



## **Concept Paper**

### **Alternate Dispute Resolution Mechanism for Islamic Finance Contracts in Pakistan**

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## **CONCEPT NOTE – ALTERNATE DISPUTE RESOLUTION MECHANISM FOR ISLAMIC FINANCE CONTRACTS IN PAKISTAN**

### **1. Preamble**

Islamic finance has become an integral part of Pakistan's financial landscape, adhering to the principles of Shariah, fostering ethical investments, and promoting economic growth. As this sector expands, the need for effective and compliant dispute resolution mechanisms becomes crucial.

Islamic finance operates under principles derived from Shariah, emphasizing justice, transparency, and ethical conduct. Common Islamic finance contracts include Musharakah, Modaraba, Murabaha, Ijarah, Wakala, Istisna, etc., each with distinct characteristics. Disputes arising from these contracts can involve issues such as contract interpretation, performance obligations, and breach of agreements. Further, the Islamic finance contracts are unique as they not only follow conventional legal frameworks but also align with Islamic jurisprudence. In cases of disputes in enforcing Islamic finance contracts, traditional litigation may not always align with Islamic principles, and there is a growing need for alternate dispute resolution (ADR) mechanisms tailored specifically for Islamic finance contracts. Dispute resolution in Islamic finance contracts is particularly challenging because it needs to ensure compliance with both legal and religious standards. An ADR mechanism tailored specifically for Islamic finance contracts can provide a harmonious blend of these requirements.

The SECP has already approved a strategic action plan for 2024-26 for the development of Islamic finance in the non-bank financial sector in light of the 26th constitutional amendment and the judgement of the Federal Shariat Court on the elimination of Riba from the economy<sup>1</sup>. The initiative 4.6 requires the introduction of an ADR mechanism for Islamic finance contracts and a concept of out-of-court settlement through ADR mechanisms, including mediation, arbitration, and neutral evaluation by June 2026. Further, the SECP has

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<sup>1</sup> <https://www.secp.gov.pk/document/secp-strategic-action-plan-2024-26/?wpdmdl=54815&refresh=67aadd46a6c451739251014>

also notified the adoption of AAOIFI Shariah, governance, and ethics standards under a staggered approach, paving the way for the promotion of Islamic finance contracts in the corporate and regulated sector<sup>2</sup>. Therefore, this concept paper is published to seek feedback and comments from the stakeholders on the introduction of an ADR mechanism in Pakistan for Islamic finance contracts.

The primary objective of this concept note is to propose a way forward for the development and implementation of a specialized ADR mechanism for Islamic finance contracts that aligns with Shariah principles and rules. This mechanism aims to provide a Shariah-compliant, efficient, and effective means of resolving disputes, thereby enhancing the confidence of stakeholders in the Islamic finance sector.

## 2. Current ADR Framework in Pakistan

Pakistan has established frameworks for ADR through the following mechanisms which apply equally to Islamic contracts:

- i. **The Alternative Dispute Resolution Act, 2017:** Promulgated on May 30, 2017, this Act is Pakistan's first codified ADR statute, providing processes for arbitration, conciliation, and mediation. It mandates courts to refer civil disputes to ADR unless specific conditions are met, such as lack of consent from parties or the involvement of significant legal questions. The Act includes provisions for companies and commercial matters, thereby facilitating dispute resolution in the capital markets and non-bank financial institutions, as well.
- ii. **The Companies Act, 2017:** The Companies Act, 2017 supplements the ADR framework by offering detailed mechanisms for mediation, reconciliation, and arbitration. Under section 276, the SECP maintains a "Mediation and Conciliation Panel" for resolving disputes within 90 days. The SECP facilitates mediation and arbitration for regulatory and compliance disputes in the corporate sector. It can conduct meetings for creditors or

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<sup>2</sup><https://www.secp.gov.pk/document/aoofi-shariah-standards-s-r-o-7291-2024-dated-may-21-2024/?wpdmdl=52065&refresh=667a9bcb7a8b11719311307>

members to discuss compromises, with outcomes binding upon approval. Aggrieved parties can also refer disputes to arbitration under the Arbitration Act, 1940.

- iii. **Pakistan Stock Exchange (PSX) Arbitration:** The PSX has its own arbitration mechanism for disputes among market participants, supported by specific arbitration regulations and panels.

### **3. Challenges in Existing ADR Mechanism**

While the current ADR frameworks offer valuable alternatives to traditional litigation, it lacks specificity regarding Islamic finance contracts. The major challenges include:

- **Basis for ADR mechanism:** Since Islamic financial transactions are based on Shariah principles, ADR mechanisms for Islamic financial contracts must comply with Islamic jurisprudence. The existing mechanisms may not focus on Islamic principles that may lead to a conclusion that is not correct as per Shariah principles.
- **General nature of ADR processes:** The mechanisms are designed for a broad range of commercial disputes and do not cater specifically to the nuances of Islamic finance contracts.
- **Limited awareness:** Stakeholders in the Islamic finance sector may not be fully aware of available ADR options, leading to under-utilization.

