



## **Arbitration in Islamic Banking Disputes: Legal-Economic Implications for Enhancing Financial Stability and Governance**

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### **ABSTRACT**

Islamic banking disputes often occur within hybrid legal systems where Shariah-based contracts interact with state arbitration and enforcement laws. While arbitration is common in Islamic finance, existing research tends to treat legal validity, economic efficiency, governance, and stability as separate issues. This approach underestimates how arbitration practices impact broader governance and stability. This study examines how arbitration aligns with Shariah and state law, influences economic outcomes for Islamic financial institutions, and affects governance quality and financial stability. Using a qualitative method doctrinal legal analysis, comparative institutional analysis, law and economics the research relies solely on publicly available academic and policy sources. Findings show that the risk of enforcement failure in Islamic banking arbitration mainly stems from legal ambiguity and public policy reviews, rather than the validity of arbitration clauses. Shariah principles are often sidelined during enforcement and in arbitration design. Economically, arbitration can increase costs by creating endogenous risk through uncertain enforcement, affecting contract choices, risk distribution, provisioning, and liquidity. The analysis highlights trade-offs, such as confidentiality and arbitrator selection, and a diminished role for Shariah boards during disputes. Overall, arbitration supports financial stability only under specific conditions, such as credible enforcement and regulatory transparency, positioning it as a governance tool for stability rather than just a procedural formality.

**Keywords:** Islamic Banking, Arbitration and Dispute Resolution, Shariah Law, Financial Stability.

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### **INTRODUCTION**

Islamic banking is based on principles that set it apart from traditional banking, notably the prohibition of *riba* (interest), a focus on risk-sharing, and adherence to Shariah law (Osman, 2025). Its core idea is profit-and-loss sharing, in which transactions link to real economic activities, ensuring that project financing involves tangible assets (Al-Shibli, 2018). The system forbids

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interest, excessive uncertainty (gharar), and gambling (maysir), promoting ethical finance and social justice. Over recent decades, Islamic banking has expanded rapidly, gaining a strong foothold in the Middle East and Southeast Asia and, increasingly, in Western markets. By 2020, Islamic financial assets exceeded \$2 trillion worldwide, with growth expected to continue. This growth highlights the need for effective dispute resolution, as Islamic finance contracts can be complex and prone to disputes. Arbitration has become a popular alternative for resolving disputes because it aligns well with Shariah principles, offering a confidential, flexible, and culturally sensitive method, unlike traditional litigation (Widjaja, 2025a; Khan et al., 2023). Despite the increasing importance of arbitration in Islamic banking, the academic literature remains fragmented, focusing either on the legal or economic aspects of arbitration in Islamic finance, without a critical exploration of their intersection. Most studies on Islamic finance and dispute resolution tend to treat arbitration as a legal process, exploring its compatibility with Shariah law or examining the procedures of specific arbitration centres. Conversely, the economic implications of arbitration, particularly its impact on the financial stability and governance of Islamic banks, have received limited attention (Farouq & Al-Shibli, 2018; Khan, 2024).

Many current arbitration frameworks in Islamic banking do not sufficiently consider their economic effects compared to traditional litigation. Although some studies highlight how arbitration aligns with Shariah principles, they often overlook broader economic impacts like liquidity, market behaviour, and the operational robustness of Islamic financial institutions (Widjaja, 2025b). The literature largely misses how legal and economic factors together influence governance structures in Islamic banks, potentially ignoring key elements that affect the stability of financial systems. Thus, a significant gap exists in understanding the dual legal-economic implications of arbitration in Islamic banking disputes, particularly regarding its impact on governance, financial stability, and the overall efficiency of dispute-resolution processes (Aljazi et al., 2024). This study aims to fill this gap by providing a comprehensive analysis of both the legal and economic facets of arbitration within Islamic banking, exploring how arbitration practices can enhance financial stability and governance (Khan & Usman, 2023).

This research primarily aims to critically evaluate the legal and economic aspects of arbitration in disputes within Islamic banking, as well as its contribution to strengthening financial stability and governance (Al-Shibli, 2025). It will address the following research questions:

1. How does arbitration in Islamic banking disputes align with both Shariah law and conventional legal systems?
2. What are the economic consequences of adopting arbitration over traditional litigation for Islamic financial institutions?
3. How does arbitration influence financial stability and governance practices within Islamic banks?

