DISPUTE RESOLUTION MECHANISMS IN THE ISLAMIC FINANCE INDUSTRY IN MALAYSIA: TOWARDS A LEGAL FRAMEWORK

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Abstract

The recent groundbreaking reforms in the legal and regulatory framework for Islamic banking and finance in Malaysia usher in a new phase in the modern history of this hitherto niche market. As part of these latest reforms, a major paradigm shift in the process of dispute resolution has taken place through the introduction of the financial ombudsman scheme (FOS) that typifies the classical muḥtasib *model in Islamic law. Against this backdrop, this paper provides a theoretical framework of dispute resolution mechanisms in the Islamic banking and finance industry in Malaysia with special reference to the Islamic legal paradigm. While adopting an analytical approach in examining the relevant issues, the paper argues that effective dispute resolution mechanisms that are annexed to the traditional litigation process, based on the Islamic legal paradigm, will enhance the grievance redress system. It therefore proposes an Islamic-based multi-tiered process of dispute resolution that does not only take into consideration the classical processes of dispute resolution in Islamic law, but also their potentials in streamlining the prevailing dispute resolution framework in the Islamic banking and finance industry in Malaysia.*

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1. Introduction

Malaysia is generally known for its government-backed highly sophisticated Islamic finance industry that is gradually assuming the position of a global hub for financial services.[1] The reforms, which have transformed the financial landscape in the country and beyond, are driven by well-reasoned legislative and regulatory characteristic. Since the enactment of the first legislation on Islamic finance, the Islamic Banking Act 1983 (now repealed), the Islamic finance industry in Malaysia had gone through several teething challenges which have consequently spurred a series of reforms over the years.[2] Most of these diverse reforms have been consolidated and codified into a new legislation called the Islamic Financial Services Act 2013 (IFSA).[3] While IFSA managed to resolve some legal ambiguities and uncertainties experienced in the thirty-year period of practice of Islamic finance in the country, there are a number of provisions that need further clarifications through guidelines and standards from Bank Negara Malaysia.[4] The new Act recognizes the importance of such operation parameters in operationalizing its provisions. The apex bank is empowered by virtue of s. 135 of IFSA to specify standards on business conduct for Islamic financial institutions with a view to ensuring the services provided by such financial institution

[1] Amin Hanudin, Abdul Rahim Abdul Rahman, Stephen Laison Sondoh Jr, Ang Magdalene Chooi Hwa Amin, "Determinants of Customers' Intention to Use Islamic Personal Financing: The Case of Malaysian Islamic Banks," *Journal of Islamic Accounting and Business Research* 2, no. 1 (2011): 23.

[2] William Case, "Malaysia: New Reforms, Old Continuities, Tense Ambiguities," *The Journal of Development Studies* 41, no. 2 (2005): 284–309.

[3] For a detailed commentary on IFSA, see generally, Mohd Johan Lee and Umar A. Oseni, *IFSA 2013: Commentaries on Islamic Banking and Finance* (Selangor: Malaysian Current Law Journal Sdn. Bhd, 2015).

[4] Engku Rabiah Adawiah Engku Ali, "Constraints and Opportunities in Harmonisation of Civil Law and Shariah in the Islamic Financial Services Industry," *The Malayan Law Journal* 4 (2008): iii.

are fair, responsible and professional when dealing with their customers. This is part of the consumer protection mechanisms introduced by the Act.

In a more specific sense, s. 135(2)(e) of IFSA clearly identifies a key area in which standards are required for proper operationalization of the objective of the Act. To this end, the apex bank is required to issue standards on "complaints and dispute resolution mechanisms". This phrase mentioned in the subsection 2(e) of s. 135 is not exhaustive, as it is drafted in a way and manner that includes any mechanism that seeks to ensure Islamic financial services are fair, responsible and professional. This is the spirit of the new Act which has revolutionalized the Islamic financial services industry in Malaysia. Against the foregoing backdrop, though IFSA severally recognises the jurisdiction of the court in hearing and determining disputes emanating from Islamic financial transactions, it however provides for proper handling of related disputes through an effective means of dispute resolution called the Financial Ombudsman Scheme (FOS).[5] This paper therefore hypothesizes that establishing a Sharīʿah-compliant process through an integrated framework for dispute resolution will enhance the practices of Islamic financial services in this emerging global hub, which are expected to be exported to emerging economies in the world.

This paper explores the feasibility of an Islamic legal framework for dispute resolution in the Malaysian Islamic finance industry whose current framework operates within a common law dominated legal system. The Islamic legal framework for dispute resolution refers to a series of Sharīʿah-based procedures for the resolution of disputes which are identified in the primary sources of *Sharīʿah* as well as the classical works of Muslim jurists. An end-to-end Sharīʿah compliance does not only require a particular transaction to be compliant with Islamic principles but the process of resolving any dispute that arise therein should also be Sharīʿah-compliant.

[5] Umar A. Oseni and Sodiq O. Omoola, "Banking on ICT: The Relevance of Online Dispute Resolution in the Islamic Banking Industry in Malaysia," *Information & Communications Technology Law* 24, no. 2 (August 17, 2015): 205–23.

