Islamic Finance & Dispute Resolution
Master’s thesis for International Business Law

Name: Yassir Rahouti
ANR: 769448

Thesis supervisors: Jing li & D.A. Pereira Dias Nunes
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1. Introduction

In the last years Islamic finance spread further and grew rapidly. In 2011, Islamic finance assets were estimated to a total of $1 trillion globally. The market had an annual growth of 20% over the past three years, which is considered to be impressive since the conventional finance markets had an annual growth of merely 9%. Western Banks turned to issue Islamic bonds (Sukuk). Goldman Sachs announced last year a $2 billion sukuk program. The new governments in North Africa that replaced the dictatorial regimes during the Arab Spring revolutions are expected to promote Islamic finance in order to attract investment funds from the Gulf region.¹

Moreover, there have been several assumptions that Islamic finance would provide a solution for the global economic crisis that has started in 2008. Many articles have been written on the causes of the current crisis. From a conventional point of view, there has been explanations that the current crisis has been caused by reckless lending practices and subprime mortgages. These causes are prohibited under the Sharia, subsequently leading to assumptions that such a crisis would not have happened in an Islamic Finance system.² However, on the 25ᵗʰ of November, Dubai shocked the world with the “Dubai Debt crisis” which was caused by the delay of $4 billion repayments of Sukuk but this will be not addressed in this thesis.³

The global crisis caused also a growth in Islamic finance disputes. The verdict of the English Court of Appeal in the Shamil v. Beximco case proved that the legal aspects of Islamic Finance, such as Islamic Law has not been yet acknowledged as an independent source of law in the western world, which is needed with its growing importance, complexity of its financial structures, maturity and its existence.⁴ There is a growing need for the establishment of a specialist body guided by Islamic law that can provide specific solutions for Islamic Finance disputes in the western world.⁵

Therefore, the research question of this master thesis is: "Can the Dutch legal system acknowledge the choice of Islamic law in contracts in Islamic Finance disputes and what can

¹ Pasha 2011.
⁴ Foster 2007. P.170 & p. 188.
⁵ Agha 2009, p.29
be the role of ADR for Islamic Finance Contracts?" This thesis will be divided in five sections. Following the Introduction, section 2 will discuss the principles of Islamic Law with regard to finance and the different forms of Islamic finance contracts assume, the permissible Islamic finance methods and investment vehicles. In section 3, I will address dispute resolution of Islamic Finance Disputes in Malaysia and the United Kingdom and discuss the landmark case Shamil v. Beximco which could endanger the further growth of Islamic Finance in the Western world. Furthermore, I will study Islamic Finance and the possibilities with regard to Islamic Finance disputes in the Netherlands in section 4. Finally, The conclusion and recommendations will be presented in section 5.
2. Islamic Finance

Modern Islamic finance exists since the seventies of the last century. Before it expanded to western countries, it was traditionally based in the Middle East and Asia. The growing interest in Islamic Finance is due the growing awareness and demand for Islamic financial products among Muslims. In the last years, there has been also a growing interest in western countries for Islamic finance for multiple reasons such as the facilitation of investments and trade with Muslim countries and the attraction of new sources of capital. In 2004, United Kingdom’s first Islamic bank (Islamic Bank of Britain) obtained a banking license by the United Kingdom’s Financial Services Authority. Other countries such as France, Ireland, Australia and Japan are working, to change or amend their laws to attract Islamic Finance.\(^6\) Since 2007, the Dutch Government started showing interest in attracting Islamic banking to the Netherlands.\(^7\)

2.1 Sharia and the sources

I believe that we cannot discuss Islamic Finance without speaking first of the Sharia and its sources. The Sharia is known as the Islamic legal system, Islamic Law or tradition. It is a code of conduct including legal, moral, spiritual, ethical as well as social aspects of the public and private life of a Muslim. Although it is one of the three major legal systems in the worlds (Civil law, Common Law and Sharia), it is only in a few countries such as Saudi Arabia, Sudan, some states in Nigeria and Iran, that it is integrated and embodied in the legal systems of these countries. Most of the Muslim countries have mixed legal systems.\(^8\)

The Sunni schools of Islamic Law (Hanafis, Malikis, Shafi‘is and Hanbalis) make the following distinction with regard to the sources of Islamic Law: the primary resources are the Quran and the Sunnah. The Quran is the Holy Book of the Muslim in which God revealed his word to the Prophet Mohammed. The Sunnah consists of the traditions and the sayings of the prophet; the secondary sources are Ijma and Qiyas. Ijma is the scholarly consensus and Qiyas is the analogical reasoning. There are also some controversial supplementary resources such as Urf (customary practices), Maslaha (public interest), Ijtihad (individual reasoning) and Istihsan (juristic preference). If the primary sources state the Law and are effective, the

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\(^6\) Ilyas 2010, p. 4-5.
\(^8\) Ahmed 2010, p. 50-52.
secondary and supplementary sources can only be used for the detailed explanation of the Law.\(^9\)

### 2.2 The prohibitions in Islamic Finance

The *Sharia* acknowledges contractual freedom, unless the contract or certain provisions of a contract are prohibited by the *Quran* or *Sunnah* or *Ijma*.\(^{10}\) The *Sharia* prohibits both undertaking and financing any activity, entity or contract that facilitates, distributes or manufactures specific objects or acts which are explicitly forbidden by it such as: alcohol, illegal drugs and intoxicating drugs, pork, pornography, gambling, and arms and so on.\(^{11}\) Furthermore, the *Sharia* prohibits *riba* and *gharar*.

#### 2.2.1 Riba

The most known prohibition within Islamic Finance is the prohibition of *riba*\(^{12}\). The *Sharia* makes the distinction between two kinds of *riba*: *riba al-fadl* and *riba al-nasi’a*. The first form is when money is exchanged in different quantities for money. The latter form is the one on which the western conventional finance systems are built and that is the form where people compensate deferment of payments, such as interest payments for mortgages.\(^{13}\) Islamic scholars share the common view that the most important reason for the prohibition of *riba* is that it is considered to be unjust. It is deemed to be unjust because in the case that the borrower ends up with a loss, he still has to pay interest to the lender. This has also been confirmed in Surah 2:279 of the Quran in which it has been stated that taking an amount above the principal amount would be unjust.\(^{14}\)

Furthermore, the beneficiary must be also subject to the risk of possible loss. The *Sharia* forbids the lender to gain from the financial activity without being subject to the risk and to enjoy a guaranteed gain, while the borrower despite of his hard work and management is not sure of any profits.\(^{15}\)

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\(^9\) Ibid, p. 53-55.
\(^{10}\) Tjittes 2011, p. 139.
\(^{11}\) Thomas & Cox & Kraty 2005, p. 3.
\(^{12}\) Quran 2:275-9 ; 3:130.
\(^{13}\) El-Gamal 2000, p. 4.
\(^{14}\) Kettel 2011, p. 40.
\(^{15}\) Ahmed & Kabir Hassan 2009, p.8-9.
2.2.2 Gharar

The other important prohibition within Islamic Finance is the prohibition of *gharar*, or in other words uncertainty. Many Islamic scholars and jurists compared *gharar* to gambling and/or speculation. Professor Mustafa al Zarqa’s definition of *gharar* is: “the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling”.

According to professor Al-Darir, these are the conditions when *gharar* invalidates a contract: Firstly, *gharar* has to be excessive. Secondly, it has to be part of commutative financial contract. Thirdly, it must affect the principal components such as the object or price of the sale. Finally, if the excessive *gharar* in a commutative financial contract serves a need that cannot be reached otherwise, the contract will not be invalid. The first rule implies that not all forms of *gharar* will invalidate a contract. The *Sunnah* prohibits *gharar* that cannot be tolerated and that could cause disputes. *Gharar* could be allowed in case there is no general consensus between the schools of Islam whether a form of *gharar* is prohibited or if the *gharar* invalidates the contract.

*Gharar* affects mainly two areas of conventional finance practices: insurance and financial derivatives. In the case of insurance, the Islamic jurists oppose the fact that the insured will make monthly payments without ever receiving any money from the insurance company. In the case of financial derivatives, the *Sharia* forbids to trade objects that may not exist at the time the trade is executed, such as options, futures and forwards and other derivative securities.

2.3 Islamic Finance methods

The *Sharia* prohibits *riba, gharar* and investment in alcohol, illegal drugs and intoxicating drugs, pork, pornography, gambling, and arms and so on. However, this does not mean that the *Sharia* prohibits all forms of Trade. The *Quran* states in verse 2:275: “Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will

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16 El-Gamal 2006, p. 58.
abide eternally therein.” Thus meaning that Islamic law allows trade as long as it respects the prohibitions stated within Islam. In the following paragraph, I will address the different Islamic Finance structures such as profit-and-loss sharing contracts, Murabahah, Islamic forwards (salam and istisna) and Ijara.

2.3.1 Profit- and-loss sharing contracts
There are two types of profit-sharing agreements in Islamic Finance: mudarabah and musharaka. Mudarabah is a silent partnership whereby the rabb-el mal (financier) gives money to the mudarib (entrepreneur), to undertake a business or other activities. The financier does not play a role in the management of the undertakings of the entrepreneur. The entrepreneur becomes an amin (trustee) for the money that has been trusted by the financier and will invest the funds in the agreed manner. The financier will earn the principal and the agreed share of the profits. The rest of the profits belong to the entrepreneur for his labor and venture activities. However, the financier is liable for the losses. This liability reaches only the investment of the financier unless he permitted incurring debts.