This study aims to explore how arbitration can enhance dispute resolution in Islamic banking, contributing to a more resilient and stable financial system. It is especially relevant amid the rapid growth of Islamic banking and the increasing complexity of its operations. As the sector expands into new markets and faces new challenges, effective dispute-resolution mechanisms are becoming increasingly essential. This research will add to the academic discussion on Islamic

finance, particularly in linking legal and economic views on arbitration. Practically, its findings could help policymakers, legal experts, and banking professionals improve governance and strengthen financial stability within Islamic banks. The study will suggest ways to refine arbitration practices to ensure Shariah compliance while addressing the economic needs of financial institutions, potentially shaping regulations in both established and emerging Islamic finance markets (Alfalahi & Al Shibli, 2023; Khan & Ximei, 2022). Additionally, its insights could support the development of stronger arbitration frameworks tailored to the specific needs of Islamic banking, making arbitration a central part of the industry's legal foundation.

This research is grounded in an interdisciplinary framework that merges Islamic law, arbitration theory, and economic theories of financial stability and governance. It integrates Islamic legal principles—especially those concerning Shariah compliance with arbitration theory to explore effective dispute resolution within Islamic financial systems. At the same time, economic theories of financial stability and governance are used to analyse how arbitration affects risk management, liquidity, and operational resilience in Islamic banks. This framework offers a comprehensive view of the relationships among legal principles, economic factors, and governance, highlighting how arbitration can enhance the efficiency and integrity of Islamic banking. Section 2 reviews existing research on arbitration in Islamic banking, highlighting gaps in understanding its legal and economic effects. Section 3 details the research methodology. Section 4 presents the findings, analyzing arbitration's influence on financial stability, governance, and operational efficiency. Section 5 summarizes key insights and suggests policy recommendations for enhancing arbitration practices in Islamic banking.

## LITERATURE REVIEW

### *Islamic Banking and the Nature of Disputes*

The literature on Islamic banking consistently highlights that disputes in this sector stem from the structural features inherent in Shariah-compliant finance, rather than from occasional contractual errors. Islamic banking relies on contractual arrangements fundamentally different from traditional debt-based finance, incorporating profit and loss sharing, asset-backed transactions, and agency relationships. While rooted in Islamic jurisprudence, these arrangements create legal and economic complexities within modern financial systems (I. Ahmad, 2025). Scholars studying Islamic banking contracts note that risk redistribution between banks and clients—especially in *mudarabah* and *musharakah* agreements—generates ambiguous legal relationships, complicating dispute resolution when losses happen. Many research findings suggest that the hybrid legal frameworks are a key dispute source. Islamic banks often operate within dual regulatory systems where Shariah principles coexist with national laws designed for interest-based finance, leading to interpretive tensions. Courts and quasi-judicial bodies, which often lack expertise in Islamic jurisprudence, tend to reframe Shariah-compliant contracts using conventional legal doctrines, undermining contractual intent and creating uncertainty. This uncertainty raises the risk of disputes escalating beyond internal resolution methods (ahmad et al., 2025; Usman et al., 2021).

The role of Shariah supervisory boards is widely examined as a governance tool designed to prevent disputes through pre-emptive compliance. However, the literature also points out their

limited authority when conflicts occur, as these boards usually lack enforcement capabilities and are separate from dispute resolution processes. Therefore, their interpretations can often be overlooked during arbitration or court cases, especially in cross-border situations. Most studies analyze governance failures at the institutional level but rarely link these issues to the frequency of disputes or systemic risks. As a result, disputes are often seen as isolated legal incidents rather than indicators of broader governance and regulatory fragmentation in Islamic banking systems (Haider, 2025; Khan et al., 2020).

