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Revisiting Islamic Finance Arbitration: An Opportunity for Malaysia?

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Aside from providing great entertainment, films such as *Wall Street* and *The Big Short* have taught us that there are numerous complex financial products which are regularly created within the banking and finance industry that could give rise to disputes.

Traditionally, litigation has been the mode of choice for resolving banking and finance disputes. However, the aftermath of the 2008 global financial crisis has resulted in the steady increase of using international arbitration to resolve certain financial disputes, especially those of a transnational nature, such as cross-border swaps and derivatives transactions.

Despite this trend, one area which is arguably yet to fully embrace international arbitration is Islamic finance. The ICC Task Force on Financial Institutions and International Arbitration suggested that this was attributable to the potential lack of desire on the part of major Islamic banks and financial institutions to have disputes relating to Islamic finance decided by arbitrators in accordance with Shari'a principles. Alternatively, it could also be due to a lack of awareness of the products and services available to deliver a Shari'a-compliant dispute resolution process. This post will explore these issues in the context of choice of law issues in Islamic finance disputes and Malaysia's suitability as a hub for Islamic finance arbitration.

What is Islamic Finance?

According to S&P Global Ratings' Islamic Finance Outlook for 2020, the Islamic finance sector, which is predominately centralised around the Middle East, Africa and South East Asian regions, is presently worth more than US$2.1 trillion.

The economics underlying Islamic finance have been around for more than a millennium and are vastly different from those of the conventional banking industry. The four core concepts of Islamic finance are that the products must be *halal* (i.e. investments should be in compliance with Shari'a principles) as opposed to *haram* (i.e. in prohibited industries), interest or excessive gain is prohibited (*riba*), as is engaging in uncertain (*gharar*) or speculative transactions such as gambling (*maysir*). Social justice is also facilitated through the systems of profit and loss sharing and requiring *zakat* (taxing of property of people who acquire wealth and distributing the same to people in need).

In terms of the financial instruments available in the industry, there are profit-and-loss sharing partnerships (*mudarabah)*, profit-and-loss sharing joint ventures (*musharakah*), and leasing (*ijarah)* arrangements, to name a few. Also available are Shari'a compliant fixed-income instruments (*sukuk)* and insurance arrangements (*takaful*). Irrespective of the product offering, it is imperative for any Shari'a product to maintain compliance with Shari'a principles throughout the lifecycle of the Islamic finance transaction.

Choice of law issues in Islamic finance transactions

Where money is involved, there may be commercial disputes. The obvious choice for resolving disputes arising from Islamic finance transactions would be for an Islamic finance or Shari'a law expert to get involved in dispute resolution process. In this regard, arbitration seems to be the go-to dispute resolution option given that parties have the autonomy to either contract in advance, or submit post-dispute, that the appointed tribunal is to have certain expertise.

However, most often, Islamic finance disputes are intentionally referred to civil courts which generally do not have the specialist expertise to address Shari'a compliance issues. Where this is the case, such disputes are resolved on the basis of the governing law, which often is English law in the context of cross-border Islamic finance disputes. Also noticeable is that there are some Islamic financing arrangements that may expressly exclude the application of Shari'a in determining the dispute and instead opts for a secular law in a jurisdiction well established to deal with financial disputes, such as English or New York law.

On the other hand, there are also some Islamic finance transactions where the underlying contract may contain a governing law clause which refers to both a national law and Shari'a. The English Court of Appeal considered such a clause in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain* [2004] EWCA Civ 19. In that case, it held that the reference to the agreement being governed by the laws of England "[s]ubject to the principles of the Glorious Sharia", was not enforceable because the language was intended to reflect the religious principles by which the Bank had held itself out as conducting business, as opposed to expressly trumping the application of English law. However, in *Sanghi Polyesters Ltd (India) v The International Investor KCFC (Kuwait)* [2000] 1 Lloyd's Rep. 480, the English High Court permitted the enforcement of an arbitral award where the arbitrator, who was a Shari'a expert, disallowed claims for additional damages on the grounds that such claims, although compliant with English law, were not compliant with Shari'a. The governing law in that dispute provided for English law "except to the extent that it may conflict with Islamic Shari'a which shall prevail".