Musharaka is another basic technique of Islamic Financial Institutions to provide capital to enterprises. It is a partnership where two or more persons combine their capital and/or labor to form a business. Every partner has the right to play a role in the management, or they have to agree otherwise. Mostly, the partners share the profit according to a specific ratio. However, there are different opinions about the relation between the capital contribution ratio and profit ratios. The Maliki and Shafi schools do not permit a difference between the two ratios. The partners share the losses according to the ratio of capital contribution.

2.3.2 Murabahah
Most of the finance operations of Islamic financial institutions and banks are based on murabahah. A certain person (customer) does not have enough money to buy a certain good and approaches another person(seller) to acquire that certain product. This means that in a murabahah contract the seller (in most cases an Islamic financial institution or Islamic Bank) buys a certain good for a customer and discloses the costs he made in acquiring a certain good.

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22 Rammal 2004, p.3
24 Rammal 2004, p.3.
Thereafter, he adds the profit for a customer in lump sum (one single payment above the price) or based on a percentage. It is a simple sale where the seller exactly tells the purchaser what the costs were for obtaining a certain good and how much profit he is going to add in regard to the costs he made. The seller must first own the item, before selling it to a customer and adding a percentage of profit. A murabahah sale is only valid when the price of a certain good can be determined, the seller discloses the exact costs of the obtained good and when there is a mutual consent on the added profit percentage.

Some scholars have been criticizing the added percentage in a murabahah contract and stated that it’s not in compliance with Islamic Law. Some of these views explain that the profit percentage in a murabahah contract is based on the interest rates of conventional banks. Another view is that the profit depends on the Inter Bank Offered Rate in London (LIBOR) and that if the LIBOR sets the interest rate on 10 percent, the Islamic Financial Institutions do the same with regard to the added percentage in a murabahah contract. There is not a specific fatwa which forbids these percentages. However, the majority of Islamic scholars do agree that that determination of the profit in a murabahah agreement should be free from limitations and should be decided and agreed upon by the seller and the buyer.

2.3.3. Bai’ Bithaman Ajil: Credit Sale

Bai’ Bithaman Ajil (BBA) is the most popular type of Islamic Finance in Malaysia. It means literally “deferred payment sale”. This means that parties in a contract agree to defer payment to the future. This finance method is used when a buyer wants to acquire a good but wants to defer the payment of the good by installments or by a specific period of time. The date of payment has to be clear or otherwise it would interfere with the prohibition on gharar. If there is any vagueness on the date of payment, the BBA will considered to be void.

The deferred price is set higher than the spot price of the good. There are no restrictions on the determination of the new price, as long both parties agreed upon it and as long as it is set before the sale contract is concluded. This implies that that the seller cannot change the price after the conclusion of the sale contract.

There are views that consider the BBA as a trick to avoid the prohibition of riba.

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25 Usmani, p. 2.
27 Usmani, p. 6.
28 Definition Fatwa from Islamic Glossary: “A fatwa is an Islamic religious ruling, a scholarly opinion on a matter of Islamic law.” <http://islam.about.com/od/law/g/fatwa.htm>
However, the BBA aims to increase the price of the object for deferment, while in conventional finance there is an increase of the debt for deferment. In this case I would like to refer to verse 2: 275 of the Quran which states: “Trade is [just] like interest.” But Allah has permitted trade and has forbidden interest.”

2.3.4 Islamic forwards: Salam and istisna

The prohibition of gharar forbids the sale of non-existing commodities. However, there are two forms of Islamic forwards that allow this certain type of business: Salam and istisna.

Islamic Jurists define salam as a sale of a good where the money is paid before the delivery of the commodity. This means that the seller and the customer agree in advance on the amount of the payment where the seller will deliver the commodity on a certain due date. The salam contract shares a lot of similarities with the conventional forward contract. However, the salam contract is invalid if the customer does not pay during the contract or in other words, before the specified delivery date of the commodity. A salam contract is binding on both parties.

Istisna is a finance method that is allowed by Islamic jurists throughout the Qiyas and Istishsan. The meaning of istisna is “commission to manufacture”. Istisna is a contract to manufacture a certain product, whereby the seller places an order that answers a certain definition and whereby the seller and manufacturer agree on a certain price and delivery date. Istisna creates a moral obligation on the manufacturer to manufacture. However, istisna is not binding and can be voided by both parties, as long as the manufacturer did not start with his work.

2.3.5 Ijarah

Ijarah is an Islamic finance form of leasing agreement that is attractive for long-term or intermediate financing. Islamic law allows paying rent for the use of an asset for a specific period of time. The lessor must own the leased asset during the lease-period, which means that the lessor will be the legal owner of the leased asset. However, this does not mean

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34 El Gamal 2000, p. 17.
36 Muhammad & Chongxx 2007, p. 25.
37 El Gamaal 2000, p. 17.
38 Muhammad & Chong 2007, p. 25.
that the lessee may get a loan with interest to make the lease payments, because that would defer the prohibition on riba.\footnote{Ibid, p.14.} The lease contract must state the lease period clearly and the lessor bears the liability for maintenance and premium costs of the leased asset.\footnote{Shariff & Rahman 2004, p. 3.}

There is a form of financial leasing called \textit{ijarah-wa-iqtana}. The lessor is mostly an Islamic Financial Institution or Islamic bank that leases a certain good to a customer, and provides the leased object for a gift or a sale to lessee at the end of the leasing period because the financial institution itself is not interested in the asset. The lessee pays money during a period of time for the use of the leased asset. The period of time is normally enough to cover the life period of the leased asset. This form of \textit{ijarah} is growing and is fit for use by the Islamic Banks and Institutions as financial intermediaries.\footnote{Kamali 2007, p. 6.}

\subsection*{2.3.6 Sukuk}

In the last paragraph of this section, I will address Islamic bonds, also known as \textit{Sukuk}. \textit{Sukuk} have been generated by Islamic financial institutions to have the same economic benefits as conventional bonds. Conventional debt structures are forbidden by Islamic law due to the \textit{riba} prohibition. However, \textit{sukuk} are interests in certain assets, which means they are not debts anymore. \textit{Sukuk} comply with the Sharia, when the underlying assets themselves are in compliance with Islamic Law.\footnote{Salah 2010, p. 18.} There are fourteen different types of \textit{Sukuk}, but I will address only the most used Sukuk structure in the western world and that is the structure based on \textit{ijarah} contract: \textit{Sukuk al-ijarah}.\footnote{Salah 2010, p. 19.} There are three main players in a \textit{sukuk al-ijarah} structure: The seller (originator), the Special Purpose Vehicle (SPV) and the \textit{sukuk} holders (see figure 2.1).

The SPV will buy certain assets from the seller and will issue \textit{sukuk} to finance the acquisition of the assets. The ownership of the assets is transferred to the \textit{sukuk} holders and the SPV holds the assets in trust(beneficial owner) for the \textit{sukuk} holders. This means that the \textit{sukuk} holders become the owners of the assets. Moreover, the SPV leases the assets back to the seller for a fixed period of time. The lease payments of the seller to the SPV will be used to make periodic payments to the \textit{sukuk} holders. At the maturity date, the seller buys the
assets back from the SPV. The repurchase price is used to pay the sukuk holders back and to redeem their sukuk certificates.\footnote{Salah 2010, p. 20.}

There has been some criticism on the structure of Sukuk al-ijarah.\footnote{Jabeen & Tariq Javed 2007, p. 410.} One example of this criticism is that the payments that are made to the sukuk holders in Malaysia were not bound to the return of the use of the assets, but to bank rates of conventional banks such as London Interbank Offer Rates, which could interfere with the prohibition on riba. However, there is not a clear fatwa on this matter. Moreover, there is also criticism that the originator (seller) and the SPV are not legal separate entities (most of the SPV’s are 100% owned by the sellers) as described by the Islamic Fiqh Academy for the permission of the issuance of sukuk. However, they are independent legal entities from the perspective of financial liability.\footnote{Jabeen & Tariq Javed 2007, p. 411.}

**Figure 2.1 Sukuk al Ijarah structure**

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\footnote{Salah 2010, p. 20.}
\footnote{Jabeen & Tariq Javed 2007, p. 410.}
\footnote{Jabeen & Tariq Javed 2007, p. 411.}
3. Islamic Finance Dispute Resolution

The growth of Islamic Finance in the past years calls for the need of an effective dispute resolution system. There are only a few legal firms and even courts in the Muslim and western world that are specialized in this legal area. Moreover, the present legal framework does not serve the current growth and the purpose of Islamic Finance.\(^49\) The disputes are subject to civil and common law courts, which could result in a verdict that does not comply with Islamic Law and could endanger the existence of Islamic Finance. Although, the Islamic finance transactions comply with Islamic Law, the verdicts and orders of (western) courts could sideline the legal principles of the *Sharia*.\(^50\)

There are several questions that challenge the existence of the industry such as: Which law should govern Islamic contracts? Should only national law govern these contracts? Or should the *Sharia* govern these contracts? Or do the laws of these countries allow a combination of the *Sharia* and national laws?\(^51\) These questions have been asked before in some important cases such as the *Shamil v. Beximco case*. Does the verdict of the English Court of Appeal close the gates for Islamic Finance in the western world or is there still a way out? I will start with addressing the legal aspects and frameworks of Islamic Finance in Malaysia and the United Kingdom before studying the challenges that are created in the *Shamil v. Beximco case*.