### ***Arbitration in Islamic Law and Contemporary Practice***

Arbitration holds a recognized place in classical Islamic jurisprudence, seen as a consensual method for achieving justice and social harmony. Juristic writings establish it as permissible when it complies with principles of fairness, competence, and moral integrity. Modern scholarship largely affirms arbitration's legitimacy under Shariah, especially when it avoids prohibited elements and aligns with Islamic law's objectives. This acceptance has led to frequent inclusion of arbitration clauses in Islamic finance contracts. However, debates persist about applying modern arbitration frameworks to Islamic finance. Some scholars believe that contemporary arbitration naturally aligns with Islamic principles due to its flexibility and party autonomy. Others warn that international arbitration, often focused on commercial efficiency, may conflict with Shariah requirements, especially when governed by national laws or international conventions emphasizing procedural uniformity over religious norms (I. Ahmad, Haider, et al., 2025). The relationship between Shariah and national arbitration laws remains disputed. Enforcement practices show varied judicial approaches: some jurisdictions recognize Shariah as valid law, while others view it as a non-state normative system subject to public policy review, which weakens predictability and raises enforceability concerns. The literature is divided on whether international arbitration institutions improve legal certainty or marginalize Shariah interpretation. Most studies primarily examine the doctrinal legitimacy of arbitration, with less focus on its practical application in financial disputes. There is a scarcity of research on how arbitrators implement Shariah principles in real cases or how institutional arbitration rules adapt to religious requirements. Consequently, discussions tend to be theoretical, creating a gap between normative concepts and actual practice (I. Ahmad et al., 2023; Khan et al., 2020).

### ***Arbitration in Islamic Banking Disputes***

A specialized branch of literature focuses on arbitration in Islamic banking disputes. These studies typically highlight arbitration as a preferable alternative to litigation, emphasizing benefits like efficiency, confidentiality, and the ability to select arbitrators with Shariah expertise. It is portrayed to maintain commercial relationships and safeguard reputational interests, which are vital in Islamic finance (Haider et al., 2024). However, closer examination shows that many of these claims lack empirical evidence. Claims of efficiency and cost savings often rely on assumptions from conventional arbitration studies rather than on Islamic banking cases. Few studies offer systematic data on dispute duration, enforcement results, or economic effects. Fairness is often viewed as an inherent feature of arbitration, rather than as dependent on institutional design or arbitrator skill. The role of Shariah compliance in arbitration decisions is under-researched. Although scholars stress the importance of Shariah-aware arbitrators, there is

little analysis of how differing jurisprudential views affect consistency. Confidentiality, appreciated by financial institutions, raises governance issues about transparency and regulation (Al-Shibli et al., 2023). The existing literature seldom addresses these tensions, instead presenting arbitration as an overall beneficial solution. Moreover, arbitration is rarely considered within the broader governance framework. The outcomes of dispute resolution influence internal compliance, risk management, and contract drafting, yet the literature largely isolates arbitration from these institutional factors, limiting its explanatory power.

### ***Legal Economic Dimensions of Arbitration***

The connection between legal and economic analysis remains weak in current scholarship. While economic research on Islamic finance often emphasizes efficiency, growth, and inclusion, legal studies tend to focus on compliance and enforceability. Arbitration is often marginal in both fields. When economic aspects are addressed, they usually highlight transaction cost reduction but overlook the specific cost structures of Shariah-compliant arbitration. Some scholars suggest that arbitration boosts investor confidence through predictable enforcement, but there is limited empirical evidence supporting this in Islamic finance contexts. Costs related to specialized arbitrators, institutional fees, and enforcement risks are seldom included in economic evaluations (L. Ahmad, Haider, et al., 2025). Additionally, arbitration outcomes can impact provisioning, capital adequacy, and liquidity, yet these connections are underexplored. The literature also fails to examine arbitration's role in risk management, despite its influence on contractual behavior and risk distribution. By not integrating legal and economic analyses, current research provides an incomplete understanding of arbitration's systemic effects.

