

Choice of Law and Choice of Forum in International Islamic Financial Contracts

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ABSTRACT: Arbitration is one of the most widely used alternative dispute resolution mechanisms due to the advantages it offers. Among these are more efficiency in terms of time and cost, achieving a dispute resolution that is a win win solution, proceedings that are not open to the public and therefore confidential, more flexible proceedings compared to court litigation, and arbitral awards that are final and binding. Meanwhile, Private International Law and Islamic Banking and Finance are two legal fields currently experiencing rapid growth and development. This is reflected in the increasing number of Sharia financial institutions established in Indonesia. Likewise, the growing practice of choosing foreign law and foreign forums in resolving Islamic financial disputes has made the discussion of Private International Law increasingly relevant in this paper. Banking institutions perform three primary functions: receiving deposits, channelling funds, and providing money transfer services. Sharia banking operates based on Sharia principles, economic democracy, and the prudential principle. The objective of Sharia banking is to support national development in order to increase justice, solidarity, and equitable distribution of public welfare. The rapid growth of Sharia banking has contributed positively to national economic development. However, if such growth is not accompanied by effective dispute resolution mechanisms, it may instead have a negative impact on the national economy. In line with these developments, Sharia arbitration has emerged as a preferred alternative dispute resolution mechanism outside the court system for Sharia banking business actors. The scope of this research is contracts in the Sharia banking sector that contain choice of law or choice of foreign forum clauses. The financial contracts examined are Sharia Banking contracts that involve foreign elements.

KEYWORDS: Arbitration, Choice of Law, International Islamic Financial Contracts.

A. INTRODUCTION

Indonesia has the largest Muslim population in the world, with about 245.9 million people (87.08%) identifying as Muslims (Muhamad, 2024). This demographic has strongly shaped Indonesia's economic and financial sectors, increasing demand for activities grounded in Sharia principles. Sharia-based financial transactions began to grow in Indonesia in the late 1990s, marked by the emergence of various Islamic financial institutions (Mardani, 2015, p. 1). This reflects a societal preference for profit-oriented activities that comply with Islamic law, creating complex legal relationships that can give rise to disputes.

The complexity of Sharia-based transactions highlights the need for dispute resolution mechanisms that ensure both legal certainty and compliance with Sharia principles. Arbitration, widely recognized as an efficient and binding alternative to court litigation, requires a normative and institutional framework adapted to Sharia-based transactions.

The development of Sharia-based economics and business, both at the national and international levels, has generated a growing demand for dispute resolution institutions grounded in Sharia principles. Disputes arising from Sharia-based economic transactions cannot always be effectively resolved through general courts or religious courts due to the distinctive contractual structures and legal principles involved. Consequently, Sharia arbitration emerged as a dispute resolution mechanism that integrates arbitration procedures with Sharia legal principles. In the Indonesian context, Sharia arbitration was institutionalized through the establishment of the *Badan Arbitrase Muamalat Indonesia (BAMUI)* or Indonesian Muamalat Arbitration Board in 1992.

The presence of BAMUI was designed to complement Indonesia's national business dispute resolution system, which had previously relied on *Badan Arbitrase Nasional Indonesia (BANI)* or the Indonesian National Arbitration Board as a conventional arbitration institution characterized by neutrality and the absence of religious affiliation. Accordingly, Sharia arbitration and conventional arbitration have developed in parallel within the Indonesian legal system, each operating with distinct institutional characteristics and normative foundations. Furthermore, pursuant to the Decree of the Indonesian Ulema Council Number Kep-09/MUI/XII/2003, BAMUI was officially transformed into the National Sharia Arbitration Board (BASYARNAS), with the mandate to adjudicate Sharia-based business disputes insofar as the parties voluntarily submit to its jurisdiction.

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Despite formal recognition, BASYARNAS remains underutilized. Challenges include regulatory fragmentation and difficulties in enforcing arbitral awards. This study examines the role of Sharia arbitration in Indonesia, identifies practical challenges, and proposes institutional and regulatory reforms to strengthen its effectiveness in supporting Sharia-based economic and financial activities.

B. ARBITRATION INSTITUTIONS AS AN ALTERNATIVE FOR SHARIA FINANCIAL DISPUTE RESOLUTION

Arbitration as a dispute resolution mechanism outside the courts has been formally recognized in Indonesia for several decades. Early recognition of arbitration can be traced to Law No. 14 of 1970 on Judicial Power, specifically Article 3(1), which stipulates that: “*The settlement of disputes outside the court through amicable means or arbitration is permitted; however, arbitral awards shall only have executorial force after obtaining authorization or an order of execution (executoir) from the court.*” This provision affirms that arbitration has been regarded as a legitimate dispute resolution mechanism, although its effectiveness remained dependent on the role of the courts at the enforcement stage.