3.1 Malaysia

Malaysia is one the first countries that started with Islamic Finance. The country is seen as one the frontrunners and is an example for many countries that try to develop new instruments that are required to be in compliance with Islamic law. Furthermore, Malaysia has been promoting an Islamic Interbank money market to connect all the players on the Islamic Financial market and to promote short-term liquidity. The growth and success of Islamic Finance can be led to the continuing support and contribution of the Malaysian Government.\(^52\)

3.1.1 Basic legal aspects of Islamic Finance in Malaysia

There are two laws that govern Islamic Finance in Malaysia: Firstly, the IBA 1983 that was set up to govern Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia

\(^{49}\) Oseni 2009, p. 5.
\(^{50}\) Adawia & Ali 2008, p. iii.
\(^{51}\) Schmitt 2008, p. 5.
\(^{52}\) Yasin 2007, p. 215.
However, there are now 12 Islamic banking institutions that are governed by this act; Secondly, the Banking and Financial Institutions Act 1989 (BAFIA) that regulates Islamic Bank Division and conventional banks. Malaysia is the only country that has such dual system in where an Islamic Finance system operates parallel to a conventional bank system.

IBA 1983 is the first law in Malaysia that regulates Islamic economic activities. This act is also the first attempt of using the Sharia outside matrimonial and family matters. The IBA consists of 60 sections and is divided into 8 parts. Furthermore, it contains a section that according to some views creates flexible definition of Islamic banking business: “banking business whose aims and operations do not involve any element, which is not approved by the Religion of Islam”. This results in the fact that Malaysian Islamic Financial institutions are able to offer alternate banking products under different forms of financing that comply with Islamic Law principles such as the issuance of Sukuk. In fact, Malaysia is the first country in the world that issued Islamic bonds.

The growth and success of Islamic Finance in Malaysia resulted in the enactment of Section 124 in BAFIA 1989. This section allowed conventional banks to conduct Islamic Finance transactions and offer Islamic Finance products to their customers. This section has the advantage of bringing healthy competition between the providers of these kinds of products. Furthermore, Section 124 requires the conventional banks to establish Sharia committees with regard to advising on the conduit of Islamic Finance business.

In the next paragraph, I will address the development of dispute resolution of Islamic Finance and the most important regulation with regard to Islamic Finance Disputes which is the Central Bank of Malaysia Act 2009.

3.1.2 Malaysia, Islamic Finance Dispute Resolution and Dispute Regulation

In the period from 1979 till now there have been several Islamic Finance cases that have been published and that have been referred to in disputes. The conclusion that can be drawn from these cases is that Malaysia has gone through three phases with regard to the attitude of the Malaysian courts toward Islamic Finance cases. The first phase is from 1979

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54 Hasan 2010, p. 2
57 Hasan 2010, p.4
58 Ibid, p. 4-5.
59 Hasan & Asutay 2011, p. 43-44.
till 2002. The ruling in the case *Bank Islam Malaysia Berhad v Adnan Omar* shows that the High Court would uphold the classic common law international view on Islamic Finance dispute and decide in favor of Islamic Financial institutions.

In this case, defendant (Adnan Omar) lent RM 583,000 from the plaintiff (Bank Islam Malyasia Berhad). The plaintiff used a *BBA* scheme to grant this loan and secured it upon a charge over a parcel of land. The *BBA* scheme was executed by three transactions: Firstly, the sale of the parcel of land by defendant to the plaintiff for RM 265,000 and which was fully paid by the plaintiff; secondly, the reselling of the land to the defendant for RM 583,000 in 180 monthly installments and; finally, the charge of the land as a security for the debt of RM 583,000. The defendant failed to make the payments and the plaintiff wanted to sell the land. The defendant stated that he only received RM 265,000 and that it was only a facility amount and therefore not in compliance with the High Court Rules 1980. The court concluded that the defendant was fully aware of the agreement. This was proved by his acceptance of the letter of offer which contained all conditions of the contract. Therefore, the court accepted the plaintiff’s statement that the amount was RM 583,000.\(^{60}\)

Thus meaning that the defendant was literally bound by the terms and conditions of the contract and the High Court did not investigate whether the Islamic Financial Institution acted in compliance with the *Sharia* as stated in IBA 1983 and BAFIA 1989.\(^{61}\)

Unlike the first phase, in the second phase (2003-2007) the courts started showing the intention to criticize the financing and the principles of the Islamic Financial Institutions. There were two cases that are of utmost importance for this phase: *Malayan Banking Berhad v Marilyn Ho Siok* and *Affin Bank Berhad v Zulkifli Abdullah*.\(^{62}\)

In the first case, the defendant (Marilyn Ho Siok) bought an BBA facility from the plaintiff in 2002. The plaintiff bought the facility for RM 500,000 and resold it to the defendant, who agreed, for RM 995, 205.64 by dividing it in 240 installments of RM 4,107 for which the Defendant charged her property as a security to pay that amount. The defendant failed to make 5 payments resulting in the application of the plaintiff for on order of sale of the property. The defendant objected that he had to pay the whole amount of RM 995, 205.64 and argued that in the light of property sale agreement, he had to pay the remaining sale price which is RM 928, 589.12 on 21 February 2005. The court ruled that it would be not equitable to allow the bank the recover the whole sale price as defined in the documents but granted the


\(^{61}\) Hasan & Asutay 2011, p. 44.

\(^{62}\) Ibid, p. 45.
order of sale of the property to get the remaining amount of RM 598,689.10 as it was on 31 May of 2006 and ordered the defendant to pay RM 106.10, as profit per day, until the full amount has been paid.63

In the second case, the defendant (Zulkifli Abdullah) bought a house. He took a loan from his employer, the plaintiff (Affin Bank Berhad) in this case, and secured it by the use of BBA scheme for RM 346,000. In 1997, the defendant resigned from his work and he requested to restructure the BBA scheme which resulted in the new selling price of the house of RM. 992,363.40 to be paid over a period of 25 years. In 2001, the defendant failed to make the payments and the plaintiff asked the defendant to pay the remaining amount of RM 958,997.21 after paying RM. 33,454.19 in installments. The Court granted the plaintiff the order for sale of the property, but stated that the defendant is not required to pay the full selling price of the property as it would go against the principle of BBA. The plaintiff is only entitled to the rightfully earned profit which is RM 616,080.99 minus the paid installments resulting in the amount of RM 582,626.60.64

Both cases show us that the Courts were critical with regard to the narrow interpretation the common law approach in the earlier rulings of the courts. They were of the opinion that the Courts should have examined whether the finance activities and practice were in compliance with Islamic Law. The judges in these cases stated that the practices of the Islamic Financial institutions were contrary to Islamic Law and therefore could not claim the unearned profits. However, the Courts did not examine the legality and validity of the structure used in these cases.65

In the last phase which is from 2008 till now, the Courts started changing their attitude and showed an active attitude in examining whether the used structures and practices of the Islamic Financial institutions in these cases were valid. Especially in the case Arab Malaysian Finance Bhd v Tahman Ihsan Jaya Sdn Bhd & Ors were the Court ruled that the used structure was not valid.66

The defendants (Tahman Ihsan Jaya Sdn Bhd & Ors) in this case purchased property from a third party and paid only a part of it. They approached the plaintiff (Arab Malaysian Finance Bhd) to gather the rest of the money and finish the payments. The parties used a BBA scheme including a PPA (property purchase agreement) and a PSA (property sale agreement) to structure this loan. The PPA was used by the defendants to sell the property to the plaintiff

63 Markom & Pitchay 2010, p 53-54.
64 Ibid, p. 54-57
65 Hasan & Asutay 2011, p. 45.
66 Ibid, p. 45.
to get the money to complete the purchase, while the PSA was used to sell the property back to the defendants. The defendants failed to make the payments which resulted in that the plaintiff applied for an order to sell the property. The defendants went to the Court to ask whether the used structure and its elements were not in contrary with Islamic law or if it had contravened IBA 1983 or BAFIA. The court ruled that the used structured violated the prohibition on riba and that this contract should not stop the court to evaluate the terms of the contract. Furthermore, these types of transactional schemes should be viewed as a whole rather than separate elements. Moreover, In the case that a finance facility buys from the customer and sell it back for a higher price, the sale and the profit violates IBA 1983 and BAIFA. 67

However, this ruling was overturned by the Court of Appeal which led to the enactment of the Central Bank of Malaysia Act 2009. This act has been designed to improve the current legal framework and to provide a more clear status of the Sharia dispute resolution.68

The Central Bank of Malaysia Act 2009 grants Bank Negara Malaysia (the central bank of Malaysia) legal powers to supervise and regulate the financial system. Prior 2009, it was the Central Bank Act of Malaysia 1958 which was the main legal framework for supervision purposes.69

The Act of 2009 grants the sole and highest authority to the Shariah Advisory Council (SAC) to which civil courts can refer to in Islamic Finance cases. In 2003, the Act of 1958 was already amended with section 16 B that stated that civil courts and arbitrators may refer with questions about Islamic Finance matters to the SAC. Furthermore, if a court referred to the SAC, the court could take the ruling of the SAC into consideration. However, in the case an arbiter would refer a case to the SAC, the ruling made was binding on the arbitrator. The purpose of the enactment of this section was to provide a better position to the National SAC. However, research showed that the civil courts were not too eager on referring to the Council. It even resulted in rulings of civil courts that are in contrary with the principles of Islamic Law. 70

