwrite more than two contracts such as Ijara, Salam, Murabaha, Musharaka, Mudharaba and other types of Islamic financial products.

More individuals and institutions are accessing the Islamic financial market through business and various transactions. International organizations such as IMF and the World Bank have been adopting Islamic finance in their financial transactions as well. As the market grows, the number of disputes, such as, breach of contract, default, and other financial difficulties have increased as an inevitable consequence.

Islamic finance emerged after the legal system for conventional finance had already been established. This meant that from its inception, the Islamic financial market had to compete with the existing conventional financial market and reconstruct its legal system to meet both the Sharīʻah principles and the conventional legal system of the country at the same time. Therefore, Islamic finance has faced a dilemma on compliancy with both Islamic ethical principles and the conventional legal system.

## (2) Triggers for Issues of Civil Disputes

There have been several lawsuits related to Islamic finance. Some dispute cases of cross-border Islamic financial transactions were dealt with in the conventional dispute resolution system, and in the earlier stages, some representative cases were judged in the UK courts, which brought up issues on litigation to deal with Islamic finance dispute cases.

The first case that brought issues related to the Sharīʻah to the court was the Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. and others [2002] All ER (D) 171 (Feb).[14] In this case, the legitimacy of the Murābaḥa contract was not discussed. The court observed the case according to the English law and did not refer to the issue being raised by the expert on the validity of this Murābaḥa contract.

The issues arising from dealing with Islamic finance in the English court did not receive negative views until the Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. [2004] EWCA Civ 19, [2004] 2 Lloyd's Rep 1, had been judged. In this case, it was clearly mentioned that the Sharīʻah is not a legitimate law to be applied in the court. In this case, it was mentioned that the applicable governing law for disputes must be the national law. National law is defined in "the 1980 Rome Convention on the Law Applicable to Contractual Obligations (Rome Convention)".[15] As the Sharīʻah was not categorized as a governing law, this caused issues for dealing with Islamic financial cases in the conventional court.

As Colon notes:

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14 This "Symphony Gems" case has brought up the issue on dealing *Murābaḥa* financing in the western legal system. For further information see [Moghul and Ahmed 2003].

15 The Rome Convention prescribed that the "contractual obligations" will need to be decided according to "the law of the country" [80/934/ECC].

> The argument that Sharīʻah is a comprehensive social code of conduct that applies outside of a state's legal framework should not create so much confusion that application of Sharī'ah becomes untenable…. Obviously, the judge need not consider principles related to personal behavior inasmuch as these did not affect the free will of parties in forming the agreement. In this respect, a judge can serve as a gatekeeper. In doing so, the judge should apply the chosen law of the parties, and when an issue is raised concerning a Sharī'ah matter, the judge should allow both sides to present their experts or to agree to send the issue to an expert chosen by the parties" [Colon 2010: 426].

In addition, having more than two laws applied to a contract is not permissible. It is also not allowed to apply dual laws in one contract according to the Rome Convention Article 3 (1). However, as "Combined-Law Contracts" are needed for Islamic finance, the Rome Convention will not be a solution for dealing with Islamic finance disputes [Colon 2010: 415-417; Mohamad and Trakic 2012: 18-20].

In the dual legal system, an Islamic finance contract will be a combination of Sharī'ah and other laws. Therefore, this combined-law contract is the appropriate form that is needed in an Islamic finance contract.

As these two cases have raised some criticism of using conventional litigation to deal with Islamic finance dispute cases, there has been growing criticism on utilizing the court for such incidents. As Islamic finance is a combination of finance and Sharī'ah, the litigation faces greater risks when dealing with Islamic financial dispute cases.

Adawiah pointed out there are Sharī'ah non-compliant risks in the Islamic finance industry in two categories, Sharī'ah advisory (Sharī'ah board) risk and Islamic financial Institution risk, as shown in Table 1.

Table 1. Sharīʻah Non-compliance Risks in Islamic Finance

| Sharīʻah Non-compliant Risk | Components of the Risk |
|---|---|
| Sharīʻah Advisory (Sharīʻah board) Risk | Incompatible practices occurring in IFI operation which the Sharīʻah advisors (Sharīʻah board) are unaware of. |
| | Inappropriate decisions by the Sharīʻah advisory (Sharīʻah board) based on inadequate/biased information from the bankers |
| | Variations of financial products lead to the Sharīʻah advisory (Sharīʻah board) not being able to cope with the development |
| Islamic Financial Institution Risk | IFI misunderstanding of Sharīʻah compliance |
| | Ignorance by the IFI and mistakes |

Source: [Adawiah 2015.15]

Sharīʻah non-compliant risk could be caused not only by the IFI, but also by a decision of a bank's Sharīʻah board. It could also be said that because the Malaysian courts are not fully aware of the Sharīʻah, there are higher risks when the courts handle Islamic finance dispute cases. Regarding these Sharīʻah non-compliance issues, Adawiah mentioned that employing the common law courts in Malaysia to adjudicate Islamic cases could lead to "anomalous decisions and non-consideration of Islamic legal rules and principles" [Adawiah 2015:16].

Malaysian litigation has been criticized for not referring to the SAC (Sharīʻah Advisory Council), not only from the Sharīʻah risks but also from the previous problems.[16] This point will be discussed in Chapter 5.

16 SAC is the Sharīʻah board for the Central Bank of Malaysia (BNM). There were litigation issues related to Islamic finance in Malaysia from 2008 to 2009 (For details,

There has been criticism of several conventional court judgments being given to such Islamic financial cases. The arguments could be divided into two types: one is the negligence or infringement of Sharīʻah principles, and the second is the difficulty of recognizing or applying Sharīʻah principles under the conventional legal system. These were caused by the conflict between conventional jurisdiction and Sharīʻah jurisdiction.

As various countries had a civil law system or common law system as their legal foundation, and Islamic finance came after the development of conventional finance, dual legal systems had to be established for Islamic finance in the major countries. The coexistence of both legal systems has created a lack of harmony in each jurisdiction from the very beginning.

### (3) Can ADR be a Solution?

Alternative Dispute Resolution methods, such as arbitration, mediation, and reconciliation were seen as solutions for dealing with Islamic finance cases in court. In order to be ready to deal with Islamic finance professionally, the court system will need to make greater efforts to amend its laws and educate its judges. However, the ADR offers a more flexible system to adopt new criteria. Each ADR institution could establish new guidelines. There are already some ADR institutions that have issued special guidelines for Islamic finance.

In previous studies, it has been suggested that ADR could be a solution for the problematic issues occurring when courts deal with Islamic finance. It was mentioned that as arbitration has been historically used in Islam, it is more reasonable to utilize the ADR system rather than establish a new court system for Islamic finance [White 2012].

As the Shamil v. Beximco case has illustrated the dilemma facing Sharīʻah as a governing law, the attention to ADR has grown. As the court's decisions have been causing issues of Sharīʻah non-compliance,

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see Chapter 5).

arbitration has been seen as the solution. It is said that choosing arbitration would be the solution to the issues of Sharīʻah compliance in the court system [Yaacob 2009].

Also, White has pointed out that in order to maintain the "legitimacy of Islamic commercial transactions and disputes", "Islamic Dispute Resolution (IDR)" needs to be established in order to maintain the growth of the Islamic financial industry [White 2012: 307].

Most Islamic countries employ the dual legal system of Western-oriented law and Sharīʻah law, but generally the jurisdiction of the Sharīʻah law covers only family law issues. As for Islamic finance, it has been categorized as commercial law, which is under the jurisdiction of Western-oriented law.

The historical background which has led to this complex situation is that the legal system for the conventional finance was established before Islamic finance had emerged. In such a situation, new legislation for Islamic finance was needed. Islamic finance needs to consider Sharīʻah principles which focus on the law and also on ethics, and ethical principles are not commonly considered in conventional finance. When developing Islamic financial products, the ethical value has more weight. However, when legal issues occur from the conflicts, the law has had more weight than ethics. Therefore, it is apparent that the nature of Islamic finance product development and civil disputes contradict each other when dealing with ethics and law.

On the other hand, various Islamic financial institutions have been collaborating with arbitration institutions to develop Islamic financial arbitration. In most cases, arbitration is seen as advantageous for dealing with legal and financial issues at the same time. INCEIF (The Global University of Islamic Finance), has signed a memorandum of understanding (MOU) to collaborate with the Charted Institute of

Arbitrators (CIArb) for conducting a course to train arbitrators, bankers, and other specialists to settle Islamic financial disputes.[17]

### (4) Initiatives Against Civil Disputes

There are several countries that have been active in solving the conflicts of law in civil dispute cases in Islamic finance. More details will be discussed in Chapter 4 for the cases in the UAE, and in Chapter 5 for cases related to Malaysia. This section will discuss the general situation regarding civil disputes of Islamic finance.

For the Malaysian case, it is known that Islamic financial dispute cases are dealt with in the Malaysian court. Civil suits related to Islamic finance have been dealt with not by the courts that apply Islamic law but by the courts that apply legislation rooted in Common law.

Previous studies have analyzed how the Malaysian court has dealt with Islamic finance cases since the 1980s [Hasan and Asutay 2011: 43-49]. This research focuses on how the Malaysian court was proactive about judging *bay‘ bi-thaman ājil* (BBA) and *bay‘ al-‘īna* [Hasan and Asutay 2011:43].[18] On the other hand, there are critical opinions on dealing with Islamic financial cases in the court system, as the court judges are lacking in knowledge of Islamic law and are not qualified to decide issues related to compliance with Sharī‘ah [Ibrahim 2008].

In addition, there are more issues related to dealing with Islamic financial dispute cases in the court. There is a possibility that the court will not seek advice from the SAC, and that the court judge will decide the Islamic financial case without the SAC's advice [Markom and Yaakub 2012: 12-15]. Thus, although the Malaysian government is proactive about reforming Islamic finance legal systems, the legislation

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17 INCEIF (September 2, 2014). "CIArb and INCEIF Collaborate on Training", Retrieved on May 8, 2020, from < http://www.inceif.org/news/ciarb-inceif-collaborate-training/>

18 BBA is one of the main schemes that has been use for deferred payment for housing. And *bay‘ al-‘īna* is a new Islamic financial scheme for liquidating currency for consumer credit.

and system for dealing with Islamic finance dispute cases is still searching for solutions.

In order to avoid the issues that arise from dealing with Islamic financial cases in the conventional courts, there are some other options known under the collective name of Alternative Dispute Resolution (ADR), such as arbitration, mediation, and conciliation. Arbitration in particular is said to be the best solution for the issues that the court faces when dealing with Islamic finance dispute cases [Yaacob 2009]. Thus, ADR is seen as a solution and an alternative to the court system.

Kuala Lumpur Regional Centre for Arbitration (KLRCA) has been set up to solve Islamic financial dispute cases by applying “i-Arbitration Rules”, a legal framework for dealing with such disputes, since 2007. KLRCA i-Arbitration has gained a lot of attention from the world as there are not many models for producing rulings dealing with Islamic financial disputes under ADR.

However, generally ADR itself also has several issues. More discussion will be introduced in Chapters 4 and 5 so we will just clarify the issues here.

Firstly, ADR rulings are not legally binding so they cannot force one or both parties to conform to the rulings against their will. Arbitration awards are decided by a tribunal which both parties agree upon. However, the final outcome of the arbitration award would only be legally binding after the court’s decision has been made.

Secondly, ADR has recently been recognized as a forum for complaint procedures rather than dispute resolution. Moreover, the procedures are becoming more complicated as it has become necessary for a conflict clause to be prescribed in the contracts. If no such clause is mentioned in the contract, it will be difficult to bring the conflict to the ADR committee.

In addition, when the conflict cannot not be solved by mediation and conciliation, if there is a “Multi-Tiered Dispute Resolution Clause”, the parties could use arbitration as the next step [Chapman 2010; Kayali 2010]. Thus, these processes are making the ADR less simple than it used to be. Therefore, if the conflict cannot be solved after the ADR process, theoretically, the case would be brought to court.

Thirdly, ADR is a way to solve dispute cases by providing a place to have both parties come together to negotiate their arguments, but there may be difficulties in making both parties attend the ADR session. In most cases, either one of the parties might hold a deeply emotional opinion that could make them avoid any confrontation with the other party. These conditions are commonly seen, not only in the Islamic financial sector but in general disputes.

To conclude, the utilization of the ADR still has various obstacles compared to the court system. In spite of this, ADR does have advantages, especially for protecting a business reputation and for reaching a rapid solution, and it has more flexibility to adopt Sharīʻah principles than the court system as it does not have to wait for the government to amend its law. There are several ADR institutions that deal with Islamic finance, and these will be explained in Chapter 3.

Chapter 2

# Ethics of Islamic Finance between Sharīʻah -based Morality and Legality

## 1. Introduction

This chapter will focus on the dilemma that Islamic finance has faced in discussions on economic theory and practice. Islamic finance is required to be compliant with the ethical values and legal principles of Islam. In addition, morals and ethics are important aspects for Islamic finance.

Simply put, conventional finance issues are primarily related to compliance with modern Western Law, while Islamic finance needs to be compliant with both modern Western Law and Islamic ethical principles at the same time. This necessity for Islamic finance to deal with these two areas of compliance has caused numerous academic discussions and some unique practices in the Islamic finance industry.

One of the issues with Islamic finance originates from its complicated legal structure. Islamic finance has its own 'law' but does not have a 'legal system'. Foster has clarified this situation: he briefly explains it as the 'formation of a body of law without a legal system' [Foster 2014:12]. A legal system is 'an operating set of legal institutions, procedures, and rules' [Merryman and Rogelio 2007: [Kindle] No. 75/3206].

Islamic finance has 'law': a bundle of rules that has legal principles based on Islamic philosophy and ethics. At the same time, it needs to be compliant with conventional law in its operation. However, the legal institutions and procedures to support Islamic finance are incomplete; therefore, when disputes occur, Islamic finance comes under the conventional judicial system and not Islamic 'law'.

The judicial organization and system for Islamic finance is under secular jurisdiction. This is because Islamic law has been categorized as customary law or a source of law but not as a law that is used in courts in modern times. In order for Islamic finance to operate within a complete legal system it will need to have legal and judicial institutions to apply the law under which it operates. Therefore, it could be said that Islamic finance has laws but not a legal system.

Islamic finance is based on two laws: secular law, which has been established based on conventional finance, and Islamic law. Contracts are formed for Islamic financial products, complying to Islamic ethics, since the secular law does not prevent such ethical applications. However, when a legal issue occurs, they are dealt with under secular law. This brings up issues about dispute resolution for Islamic finance. Secular law has its own 'legal system' to govern conventional finance. While Islamic finance only has its own 'law' without any legal institution that could constitute a 'legal system' such as the court or any other executive organ to enforce its 'laws'.

Maintaining Sharīʻah compliance is one of the keys to successful dispute resolution. Islamic financial dispute cases are occurring while legislation and regulations for Islamic financial dispute resolution remain under discussion. Therefore, some cases are being considered under the same dispute resolution system as the conventional financial system.

In order to overcome the issue of dealing with Islamic financial cases in conventional courts, Alternative Dispute Resolution or ADR has been widely discussed as an option in academic circles. Although this academic discussion has included practical dimensions, especially on its benefits, to save costs and time Islamic financial disputes have been brought before conventional courts.

Some court judgments, like the representative case of *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004]EWCA Civ 19 (January 28, 2004) have raised questions on dealing with Islamic financial cases in the conventional courts. Regarding this case it was mentioned that Sharīʻah principles are not a legitimate law to be applied in court. The applicable governing law needed to be a national law according to 'the 1980 Rome Convention on the Law Applicable Contractual Obligations (Rome Convention)'. Discussions about Islamic financial dispute resolution have increased globally after such incidents. For political and economic reasons, new dispute resolution systems for Islamic finance have emerged in the UAE and in Malaysia. These will be discussed in Chapters 5 and 6.

## 2. Dichotomy within Modern Western Law and Islamic Law

The legal conflict between modern western law and Islamic law can be seen in the Islamic financial contract. In conventional finance a contract is based on modern western law. In such cases, there will be no regulation that requires a Sharīʻah board to be established in a bank, as modern western law does not anticipate Islamic banking.

Another issue is related to a difference in the principle of the law between modern western law and Islamic law. This aspect will be discussed in Section (1).

Islamic banking and financial institutions are required by law or financial guidelines in a country to establish a Sharīʻah board within their institutions. According to the conventional financial system there are no such requirements. Therefore, Islamic financial institutions needed to develop their own laws or legal frameworks. This situation has led to developing a dual legal system or special law for Islamic banking and finance. Such developments of Islamic finance legal systems have appeared on diversified levels which will also be discussed in the following section.

## Dual Legal Framework for Islamic Finance

The comprehensive structure for the Islamic finance legal framework caused issues related to adherence to the Sharīʻah. This has led to some Islamic finance and banking sector products failing to fulfill *maqasid as-Sharīʻah* (the aim of the Sharīʻah) and just mimicking conventional finance. [19] Criticism of the Islamic financial market has increased recently, not only from the legal aspect but also from the political-economic viewpoint. The failure of the Islamic finance and banking sector to contribute to the economy has been discussed in previous studies [Asutay 2012].

Thus, Islamic finance emerged to confront economic and social issues in the Muslim world from the standpoint of Islamic moral values. The modern Islamic economic discussion led to the birth of Islamic banking in 1975 and has subsequently grown to its present global scale. Therefore, Islamic finance has emerged as a counterpart to the conventional financial system, which also means that the Islamic finance legal system was established after the establishment of the conventional financial system.

The fact that there was already a conventional financial system in existence created a contradiction for the Islamic financial legal system. Legal systems in the finance field had adopted common law or civil law as their model, and consequently, amendments or revisions of financial law became necessary. In particular, having a Sharīʻah board in a bank was totally different from conventional banking governance.[20]

The role of the Sharīʻah board is broad as it governs the Sharīʻah compliancy of the financial product, its management, and the audit as well. In addition, when the Islamic financial institution's contract is breached or customers have trouble with their financial plan, the

[19] The differences among *madhaahib* have raised debates on the legitimacy of financial products such as *tawarruq* and *ʻīna*. However, this controversy has also shown the regional diversity of the Islamic financial industry [Nagaoka 2008].

[20] Sharīʻah boards may be called Sharīʻah committees or Sharīʻah advisory boards. This paper uses the term "Sharīʻah board".

Sharīʻah board will also give advice and renew the contract.

The legal framework for Islamic finance in each country was transformed into various patterns that can be categorized into three categories:

a. Applying the conventional legal system to Islamic finance without differentiating it from conventional finance.
b. Amending or revising the law in order to legitimize Islamic finance to coexist with conventional finance; or establishing special laws for Islamic finance in order for it to be conducted separately from conventional finance.
c. Changing the whole financial system into Islamic finance.