The development of arbitration regulation in Indonesia reached a more comprehensive stage with the enactment of Law No. 30 of 1999 on Arbitration and Alternative Dispute Resolution. This law establishes arbitration as an autonomous dispute resolution mechanism grounded in party agreement, whose awards are final and binding. As a result, arbitration gained stronger legal legitimacy as a consensual method of resolving disputes outside the court system.

In the context of the development of the Islamic economy, the establishment of sharia arbitration in Indonesia represents a normative response to the increasing number of civil legal relationships based on sharia principles that have evolved alongside the growth of Islamic financial institutions. The juridical recognition of Islamic banking through Law No. 10 of 1998 amending Law No. 7 of 1992 on Banking has consequently increased the potential for disputes arising from contracts grounded in sharia principles. Such disputes require a dispute resolution mechanism that not only ensures legal certainty but also guarantees the application of sharia principles as the substantive law governing the legal relationships between the parties.

Sharia arbitration was first institutionalized in Indonesia through the creation of BAMUI, established as a foundation via Notarial Deed No. 175 dated 21 October 1992, and approved by the Minister of Justice through Letter No. C-190.H.T.03.07.TH.1992 dated 7 August 1992. BAMUI provided a forum for resolving Sharia-based business disputes outside the court system. In 2003, pursuant to the Decree of *Majelis Ulama Indonesia* or “MUI” (the Indonesian Ulema Council) Number Kep-09/MUI/XII/2003, BAMUI was formally transformed into BASYARNAS, mandated to adjudicate Sharia disputes for parties voluntarily submitting to its jurisdiction.

Although arbitration, including sharia arbitration, has been formally recognized within Indonesia’s national legal system, in practice the enforcement of arbitral awards, including sharia arbitral awards, still faces several obstacles, particularly at the execution stage, which requires the involvement of the courts (Zuraida, 2009, p. 222). Arbitration is increasingly preferred in business contracts, particularly Sharia banking agreements involving foreign elements, such as different nationalities, domiciles, or choice-of-law and choice-of-forum clauses. Such disputes situate Sharia arbitration at the intersection of Private International Law and Islamic Banking and Finance, both of which are rapidly evolving alongside the expansion of Sharia financial activities in Indonesia.

Based on this framework, the scope of this study specifically focuses on contracts in the field of Islamic banking that contain foreign elements, whether in the form of choice of law or choice of dispute resolution forum. This focus is adopted to assess the extent to which Sharia arbitration can function effectively in addressing the complexity of cross-jurisdictional Islamic banking disputes.

As Islamic banking continues to expand, Sharia arbitration has increasingly been positioned as a primary alternative for dispute resolution outside the courts (Asro & Kholid, 2011, p. 291). The widespread incorporation of Sharia arbitration clauses in financing contracts, including *mudharabah*, *musyarakah*, *istishna*, and *takaful* insurance agreements, illustrates the operation of the principle of *pacta sunt servanda*, (Asro & Kholid, 2011, p. 291) under which the parties voluntarily agree to be bound by a dispute resolution mechanism that aligns with the nature of the contract and their commercial interests.

In comparison with dispute resolution through courts, Sharia arbitration is considered more efficient because it does not provide room for prolonged and multi-tiered legal remedies. Lengthy judicial proceedings, which may continue until a final and binding judgment is obtained, have the potential to cause economic losses for business actors. Therefore, Sharia arbitration is regarded as more compatible with the needs of the business community, which demands legal certainty, speed, and efficiency in dispute resolution.

Despite formal recognition, Sharia arbitration has been underutilized. Since BAMUI’s transformation into BASYARNAS in 2003, only a few Islamic financial disputes have been resolved. The first BASYARNAS decision was rendered in 2007 (Decision No. 15/2007) concerning a breach of contract in *Mudharabah Muqayyadah* agreement. By 2017, BASYARNAS had handled only two banking disputes resulting in awards, while several others could not proceed due to unmet arbitration requirements (CRH, 2007). Between 1993 and 2003, BAMUI had resolved approximately twelve disputes. These figures highlight a gap between the normative need for Sharia arbitration and its actual utilization.