This status quo changed with the enactment of the Central Bank Act of Malaysia 2009. Section 56 mandatorily requires civil courts and arbitrators to refer to the SAC on Sharia

68 Hasan & Asutay 2011, p. 48.  
matters including Islamic Finance disputes.\textsuperscript{71} Section 55(2) states that any Islamic Financial institution may seek advice to be certain that their products are in compliance with the principles of Islamic Law, or refer for a ruling of the SAC. The Central Bank of Malaysia Act 2009 ensured this time that rulings of the SAC will be binding on courts by introducing section 57. This sections states that every court or arbitrator that made a reference to the SAC under section 56 or every Islamic Financial institution that referred to the SAC under section 55, is bound by the ruling made by the SAC. Thus meaning that if a court or arbitrator referred to the SAC about an Islamic Financial dispute, both are obliged by and bound to the reference made by the SAC. It will be almost impossible for the civil courts to come up with a ruling that is in contrary with the Sharia.\textsuperscript{72}

3.2 United Kingdom

In the 1990s, Islamic Finance started growing in the UK. There has been a significant growth in the wholesale and retail sectors. The UK has the highest place of western countries in the Banker’s league table of Islamic assets. Furthermore, Islamic finance activities are not limited to London because there have been also regional developments in Edinburgh and Birmingham on Islamic Finance. The Bank of England and the Financial Service Authority have been active supporters of the development of Islamic Finance in UK.\textsuperscript{73}

3.2.1 Basic Legal aspects of Islamic Finance in the United Kingdom

In the case of conducting a regulated activity, it is required to apply and get permission under Part IV of the Financial Services and Markets Act 2000 (FMSA), which deals with all the regulation in regard to financial services in the United Kingdom. The Financial Services Authority is the only regulator on the financial area in the UK. Individuals, partnerships, corporate and unincorporated associations are all permitted to conduct financial services that are subject to the FMSA. Furthermore, section 19 of the FMSA states that every person that wishes to conduct regulated activity in the United Kingdom must get authorization by the FSA or be exempt. Representatives of professional firms such as accountants and solicitors are exempt. Any person who breaches this section may commit a criminal offence. The FSA received applications from Islamic Financial Institutions, which are mainly applications to establish Islamic Banks. However, under the FMSA, there is no clear

\textsuperscript{71} Hasan 2010, p. 2.  
\textsuperscript{72} Miskam 2011, p. 5-6.  
\textsuperscript{73} HM treasury 2008, p. 8-10.
definition of banking as a regulated activity. Therefore, these institutions seek a classification as a credit institution under the EU Banking Consolidation Directive and are required to perform their activities within its scope.\textsuperscript{74}

The government of the UK and the FSA state that all financial institutions that are permitted by the FSA and that operate in the UK are subject to the same standards. The UK government strives to have a “neutral” religious position. This resulted in the fact that all amendments to legislations to establish a positive playing field for Islamic Finance, refer to ‘alternative financial Instruments’ when it means to refer to Islamic Financial instruments or ‘alternative bonds’ when it means to refer to sukuk.\textsuperscript{75}

In contrast with Malaysia, the UK government has no clear regulation on the Sharia Supervisory Boards which are responsible to check whether Islamic Finance products are in compliance with the principles of Islamic Law. There are many concerns about the role of the Sharia Supervisory Boards, because there is no clear legal framework with regard to the process, composition and the credibility of these boards. The FSA focuses only on whether these boards have an advisory or executive role in the Islamic banking firm. In the case, these boards would have an executive role, it could cause a conflict of interest which would likely jeopardize the impartiality that must characterize the undertaking of the advisory function of such boards. However, the FSA acknowledges that role of the Islamic scholars in these boards could have an implication on the confidence in these Islamic Financial Institutions, assets and even on their reputation.\textsuperscript{76}

3.2.2 Islamic Finance Dispute Resolution in United Kingdom & for contracts that are governed by English Law

In the last paragraph, I have discussed some basic legal aspects of Islamic Finance in the UK and showed that the FSA does not have clear rules on Sharia Supervisory boards. This could have an implication on the confidence in Islamic Finance and its products. It is important to know that most of the Islamic Finance contracts in the UK(and in the rest of the world) are governed by English law.\textsuperscript{77} I will not explain the dispute resolution system with regard to Islamic Finance Disputes in UK but I will use the ruling in the Shamil v. Beximco case to explain how the Courts in United Kingdom can deal with Islamic Finance disputes and how

\textsuperscript{74} Ainly, Mashayekhi, Hicks, Rahman & Ravalia 2007, p.10-11.
\textsuperscript{75} Ercanbrack 2011, p. 73.
\textsuperscript{76} Ibid, p. 74-75.
\textsuperscript{77} Ainly, Mashayekhi, Hicks, Rahman & Ravalia 2007, p. 17.
they could rule about the Sharia-compliance of a product and what the consequences are for the existence of Islamic Finance in UK.

3.2.2.1 Shamil v. Beximco Case

Beximco Pharmaceuticals & others entered into murabahah agreements with Shamil Bank of Bahrain. The bank provided Beximco & others loans that stated that if there were any payments left before the due date, they would be obliged to pay compensations to the bank.  

In this case, the dispute rose out from two different murabahah transactions between defendant 1 and defendant 2. The first agreement was written down in 1995. Defendant 2 acted as the agent of the bank and got USD 15 million to purchase certain goods and sell them to defendant 1 for a pre-agreed price on the basis of a deferred credit. The mark-up was USD 2,585,583. The first payments and re-payments would start in March 1996 and end with the final payment of USD 15,323,322 on December 1997. The agreement of 1996 was similar to the one of 1995. The only difference is that defendant 1 acted as the agent of the bank and defendant 2 was the purchaser.

Shamil Bank of Bahrain was established under Bahrani Law and its own Sharia Board stated that its business is in compliance with Islamic Law. The agreements between the parties contained the following clause: “Subject to the principles of the Glorious Sharia, this agreement shall be governed by and construed in accordance with the laws of England”. The other clause which is also of great importance stated that the agreements would be: “governed by and shall be construed in accordance with English Law”.

The parties (defendant 1 and defendant 2) failed to make all the payments before the due date, which led to the bank claiming the amount of compensation agreed in the murabahah contract. The defaulting debtors argued that the murabahah agreement was not more than disguised interest loans. This would mean that the whole agreement is not in compliance with Islamic and would thus be invalid.

The High Court and the appellate court rejected the claim for the following reasons: Firstly, it is not possible that a contract is governed by two different systems of law, thus meaning that the contract should either governed by English law or by the Sharia; secondly, the Contracts Act 1990 of the UK following the Rome convention, states that it allows the choice of law of a country instead of non-state law, thus apparently excluding the Sharia from

78 Nasim 2004, p. 37.
79 Abdelhady 2011, p. 3-5.
81 Ibid, p. 38.
the available laws of choice, which is a transnational, religious, non-statal code of rules; Thirdly, the Sharia principles are not the principles of law that apply to other aspects of behavior and life; Finally, even if the principles of Islamic Law would be acknowledged as the principles of law, it is unlikely that the parties meant the English Court to apply such controversial principles.\(^2\)

Lord Justice Potter delivered the judgment at the Court of Appeal and agreed on all points made by the High Court. However, he stated that the parties in this case did not add the Sharia clause without a reason. It was meant to be more than a “surplusage”. The intention of this clause was to give a reflection of the Sharia principles in accordance with which the bank would be conducting its business. It was not intended to use English law as a “trump” with regard to the determination of liability of the parties in this agreement.

3.2.2.2 The possible consequences of the Shamil v. Beximco Case

I have described the facts and the ruling of the High Court and Appelate Court with regard to the Shamil v. Beximco case, but what are the possible effects of the ruling in this case?

First of all, the most important consequence in this case is that Sharia clauses, such as the ones found in the murabahah agreements entered into between the parties to Shamil v. Beximco cannot be enforced by the English Courts. As stated above, the Courts do not recognize the Sharia as a source of law thus leading to the consequence that Islamic clauses in Islamic finance contracts are not fully enforceable.\(^3\)

Secondly, the ruling shows the possible difference between the real practices of Islamic Financial Institutions and their claim of acting in accordance with the Sharia. This could result in that these Islamic Financial Institutions will have to deal with some reputations loss. The cornerstone of Islamic Finance is that it’s customers think that the products that are offered by the Islamic Financial Institutions are in accordance with Islamic Law. This constitutes the main rationale that underlies Islamic Finance customers’ decision to purchase financial products from Islamic banks instead of conventional, mainframe banks. This reputation loss could increase because there seems to be no regulatory design for the English courts to avoid such a problem in the future and restore the faith of the Islamic Finance customers in those institutions. The lack of a regulatory framework could lead to institutional failure thus affecting the stability of the Islamic financial system.\(^4\)

\(^{2}\) Ibid, p. 38.

\(^{3}\) Hassan & Asutay 2011, p. 62.