Most of the Muslim countries are following categories ‘a’ or ‘b’. These categories offer more flexibility for both conventional finance and Islamic finance so that it is possible for a country to maintain its status of being an international hub, while at the same time, extending its new market for Islamic finance. Therefore, global financial hubs and international financial centers developed their laws or tailored new guidelines for Islamic finance.

The major Islamic financial hubs in the world have a similar legal system to category ‘b’. The origins of the legal systems of Gulf countries and Malaysia resemble each other. The Gulf countries were British protectorates in the early 20th century. During that period, most of the Gulf countries adopted a common law or civil law legal system.

Likewise, Malaysia was a British colony and its financial legal system was established by the British authority. This led Malaysia to have a dual legal system with Common law jurisdiction and Sharīʻah jurisdiction. However, the history and development of the legal systems of the Gulf and Malaysia have since become uniquely different. This can be seen in the comparison of the Dubai approach with the Malaysian model which will be discussed in Chapters 5 and 6.

The Islamic financial market has faced numerous challenges in accomplishing its original aim. One example can be found in the mismatch between the theoretical discussion and the Islamic finance market's performance. This has led to discussion on the emergence of the Islamic Moral Economy, which we will discuss in Section 4 of this chapter.

Theoretically, Muḍārabah has been seen as the most preferable financial scheme for Islamic finance. However, most Islamic financial schemes do not utilize Muḍārabah but chose Murābaḥah or other financial products as an option [Nagaoka 2012][21]. The issues of Islamic financial products have been discussed critically by El-Gamal using the concept of "Sharīʻah Arbitrage" [El-Gamal 2006].

Another legal issue is related to the feature of the Islamic financial products constructed according to contracts formed by Islamic principles. Financial products are a bundle of contracts. Most Islamic financial contracts use Arabic terms in order to clarify the financial scheme. These Arabic terms correspond to the secular law legal concepts. It is possible for these Arabic terms to be converted to common law or civil law concepts such as Muḍārabah which would fit the requirements of anonymous association contract and Ijārah, which is translated and generally understood as lease contract.

However, the Arabic concept explained by utilizing the secular law concept, will bring up the issue on the "source of law" for Islamic financial product development. If the Islamic financial products focus on fulfilling secular law, these products will prioritize being compliant with secular law first, then with Sharīʻah. This has happened and was already criticized during the emerging period of Islamic finance.

Islamic finance has now entered its second stage, which can be described as determining how to maintain market stability [Nagaoka 2016]. In order to stabilize the market, there is an interesting discussion,

[21] This has been discussed as the "Murābaḥah Syndrome" issue for decades.

which mentions the need for a common standard in the global market of Islamic finance. In this perspective, it is pointed out that the lack of global standardization for Islamic finance will be a factor for creating an unstable market [Yaacob and Abdullah 2012:494].

It is also mentioned that the key element for the Islamic financial industry to avoid a desperate battle is to adhere to its Islamic principles, and that it is necessary to standardize the legislation of Islamic finance [Yaacob et al. 2011:21; Yaacob and Abdullah 2012: 496].

Nur Yasmin Yaacoob also mentions that the members of the Organization of Islamic Countries (OIC) should make a *lex mercatoria* in order to form an international convention or "Model Law of Arbitration" and that this will smooth the misunderstandings occurring in the Islamic financial industry [Yaacob et al. 2011: 34-38].

When dispute occurs in international transactions or other cross-border contracts, the issue of what legal ruling should be chosen is the choice of the governing law. If there are more than two jurisdictions in the case, the decision of the jurisdiction is inevitably that, in most cases, common law will be chosen as the governing law for International transactions.

## 3. Dilemma of Sharīʻah Compliance: Moral Foundations and Legal Technicalities

While there were discussions on the legal development of Islamic finance, ethical and moral discussion was commonly passed over, although it is one of the crucial elements for Islamic finance. Islamic finance is not only a financial transaction but also stands on the foundations of Islamic morality. Islamic finance is intended to practice the moral and ethical values of Islam.

Therefore, this section will discuss the importance of the Islamic moral and ethical values that are applied in Islamic finance.

## (1) Prohibition of Ribā

The prohibition of Ribā emerged in Islamic Economic discussion in order to achieve the justice of Islam. Ribā literally means “increase”. However, it is well known in Islamic economics that Ribā is translated as “interest”. In particular, Ribā is considered as unequal gain by one party in a transaction. In order to achieve the goals of Islamic justice, which is also known as Maqāsid as-Sharīʻah, Ribā is prohibited in Islamic financial transactions. Conventional finance considers the “interest” as a profit. Islamic finance also needs to gain profits, as gaining profits is essential for any business to be sustainable. Therefore, Islamic finance had developed its own financial commodities to avoid “interest” while gaining profits.

Murābaḥa is one of the most popular Islamic financial commodities. In Murābaḥa, the bank will purchase a commodity from a third party at the request of the client. This is because, it is prohibited to deal money for money, and it is also prohibited to sell commodities one does not own. As a result, the bank will buy the commodity for the client. As the bank now owns the property or the commodity, it can legally sell it to the client with a profit called “cost-plus” or “mark-up”. The mechanism of Murābaḥa resembles trading. Trading is permitted in Islam as it is mentioned in the Quranic verse “Allāh has permitted trading and forbidden Ribā” [Qur’ān 2: 275].

As Murābaḥa is similar to trading, it is also criticized that Murābaḥa is similar to an interest-bearing loan [El-Gamal 2006: 2-5]. On the other hand, Murābaḥa has the advantage of “resembling an interest-based banking practice, while at the same time being Sharīʻah compliant” for two reasons. One is because it shows the “inventiveness of scholars” as they have adapted the traditional form of transaction into the new banking scheme. Secondly, it helps to decrease the risks and is able to compete with the conventional banking system [Sairally 2002: 77-78]. As the conventional financial system is based on debt it is natural for

Murābaḥa to be used as it has a similarity to the traditional system while at the same time being compliant with the Sharīʻah [Yousef 2004].

Accordingly, the legislation of Islamic finance has to apply Sharīʻah but at the same time differ with the conventional financial system as Islamic finance does not allow the use of any interest in their financial products. Here, the role of the Sharīʻah board and the required legislation for it is vital in order to judge whether the Islamic financial product is following Sharīʻah rules. The role of the Sharīʻah board is crucial to maintain the legitimacy of the Islamic financial product as Sharīʻah compliant.

### (2) Contradiction in the Legislation and Ethical Practice

Previously, much of the debate on Islamic finance revolved around the question of how financial schemes would be designed to avoid *harām* (prohibited) elements. Therefore, the issue of how Islamic financial products should be consistent with the Islamic law was associated with financial structures and other economic elements. However, after the world financial crisis of 2009, another debate over the compliancy of Islamic finance with the Islamic law arose. The UK courts issued a ruling on a case that had involved Islamic finance, which brought international attention to the issue of how to deal with Islamic financial cases in a non-Islamic legal system.

The UK is not an Islamic country, but even Islamic countries, including the Gulf countries, had adopted Western legal systems after they became independent. Therefore, when issues of Islamic finance were brought to the ordinary courts or alternative sites of dispute resolution, there was always the fear that these ordinary courts would infringe on the Sharīʻah's jurisdiction. This issue had started to be addressed by local Islamic banks in the UAE by the end of the first decade of the 2000s.

In the UAE, Islamic financial institutions are all under the jurisdiction of the central bank, except those related to Islamic law jurisdictions, according to the 1985 Union law No. 6.[22] This law regulates the establishment and operation of Islamic financial institutions. However, this law does not address how the Islamic finance organizations will apply Sharīʻah law, where the cases will be brought, and how Islamic law will be followed when the parties have selected an ordinary dispute resolution system. As the central bank regulates Islamic financial institutions, if the conflict is related to the banking system, the central bank will decide the case; for an insurance company, the case will be decided by the Ministry of Economy and Commerce [Feulner and Khan 1986: 316]. However, most cases in the UAE were being brought to the ordinary courts or alternative dispute resolution systems such as arbitration or reconciliation were being used.

On the other hand, Sharīʻah board members at the local Islamic banks considered this situation a potential risk because it ignored Islamic law by dealing with cases through conventional legal systems.[23] This dilemma had been caused by inconsistencies in the legal jurisdictions of Islamic financial institutions.

Federal law secured Islamic law jurisdiction for Islamic financial institutions from their establishment to their operation, but when it came to disputes, the conventional legal system had jurisdiction. If cases involving Islamic financial institutions are brought to ordinary courts and ordinary arbitration institutions, this contravenes Islamic law.

In 2006, a movement began in Dubai to establish an arbitration institution to address cases that had Islamic law as their governing law.

[22] 'Islamic financial institutions' here refers to all financial institutions that mention that the organization or company will be established according to Islamic law. Such institutions include Islamic banks, Islamic insurance (takaful) companies, and Islamic investment companies.

[23] According to an interview with a Sharīʻah scholar from an Islamic bank in the UAE, the 1985 Union law had guaranteed Islamic financial institutions would be under Islamic legal jurisdiction; therefore, if a dispute among institutions was brought to the conventional court, this would contradict Islamic law. Another legal supervisor of an Islamic bank had also mentioned that if an Islamic financial case is brought to the court as a conventional financial case, it would be controversial under Islamic law.

If there was no clear legal framework for Islamic financial cases, these cases were generally brought to ordinary courts. Against this background, a new dispute resolution system for Islamic finance cases was established in 2009. This movement is a clear example of the pressure to establish a dispute resolution system that applied Islamic law. The full scope and significance of this new system will be discussed in the Chapter 5.

There is some criticism of the gaps between legislation and ethical practice in Islamic finance. One such discussion can be seen in the divergence of the legal decisions by the Islamic school of law and the practice of Islamic finance.

## 4. Emergence of the Islamic Moral Economy

As the Islamic financial market expanded, the dilemma of the identity of Islamic finance started to surface. The most crucial problem for the Islamic financial market was how to compete with conventional finance while maintaining its identity as Islamic.

Islamic finance and conventional finance are both related to the real industry sector which prefers to choose the most profitable option. This need for profitability has caused issues when choosing preferable financial options. In the discussion on Islamic economic theory it is considered that the preferable financial option has a higher cost and greater risks, such as in Mudhāraba contracts.

Therefore, the Islamic financial market tends to choose more profitable financial schemes, which are Murābaha contracts and other products which sometimes trigger debates on their Sharīʻah compliance. One of the representative cases was the use of a specific Islamic finance product in Malaysia. This point will be discussed in detail in Chapter 5.

Development has been one of the crucial topics in the Islamic world since the 1940s, especially in the post-colonial era. The Islamic world has been facing the issue of mostly belonging to the third world and therefore being underdeveloped. Islamic finance emerged in order to tackle such issues related to economic development, poverty, wealth distribution and other economic issues in the Islamic world.

However, as the founding fathers of Islamic economics pointed out, the Islamic world has been focusing on the kind of economic development that the western countries have been doing. They criticized that the Islamic world has adopted Western development strategies which are without justice, one of the most fundamental values which Islam aims to accomplish as *Maqāsid al-Sharīʻah* [Chapra 2008].

In addition, Mehmet Asutay also criticized the "Eurocentrism" of economic theories that lack the justice of Islam but have been adopted in the Islamic world [Asutay 2012]. In other words, development in the Islamic world not only aims for material or physical development, but also spiritual and moral development to achieve social justice [Jan and Asutay 2019: 56-59].

After W.W.II, newly independent Muslim nations implemented economic policies formulated in the West which resulted in the failure of economic development to solve poverty and other economic issues. The Islamic Moral Economy (IME), as an "alternative to capitalism and socialism emerged as a response to such failure with a promise to not only trigger economic growth but also to provide an environment in which Muslim human-centered economic development could take place for the purpose of achieving *falah* or salvation" [Jan and Asutay 2019: 61].

In addition, the IME created its own unique "Value System" based on a balance between the material world and the *akhirah*, the Hereafter [Jan and Asutay 2019: 71]. In order to proceed with such a system, the economic agent in the IME system would be acting as "homo Islamicus" [Asutay 2007a; 2007b].

Therefore, a moral 'filtering' process would be necessary for the IME to check its methodology. It has been mentioned that the only "modern institutions that have come out of the IME" are "Islamic banking and financial institutions" [Jan and Asutay 2019: 77].

However, Islamic financial practices have been criticized for not complying with the original aim of Islam. The issues of the convergence between Islamic financial practices and conventional finance have been discussed by El-Gamal who stated:

> "As previous juristic innovations become commonly accepted, and as competitive pressures mount, jurists are likely to continue offering innovations that lead to the convergence of Islamic financial practice with its conventional counterpart. This, in turn, will cause disenchantment among potential new customers and existing customers of Islamic finance, as product differentiation between and an Islamic product and its conventional counterpart appears increasingly more contrived" [El-Gamal 2007: 183].

In order to differentiate the practice of Islamic finance and its theory from the original goal of the founding fathers of Islamic economics, Mehmet Asutay has separated it by calling it the Islamic Moral Economy (IME).

It is said that in "the post-1960s period, the failure of economic development in the Muslim world and the rise of the Islamic political identity motivated certain academics, activists and financiers/bankers to discuss the initial foundational issues of what was later to become Islamic economics or IME" [Asutay 2012: 94].

In order to execute the IME system, the methodological framework has been summarized as:

1. "An individual should not only be concerned about his or her own interests because concern for society is also important".
2. "Material progress is not the ultimate goal".
3. "Trying to maximize his/her utility seek to maximize social welfare as well" by considering the next life, *akhirah*.

4. "Man needs guidance from Allah for making various decisions in life".
5. "Market exchange mechanisms through moral filters produce a socially concerned environmentally friendly system" [Jan and Asutay 2019: 76-77, Asutay 2007a: 12].

These days 'Islamic banking and finance' has been criticized for "mimicking" conventional finance and by "mirroring", thus losing its identity [Asutay 2016].

## (1) Institutional Grafting

This section will discuss how a new institution, theory and concept emerges in the Islamic finance. Islamic finance also emerged as a new economic system and created a new social and economic institution and value to the society and economy. The emergence of a new "institution" or "value" has been discussed in the social economic field. From the social economic aspect, new institutions, theories, and concepts develop from the social value that is "embedded" economic activities. Section (2) will also illustrate the issue of "emergence" in the Islamic financial industry.

Islamic economics, according to the IME perspectives, is not another version of market economy. It should be understood as a kind of embedded economy. The 'embedded' economy has been explained by Alejandro Portes as being created based on the 'value' of the society. In such a mechanism, the emergence of new institutions is created from a value that both becomes a 'norm' and has 'cognitive repertoires' which will eventually create a 'role' in a society that will eventually create a new 'Theory' or so called 'Institution' that will be sustained by the social capital [Portes 2010].

The emergence of the embedded economy has been explained by Alejandro Portes as how the 'institutions' emerge to become visible by starting as a cultural 'value' in the society from the grafting model as illustrated in Figure 2.

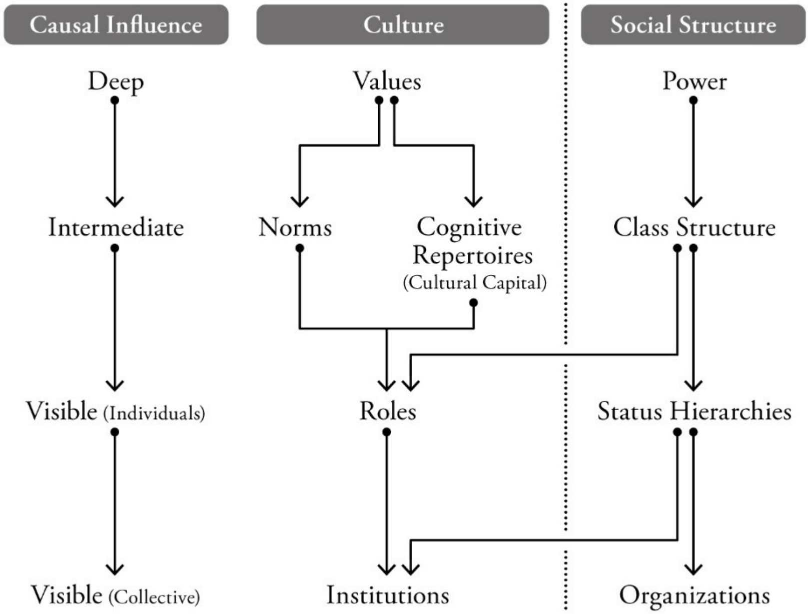



Figure 2. Grafting Model on the Elements of Social Life by Alejandro Porte
Source: Modified by the author from [Porte 2010: 54]

This model shows the correlation between the social structures which create 'Institutions' or the theory of the economy embodied in the society, and also shows the parallel relationship with the 'power' of the society. This model has been adapted in Mehmet Asutay's theory on grafting the 'disembedded' social structure that Islamic banking and finance has.

## (2) Grafting Model from Porte to IME

The grafting model by Alejandro Porte was developed by Mehmet Asutay to explain how Islamic banking and financial institutions are "disembedded" [Asutay 2016]. As was discussed in the previous section on social economy, the emergence of institutions, theory, and concept have mutual relations with the social and cultural values. One of the clear criticisms comes from the direction of the emergence process which is the opposite to the 'embedded' one.

Alejandro Porte explained that the "embedded" economy would be created by the cultural "value", which becomes a norm and becomes recognized by the society as "cognitive repertoires". In the "embedded" society these two elements would create a new "role" to the society and then a new theory, concept, and institution would emerge.

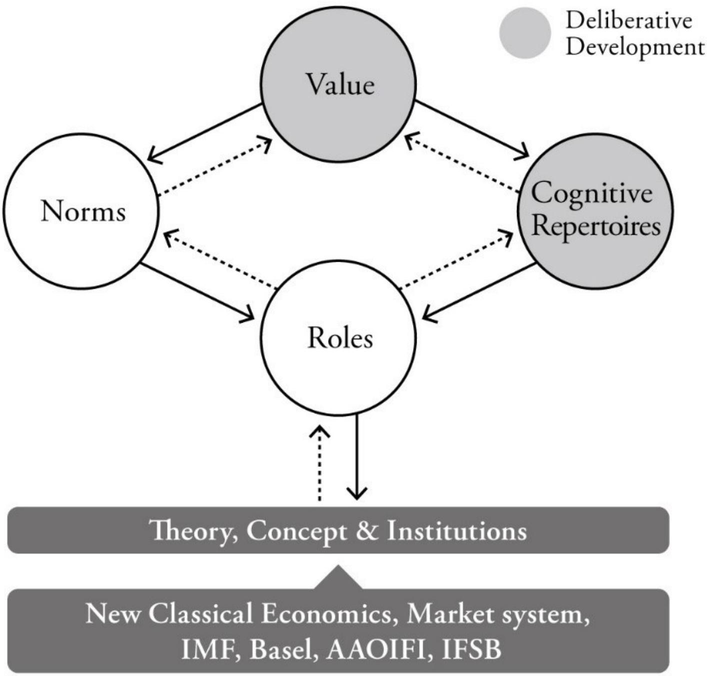



Figure 3. Grafting Theory, Concept, and Institution in Islamic Finance
Source: Adapted from [Asutay 2019:70]

However, as Asutay illustrated in Figure 3, the arrow is pointing in the opposite direction to the one in the "embedded" economic structure. This could be explained from the critical aspect of Islamic finance focusing on capital, which is discussed in neo-classical economics, the market system of the capitalism, or other international institutions related to the world economy, rather than the values of Islam. The market economy is creating the social and economic value of Islamic finance. Therefore, the reality of Islamic finance is seen as "disembedded", as the impulse for creating an institution, theory and concept comes from the market, rather than the value of the society which is "embedded".