A number of institutional shortcomings remain evident, including limited human resources, inadequate financial support, and insufficient institutional outreach and accessibility in regional areas. Meanwhile, the demand for Islamic arbitration is expected to

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grow in tandem with the rapid expansion of the Islamic economic and financial sectors. In the future, Islamic arbitration will need to anticipate disputes arising from areas such as the Islamic money market, Islamic capital market, Islamic pawnshops, and Islamic venture capital (Asro & Kholid, 2011, p. 292). Therefore, strengthening Islamic arbitration through regulatory harmonization and institutional reinforcement has become an urgent necessity to ensure the availability of an effective, fair, and sustainable dispute resolution mechanism in supporting the development of Islamic economics and finance in Indonesia.

C. IDENTIFYING CONNECTING FACTORS IN INTERNATIONAL LAW

From a formal legal perspective, the concept of connecting factors in Private International Law (**PIL**) plays a central role in identifying whether a legal event involves an international element. It also helps determine the applicable law and the appropriate forum for dispute resolution. This section presents an analytical PIL framework that will be applied to cross-border Islamic banking and financial contracts.

Analyzing choice of law and choice of forum is central to understanding connecting factors, including both primary connecting factors and secondary connecting factors. A primary connecting factor serves as an initial indicator that a legal relationship involves a foreign element, bringing it within the scope of PIL.

Several factors that are doctrinally categorized as primary connecting factors include nationality, domicile, the place of establishment of a legal entity, choice of law and choice of forum. These factors are especially relevant in cross-border Islamic banking and financial contracts. The presence of one or more of these elements is sufficient to place a legal event within the PIL regime. In the context of international contracts, particularly in the field of Islamic banking and finance, choice of law and choice of forum hold strategic significance. These two clauses function not only as indicators of the existence of a foreign element but also as the primary instruments for judges or arbitrators in determining the applicable law and the competent forum to examine and resolve disputes. The importance of PIL in this field continues to increase, particularly due to the rapid growth of the Islamic finance industry and the expanding use of foreign law and foreign forums in the settlement of cross-border Islamic financial disputes.

In the PIL analysis concerning choice of law, the secondary connecting factor, examined to determine the law applicable to a particular legal event is the intention or will of the parties (Basuki et al., 2014, p. 6.25). This is consistent with the terminology found in English-language literature on choice of law, which emphasizes the concept of “party autonomy.” In a commercial agreement, the law governing the legal relationship arising from the contract constitutes the legal system subjectively chosen by the parties in accordance with their intentions. According to Private International Law theory, there are two ways in which the parties may express their intention to select a particular governing law. The methods through which parties may exercise a choice of law in an agreement are as follows:

- a) An express choice of law by the parties;
- b) An implied choice of law by the parties (Gautama, 1998, p. 233).

Sudargo Gautama explains that express choice of law occurs when the parties clearly and explicitly designate the governing law within their agreement (Gautama, 1998, 32). This minimizes ambiguity and ensures legal certainty regarding the applicable legal system. In some cases, parties may even select multiple governing laws within a single contract, for instance, applying the law of State X to one issue and the law of State Y to another (Gautama, 1998, p. 249). Although no specific language is mandated, clarity and precision in contract drafting are essential to reflect the parties’ intentions.

An express choice of law is typically incorporated into a contract through a specific provision known in international contractual practice as a “governing law” or “applicable law” clause. Such clauses are frequently found in standardized commercial agreements, including banking contracts, transportation agreements, and international trade contracts. No specific rules prescribe the language that must be used in these clauses, as long as the wording clearly reflects the intention of the parties (Basuki et al., 2014, p. 6.26).

In contrast, an implied choice of law arises when the parties’ intention to select a governing law can be inferred from their conduct or actions, rather than explicitly stated. This method of implied choice of law began to develop in the 1980s (Marshall, 2012, pp. 7–8). According to Sudargo Gautama, an implied choice of law is considered to exist when the parties’ intention can be inferred from their conduct or actions pointing in that direction. When translated into English, an implied choice of law is often expressed using the terms “impliedly” or “tacitly.” Both terms refer to a situation in which a party intends something but does not state it directly through words (Oxford Dictionaries, 1989). Although not explicitly stated, the parties’ intention must be supported by adequate objective facts and cannot be inferred merely from speculation that the law of State X applies. For this reason, this method is also known in English as “inferred intention,” meaning an intention derived from the surrounding circumstances (Oxford Dictionaries, 1989).

In addition to the choice of law, parties in international contracts also have the freedom to determine the forum for dispute resolution. The choice of forum may be directed to the courts of a particular state or to alternative dispute resolution mechanisms, such as negotiation, mediation, conciliation, and arbitration (Proyek Penelitian & Pengembangan Mahkamah Agung RI, 2000, pp. 15–18). Where the parties choose arbitration, the forum selected for conducting the arbitral proceedings, commonly referred to as the seat of arbitration, has important legal implications, as it determines the applicable procedural law as well as the extent of judicial supervision over the arbitral process.