Therefore, besides this introduction, the remainder of the paper is structured as follows. Sub-topic 2 examines the need to consider litigation as a last resort in the continuum of dispute resolution processes, particularly in Sharīʿah-compliant transactions. Sub-topic 3 discusses the Islamic dispute resolution (IDR) processes from their evolution to the modern-day practices and their relevance to the Islamic finance industry. Sub-topic 4 appraises the existing dispute resolution framework utilized for Islamic finance disputes in Malaysia and its appropriateness for the Islamic finance industry. Sub-topic 5 gives the way forward to overcome the current challenges associated with dispute resolution in the Islamic finance industry and emphasizes on the need to properly operationalize the new legal framework introduced by IFSA and integrate such a process to other sustainable institutions, bearing in mind the overarching Islamic legal framework which should guide the process. Sub-topic 5 gives the conclusion and some policy recommendations.

2. Litigation as the Last Resort for Islamic Finance-related Disputes

The foundation of dispute resolution mechanisms in Islamic law is not entirely premised on settlement by way of litigation or adjudication by judicial processes. Even though the system of court adjudication (*qaḍā*) in Islamic law was highly developed in the early period of Islam, more emphasis is placed on effective dispute settlement in order to promote the spirit of brotherhood, the sense of belonging, and sustainable relationships.[6] The Qur'an and *sunnah* unequivocally give preference to the amicable settlement of disputes, known as *ṣulḥ* to promote harmony and peaceful co-existence in society.[7] For instance, the following verses of the Qur'an explains the importance of the amicable settlement of disputes:

> And if two parties or groups among the believers fall to fighting, *Then make peace between them both*, but if one

[6] Aida Othman, "'And Amicable Settlement Is Best': *Ṣulḥ* and Dispute Resolution in Islamic Law," *Arab Law Quarterly* 21, no. 1 (2007): 64–90.

[7] Syed Khalid Rashid, "Alternative Dispute Resolution in the Context of Islamic Law," *The Vindobona Journal of International Commercial Law and Arbitration* 8, no. 1 (2004): 95–118.

> of them rebels against the other, Then fight You (all) against the one that which rebels till it complies with the command of Allah; Then if it complies, *Then make reconciliation between them justly, and be equitable*. Verily! Allah loves those who are equitable. *The believers are nothing else than brothers. So make reconciliation between your brothers*, and fear Allah, that you may receive Mercy.[8]
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> If a wife fears cruelty or desertion on her husband's part, there is no blame on them if they arrange *an amicable settlement between themselves; and such settlement is best*; Even though men's souls are swayed by greed. But if ye do good and practise self-restraint, Allah is well-acquainted with all that ye do.[9]
>
> If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from her's; *if they both wish for peace, Allah will Cause their reconciliation*. Indeed Allah is ever All-Knower, Well-acquainted with All things.[10]

Though some of the verses relate to family dispute settlement, they are nevertheless, relevant in Islamic commercial law.[11] The concept of *ummah* or nation from the Islamic sense mirrors the common bond that unites members of such a nation, and as such, they are expected to resolve whatever differences, whether commercial or civil, through effective dispute resolution.[12]

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[8] Qur'an (Al-Hujurāt) 49: 9-10. (Emphasis added)

[9] Qur'an 4: 128. (Emphasis added)

[10] Qur'an (Al-Nisā') 4:35. (Emphasis added)

[11] Umar A. Oseni, "Sharī'ah Court-Annexed Dispute Resolution of Three Commonwealth Countries – a Literature Review," *International Journal of Conflict Management* 26, no. 2 (2015): 214–38, doi:10.1108/IJCMA-06-2012-0050.

[12] Umar A. Oseni, "Dispute Resolution in the Islamic Finance Industry in Nigeria," *European Journal of Law and Economics*, 2012, http://link.springer.com/article/10.1007/s10657-012-9371-y.

The concept of *ṣulḥ* is general and all-encompassing, as there is no single English word that can appropriately define it. Hence, different analogous terminologies are used to describe the concept. Therefore, *ṣulḥ* may mean negotiation, mediation, conciliation, and even compromise of action.[13] Compromise between the disputing parties should be considered essential, in contrast to confrontation that is often associated with litigation.[14] It is pertinent to clarify that court adjudication in Islamic law is different from the accusatorial procedure of the civil courts.[15] Court adjudication in Islamic law involves an inquisitorial procedure where the judge plays an active role in the dispute resolution process which might even involve mediation and compromise of action.[16] In classical Islamic law, the dispute resolution processes are highly appreciated through amicable dispute settlement such as *ṣulḥ* which rules out enmity and hatred.[17]

The adverse effect of litigation has been recognized in many developed countries. In fact, the ADR movement of the 20th century which spurred a series of developments emerged as a popular dissatisfaction against the administration of the justice system in the United States of America.[18] Roscoe Pound considers the challenges faced by the adversarial procedures in litigation as hindering access to justice and therefore called for the improvement of legal procedures which includes the need to introduce effective dispute resolution procedures.[19] This consequently led to the landmark Pound

[13] Umar A. Oseni and Abu Umar Faruq Ahmad, "Blazing the Trail: The Institutional Framework for Dispute Resolution in Malaysia's Islamic Finance Industry," *ISRA International Journal of Islamic Finance* 4, no. 2 (2012): 159–65.

[14] Rashid, "Alternative Dispute Resolution in the Context of Islamic Law," 118.

[15] For a detailed analysis of the judicial system in Islam, see generally, Ghulām Murtaẓā Āzād, *Judicial System of Islam*, No. 72 (Pakistan: Islamic Research Institute, International Islamic University, 1987).