Compared to Porte's model of an 'embedded' economy, Figure 2 shows that the Islamic financial market is created by the market economy. The Islamic financial market is creating the theory, concept, and institution, then eventually creating the 'value' in the society. There is not an "emerging" or "embedded" economy as the creation of the theory, concept and institution does not start from the "value" of the society or culture.

In other words, the Islamic financial market creates its theory and institutions based on their criteria and creates a new "role" for such institutions which in this case, focuses on 'capital domination' which is aiming at moneymaking, and in the end, this creates the 'value' for Islamic finance to be market driven. Such a process could be shown as the grafting in Figure 2. In other words, 'capital domination' for each institution means that Islamic finance will be focusing more on capital growth, just as capitalism aims to do. In such a case, ironically, the aim of the Islamic financial institution will be the same as capitalism.

Asutay has introduced another model that will be able to accomplish the ideal which Islam aims for. The "value" of the Islamic society would be formed by the balance created by its unity and complementarity (Tawḥīd), an Arabic word which defines the unified nature of all things. This Tawḥīd would also be affective for finding sustainability (Rububiyah) which would lead to finding social justice and economic equilibrium (Adalah and Ihsan) [Asutay 2019: 47].

As a result, the "cognitive repertoires" of the social and cultural "value" would be articulated by the Islamic Moral Economy and Islamic Political Economy through social life.

Figure 4 shows Asutay's model which illustrates the paradigm of how the 'value' from the Islamic world creates new 'theories and institutions' which would lead to the realization of Maqāsid al-Sharīʻah. This whole institutional constitution in *Iqtisad* (economics) and the emergence of Iqtisad institutions has a grafting structure as in Figure 3.

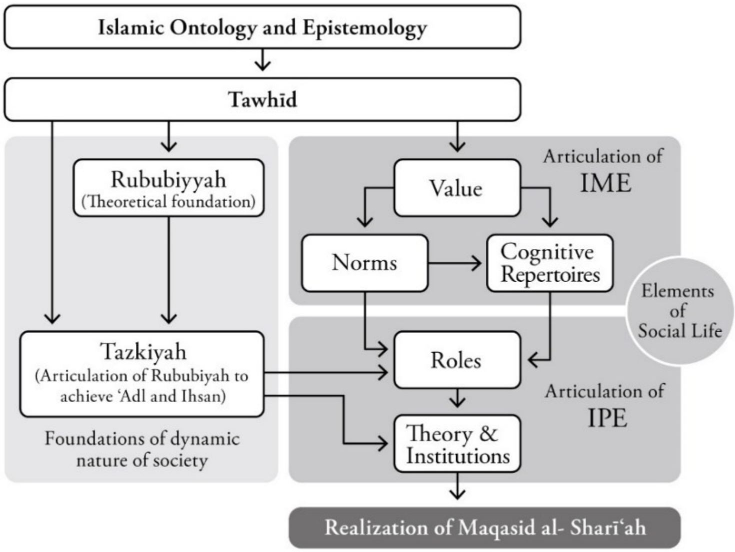



Figure 4. Iqtisad Grafting Model by Mehmet Asutay
Source: Adapted from [Asutay 2019: 51]

## (3) Emergence and Divergence in the Islamic Economic and Finance

The Islamic financial industry started to face its identity dilemma from the 2000s. The more the Islamic financial market expanded, the more efficiency in the business had been prioritized and caused a gap between Islamic economics theory and the practices of Islamic financial institutions.

As such incidents increased, the development and reconstruction of Islamic financial products started to gain attention in academic fields. At this time, the role of the Sharīʻah board started to gain more importance. A Sharīʻah board is an independent institution in Islamic financial institution. The role of the Sharīʻah board is to maintain and guarantee the financial product to be Sharīʻah compliant. The Sharīʻah board is a committee formed by a group of Islamic law specialists. Each of the Islamic financial institutions has its own independent Sharīʻah board. Sharīʻah board members are responsible for guaranteeing that the Islamic financial products are Sharīʻah compliant or not. Sharīʻah board is one of the unique characteristics of Islamic financial institutions which does not exist in conventional financial institutions.

The Sharīʻah board is seen as taking an important role in the Islamic financial industry as its existence is one of the characteristics that distinguishes Islamic finance from conventional finance. As the demand for Sharīʻah scholars is proportional to the expansion of the industry so the number of Sharīʻah scholars is increasing.

However, the supply of qualified Sharīʻah scholars is not adequate and as a result, the Islamic financial market has been criticized for hiring specific figures repeatedly. It has been shown in the previous studies that the Sharīʻah board memberships are dominated mostly by particular well-known Sharīʻah scholars [ISRA-Thomson Reuters 2016: 29]

Chapter 3

# The Gulf and Southeast Asia in the World Map of Islamic Finance

## 1. Introduction

As the demand for Islamic finance increased, different countries took their own approaches toward it. Some were proactive while others were skeptical of accepting it. In some cases, the government was not that proactive in expanding Islamic finance, but the industry was able gain autonomy by itself. This chapter will describe the jurisdictional differences by comparing the representative countries of each category, especially describing the importance of the Gulf countries and the Southeast Asian countries.

After the 2000s more non-Islamic countries started to adopt Islamic finance in their economies. Before that, it was mainly the OIC member states that had been adopting Islamic finance. Currently, the UK hosts its own full-fledged Islamic banks and is also well known for its academic contributions to Islamic economics. The UK government has shown an interest in Islamic finance from the early stages and committed itself to nurturing the Islamic financial market as an alternative to conventional finance. Moreover, the former Chancellor Gordon Brown mentioned that the UK could become a "gateway" for Islamic finance in 2006.[24]

As countries where Muslims were a minority had started to join the market, the GCC countries and the Southeast counties were taking advanced steps towards Islamic finance. The Gulf Cooperation Council (GCC) countries and the Southeast Asian countries became the main

[24] BBC News. (June 13, 2006). *UK'S Brown Backs Islamic Finance*. Retrieved April 13, 2020, from <http://news.bbc.co.uk/2/hi/business/5074068.stm>

hubs for the Islamic finance industry. This chapter will describe why these two areas have become the outstanding places for Islamic finance.

## 2. The Growth of the Islamic Finance Market

The United Arab Emirates (UAE) and Saudi Arabia have been two of the key areas during the development of the Islamic banking sector. The UAE was the first country that started Islamic banking in the commercial sector, by establishing the Dubai Islamic Bank.

Saudi Arabia had a different approach, but it has been one of the important countries related to Islamic finance. For example, it is home to the headquarters of the Islamic Development Bank (IDB), and the IDB Group. The IDB has become one of the key figures in Islamic economics and Islamic finance.

For several decades, the Gulf countries and Southeast Asian countries, especially Malaysia, have been leading the Islamic financial industry. This section will introduce some economic aspects of the Islamic financial market from 2008 till 2018.

As is well known, the global financial crisis of 2008 hit the world economy severely. While the conventional financial system struggled to recover from the economic crisis, the Islamic financial sector was also facing a negative effect during this time. However, the global assets of Islamic finance continued growing. According to the report by TheCityUK, the global assets of Islamic finance had reached US$1,130 billion at the end of 2010 and were estimated to reach US$ 1,289 billion by 2011 as shown in the Figure 5 [TheCityUK 2012:1].

The UAE has become one of the main financial centers and the Islamic financial market there has a large presence. According to the Emirates Banks Association, Islamic finance had an 18% share compared to conventional finance in 2011 in the domestic market.[25] The

[25] These statistics supplied by the Emirates Banking Association include the assets of

strength of the domestic Islamic market of the UAE has been pointed out by Wilson as he stated that UAE's Islamic banks have targeted the local markets like Qatar [Wilson 2012: 138].

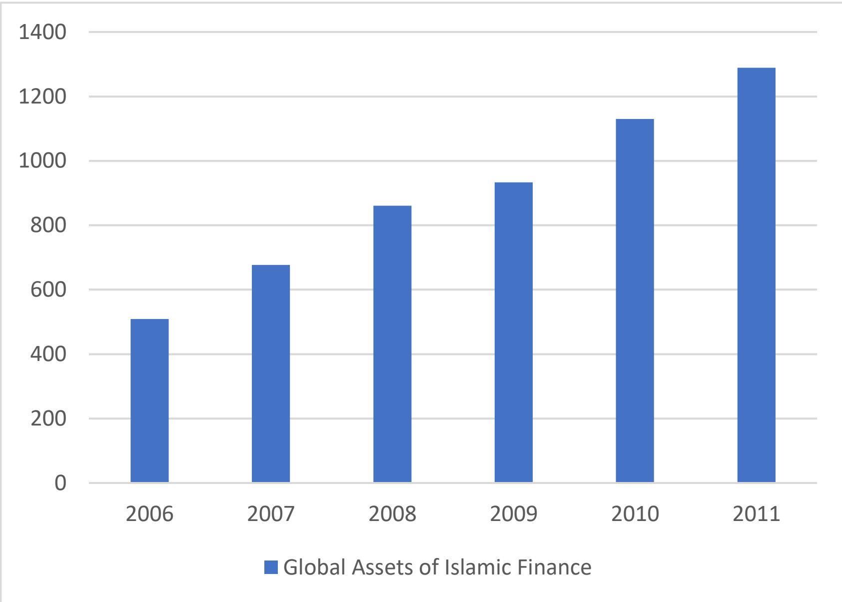
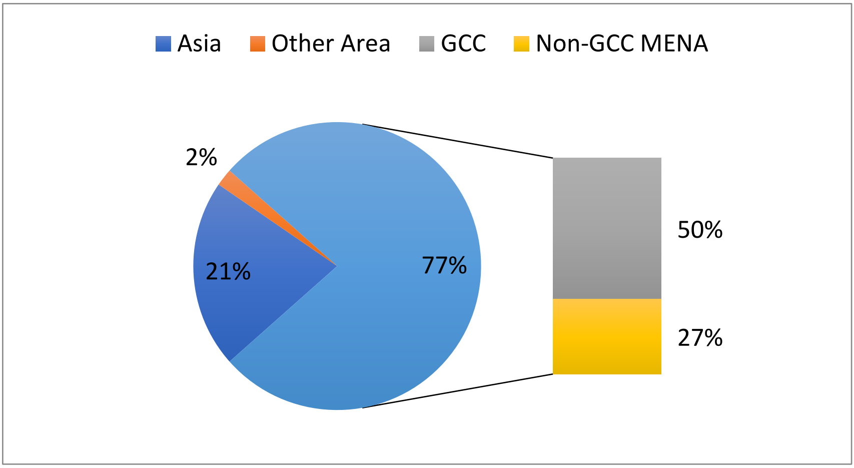



Figure 5. Global Assets of Islamic Finance
Source: Created by the author based on [TheCityUK 2012: 1]

In 2014, the US dollar exchange rate negatively affected Islamic finance, and assets which were Sharīʻah compliant had declined to $1.273 trillion in 2015. However, although the outcome shows a decline in Sharīʻah compliant assets, the actual substance of the Islamic financial market was still in a positive condition. *The Banker Report* pointed out that the downturn in Sharīʻah compliant assets was mainly caused by the Iranian currency rate.

the Dubai Bank which was combined into the Emirates Bank in 2011.




| Region | 2015($bn) | 2014 ($bn) |
|---|---|---|
| GCC | $640 | $561 |
| Non-GCC MENA | $339 | $537 |
| Sub-Saharan Africa | $8 | $11 |
| Asia | $269 | $259 |
| Australia/ Europe/ America | $17 | $24 |
| Global total | $1,273 | $1,392 |

Figure 6. Regional Assets ($bn) in 2014
Source: Created by the author based on [The Banker 2015: 3]

After the commercial practice of Islamic finance was introduced, two large hubs formed in the Middle East and Southeast Asia. The Gulf countries and Malaysia had become well known for Islamic finance by the turn of the century. These countries together own the majority of the Islamic financial assets in the world.

As is shown in Figure 6, the MENA region has the largest Sharīʻah compliant assets in the global Islamic financial market, and the Gulf countries have the highest percentage of those assets. The MENA region has 77% of the total Sharīʻah assets while Asia (excluding West Asia) and the other regions, namely, Asia, Australia, Europe, and America, share the rest of the pie.

Islamic finance services did not reach out only to Muslim countries but also to some countries where Muslims were in a minority such as the UK, or countries that are categorized as non-Muslim such as Hong Kong, and Luxembourg.

By 2015, the UK had over twenty banks offering Islamic financial services, including five full-fledged Islamic banks. The UK government has been opening doors to Islamic finance from the early stages in Europe.

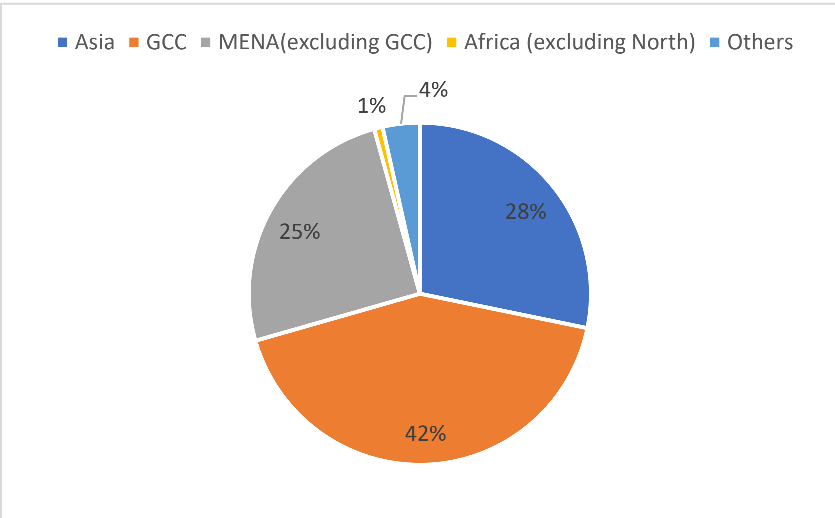



Figure 7. Breakdown of the Islamic Financial Sector by Region (share %) in 2018
Source: Created by the author based on [IFSB 2019: 10]

A new Islamic financial market was also developed in 2014. Indonesia and Africa were seen as the developing markets for Islamic finance in order to fill the financial gaps among the Muslim population. After four decades of Islamic finance markets' development, the opening of new frontiers has been encouraging Muslim economic activity with support from the Islamic financial market.

The share of the total assets of the Islamic financial industry in 2018 is shown in Figure 7. In 2018, the global economy faced some setbacks due to political movements such as Brexit. Although the global economy faced several setbacks in 2018, the Islamic finance industry enjoyed positive growth, according to the 2019 IFSB report. It was estimated that the total assets in Islamic banking, capital markets and Takaful was 2.19 trillion US$ in 2018.

The global assets of the Islamic banking industry broken down by country are shown in detail in Figure 8. Iran and Saudi Arabia own more than half of the total Islamic banking assets. The reason these two countries have such a large amount comes from how the assets are gathered in each nation. When analyzing the banking sector, it is important to see how the Islamic banking assets are calculated. The IFSB report in 2018 analyzed the total bank assets under the jurisdiction of

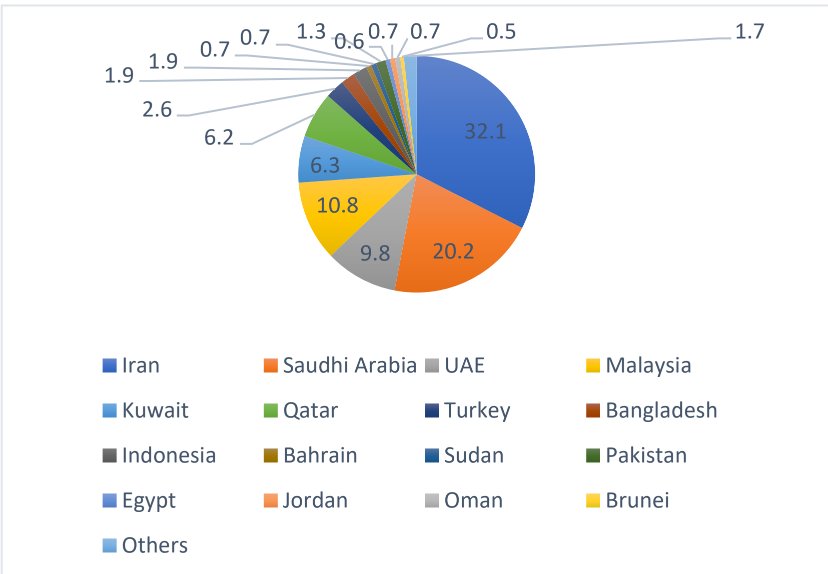



Figure 8. Breakdown of Islamic Finance Assets by Countries
Source: Created by the author based on [IFSB 2019: 12]

Islamic banking for Iran as 100%, and for Saudi Arabia as 51.5%. On the other hand, assets under the jurisdiction of Islamic banking in the UAE are 20.6% and Malaysia 26.5%. Considering the extent of the jurisdiction of Islamic banking in the national banking sectors in these countries, the UAE and Malaysia have comparatively large assets for Islamic banking.

As the market grew, Muslim majority countries were not the only areas where it the Islamic economy expanded. The total Islamic financial assets in non-OIC countries were estimated to be US$ 30 billion in 2016 and the top three countries were the UK, Switzerland, and the United States [Thomson Reuters 2018: 13].

The LARIBA Bank in the United States is also an interesting practice of Islamic finance in a non-OIC country. The practice of LARIBA bank is an interesting case where the founder, Dr. Yahia Abdul-Rahman practices the Ribā-free banking style and also develops his philosophy on Islamic banking and finance [Abdul-Rahman 2010: Abdul-Rahman 2014]

## 3. The GCC as the Birthplace of Commercial Islamic Finance

The Gulf countries as specified in this paper are those who are the members of the Gulf Cooperation Council of the Arab States (GCC). Those countries are Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates (UAE), and Oman.