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Choice of law and choice of forum are closely related concepts, yet they perform distinct functions. The legal system selected by the parties governs the validity of the contract and the substantive rights and obligations arising from the agreement (Basuki et al., 2014, p. 6.25). By contrast, the chosen forum serves as the procedural mechanism through which the selected law is applied and enforced (Zaphiriou, 1978, p. 311). Accordingly, the selection of a forum does not necessarily determine the applicable law, just as the choice of law does not automatically determine the forum for resolving disputes.

Nevertheless, the freedom of the parties to determine their choice of forum is not absolute. The selection of a forum must still comply with the applicable provisions of national and international law. In making a choice of forum, the parties are not permitted to designate a court as having jurisdiction to resolve a dispute if, according to the internal legal rules of the state concerned, that court does not in fact possess jurisdiction (Gautama, 1998, p. 233). Examples of fields in which the freedom to determine a choice of forum cannot be applied are set out in Article 2 of the Hague Convention on Choice of Court Agreements, a convention addressing agreements on choice of forum. Generally, matters relating to personal status, family law, and issues concerning public law cannot be subject to freedom of forum selection (Hague Conference on Private International Law, 2005, art. 2).

D. THE DEVELOPMENT OF ISLAMIC BANKING LAW IN INDONESIA

Islamic Economic Law represents an evolving field of legal scholarship grounded in Islamic principles and provides a normative framework for regulating economic and financial activities, including Islamic banking. In the Indonesian legal system, the constitutional foundation for the development of Islamic economics can be traced to Article 29 of the 1945 Constitution of the Republic of Indonesia, which guarantees freedom of religion and recognizes the role of religious values within society. This provision provides sociological legitimacy for the development of sharia-based economic and financial norms within Indonesia's national legal framework.

Prior to the enactment of Law Number 10 of 1998, banking activities based on sharia principles had already received limited legal recognition, among others through Government Regulation Number 72 of 1992 on Banks Based on Profit-Sharing Principles. This regulation reflects the early stage of the state's acceptance of Islamic banking practices, although it had not yet been accompanied by a comprehensive regulatory framework. In addition, various laws and regulations in the economic and financial sectors may function as written legal sources for the Islamic economic system insofar as their regulatory substance does not contradict the principles of Islamic law.

From a normative perspective, Decree of the Minister of Finance of the Republic of Indonesia No. 792 of 1990 defines a financial institution as a business entity engaged in financial activities through the mobilization and allocation of funds to the public, primarily for the purpose of financing corporate investment. Over time, however, and in response to evolving societal needs and the diversification of financial products, the role of financial institutions has expanded beyond investment financing to include consumer financing and the distribution of goods and services, including financing schemes based on sharia principles.

Banking institutions essentially perform three main functions: receiving deposits, channeling funds, and providing money transfer services (Mardani, 2015, p. 12). In the context of Islamic banking, a sharia bank is a bank that conducts its business activities based on sharia principles (Islamic law) and is guided by the fatwas issued by the National Sharia Council of the Indonesian Council of Ulama (DSN-MUI) (Mardani, 2015, p. 12). In carrying out its business activities, Islamic banking is based on sharia principles, economic democracy, and the principle of prudence (Mardani, 2015, p. 25). The objective of Islamic banking is not solely oriented toward profit but also toward achieving justice, solidarity, and equitable distribution of public welfare.¹ Furthermore, the functions of Islamic Banks and Sharia Business Units include mobilizing and distributing public funds, receiving funds originating from zakat, infaq, sadaqah, grants, or other social funds, and channeling such funds to zakat management organizations (Mardani, 2015, p. 27). In practice, the growth of Islamic banking has contributed positively to the national economy. However, if it is not accompanied by adequate dispute resolution mechanisms that are consistent with the characteristics of sharia contracts, such development may give rise to legal uncertainty. Therefore, sharia arbitration has become increasingly relevant as an out-of-court dispute resolution forum chosen by parties in Islamic banking and finance contracts, particularly as a mechanism capable of bridging legal certainty with compliance with sharia principles.

Historically, the development of Islamic banking in Indonesia was initiated by the Indonesian Council of Ulama (MUI) in 1990 through the establishment of the MUI Banking Team. On 18–20 August 1990, the MUI organized a workshop on bank interest and banking in Cisarua, Bogor, West Java, which discussed the legal position of bank interest from a sharia perspective as the basis for the development of Islamic banking. The results of this workshop were further discussed at the Fourth National Conference of MUI, held at Hotel Sahid Jaya Jakarta on 22–25 August 1990, resulting in a mandate to establish a working group for Islamic banking in Indonesia. This working group was tasked with conducting consultations and coordination with all relevant stakeholders. As a result of the work of the MUI Banking Team, PT Bank Muamalat Indonesia was established on 1 November 1991 as the first Islamic bank in Indonesia and officially began operations on 1 May 1992. Initially, Islamic banking had limited public attention. As public literacy

¹ Lihat Pasal 1 ayat (10) Undang-undang No. 21 Tahun 2008 tentang Perbankan Syariah.