### ***Arbitration, Financial Stability, and Governance***

Research linking arbitration to financial stability and governance is limited and scattered. Policy reports highlight that weak legal certainty can undermine confidence and increase systemic risk in Islamic banking. However, academic research rarely translates these issues into analytical frameworks that incorporate arbitration. Governance literature emphasizes the importance of credible enforcement mechanisms for maintaining regulatory trust (I. Ahmad et al., 2024). Arbitration can strengthen governance by encouraging contractual discipline and fostering a compliance culture. Conversely, inconsistent or opaque arbitration practices may weaken oversight and diminish confidence. These effects are acknowledged but not systematically examined. The divide between dispute resolution and stability analysis creates a significant gap—financial stability discussions focus on prudential regulation and liquidity, while arbitration is viewed as a legal technicality. This separation masks arbitration's role in building long-term institutional resilience. The literature reveals several interconnected shortcomings: legal and economic analyses remain isolated, limiting a comprehensive understanding; financial stability considerations are marginalized despite the systemic importance of dispute resolution credibility; governance implications are recognized but not thoroughly theorized; cross-jurisdictional dynamics are underdeveloped, and empirical evidence is limited (Singh, 2023). These gaps justify this study. By integrating legal and economic perspectives and positioning arbitration within governance and stability frameworks, this research addresses unresolved debates and enhances

understanding of arbitration as a structural element in Islamic banking systems, not merely a procedural option.

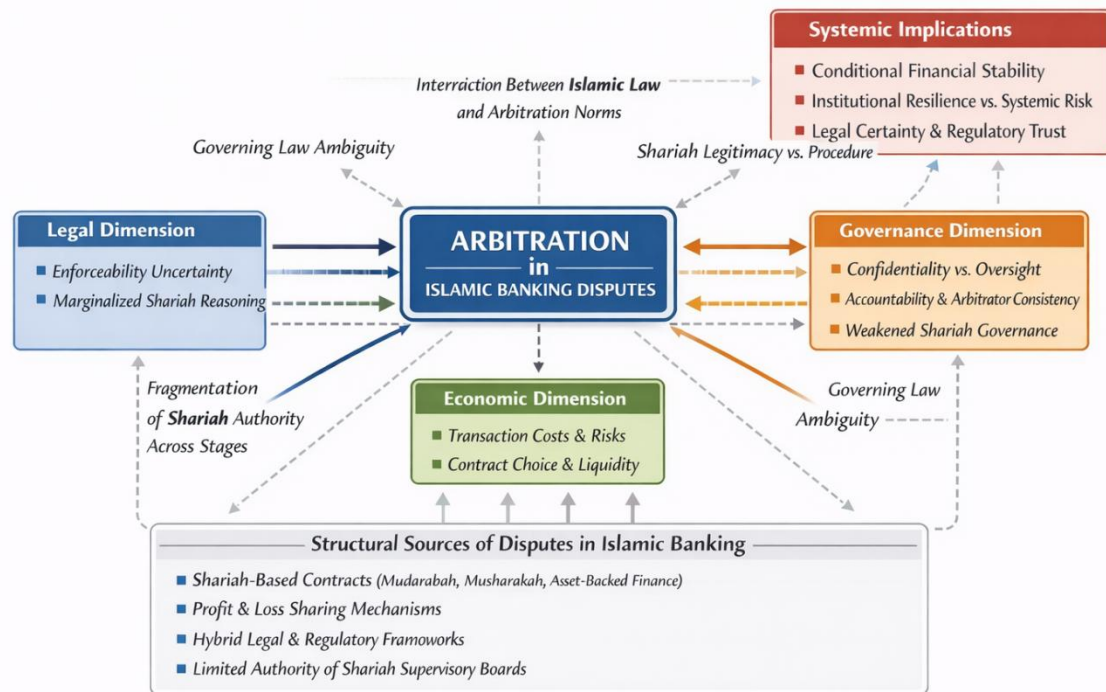


Figure 01: Arbitration in Islamic Banking Disputes: A Multidimensional Conceptual Framework

Figure 01 illustrates how Islamic finance's structure causes disputes, with arbitration as the key resolution. It shows arbitration's influence on legal, economic, and governance aspects, highlighting feedback loops and Shariah authority fragmentation. Systemic outcomes like stability and trust depend on institutions, stressing arbitration's conditional impact in Islamic banking.