[16] Irit Bligh-Abramski, "The Judiciary (Qāḍīs) as a Governmental-Administrative Tool in Early Islam," *Journal of the Economic and Social History of the Orient* 35, no. 1 (1992): 40–71.

[17] Othman, "'And Amicable Settlement Is Best': Sulh and Dispute Resolution in Islamic Law," 68–70.

[18] Roscoe Pound, "The Administration of Justice in the Modern City," *Harvard Law Review* 26, no. 4 (1913): 302–28.

[19] Roscoe Pound, "Justice According to Law," *Columbia Law Review* 13, no. 8 (1913): 696–713; Roscoe Pound, "The Causes of Popular Dissatisfaction with the

Conference in 1976 where Frank Sanders introduced the concept of the multi-door courthouse.[20] From the sparks of the Pound Conference, the court systems in USA were reformed, and court-annexed or court-assisted alternative dispute resolution mechanisms were introduced. Additionally, dispute resolution mechanisms other than litigation were immediately introduced, rapidly developed and progressively embodied into a variety of sectors to cater to unique disputes emanating from certain sectors: commercial, corporate and employment. The realization of the relevance of having alternatives to litigation warrants the adaptation of dispute resolution mechanisms in the realm of the banking and the finance industry.[21] The overarching influence of the adversarial common-law based adjudication has triggered what might be referred to as reputational risk in the modern practice of Islamic finance.

The disadvantages of litigation, particularly in commercial disputes, are summarized by Sir Bernard Rix:

> Litigation's disadvantages, on the other hand, are that it can be slow and has become increasingly expensive, with potentially ruinous costs implications. It can produce answers which are very black and white, so that you fall on either one side of a line or the other, even if the facts appear to be rather more grey than black and white. Its remedies are limited, to the standard remedies of damages, and some discretionary remedies in terms of injunctions and declarations and such like. Because it is coercive, and the process is owned by the courts, not by the litigants, it can be an extremely divisive and

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Administration of Justice," *Annu. Rep. ABA* 29 (1906): 395–417; Roscoe Pound, "The Causes of Popular Dissatisfaction with the Administration of Justice," *J. Am. Jud. Soc.* 20 (1936): 178–87.

[20] Frank E. A. Sander, *Varieties of Dispute Processing* (Eagan, USA: West Publishing Company, 1976); Larry Ray and Anne L. Clare, "The Multi-Door Courthouse Idea: Building the Courthouse of the Future... Today," *Ohio St. J. on Disp. Resol.* 1, no. 1 (1985): 7–54.

[21] The Pew Charitable Trust, "Banking on Arbitration: Big Banks, Consumers, and Checking Account Dispute Resolution" (Washington, D.C., 2012), http://www.pewtrusts.org/~/media/assets/2012/11/27/pew_arbitration_report.pdf.

> anxiety-ridden experience. Finally, its openness can count as a disadvantage.[22]

Such "anxiety-ridden experience" should not be triggered by the usual tendency of financial institutions to proceed to court for summary judgment in the event of defaults in payment. Even though summary judgment is often used to expedite matters and reduce costs, especially when claims are supported by strong facts and convincing evidence, some preliminary steps involving good faith negotiation and mediation might help the parties. There should definitely be a better approach, particularly when it comes to Islamic finance facility. This calls for more sustainable and innovative means of dispute resolution that will not only sustain existing business relationship, but also provide a platform for value creation in relation to the subject matter of the dispute.

One must acknowledge the reforms introduced in the pre-IFSA 2013 period. Two essential reforms introduced then were geared toward achieving a Shari'ah-compliant procedure in the settlement of Islamic finance cases in the court of law. Firstly, in 2003, the Muamalat Bench of the High Court of Malaya was established where the Islamic banking and finance cases could be registered and specially dealt with at Commercial Division 4.[23] Based on an empirical study, there is an increase in the number of cases relating to

[22] Sir Bernard Rix, "The Interface of Mediation and Litigation," *Arbitration* 80, no. 1 (2014): 21–22.

[23] Ruzian Markom et al., "Adjudication of Islamic Banking and Finance Cases in the Civil Courts of Malaysia," *European Journal of Law and Economics* 36, no. 1 (April 19, 2011): 1–34; Unaizah Abdul Manaf et al., "The Development of Islamic Finance Alternative Dispute Resolution Framework in Malaysia," *International Business Management* 8, no. 1 (2014): 1–6. Also see Practice Direction No. 1/2003 of the Malaysian Judiciary. Specifically, under the paragraph 2 of Practice Direction No.1/2003, all Islamic banking and finance cases will use 22A as their code when the cases are filed to the High Court of Malaya, whereby the cases will be registered and heard in the special High Court Commercial Division 4 (Muamalat Bench) in High Court of Kuala Lumpur. This Practice Direction is only meant for the Islamic banking and finance cases only which enforced starting from 6 February 2003 and it is applicable to all courts in Malaysia from the Magistrates' Courts up and until the High Courts.

Islamic finance contracts in Malaysian courts.[24] Such increase indicates that litigation remains the preferred option for dispute resolution in the Islamic finance industry in spite of the availability of other processes. Based on this finding, there is a high tendency for the existence of a backlog of cases even at the Muamalat Bench.[25] The Muamalat Bench has consistently performed very well in disposing relevant cases. Figure 1 below shows the tracking chart on the registration and disposal of Muamalat cases in the Commercial Division of the High Court in the year 2014.