There are two reasons for Islamic finance to gain strength in the GCC countries. The first reason is their extensive oil or natural gas revenues. The GCC countries, except for Bahrain, have been able to nourish Islamic finance due to the abundant petroleum related revenue.[26] Since

[26] Bahrain had developed its economy to focus on the banking industry from the early years. Bahrain had found petroleum in 1932. Later on, petroleum was found in Saudi Arabia and Kuwait in 1938, and Qatar in 1939. In the UAE oil was discovered in 1958 in Abu-Dhabi. Therefore, it is said that Bahrain was the first country to

the discovery of oil in Iran in the beginning of the 20th century, the Gulf countries have been able to get preferential benefits from their oil and natural gas income. Due to the oil boom the GCC counties were able to gain enormous oil income, and this coincided with the advent of "Islamic revivalism" [Kosugi 2006: 95-96].

Thus, the second reason for the emergence of Islamic finance was the "Islamic revival" movement in the Islamic world. Muslims thinkers recognized that most of the areas where they were living were economically part of the third world. In addition, the realization that the so-called Islamic world was not strictly speaking following the ideology of Islam led to a call for the revitalization of the Islamic way of life, and the reform of the social and political structure of the Islamic world [Kosugi 1994]. Islamic economics had emerged first to seek an economic theory of the Islamic way of life in the 1940s, then Islamic finance emerged in order to tackle issues related to economic development and poverty, equitable wealth distribution, and other economic issues in the Islamic world in practice.

The birth of Islamic finance as commercial banking was conceived by the Dubai Islamic Bank in 1975. As there were no regulations for Islamic banking at that time, Dubai Islamic Bank was categorized as the Sharikat (Company) by the Dubai Decree issued on March 20, 1975.[27]

In October of the same year that Dubai Islamic Bank was established, the Islamic Development Bank (IDB) headquarters was established in Jeddah. The membership of the IDB consists of the same members as the

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discover oil in the Gulf countries. However, Bahrain understood its limitation in producing oil as it did not possess as much petroleum as the other Gulf countries. Therefore, Bahrain struggled to find its way by diversifying its industries in the early years. After becoming independent in 1971, Bahrain entered a new stage by establishing various industries which did not rely on the oil industry like the other countries in the Gulf region. This diversification made it possible to establish a new financial industry in Bahrain. It is notable that Bahrain had started to envisage post-oil era industries from the early stages which gave it a great advantage to become one of the financial sectors in the Gulf area.

27 Marsūm bi-Ta'sīs Bank Dubayy al-Islamīya 1975

Organization of Islamic Cooperation (OIC) except for Syria.[28] IDB has been active in promoting development in the Islamic world by utilizing Islamic financial products.

The commercial development of Islamic finance started with the establishment of Islamic banks. In 1977, Kuwait Finance House (KFH) was established. Then followed the Bahrain Islamic Bank in 1979. Later in 1982, Qatar Islamic Bank was established.

While the UAE, Kuwait, Bahrain, and Qatar started their development of the Islamic financial market, Oman had to wait until 2012 for its first Islamic bank to be established. Saudi Arabia had also contributed to expanding Islamic banks outside its borders.

Muhammad al-Faiṣal bin Abdul Āl Saʻūd, Prince of Saudi Arabia, is well known as a pioneer of Islamic banking and finance. He contributed to the founding of the Faisal Islamic Bank of Egypt and Faisal Islamic Bank of Sudan.

Due to Saudi Arabia's official position that the entire country is Islamic, it was difficult to establish a new Islamic bank as it would clearly differentiate what were Islamic and non-Islamic banks in the country. As Saudi Arabia is a strictly Islamic nation, it was not acceptable for such a divergence to happen. Therefore, the establishment and registration of the Islamic banks owned by Saudis was done outside of Saudi Arabia but utilizing the assets from the country. The case of the DMI Group and Albaraka Group exemplifies this issue exactly. The DMI Group was established in the Bahamas and their entities are mostly established or registered outside of Saudi Arabia, although, the founder of the DMI Group is Mohammed Al-Faisal Al-Saud, a member of the royal family of Saudi Arabia. Similarly, the AlBaraka Group was licensed for Islamic banking in Bahrain.

In comparison to the establishment of the Dubai Islamic Bank, the Faisal Islamic Bank in Egypt gained its license as a "economic and social

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28 Syria's membership of the OIC has been suspended due to the humanitarian issues related to the Syrian conflicts at the 4th Extraordinary Summit held in Mecca in August 2012.

institution taking the form of and Egyptian joint-stock company operating in compliance with the rulings of Islamic Sharī‘ah", by the law No.48 of 1977 and started its operation from 1979.[29]

Although there were obstacles related to establishing Islamic banks, the GCC countries were able to mobilize their vast assets to develop Islamic finance in their region, and also formed a multinational group that contributed to expanding the Islamic financial market on a global scale.

## 4. Southeast Asian Governments Take Action on Islamic Finance

Southeast Asia has become a hub for Islamic finance, especially Malaysia. Indonesia has also been noticed as a rising country in the Islamic financial industry. In particular, Malaysia has been able to create its own status as a pioneer in the Sukuk market.

As Figure 9 shows, Malaysia issued 32.82% of the total Sovereign Sukuk in 2018. In addition, Malaysia is known to have developed its domestic regulations to be compatible with Islamic finance. In the State of the Global Islamic Economy Report 2019/20, it is said that "Malaysia

[29] Faisal Islamic Bank of Egypt, Incorporation & History, Retrieved on April 14, 2020, from <https://www.faisalbank.com.eg/FIB/english/about-us/incorporation-history.html >. The law No. 48 of 1977 was amended as law No. 97 of 1996 in which Faisal Islamic Bank was registered as a commercial bank and supervised under the Central Bank of Egypt. Faisal Islamic Bank of Egypt was the first Islamic bank in Egypt. However, it suffered due to the negative experiences of fraud by Islamic investment companies during the 1970s. Egypt had experienced of Islamic finance from the early time due to the establishment of the Mit Ghamr Savings Bank in 1963. Ahmad Al-Najjar, the founder of this social savings bank, modeled it on the German Cooperative Savings Bank [Habib 2018:13]. However, Egypt was wary of Islamic banking as the Islamic movement was a part of the Muslim Brotherhood's activity. Therefore, the Mit Ghamr Savings Bank had been transformed into the government bank, Nasir Social Bank, where it had established Zakat funds.

and the UAE continue to lead" the Islamic economic market, which includes Islamic finance, Halal food, Muslim friendly travel, Modest Fashion, Media & Recreation, and Pharmaceuticals & Cosmetics [Salaam Gateway 2019: 14].

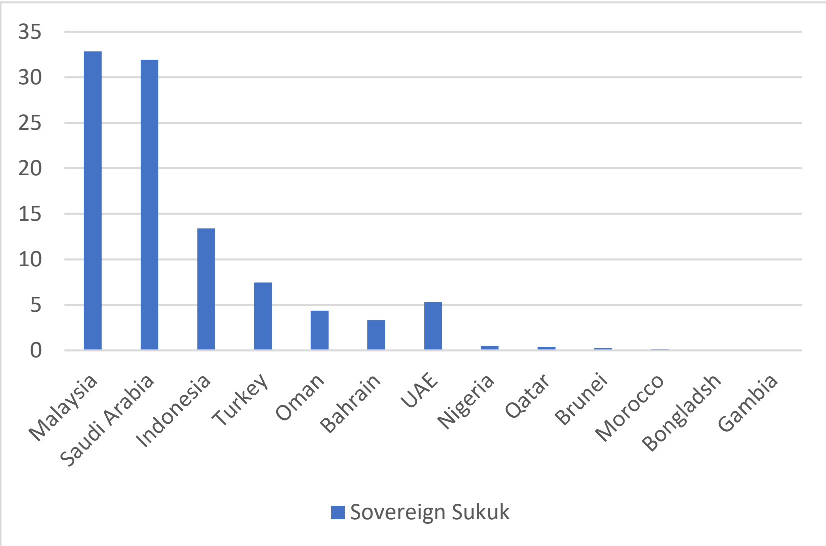


Figure 9. Sovereign Sukuk Issued in 2018
Source: Created by the author based on: [IFSB 2019: 19]

When compared to the UAE, the Malaysian government has taken stronger initiatives in developing the country's Islamic financial market. One of the main reasons was to stimulate the Malay society to commit more to economic activities by promoting Islamic finance [Venardos 2006: 144-146]. It is often mentioned that Malaysian Islamic financial infrastructures were developed by applying a top-down model.

### (1) The Formation of the Malaysian Legal System During the Colonization Period

In order to understand the Malaysian legal system, it is important to consider Malaysia's cultural background and its history with Great

Britain. Although Islam is mentioned as the official religion of the Federal Government of Malaysia in the constitution, this does not make Islamic law the only source of law.[30]

Before Islam arrived in this area, Hinduism and Buddhism had been the main religions and ancient Hinduism had influenced Malaysian customary law, known as Adat, which is still practiced in the western part of Malaysia today [Ibrahim and Jones 1987:35-36]. This customary law differs from Islamic law and Adat is considered as among the "Malay cultural customs and traditions, including moral value system" [Abdullah et al. 2010: 164]. The influence of Hinduism and Buddhism could be explained by the presence of other ethic cultures forming Malaysia, such as the Indian and Chinese ancestors.

Islam arrived in Malaya in the 14th century and gave birth to the Islamic kingdom of Malacca in the 15th century. Islamic law started to take root in the area from this period. Until Great Britain intervened in Malaya, the Shāfiʻī school of Islamic law had been dominating as the land law. There was a separate judicial system for Islamic law to deal with Muslims' family law issues.[31]

Malaya was colonized by Great Britain since the early 19th century. In 1824 the East Indian Company gained its first Straits Settlements, which were Penang, Malacca, and Singapore.[32] This was when the British started governing these areas. The colonization continued until 1957 when the Federation of Malaysia became a commonwealth nation. Then, in 1963, it became an independent nation along with Singapore, which separated from Malaysia in 1965. It is said that English law had been adopted in Malaysia in two ways [Ibrahim and Jones 1987].

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[30] The Federal Constitution Article 3(a) states "Islam is the religion of the federation; but other religions maybe practiced in peace and harmony in any part of the federation".

[31] Islamic law is applied in the Sharīʻah courts which exist in all 13 provinces in Malaysia.

[32] First the jurisdictions of these Straits Settlements were under the Government of Bengal in India, but the jurisdiction was transferred to the Colonial Office in 1867.

First of all, most of the legislation was modelled or based on the English law. Secondly, most of the judges who decided legal issues in Malaysia had been dealing with laws which were based or modeled on English law, and judges would make their judgments according to the precedents of English law, *stare decisis*. The higher court presided over the lower court. Therefore, the Malaysian legal system is formed of five elements which are:

1. Written law
2. Judicial Decisions
3. English Law
4. Islamic Law
5. Customary Law [Ibrahim and Jones 1987:5]

The Central Bank of Malaysia is known as Bank Negara Malaysia (BNM). It was established according to the Central Bank Ordinance in 1958 and started its operation from 1959.[33] Malaysia had experienced the currency split with Singapore in 1967. The Ordinance has been amended as Central Bank of Malaysia Act 2009. Islamic Financial Business is mentioned in Part VII of this Ordinance which differs from UAE banking law.

### (2) Islamic Banking Act 1983 and Guideline for Islamic Banking in Malaysia

The regulatory system of Islamic banking in Malaysia developed after the Islamic Banking Act (IBA) 1983 had been established. Hassan stated that the development of the Islamic banking industry could be separated into two phases, the first phase from 1983 to 1993, and the second phase from 1994 to 2010 [Hassan 2010: 85].

Islamic banks are regulated by the IBA under the Banking and Financial Institutions Act (BAFIA) 1989 from the BNM. The IBA

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[33] Before 1956 Malaysia and Singapore had been governed by East India and had a common Currency Board. For details see [Sheng-Yi 1990: 7-50].

regulates Islamic banks' licensing, supervisions, management, and the establishment of their Sharīʻah boards [Triyanta 2010: 4].

The IBA legislated and amended the law three times. Also, it has been said that the has IBA had "led the government to make subsequent amendments to various legal instruments" which helped the Islamic financial industry to gain "proper recognition equal to that of conventional banking" [Triyanta 2010: 5].

In addition, Malaysia has established Guidelines for Islamic banks to instruct the court on how to deal with Islamic banking and finance separately from the conventional banking system. For example, "Guidelines on the Governance of Sharīʻah Committee for the Islamic Financial Institutions (BNM/GPS1) 2004" gives guidelines for the Sharīʻah Committee about the duties and responsibilities they need to follow. For conventional banks there is "Guidelines on Skim Perbankan Tanpa Faedah (SPTF) 1993" which aims at facilitating conventional banks licensed by the BAFIA to be involved in the Islamic banking industry. The terms of these guidelines have been changed to "Skim Perbankan Islam (SPI)" in 1998 [SPI]. Therefore, it could be said that Malaysia is under a dual legal system with the conventional banks and the Islamic banks.

However, there are some discussions about the legislation of Islamic banking. As Malaysia had been colonized by Britain, most of the banking acts are English legislations like; Contract Act 1950, Company Act 1965, BAFIA. However, most of these English legislations now consider Islamic banking as a separated legal system. For example, the Central Bank Act 1958 has been amended to Central Bank of Malaysia Act 2009. In this law, Part VII deals with Islamic Financial Business in its second chapter. The first chapter deals with the Sharīʻah Advisory Council and the second chapter mentions about how BNM will deal with Sharīʻah matters and the promotion of Malaysia as an international Islamic financial center.

The latest legal amendment in Malaysia for Islamic finance is the Islamic Financial Services Act 2013 (IFSA 2013). IFSA 2013 developed its category of Islamic financial products where the definition of each product was clarified. In addition, the BNM also announced the "Exposure Draft on Sharīʻah Governance" where it gave a more detailed framework for the operation of the Islamic financial institutions from 2017.[34]

Table 2. Local Islamic Banks in Malaysia (Sourced from respective banks)

| Year of Establishment | Name of the Bank |
|---|---|
| 1983 | Bank Islam Malaysia Berhad |
| 1999 | Bank Muamalat Malaysia Berhad |
| 2003 | CIMB Islamic Bank Berhad[35] |
| 2005 | RHB Islamic Bank Berhad[36] |
| 2005 | Hong Leong Islamic Bank Berhad[37] |
| 2006 | Affin Islamic Bank Berhad[38] |
| 2006 | AmBank Islamic Berhad |
| 2008 | Alliance Islamic Bank Berhad[39] |
| 2008 | Maybank Islamic Berhad |
| 2008 | Public Islamic Bank Berhad[40] |
| 2018 | MBSB Bank Berhad[41] |

34 BNM (November13, 2017). "Notice & Announcements: Exposure Draft on Shariah Governance" Retrieved on May 12, 2020, from <https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=645&bb=file.

35 MBSB Bank Berhad was established by the merger between non-bank lender Malaysia Building Society Bhd and Asian Finance Bank Bhd (AFB) on February 7, 2018 and was renamed as MBSB Bank on April 2, 2018 [MBSB 2018: 5].

36 Islamic banking subsidiary of RHB Banking Group. Retrieved May 5, 2020, from < http://www.rhb.com.my/corporate_profile/about_us/history/main.html >.

37 EONCAP Islamic Bank Berhad has become a part of Hong Leong Bank Berhad in 2011. Retrieved May 5, 2020, from <http://www.eonbank.com.my/islamic.shtml >. Hong Leong Islamic Bank Berhad is subsidiary of Hong Leong Bank Berhad.

38 Islamic banking subsidiary of Affin Bank Berhad which started it operations in 2001.

39 Islamic banking subsidiary of Alliance Bank Malaysia Berhad (ABMB). ABMB had been providing Islamic banking windows in 1994. Retrieved May 5, 2020, from < http://www.allianceislamicbank.com.my/ourhistory.html>

40 Public Islamic Bank is a wholly owned subsidiary of Public Bank Retrieved May 5, 2020, from <http://www.publicislamicbank.com.my/pibb/en/en_content/about/index.html >

41 MBSB Bank Berhad was established by the merger between non-bank lender

Therefore, the legal adjustment for the Islamic bank in Malaysia was activated in the first phase and then a more detailed infrastructure was built into the Malaysian legal system in the second phase.

These legal adjustments caused Malaysia's Islamic banking sector to grow [Triyanta 2010: 14]. It is said that the overall assets of the Islamic bank were around $116 billion and had grown 16% in 2010.[42] There are 11 local Islamic banks (Table 2.) and 5 foreign Islamic banks operating in Malaysia.

The foreign banks that provide Islamic finance in Malaysia are the Al Rajhi Banking & Investment Corporation, Kuwait Finance House, Standard Chartered Saadiq Berhad, OCBC Al-Amin Bank Berhad, and HSBC Amanah.[43]

## 5. Legal Environment for Islamic Finance

The legal system for Islamic finance in each country was transformed in various patterns. The legal system for Islamic finance can be categorized into three types, as shown in Table 3.

For these categories, many of the Muslim countries are in Category B. Most Muslim countries developed their financial system prior to the introduction of Islamic finance in 1975. By that time, the conventional finance system had developed and taken root as the major financial system in these countries. The Gulf countries had been opening their financial markets as offshore havens in order to diversify their financial

Malaysia Building Society Bhd and Asian Finance Bank Bhd (AFB) on February 7, 2018 and was renamed as MBSB Bank on April 2, 2018 [MBSB 2018: 5].

42 Saraya P. (March 23, 2010) "Malaysia Islamic Banking Assets Rise 16% to $116 Billion", *Bloomberg*. Retrieved May 5, 2020, from <http://www.bloomberg.com/news/2011-03-23/malaysia-islamic-banking-assets-rise-16-percent-to-116-billion.html>.

43 Bank Negara Malaysia HP "Financial Stability" Retrieved on May 12, 2020, from <https://www.bnm.gov.my/index.php?ch=li&cat=islamic&type=IB&sort=lf&order=desc >.

markets and developed their financial system following the western countries' financial system. In addition, other Middle Eastern countries had developed their financial system based on the conventional finance system.

As shown in Table 3, most of the Muslim countries had started to reform their financial systems in order to adopt Islamic finance. As a result, a significant number of Muslim countries moved from the category A to B.

Table 3. Legal Framework for Islamic Finance

| | Legal Framework | Country |
|---|---|---|
| A | Applying the same conventional legal system to Islamic finance as to conventional finance | Algeria, Australia, Canada, China, Egypt, Germany, Maldives, Saudi Arabia, Singapore, South Africa, Switzerland, Nigeria, Philippine, Russia, the UK, the USA |
| B | Amending or revising the law in order to legitimize Islamic finance to coexist with the conventional finance. Or establish special law for Islamic finance in order to be totally separated from the conventional finance | Afghanistan, Bangladeshi, Bahrain, Brunei, Darussalam, Djibouti, Gambia, Indonesia, Kuwait, Kazakhstan, Kyrgyz, Lebanon, Malaysia, Jordan, Mauritius, Pakistan, Thailand, Tunisia, the UAE, Qatar, Sri Lanka, Turkey |
| C | Develop at totally new legal framework for Islamic finance | Iran, Sudan |

Source: Modified by the author from [ISRA 2012]

The Gulf countries, Middle East countries and South-East Asian countries had developed their financial system like those in category B.