## CONCEPTUAL AND THEORETICAL FRAMEWORK

This study is grounded in an integrated conceptual framework that combines Islamic legal theory (Shariah governance and *fiqh al-mu'āmalāt*), institutional theory, and law-and-economics analysis to explain how arbitration in Islamic banking disputes shapes financial stability and governance outcomes. Conceptually, arbitration is treated not merely as a dispute resolution mechanism but as an institutional governance device operating within a hybrid legal order where Shariah norms, state arbitration laws, and public policy controls intersect. The framework assumes that legal certainty, enforcement credibility, and normative coherence between Shariah and state law directly influence economic behavior within Islamic financial institutions, including contract design, risk allocation, compliance costs, and liquidity management. Theoretically, the study draws on new institutional economics to analyze how enforcement uncertainty and regulatory intervention create endogenous risks, and on Islamic governance theory to assess how the marginalization of Shariah principles and Shariah boards during arbitration undermines both legitimacy and stability. By linking legal validity, economic efficiency, and governance quality, the framework positions arbitration as a conditional stabilizing mechanism whose effectiveness

depends on transparent enforcement standards, meaningful integration of Shariah norms, and alignment with broader financial regulatory objectives.

## RESEARCH METHODOLOGY

This study adopts a qualitative research design that combines doctrinal legal analysis, comparative institutional analysis, and law and economics reasoning. It aligns with the manuscript's goal to examine arbitration in Islamic banking disputes as a legal institution with implications for economics, governance, and financial stability, rather than merely as a procedural dispute resolution method. This approach is ideal for analyzing how Shariah-based contractual principles interact with national arbitration laws and the economic impact of dispute resolution choices in Islamic finance. The study relies exclusively on publicly available sources, including academic legal research on Islamic arbitration and banking contracts, studies on arbitration law and enforcement in relevant jurisdictions, institutional arbitration rules governing Shariah-compliant disputes, and policy and regulatory materials on governance and stability in Islamic banking systems. No interviews, surveys, confidential arbitral awards, proprietary datasets, or empirical fieldwork are involved.

The analysis follows a structured interpretive approach. Arbitration is assessed based on four interconnected criteria, stemming from the research questions and identified literature gaps. These criteria include the certainty of enforceability of arbitral awards, the integrity of Shariah compliance within arbitral reasoning, economic risks such as costs and enforcement uncertainties, and the impact on governance quality and financial stability at both institutional and systemic levels. Legal results are examined considering their economic impacts and governance implications, enabling a comprehensive assessment. The study's scope is naturally limited by variations in arbitration laws and court practices across jurisdictions, as well as by limited access to confidential arbitration proceedings. Therefore, the focus is on analytical explanation and conceptual integration rather than statistical generalization or empirical measurement.

Factor	Description	Impact on Outcomes	References
Enforceability Certainty	Judicial review of Shariah-based awards under national public policy doctrines in hybrid legal systems	Increases post-award challenges and reduces finality, especially cross-border	Widjaja et al. (2025); Abdallah (2020) Arbitration-in-Islamic-Banking-Disputes-1.docx
Shariah Compliance	Extent to which Shariah principles shape core arbitral reasoning, beyond contractual	Undermines award legitimacy and stakeholder trust when marginalized	Kunhibava (2015); Aldabousi (2025) Arbitration-in-Islamic-Banking-Disputes-1.docx

Factor	Description	Impact on Outcomes	References
	references		
Economic Risks	Direct costs from Shariah experts and dual counsel; indirect endogenous risks from uncertain enforcement, affecting expected payoffs	Elevates provisioning and liquidity strains; prompts preference for fixed-return murabahah over risk-sharing musharakah/mudarabah	Ahmad et al. (2023); IMF (2017)Arbitration-in-Islamic-Banking-Disputes-1.docx
Regulatory Oversight &Governance	Trade-offs of confidentiality limiting supervisory access; risks from repeated arbitrator appointments	Fragments Shariah board accountability; heightens systemic risk perception	IFSB (2025); Aldabousi(2025)Arbitration-in-Islamic-Banking-Disputes-1.docx

Table: 01 Factors Influencing Arbitration Outcomes in Islamic Banking Disputes

Table 01 outlines key factors affecting arbitration outcomes in Islamic banking disputes, including enforceability, Shariah compliance, economic risks, and regulatory oversight. Each factor is described, along with its associated impact on outcomes and relevant academic references. This analysis highlights the complex interplay between legal, economic, and governance aspects of arbitration in the context of Islamic finance.

