The Challenges of Alternative Dispute Resolution for Islamic Finance in Malaysia

(Cabaran Penyelesaian Pertikaian Alternatif dalam Kewangan Islam di Malaysia)

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ABSTRACT

Malaysia’s authority on Islamic Finance is recognized worldwide. Islamic finance benefits and advantages have helped to develop many countries regardless of religions or communities. However, many countries such as United Kingdom, UEA, Asian countries that are adopting Islamic finance will bound to encounter some disputes through the Islamic finance application. This article provides some insights on the judgment of Malaysian court (Muamalat court) and seek to evaluate the best way for Malaysia to approach the issues. Issues such as whether financial products offered by Islamic banking institutions are Sharia compliant and whether the terms and conditions of the contracts embodied in such products are fair to all parties involved. It is suggested that while a Malaysian court have long solved many disputes through its application, it is still possible for future disputes be resolved using Alternative Dispute Resolution.

Keywords: Islamic finance; Muamalat Court; alternative dispute resolution; justice

ISLAMIC PRINCIPLES IN THE FINANCIAL SECTOR

Islam has long affected the way of life of community. Today the Islamic teachings related to financial issues or muamalat has dabbled for a foothold in Malaysia as an alternative to the conventional financial issues. Islamic finance bans the practice of usury and gharar and this may attract non-Muslims to join the Islamic financial market. Islam is not merely relevant to the belief and religion but a complete way of life, including participation in economic activities. In fact, the business activities are focused in Islam, and in addition to undergo rites of religion, Muslims are encouraged to get involved and succeed in economic activities as stated in the Qur’an:

Believe in Allah and His Messenger and spend out of that in which He has made you successors. For those who have believed among you and spent, there will be a great reward.

Do not usurp one another’s property by unjust means, nor offer it to the judges (as bribe) so that you may devour knowingly and unjustly a portion of the goods of others.

The above verses show that Muslim community is encouraged to participate in business activities. Its aim is to improve their way of life towards seriousness and transparency.

According to Mittelstaedt, in order to achieve the macro market, one of the factors to be considered is the effect of religion on the market based on the standard of business ethics. Explore the ins and outs of marketing and business ethics necessarily linked to moral and ethical authority prescribed by religion. Mittelstaedt’s research are also evidenced in the research Klein research. Klein proves that religion has a big influence on the market that affect aspects of what, how, where and when a market activity can be practiced.
In addition, Islamic financial issues and Islamic transaction (muamalat) often associated with the use of maqasid shariah. Maqasid Al-Shariah or objectives of shariah are classified in various ways. Traditional classifications of maqasid divide them into three level of necessity, which are necessities (darurat), needs (hajiyat) and luxuries (tahsiniyat). Necessities are further classified into what ‘preserves one’s faith, soul, wealth, mind and offspring.’ These necessities were considered essential matters for human life itself. There is also a general agreement that the preservation of these necessities is the ‘objectives behind any revealed law.’

Next, contemporary classifications of maqasid has introduced new universal maqasid that were directly induced from the scripts, rather than from the body of fiqh literature in the schools of Islamic law. This approach, significantly, allowed maqasid to overcome the historicity of fiqh edicts and represent the scripts’ higher values and principles. Based on Rashid Rida, he had surveyed the Quran to identify its maqasid, which included, ‘reform of the pillars of faith, and spreading awareness that Islam is the religion of pure natural disposition, reason, knowledge, wisdom, proof, freedom, independence, social, political and economic reform, and women’s rights.

Mohammad al-Ghazaly had called the term of maqasid as the ‘Learning lesson from the previous 14th centuries of Islamic history,’ and therefore, included ‘justice and freedom’ in maqasid at the necessities level. The above maqasid were presented as they appeared in the minds and perceptions of the above jurists. None of the above classical or contemporary classifications and structures could claim to be ‘according to the original divine will.’ According to Jasser Auda, Maqasid al-Shariah is best described as a multi-dimensional structure in which it includes level of necessity, scope of rulings, universality that represent valid classifications of perspectives.