Moreover, the decision could also influence the western share on the Islamic Finance market. The ruling will have the consequence that Islamic Finance cannot function as a whole alternative financial service beside conventional finance system. As stated before, the Sharia is not recognized as source of law thus having the effect that there is no effective control mechanism on the practice of the Islamic Financial institutions in the western world. European countries such as the United Kingdom will have a disadvantage compared to the countries that are willing to produce an effective regulatory framework which can weaken their position internationally on the Islamic Finance market. This could lead to the run of domestic capitals and a decrease of attraction of international funds. This means that Islamic customers who were born and live in these countries will run off with their capital to other countries with a more effective regulatory framework and for the same reason leading to a decrease of International Islamic Financial Institutions that are willing to invest in these countries. 85

The above stated consequences showed us the possible negative effects on the existence of Islamic Finance in the United Kingdom. Are there any other solutions besides the creation of a more effective regulatory framework for the English Courts to test the Shariah-compliance of Islamic Finance contracts? And what role does Alternative Dispute resolution has in this matter?

3.3 Alternative Dispute Resolution
Since the start of humanity, humans have been practicing dispute resolution. It is in the nature of the human being to engage in disputes and we can find stories in the Bible, Quran but also in other cultures such as native Americans and others describing different forms of dispute resolutions. 86

Conflict is a dangerous and could harm the relationship between parties. Therefore, it is interesting in this thesis to address Alternative Dispute Resolution (ADR) and to look whether ADR is an option for cases such as Shamil v. Beximco case and specifically, for such countries whose jurisdictions refuse to accept Sharia as a valid source of law.

ADR aims to create a win-win situation and resolve the dispute without any real losses. The current ruling in this case aggravates the situation and it is very interesting to see whether ADR is able to “enlarge the pie” instead of putting parties in a conflict as

However, I will first address the problem of establishing a workable definition, different types and the history of ADR before studying whether ADR fits in Islamic Finance Dispute Resolution and whether it could provide a way out from the possible negative consequences of the ruling in the *Shamil v. Beximco* case for Islamic Finance.

### 3.3.1 Definition & types of Alternative Dispute Resolution

There is still some controversy on the definition of ADR. Is it something that falls completely outside of court litigation or can it go hand-in-hand with the traditional form of dispute resolution? Therefore, I choose the following definition of ADR: “ADR is a range of processes for amicable resolution of disputes outside the formal court procedure or litigation where a third party neutral intercedes to resolve the dispute”.

There are four different types of ADR: Firstly, adjudication-based processes where a third party is appointed to make a decision for the parties after listening to both sides. The parties in this form of ADR are bound to the decision made by the neutral third party; Secondly, there is the recommendation-based processes where obviously the neutral third party will function as an advisor and will make recommendations to resolve a dispute instead of a binding ruling; Thirdly, in the facilitation-based processes, the neutral party guides the parties in a dispute to find their own resolution. Finally, there is the hybrid process in which per example the neutral third party can firstly guide the parties to find their own solution for the dispute. However, if the parties do not succeed in mitigating their divergence, the third neutral party can still act as an arbitrator in the case.

### 3.3.2 Alternative Dispute Resolution in 20th century

In 1906, Roscoe Pound held a speech where he addressed the public discontent with the justice system in the United States. In his speech, he pointed some causes of the “failure” of justice system and came up with certain recommendations which were not taken serious in that time. However, his speech started the first changes in the justice system of the U.S. and marked the start of amicable dispute resolution. Other jurisdictions around the world started copying these developments that the U.S. jurisdiction featured, that once started with the famous speech of Roscoe Pound. However, the first real reforms started in the 1960s. Anti-litigation movements started to grow in the 1970s and there were more reforms in the

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88 Oseni & Ahmad 2011, p. 2.
89 World Bank Group 2011, p. 3-4.
following decades. Moreover, the United States enacted the Alternative Dispute Resolution Act in 1998.\textsuperscript{90}

The United Kingdom showed a similar development with regard to Alternative Dispute Resolution. The most popular report written that tackled the “failure” of court litigation in the United Kingdom is: “Lord Woolf’s Report on Access to Justice”. The report is known for its critical review of the English litigation and its recommendation of introducing ADR as a part of how the English judges manage their cases by encouraging the parties in a case to think over the possibility of choosing ADR and facilitate such procedure. This report stated five reasons for the introduction of ADR: Firstly, low priority that was given to civil cases; secondly, the delay to progress the disputes from issue to trial; thirdly, the delay to reach settlement; fourth, the delay to get a hearing date and finally, the delay which is caused by the time taken by the hearing.\textsuperscript{91}

3.3.3 Alternative Dispute Resolution, Islam and Islamic Finance

As stated above, the support for Alternative Dispute Resolution in the western World gained a lot of support in the 20\textsuperscript{th} Century, but what about the Islamic world? Since the beginning of Islam itself, Islam and ADR existed and cooperated together\textsuperscript{92} and it has been even mentioned in the \textit{Quran} in Surah 4 verse 35: “And if you fear dissension between the two, send an arbitrator from his people and an arbitrator from her people. If they both desire reconciliation, Allah will cause it between them. Indeed, Allah is ever Knowing and Acquainted [with all things].”\textsuperscript{93} This verse shows the use of arbitration, a form of ADR, in matrimonial matters. However, the legal history of Islamic Law shows us that it has also been extensively used in matters with regard to commercial transactions.\textsuperscript{94} The definition of ADR in Islamic law does not differ that much from the definition that is given above. There is one crucial element that is added and that is the concept of \textit{halal} (permissible) and \textit{haram} (prohibited). This means that all processes are allowed as long as these processes do not permit what has been forbidden in the \textit{Sharia} and do not forbid what has been permitted. Oseni and Ahmed introduced the following definition of Dispute Resolution in Islamic law: “Dispute Resolution in Islamic law can be defined as a range of processes for amicable resolution of disputes either as court-annexed processes or outside-court-settlement by a third

\begin{itemize}
\item \textsuperscript{90}Oseni & Ahmad 2011, p. 3.
\item \textsuperscript{91}Ibid, p. 4.
\item \textsuperscript{92}Oseni 2009, p. 8.
\item \textsuperscript{93}Sahih International <http://quran.com/4>
\item \textsuperscript{94}Oseni 2009, p.8.
\end{itemize}
party neutral based on the Islamic worldview without compromising the Fundamentals of Islamic Law.”

Islam offers different ADR processes that could be applied to Islamic Finance cases such as: *Sulh* which can be described as a form of negotiation based on good faith or mediation; *Tahkim* which can be described as arbitration; *Med-Arb* which can be described as a mix of *Tahkim* and *Sulh*; *Muhthasib* which is also known as the ombudsman; Wali al-Mazalim which can be described as the Chancellor; and the expert determination or known in Arabic as *Fatwa/Mufti*.

In the last years, there has been an increasing demand for ADR in Islamic Finance. In countries such as Malaysia and Indonesia, where the courts are quite familiar with Islamic Law, Islamic Finance showed a growing need for a replacement of the current court litigation system. The growing amount of cases in the last years proved that the current litigation system and legal framework are not effective and sufficient enough to handle these Islamic Finance disputes. It is a fact, that these disputes should be served by an efficient and expedite process. This is to avoid certain unwanted public attention, to secure the relationship between business partners in the future, and to avoid that the credibility of Islamic Finance will be damaged. Moreover, there are not enough judges that are considered to be experts with regard to Islamic law and Islamic Finance. In Malaysia, there is only one judge that can be seen as a true expert on the field of Islamic Finance. This leads to the conclusion that Malaysia will have to embrace/increase the use of ADR to handle the growing amount of Islamic Finance disputes.

### 3.3.4 Alternative Dispute Resolution & Shamil v. Beximco case

It is very interesting to investigate whether the ruling in the *Shamil v. Beximco* case would have been different if it would have walked down the road of ADR instead of that of traditional court litigation. The mixed choice of law was the main reason why the High Court and Appellate Court did not rule in favor of the defendants. One of the possible forms of ADR is arbitration.

The characteristics of arbitration procedures are that the parties are free to choose their arbitrators, the procedures and where it can take place. Party autonomy is the essence of

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97 Ibid, p.17.
98 Oseni & Ahmad 2011, p. 9.
Contracts are mainly responsible for its law components. A contract will state whether parties will come in front of an arbitration procedure with regard to a dispute. The parties that draft the contract authorize the hearings and decision of the arbitrators. Moreover, the arbitrators are bound by the views of the parties and do not have any power to decide outside of the scope of the contract. It goes so far that even the awarded remedies should fall in the scope of the agreement. This distinguishes arbitrators from judges because the former are mainly bound by the contract of the parties and this extends not only to decision and remedies but also the choice of law by parties in a commercial contract, if applied to Islamic Finance, this could mean that an arbitrator will be also bound to an Islamic Finance contract.

The general rules of arbitration shows us that there is a different path than the chosen path of the judges in the *Shamil v. Beximco* case. If the parties would have drafted an arbitration clause in their contract, the general rules of arbitration could have worked in favor of the defendants, because the arbitrator would have been bound by the rules of the contract written by the parties. However, the combined-law approach is not very popular in the United Kingdom. This is due to the fact that arbitrators in the United Kingdom do not have enough knowledge of the Sharia and have to refer to an expert and because some arbitrators are of the opinion that their forum of alternative dispute resolution should be secular and should not be interfering in religious disputes. But does this mean that every arbitrator would have decided the same?