Figure 1: Tracking Chart, High Court of Kuala Lumpur (January – December 2014)[26]

	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
Balance Last Month	54	45	57	50	61	67	52	65	73	61	58	65
Registration	19	34	29	38	48	20	39	33	29	23	25	25
Disposal	28	22	36	27	42	35	26	25	41	26	18	34

[24] Hakimah Yaacob, "Analysis of Legal Disputes in Islamic Finance and The Way Forward: With Special Reference to a Study Conducted at Muamalat Court, Kuala Lumpur, Malaysia," ISRA Research Paper No. 25/2011 (Kuala Lumpur, 2011), 9.

[25] Zaki Azmi, "Using Technology to Improve Court Performance: Malaysia's Experience," in *Asia Pacific Judicial Reform Forum 2010* (Beijing, 2010), http://www.kehakiman.gov.my/sites/default/files/document3/Arkib/Ucapan2.pdf.

[26] The Malaysian Judiciary, *The Malaysian Judiciary Yearbook 2014* (Kuala Lumpur: The Malaysian Judiciary, 2015), 203.

From the tracking chart above, it is revealed that the total number of Muamalat cases, which are basically Islamic finance cases, was 362 from January to December 2014. The High Court managed to dispose of a total number of 360 cases during the year while leaving 56 pending cases which were brought forward to the year 2015. It, however, appears that there are understandable delays when cases proceed on appeal at the Court of Appeal. As of 31 December 2014, only six out of the nineteen appeals registered in 2014 had been disposed. Thirteen of such appeals were brought forward to 2015.[27]

The second major reform which came as part of the pre-IFSA 2013 reforms is the introduction of the referral procedure to the Sharī'ah Advisory Council (SAC). It began with the amendment to section 16 of the Central Bank of Malaysia Act 1958 (now repealed) which introduced section 16B (8) which provided that the court or arbitral tribunal may refer Sharī'ah questions to SAC or take into consideration published resolutions of the same body. Further amendments were introduced when an entirely new law was enacted to regulate the entire banking industry in 2009. The Central Bank of Malaysia Act 2009 (Act 701) (CBMA) introduced a new procedure which makes reference to SAC mandatory on the courts and arbitral tribunals in the ascertainment of any Sharī'ah issue. Section 57 of CBMA binds the courts to any ruling made by the SAC when the courts themselves refer Sharī'ah issues to SAC. However, the binding nature of the SAC resolution was challenged in court on constitutional grounds where it was alleged in *Tan Sri Abdul Khalid Ibrahim* v *Bank Islam Malaysia Bhd*[28] that the judges were abdicating their judicial power by conferring such powers on another body.[29] It was argued in the case that sections 56 and 57 of CBMA contradicts the Federal Constitution (FC) of Malaysia. The court held inter alia that: "It is settled law that ss 56 and 57 of the Act are valid federal laws enacted by Parliament and as such were not in contravention of the FC. Difference of opinion on Sharī'ah issues relating to Islamic banking should be resolved within the SAC. It is

[27] Ibid., 30.

[28] [2012] 7 MLJ 597.

[29] Arifin Zakaria, "A Judicial Perspective on Islamic Finance Litigation in Malaysia," *IIUM Law Journal* 21, no. 2 (2013): 168–170.

advisable and practical that a special body like the SAC should ascertain the Islamic law most applicable to the Islamic banking industry in Malaysia".[30] On appeal to the Court of Appeal in *Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Bhd*,[31] the decision of the High Court was upheld with further clarifications:

> The fact that the court is bound by the ruling of the SAC under section 57 does not detract from the judicial function and duties of the court in providing a resolution to the dispute(s) which the parties have submitted to the jurisdiction of the court. In applying the SAC ruling to the particular facts of the case before the court, the judicial functions of the court to hear and determine a dispute remain inviolate.

Though there was a further appeal to the Federal Court, the matter was later settled out of court during the pendency of the proceedings at the apex court.[32] Such procedural and legal technicalities have further complicated the adjudication of Islamic finance disputes in the court. Above all and regardless of the Sharīʿah safeguards provided under the law, the entire Islamic finance industry is subject to the overarching legal system of the country that is a by-product of the English common law.

Besides the above challenges facing Islamic finance litigation, the issues of cost and delay are yet to be properly addressed. These are also by-products of legal technicalities involved in court proceedings. Over the years, the Malaysian judiciary had introduced several measures to reduce the backlog of cases in the court. It seems some litigants deliberately cause delays. For example, in *KTL Sdn Bhd v Azrahi Hotels Sdn Bhd (formerly known as Virtual Amber Sdn*

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[30] *Tan Sri Abdul Khalid. Ibrahim vBank Islam Malaysia Bhd* [2012] 7 MLJ 614-618.

[31] [2012] 3 CLJ 249.

[32] Shazwan Mustafa Kamal, "Khalid Confirms out-of-Court Settlement with Bank Islam for Undisclosed Sum," *Malaymail Online*, February 14, 2014, http://www.themalaymailonline.com/malaysia/article/khalid-confirms-out-of-court-settlement-with-bank-islam-for-undisclosed-sum.