According to Woodley, the Islamic economics emerged as a concept in the 1970s. The main feature is the prohibition of usury in Islamic economics and a ban on business or any activity related to alcohol, interest, gambling and pork. Furthermore, Obaidullah emphasized that in an Islamic economic system, all transactions will be carried out based on the norms of Islamic ethics as applied in the shariah. Basically Islamic financial system can be described as ‘fair’ in accordance to shariah law. The Islamic financial system allows the freedom to make any transactions. But this does not mean that there is no restriction of freedom, as the prohibition of usury and Gharar (risk of unclear or uncertain) still controlled and banned its practice in any practice of the Islamic financial system.

Based on Cebeci, the relationship of Islamic financial with the development in the society is known as ‘Maslaha.’ Despite the booming of Islamic finance in the society, there are also some challenges. For example, firstly, most of the Islamic business products have been influenced by elements of capitalism in the market. Second, the practice of Islamic banking products are said to be unprofitable. Islamic banks do not give money to get money exchanged. Instead, money is managed to produce other Islamic business contracts such as partnerships, leasing and others. As a result, advantages of the Islamic financial system failed to attract public attention. Furthermore, the influence of political bodies and international organizations are more likely to support the elements of capitalism and laissez faire principles compared to Islamic Financial system.

Adam Smith seemed to give more intellectual credence to laissez faire economics when his writings showed how if individuals pursue their own self-interest in can end up being for the public good. This seemed to be justification for minimal government intervention and leaving economies to the invisible hand of the market. Some of the benefits of laissez faire principles are they avoid the distortion of tariffs and welfare loss. Free trade is an important principle of maximising economic welfare and enabling countries to mutually profit from trade. Other than that, this principle creates market incentives. The main principle of laissez faire principles is that entrepreneurs, workers and firms have an incentive to work hard and create goods that consumers want. Inefficient firms will tend to go out of business, creating a dynamic of creative destruction and increased efficiency.

The principle of laissez faire had dominated economic transition and structural adjustment policies (as proposed by bodies such as the IMF and the World Bank). Despite statements about the need to provide social welfare network (for those who have suffered loss as a result of economic development), social welfare has been ignored in favour of the current economic efficiency. Adam Smith also had raised the problem of monopolies, which can arise under an economic system of laissez faire. Monopolies can charge higher prices, restrict supply, and those firms with monopsony power can pay lower wages to workers. Wealth and opportunity tend to get inherited, and those with limited opportunities, struggle to compete against established interests. Far from creating an equal playing field, laissez faire enables powerful vested interests to dominate wealth and income.

Laissez faire market is that it has a built in possibility of distortions in the smooth functioning of the market economy, mainly on account of the unbridled ‘profit motive’ leading to focus on enrichment without any care for the impact on others or the society. Due to the low importance for the growth of marginalised sections, their education, health care, and infrastructure development in remote and rural areas, the possibility of achieving inclusive social development is very less under the free market model of the capitalism.

In contrast, the concept of profit optimisation can be best explained as the earning of more and more profit
by doing business with Islamic rules and regulations and by observing strict adherence to socio-economic equity. Even inside a free market, Islam instructs to overcome the love for wealth, to follow moderate consumption by achieving needs and setting aside the wants, and to spend in excess on others, especially the poor and destitute.39

JUSTICE AND EQUALITY IN ISLAMIC FINANCE

The practice of the Islamic financial system is different from the conventional financial system, namely because of the impermissibility on the use of usury and gharar enforced in the shariah.39 Its aim is to balance the need for moral and material needs of the community and uphold justice as well as fairness in their social and economic aspects. This is all based on the teachings of Islam which emphasizes the concept of justice.

Several verses of the al-Quran stating/emphasizing under which explained that all financial matters should be documented are:

O you who have believed, do not consume one another’s wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful.32

The following hadith in which Abu Said narrated that the Prophet stated: “Any dealer that are honest and trustworthy, will be with the Prophet, among the righteous and the martyrs.”32 This particular hadith explained that trading was one of the most honourable professions and people were taught to be generous in their dealings with one another.