In the last years, there has been a lot of improvement on arbitration with regard to Islamic Finance disputes in Malaysia. As stated before, Malaysia passed the Central Bank of Malaysia Act 2009 in 2009. The Shariah Advisory Council became an ADR forum of which the decisions are binding on the Courts. There is a general view that an agreement to arbitrate is binding in Islamic Finance Countries such as the United Arab Emirates, Saudi Arabia and Malaysia. Moreover, it is becoming a standard that these kind of arbitration bodies, such as the Kuala Lumpur Regional Centre for Arbitration, use a combined-law approach with regard to Islamic Finance disputes and write it down in their rules. One of its rules states: “*the arbitral tribunal shall apply Shariah principles and the law designated by the parties as*

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100 Ibid, p. 67-68.
101 Colon 2011, p. 431.
102 Colon 2011, p. 431-432.
applicable to the substance of the dispute”.\textsuperscript{103} This means that combined-law contracts are possible.

The negative view of the combined law-approach in the United Kingdom and the growing expertise on Islamic Finance dispute resolution in some Islamic countries leads to the conclusion that some Islamic finance experts believe that the Industry of Islamic Finance can be only protected and controlled by an Islamic ADR system\textsuperscript{104}. The lack of expertise of Islamic Finance in the United Kingdom, the wish of keeping arbitration secular and the negative view on combined law contracts leads to the conclusion that an arbitration body in the United Kingdom would not have decided differently from the High and Appellate Court. However, the outcome of the case could have been different if they would have drafted an arbitration clause that would have referred to an Islamic Finance ADR system for their possible disputes.

\textsuperscript{103} Ibid, p. 421
\textsuperscript{104} Ibid, p. 431.
4. **Netherlands, Islamic Finance & Islamic Finance Dispute Resolution**

In 2007, the former Finance Minister of the Netherlands Wouter Bos stated that he believed that there are opportunities for Islamic Finance in the Dutch financial sector. Moreover, he added that the Netherlands fits itself in playing a role for the development of London and Dubai as International Centers for Islamic Finance. The former Minister of Integration stated that the Netherlands is moving from a traditionally Jewish-Christian society to a Jewish-Christian-Islamic society and there also seemed to be an increase in financial products that are in compliance with the prohibition of *riba*.\(^{105}\)

The current Muslim population in the Netherlands is 6% of the total Dutch population and is estimated to grow to 7% in 2020. Especially the Muslims, which were born from one or both parent who were born in a foreign country, known as the second generation, are interested in Islamic Financial products that comply completely with the *Sharia*. Moreover, there also has been an increase in the gross income of the second generation Muslims which will additionally provide them with more opportunities to save, buy houses or invest. Although the second generation Muslims does not have strong ties with the countries of their parents, they feel a strong need to establish their own identity within the Dutch Society in which faith plays an important role and increases the demand of the second generation Muslims for Islamic Financial products.\(^{106}\)

There are almost 1 million Muslims in the Netherlands. However, there have been some different initiatives such as Islamic mortgages, which have failed because the Dutch Tax Authorities refused to apply tax rebate on Islamic mortgages.\(^{107}\) Hans Moison\(^{108}\), who works currently as the Advisor for Financial Services for KPMG in Amstelveen, stated that the Netherlands is missing out on the possible opportunities of Islamic Finance and that the Netherlands should take initiatives, as the United Kingdom does, to ensure a bright future for the developments of Islamic Finance in the Netherlands.\(^{109}\)

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\(^{106}\) Verhoef, Azahaf & Bijkerk 2008, p. 22.
\(^{107}\) Van Rossum 2009, p. 360.
\(^{108}\) Profile of H. Moison on Linkedin: [<http://nl.linkedin.com/pub/hans-moison/8/6ab/427>].
\(^{109}\) H. Moison, *de toekomst (muziek) van Islamitisch Financieren* [http://www.bankingreview.nl/?portlet=bankingreview&page=opinie/artikel&id=88].
4.1 Islamic Finance and the Dutch Market

In the case of offering financial products on the Dutch market, first the provider must obtain the permission from the financial supervisors. There are two financial supervisors: The Dutch Central Bank (DNB) and the Netherlands Authority for the financial market (AFM). The responsibilities of DNB are granting licenses to banks, pension funds, trust offices and insurers. The AFM grants licenses to financial institutions, companies and financial service providers. There are some elements that need to be looked at before the AFM and DNB grant licenses, such as the efficiency and effectiveness of the procedures while conducting business and the trustworthiness and knowledge of the policymakers.

The DNB has standard supervisory procedures which make ensure that there will be compliance to supervisory regulations and laws, integrity of business procedures and a proper governance of the solvency and liquidity risks. The AFM focusses mainly on the conduct of the financial institutions and companies which should be in accordance with the Act on Financial supervision (Wet Financieel toezicht or Wft). All financial companies who want a license, including Islamic Finance companies that seek a license to offer Islamic financial products, are subject to the conditions as they are written in Wft, irrespective of their country of origin, religious principles or sector. One of the key objectives of the Wft is to guarantee a level playing field which means that equal cases must be treated equally and not only on international areas but also through different sectors.  

In the case that an Islamic Financial institution wants to provide some banking services, it has to be defined as a “bank” in the meaning of Wft. This act defines bank as following: “A party whose business it is (1) to receive funds from private parties and (2) to grant credit at its own account.” The first condition is easily satisfied as it is normal for a bank to get nominal guaranteed deposit from private parties. However, Islamic Finance methods cannot be seen as credit and therefore it will be a problem for Islamic Financial Institutions to be qualified as a “bank” as stated in Wft, but there is a solution for Islamic Financial companies. They can apply for a license as a bank investment company, but this solution applies only for companies that already have a banking license. Finally, there is the question whether Sharia Supervisory boards fit within the system of the Dutch market and how they could be regulated. There are no clear rules and there arises the question whether these boards can be seen as a senior management or executive board. This would mean each product that would be licensed by them, would be assessed by a licensing supervisor. There is

111 Ibid, p. 27
also the possibility to see these boards as approval committees, which would mean there
would not be an assessment of each of their license activities. However, it would be necessary
to write the scope of their responsibilities and tasks down.\footnote{Ibid, p. 26-27.}

\section*{4.2 Islamic Finance methods and Dutch Law}

The Netherlands has a continental law system which means that it has a body of written law
such as statute law and codes which are issued by the Dutch Parliament. This body of law is
applied on every individual case. In 1883, the Netherlands formed the first Dutch Civil Code
which was based on French civil law. In the following decades, the Netherlands amended the
Dutch Civil Code many times and in 1992 it was revised and divided into ten books. The Wtf,
Code of Commerce and Bankruptcy act are also considered to be part of the Dutch civil
law.\footnote{<www.dutchcivillaw.com>.}

In this section, I choose four of the most used methods of Islamic Finance and will
study whether they fit within Dutch civil law. I have chosen to discuss the following Islamic
finance methods: \textit{Murabahah, Musharakah, Ijarah} and \textit{sukuk}.

\subsection*{4.2.1 Murabahah & Dutch Civil Law}

As stated before, most of the finance operations of Islamic financial institutions and banks are
based on this method of Islamic Finance.

In the first place, \textit{murabahah} seems to fit in within the Dutch civil law and can be
identified as a sale on installment as regulated in art. 7A:1576 \textit{et seq.} CC.\footnote{Van Rossum 2009, p. 362.}
Moreover, the Dutch Supreme Court ruled that these regulations also apply for securities and other property
rights.\footnote{HR 28 maart 2008, RF 2008, 45 enJOR 2008/131.} However, art. 7A:1576(4) CC exempts the sale on installments of immovables. The
articles of Book 7A of the Civil Code with regard to sales on installments are mandatory,
which means that the \textit{murabahah} (with the exemption of immovables) is subject to the
mandatory rules of art. 7A: 1576 \textit{et seq.} CC. This means, as stated in art. 7A:1576c (1 and 2)
CC, that in the case of default, early repayment will be only possible if the default is 10
percent of the whole amount in case of one period or when the default is 5 percent of the
whole amount in the case of two or more periods. Article 7A:1576e(2) states that the buyer
will get at least 5 percent annual discount in the case of early repayment, but that could go
gainst Islamic Law because giving a discount for an early repayment would mean that the
amount that is repaid will be based on time and not on an agreed profit which goes against the Sharia.\textsuperscript{116}

4.2.2 Musharakah & Dutch Civil Law

The Dutch legal system provides some opportunities for musharaka. I will discuss only two forms: Community of property (gemeenschap) and a non-public partnership (vennootschap).