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and demand for sharia-based financial services grew, interest in Islamic banking gradually expanded, leading to the establishment of additional Islamic banks.

From a regulatory standpoint, the early operations of Bank Muamalat Indonesia were based solely on Law No. 7 of 1992 on Banking, which did not explicitly regulate sharia principles, except through the introduction of a profit-sharing scheme. The legal framework governing Islamic banking was subsequently refined through Law No. 10 of 1998, which expressly acknowledged the existence of a dual banking system in Indonesia, consisting of both conventional and Islamic banking systems. The recognition of this dual banking system significantly encouraged the development of Islamic banking in Indonesia, both through the establishment of Islamic commercial banks and through the creation of Islamic business units within conventional banks, thereby strengthening the legal standing of Islamic banking within the national banking system.

Further strengthening was carried out through Law No. 21 of 2008 on Islamic Banking, Law No. 19 of 2008 on State Sharia Securities, as well as various regulatory adjustments in the fields of taxation and financial markets that accommodate sharia-based transactions. This regulatory framework not only expands the scope of Islamic financial transactions but also increases the complexity of the legal relationships arising from Islamic banking and financial activities, thereby requiring the existence of dispute resolution mechanisms that are effective, fair, and consistent with sharia principles.

Islamic banks have characteristics that differ from those of conventional banks. The characteristics of Islamic banks include the following (Mardani, 2015, p. 75-77):

- 1) Costs agreed upon at the time of the contract are expressed in the form of a nominal amount. The amount is not rigid and may be determined through reasonable negotiation between the parties. Such costs are only charged within the time limit agreed upon in the contract.
- 2) The use of percentages in payment obligations is generally avoided, because percentages remain attached to the outstanding debt even when the contractual period has not yet ended.
- 3) In project financing contracts, Islamic banks do not apply calculations based on predetermined profits established in advance, because in essence only God knows whether a financed project will incur profit or loss.
- 4) Funds collected from the public in the form of savings deposits are considered deposits (*al-wadi'ah*) by the depositor, while for the bank they are treated as entrusted funds to be invested in projects financed by the bank in accordance with sharia principles. Therefore, depositors are not promised a fixed return.
- 5) The Sharia Supervisory Board (*Dewan Pengawas Syariah*/"DPS") is responsible for supervising bank operations from the perspective of sharia compliance. In addition, managers and leaders of Islamic banks are expected to understand the basic principles of Islamic muamalah.
- 6) In addition to functioning as an intermediary between capital owners and parties requiring funds, Islamic financial institutions also perform a specific institutional function, namely the *amanah* function, which refers to the obligation to safeguard and take responsibility for the security of deposited funds and to ensure their availability whenever the owner withdraws them.

The following table provides a comparison between Islamic banking institutions and conventional banking institutions:

No.	Aspect of Difference	Islamic Banking	Conventional Banking
1.	Contract and Legality	Islamic law and positive law	Positive law
2.	Arbitration Institution	BASYARNAS	BANI
3.	Organizational Structure	Has a Sharia Supervisory Board	Does not have a Sharia Supervisory Board
4.	Investment	Halal	Halal and haram
5.	Operational Principle	Profit-sharing, sale, and lease	Interest-based instruments
6.	Objective	Profit and <i>falah</i> oriented	Profit oriented
7.	Customer Relationship	Partnership	Debtor–Creditor

Table 1 Comparison between Islamic Banking vs Conventional Banking

Further distinctions between Islamic banking institutions and conventional banking institutions can be summarized as follows:

No.	Differences	Islamic Banking	Conventional Banking
1.	Philosophy	Not based on interest, speculation, or uncertainty	Berdasarkan bunga
2.	Operational Mechanism	Public funds are mobilized in the form of deposits and investment funds that generate returns only when productively utilized. Financing is directed toward halal and profitable business activities.	Public funds are mobilized as savings deposits for which interest must be paid upon maturity. Financing is directed toward profitable sectors, where halal considerations are not the primary concern.
3.	Social Dimension	Explicitly incorporated in the institution's vision and mission.	Not explicitly defined.