In the western perspectives, Rayner33 described the Islamic finance practices is any financial matter that are documented that contained these have four elements in their property contract (mal): that is halal, the existence of a merchandise, delivery and accurate determination. Beck et.al34 also highlighted the five principles that distinguished Islamic finance with conventional finance. The first principle is that judicial authorities in a country that practices Islam will characterize the market to ban usury. The second principle is the principle of prohibiting the practice of gharar and the third is to prohibit funding for illegal products (such as weapons, drugs, alcohol, and pork). For the fourth principle, all gains profits and losses must be shared equally. Finally, the fifth principle states that respective transactions should involve tangible assets.

In the same way, the definition of profit here too must reflect the compassioned aspects in its approach. In addition, any definition of profit is not necessarily a rationalize behaviour based solely on the expected reward in the hereafter, but also include temporal compensated financially possible. In an atmosphere of Islamic Finance, the real ‘profit’ is in the afterlife, and the pursuit of worldly gain is acceptable as long as it contributes to this goal.35

In summary, the Islamic Finance market can exist in many forms, and so on, their internal structure, which will also be subjected to different social context, religion, and history. Competition is not an essential element of the market. It is considered as the profit motivator and not an essential prerequisite for showing the market behaviour.

EVOLUTION OF ISLAMIC FINANCE IN MALAYSIA

Equitable economic development is an important element to achieve justice and equality in a society that consists of different races. In reality, Malaysia is a country with a multi-ethnic societies, multi-religious and multicultural. Therefore the concept of justice and fairness are different from other countries, particularly countries that have homogeneous society.

The supreme law of Malaysia stated that Islam is the official religion. Two different legal systems are needed in order not to overlap each other. Two different legal systems consists of civil law and Shariah. When it comes to the financial aspect, Malaysia is a country that practices two different economic systems, namely the system of Islamic finance and conventional finance system.26

The system of Islamic finance in Malaysia mainly focusing towards the Islamic banking products. The diversity of the Islamic banking products that are based on the principles of Sharia has attracted interest of banking consumers, Muslims and non-Muslims alike, which resulted in increase in demand for such products. One of the attractive factors of Islamic banking products that brought about this surge in demand is that because Islamic financial products have no elements of riba (usury) and gharar (uncertainty). Further, they are also confined to lawful activities, perceived as fair and must of all it is in accordance with Islamic teachings (which is a selling factor for Muslim consumers).

Islamic banking is built on the principle which prohibit the acceptance of interest (riba). It reflects the concept of fairness manifested through the concept of profit and loss sharing and prohibiting of the practice of riba. In a number of court cases, this principle of Sharia law is reiterated over and over again i.e. any business or commercial activity must be fair and equitable.27 In the case of Bank Islam Malaysia Bhd v Rhea Zadani Corp Sdn Bhd,28 CIMB Islamic Bank Bhd v LCL Corp Bhd & Anor29 Bank Muamalat Malaysia Bhd v Kong Sun Enterprise Sdn Bhd & Anor30 and Tan Sri Abdul Khalid Bin Ibrahim v Bank Islam Malaysia Bhd,31 two general issues were raised, namely, whether financial products offered by Islamic banking institutions are Sharia compliant and whether the terms and conditions of the contracts embodied in such products are fair to all parties involved.
The establishment of courts play an important role in avoiding exploitation and unfairness. The courts will deal with the contracts between the banks and their customers where they can read just the contractual obligations judicially if the parties are unable to settle disputes amicably. The role of the judges too is to set aside a contract which is grossly unfair to one of the parties.  

ESTABLISHMENT OF THE MUAMALAT COURT

According to Abdul Hamid Mohamad, the Islamic banking cases should not transfer their jurisdiction from the civil court to shariah courts. This is because, the cases being tried did not concern with the Islamic laws. The Islamic finance cases usually deal with land law, company law and other civil matters. Second reason is the cases include parties that are non-Muslim. shariah court do not have jurisdiction over the non-Muslims. The third reason, the shariah courts are state courts, independent of each other and with their own appellate court. The scope of the jurisdiction in shariah law is limited by the Federal Constitution. In addition, there is no special jurisdiction for issues on Islamic Financial Transactions provided. Referring to the High Court Act 1964, the law empowers the civil court to carry out legal actions relating to civil matters, including matters related to muamalat and Islamic Finance.