These characteristics can be seen from the legal framework for Islamic finance.

Category B has more flexibility for both conventional finance and Islamic finance, so it is possible to maintain their status as an international hub, and at the same time, extend their new market for Islamic finance. Therefore, global financial hubs and international financial centers have developed laws or tailored new guidelines for Islamic finance, and the major Islamic financial hubs in the world have a similar legal system to category B of Table 3. The legal systems of the Gulf countries and Malaysia had a resemblance at the starting point. The Gulf countries were British protectorates in the early 20th century. During that period, most of the Gulf countries had adopted English common law or a civil law legal system.

Likewise, Malaysia was a colony of Britain and had its legal system established by the British authority. This led Malaysia to have a dual legal system with a Common law jurisdiction and a Sharīʻah jurisdiction. However, the history and development of the legal systems were uniquely different from each other, which can be seen by a comparison of the Dubai Approach with the Malaysian Model as we will show in the following chapters.

While conventional banks can easily deal with lawsuits under existing conventional law based on Western law, the judicial system for Islamic finance has not yet been clarified and there are no clear rules to go by. Islamic finance has its features characterized by Islamic Law, the Sharīʻah, Islamic Law which causes some legal problems when legal disputes occur.

First of all, Islamic finance has problems concerning which is the "proper law", or so called the governing law, to follow. This is because internationally, finance is dealt with according to the universally adopted Western law system. As most of the Islamic countries have modeled their legal systems on English law, French law and other Western-style legal systems as in the case of Egyptian Law, Islamic Law has been applied mostly for disputes within the realm of family law rather than disputes in the economic legal sphere such as property law or contract law. As mentioned earlier, Bahrain and other Gulf countries were under British protection until the mid-20th century, though not directly colonized. Consequently, the duality of civil law in Bahrain, which is both Islamic law and Western law, or to be specific, the English law, is quite apparent.

Therefore, Islamic law and Western law have been coexisting for decades and their influence has changed with the times. Westernized laws were dominant in the field of property law until 1970. This was because the influence of the Sharīʻah on civil law had declined under the British protection.

However, as they achieved full independence and the Islamic revival gained ground, so Islamic law began to gain rapid influence, and this phenomenon has led to a legal duality in the Gulf countries. Consequently, there is an issue regarding how Islamic finance can been governed by Sharīʻah while there is another financial system governed by Western law. Moreover, there are no guidelines as to how Islamic financial groups should deal with their legal cases.

More details on this topic will be discussed in the coming chapters.

Chapter 4

# Statue Law or Hybrid Law? Systemic Ambiguities for Civil Disputes

## 1. Introduction

Islamic finance has expanded rapidly, as indicated by the annual growth rate of around 20% at the end of 2000s. As the Islamic financial market expanded, this enabled the industry to get involved in larger projects, while at the same time developing its domestic financial markets. Usually, when Islamic finance is introduced, the legal system and the regulations of the domestic financial markets have already been established to regulate conventional finance, and this causes a conflict with Islamic finance.

The most representative issue of conflict between conventional finance and Islamic finance is that in order to be ‘Sharī‘ah-compliant’, Islamic finance has to follow the prohibition of taking interest and other un-Islamic elements such as *Gharar* (uncertainty). Sharī‘ah-compliance applies not only to financial products, but also requires a regulatory body, so that governance and authority come under the jurisdiction of Sharī‘ah.

Previously, the debate about Islamic finance and ‘Sharī‘ah-compliance’ was mostly about how a financial scheme could be formed while avoiding Harām elements. Therefore, the issue of ‘Sharī‘ah-compliance’ is associated with financial structure or other economic elements of each product when a bank offers a new product to its customers.

However, during the global financial crisis, a new debate arose related to ‘Sharī‘ah-compliance’. It was related to court cases dealing with Islamic financial products, especially after a number of Islamic finance disputes had been brought before the courts.

Before the global financial crisis, the UK court had dealt with the issues of cases related to Islamic finance. This drew international attention and initiated discussions about how to deal with Islamic financial cases in non-Islamic legal systems since the UK is a non-Islamic country. Even Islamic countries, however, had adopted predominantly western legal systems before and after gaining their independence. Therefore, whenever a case of Islamic finance was brought before the ordinary court or another form of alternative dispute resolution, there were possibilities that these ordinary courts would ignore the jurisdiction of Sharīʻah.

In order to see how such issues are being tackled, this chapter will focus on the previous research on how the legal framework for Islamic finance has developed. Then it will clarify the issues around whether civil disputes should be judged by statute law or what I would call hybrid law.

## 2. Legal Development of Islamic Finance

### (1) Islamic Law

For Muslims, Islamic Law applies to the whole Universe. It provides not only the Cosmology of how the Universe was created and maintained by God, but also the actual guidelines for Muslims' daily lives, and provides rules on the relations among Muslims as well as relations between Muslims and non-Muslims and how the Muslim world should be governed. Unlike western countries there is no distinction between civil law and canon law, or between the State and the Church.

Islamic Law is applied according to "divine revelation (wahy) and human reason ('aql)" [Kamali 2008: 40]. Moreover, Islamic Law could be categorized into two parts. One is fulfilment of the obligations of Sharīʻah as taught by Prophet Muhammad. The other is Islamic

Jurisprudence (Fiqh), which is formed of legal rulings derived from the Sharīʻah through interpretations by Islamic scholars to deal with contemporary issues.

The origins of Islamic Law are Qur'ān, Sunna, Ijmāʻ and Qiyās.[44] The Qur' ān is Allah's word and the Sunnah are Prophet Muhammad's teachings and examples. These two original sources are the fundamental resources for Islamic legal decisions. If it is difficult to make a decision only by reference to the Qur' ān and Sunna, the next step will be managed by Ijmāʻ, agreement among the Islamic community (Umma). Ijmāʻ is a consensus from the representative Islamic scholars. If Ijmāʻ is not suitable or not sufficient to make a judgement on a case, the fourth step is by analogy from the Qur' ān and Sunna, which is called Qiyās, or legal reasoning through establishing an analogy between the similar cases. If the problem is not solved by Qiyās, then it will be taken to other jurisdictional procedure known as the Science of Fiqh, that is, Islamic Jurisprudence.

Fiqh is the legal process by which the Sharīʻah rules can be adapted to any period and any situation. The Principles of Sharīʻah, originating directly from the Qurʻān and Sunna, are eternally unchangeable as they are the words of the God and the established practice of the Prophet. However, as the times change, so the living conditions of the people will change. Therefore, there is a need to interpret the Sharīʻah rules according to the changing demands of the people. As a result, Islamic Jurisprudence had been essential for interpreting the Sharīʻah.

## (2) The Penetration of Western Law[45]

Since the late 17th century, the Ottoman Empire had started to lose its power gradually, and by the 19th century, the Gulf area had become

[44] *Ijtihād* is also included as the origin of Islamic Law. *Ijtihād* is a way of reading a particular situation by Islamic Law specialist called, *Mujtahid*. *Mujtahid* are those who are authoritative scholars to give and legal opinion generally.

[45] "Western Law" is about legal systems which penetrated from European countries like Common Law and Romano-Germanic Law.

one of the danger zones known for local "pirates" when the British gained dominance in the region. In order to protect its investments, Britain set out to stabilize this area by concluding a peace treaty with the local tribes[46]. Since Britain had extended its protection to the Gulf area, most of the tribes had settled their territory and had started to create a modern nation. In order to become modern nations, they had established Civil Services and Congresses. Most of these administrative reforms were led by the British government.

Bahrain, for example, made a treaty with the British Government that there would be "no cession of territory except to the British Government" in 1898 [Ballentyne 1986: 174]. This was the outset of the territory of Bahrain coming under the protection of the British Government [Amin 1985:20]. At this time, Bahrain had been ruled by the Khalifa tribe since they took over the land from the Safavid from Iran in 1783.

The Bahrain Order in Council (BOIC) was published in 1913 and enforced in 1917 [Radhi 2003: 28-30; 76]. The BOIC classified the attribution of Common Law and Islamic Law. While the jurisdiction was attributed to Common Law and Islamic Law, the legislation was classified into Romano-Germanic Law and Islamic Law. This was because most of the legislations were influenced by the Egyptian scholar 'Abd al-Razzāq al-Sanhūrī and most of the laws were modeled on western law as a result [Rahdhi 2003: 77]. Al-Sanhūrī contributed to introduction of western law, as the father of modernization of law, not only in Egypt but also in other Arab countries. Egyptian Law had been directly affected by the French Civil Code, especially in the realm of civil law. The legislation had been organized mostly by Egyptians and specialists from other Arab countries which had also adopted the Egyptian model. As a result, Bahrain enacted most of its laws according to the Egyptian judicial system.

46 See [Ballentyne 1986] Appendix II for details.

In addition, Western Law was applied to the commercial law practically, not only in the Gulf countries but also throughout the Middle East [Mallat 2000].

### (3) The Demise of Islamic Law

On the other hand, Islamic Law had kept its jurisdiction in "a few core areas such as the law of personal status, family law" and the law of Succession [Foster 2010:276].

The BOIC had limited the authorization of the Sharīʻah court by giving the British Government control over the court [Rahdhi 2003:33]. However, the Sharīʻah court, which dealt with Muslims' personal matters, had remained within the judiciary system. According to the provision of Article 8 of Legislative decree No. 13 of 1971, the court system was divided into two parts, the Sharīʻah court and the Civil Court. At the Sharīʻah court Sunni and Jaʻfari courts were established in order to deal with Sunnis and Shi'as according to their particular Schools. In Article 8 of Legislative decree No. 13 of 1971, the Sharīʻah court was a two-tiered system at the time of independence. Later, this law was amended by Legislative decree No. 4 of 1999 and the Sharīʻah court system became a three-tiered judicial system. According to the amendment, it is stated in Article 17 that cases before the Sharīʻah court would be examined by Lower Sharīʻah court, and if not resolved would proceed to the Higher Sharīʻah court and then the Higher Sharīʻah court of Appeal. In the same Article 17 it is mentioned that these Sharīʻah courts would only deal with the personal matters of Muslims. To be specific, the Sharīʻah court would have jurisdiction over marriage cases, issues of inheritance, donations, bequests and endowments. Also, in Article 20 of Legislative decree No. 4 of 1999, it says that every case should be dealt with according to the legal school to which the plaintiffs belong. A marriage contract by Sunnis would be dealt with according to the Sunni schools while followers of the Shia Jaʻfari school would be deal with in a Jaʻfari court.

## (4) Emergence of Islamic Finance and Transformation of the Legal System

### 1) The Character of Islamic Finance

Islamic Finance is a financial scheme compliant with the Sharīʻah. This means that Islamic Finance has to be controlled or governed by Sharīʻah scholars, and it must be managed differently from the legislation of Western Law. Modern Western Law has mostly been established or written according to human values, while Islamic Law is regulated by Allah and interprets the words of the Prophet.

A conclusive difference between Islamic Law and Western Law can be seen in the principles applied in Islamic Finance. Under Sharīʻah law, ribā is prohibited. Ribā is similar to the interest used in conventional finance which adds value to currency by currency itself without risk or further effort by the lender. In order to prevent ribā, Islamic Finance has created a special scheme represented by Murābaha, through a combination of trade contracts. The basic schemes of Islamic Finance are created by a combination of trades. For example, if someone wants to purchase a car using Islamic Finance, there will be two purchases, without a loan. In conventional finance, the purchaser asks the bank to lend them the price of the car and promises to return a specific additional amount of money to the bank. However, in Islamic Finance, the bank purchases the car and then sells it to the purchaser for the original price plus a margin.

Another scheme for Islamic Finance is applying the Profit and Loss Sharing (PLO) system. This PLO can finance big projects such as building infrastructure and other types of development projects. One of the representatives of this kind of scheme is Mudāraba. This scheme works by dividing the risk and profit among the investors and the entrepreneurs, as opposed to the conventional financial system, where, if a project fails, the risk will fall only upon the entrepreneur who must pay back the loan to the lender in full, adding the prescribed interests. Islamic economic ethics considers this unequal bearing risks between two parties unjust.

**2) The Development of the Islamic Finance Legal Framework in the Gulf Countries**

Islamic financial products could not be compliant with Islamic law under the jurisdiction of the conventional legal system. The reason for this is simple. Contemporary Islamic finance emerged after the traditional Islamic jurisdiction had been lost to western conventional finance. Therefore, the regulations for conventional finance had been dominant before the emergent Islamic finance and the modern legal system were fully developed for the purpose of regulating conventional finance.

One might be tempted to imagine that the mindsets of the British administrators, when they changed the legal system of the countries under their control, were that they had an obligation to help local peoples to get out of the obsolete Islamic rules and make them modern. From such a mindset, it must be unimaginable that the same people opted for the return of Islamic ethics in the late 20th century.

As the legal system for Islamic finance has imperatives with Sharīʻah compliance, we will briefly see how the Gulf countries have developed their legal systems to accommodate newly emergent Islamic finance. The Gulf includes six countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE. These countries, except for Saudi Arabia, were under British protection during the 19th century and had modernized their legal systems.

The civil codes in these countries represent a blend of Egyptian civil law and Western civil law. Egyptian civil law, in turn, was modeled on the French Civil Code and Al-Majallah, the Othman civil code, by the Egyptian scholar ʻAbd al-Razzāq al-Sanhūrī.

Historically, most of the civil law in the region has been modernized based on the Egyptian civil code, except for Muslim family law and to some extent property law [Amin 1985; Ballantyne 1986; Brown 1997].

Cases of Muslim family law and other branches of Islamic law are heard in the Sharīʻah courts, which are separate from the Western law courts. In addition, taking interest became legal for commercial transactions [Hasan 2010: 91].

Sometimes, it is oversimplified to say that commercial laws in the Gulf countries introduced Western law, as some of the contracts were formed by law firms dealing with common law [Al-Tamimi 2003; Mallat 2000]. This led to difficulties in dealing with Islamic financial products under such western law is difficult [Nyazee 1998; Kuran 2005; Usmani 2008; Foster 2010a; 2010b].

On the other hand, Al-Tamimi states that while the UAE civil law has been influenced strongly by French Civil Code and Common law, the UAE civil law and commercial law have adopted some Islamic law principles [Al-Tamimi 2003: 5]. Similarly, Coulson has identified that in the UAE court, the Islamic law concept and the common law concept of loans were put together as legal requisites [Coulson 1964: 1-3].

Nevertheless, this mixture was not helpful for dealing with the new Islamic finance products. A conspicuous example is related to the issues of interest, which is prohibited in Islamic law. According to article 714 of Union law No. 5 of 1985, interest is prohibited. This Union law No. 5 of 1985 is known as a civil transaction law.

However, Union law No. 1 of 1987 stated that the prohibition of interest would be limited only to civil law and commercial issues would be dealt with by the Union law No. 5 of 1985 until commercial law was established [Ghanam 1991; Hosni 1992: 163].[47] By Union law No. 3 and No. 4 of 1987, commercial transactions which dealt with interest were excluded from applications and interest which did not exceed 9% was permissible [Al-Suwaidi 1993: 294].

[47] Union law No. 1 of 1987 was established in order to broaden the legal jurisdiction of the Union law No. 5 of 1985 and Union law No. 8 of 1984 which is the company law. It was intent to legalize various companies which were not able to be categorized as a company in the previous legislations.

Then, the Federal law No.11 of 1992 made charging interest in commercial transactions permissible. It is said that this modification was taken in view of necessity, which is supported by the Islamic concept of Dharuriyat (necessity) as "for economic stability and the needs of the people" [Hasan 2010: 91-92].

As for exceptions, this Federal law No. 11 of 1992 would not be retroactive on those whose legal basis was from the Union law of 1970, therefore, the Abu Dhabi Supreme court had made the contract that dealt with interest ineffective [Tamimi 2000]. In general, interest was legitimated, and there was a judicial precedent made in 1997 that mentioned that it was a duty to pay interest for debt, and interest was legitimate [Price and Al Tamimi 1998: 53-55].

Hence, it is difficult to say that the UAE law took Islamic law into proper consideration in its commercial legal system. In addition, most of the law firms were said to come from common law backgrounds, and this resulted in the fact that English law was frequently applied when forming contracts in the UAE [Al-Tamimi 2003: 5]. As a result, from the precedent and legal reform, it would be difficult to deal with cases related to Islamic finance under a legal system which legitimates interest. So, it is necessary to separate the legal system for Islamic finance from the conventional legal system.

In the UAE the legislation for Islamic banks is the Federal Law No. 6 of 1985 "Regarding Islamic Banks, Financial Institutions and Investment Companies (Qānūn al-Ittihād Raqm 6 li-Sana 1985 bi-Sha'n al-Maṣārif wa al-Mu'ssasāt al-Mālīya wa al-Sharikāt al-Istithmārīya al-Islāmīya)". This legislation was intended to separate the legal system for Islamic financial institutions from the conventional legal system. Therefore, the UAE legal system for Islamic finance has been categorized as a dual legal system, which is similar to the Malaysian legal system [Wilson 2012: 107-111].

Generally, Islamic financial institutions need to have an independent Sharī'ah board to guarantee their financial products to be Sharī'ah compliant. Article 6 of UAE law No.6 of 1985, states that each

Islamic bank and financial institution must organize a Sharīʻah board with at least three members and each member must be authorized by the Higher Sharīʻah Authority. This Higher Sharīʻah Authority is attached to the Ministry of Justice and Islamic Affairs and its decision will be binding over domestic Islamic financial institutions.

Other Gulf countries have also established their own legal framework for Islamic finance. In order to see the characteristics of the legal system for Islamic finance in the UAE, this section will also compare the UAE system with the other Gulf countries.

Bahrain has developed the Prudential Information and Regulatory Framework for Islamic Banks (PIRI) to provide a regulatory framework for Islamic banking. The PIRI is a framework for Islamic banks to be properly regulated under the Bahrain Monetary Agency which was reformed as the Central Bank of Bahrain in 2006.

After the Central Bank of Bahrain was established, the rule books for Islamic banking and other Islamic financial institutions were published in order to provide guidelines for the operation of these institutions which were differentiated from conventional financial institutions. A similar legal framework was developed in Qatar by having Law. No.33 of 2006 as the legislation, and Instruction to Banks 2009 as the regulation guideline.

Kuwait used to have separate regulations for Islamic banking which had enabled the Kuwait Finance House to dominate the Islamic financial market in Kuwait [Smith 2004]. Islamic finance in Kuwait had been permitted by special decree until 2003. From 2003 the separated law for Islamic finance was united with the central banking law in Kuwait.

Oman is a newcomer to Islamic finance in the Gulf countries. An official notice was published by the central bank of Oman in June 2011 and Bank Nizwa, the first Islamic bank for Oman. was established in March 2012.

Among the GCC countries, Saudi Arabia needs special attention. Unlike the other member states, it never entered under the British domination, and kept the supremacy of the Sharīʻah in its legal system.