## ANALYSIS

### *Analytical framing and approach*

This analysis employs a mixed framework combining doctrinal, institutional, and law-and-economics approaches to assess arbitration in Islamic banking disputes. The selection of this method is based on empirical and doctrinal limitations noted in existing literature, which indicates that arbitration in Islamic finance has been studied either as a legal tool disconnected from economic results or as a means to improve efficiency without considering enforceability and governance issues (Alshawabkeh, 2025). The evaluation proceeds by examining arbitration through four interconnected criteria derived from identified gaps. First, enforceability certainty, which considers how national courts treat arbitral awards based on Shariah reasoning. Second, Shariah compliance, evaluated by whether Shariah principles materially shape arbitral reasoning



or just serve as contractual references. Third, economic risk factors, including dispute resolution costs, enforcement uncertainties, and impacts on provisioning and liquidity. Fourth, governance and stability implications, analyzed through regulatory viewpoints and institutional behavior documented in policy and academic sources. This structure directly addresses the research questions by connecting arbitration design to legal outcomes, economic incentives, and systemic stability.

### ***Legal analysis: arbitration design and enforceability in Islamic banking disputes***

The validity of arbitration clauses in Islamic finance contracts is generally recognized under national arbitration laws. Research on disputes involving Islamic banking in Malaysia, Indonesia, and GCC countries shows that arbitration clauses are typically upheld during jurisdictional assessments. Nonetheless, enforcement challenges tend not to stem from the clauses' validity but from uncertainties regarding governing law and public policy considerations. Contracts that specify Shariah as the governing law often face significant enforcement doubts. Courts in common law and civil law systems have frequently viewed Shariah not as a comprehensive legal framework but as a set of non-state norms, subjecting arbitral awards to detailed review based on national public policy (Al-shawabkeh et al., 2025). This stance is supported by comparative case analyses in which courts enforced awards only after reinterpreting Shariah obligations as conventional contractual terms. To mitigate this issue, hybrid clauses that combine national law with Shariah principles are common. However, empirical evidence indicates that such clauses often lead to interpretive ambiguity rather than clarity, especially when arbitral tribunals lack guidance on the precedence of Shariah versus national law (Haider et al., 2025). This ambiguity increases the risk of post-award disputes, thereby threatening the finality of arbitration.

Public policy remains the primary legal restriction. Although jurisdictions like Malaysia recognize Shariah decisions through centralized advisory councils, this institutional backing does not extend beyond their borders. In cross-border enforcement, courts typically exclude Shariah reasoning if it conflicts with compulsory national standards, even when parties agree to Shariah arbitration. This elevates the enforcement risk for Islamic banking disputes compared to conventional finance. Shariah supervisory boards usually have no formal role once disputes proceed to arbitration, unless explicitly incorporated into the arbitral rules. Evidence indicates that most arbitration frameworks permit, but do not require, tribunals to consult Shariah experts. Consequently, Shariah reasoning often remains peripheral, undermining the legitimacy of outcomes for Islamic finance stakeholders.

### ***Economic implications: arbitration as a risk management mechanism***

The economic effects of arbitration in Islamic banking disputes differ from those suggested by traditional arbitration literature. Evidence from Islamic finance shows that direct dispute-resolution costs are often higher due to the need for Shariah expertise, dual legal counsel, and lengthy enforcement processes (Al Shawabkeh, 2016). Indirect costs, such as enforcement uncertainty, are even more impactful (Sadiq & Haider, 2024). This uncertainty raises expected losses and influences bargaining strategies. Research indicates that Islamic banks often settle

disputes at discounted amounts to avoid extended uncertainty, especially when asset recovery relies on foreign enforcement. Such enforcement risks impact initial contract pricing and lead Islamic banks to prefer fixed-return instruments like murabahah over profit-and-loss sharing models, even though these are less aligned with Shariah principles.

Dispute uncertainty also impacts provisioning and capital planning. Policy reports indicate that unresolved legal disputes in Islamic banks lead to higher provisions, which diminish capital buffers and limit liquidity. Although the IMF does not conduct empirical analysis on arbitration effects specifically, it clearly recognizes legal uncertainty as a factor causing stress on balance sheets in dual banking systems (Al-Shawabkeh, 2020). The idea that arbitration boosts investor confidence is plausible in theory but lacks substantial empirical evidence notes that practitioners perceive arbitration as improving predictability, but there is no quantitative data showing that arbitration reduces funding costs or risk premiums in Islamic banks. This remains an empirical question and should not be overstated.