Diminishing musharaka is the form where the client and financier start a partnership of property, equipment and/or labor or have a joint company. The financier has shares in this joint company and will sell his shares to the client periodically until the client is the sole owner of the company.\textsuperscript{117} This has some similarities with the growing property schedule which was recently developed for the Dutch housing market. This schedule can be qualified as co-ownership and is therefore regulated by title 3.7 (Community of property) of the Dutch Civil Code. It seems that this form of musharaka fits within the Civil Code, but article 3:178 CC gives the right to each of the partners to claim at all times the division and appointment of their share in a community property which would defer the prohibition on gharar. This cannot be contractually postponed for a period longer than 5 years.\textsuperscript{118}

A musharaka between a financier and a client for a joint company can be qualified as a non-public partnership in the meaning of article 7:800 CC with the advantage that according to article 7:806 (1) CC that the client cannot claim the division of his share. However, there is the disadvantage that the partners are jointly liable for the losses of their joint company. Therefore, it is recommendable to choose for the form of “commenditaire vennootschap” (limited partnership) where the financier is only liable for his own share. A CV can be only established by a public partnership. However, the financier is not allowed to have a share of profit that exceeds the ratio of his capital contribution as stated by the Sharia. In the case that the financier has decisive influence in the company, he will be held severally liable for the company’s losses.\textsuperscript{119}

\textsuperscript{116} Van Rossum 2009, p. 362-363.
\textsuperscript{117} Usmani 2009, p. 57.
\textsuperscript{118} Van Rossum 2009, p. 365
\textsuperscript{119} Ibid, p. 365.
4.2.3 Ijarah & Dutch Civil Law

As stated before, *Ijarah* is an Islamic finance form of a leasing agreement that is attractive for long-term or intermediate financing and is besides the *Murabahah*, one of the most used Islamic Finance methods\(^{120}\), especially the form which is known as *ijarah-wa-iqtana*.\(^{121}\)

An *ijarah* can be qualified as a rental agreement under article 7:201 CC with the application of the mandatory rules under article 7:232 CC and 7:290CC. A *ijarah-wa-iqtana* which does not provide the leased object for a sale at the end of the leasing period can be qualified as a hire-purchase under article 7A:1576H CC and TWHOZ (Tijdelijke wet huurkoop onroerende zaken/Temporary property hire purchase act). The *ijarah-wa-iqtana* can be qualified as hire-purchase in case the lessor provides the leased object for sale and if he asks a symbolic money amount for the leased object. If he asks a price that is equal to residual value of the object, the *ijarah-wa-iqtana* does not qualify as a hire purchase.\(^{122}\)

4.2.4 Sukuk & Dutch Civil Law

As known, there are fourteen different types of *sukuk*, but I will only discuss whether the most used form, *sukuk al-ijarah*, could fit within the Dutch legal system\(^{123}\). A *sukuk al-ijarah* structure consists of two parts: the sale and lease back (SALB) agreement between the Seller and the SPV and the issuance of the *sukuk* by certification of the assets.\(^{124}\)

The SALB agreement can be qualified as a rental agreement under article 7:201 CC and has to meet all the requirements for transfer that are written in article 3:84 (1) CC.\(^{125}\) Moreover, the SALB agreement does not interfere with the fiducia-prohibition of article 3:84(3). This refers to the prohibition of security interest which are not regulated. The question was whether SALB falls under this prohibition which forbids to transfer ownership for security purposes. The Dutch Supreme Court decided in the Sogelease Case that a SALB agreements does not interfere with the prohibition of article 3:84 (3) CC as long as there is a real transfer of property without any limitations.\(^{126}\)

The SPV functions as a trust, but the Dutch Legal system does not acknowledge the trust concept. However, the Dutch law provides a certain substitute, which is the use of the

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\(^{120}\) Vogel and Hayes 1998, p. 190.
\(^{121}\) Kamali 2007, p. 6.
\(^{122}\) Van Rossum 2009, p. 364.
\(^{123}\) Salah 2010, p. 19.
\(^{125}\) Ibid, p. 37.
\(^{126}\) Ibid, p. 30.
form of foundation. This form creates a similar trust relation and a limited object clause reduces the risks of bankruptcy of the SPV. Finally, the certification agreement fits within Dutch Law as long as it states that sukuk holders are the beneficial owners of the assets, which means that they can become beneficial owners by certification of the underlying assets. This leads to the conclusion that the sukuk al-ijarah fits within the Dutch Legal system.

4.3 Islamic Finance Dispute Resolution and the Netherlands
In contrast to the United Kingdom, the Dutch legal system is not familiar with Islamic Finance Disputes. However, I still studied whether its legal system would acknowledge the choice of the Sharia in contracts in Islamic Finance Disputes. In the Shamil v. Beximco case, I showed that the English Courts did not accept the choice Islamic law as source of law in Islamic Finance Disputes, but what about the Dutch Courts and how could the Rome I Regulation influence this?

The Rome I Regulation came into force on the 24th of July 2008 and was applied EU-wide, with the exception of Denmark, from the 17th of December 2009, which means that it also applies in the Netherlands. It has been converted from the “old” Rome Convention (Convention on Law applicable to contractual obligations).

The Rome I Regulation does certainly influence whether Dutch Courts will recognize Islamic Law as a source of law in contracts in Islamic Finance Disputes governed by Dutch Law. Article 3 of this regulation states that the parties in a contract, such as an Islamic Finance contract, have the freedom to choose the law that can be applied in their contract or even in a part of the contract. It seems that the Sharia could be chosen as a source of law for a contract, as long this choice is presented clearly. However, this regulation seems to uphold the old rule of the Rome convention, that the contracting parties can only choose a state law. This is also been repeated by Tjittes in his article. He refers to the Explanatory Memorandum of this regulation. This memorandum authorizes the use of non-state law such as the Principles of European Contract law and UNIDROIT principles but excludes the use of lex mercatoria as a non-state law because its codification is not completely recognized by the international community and because it is not precise enough. However, in the end the European

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127 Ibid, p. 32.
128 Ibid, p. 36-37.
130 Tjittes 2008, p. 142-143.
131 Commission of the European Communities 2005, p. 5.
Commission also excluded the UNIDROIT principles and the principles of European Contract Law. 132

This exclusion of *lex mercatoria* and the rest leads to the conclusion that it is very unlikely that the Dutch Courts will accept the choice of *Sharia* in contracts in Islamic Finance disputes because it is not complete codified set of rules. 133

Moreover, Tjittes refers to another point which influences the question whether Dutch Courts will recognize Islamic Law as a source of law in contracts in Islamic Finance disputes and that is the decision of the English Court of Appeal in *Shamil v. Beximco* case. He refers, believing that Dutch Judges will take this into consideration, to the statement that a general reference to the Sharia ("subject to the glorious principles of the Sharia") is not sufficient enough to apply this law besides English Law, the other chosen law in that case. The choice of law should be sufficiently determinable. The judge focused mainly on the point that parties in this case did not point out which parts of Islamic Law they chose for their contracts. However, Tjittes believes that if the parties refer to a part of the Sharia such as *fiqh al mualamat* (civil laws), then this choice could be seen by the Dutch Judges as sufficiently determinable. 134 I do not share this opinion and think that Tjittes is too optimistic in this matter. I would like to refer to the following statement of the English judges in the *Shamil v. Beximco* case. They pointed out that even in the case that the Sharia would be sufficiently determinable, it would be most unlikely that they would apply these “controversial” principles. 135 It seems that like in the United Kingdom, Islamic Finance will face significant problems if the Sharia is not recognized by the Dutch Legal system as a source of law in contracts in Islamic Finance disputes. But does the same problem apply in the case parties choose for alternative forms of dispute resolution instead of the Dutch Courts?

4.4 Netherlands, Islamic Finance and alternative dispute resolution

Alternative dispute resolution in the Netherlands has another definition than I introduced in section 3.3.1. ADR in the Netherlands can be defined as “*other than the ruling of the court*”. The popularity of ADR in the Netherlands has grown in the last years and fits the developments in the Netherlands such as the development in privatization and individualization. The Dutch citizens have become more empowered and this form of dispute resolution seems to go hand in hand with their will to solve their disputes by themselves.

132 Vernooij 2009, p.73.
133 Tjittes 2008, p. 143.
134 Ibid, p.143.
135 Hassan & Asutay 2011, p. 62.
Moreover, ADR seems also to solve the growing workload of the judiciary. The slow formal court proceedings and the low accessibility of the judiciary strengthens the will to find an alternative solution for disputes than through the Dutch legal system. There are different forms of ADR in the Netherlands, such as mediation and binding advices, but I will focus in this thesis specifically on arbitration, which is governed by national and international law.

Arbitration in the Netherlands is regulated in the Dutch code of civil procedure in article 1020 et seq. CP (Civil Procedure). This is also known as the Dutch Arbitration Act. These articles ensure that the arbitration procedure in the Netherlands meet the requirements for a due process. However, the “normal” Dutch judge can have a limited monitoring on arbitration as there are some possibilities provided by the Dutch code of civil procedure such as annulment (article 1065 CP) and a cancellation (article 1068 CP) of an arbitration judgment. The arbitrated disputes may rise from civil wrongs such as tort or from agreements or contracts, such as the contract in the Shamil v. Beximco case. Internationally, the Netherlands is also a party to the ICSID (Convention on the settlement of investment disputes between States and Nationals of other States) and the New York Convention of 1958. Do these regulations provide the opening for Islamic law to be recognized as a source of law in Islamic Finance Law if parties in an Islamic Finance Dispute choose for Dutch Arbitration?