However, in the sectors of modern economy, the western system and its legal rules *de facto* encroached into the country's system during its modernization, and conventional banks were set up in the country. The duality of law has a different kind of complication here, because the western system penetrated into its economy, without changing the supremacy of the Sharīʻah in the courts. Foreign companies found themselves puzzled, being able to make contracts involving interest in one form or another in the country, but unable to win when a civil dispute arises, because the judge in a court would certainly decide the interest was illegal.

Table 4. Legal Framework for Islamic Finance in Five Countries in the Gulf

| Country | Legal Framework |
|---|---|
| Bahrain | PIRI, Central Bank of Bahrain Rulebook Volume 1-6 |
| Kuwait | Central Banking Law 2003 |
| Qatar | Law No.33 of 2006, Instruction to Banks 2009 |
| UAE | Federal Law No. 6 of 1985 |
| Oman | Royal Decree 69/2012, Circular BM 1080, Islamic Banking Regulatory Framework |

Source: Created by the author based on website of each respective country's central bank

In Saudi Arabia, the government did not recognize Islamic banks on its soil in the 1980s and 90s, because the introduction of Islamic banks would have indicated that the existing conventional banks were non-Sharīʻah compliant [Nagaoka 2011: 25-27]. Therefore, two large leading Islamic financial conglomerates established by Saudi founders, namely, DMI and ABG, were established outside the country.

Table 4 shows that the UAE has another interesting feature of creating Free Zones with autonomous legal systems separate from their domestic ones. Dubai has Dubai International Financial Centre (DIFC), a special financial center which is separated from the domestic market. DIFC is a special financial zone established by Dubai Law No. 8 of 2004. All the financial institutions in DIFC are regulated under the Dubai Financial Service Authority (DFSA) by Dubai law No. 9 of 2004. The judicial system of DIFC is also separated from the domestic system as it is mentioned in DIFC Law No. 12 of 2004 that the DIFC will establish its DIFC court independent from the domestic court of Dubai.

In addition, DIFC Law No. 13 of 2004 is the regulation for Islamic finance in the DIFC. Islamic financial institutions are under the regulation of the DFSA according to the DIFC Law No.13 of 2004. DIFC Islamic Finance Advisory Council was established in December 2005 in order to promote and develop Islamic finance. Operation guidelines for Islamic financial institutions are given in the DFSA Rulebook. More detailed guidelines are provided in the DFSA Islamic Finance Tailored Handbook, which instructs Islamic financial institutions on how they should follow DIFC legislation [Wilson 2012: 13][7]. This handbook is divided into 5 fields, which are Islamic banks, Islamic investments projects excluding funds, Islamic insurance, meditators of Islamic insurance and Islamic funds. Therefore, these guidelines are differentiated between Islamic finance and conventional finance. Thus, legal infrastructures were built in the UAE and DIFC for Islamic finance.

## 3. Harmonization or Standardization?

The lack of standardization among Islamic financial products has been made apparent by the issues related to the discussions on ʻĪnah and Tawarruq. Both these Islamic financial products have brought up issues on their Sharīʻah compliance or lack of it. However, this also illustrates the diversification of the interpretations of the Sharīʻah rules.

Sharīʿah compliance is a crucial element in establishing the validity of an Islamic financial product and differentiating it from conventional financial products. Being Sharīʿah compliant is of fundamental importance for Islamic financial institutions to gain the trust of their customers and the industry at large, as well as the trust of the authorities. It has lead the Muslim world to develop its own economies. Sharīʿah compliance has been discussed legally in dispute cases but there has not been any consensus on its standardization.

The standardization of the Sharīʿah compliance has not been achieved globally, but it has been possible to gain a consensus on some topics through the work of the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Although AAOIFI has been working on its standardization since 1991, there is no universal standardization up until now. Now let us turn our eyes to a movement toward the harmonization of Sharīʿah compliance and examine the degree of its success.

## (1) Standardization in Islamic Finance: AAOIFI or IFSB?

Standardization can be translated as 'Tawḥīd', which is the Islamic principle of divine unity [Kamali, 2008]. Creating a unified Islamic principle has been one of the crucial topics for sustaining the Islamic financial market.

The discussion on standardization in Islamic finance stemmed from concerns and criticism about the risk of some products being Sharīʿah non-compliant and the creation of "Sharīʿah arbitrage".

Standardization has also been a topic discussed in dispute resolution [Yaacob et al., 2011]. The need for standardization of legislation was presented in order to clarify Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. [2004] EWCA Civ 19, [2004] 2 Lloyd's Rep 1 case in the UK. After mentioning that there was some negativity for the standardization of Islamic financial products, it was suggested that:

> "Apart from reducing confusion and increasing efficiency, standardization would increase consistency and transparency, reduce costs and provide more time for innovation. One of the suggested solutions (although it may not be perfect one) would be to establish an International Sharīʻah Board that would consist of members from all schools of law and whose decisions would be mandatory for all jurisdictions" [Yaacob et al., 2011].

It is also mentioned emphatically that "Without standardization, the authors believe that the IFI will suffer in the long run" and that "OIC, should make a *lex mercatoria* in order to form an international convention of 'Model Law of Arbitration'" [Yaacob et al., 2011].

Although there are negative forecasts against standardization as it will negatively affect the diversified opinions that flourish in the Islamic market, in such cases, harmonization has been seen as an alternative to standardization.

The IFSB is an international organization for standard setting for international organizations for Islamic finance. The objective of the IFSB is "(T)o promote the development of a prudent and transparent Islamic financial services industry through introducing new or adapting existing international standards consistent with Sharīʻah principles and recommend these for adoption" mentioned in Article 4 of the Articles of Agreement [IFSB, 2018].

The IFSB has gained a juridical personality and a common seal since 2002. This has enabled the IFSB to form a (a) contract, (b) acquire, hold, and dispose of movable and immovable property and (c) institute legal proceedings [Federal Constitution of Malaysia, 2002].

As the IFSB is located in Kuala Lumpur, its standard has been widely adopted by the Malaysian Islamic financial institutions. In addition, the IFSB has also been selected as the standard for more than 180 members of seventy-eight regulatory and supervisory authorities in fifty-seven different jurisdictions.

The AAOIFI has become well known for its international standardization of Islamic financial products. It has been issuing standards for accounting, auditing, and Islamic products Sharīʻah compliance. Although it is a non-profit organization, the AAOIFI has been able to gain recognition as a well-known standardization institution for Islamic financial organizations. As the AAOIFI is located in Bahrain, Bahrain prioritizes AAOIFI standards over those of the IFSB.

The Central Bank of Bahrain had issued a handbook on Islamic Banks in the Central Bank of Bahrain, Volume 2. In HC-9.2 "Governance and Disclosure Per Sharīʻah Principles" it is clearly mentioned that AAOFIF standards will be the standards for all licensed Islamic banks.

In the Bahrain Islamic Bank Annual Report, the AAOIFI is clearly mentioned as the standard. "1. All the Financial Statements inspected by the Sharīʻah Board conform to what has been approved by the Board, and to the standards issued by the Accounting & Auditing Organization for Islamic Financial Institutions AAOIFI," and "6. The Bank was committed to the Sharīʻah standards issues by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI)" [Bahrain Islamic Bank, 2017: 42]. As there are also reports on the new standards' amendments and interpretations in the report, it could be said that AAOIFI standards are considered as the general standards by the Bahrain Islamic Bank.

The AAOIFI standards have a clear statement on the prohibition of ʻĪna, while the IFSB standards, Technical Note and Guideline Note do not mention it. In the AAOIFI standards the definition of Monetization is as follows:

> "Monetization refers to the process of purchasing a commodity for a deferred price determined through Musāwamah (bargaining) or Murābahah (Mark-up Sale) and selling it to a third party for a spot price so as to obtain cash. Whereas ʻĪnah refers to the process of purchasing the commodity for a deferred price and selling it for

a lower spot price to the same party from whom the commodity was purchased" [AAOIFI Sharīʻah Standard No. (30): Monetization (Tawarruq)].

We can clearly see in the difference of these two standards a lack of universal standardization of Islamic financial jurisdiction so far.

## (2) Harmonization in Malaysia

Harmonization has been translated as 'Tawfiiq' in Arabic. Such a term was used to explain the harmonization between the Islamic law and common law traditions in Malaysia (Hasan, 2007]. The "integration of both Islamic and common law" is a "process" for creating "harmony between the Sharīʻah and common law" [Hasan, 2007].

Such processes have been taking place in the reformation of the Malaysia legal framework for Islamic finance, especially focusing on the creation of the Sharīʻah Advisory Council (SAC) in the Central Bank of Malaysia.

The Malaysian Islamic financial market faced a negative impact after their court had ruled *bayʻ bi-thaman ājil* (BBA) to be "contrary to the Islamic Banking Act 1983 or Banking and Financial Institutions Act 1989" in the case of Arab-Malaysia Finance Bhd v. Taman Ihsan Jaya & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party) MLJ 5 [2008]. This will be explained in detail in Chapter 5.

After such a decision was ruled out, other similar judgments were also made. After the court had ruled against the BBA, the Islamic financial market received a negative reputation for dealing with non-compliant products. In order to protect the market's reputation, the SAC expanded its supervision over dispute resolution and other Sharīʻah related issues.

Therefore, the SAC has expanded its role to harmonize between the Sharīʻah and the conventional legal system, ruled over by the conventional courts, and also expanded its role to rule not only on Islamic financial products but also on Sharīʻah issues that are dealt with in conventional courts.

This harmonization has created a prototype for other nations that have a similar legal structure to Malaysia's. However, such harmonization requires a strong initiative by the government to protect the principles of Islamic law. As in most transactions in the Muslim world the governing law is common law or civil law jurisdiction, these jurisdictions are generally preferred in business, so Islamic law has a great disadvantage when being chosen as the governing law.

Furthermore, such harmonization needs huge consideration on what goals should be set and what processes should be taken, as harmonization is only a "process" towards unification, or standardization. For more on this topic, harmonization in Malaysia will be discussed in Chapter 5.

## 4. Statue Law or Hybrid Law?

Some cross-border dispute cases of Islamic financial transactions were dealt with in the conventional dispute resolution system. In the earlier stages, there have been some representative cases judged in the UK court.

There have been several lawsuits of this kind. Some of these cases have been judged in the UK court, which have brought up issues on litigation to deal with Islamic finance dispute cases. The first case which brought up issues of Sharīʻah to the court was the Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others [2002] All ER (D) 171 (Feb). In this case, although the Murābaḥa contract was focused on, its legitimacy as an Islamic contract was not discussed. The court observed the case strictly according to English law and did not refer to the issue being raised by the Sharīʻah expert on the validity of this Murābaḥa contract.

The issue of dealing with Islamic finance in the English courts did not receive any negative reviews until the case of Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd. [2004] EWCA Civ 19, [2004] 2 Lloyd's Rep 1, had been judged. In this case, it was clearly stated that the Sharīʻah is not a legitimate law to be applied in court. In the case, it was mentioned that in order for a law to be an applicable law for governing disputes, it must be a national law. National law is defined in "the 1980 Rome Convention on the Law Applicable to Contractual Obligations (Rome Convention)". As the Sharīʻah was not categorized as a governing law, this case brought out the fundamental problems which could occur when dealing with Islamic financial cases in the conventional courts, to the industry and the public.

As Colon notes:

> The argument that Sharīʻah is a comprehensive social code of conduct that applies outside of a state's legal framework should not create so much confusion that the application of Sharīʻah becomes untenable…. Obviously, the judge need not consider principles related to personal behavior inasmuch as these do not affect the free will of parties in forming the agreement. In this respect, a judge can serve as a gatekeeper. In doing so, the judge should apply the chosen law of the parties, and when an issue is raised concerning a Sharīʻah matter, the judge should allow both sides to present their experts or to agree to send the issue to an expert chosen by the parties" [Colon 2010: 426].

In addition, having more than two laws applied to the contract is not permissible. It is also not allowed to apply dual laws in one contract according to the Rome Convention Article 3 (1). However, as "Combined-Law Contracts" are needed for Islamic finance, the Rome

Convention will not be a solution for dealing with Islamic finance disputes [Colon 2012: 415-417; Mohamad and Trakic 2012: 18-20]. In the dual legal system, an Islamic finance contract will be a combination of a mixed law of Sharīʻah and other laws. Therefore, these combined-law contracts are a form that is needed for Islamic finance contracts.

While these two cases have raised some criticism on employing conventional litigation to deal with Islamic finance dispute cases, there has been even more criticism on utilizing the court for such matters. As Islamic finance is a combination of finance and Sharīʻah, this makes the litigation face more risks when dealing with Islamic financial dispute cases.

Adawiah has pointed out that there are Sharīʻah non-compliant risks in the Islamic finance industry in two categories, Sharīʻah advisory (Sharīʻah board) risk and Islamic financial Institution risk as a shown in Table 5. The Sharīʻah non-compliant risks could be caused not only by the IFI, but also by the decision of the Sharīʻah board in the banks. It could also be said that as the Malaysian courts are not able to be fully aware of Sharīʻah issues, therefore, as a result, there are higher risks if the court handles Islamic finance dispute cases. Based on these Sharīʻah non-compliance issues, Adawiah concluded that deciding cases in the common law courts in Malaysia could lead to "anomalous decisions and non-consideration of Islamic legal rules and principles" [Adawiah 2015:16].

Previous Malaysian litigation has been criticized not only from the aspect of Sharīʻah risks but also for not referring to the SAC. This point will be discussed in the next chapter.

There has been criticism of several conventional court judgments being given to Islamic financial cases. The arguments can be divided into two types: one concerns the negligence or infringement of Sharīʻah principles, and the other is the difficulty of recognizing or applying Sharīʻah principles under the conventional legal system. These have been caused by the complexity of the legal system between conventional jurisdiction and Sharīʻah jurisdiction.

Various countries have a civil law system or common law system as their legal foundation, and as Islamic finance arrived after conventional finance had been developed, a dual legal system has been established for Islamic finance in the major Islamic countries. The coexistence of both legal systems has caused a lack of harmony in each jurisdiction from the very beginning.

Table 5. Sharīʻah Non-compliance Risks in Islamic Finance

| Sharīʻah non-compliant risk | Component of the risk |
| --- | --- |
| Sharīʻah Advisory (Sharīʻah board) Risk | • Incompatible practices occurring in IFI operation which the Sharīʻah advisors (Sharīʻah board) are unaware of.<br>• Inappropriate decision by the Sharīʻah advisory (Sharīʻah board) based on the inadequate or biased information from the bankers<br>• Variations of financial products leads Sharīʻah advisory (Sharīʻah board) to be unable to cope with the development |
| Islamic Financial Institution Risk | • IFI misunderstanding of Sharīʻah compliance<br>• Ignorance of the IFI and mistakes |

Source: [Adawiah 2015:15]

Chapter 5

# Dubai Approach: A Drastic Resolution to Civil Disputes in an Economic Crisis

## 1. Introduction

This chapter will focus on the UAE case on developing a new dispute resolution system which presented an alternative for Islamic financial disputes. The UAE faced an unprecedented financial crisis that involved Islamic financial transactions, and Islamic financial institutions at the end of 2009.

The UAE is one of the international hubs for Islamic finance. In addition, its legal system has a unique structure compared with other countries with its federal system and a mixture of common law resulting from its historical background.

While there were no models for an Islamic financial dispute resolution system, a new system, which we call the Dubai Approach, has emerged. This chapter will describe its emergence by following the chronological development of this new dispute resolution system for Islamic finance.

## 2. Legal Framework for Islamic Finance in the UAE

UAE legislation for Islamic banks was established in the early stages of the Islamic financial market. The world’s first Islamic commercial bank, the Dubai Islamic Bank, was established in 1975 and Federal Law No. 6 of 1985, ‘Regarding Islamic Banks, Financial Institutions, and Investment Companies,’ was promulgated as the legal framework for

Islamic banking and finance in the UAE. This legislation aimed to separate the legal system for Islamic financial institutions from the conventional legal system. Therefore, the UAE legal system for Islamic finance has been categorized as a dual legal system, applying both Western oriented national law and Islamic law [Wilson 2012: 107-111]. In addition, most law firms in the UAE originated from common law backgrounds, and this has resulted in English law being frequently applied when forming contracts in the UAE [Al-Tamimi 2003:5].

The judicial system in Dubai has several sub-systems that consist of Dubai's domestic system, the common law system, and the federal system. The UAE adopted a federal system and each of the seven emirates, including Dubai, operates its own state legal system along with the federal legal system. Dubai also has an additional judicial system (which excludes the federal system), consisting of the domestic judicial system and the common law system in the Dubai International Financial Centre (DIFC). The domestic judicial system has the main features of the civil law system, where decisions are made according to the legislation. On the other hand, the DIFC judicial system has features of a common-law jurisdiction, in which decisions are made according to previous court judgments.

Dubai's two judicial systems, the DIFC judicial system and the domestic judicial system, have been responsible for 'providing accessible and superlative service to litigants and court users' since 2009 [DIFC Court 2009]. The Memorandum of Understanding in Dubai Courts and DIFC Courts has enabled parties to form contracts based on civil law but to choose common law for the court. It had been possible to deal with a contract formed under a civil law system in the DIFC since October 31, 2011.

The federal court is located in Abu Dhabi and the federal legal system is applied to the whole Union of the Emirates. It is also possible for an individual from the UAE to choose the federal law over the local domestic law and vice-versa.

Thus, legal issues dealing with Islamic financial cases might be brought under any one of these jurisdictions, as the domestic legal system and the DIFC legal system are based on different legal systems. Further, Islamic finance does not have its own legal system but only a legal framework, which means that Islamic finance must decide which legal system to use as its judicial system. This issue arises from the nature of the dual legal system for Islamic finance. The new judicial bridge of October 2011 between domestic law and DIFC law theoretically allows contracts formed under civil law jurisdiction to be dealt with under DIFC law.

As common law and civil law have different provisions about freedom of contract, the characteristics of being legally binding, and other elements, this could lead to legal issues as conflicts of law and other legal concepts that do not exist in either jurisdiction [Tetley 1999]. This is a similar issue to Sharīʻah compliance and conventional laws, as each of these has different legal concepts. Islamic financial concepts have caused conflicts of law for Islamic law on occasions that have eventually led to amendments to conventional law. For example, double taxation was once an issue for *sukūk* in general. *Sukūk* does not have the same scheme as a bond, since bonds use *ribā,* or interest. In order to prevent *sukūk* from being subject to double taxation, several countries have amended their law. Even Japan amended its banking law in 2011 to accommodate *sukūk* from Muslim countries.