The establishment of the muamalat court is in line with government’s plans to make Malaysia a centre of Islamic Banking and Finance. As a result, the Department of Justice has established a special division under the Civil Court to deal with matters relating to Islamic banking and finances based on Practice Direction No. 1 of 2003, issued by the former Chief Justice, Dato’ Haidar Mohd Nor. Since 2003, muamalat case was registered under Commercial Courts 4 and awarded a special reference code. At first, the case heard in court Trade 4 is a mixture of Islamic banking and other commercial cases.  

The muamalat court has also similar jurisdiction with any of the High Court in Malaysia under the provisions of the Courts of Judicature Act 1964. There are existence of Court of Appeal for muamalat cases. These muamalat appeal cases are categorised under the Full Trial Civil Appeals, in collateral with five other sub-categories which are the New Commercial Court Appeals, New Civil Court Appeals, Intellectual Property Appeals and Admiralty Appeals.

In addition to that, the jurisdiction of the muamalat court also has to hear the case of specialization in Islamic banking and finance. In these courts, shariah issues will be referred to the Shariah Advisory Council (SAC) of Bank Negara Malaysia. Reference to the SAC is based on Section 56 of the Central Bank Act 2009, in which they will be the expert to decide on shariah issues relating to Islamic banking and finance. As a result, the establishment of the muamalat court has made Malaysia the first country to have a court system that is structured to determine the principles of shariah and legal issues in the field of Islamic finance.

However, according to Rusni Hassan, Mohammad Azam Hussain and Adnan Yusoff, the trial process in muamalat court has some drawbacks. For example, the number of judges involved in solving all cases as fast as possible in line with the rapid development of the Islamic financial sector itself. Secondly, the yearly increase in the number of cases registered in muamalat court. The increased number of cases involving Islamic finance in Kuala Lumpur muamalat court can be seen in the figure below.
There are also special code for muamalat case that should be a reference and guidance to the courts and lawyers. It shows that the muamalat cases should be treated differently from ordinary commercial cases. The classification code may be practical in the High Court in Kuala Lumpur and the muamalat courts, but still not effective at any other levels of the state in Malaysia. The special code for all Islamic banking and finance cases that are filed at the muamalat court at Kuala Lumpur High Court are Code 22M (previously Code 22A) for civil suits based on writ action and Code 22MF (previously Code 24A) for foreclosure matter and action based on originating summons. This muamalat court comprises of one High Court judge, one deputy registrar and one senior assistant registrar. Furthermore, according to Ahmad Hidayat Buang,\textsuperscript{39} muamalat court could not provide a suitable solution since the core of the matter is the application of laws other than the shariah in Islamic finance cases.

In addition to that, the procedures and practice of the muamalat court is not different from other courts within the Commercial Division of the Kuala Lumpur High Court. The practice direction issued by court does not provide any special procedure for adjudication of Islamic finance cases.\textsuperscript{79} As for selection of judges in the muamalat court, there is no requirement imposed that the judges must have adequate knowledge in shariah laws and well trained in Islamic banking and finance. There is no specialist judge trained in Islamic banking or finance and thus he encourages the Islamic financial disputes to be referred to alternative dispute resolution avenues. Due to lack of judges who are qualified and competent in both civil laws and Islamic finance practice to head the muamalat court, the setting up of muamalat court \textit{per se} does not provide an antidote to the problems in Islamic finance litigation.\textsuperscript{40}

Looking at the diversity of barriers in the legal framework, Islamic finance dispute may be resolved when conducted by other than trial in a court which is the alternative dispute resolution (\textit{ADR}) in Islam. \textit{ADR} in Islam can be defined as a procedure that acts as an alternative to legal action to resolve the dispute. It can be formal (e.g. arbitration rules) or informal (e.g. negotiation and mediation methods). It is a private process and its decision will bind \textit{ADR} process when agreed by the parties involved. Any disputes that have reached a mutual agreement, any of the \textit{ADR} method will give an award in which the process was created by an independent tribunal (e.g. by an arbitrator, mediator and more).