### ***Governance implications: transparency, accountability, and regulatory trust***

Arbitration's confidentiality has complex effects on governance. While it safeguards reputational capital, it also hampers regulatory oversight and market discipline. Regulatory reports indicate that keeping dispute resolution confidential limits supervisors' ability to identify recurring governance issues or patterns of Shariah non-compliance. The process of selecting arbitrators raises additional governance concerns. Empirical research shows that a small group of arbitrators are repeatedly appointed in Islamic finance disputes, which may increase the risk of institutional bias. Although direct evidence of capture is absent, governance theories suggest the risk rises when transparency is limited. During arbitration, Shariah governance is weakened. Shariah boards, essential for pre-emptive compliance, are structurally excluded from dispute resolution, resulting in fragmented accountability. This disconnection undermines the internal compliance culture and reduces deterrence against misconduct (Amelia et al., 2024). Trust in regulation relies on credible, observable enforcement. When arbitration occurs outside supervisory oversight, regulators see higher systemic risk, especially in systemically important Islamic banks.

## **DISCUSSION**

### ***International Refugee Law***

#### ***Reinterpreting the Legal Findings: Arbitration as a Structurally Incomplete Legal Institution***

The legal findings indicate that arbitration in Islamic banking disputes should not be viewed as a faulty mechanism. Instead, it functions as a legally incomplete institution when embedded in hybrid legal systems. Current scholarship often considers enforceability issues as technical or jurisdiction-specific problems. However, this analysis suggests that enforceability uncertainty is a predictable result of the interaction between Shariah-based contractual principles and state-centric enforcement systems. Although arbitration clauses may be formally valid, ambiguity around governing law remains because Shariah does not have a stable position in national conflict-of-laws frameworks. Hybrid governing law clauses do not fix this instability; they simply shift it to the enforcement phase, where courts must prioritize mandatory public policy

norms. The marginalization of Shariah reasoning at this stage is intentional, reflecting an institutional hierarchy where non-state normative systems are tolerated procedurally but limited substantively.

This finding broadens earlier doctrinal debates by moving focus from whether arbitration is permissible to its institutional authority. While arbitration can be valid under Shariah law, its legal effectiveness relies on enforcement institutions that do not treat Shariah as a standalone legal system. This mismatch explains why arbitration has not provided the legal certainty often assumed in Islamic finance studies. It also shows why disputes in Islamic banking are more prone to post-award challenges compared to those based solely on state legal norms.

### ***Economic Interpretation: Arbitration as a Source of Endogenous Risk***

From an economic standpoint, the findings challenge the common belief that arbitration mainly reduces costs. The analysis shows that arbitration introduces endogenous risk into Islamic banking transactions when enforcement is uncertain. This risk is not external or incidental but arises from the legal design of arbitration itself in Shariah-based contracts. Uncertainty about enforcement changes expected payoffs and bargaining power, prompting Islamic banks to adapt by modifying contract structures, pricing, and risk sharing. The preference for debt-like instruments over profit-and-loss sharing should be seen as a defensive response to dispute resolution risks, not a failure to adhere to Shariah. In this way, arbitration indirectly influences the product design of Islamic banking.

### ***Governance Reconsidered: Arbitration as a Reallocation of Accountability***

The implications of arbitration governance are more significant than previously recognized. Instead of just adding to existing governance frameworks, arbitration redistributes accountability within Islamic banking institutions. By moving dispute resolution from courts to private tribunals, it changes how authority is shared among management, Shariah boards, regulators, and external stakeholders. Confidentiality is key in this process (Al Quhad et al., 2025). While it guards institutions from reputational damage, it also hampers regulatory learning and market discipline. The analysis indicates that confidentiality is not neutral for governance; it selectively hides information that could help supervisors identify ongoing contractual issues or compliance problems. The reduced involvement of Shariah boards during disputes further fragments accountability. Governance by Shariah is mainly focused on the pre-contractual stage, whereas enforcement decisions are made elsewhere, weakening overall oversight and deterrence. Therefore, arbitration design impacts dispute outcomes, internal compliance culture, and managerial incentives. The study also challenges assumptions about arbitrator expertise. Although expertise is essential, frequent appointments can create risks of institutional bias, especially in environments where procedures are opaque and repeated interactions occur within a small, insular community, without necessarily involving misconduct.