Similar issues of conflicts of law and private international law could arise in relation to Islamic financial disputes. Islamic financial contracts can be formed according to the contract law of the relevant jurisdiction, but the transactions and financial products will be structured to be Sharīʻah compliant. Forming an Islamic financial contract under civil law jurisdiction and then bringing it into common law jurisdiction is a problem for the governing law and dealing with an Islamic financial contract in the conventional court causes a reputational risk. This problem for the court dealing with the Islamic financial case had caused

Malaysia to expand its Sharīʻah Advisory Council, which will be discussed later in the next chapter.

When securing Sharīʻah compliance in common law and civil law jurisdictions there are various obstacles to be tackled from both academic and practical perspectives. Therefore, Dubai's jurisdiction seems to pose risks of conflict of laws and private international law issues. Sharīʻah compliance is a further legal issue to take into consideration for Islamic financial contracts.

Some Islamic finance cases have been dealt with in courts in the UAE. The Dubai court has experience in dealing with disputes related to Islamic finance [Kawamura 2013: 108]. In addition, several ADR institutions handle cases related to Islamic finance in Dubai. In domestic arbitration, the International Islamic Centre for Reconciliation and Arbitration (IICRA) is a special institution for dealing with Islamic financial disputes. The DIFC absorbed the DIFC Arbitration Institute (DAI) in 2004.[48] The establishment of a special arbitration institution for Islamic finance was a response to criticism from Islamic scholars in relation to the courts dealing with Islamic financial cases without considering Sharīʻah compliance [Kawamura 2013: 99].

## 3. The Dubai Shock

A sovereign company of the Dubai government, Dubai World, faced delays in its repayments for project financing and completion on November 25, 2009. This incident triggered what is known as the Dubai Shock. During the Dubai Shock, other real estate agents such as Nakheel Public Joint Stock Company (PJSC), Tamweel PJSC, and Amlak PJSC, came close to defaulting. These companies had utilized Islamic financial products for their mortgage transactions. The following paragraphs

48 DAI and the London Court of International Arbitration (LCIA) were restructured as DIFC-LCIA on November 18, 2015.

discuss three elements that contributed to the great impact of the Dubai Shock.

The first element is the expansion of the market for foreigners without specific legislation about real estate and credit. Article 4 of Dubai Law No. 7 of 2006 created specific rights for real property.

The right to own Real Property in the Emirate will be restricted to UAE nationals, nationals of the Gulf Cooperation Council member states and to companies fully owned by these, and to public joint-stock companies. Subject to the approval of the Ruler, non-UAE nationals may, in certain areas determined by the Ruler, be granted the following rights:

a. Freehold ownership of Real Property without time restrictions; and

b. Usufruct or leasehold over Real Property for a period not exceeding ninety-nine (99) years.

This legislation enabled foreign investors to take part in a wide range of real estate investments in Dubai. These amendments also created an environment for speculative short-term investments in real estate and mortgage development in Dubai. In fact, pre-sale and re-sale of real estate was taking place when the real estate concerned was still under construction or construction had not even begun [Renaud 2010: 8].

The second element of the Dubai Shock was the absence of any unified credit bureau at that time. The lack of a credit bureau to supervise the UAE market caused some mortgage developers and other actors to continue re-selling the property rights of mortgages for incomplete constructions.[49] This caused a rise in real estate prices and speculation in the Dubai real estate market. Most contracts were pre-sold without considering the risk of default. For instance, such procedures had been adopted without regard to the ratio of the mortgage price that would be covered to the payment made when the mortgage was established.

The third element of the Dubai Shock was regulatory arbitrage. There are various ways to define regulatory arbitrage. From a legal perspective, regulatory arbitrage is a loophole for businesses, companies,

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49 Al Etihad Credit Bureau was established in August 2014 to supervise credit in the UAE.

and individuals to avoid extra costs or legal responsibility by using another legal system. The previous two elements for Dubai Shock caused more foreign investors to invest in Dubai's real estate market: finally, it created a huge real estate bubble that lasted until the end of 2008 and caused a dramatic fall in mortgage prices when it burst. When this happened, investors could not claim their property based on the real estate or building, as there was no such object in the first place.[50]

The concept of "regulatory arbitrage" emerged during the World Financial Crisis that occurred in 2008. Regulatory arbitrage, from the legal point of view, could be explained as an international business loophole. Companies could avoid extra costs or legal responsibility in one country, by utilizing another country's legal system or regulations. This is also mentioned by Riles [2014: 63-76] in the international law concept of "Conflict of Law". Cross-border transactions had enabled investors or other economic actors to choose how they handled their financial risks.

There are still debates on the definition of "regulatory arbitrage". However, generally it could be a special financial scheme designed to increase benefit or reduce cost by utilizing a specific regulation or legislation. This behavior could be seen when the parties chose a high-risk high-return financial transaction over less risky financial scheme where the regulation cannot supervise its risk.

The Dubai Shock was not caused only by "regulatory arbitrage". However, there are several incidents that show that "regulatory arbitrage" in the legal system and regulations had led to such a financial crisis. The element of "regulatory arbitrage" could be found in Dubai Shock by dividing the process into three stages, where "regulatory arbitrage" could be seen to distort the incentive for financial investors to take higher risks.

The first stage was during the real estate bubble from 2006 to mid-2008. During this period, the real estate freehold right had been expanded

[50] A. Kawamura, 'Regulation for Islamic Banking in Two Dimensions: The UAE toward Islamic Moral Economy System', presentation at the Society for the Advancement of Socio-Economics (SASE) Lyon (2017).

to foreign investigators. The first step to open Dubai's real estate free hold had started from May 2002. The turning point to create "regulatory arbitrage" started when the Dubai Decree No.7 of 2006 was issued. This decree had allowed foreign investors to gain real estate property rights for an unlimited time and the right to rent for 99 years.

The issue here is not on opening Dubai's real estate market to foreigners. The problem occurred as a result of there being no reconstruction of the legal framework regarding the deregulation of its real estate market. This created two risks; short term speculation caused by opening the market and the lack of a unified credit bureau in the UAE during this period.

The second stage was the formation of a higher risk-taking process in the Dubai real estate industry. This was formed during and slightly after the real estate bubble had burst. As mentioned before, there was no unified credit bureau established in the UAE until 2014, which made it possible for high-risk speculations to occur. For instance, customer D could go to bank B and be financed to buy a real estate property or invest according to the credit limit. Then this customer D could go to bank C and ask for the same service without it being noticed that this customer D already has a debt with bank B. This leaves customer D with an excessive debt far over the credit limit.

As the number of disputes rose, the more the needs for solving disputes were growing. The lack of regulations or a legal framework for dealing with Islamic finance was not an issue then as most of the disputes were handled by a new approach. The author calls this system the Dubai Approach [Kawamura 2014].

In the end, Dubai received a financial bailout of $10 billion ($4.1 billion for Nakheel Sukuk) from the Abu Dhabi government on December 14, 2009 [Greame 2009; Landon 2009].

Although the Abu Dhabi government provided the bailout, there were multiple civil disputes related to Nakheel PJSC, Tamweel PJSC, and Amalk PJSC and their projects utilizing Islamic financial products. A special judicial committee (*Lajna Qaḍā'īya Khāṣṣ*) was formed by

Dubai Decree No. 57 of 2009 and Dubai Decree No. 61. This was a very unusual occurrence. The Dubai Court had been dealing with disputes related to Islamic finance on a small scale. However, the court did not have the requisite experience to deal with massive disputes related to Islamic finance. These had occurred as a result of the Dubai Shock due to delays in repayments. The Special Judicial Committee was established by a specific Decree, in order to deal with these massive cases.

According to *Emirates247.com*, this Special Judicial Committee had decided 25 cases by October 2009 and the Committee found against the mortgage lenders, the investors, and buyers of Tamweel PJSC and Amalk PJSC, in 95% of 55 cases [Sadafy 2010]. After Dubai Decree No. 27 of 2011 was issued, all cases related to Tamweel PJSC were transferred to the Dubai Court of First Instance.

As shown in Figure 10, property prices dropped nearly 50% from the third quarter of 2008 to the first quarter of 2009. In the end, real estate developers faced bankruptcy. Some real estate developers were providing Islamic financial products for their projects. The representative companies were Nakheel PJSC, Tamweel PJSC and Amlak Finance PJSC.

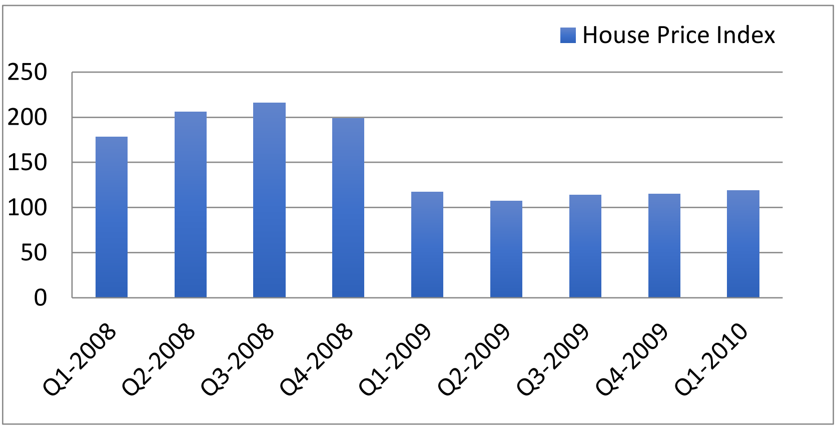


Figure 10. House Price Index

Source: Created by the author based on Colliers International House Price Index. 2012. *Dubai House Price Index: Second Quarter*.

As the repayments delayed, there were number of disputes caused by the Dubai Shock. Most of the real estate development had been delayed or setback due to the financial difficulties. Dividend incomes for the investors were not paid on time nor had any expectation of being paid. In addition, if a company had defaulted from the Dubai Shock, there was no Corporation Reorganization Law in Dubai and in the UAE. Therefore, when a company faced default, the protection measures for the investors were lacking, or at least unclear. Various defaults were emerging and needed fast settlement in order to revitalize projects due to the likelihood of further default.

It is said that after the Special Judicial Committee had dealt with only Amlak PJSC and its subsidiaries, 150 cases had been brought to the committee and 20% of these cases were 'amicably solved' between both parties [Sadafy 2012a]. In addition, according to an article published on October 31, 2012 by *Emirates247.com*, there were "just eight cases, including three new ones filed in the past two months" against Amlak PJSC [Sadafy 2012b].

Therefore, most cases brought to the Special Judicial Committee were dealt with before 2012, according to the chairman of the Committee.[51] The chairman also stated that most cases took about two to five months before a decision was reached. In some cases, it took longer due to the need to translate materials in other languages into Arabic. Commonly, most cases that were dealt by the Special Judicial Committee took less time than dealing within the court system. Court cases in the UAE were usually taking more than six months.

Judge Bassiouni also identified two reasons for the decline in cases. First, Amlak PJSC had been improving its performance by increasing its liquidity. Second, investors were afraid to bring cases to the Special

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[51] The author conducted an interview with the Chairman of the Special judicial committee during field research in Dubai from June to July, 2011.

Judicial Committee because of the expense. This was also mentioned as a reason for the decline in the number of cases in a previous report [Sadafy 2012c].

## 4. Dubai Approach

The Special Judicial Committee has unique characteristics as a mechanism for dispute resolution. There were two phases in its creation and the chronology is set out in Table 6.

Table 6. Chronology of the Special Judicial Committee

| Timeline | Decrees and incident | Category |
|---|---|---|
| 1 November 2009 | Dubai Decree No. 56 of 2009 | Phase One |
| 25 November 2009 | Dubai World faces liabilities of $26 billion for delay | |
| 13 December 2009 | Dubai Decree No. 57 of 2009 | Phase Two |
| 27 December 2009 | Dubai Decree No. 61 of 2009 | |

Source: [Kawamura 2016:8]

Dubai Decree No. 56 of 2009 was issued just before the Dubai Shock occurred. The decree provided a specific remit to deal with disputes concerning ‘cheques related to real estate transactions’. A Special Judicial Committee with three members (two judges from the Dubai court and one specialist from the Dubai Land Department) could be formed under the decree. The Committee would conduct a single trial. Table 7 shows the characteristics of the Special Judicial Committee.

In the second phase, Dubai Decrees No. 57 and 61 of 2009 had a more specific remit for jurisdiction over companies, with company names specified in the decrees. Both decrees specify the companies that were to be judged under the jurisdiction of the Special Judicial Committee.

Table 7. Phase One of the Dubai Approach

| Dubai Decree No. 56 of 2009 | |
|---|---|
| Subject | Cheques Related to Real Estate Transactions |
| Members of the Special Judicial Committee | Two judges from the Dubai Court + one from the Dubai Land Department |
| Number of trials | Single trial |
| Governing law | ▪ UAE laws and ordinances applicable in Dubai<br>▪ Islamic law<br>▪ Custom<br>▪ Equity and fairness |

Source: [Kawamura 2016: 6]

Dubai Decree No. 57 of 2009 (the second to be issued) established a Special Judicial Committee for any issues or disputes related to Dubai World, including Nakheel's issues. The Special Judicial Committee consisted of three DIFC judges in the beginning and could be increased to five members. The members of the Special Judicial Committee are mostly from the DIFC court according to the Article 2 of Dubai Decree No. 57 of 2009. After the amendment by the Dubai Decree No.11 of 2010, the Chairman of the Special Judicial Committee had the right to increase the members from "the judges of the DIFC court, or in coordination with the Director of Dubai Courts, from among the judges of Dubai court" according to the Article 2(b) of Dubai Decree No. 11 of 2010.

Later, Decree No. 326 of 2011 was issued by the Dubai Government Legal Affairs Department. This Decree separated the Dubai World and Nakheel PJSC disputes. This separation was apparently due to the distinctive legal issues in each case, such as joint liability for guarantees, protection of investors, usufruct rights, and governing law issues. This was apparently because Nakheel PJSC was dealing mainly in Islamic financial products.

Table 8. Phase Two of the Dubai Approach

| | Dubai Decree No. 7 of 2009 | Dubai Decree No. 61 of 2009 |
|---|---|---|
| Subject | Revitalizing the Dubai World (including Nakheel PJSC) | Any conflicts related to Amlak Finance PJSC and Tamweel PJSC |
| Members | 1~3 Judges from the DIFC + other judges | Three judges from the Dubai Court + Islamic accountant |
| Trials | Single trial | Single trial |
| Governing Law | ▪ DIFC Laws and the UAE Laws<br>▪ Principles of Justice and rules of righteousness and equity | ▪ UAE Laws and ordinances applicable in Dubai<br>▪ Islamic Law<br>▪ Custom<br>▪ Equity and fairness |

Source: [Kawamura 2016: 8]

A Special Judicial Committee was formed in order to deal with dispute cases related to Tamweel PJSC and Amlak Finance PJSC according to the Dubai Decree No. 61 of 2009. Both companies provided Islamic financial products for their real estate projects. The characteristics of Phase Two of the Dubai Approach are shown in Table 8.

Tables 7 and 8 illustrate the similarities between Phases One and Two. The most striking similarity is the formation of the Special Judicial Committee, which has unique features compared with the conventional judicial system.

Table 9. Characteristics of the Dubai Approach[52]

| | General Court | **Dubai Approach** | ADR |
|---|---|---|---|
| Information disclosure | Open (civil law procedure) | **Closed door** | Closed door |
| Terms for settlement | More than 1 year (Average 2 to 3 years) | **Within six months** | Within 1 year |
| Members | 1~3 judges | **1~3 Judges + 1~2 Islamic finance specialist** | 1~3 arbitrators or mediators |
| Trial | Three-Tiered court system | **No appeal (Substantially single tiered trial court)** | **Single tier** |
| Legally Binding Decisions | Yes | **Yes** | Substantially no |

Source: [Kawamura 2016: 11]

Table 9 compares the Special Judicial Committee with existing dispute resolution mechanisms.

The Dubai Approach also has a unique decision-making process compared with the court and ADR. In the first step of the Dubai Approach, the case is brought to the Court of First Instance. When this court refers the case to the Dubai Decree, the Special Judicial Committee deals with the case. When the appeal is found to fit the criteria of the previous Dubai Decree, the case is brought to the Special Judicial Committee in a closed trial.

The Dubai Approach has some features that are found in both the court and ADR; however, some features of the Dubai Approach differ from both of the other dispute resolution systems. Therefore, the Dubai Approach could be categorized as a third type of dispute resolution, in

52 *Ibid.,* p. 11.

addition to the court and ADR systems [Kawamura 2013: 115-118]. The main feature of the Dubai Approach is that it represents a breakthrough for those issues that fall into the jurisdiction of both the court system and ADR.

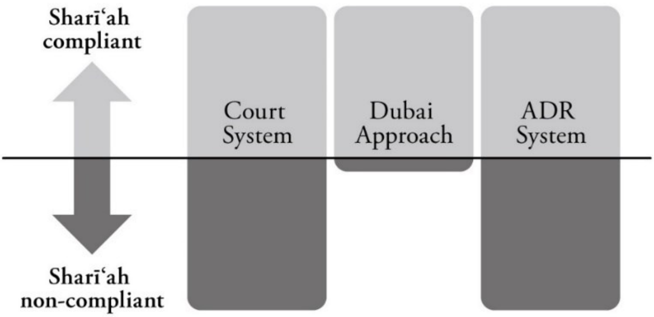


Figure 11. Dubai Approach and its Relationship with Existing Dispute Resolution Processes
Source: Adapted from [Kawamura 2017: 11]

In addition, the Special Judicial Committee makes the Dubai approach an ad-hoc system. The committee deals with cases when all the steps required under each decree have been take in accordance with the statutory procedure.

In order to create and to maintain a Sharī'ah-compliant judicial system for Islamic finance, the Dubai Approach has made a breakthrough by combining the advantages of the court and the ADR system, as shown in Figure 11.

Chapter 6

# Malaysian Model: A Gradual Sinergy of Dispute Resolutions

## 1. Introduction

Malaysia, one of the leading countries for Islamic finance and well known for its political aim to expand its Islamic economical market, has an interesting case of Islamic finance dispute resolution which differs from the “Dubai Approach”. Therefore, this chapter will discuss the development and expansion of the dispute resolution system for Islamic finance in Malaysia and the social and political affairs that are having an effect on the development of its dispute resolution system for Islamic finance. The legal environments for Islamic finance are diverse due to its legal history, political background, economic strategy and so on. Malaysia is an important case to examine due to the unique approach it has taken towards building its Islamic finance dispute resolution system.

## 2. The Reformation of Islamic Financial Jurisdiction in Malaysia

Malaysia established the Islamic Banking Act 1983 (IBA 1983), which created a legal framework for Islamic financial institutions. It has been an active and leading country in developing a legal framework for

The judicial system was also reformed to deal with Islamic finance, especially after the Malaysian court had adjudicated on the Sharī‘ah compliance of specific Islamic financial products.