However, such issues relating to the choice of law in Islamic finance transactions should not deter parties from opting to resolve their disputes using arbitration. This is especially so given that certain jurisdictions, such as Dubai and Malaysia, have arbitration frameworks to ensure compliance with Shari'a.

Malaysia's Potential to become a hub for Islamic Finance Arbitration

To date, Kuala Lumpur is considered a leading centre for Islamic finance. Indeed, Malaysia is one of the world's largest issuers of *Sukuk* having issued nearly US$19.4B in the first half of 2018

alone. This industry expertise places Malaysia on a strong footing to spearhead the growth of Islamic finance arbitration.

A prime benefit of resolving Islamic finance disputes in Malaysia is that the national legal framework explicitly supports the resolution of Islamic finance disputes through civil proceedings or arbitration. Specifically, Section 56 of the *Central Bank Act 2009 (*the "Act") provides that where a question arises in a court or arbitration proceeding with respect to a Shari'a matter, the court or the arbitral tribunal shall either: (a) take into consideration any published ruling issued by the Shariah Advisory Council ("SAC") on that question, or (b) refer the question to the SAC for a ruling which shall be binding on the court or arbitral tribunal.

The SAC is a body which was established under the Act to, *inter alia*, advise the Central Bank of Malaysia (Bank Negara Malaysia) and Islamic finance institutions on matters relating to Shari'a law and compliance. In a recent landmark decision, the Malaysian Federal Court, by majority, held that the powers of the SAC were not unconstitutional because the SAC does not exercise a judicial function; rather, its purpose is to ascertain Islamic law for the purpose of Islamic finance disputes, which are binding on courts in the interest of harmonising the proliferation of Shari'a opinions in the industry. This, in turn, conserves and protects public interest.

A similar provision is reflected in the AIAC i-Arbitration Rules 2018. Specifically, Rule 11 contains a detailed provision on references to the SAC, or a Shari'a expert, whenever the arbitral tribunal has to form an opinion on a point related to Shari'a principles and decide on a dispute arising from a Shari'a aspect of the contract. Further, Rule 6(g) permits the arbitral tribunal to award a late payment charge on the awarded sum, determined by applying the principles of *ta'widh* and *gharamah*, in lieu of awarding pre- or post-award interest. Additionally, the AIAC i-Arbitration Rules 2018 also provide for the technical review of awards, which are aimed verifying the procedural aspects of the dispute and ensuring that the award meets the formal requirements at the seat, to minimise any issues with enforcement. Granted, these rules require some reworking to reflect best standards in international arbitration practice, but they are a good example of how Shari'a compliance can be facilitated through institutional arbitration.

With respect to the choice of law issue highlighted above, the 2018 amendments to Section 30 of Malaysia's Arbitration Act 2005 clarify that the arbitral tribunal, in both domestic and international arbitrations, shall decide the dispute in accordance with *such rules of law* as are chosen by the parties as applicable to the substance of the dispute. The reference to "such rules of law" is arguably broad enough to encapsulate an agreement where the substantive law provision only makes reference to Shari'a, or a combination of a national law and Shari'a.

The Way Forward

Despite the above-mentioned advantages of arbitrating Islamic finance disputes in Malaysia, the uptake of the same has been low across the board. However, in light of the World Bank's recent remarks on the potential of using Islamic finance to alleviate the impact of COVID-19, and Malaysia's role as a global leader in effecting the same, it is likely that the remainder of this new decade will see a flourishing of Islamic finance activity, and hopefully, greater use of arbitration as the preferred dispute resolution tool. In this regard, the AIAC will also be making a greater investment to revitalise its Islamic arbitration offering in the near future.

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