Bhd); Advance Hotels Supplies (M) Sdn Bhd & Anor, Supporting Creditors,[33] Vincent Ng J contends that:

> Modern day courts, in this era of rapid development are lumbered with an ever-increasing backlog of cases. Encompassed within this truism are cases where the clearly manifest intention of a defendant or respondent in a proceeding is to secure time to settle rather than to contest the matter, though he may also file rebuttal papers as a matter of formality. A court is naturally impelled to obviate unnecessary expenditure of its time entailed in managing and adjudicating upon matter bereft of a serious intention on the part of the defendant or respondent to join battle. Obviously, in such situations, if the intention is to do battle, armed with cogent or even arguable grounds, the predominant focus would not be to request for time to settle the amount claimed as in the current case where, indeed, the respondent was given more time than it requested. Thus, in the interests of justice and good grace a defendant's or respondent's request for an adjournment of the hearing to another date to settle the matter amicably ought to be allowed; but allowed on terms such that the court's time is not wasted in permitting the latter party to renege on his promise to settle, especially after being given reasonable time – nay, such time as requested – to settle. This is how the concept of 'unless orders' took root in jurisprudence.

Apart from such delays, the cost expended on an ongoing suit is determined by the complexity of legal issues[34] and requirements of evidence[35].

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[33] [2003] 5 MLJ 503 at 508.

[34] Francisco Cabrillo and Sean Fitzpatrick, *The Economics of Courts and Litigation* (Cheltenham, UK: Edward Elgar Publishing, 2008).

[35] Calvin A. Kuenzel, "The Attorney's Fee: Why Not a Cost of Litigation," *Iowa Law Review* 49, no. 1 (1963): 75.

Furthermore, litigation involves confrontation [36] between the disputing parties, and this leads to emotional distress on the part of the customer and reputational risk on the part of the bank. This confrontation is not only necessary to access the true situation of legal issues at hand, but it is also essential in evaluating the reality of facts which is sometimes related to the reputation and good names of the parties involved. Moreover, through such protracted proceedings, emotional distress is developed between the disputing parties. In commercial relationships, the existence of emotional distress could erode trust and confidence between the parties. The elements of trust and confidence are essential in the continuation of commercial relationship in business and for developing the good name and reputation of the parties, especially for the Islamic finance industry as a whole. Therefore, exploring such alternatives to litigation might help to sustain continued business relationship thereby mitigating the risk of the bank's reputation. While one might not discount the relevance and the value of the court system, it might be more appropriate to consider the court forum as the last resort in dispute resolution in Islamic finance.

3. An Overview of Dispute Resolution in Islam

The theory and practice of dispute resolution in Islamic law have developed over time since the early days of Islam. It began with some legal texts in the Qur'an which were practically demonstrated by the Prophet, and hence, the historical precedents were established. Therefore, Islamic dispute resolution (IDR) simply means any process or mechanism that promotes the amicable settlement of disputes, including the court adjudication (*qaḍā*), whose procedure and final outcome are in accordance with Sharī'ah principles.[37] In Islamic law, IDR is not considered as an alternative to the court, but complementary processes to facilitate the process of dispute resolution.[38]

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[36] Rashid, "Alternative Dispute Resolution in the Context of Islamic Law," 118.

[37] Āzād, *Judicial System of Islam*.

[38] Umar A. Oseni, "Dispute Management in Islamic Financial Institutions: A Case Study of near Sukuk Defaults," *Journal of International Trade Law and Policy* 13, no. 3 (2014): 198–214.

Based on the spirit of the *sharīʿah*, confrontation is not the preferred option when there are conflicts, which are ordinarily inevitable in human relationship, particularly in commercial transactions. Compromise through amicable settlement is encouraged in the primary sources of the *sharīʿah* in almost every kind of dispute. The Islamic finance industry is established based on similar Sharī'ah principles which seek to promote mutual satisfaction in financial and commercial dealings. This makes a case for the relevance of IDR as part of the overall dispute management strategy for the Islamic finance industry. The following represent different types of IDR: *ṣulḥ* (negotiation, mediation, compromise of action), *nasīḥah* (counselling or advisory services), *taḥkīm* (arbitration), Med-Arb (which is a combination of *ṣulḥ* and *taḥkīm*), *muḥtasib* (ombudsman), *walī al-mazālim* (special tribunal), and *fatwā al-muftī* (expert determination).[39] The relevant IDR processes in Islamic finance disputes are *ṣulḥ*, *taḥkim*, *nasīḥah*, Med-Arb, *muḥtasib*, and *fatwā al-muftī* due to their suitability with the legal framework of Islamic banking and finance, specifically by referring to Malaysia.[40] Three of this IDR processes are briefly discussed to explain their utilitarian value in the Islamic finance industry.

Advisory roles in the form of counselling (*naṣīḥah*) play a significant role in dispute avoidance which gives a clear-cut direction to every transaction. While this is necessary at the product development stage, it is also important to include a viable governing law and jurisdiction clause in the Master Agreement. This provides a good basis for the *ṣulḥ* process, which should be made a *sine qua non* to exploring any other proceedings in the process of resolving a dispute. The concept of *ṣulḥ* represents the foremost method of IDR.[41] *Ṣulḥ* can be considered as an umbrella concept that exists

[39] Rashid, "Alternative Dispute Resolution in the Context of Islamic Law."