### ***Financial Stability: Dispute Resolution as a Stability Transmission Mechanism***

A key contribution of the study is its demonstration that arbitration acts as a stability transmission mechanism within Islamic banking. Dispute resolution influences financial stability

indirectly, through a series of legal and economic interactions that shape confidence, balance sheet health, and governance credibility (Ghani et al., 2025). On an institutional level, uncertainty in enforcement extends asset impairment periods and causes volatility in provisioning, thereby weakening capital planning and liquidity management, especially during crises. Systemically, inconsistent enforcement undermines legal certainty, raising the risk of contagion among systemically important institutions or shared contractual structures. Importantly, the study shows that arbitration promotes stability only under certain conditions, such as enforceable awards, credible integration of Shariah principles, regulatory oversight, and consistent judiciary practices. Without these conditions, arbitration might mask risk buildup rather than reduce it. This indicates that dispute resolution should be viewed as a structural stability issue, not just a matter of procedural efficiency (Rosendorff, 2005).

The findings suggest that enhancing arbitration results depends on achieving institutional harmony rather than just refining procedures (Brooklyn & Tioluwani, 2025). Regulators should see arbitration as aligned with supervisory goals, not separate from them. Arbitration institutions, on the other hand, need more than just procedural flexibility to accommodate Shariah—they require deep jurisprudential integration. For Islamic banks, arbitration influences risk management and governance beyond individual cases. Shariah governance frameworks face a structural issue: they are strongest at contract certification but weakest at enforcement. This imbalance affects perceptions of Shariah compliance and calls for institutional reform, which will be discussed in the policy section. The analysis here is limited by the available empirical data. While doctrinal and institutional evidence supports the causal links, quantitative validation is scarce. Jurisdictional differences also hinder broad generalizations. These limitations highlight key research needs: measuring enforcement risk empirically, comparing arbitration systems, and systematically analysing governance outcomes.

## **CONCLUSION**

The analysis advanced in this paper establishes that arbitration in Islamic banking disputes cannot be understood as a value-neutral procedural mechanism but must be analysed as a structural legal-economic institution embedded within hybrid legal and governance frameworks. By integrating doctrinal legal analysis with economic reasoning and governance assessment, the study demonstrates that arbitration actively shapes incentives, risk transmission and institutional credibility in Islamic banking systems. This integrated perspective addresses a core limitation in existing scholarship, which has treated legal enforceability, economic efficiency, and stability effects in isolation. A central contribution of the paper lies in demonstrating that enforceability uncertainty is not an incidental weakness but a predictable systemic outcome of hybrid legal orders. Governing law ambiguity and public policy review at the enforcement stage consistently undermine the finality of arbitral awards, even where arbitration clauses are formally valid and widely used. This structural condition explains why arbitration has failed to deliver the level of legal certainty often presumed in Islamic finance discourse. Closely connected to this is the finding that Shariah reasoning is progressively marginalised as disputes move from contract design to arbitration and judicial enforcement, weakening the continuity and legitimacy of Shariah governance across the dispute lifecycle.

The paper further shows that arbitration generates endogenous economic risk when enforcement outcomes are uncertain. Rather than reducing transaction costs unambiguously, arbitration reshapes bargaining power, influences contract selection, and encourages conservative risk allocation. These dynamics affect provisioning behaviour, capital planning, and liquidity management, particularly in cross-border disputes. As a result, claims that arbitration enhances efficiency or investor confidence cannot be sustained without reference to institutional context and enforcement credibility. From a governance perspective, the findings reveal that arbitration reallocates accountability within Islamic banking institutions. Confidentiality and arbitrator concentration create persistent trade-offs between efficiency and oversight, while the limited post-dispute role of Shariah supervisory boards fragments accountability and weakens compliance incentives. By linking these legal, economic, and governance effects to financial stability, the paper reframes dispute resolution as a stability-relevant institutional determinant. Arbitration contributes to stability only under specific conditions of enforceability, Shariah integration, and regulatory visibility. Despite limitations arising from jurisdictional variation and restricted access to confidential awards, the analysis underscores a critical insight: dispute resolution design is central to the credibility, resilience, and systemic integrity of Islamic banking.

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