DIFERENCES BETWEEN SETTLEMENT THROUGH COURT AND ALTERNATIVE DISPUTE RESOLUTION

Under Article 4 (1) and 128 of the Federal Constitution, the courts has the power to review the legality of legislative and executive actions by reference to the norms of the legal system. The doctrine of precedent will bind the decisions in the judicial system. It is intended to promote the principles of justice applied in cases that have similarities. It is also to ensure there is no doubt, stability and predictability in the judicial process.\textsuperscript{41}

The purpose of applying or referring to the doctrine of precedent is based on a hierarchy of decision in court. The implication on the doctrine of precedent is based on the principle that the decisions of the higher courts will be binding on the lower courts. However, the judges of the superior courts may refuse to be bound by the doctrine of precedent, they may reject the decision of the previous court if the case is related to the appeal and the decision of the previous cases decided \textit{per incuriam}.\textsuperscript{42}

The practice on doctrine of precedent is in contrast to litigation for \textit{ADR} methods. In order to solve any disputes in any field or aspect of alternative dispute resolution methods, \textit{ADR} will evaluate a dispute through discussion with parties involved and not to resolve them by the doctrine of precedent. Any disputes that are resolved by \textit{ADR}, the procedures and its solutions will be restructure accordingly and must obtained favourable decisions to all parties involved. Among the methods of \textit{ADR} practiced in Malaysia such as method of arbitration, conciliation, mediation and others.

There are other dispute resolution mechanisms available to the parties to resolve their disputes without going to court. The method of alternative dispute resolution is an appropriate way to resolve the dispute, based on freedom of choice towards the law and procedures of their dispute. According to “The Star,”\textsuperscript{43} \textit{ADR} methods which is conciliation method is one of the important settlement mechanism to resolve problems in the employment sector.

\textit{ADR} is not new in the legal system. Its development and its implementation has been widely practiced throughout the world and Malaysia is part of this development. Among the \textit{ADR/ADR} in Islam method as practiced in Malaysia are arbitration, conciliation, mediation and \textit{Sulh} methods. \textit{ADR} in Malaysia was launched with the introduction of the Arbitration Act 1952, which was later replaced by the Arbitration Act 2005.

Malaysian regulatory framework provides two resolution mechanisms for the disputes in Islamic banking, which is known as litigation or arbitration as provided in Section 56 of the Central Bank Act 2009. This section states that proceedings relating to Islamic banking and finance can be made through the court and the arbitral par subject to the reference made to the Shariah Advisory Council.\textsuperscript{44} Even with reference to the outcome of the case of \textit{Bank Islam Malaysia Bhd v Adnan bin Omar}\textsuperscript{45} the parties may, however, choose to resolve disputes in Islamic finance through arbitration or mediation provided that the \textit{ADR} provision should be included in the agreement (section 24 (4) of the Courts
of Judicature Act 1964). The parties would then have the right to choose an arbitrator or mediator who specializes in Islamic finance to resolve the case. The arbitrator’s decision is final and need no reference to the court.\textsuperscript{46}

Arbitration and mediation is a method that is often practiced in ADR’s financial disputes in Malaysia.\textsuperscript{47} Arbitration is a dispute resolution methods that require disputants presenting their case before an independent arbitrator, impartiality and an expert who has knowledge of the law. When questioning any issues arise, the arbitrator will make a decision. If the parties involved have reach an agreement, the decision will be binding.\textsuperscript{48} Whereas mediation method is a process in which a third party (neutral party) try to reach an agreed settlement of their conflict.\textsuperscript{49}

Arbitration is one of the ADR approach which can reduce the time and cost when achieving a solution. There is a term which said arbitration rules is ‘Businessman’s method of resolving disputes’ which are administered by federal law, and based on the rules of arbitration. Bennett\textsuperscript{50} had mentioned that ADR is neutral process, like a judge who serves as the decision maker and provide all parties involved the merit assessment in every aspect of the case.