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4.	Organizational Structure	Required to have a Sharia Supervisory Board.	No Sharia Supervisory Board.
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Table 2 Further Comparison between Islamic Banking Vs Conventional Banking

Comparison between Interest in Conventional Banking and Profit-Sharing in Islamic Banking.

INTEREST	PROFIT SHARING
The determination of interest is made at the time of the contract with the assumption that the lender will always gain profit.	The determination of the profit-sharing ratio (nisbah) is made at the time of the contract based on the possibility of profit and loss.
The percentage is determined based on the amount of money (capital) lent	The profit-sharing ratio is determined based on the amount of profit obtained.
Interest payments remain fixed as agreed regardless of whether the customer's project generates profit or loss.	Profit-sharing depends on the profit generated by the project. If the business incurs losses, the losses are borne jointly by both parties.
The amount of interest payment does not increase even if profits multiply or when economic conditions are booming.	The amount of profit distribution increases in line with increases in income.
The legitimacy of interest is questioned (if not criticized) by all religions, including Islam.	The legitimacy of profit-sharing is generally not disputed.

Table 3 Interest in Conventional Banking and Profit-Sharing in Islamic Banking.

The evolution of regulatory and institutional frameworks governing Islamic banking has significantly increased the complexity of legal relationships and the potential for disputes. Consequently, this development reinforces the importance of examining issues of choice of law, choice of forum, and sharia arbitration as mechanisms for resolving such disputes.

E. THE DEVELOPMENT OF ISLAMIC BANKING IN OTHER COUNTRIES

The global development of Islamic banking began long before Islamic banking gained widespread attention in Indonesia. The practice of Islamic banking and finance can be found in various countries, including Pakistan, Egypt, Cyprus, Kuwait, Bahrain, the United Arab Emirates, and Malaysia, demonstrating that Sharia-based financial systems are an integral part of the international economy (Antonio, 2019, p. 30).

A comparison of the development of Islamic banking in Indonesia and Malaysia is an interesting subject of study, considering that although the two countries are geographically close and share direct borders, they have developed within historically different legal system backgrounds. Indonesia, as a former colony of the Netherlands, adopts the Continental European legal system tradition, whereas Malaysia, as a former colony of the United Kingdom, has developed within the Anglo-Saxon legal tradition based on common law.

A distinctive characteristic of the legal system in Malaysia is its judicial dualism, which is manifested in the separation between federal and state legal systems. Federal law is largely shaped by the English common law tradition, while state law is founded upon Islamic law and Malay customary law. Consequently, the federal judiciary operates within a secular legal framework, while the state judiciary reflects religious and local legal traditions (Hidayat, 2020, p. 106).

Within the Islamic banking sector, Malaysia has experienced substantial development since the early 1990s. Bank Islam Malaysia Berhad (BIMB), established in 1983, represents the first Islamic banking institution in Southeast Asia, with approximately 30 percent of its share capital held by the federal government. In 1992, BIMB Holdings Berhad became a publicly listed company, with a majority of its shares controlled by the Lembaga Tabung Haji. By the end of 1999, BIMB had expanded its operations to approximately 70 branches located across nearly all states and major cities in Malaysia. In addition to BIMB, another Islamic banking institution, Bank Bumiputra Muamalat Malaysia, was established in 1999. This bank operated as a subsidiary of Bank Bumiputra Malaysia, which had recently undergone a merger with Bank of Commerce (Sinal, 2025, p. 35).

The strengthening of this industry was also supported by the establishment of the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) in 1995. The members of this association consist of Islamic banking institutions, commercial banks, financial service companies, merchant banks, and other institutions that offer Islamic financial products and services. The association advocates for the development and promotion of Islamic banking systems and practices in Malaysia (Ahmed, 2006, p. 196). In addition to fully-fledged Islamic banking institutions, the government of Malaysia also permits the Islamic window system, which allows conventional banks to offer sharia-compliant financial services.

In terms of dispute resolution, one of the institutions that plays a central role in resolving banking and financial disputes in Malaysia is the Kuala Lumpur Regional Centre for Arbitration (KLRC). The institution has developed specific regulations concerning Islamic Banking and Finance Arbitration, which are designed to resolve disputes related to Islamic banking and finance in Malaysia.

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The existence of these sharia arbitration rules reflects an awareness of the need for dispute resolution mechanisms that are aligned with the characteristics of Islamic financial transactions, particularly in the context of cross-border legal relationships.

The development of Islamic banking in other countries demonstrates that the implementation of Sharia-based economics, finance, and banking has become part of a global trend, with Islamic legal principles serving as its normative reference. This trend not only strengthens the financial sector but also necessitates the availability of effective and credible dispute resolution mechanisms.

