

Abdul Rasheed Ghaffour: Practical aspects of dispute resolution in Islamic finance facilities

Remarks by Mr Abdul Rasheed Ghaffour, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Association of Islamic Banking Institutions Malaysia (AIBIM) Law Seminar on "Practical Aspects of Dispute Resolution in Islamic Finance Facilities", Kuala Lumpur, 14 November 2017.

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“Past, present and future: Legal certainty and Islamic finance in Malaysia”

It is my honour to join all of you today in exploring this interesting topic on the practical aspects of dispute resolution in Islamic finance. This seminar marks another significant step in fostering dialogue between Islamic financiers, Shariah scholars and the legal fraternity. Gatherings such as this serve as an important platform for Islamic finance practitioners to develop a better grasp of legal issues, and for lawyers to gain a keener sense of Islamic finance. I am encouraged to see the Association of Islamic Banking Institutions Malaysia (AIBIM) taking the lead in advancing this mission.

Disputes in business transactions have been around for as long as commerce itself. It is therefore no surprise that we come across judges and lawyers very early on in human history. Earlier than bankers – and definitely long before we see the first central banker . Disputes are bound to happen. One party may not be able or willing to honour their obligations. The other party may be dissatisfied with how an obligation is performed. Still, there may be a fundamental disagreement between the parties about what was agreed in the first place. It is the inevitability of disputes that makes the existence of dispute resolution systems so universal.

Dispute resolution in Islamic finance is gaining more attention these days. I would take this to be a good sign. In a legal system, disputes may be viewed as an indicator of vigour rather than weakness – so long as they are resolved effectively and efficiently. The common law legal system is exemplary in this regard. Today, common law systems are the most widespread in the world, in terms of GDP generated under these jurisdictions . The large volume of commercial disputes resolved by these jurisdictions are a reflection of the widely-accepted strength of the common law legal system in providing certainty to business dealings.

Today, legal certainty is widely said to be central to the rule of law . It is important that the law be accessible, clear and predictable. People should be assured that questions of legal right and liability will be determined by rules that meet these characteristics. This is not just crucial for social justice – this ensures a stable environment to facilitate sustained business growth. Of course, legal certainty does not mean that the laws are inflexibly set in stone such that justice and common sense are frustrated. In fact, dispute resolution in a healthy legal system will lead to evolution in the law over time – often with positive knock on effects. For instance, landmark judgments may not only re-shape policies, but also lead to improvements in risk management practices or fairer outcomes to the customers. The series of legal cases involving the sale and purchase contract (Bai` Inah) highlight several important lessons in this regard. For Islamic banking institutions, the decisions have led to further enhancements to the legal documentations for Bai` Inah contracts itself.

In the context of Islamic finance, the task of upholding legal certainty is even more complex, for two reasons. First, Shariah principles and requirements must be infused into the law of the land from the religious sources. Secondly, these prescriptions – written many centuries ago – must be applied to the context of modern finance. For brevity, I will refer to these two aspects of legal certainty as Shariah certainty.

My remarks today will focus on the importance of legal certainty in the development of Malaysia's Islamic finance industry – with a particular emphasis on Shariah certainty. I will begin by reflecting on the past, before sharing some thoughts about some considerations for the present as well as future.

Looking at the past, Islamic finance has developed rapidly in Malaysia over the recent decades. To a large extent, this progress is attributable to the certainty provided by the legal framework for Islamic finance in Malaysia. This can be traced back to the enactment of the Islamic Banking Act in 1983 and the Takaful Act in 1984 which facilitated the birth of the first full-fledged Islamic banking institution and takaful operator. Prior to this, Islamic finance was very niche. Its relevance was mostly limited to the provision of custodian services such as the pilgrimage fund as managed by Tabung Haji. There was no appeal to the wider market, then.

Since the early 1980s, we have witnessed a significant transformation of Islamic finance in Malaysia. Over the years, this sector began to offer a wider range of solutions to cater for the evolving needs of the national economy and the local communities. Islamic finance now makes up a significant and growing share of the domestic market. The share of Islamic banking assets more than doubled from 12.9% in 2007 to 28% in 2016. Takaful penetration has now reached 14.6% of the population. Globally, Malaysia has established itself as a leading hub for Islamic finance. In the global sukuk market, we hold a share of more than 50% of the global outstanding sukuk.

To cater for the growing size and sophistication, the legal foundation for Islamic finance has undergone several enhancements over the years. The Shariah Advisory Councils – or the SACs – of the Securities Commission and Bank Negara Malaysia were established roughly twenty years ago to promote greater Shariah certainty. They since have played an increasingly important role in the ascertainment of Shariah for matters of Islamic finance. The Central Bank of Malaysia Act 2009 formally established a “dual financial system” in this jurisdiction, setting the pace for the progressive development of an Islamic financial system that is equally competitive and sound as the conventional system. The Islamic Financial Services Act 2013 consolidated and updated the earlier legislations on Islamic banking and takaful. Its focus was to elevate the standards of Islamic finance regulation in Malaysia; drive greater innovation; and promote more inclusive growth.

Today, Malaysia is internationally recognised for its comprehensive legal and regulatory framework for Islamic finance. Many emerging Islamic finance markets now see Malaysia as a model to emulate in this respect. Looking back, I believe that the certainty provided by our legal and regulatory framework has contributed significantly to the development of a sound and progressive Islamic financial system in Malaysia.