Asian International Arbitration Centre (AIAC)\textsuperscript{51} or formerly known as Kuala Lumpur Regional Centre for Arbitration (KLRCA) is the centre where arbitration method is an option for those who seek alternative solution involving financial matters. AIAC was established in 1978 by the Association of Asian-African Legal Consultative Organization (AALCO) to provide institutional support as a neutral and independent to conduct the arbitration in domestic and international markets. By virtue of an agreement between the Government of Malaysia and AALCO, the Malaysian Government to support the establishment of a regional centre for commercial arbitration in Kuala Lumpur and agreed to provide for the establishment of the centre. AIAC capable with certain privileges and freedom to carry out its function as an international institution.

When any Islamic finance matters is involved, the I-Arbitration method will be referred. There are rules pertaining to Islamic finance matters when it comes to arbitration methods. Rules for AIAC Arbitration (Islamic Banking and Financial Services) Act 2007 is associated with any commercial arbitration contracts, business or transaction based on Sharia principles. Therefore, any dispute arising out of any financial transaction which is subject to Sharia arbitration process shall be in accordance with the Regulations AIAC (Islamic Banking and Financial Services) Act 2007.

Among the dispute that may adopt arbitration under the Rules AIAC is as follows:

Any dispute, controversy or claim arising out of the business relating to Islamic finance, Islamic banking, takaful, Islamic capital market products or services or any other business transactions based on Sharia principles of this agreement/contract shall be decided by arbitration in accordance with the Rules of AIAC (Islamic Banking and Financial Services).\textsuperscript{52}

However, according to Sundra Rajoo\textsuperscript{53} (Director of AIAC), statistics for cases registered for arbitration were 85 cases in 2012. In 2013, cases registered for applying the arbitration method is increasing by 156 cases. Subsequently in 2014 also showed an increase of 226 cases, 20% of which being international cases. However, no Islamic finance-related cases have been reported so far.

\begin{figure}[h]
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\includegraphics[width=\textwidth]{chart.png}
\caption{Statistic on Commercial Dispute cases solve by Arbitration method (KLRCA) (2012-2016)}
\end{figure}
Another ADR in Islam method that currently not yet venture into the field of Islamic finance is the Sulh method. According to Oseni, any case involving the proper management of waqf assets is better settled by Sulh instead of a court declaration. Intermediary methods in the syariah law involve compromising action, which is practical demonstration with the initiative and give-and-take initiative. When parties consider the option to choose a Sulh, it is not a difficult step to proceed. He further mentioned that in Malaysia, all issues related to Islamic financial issues will refer to the Bank Negara Syariah Advisory Council. As such, the Sulh Officer will also be referring to the Bank Negara Shariah Advisory Council in assisting to reduce the number of problems existing in the Islamic finance industry in Malaysia.

Hence, an ADR is a step that can overcome the dispute that will be experienced in the field of Islamic finance. This is because the procedures in alternative dispute resolution are divided into two categories namely formal and informal method. The formal method such as the arbitration method, its decisions will bind the parties involved. While the informal approach is through negotiations, mediations, peace negotiations that resolve the solution without formal procedures and it will provide an effective solution to both parties. Table 1 below explain the advantages of solving Islamic finance disputes through ADR.

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<th>Advantages in referring to alternative dispute resolution.</th>
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<td>Smooth and Easy</td>
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<td>Solution technique</td>
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<td>Fast</td>
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<td>Expertise</td>
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<td>Low cost</td>
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**Table 1. Advantages in referring to alternative dispute resolution.**

**CONCLUSION**

What cause a dispute to occur? According to Neale and Kleiner, issue or dispute occurred due to the occurrence of a different perception towards the interest between the parties involved. Furthermore, if every industry can comply and accept the universal business practice, it will certainly reduce the number of disputes. Nevertheless, problems or disputes still occur because of the existence of cultural differences in doing business or when each party did not trust each other.

In conclusion, all disputes related to Islamic Finance in Malaysia can be solved in two major ways either through trial in muamalat court or through ADR. Historically, settlement of disputes related to Islamic financial issues is often through court proceedings but the ADR method has also shown positive developments in this area. In fact, the ADR method is more convenient than settlement through trial in court when it comes to dealing with Islamic financial affairs in the future.

**NOTES**

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