In Indonesia, the growth of Islamic banking has contributed positively to national economic development. However, without adequate dispute resolution mechanisms, this growth may give rise to legal uncertainty and negatively affect the national economy. In line with this development, Sharia arbitration has emerged as the primary alternative for resolving disputes outside the court system for Islamic banking practitioners (Asro & Kholid, 2011, p. 291).

F. SHARIA ARBITRATION AS A MECHANISM FOR RESOLVING SHARIA ECONOMIC DISPUTES IN INDONESIA

The urgency of regulating the procedures for resolving Sharia economic disputes cannot be separated from the rapid development of Sharia-based economic and financial activities in Indonesia. This growth has led to increasingly complex legal relationships within Sharia economic activities, which in turn raises the potential for conflicts and disputes among parties.

As the potential for disputes increases, there is a pressing demand for mechanisms that are efficient, ensure legal certainty, and uphold a sense of justice for the parties. It is this need that has fostered the rise of win-win solutions through out-of-court dispute resolution, including Sharia arbitration (Anwar, 2018, p. 82).

These circumstances make regulatory and institutional frameworks for dispute resolution essential instruments to secure legal certainty and uphold Sharia principles. Law and economics are closely intertwined, with the law serving not only to regulate but also to steer economic activities.

Rachmat Soemitro defines economic law as the collection of norms enacted by the government or ruling authority, representing society, to manage economic life, in which individual and collective interests may clash. This highlights the crucial role of law in guiding economic activity, including Sharia economics, to ensure it does not evolve without regulatory control.

The need to regulate dispute resolution in Sharia economics can be grasped through the concept of Islamic economics itself. According to M. Umar Chapra, Islamic economics is a discipline aimed at achieving human well-being through the allocation and distribution of limited resources in accordance with Islamic values and principles. In Chapra's view, economic freedom is not absolute but must be constrained by moral values, social justice, and responsibility for economic stability and environmental sustainability. Consequently, Sharia economic activity is not only oriented toward efficiency and profit but also directed toward preventing injustice, inequality, and systemic imbalances in economic life.

In line with this, Muhammad Nejatullah Siddiqi views Islamic economics as a normative response to economic challenges at a given time, grounded in the Qur'an, the Sunnah, reason, and *ijtihad*. This perspective is reinforced by Hasanuz Zaman, who defines Islamic economics as the application of Sharia law to prevent injustice in the utilization and development of material resources as a form of responsibility toward Allah SWT and society. Thus, Sharia-based economics is oriented not only toward profit but also toward justice, balance, and social responsibility.

In the practice of Islamic banking in Indonesia, the inclusion of Sharia arbitration clauses in various financing contracts, such as *mudharabah*, *musyarakah*, *istishna*, and *takaful* insurance agreements, demonstrates the growing confidence of business actors in arbitration as a dispute resolution forum. The inclusion of these clauses reflects the principle of *pacta sunt servanda*, affirming that the parties are bound to submit to a dispute resolution mechanism voluntarily agreed upon (Anwar, 2018, p. 82).

The presence of Sharia arbitration clauses functions not only as a preventive instrument against breaches of contract but also demands that Sharia arbitration institutions be prepared to resolve disputes swiftly, simply, and fairly, particularly in the fields of trade, finance, and banking services based on Sharia principles. Compared to dispute resolution through the courts, resolving Sharia economic disputes via Sharia arbitration is considered more efficient. Judicial proceedings generally require a lengthy period due to ordinary and extraordinary legal remedies, which can create uncertainty and economic losses for business actors. Therefore, Sharia arbitration is viewed as more aligned with the needs of the business community, which demands certainty, efficiency, and finality of decisions. Conceptually, Sharia arbitration is a method of resolving civil disputes outside the courts based on a written arbitration agreement between the parties, with proceedings conducted in accordance with Sharia principles. The fundamental difference between conventional arbitration and Sharia arbitration lies in the normative foundation employed, while the procedural mechanisms are essentially similar.

According to Abdul Manan, arbitration from an Islamic perspective can be equated with the term *tahkim*. *Tahkim* originates from the words *hakkama-yuhakkimu-tahkīman*. Etymologically, *tahkim* means appointing someone as a preventer of a dispute. In general terms, *tahkim* has the same meaning as modern arbitration, namely the appointment of one or more individuals as mediators (third parties) by two disputing parties in order to resolve their disagreement peacefully. The person who resolves the dispute is called a *Hakam*. Scholars often equate a *Hakam* with an arbiter. In *fiqh* studies, there is a similarity between "Hakam" and "arbiter" based on their role and authority. The appointed *Hakam* is required to be a just, careful, and reliable male. Preferably, he should be from

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the family of the disputing parties; if no suitable family member is available, another person may be appointed, with priority given to a neighbor if the neighbor is more knowledgeable and respected. The legal basis for Sharia arbitration in the Qur'an is found in Surah An-Nisaa: 35.