Article 1054 CP states that the Arbitral Tribunal in the Netherlands shall make its award in accordance with the rules of law. The choice of law can be chosen by the parties and if not, the arbitral tribunal will make its award with the rules of law which it considers appropriate. The definition of “law” in this article differs from the definition in the Rome I Regulation where law is defined purely as state law. The definition of law in this article includes also non-state law such as lex mercatoria. In the case parties refer to arbiters as “good men in fairness”, Sharia could be classified as a source of law in contracts in Islamic finance disputes by fairness. Moreover, it is noteworthy to mention that the link between arbitration and religious law in the Netherlands is a known phenomenon within Jewish and

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141 Tjittes 2008, p. 143. 
142 Tjittes 2008, p. 143.
Christian circles and therefore it could also apply in arbitral cases which chooses the Sharia as a source of law.\textsuperscript{143}

However, I would like to also refer to article 1065 (1) CP which states that an arbitral award can be reversed if the award or the manner in which it was made violates public policy or good morals.\textsuperscript{144} Sharia could be refused to be accepted by an Arbitral tribunal in the Netherlands as a source of law in contracts in Islamic finance disputes because it is not in accordance with the fundamental values and principles of Dutch Law. Moreover, the PVV politicians Wilders and Fritsma asked Parliamentary questions about the Sharia in the Netherlands to ex-Minister for Justice Hirsh Ballin on 30\textsuperscript{th} of June 2009. This was answered as following: “Islamic legislation shall neither be accepted by Dutch law nor introduced to it. Neither will it be possible for different legal systems to exist in the Netherlands alongside each other. (…) In the Netherlands there can be no question of a parallel legal structure that undermines the operation of the Dutch legal system.”\textsuperscript{145} This statement by the ex-Minister for Justice seems to exclude the Sharia completely from the Dutch Legal system and does not provide any hope that it will recognize the choice of Islamic law in contracts in Islamic finance disputes.\textsuperscript{146}

Finally, article V in the New York Convention states also that courts of Contracting States may refuse to enforce an arbitral award for reasons of public policy. This means that if the Sharia goes against their public policy of the Contracting States, such as in the Netherlands, they can refuse to enforce an arbitral award, recognizing the choice of Islamic Law in contracts in Islamic Finance disputes, which was made in another country.

\textsuperscript{143} Forum Institute for Multicultural affairs 2009, p. 4.


\textsuperscript{145} Forum Institute for Multicultural affairs 2009, footnote 17

\textsuperscript{146} Ibid, p. 4.
5. Conclusion & recommendation

5.1 Conclusion

In search for the answer of the research question if the Dutch legal system would acknowledge the choice of Islamic Law in contract in Islamic Finance Disputes, I have first studied the situation in Malaysia and United Kingdom.

In the beginning, the courts in Malaysia did not have a positive attitude towards the Sharia in disputes regarding Islamic Finance.

The case law showed that Malaysia went through three phases with regard to the attitude of its courts toward Islamic Finance cases, but many courts kept ruling in favor of Islamic Financial institutions and thereby ignoring the choice of the Sharia in contracts in Islamic finance disputes. However, the enactment of The Central Bank Act of 2009 made sure that the Malaysian civil court cannot come with a ruling in Islamic Finance disputes that ignores Islamic Law. Civil courts are required to refer to the Shariah Advisory Council in sharia matters thus including Islamic Finance disputes and they are bound by the ruling made by the council.

In the United kingdom, there was the Shamil v. Beximco case which came with the ruling that rejected the Sharia as a source of law in contracts in Islamic Finance disputes. The court argued that only one law should govern a contract, while this contract stated that it was governed by English and Islamic Law. Moreover, it is a non-state law which is now allowed by the Contract Acts 1990. Finally, it argued that the parties could not have intended that the English Court would apply such controversial principles.

I have showed that the Islamic Finance methods could fit within Dutch law which shows that Islamic Finance could theoretically be introduced in the Netherlands. However, there could be problems on a practical level such as in the case of Islamic Finance disputes. In that case, it is important to look at the Rome I Regulation, which is applied EU-wide and therefore also in the Netherlands. This regulation excludes non-state law such as lex mercatoria. This could have the consequence that the Dutch courts could also exclude the choice of Sharia in contracts in Islamic Finance disputes. Furthermore, the Dutch courts could state that the choice of the Sharia in a contract is not sufficiently determinable and that there should be a specific referral to a part of Islamic Law such as civil law, but even then it is very improbable that the court would apply such “controversial principles”. Alternative forms of Dispute resolution in the Netherlands do not seem to provide a different solution from the Dutch Courts. Although, it seems that the Dutch Arbitration Act allows for the Sharia to be defined as “law”, an arbitral tribunal in the Netherlands could reject the choice of the Sharia
on the ground of violation of public policy and good morals. Moreover, there seems to be a negative view on Islamic law in the Dutch society and politics.

This leads to the conclusion that the Dutch Legal system will not acknowledge the choice of Islamic Law in contracts in Islamic Finance disputes and that alternative forms of dispute resolution in the Netherlands do not provide a solution for the possible rejection of the Sharia by the Dutch courts.

5.2 Recommendations

It is a fact that Islamic Finance is the fastest growing form of finance in the world. However, it seems that the answer provided in this thesis shows that Islamic Finance will have to face great challenges in the western world. The ruling in the Shamil v. Beximco case, the Rome I Regulation and the Dutch Arbitration Act could have the consequence that Islamic clauses in Islamic Finance contracts are not fully enforceable thus undermining the cornerstone of Islamic Finance itself. This will discourage Dutch customers to purchase Islamic Finance products and this could mean that the Netherlands is missing out on the possible opportunities of Islamic Finance. However, there are certain recommendations for the acceptation of the choice of Islamic law in contracts in Islamic Finance disputes and the possibility of a growth of Islamic Finance in in the Netherlands and in the rest of western world.

Firstly, I would recommend the establishment on an umbrella Islamic ADR system. As explained above, arbitration in the United Kingdom and the Netherlands is most unlikely to apply Islamic principles because they share the opinion that these principles are not reconcilable with the public policy and morals of their societies. Arbitration bodies such as the Kuala Lumpur Regional Centre for Arbitration (KLRCA) are set in the Islamic countries of which the Sharia makes part of its public policy and good morals. Furthermore, Islamic countries such as Malaysia have many more advantages to be chosen as arbitral forum. Malaysia took many steps to become an arbitration country by having a supportive government and courts that developed an arbitration friendly attitude. Moreover, the costs of arbitral proceedings in Malaysia are around 60 percent lower than in Singapore. Expenses such as transport, accommodations and foods are considerable lower than in western countries. Arbitration bodies in Malaysia are also familiar with Islamic Finance disputes which makes it more attractive to be chosen as the country for an umbrella Islamic ADR system. The familiarity with the Sharia, arbitration-friendly environment and significant lower costs

makes it recommendable to choose for an Islamic country such as Malaysia to be the center for an umbrella Islamic Finance ADR system. Moreover, I would like to recommend the inclusion of an International Sharia Advisory Council with Islamic Finance experts all over the world, to this Islamic Finance ADR system to make it more credible. A global Sharia Advisory council would be able to create uniform Islamic Finance standards for its products and structure the Islamic Finance industry which is very important for its stabilization and its further growth. It could also harmonize the code of conduct for the scholars in Sharia boards around the world and prevent the selection of inexperienced members, because they are not required to be certified like in other professions. The combination of an Umbrella Islamic ADR system with a global Sharia Advisory Council will enlarge the chance that its arbitral awards would be enforced in western countries.

Furthermore, I would recommend the international recognition of the principles of Islamic Finance by establishing an International treaty that codifies and standardizes the principles of Islamic Finance and to which parties can refer to in Islamic Finance contracts rather than the Sharia. As explained in the first chapter, Islam has different schools which have different opinions on the same matters. An International Islamic Finance Treaty will create the opportunity to standardize the rules on Islamic Finance methods and prevent confusion between Islamic Finance experts and the customers of Islamic Finance institutions and improve the confidence of all the stakeholders. The standardization of the rules on Islamic Finance will realize that certain Islamic Finance rules and products will transcend borders more easily and will result in an Islamic Finance market that will be more efficient and transparent. An International treaty will also reduce costs and save time regarding the creation of new Islamic Finance products and will stimulate new innovation on the Islamic Finance market. The global financial crisis showed the importance of a well-developed regulatory framework and supervision. The Islamic Finance market is the fastest growing financial market with large new players and therefore it is important to have an International Islamic Finance Treaty. This will promote standardization to improve the regulation of the Islamic Finance market and prevent it from facing the same problems that caused the global financial crisis. Moreover, the principles of Islamic Finance itself do not breach public policy or morals of western countries. The recognition of this treaty by (western) countries and the reference to it by other parties will have the effect that the arbitral tribunals of these countries

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148 Hamzah & Vizcaino 2013 <http://www.reuters.com/article/2013/05/16/islamic-finance-scholars-idUSL6N0DX1D220130516>
149 Yaacob, Muhammed and Smolo 2011, p. 20-23.
150 Ibid, p. 33.
and international arbitral tribunals will be more likely to apply these principles in their arbitral awards. Moreover, they could enforce the arbitral awards made in another country that applies these principles.

Finally, I would recommend western legal experts to start a dialogue with Islamic legal experts in the field of Islamic Finance. Countries and companies cannot isolate themselves from other forms of laws than their own, especially in the field of Islamic Finance. The lack of knowledge in the western world seems to create a negative view of Islamic law which resulted in the framing of the English Court in the *Shamil v. Beximco* case of the *Sharia* as “controversial principles”. I believe that the dialogue between different legal cultures could create mutual understanding of each other’s legal cultures and would make it more likely to create an International Islamic Finance treaty. Moreover, it could have a positive effect on the development of International arbitration with regard to Islamic Finance disputes and creating the possibility to come with arbitral awards that are in compliance with western values and the *Sharia*. This will result in further growth of Islamic Finance in the western world.

The growth of Islamic Finance in the western world will not be realized and will miss many opportunities on the financial market if the *Sharia* is not respected as a source of law in contracts in Islamic Finance disputes.
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