

Islamic finance: a significant potential for international arbitration

With an annual growth rate of 10-12% over the past 10 years, Islamic finance (i.e., financial intermediation in line with fundamental sharia principles) is undeniably on the increase. True, the industry still represents a relatively small share of the global financial market, and its rise is currently concentrated in Muslim-majority countries (Figure). However, the upward trend is expected to prevail on a global scale. Islamic banking entities operate in more than 60 countries at the moment. Sharia-compliant financial assets are forecast to reach USD 3tn sometime in the next decade from an estimated USD 2.1tn at the end of 2016. The International Monetary Fund (IMF) considers Islamic Finance as “systemically important in Asia and the Middle East”. At the same time, the Bretton Woods Institution points to the noteworthy internationalisation of the sukuk market – the Islamic equivalent of the bond – with issuances made across the Middle East and key financial centres such as London and Hong Kong.

Figure: Regional contribution to growth in 2014

The rise of Islamic finance has led to an increase in the breadth and sophistication of product offerings in international finance. However, the potential of international arbitration in the context of Islamic finance transactions and dealings remains virtually unexploited. Islamic financial intermediation is viewed as a partnership in which all participants take a risk and share in both profits and losses. Compliance with *sharia* must be maintained throughout the lifecycle of the Islamic finance transaction – not only with regard to the collection and pooling of available funds, but also as to the investment and the distribution of returns. What is more, Islamic finance operates within the sphere of international financial markets. By way of consequence, it must offer financial products that are compliant with both *sharia* and with the requirements of operations in global financial markets. Put differently, simultaneous compliance with *sharia* and with the secular laws governing financial intermediation is necessary for all Islamic financial products. This twofold requirement can present challenges not only for capital adequacy, risk management, corporate governance, transparency and disclosure, but also for dispute resolution. Although compliance is verified upfront (with the help of *sharia* boards), issues may still arise, as in any dispute resolution process. By way of illustration, two decisions, one made in the English courts and the other in arbitration, have produced fundamentally different outcomes. In the first case, involving a *murabaha* financing agreement, the English court was asked to interpret a governing law clause that provided as follows: “Subject to the principles of the Glorious Sharia, this Agreement shall be governed by and construed in accordance with the laws of England.” According to the court, this stipulation was inadequate for the purpose of incorporating the principles of Islamic law into the parties’ agreement, and thus English law, not *sharia*, governed the transaction. The Court of Appeal upheld the ruling as it confirmed that the reference to *sharia* was not an enforceable provision, stating that “[...] the words [of the provision] are intended simply to reflect the Islamic religious principles according to which the Bank holds itself out as doing business rather than a system of law intended to “trump” the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement”. In the second case, which pertained to an *istisna’a* financing arrangement, arbitration was the chosen dispute resolution mechanism, the place of arbitration was London, and the applicable substantive law was stated as follows: “This dispute shall be governed by the Laws of England except to the extent it may conflict with Islamic Sharia, which shall prevail.” The arbitral award, which was enforced in England, gave effect to the parties’ choice of English law, subject to its compatibility with *sharia*. The arbitrator, who was an expert in Islamic law, issued a monetary award of both principal and profit, but disallowed claims for additional damages because, although such claims were compliant with English law, they would have been in conflict with *sharia* principles. The potential risk that English courts may disregard the parties’ choice of *sharia* to govern their dispute will not cause all participants in Islamic finance transactions to reject the benefits of submitting their disputes to the English courts. Nonetheless, uncertainty over the attitude of the English courts encourages the use of arbitration, particularly for those participants whose religion is the primary driving force behind their participation, i.e., the depositors. In the long term, one option consists in creating a global legal framework for Islamic finance, through the convergence and codification of Islamic

contract law. However, in the near term, the only plausible option is to provide for dispute settlement through arbitration in cases where the parties wish the mandatory principles of *sharia* to prevail. In addition, this would allow parties to ensure that nothing is permitted during the dispute resolution phase that would be prohibited by *sharia*. As a consequence, it would be beneficial to make depositors aware of the advantages of arbitration as a dispute resolution mechanism in the sphere of Islamic finance. It would also be necessary to train the professionals who may be involved in the resolution of Islamic finance disputes. In recent years, two arbitral institutions have promoted themselves as particularly apt to address Islamic finance disputes. In 2007, several Islamic financial institutions located primarily in the MENA region established the International Islamic Center for Reconciliation and Mediation (IICRA), which is based in Dubai. IICRA has reportedly administered a small number of arbitral proceedings but has not achieved widespread acceptance within the Islamic financial community. In 2012, the Kuala Lumpur Regional Centre for Arbitration (KLRCA) published its i-Arbitration Rules for disputes arising out of commercial agreements based on *sharia* principles. These rules allow the parties to designate any country as the seat of the arbitration. However, on a practical level, this remains a challenge as they have not met with any significant uptake outside South East Asia. It should be noted that the Rules of the International Chamber of Commerce (ICC) are suitable for the arbitration of Islamic finance disputes, as they are for any other dispute involving financial institutions. Most advocates of the arbitration of Islamic finance disputes regard arbitration as being well suited to ensuring that the Islamic finance industry meets its customers' expectations over compliance with *sharia*. They generally deplore the industry's practice of designating English or New York law (to the exclusion of *sharia*) as the governing law of contracts, arguing that this practice will have a negative impact on the industry's growth as its customers become increasingly sceptical about the compliance of their contracts with *sharia*. These individuals advocate resolving Islamic finance disputes through arbitration conducted by arbitrators mandated to decide the parties' dispute in accordance with both *sharia* and national law. Precedents for this type of arbitration do exist, as illustrated by the English Commercial Court's judgment that denied an application to set aside an arbitrator's award in *Sanghi Polyesters Ltd (India) v. The International Investor KCFC (Kuwait)*. Moreover, both KLRCA and IICRA offer procedures that specifically contemplate that the parties' contract will be governed by *sharia* in addition to national law. However, as noted in a 2016 ICC report, the efforts to promote the arbitration of Islamic finance disputes have gained very little traction among major Islamic banks and financial institutions. Finally, secular arbitration is also an option for Islamic finance transactions. In this case, the parties to an Islamic finance transaction provide in their contract that any dispute will be referred to arbitration, but they require the arbitrators to apply only English or New York law (to the exclusion of *sharia*). At present, this option appears to have a range of advantages, namely, (a) the parties can agree to arbitrate in an arbitration friendly jurisdiction that is geographically convenient for them; (b) the parties can select arbitrators with general expertise in financial disputes; (c) an arbitral award can be easier to enforce internationally as opposed to a court judgment; and (d) arbitration is a flexible process that can be adapted to the specific circumstances of the dispute. In 2010, the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) endorsed the secular arbitration option when they launched the ISDA/IIFM Tahawwut (Hedging) Master Agreement. Section 13(c) of the agreement gives the parties the option of choosing ICC arbitration with a London or New York seat, and of applying English or New York law as the governing law, while section 1(d) specifically provides that the governing law does not include Islamic *sharia*.