This brings me to my second point, – which is the present. We are faced with both opportunities and challenges as we move forward.

Global Islamic financial assets stood at USD1.9 trillion in 2016 – and is estimated to reach USD3.2 trillion by 2020. Muslims now make up 24% of the world's population . This is a very large and rapidly expanding market. The potential is enormous. Islamic financial institutions and legal professionals in Malaysia stand to gain –from this, only if we position ourselves well enough to serve this boom. Doing this will require a variety of measures, and it is beyond the scope of my address today, to talk about all of them now. But one thing is clear – in order to remain as a leading Islamic financial hub, Malaysia must uphold legal certainty for effective dispute resolution.

As I mentioned earlier, Shariah certainty entails two unique challenges – Shariah prescriptions must both be infused into law, as well as applied to contemporary settings.

These challenges are augmented by the fast-changing times in which we live. Business is constantly evolving, and finance is likewise far from static. The expectation now for our legal

system is to apply the principles of Shariah to novel products and approaches in a timely manner – while remaining clear, sufficiently flexible to innovation and yet faithful to the tenets of the religious sources. This is a tall order, and the jurisdiction which succeeds in doing this most reliably, will stand in good position, to ride the wave of the Islamic finance boom.

Certainty around the Shariah rules applicable to a particular Islamic finance facility is crucial. Equally important is certainly on the legal enforceability of obligations in the event that there is non-compliance to the relevant Shariah requirements. Uncertainty in any of these areas may lead investors to view such facilities as high risk instruments, and in extreme cases even destabilise the Islamic finance market more generally. An interesting case in point is the one involving Dana Gas, which is now being considered by the High Court in London. The UAE-based energy company declared that its USD700 million sukuk was no longer Shariah-compliant – and thus unenforceable – because the scholarly consensus was said to have shifted since issuance in 2003.

Now, let's move on to the future – we need continued certainty. We have come a long way in setting in place the strong foundation of a legal framework. The law review and harmonisation committees have done good work in ensuring that Shariah principles can be imported into Malaysian law in a way that is effective and seamless. The progress of the past has positioned us with both opportunity and challenge at present. To navigate these well, we need to promote continued certainty as we move into the future. This will require excellence at both the institutional and individual levels.

Institutional excellence

At the institutional level, the judiciary plays a vital role in upholding legal certainty. Judges – along with arbitrators – ensure that disputes are settled by the application of the law, rather than unbounded discretion. The courts also ensure that these laws are intelligible, clear and also predictable.

For Islamic finance, the Shariah Advisory Councils (SACs) of Bank Negara Malaysia and the Securities Commission play a complementary role to the courts – by providing Shariah certainty. It is important to note that this role does not [in any way] substitute the function of the judiciary in upholding legal certainty. Rather, the SACs support the courts – by providing predictability and uniformity in the interpretation of Shariah rulings that are applicable to Islamic financial business. Unlike a scientific question, a Shariah question can be answered by reference to at least four different schools of thoughts, all of which provide valid answers from a Shariah perspective. Having the SACs as central authorities for providing finality of Shariah rulings – helps the court apply the rulings to the specific circumstances of a particular case with full certainty. This will then inform the final judgment by the courts.

A clear process has been set out to facilitate judges, arbitrators and Islamic financial institutions to refer matters which require the ascertainment of Islamic law to the SACs for their ruling or advice. Matters beyond the ambit of the SACs' authority will be left for the courts to adjudicate. The composition of the SACs, which includes former judges, ensures it functions well within the boundaries of its purview. To promote procedural legitimacy, efforts have been also directed towards ensuring that the reasoning of the SACs are well-documented and accessible to the public.

Other than the courts and the SACs, another important institutional arrangement for our path forward will be the financial regulators. In particular, Bank Negara Malaysia and the Securities Commission will continue to play a proactive role in identifying pertinent Shariah issues that need to be clarified for the domestic market. By the end of this year, Bank Negara Malaysia will have completed a compendium of regulatory standards to provide clarity on the Shariah and operational requirements for 14 Islamic finance contracts. This endeavour began in 2013, and incorporates the interpretation of the SAC. The task for the regulators is to come up with similar

standards in the future – especially as the market ventures into novel and more innovative approaches. This will provide an invaluable resources in helping Islamic financial institutions and their lawyers in structuring Islamic finance products as well as identifying the necessary legal documentation.

Individual excellence

At the individual level, the promotion of legal certainty will require a strong base of legal and Islamic finance professionals. As the domestic industry and global market for Islamic finance grows, so must our talent pool. Lawyers involved in product structuring, for example, can provide value-added advice to their clients on the parameters of Shariah requirements and legal rules, which helps in the design and developing the documentation of the products. Litigation experts with sound understanding of Shariah requirements can reason better in courts. Certification programs and targeted seminars such as today's will be important in equipping legal practitioners with a solid understanding of both applied Shariah knowledge and the necessary legal expertise.

In conclusion, the world of modern finance is in need of anchoring principles to ensure that intermediation serves rather than enslaves the real economy. Islamic finance, ingrained with the values of socio-economic justice and the spirit of cooperation, has the potential to provide an answer to this quest. Already, it is gaining much traction around the globe. "For Malaysia to remain a central part of this solution", we must build on our experience and continue to promoting legal certainty for Islamic finance – especially in importing and applying Shariah requirements to the Malaysian law. I certainly believe we can. I wish you all the best in your interesting discussions on dispute resolution today, and also in the days to come.