[40] Umar A. Oseni, "Dispute Resolution in the Islamic Finance Industry in Nigeria," *European Journal of Law and Economics*, December 11, 2012, doi:10.1007/s10657-012-9371-y.

[41] Surah Al-Anfāl, verse 1 reads: "They ask you, [O Muhammad], about the bounties [of war]. Say, "The [decision concerning] bounties is for Allah and the Messenger." So fear Allah and amend that which is between you and obey Allah and His Messenger, if you should be believers." Surah Al-Hujūrāt, verses 9-10 read: "And if two factions among the believers should fight, then make settlement between

within other processes of IDR. *Ṣulḥ* can be referred to as a hybrid method of dispute resolution [42], which includes good faith negotiation, mediation, conciliation and compromise of action. The process of *ṣulḥ* is party-driven and the parties are free to stipulate whatever terms and conditions they agree upon in their settlement agreement. Basically, *ṣulḥ* is often regarded as an informal process of IDR. However, when the parties have reached a settlement agreement, it may be binding on the parties where such an agreement is considered a valid contract enforceable in a competent court. This is in line with Article 1531 of *Mejelle* where *ṣulḥ* is defined as "a contract where the parties agree to end a dispute by mutual consent. It is concluded as contract by offer and acceptance". [43] *Ṣulḥ* embodies the spirit of compromise and conciliation as stated in the Qur'an in Chapter 49, verse 10. The most common application of *ṣulḥ* in Malaysia can be traced to the practice of court-annexed mediation in the Sharīʿah Court which is majorly used for the settlement of family disputes. However, one may argue that the Mediation Act 2012 (Act 749) is applicable to Islamic finance disputes, too, as financial issues are not contained in the exclusion list in the Schedule of the law. Section 14(1) of the Mediation Act provides that a settlement agreement is binding on the parties. Therefore, a settlement agreement obtained from an Islamic finance mediation will be binding on the parties, and enforceable in a competent court.

Besides, *ṣulḥ*, the Islamic procedure of arbitration or *taḥkīm* is more suitable to Islamic finance disputes. *Taḥkīm* takes place when an agreement is entered by the disputing parties to appoint a qualified

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the two. But if one of them oppresses the other, then fight against the one that oppresses until it returns to the ordinance of Allah. And if it returns, then make settlement between them in justice and act justly. Indeed, Allah loves those who act justly. The believers are but brothers, so make settlement between your brothers. And fear Allah that you may receive mercy." These are from *Sahih International* translation.

[42] Nora Abdul Hak, Saodah Ahmad, and Umar A. Oseni, *Alternative Dispute Resolution in Islam* (Kuala Lumpur: IIUM Press, 2013), 19–24.

[43] Charles Robert Tyser, D. G. Demetriades, and Ismail Haqqi Effendi, *The Mejelle : Being an English Translation of Majallah El-Ahkam-I-Adliya and a Complete Code on Islamic Civil Law* (Kuala Lumpur: The Other Press, 2007).

person (arbitrator) to settle their dispute by referring to Islamic law through a formal process.[44] The arbitrator is known as *ḥakam* under Islamic law and this is clearly indicated in Article 1790 of *Mejelle* where *taḥkīm* is defined as a process where parties to an action agree to appoint a respectable third party to settle the dispute between them, and such a person is known as an arbitrator (*hakam*)".[45]

Another similar IDR process is through a *muḥtasib* who also has the same authoritative mandate to resolve relevant disputes. While *muḥtasib* is the ombudsman, the institution of *ḥisbah* is an official body that is empowered to ensure moral probity and justice in market dealings as well as in civil transactions. The newly introduced Financial Ombudsman Scheme (FOS) in the Islamic finance industry in Malaysia is based on this concept. The *muḥtasib* practice is both relevant for dispute avoidance and dispute resolution as it provides a grievance remedial mechanism for the industry which does not only ensure prudent market practices, but also consumer protection.

4. The Current Dispute Resolution Mechanisms

From the perspective of the customers, the foremost way of ventilating their grievances is through the channels provided by the banks such as a customer service unit or complaints handling department. However, for the banks, the courts remain the foremost forum to recover outstanding payments in order to mitigate the effects of credit risks. In Malaysia, the current dispute resolution processes commonly used in the Islamic finance industry include the court adjudication, mediation and adjudication at the Financial Mediation Bureau (FMB), arbitration under the i-Arbitration Rules of the Kuala Lumpur Regional Centre for Arbitration (KLRCA), mediation and adjudication of securities disputes by the Securities Industry Dispute Resolution Centre (SIDREC), and the Small Debt Resolution Committee (SDRC) under the Small Debt Resolution Scheme established by Bank Negara Malaysia for small and medium

[44] Abdul Hak, Ahmad, and Oseni, *Alternative Dispute Resolution in Islam*.

[45] Tyser, Demetriades, and Effendi, *The Mejelle : Being an English Translation of Majallah El-Ahkam-I-Adliya and a Complete Code on Islamic Civil Law*.

enterprises. [46] These established modern dispute resolution mechanisms are almost identical to the IDR processes of *qaḍā*, *ṣulḥ*, *muḥtasib* and *taḥkīm*.