According to Wahbah Al-Zuhaili, arbitration in *fiqh* is defined as an agreement between two or more disputing parties to submit their conflict to a third party for the determination of a legal ruling. Meanwhile, according to Islamic jurists of the Hanafi school, arbitration is understood as the resolution of a dispute or the establishment of a legal decision among people through a pronouncement that is binding on both parties, deriving from a party vested with general authority.

In the study of positive law, arbitration derives from the words *arbitrase* (Latin), *arbitrage* (Dutch), *arbitration* (English), *schiedsspruch* (German), and *arbitrage* (French), all of which mean the authority to resolve a matter according to the discretion or peaceful judgment of an arbiter or referee. Philip Capper describes arbitration as follows (Anwar, 2018, p. 83):

“arbitration may be described in general term as a consensual, private process for submission of dispute for a decision of tribunal, comprising one or more independent third persons. In making decision, the tribunal must follow certain basic requirements, such as to act fairly and impartially, allowing each party to put its case and respond to that of its opponent. The decision of the tribunal (referred to as the award) is final and legally binding on the parties and will be recognized and enforced by the courts of most states around the world.”

According to Abdulkadir Muhammad, arbitration is a private tribunal operating outside the general courts, particularly in the business sector. It is a judicial process voluntarily chosen by the disputing parties, with their free will formalized in a written agreement either before or after a dispute occurs, following the principle of contractual freedom in corporate law. Rachmadi Usman further explains that arbitration is one way to resolve disputes outside general courts, based on a written agreement, in addition to consultation, negotiation, mediation, conciliation, or expert assessment. R. Subekti, on the other hand, defines arbitration as a dispute resolution conducted by one or more arbiters, to whose decisions the parties have agreed to submit.

In accordance with the principle of the rule of law, every dispute resolution mechanism that produces binding legal effects must be acknowledged and regulated under positive law. Arbitration, including Sharia arbitration, is formally legitimized under Law No. 30 of 1999, with Article 1(1) defining it as: *“arbitration is a method of resolving a civil dispute outside the court, based on a written arbitration agreement made by the parties in dispute”*

From these definitions of arbitration, several juridical characteristics of arbitration can be identified:

1. The existence of a controversy between the parties.
2. The controversy is submitted to an arbiter.
3. The arbiter is appointed by the parties or designated by a specific body.
4. The submission of the dispute to arbitration is based on an agreement.
5. The arbiter conducts an examination of the case.
6. After examining the case, the arbiter issues a decision, which is binding on the parties.

In addition to these juridical characteristics, modern arbitration must meet the following minimum requirements:

1. Conventional courts recognize the jurisdiction of the arbitration body.
2. The arbitration clause or contract is binding and cannot be annulled.
3. Arbitration awards are, in principle, final and binding and may only be reviewed by conventional courts under very specific and limited circumstances.
4. Conventional courts must facilitate the functioning of the arbitration process.

From these various perspectives, it can be understood that dispute resolution in the context of Islamic economics cannot be separated from the goals of achieving justice, balance, and social responsibility. Therefore, Sharia arbitration becomes a relevant mechanism to ensure that dispute resolution is not only legally formal but also aligned with the fundamental values of Islamic economics. Based on these definitions, arbitration is characterized as consensual, private, final, and binding, thereby providing legal certainty to the parties involved in resolving disputes.

G. CONCLUSION

This study demonstrates that Sharia arbitration does not merely function as a technical instrument for dispute resolution, but constitutes an integral part of the legal architecture of Islamic economics. The development of Islamic banking and finance, increasingly integrated with the global financial system, demands dispute resolution mechanisms that are adaptive, credible, and provide legal certainty. In this context, Sharia arbitration holds strategic potential to serve as the primary forum for resolving disputes in Islamic banking, particularly cross-border disputes involving foreign elements.

The presence of foreign elements in these contracts necessitates the application of Private International Law principles, particularly concerning choice of law and choice of forum. This situation positions Sharia arbitration at the intersection of national law, international law, and Sharia principles, requiring a regulatory and institutional framework capable of harmoniously bridging these three legal regimes.

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However, the primary challenges lie in implementation, including limited use of Sharia arbitration institutions and difficulties in executing their decisions. This underscores the need for cohesive legal policies that enhance Sharia arbitration, particularly by harmonizing national arbitration law, Sharia banking regulations, and Private International Law principles.

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