The evolution of Islamic financial litigation in Malaysia went through three phases between 1987 and 2010 [Hasan and Asutay 2011]. The first was from 1987 to 2002. This period took a classic common law approach. The court found primarily in favour of the Islamic banks during this first phase. In the second phase between 2003 and 2007, some Malaysian judges indirectly criticized previous judgments and the Malaysian court began to find against Islamic financial institutions' products. This critical position of the court became clear in the third phase between 2008 and 2010. The majority of Islamic financial dispute cases were registered during this period. They were mostly related to *bay' bi-thaman ājil* (BBA). In the High Court (Kuala Lumpur), *Arab-Malaysia Finance Bhd* v. *Taman Ihsan Jaya & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631, the BBA transaction was judged to be 'contrary to the Islamic Banking Act 1983 or the Banking and Financial Institutions Act 1989'.[53] In other cases, such as *Bank Islam Malaysia Bhd* v. *Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839 and *Tan Sri Abdul Khalid Ibrahim* v. *Bank Islam Malaysia Bhd & Another Case* [2010] 4 CLJ 388, the judge ruled on the legitimacy of BBA.[54] In *Bank Islam Malaysia Bhd* v. *Lim Kok Hoe* case, the judge compared the BBA contract, a sales contract, and the loan, a money-lending contract. The judgment states that BBA contracts are '[f]ar more onerous than the conventional loan with Ribā.[55]

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[53] *Arab-Malaysia Finance Bhd* v. *Taman Ihsan Jaya & Ors (Koperasi Seri Kota Bukit Cheraka Bhd, third party)* [2008] 5 MLJ 631, at p. 633.

[54] Both cases had a totally different judgement by the Malaysian court. In the case of *Bank Islam Malaysia Bhd* v. *Lim Kok Hoe*, BBA was criticized as being 'far more onerous than the conventional loan with Ribā' and that the 'BBA contract was not acceptable by all the four mazhabs and thus not acceptable in the religion of Islam'. On the other hand, *Tan Sri Abdul Khalid Ibrahim* v. *Bank Islam Malaysia Bhd,* BBA was legitimized due to *stare decisis*. The cases which were referred for *ratio decidendi* for BBA to be legitimized were *Bank Islam Malaysia Bhd v. Adnan Omar* [1994] 3 CLJ 735 and *Bank Kerjasama Rakhat Malaysia Bhd v. Emcee Corporation Sdn Bhd* [2003] 1 CLJ 625.

[55] *Bank Islam Malaysia Bhd* v. *Lim Kok Hoe & Anor and other appeals* [2009] 6 MLJ 839 at p. 850.

It has been noted above that the Malaysian court was proactive in ruling against BBA and *bay‘ al-‘īna* in the second phase [Hasan and Asutay 2011: 43]. As noted, decisions by the court began to affect the Islamic financial market during the second phase. SAC supervision was instituted as the Malaysian government wished to secure the market. One solution was to have the SAC judge the Sharī‘ah compliance of the cases brought before the court. While the role of the SAC was under development, there was criticism of court rulings in Islamic financial cases, as the judges lacked knowledge of Islamic law and could not decide issues related to compliance with Islamic law [Ibrahim 2008].

The SAC had been launched in 1997 as the highest Sharī‘ah authority to supervise the Islamic financial market. Theoretically, the courts in Malaysia could refer cases to the SAC if there were any issues related to the Sharī‘ah, but the SAC has not been effective for the courts until recently. The Central Bank Act was amended in 2003, and the courts could voluntarily refer cases to the SAC; therefore, but the courts were not obliged to do so. This was one reason why the courts did not refer matters to the SAC. When the Central Bank Act 2009 was established, the court was required to consider referral to the SAC. The authority of the SAC is set out in Sections 51 to 58 of the Act. SAC supervision of litigation is mentioned in Section 56(1) as below:

Where in any proceedings relating to Islamic financial business before any court or arbitration any question arises concerning a Sharī‘ah matter, the court, or the arbitrator, as the case may be, shall:

a. Take into consideration any published rulings of the Sharī‘ah Advisory Council; or
b. Refer such question to the Sharī‘ah Advisory Council for its ruling.

This section has involved the SAC in litigation regarding Islamic finance more frequently than the previous Central Bank Act 1958 (amended 2003), Section 16B (8). In the previous Act, the court had more freedom in reaching their decisions; in the 2009 amendment, the role of the SAC is prescribed [Lee 2014: 17]. In addition, the Islamic Financial Act 2013 made consulting with the SAC and adhering to their advice 'obligatory'.

However, the SAC has not reviewed many Islamic finance cases dealt with by the court. Tun Abdul Hamid Mohamad stated:

"Sharīʻah issues are very rare in court. In 2009, the Mua'malat Division of the High Court in Kuala Lumpur alone disposed of 940 cases as against 691 registered in that year… (First, please note that the courts are disposing [of] more cases than registered during the year, cutting down the old backlog). So far only one Shari'ah issue has been referred to the SAC of Bank Negara Malaysia [Mohamad 2011: 64]."

In addition, there are issues related to the complex range of Islamic financial products. The legislation could not cope with the rapid development of schemes and technology for financial products. The structure of financial products for Islamic finance has also become more complicated. Therefore, contracts will eventually become more sophisticated, and the court will not be able to deal with all the issues. In such cases, it is preferable to use ADR rather than the court.

Generally, ADR is used in order to protect the reputation of the company. Making the case public could result in the business being negatively affected and the lower cost and faster resolution of ADR compared with litigation is an advantage for deciding on Islamic financial cases.

## 3. The Malaysian Model

The evolution of the Sharīʻah Advisory Council (SAC) is one of the characteristics of the Malaysian model of Islamic finance dispute resolution. After the negative judgment on BBA and *bayʻ al-ʻīna*, the SAC gradually expanded its authority to supervise the Malaysian court's judgements on Islamic financial cases. The SAC also gives advice to ADR institutions.[56]

The role of the SAC had changed after the three phases of development in the judicial system in Malaysia in connection with Islamic finance. As shown in Table 10, the SAC had expanded its authority to govern Sharīʻah issues. After the amendment of the Central Bank Act 2009, the Islamic Financial Services Act 2013 ensured that the court would seek the advice of the SAC.

Table 10. Development of SAC Involvement in Islamic Finance Court Cases

| | |
|---|---|
| 1980-2002 | No obligation for the court to refer to the SAC when the case is related to Islamic finance |
| 2003-2007 | The court began to decide proactively on Islamic financial dispute cases. Islamic financial disputes brought up issues about the court's competency to deal with Sharīʻah compliance |
| 2008-2010 | Most of the court cases related to Islamic finance dealt with the legitimacy of the BBA. As negative judgments increased, they affected the Islamic financial market negatively. |
| 2011-2014 | The SAC gained more jurisdiction over court judgments associated with Islamic finance. During this stage, referral to the SAC became obligatory for the court when there was an issue about Sharīʻah |

Source: Author, based on field research in Malaysia in June to September 2015

56 There are three ADR institutions that would be theoretically seek advice from the SAC in Malaysia, which are Kuala Lumpur Regional Centre for Arbitration, Financial Mediation Bureau and Malaysian Mediation Centre.

# 4. ADR for Islamic Finance: Practice and Legal Framework in Malaysia

Malaysia has focused on the utilization of ADR for Islamic financial disputes from the early stages of the development of the Islamic financial market in the country. For example, there were early concerns that the court might not seek advice from the SAC [Markom and Yaakub 2015: 577-579]. Further, the need for a *Lex Mercatoria* for Islamic financial dispute resolution to improve the functioning of the Malaysian system has been noted [Yaacob 2014]. Some writers have argued that members of the Organization of Islamic Cooperation (OIC) should agree on a *lex mercatoria* in order to form an international convention or Model Law of Arbitration in order to smooth the misunderstandings arising in the Islamic finance industry [Yaacob et al. 2011: 34-38].

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) has published i-Arbitration, an arbitration guide for Islamic financial cases. KLRCA introduced 'Rules for Islamic Banking and Financial Services Arbitration 2007' to deal with Islamic financial dispute cases. Although the role of the SAC for dealing with Islamic finance was not identified clearly until the Central Banking Act 2009, Rule 33(1) of that Act requires arbitrators to refer to the SAC.

However, i-Arbitration 2007 rule 33 (2) states that the arbitrator could ask the SAC or a Sharīʻah expert for their opinion. In 2012, the rules were updated as the 'KLRCA i-Arbitration Rules,' which adopted the United Nations Commissions on International Trade Law (UNCITRAL) model law. Under the previous rules, it was difficult to unify the adaptation of specific arbitration awards; however, the UNCITRAL Model Law recognises and enforces arbitration awards of any country that is a member of the New York Convention.

The latest amendment to i-Arbitration occurred in 2013. The i-Arbitration 2013 Rule 11 states that, if a Sharīʻah issue is found in Islamic finance cases that are brought to the KLRCA, the arbitrator could refer the case to the SAC. This lengthened the time taken for the procedure. The new amendment allows the party to refer not only to domestic Sharīʻah experts but also to overseas experts. This is expected to improve speed and efficiency.

The i-Arbitration 2013 Rule 12(8), developed under the supervision of the SAC, added a specific provision regarding *taʻwīḍ* and *gharāmah*. These two concepts explain the late payment charge from a Sharīʻah compliant perspective. When the customer faces default or for other reasons is late paying their debt, a conventional financial institution will charge interest, or *ribā*. Such charges cannot be imposed by Islamic financial institutions, and these two concepts legitimise late payment charges in a Sharīʻah compliant way [Lahsana 2014].

*Taʻwīḍ* literally means compensation or indemnity in Arabic, and in the Islamic financial context, 'payment of financial compensation for loss inflicted upon another'[ISRA 2010: 334]. *Gharāmah* literally means penalty and in the context of Islamic finance, 'a disciplinary measure or compensation' [ISRA 2010: 134]. The late payment charge is calculated as a combination of *taʻwīḍ* and *gharāmah*.

KLRCA has also been dealing with numerous arbitrations, mediation, and adjudication cases. Increasing numbers of arbitration cases have been brought to the KLRCA, especially after 2006. The KLRCA has gained experience from the 282 non-Islamic arbitration and mediation cases heard during 2014. There have also been several Islamic financial arbitration awards since 2007. However, some obstacles remain that prevent arbitration from being chosen for dispute resolution.

From the perspective of academics and practitioners, ADR is promoted in Malaysia. Theoretical discussion and legal developments are taking place and advancing ADR. However, statistics suggest that there are some issues in utilizing ADR in preference to the court system. First, arbitration for Islamic finance in the KLRCA has yet to increase. Second, from the perspective of cost, the experience of the court in dealing with Islamic financial cases and the requirement for arbitration decisions to receive final approval by the court has been an obstacle to ADR's full utilization.

There are several reasons for the court to be selected over ADR. First, according to KLRCA i-Arbitration Rule 6 (2) of 2013, Islamic financial institutions prefer to have Sharīʻah scholars they know, or to bring the case to court in the UK or the Middle East (BCDR-AAA) as they are familiar with the procedures there.

Second, although arbitration is cheaper than litigation, it is difficult to recover costs from the court. The process of ADR is much simpler and cheaper. However, ADR has a great disadvantage compared to the court when the decision needs to be enforced.

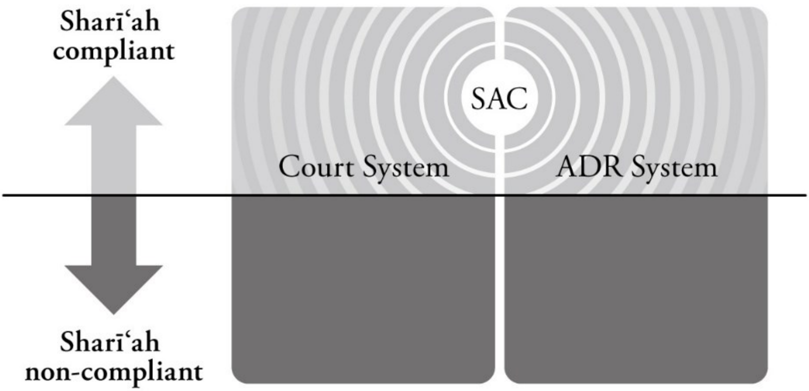


Figure 12. SAC and its Relation to Existing Dispute Resolution Processes
Source: Adapted from [Kawamura 2017: 11]

Third, the involvement of the SAC makes it preferable to choose the court rather than the KLRCA: historically, the court has longer experience than arbitration institutions. In addition, if the contract has a clear definition in the arbitration clause, it is faster to use the court.

Fourth, lawyers are aware of the risk that an arbitration award could be invalidated under the Act for Arbitration 2005, Section 38. Finally, there are more general issues for ADR, including non-legal professionals' poor knowledge of and access to the ADR system including KLRCA i-Arbitration. The KLRCA is well known only to legal professionals. Banks and general customers do not know about arbitration or its benefits. In comparison to the "Dubai Approach", Malaysian Model focuses on protecting Sharīʻah compliance. This has been made possible by the role the Sharīʻah Advisory Council in the Central Bank of Malaysia as we have seen in this chapter and as shown in Figure 12.

Malaysia had also taken a further step to develop a Sharīʻah compliance mindset for its industry. The strategy paper on "Value Based Intermediation (VBI)" was introduced by the Central Bank of Malaysia in 2017. The aim of the VBI is "to deliver the intended outcomes of Sharīʻah through practices, conduct, and offerings that generate a positive and sustainable impact to the economy, the community and the environment, consistent with the shareholders' sustainable returns and long-term interests" and moreover "emphasizes the minimalization and prevention of negative impacts arising from the Islamic banking industry's practices, conduct, and offerings" [BNM 2018: 12].

The VBI beneficiaries are considered to be the financial industry, the customers/community, the government, and the regulating body. Therefore, there is no platform for dispute resolution in this VBI. In addition, the VBI could be seen as a "market driven" strategy to boost the Islamic financial market.

In order to maintain the Islamic moral mindset and the Islamic justice for Muslims, it is also crucial to recognize the issues related to the justice system. Especially, when each party disputes on their own justice in the judicial system for Islamic finance dispute resolution system.

In conclusion, we must admit that as the whole economics system is driven by the capitalist mindset, or the accumulation of more wealth by the wealthy, it is difficult for all the actors involved to commit to upholding the Sharīʻah aspects of Islamic finance, or stick to Islamic morality and Sharīʻah compliance when their profits are at stake. It is clear that economic justice for Muslims, and indeed establishing a moral economy for all, requires a quantum shift in the human mindset towards a more sustainable environment.

# Conclusion

This book has focused on the dispute resolution system for Islamic finance in order to shed light on this neglected area of research in the fields related to Islamic economics. Islamic economics emerged in the 1970's and developed rapidly in the following decades. The growth of Islamic finance was accompanied by an increase in civil disputes. However, as demonstrated in this book, compared with the rapidity of Islamic financial expansion, dispute resolution systems were slow to develop.

Islamic finance as such has always faced some challenges when competing with conventional finance. It has sprung out of the capitalist system, and yet its purpose is to overcome the shortcomings of capitalism, as the Islamic ideals demand. Under these conditions, we have traced the development of Islamic finance and explained why the ideal of the Islamic Moral Economy has emerged.

Under the Islamic Moral Economy, Islamic banking and financial institutions should behave morally and uphold social justice. Consequently, a nation's economic system, legal system and, of course, its dispute resolution system would need to be consistent with the application of Islamic ethics and morality to guide and protect the Islamic banking and financial activities in order to achieve Islamic justice. However, as we discussed in Chapter 2, the reality has shown a divergence between what the Islamic economic ideal demands and the actual practices we have observed in the Islamic financial sector. Therefore, the discussion on maintaining ethics and morality in Islamic banking and finance is a crucial issue for the Muslim society to resolve.

While there are challenges in the Islamic financial industry, the Gulf countries, and the Southeast Asian countries, especially Malaysia, have become outstanding examples of its developments, as we explained in Chapter 3. These regions have propelled the Islamic banking and financial market to expand and become a global force. At the same time, although both these areas are well known as global hubs for Islamic finance, they have adopted different approaches to it. The political backgrounds of the Gulf countries and Malaysia have led to diversified economic and legal systems developing in these countries.

The legal histories of the Gulf countries and Malaysia have some similarities, in that under British domination, they both inherited a western, mainly British-style legal system. While these western oriented legal systems developed into commercial and civil law, this gave rise to issues concerning how Islamic finance should be handled. There are still no clear answers as to whether to choose statutory law or hybrid law for Islamic finance as we saw in Chapter 4.

While the debate on Islamic finance continues, civil disputes on Islamic finance have led to the creation of new dispute resolution systems for the UAE and Malaysia as we saw in Chapters 5 and 6. Both of these countries are leading the Islamic finance industry, and solving the disputes in both cases was crucial to protecting the industry. However, as we saw in these chapters, the UAE and Malaysia took totally different approaches to their civil disputes related to Islamic finance. In addition, the disputes themselves were different as in the UAE cases Islamic finance was a part of a massive financial dispute, while in Malaysia, Islamic financial products were an issue for creating a new dispute resolution model.

What we can learn from the present case study is limited as we have investigated only two out of a wide spectrum of Muslim countries and societies. However, this book has shown we can analyze the uneven Islamic world from an even perspective. Islamic banking and finance institutions have been criticized for mimicking conventional finance and for losing sight of their original mission to fulfil the social justice of Islam. Accordingly, an ideal discussion on the Islamic Moral Economy has emerged to tackle this issue.

At the same time, Islamic financial markets in the UAE and Malaysia suffered crises that they had never experienced before. The UAE had to deal with an Islamic financial market that almost faced bankruptcy due to massive disputes. This led to the emergence of the “Dubai Approach” to solve this issue by creating a third type dispute resolution system. Meanwhile, Malaysia faced the negative effect of its courts’ decisions on its most popular Islamic financial products. Although its dispute system structure was different from the “Dubai Approach”, we saw how the role of the Sharīʻah Advisory Council (SAC) expanded and created the “Malaysia Model” of Islamic finance dispute resolution.

Both these new dispute resolution models reflect the political and legal aspects of their respective countries. In addition, they reveal the uneven development of Islamic dispute resolution. The justice system for Islam is theoretically unified under the Sharīʻah, but as the representative dispute resolution systems have shown, diversified approaches were taken to protect the Islamic financial markets. It is obvious that the diversified features of the respective economic, legal, political, and social elements, created such diversification. Therefore, it is important to consider that the shared common sense of Sharīʻah based Islamic ethics and morality might lead to diversified outcomes due to different circumstances. In order to see the even distribution of justice exemplified by the Islamic finance dispute resolutions system, it is crucial to expand this study further to other countries. This study has clarified the issues of the divergence between the reality of Islamic financial practices and the ideology of Islamic economics. In addition, this book has also illustrated the challenges faced and adjustments that were made in the UAE and Malaysia in order to protect the Islamic financial market.

For further studies, it is crucial to discuss how the Islamic society will develop its dispute resolution system for Islamic finance in order to accomplish Islamic social and economic justice. This could lead to the discovery of the common ground in a diversified Islamic world.

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