The FMB was established by the Central Bank of Malaysia and operates as an independent body that carries out the dispute resolution process through mediation and adjudication between financial service providers who are its members and their customers.[47] The main objective for the establishment of FMB is to redress any discrepancy complaint pertaining to the dealings between the customers or the member of the public at large with their listed members (financial services providers). The Islamic banks are also listed as members of FMB.[48] The decision of FMB binds only the financial service providers and does not bind the customers. Two main processes are used in FMB – mediation and adjudication. While mediation is more party-driven as it is less formal, adjudication is similar to conciliation where a decision is made by the third party neutral. This is similar to *muḥtasib*. The FOS introduced in IFSA 2013 will be operationalized by FMB by scaling up the existing processes to cater for the growing number of complaints, claims and disputes in the Islamic finance industry.

The Securities Industry Dispute Resolution Centre (SIDREC) is similar to FMB, but as the latter is meant for banking and *takāful* disputes, the former is specifically meant for disputes involving investors and capital market intermediaries who are registered as its members. The establishment of SIDREC is based on an approval given under the Capital Markets and Services (Dispute Resolution) Regulations 2010 which identifies SIDREC as an independent body corporate that delivers free services.[49] The members of SIDREC include stockbrokers, derivatives brokers, unit trust management

[46] Umar A. Oseni, "The Legal Framework for Alternative Dispute Resolution in Courts with Shari'ah Jurisdiction in Nigeria, Malaysia and Singapore" (International Islamic University Malaysia, 2011).

[47] Financial Mediation Bureau, "Biro Pengantaraan Kewangan," 2013, http://www.fmb.org.my/index.htm.

[48] Financial Mediation Bureau, "Essential Related Links," 2013, http://www.fmb.org.my/pc05.links.htm.

[49] SIDREC, "Securities Industry Dispute Resolution Centre," 2015, https://sidrec.com.my/.

companies and fund managers. Just like FMB, SIDREC also has the two-tier process of dispute resolution of mediation and adjudication.[50]

Parties may also decide to explore the pioneering dispute resolution process under the KLRCA i-Arbitration Rules. The foundation of arbitration under the KLRCA i-Arbitration Rules can be traced back to the decision of Asian-African Legal Consultative Organization (AALCO) in 1978, where the need for a useful forum for the settlement of disputes with specific references to economics and commerce issues in Asia-Pacific countries was emphasized.[51] This edition of KLRCA i-Arbitration Rules was launched on 20th September 2012 at the Global Islamic Finance Forum 2012.[52] The rules apply to any Sharī'ah compliant commercial transaction, whether those involving the *halal* industry or the banking industry. The rules allow for reference to the Sharī'ah Advisory Council or a Sharī'ah expert to give a resolution or form an opinion on any controversial Sharī'ah principle. While this arbitration process largely satisfies the requirements of *taḥkīm* in Islamic law, there is still the need to ensure full compliance. For instance, while the Frequently Asked Questions (FAQs) appended to the rules clarify that the late payment charges rules have been introduced since the tribunal is unable to award interest on damages, a close scrutiny of the provisions of the rules leaves much to be desired. Rule 12(8)(b) of i-Arbitration Rules provides that unless otherwise agreed upon by the parties, the arbitration tribunal may order interest to be paid on an award. This aspect of the rules may be revised in future revisions.

The court-annexed mediation process, the Kuala Lumpur Court Mediation Centre (KLCMC), provides an avenue for parties to have their disputes mediated within the court system. This practice was introduced by Practice Direction No. 5/2010 issued by the Chief Justice, which encourages judges to identify disputes that are amenable to mediation at the case management stage. If the parties

[50] Ibid.

[51] Kuala Lumpur Regional Centre for Arbitration, "Kuala Lumpur Regional Centre for Arbitration (KLRCA) (2013). KLRCA I-Arbitration Rules," 2013, http://www.klrca.org.my/scripts/list-posting.asp?recordid=288.

[52] Ibid.

agree, they have to enter into an agreement by completing the relevant form (Form 1). The mediation process is usually conducted in accordance to the wishes of the parties. The parties have the option to either continue with the mediation process facilitated by a judge (judge-led mediation) or refuse to settle amicably, which would take them back to the courtroom. The sitting judge makes the referral to KLCMC within one month of the filing of the case and settlement is usually expected within 3 months. The process of mediation is completely done in private and in a confidential manner. Although the KLCMC has performed well over the years since its establishment, it has not been so successful in mediating Islamic finance disputes; some Islamic finance disputes referred to it were duly mediated, but the mediation failed and the parties returned to the courtroom for normal proceedings.[53]

5. The Way Forward

As established in this study, the courts are indispensable in the process of dispute resolution in Islamic finance when it comes to issues relating to certainty, predictability and enforceability. However, as the litigation process has metamorphosed over the decades, coupled with the influence of English law principles applied to Islamic finance matters, there has arisen a need to consider ways to ensure Sharīʿah-compliance of the process. This is further justified with the abundant legal principles and concepts in Islamic legal theory that provide for amicable dispute settlement. Therefore, one would ordinarily expect that IDR processes to be applied to anything related to Islamic law such as Islamic banking and finance matters.

Considering the strides recorded in the Malaysian Islamic finance industry with the introduction of dispute management processes in IFSA 2013, and the fact that the FOS is Sharīʿah-compliant, there is a need to take a step further to ensure that the procedure used in materialising the FOS is Sharīʿah-

[53] The fact was revealed during the Question and Answer session where Umar A. Oseni asked the Director of the Kuala Lumpur Court Mediation Centre (KLCMC) about the number of Islamic finance cases the KLCMC has handled. ILKPA, "Forum on Court Annexed Mediation - The Way Forward", organised by Judicial and Legal Training Institute, Malaysia (ILKAP), on 19th JUNE 2013.

compliant. Necessary Sharīʿah-compliance safeguards should be introduced in the procedure to ensure that the final out-come, award or decision does not violate any fundamental principle of the *sharīʿah*. A perusal of the Concept Paper on Financial Ombudsman Scheme released by Bank Negara Malaysia on 29 August 2014 reveals that the FOS operator is required to uphold the following underlying principles: independence, fairness and impartiality, accessibility, accountability, transparency, and effectiveness. [54] When properly implemented, these underlying principles are considered as Sharīʿah-compliant as they all represent the building blocks of an effective dispute resolution framework in Islamic law.

One notable observation in the Concept Paper on FOS with far-reaching implications is the absence of referral procedure to Sharīʿah expert or Sharīʿah Advisory Council. There should be some sort of Sharīʿah safeguards through a final endorsement of every decision of the FOS. While it may not be practicable for SAC members to sit to resolve disputes, as that transcends their statutory role, it might be necessary to include a requirement that FOS utilize the resolutions of SAC or even refer some specific issues to SAC when there are controversial Sharīʿah issues in a dispute before it. One may want to dispute this submission on the basis that every financial dispute can be resolved in the same way and manner; hence, the provisions on FOS in IFSA 2013 and FSA 2013 are exactly the same. Though one may concede that the procedure and process may be similar, but the substantive rules may be different, resulting in different outcomes. Even the process of determining the final outcome, decision or award is different. The courts and arbitral tribunals have even realized this, hence, the need for a statutorily-imposed Sharīʿah reference to SAC when there is a controversy on a Sharīʿah issue. Then, what makes FOS an exception to this highly commendable practice?

From the practical side of the discussion, application of the fundamental principles of IDR may be carried out in three different stages: contract and documentation stage, execution of the contract period, and post-contract stage. For an end-to-end Sharīʿah compliance, parties must ensure the entire process in each stage is

[54] Lee and Oseni, *IFSA 2013: Commentaries on Islamic Banking and Finance.*

Sharī‘ah-compliant. Apart from the principle of party autonomy that empowers the parties to stipulate their terms and conditions, the existing laws in Malaysia have introduced necessary Sharī‘ah safeguards to ensure such end-to-end compliance. During the first stage, which is the contract and documentation stage, parties must ensure all the terms are Sharī‘ah-compliant. The common practice in the Islamic finance industry is to adopt standard templates which provide for the governing law or jurisdiction clause. Parties might need to take a step further to emphasize that the dispute resolution process must be Sharī‘ah-compliant.

The second stage requires a proper dispute management framework to ensure that complaints, claims, and minor disputes are properly managed to avoid further escalation into full-blown disputes. This is where the Islamic banks should scale up their customer services system. One is not oblivious of the existence of feedback and complaint handling services in most of the Islamic banks in Malaysia. This may require further structuring to ensure that the principles of consumer protection are maintained without compromising the rights and privileges of the bank itself. After all, the basic principle of commercial contracts in Islamic law is mutual satisfaction. This must be reflected in the entire process adopted during the execution stage of the contract.

In the third stage, any step taken by either party to enforce any right in an appropriate forum should not violate any Sharī‘ah principles. In most cases, once there is a breach of contract such as a payment default in a Sharī‘ah-compliant home financing, the aggrieved party must ensure the process is in line with the original value proposition of Islamic financial intermediation. The courts may be helpful in recovering outstanding debts, but the banks may explore other alternatives that may not cause hardship to the client in line with the injunctions in the Qur’an 2: 280 which stipulates: “And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [from your right as] charity, then it is better for you, if you only knew.” Though one would admit that Islamic banks are not necessarily charitable organizations, as they are established as business outfits, the banks may explore the possibilities of introducing good refinancing or restructuring

mechanisms to overcome such defaults as part of the overall strategies for dispute management.

6. Conclusion

Malaysia has been at the forefront in deep-rooted legal reforms specifically meant to transform the financial industry for the past few decades. With the latest commendable efforts to set up two different legal and regulatory frameworks for both the conventional and Islamic finance industries under different laws, albeit under the same umbrella of the apex bank, there is ample opportunity for innovative guidelines that will shape the face of the dispute resolution landscape. This paper has focused on the need to introduce guidelines under the IFSA 2013 that regulates the Islamic finance industry in the country. Such guidelines should reflect the unique nature of Islamic finance transactions, which takes into consideration the Sharīʿah-compliant nature of the whole process involved in negotiation, documentation, and execution of related transactions, including post-contract issues such as dispute resolution. In order to actualize this in the very spirit of the original value proposition of Islamic financial intermediation, the dispute resolution processes should not just mirror conventional mechanisms, but should go a step further to streamline such processes to reflect the classical processes of dispute resolution in Islamic law which seem to be an untapped treasure-trove for the modern Islamic finance industry. Though the newly introduced FOS might not be suitable for all cases due to the financial limit of such a scheme, it is expected that the new guidelines from the apex bank will expand the financial limits of the existing FMB and embed the FOS to other existing mechanisms for dispute resolutions in order to promote an Islamic-based multi-tiered process for dispute resolution in the Islamic finance industry.

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