### **4. Need for ADR in Islamic Finance Contracts**

The foundational framework for Islamic finance contracts is Maqasid al-Shariah (higher objectives of Shariah) aimed at promoting human well-being and preventing harm. Further, the Shariah maxims (qawa'id al-fiqhiyyah) prescribe fundamental rules for understanding and interpreting Islamic jurisprudence. Shariah principles and rules for Islamic finance provide for specific prohibitions, requirements and guidelines. Such as Islamic finance prohibits elements

such as Riba (interest), Gharar (excessive uncertainty), and Maysir (gambling). This foundational framework is well captured by the Shariah standards issued by the AAOIFI<sup>3</sup> for contemporary Islamic finance contracts.

For any dispute resolution in the case of an Islamic finance contract, a mechanism must respect this foundational framework. Further, the Enforcement of Shariah Act, 1991 (Act X of 1991) was enacted in Pakistan to establish the supremacy of Shariah within the country's legal framework. Section 3 of the said Act declares Shariah as the supreme law of Pakistan by explicitly stating that Shariah shall be the supreme law and shall override all other laws, customs, and usages.

However, in traditional contract enforcement and litigation systems, achieving the above is not easy, as the process can be slow and expensive. Traditional litigation poses several challenges, including lengthy court processes, delaying resolution, costly legal fees, and other costs that can be burdensome for parties, and more importantly, incompatibility of court judgements with Shariah principles may not always align with Islamic legal principles, leading to dissatisfaction among parties.

ADR offers a faster, more cost-effective means of resolving disputes, which is crucial for maintaining trust and stability in financial transactions. Financial disputes often involve sensitive information. ADR mechanisms such as arbitration and mediation can provide the necessary confidentiality, which is particularly valued in Islamic finance. ADR allows for the inclusion of experts in Islamic finance and Shariah law, ensuring that decisions are well-informed and contextually appropriate. Following are some expected benefits of ADR for Islamic finance contracts.

- **Compliance with Shariah principles:** Traditional legal systems and courts may not always fully align with Islamic principles, potentially leading to outcomes that are not acceptable under Shariah. An ADR mechanism designed for Islamic finance contracts can ensure that dispute resolutions adhere strictly to these principles.

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<sup>3</sup> <https://aaoifi.com/shariaa-standards/?lang=en>

- **Efficiency and cost-effectiveness:** ADR mechanisms such as mediation and arbitration can often resolve disputes faster and at a lower cost compared to traditional litigation. This efficiency is particularly important in the fast-paced financial sector.
- **Confidentiality:** ADR processes typically offer greater confidentiality than court proceedings, which is beneficial for financial institutions and their clients.
- **Specialized expertise:** An ADR mechanism dedicated to Islamic finance contracts can be staffed with experts in both finance and law, ensuring informed and equitable resolutions.

## 5. Key ADR Mechanism for Islamic Finance Contracts

1. **Arbitration:** Arbitration involves a neutral third party or panel making a binding decision on a dispute. For Islamic finance contracts, arbitrator(s) in the panel of arbitrators should have expertise in both Shariah and finance. The arbitration process should ensure compliance with Islamic principles and rules and can be conducted under specialized Islamic arbitration frameworks.
2. **Mediation:** Mediation involves a neutral mediator facilitating a resolution between disputing parties. It is a non-binding process that encourages mutually acceptable solutions. Mediation is particularly aligned with the Islamic rules and principle of Sulh (amicable settlement), which promotes peace and reconciliation.
3. **Hybrid Models:** Combining elements of arbitration and mediation can offer flexible solutions. For instance, an initial mediation phase can be followed by binding arbitration if mediation fails, ensuring a comprehensive approach to dispute resolution.

## 6. Proposals for Islamic Finance Contracts-Specific ADR Mechanism

To address the identified gaps, this paper proposes integration of Islamic finance related principles and conditions into the ADR mechanisms available in regulated sectors of SECP including mechanisms under section 276 of the Companies Act, 2017, the Arbitration Act, 1940 and the Alternative Dispute Resolution Act, 2017, incorporating the following elements:

**(a) Composition of Mediation and Conciliation Panel:** Include arbitrators and mediators with specialized knowledge in Islamic finance and dispute resolution into the Mediation and Conciliation Panel maintained under sub-section (2) of section 276 of the Act. The purpose is to develop mediation services where trained mediators facilitate discussions between disputing parties to reach a mutually acceptable solution, emphasising reconciliation and harmony as preferred under Shariah principles and rules. Mediation and arbitration processes will be designed to adhere strictly to Shariah principles and rules, ensuring that all resolutions respect Islamic values of justice, fairness, and ethical conduct. Arbitrators and mediators will possess knowledge of both Islamic law and the specific contractual context.

**(b) Provide ADR Guidelines for Islamic Finance Contracts:** The ADR framework to include clear ADR guidelines for Islamic finance contracts providing therein key considerations and operational mechanisms that may include

- Scope and mandate of Mediation and Conciliation Panel for Islamic finance contracts
- Eligibility criteria for the constitution of a panel of arbitrators and mediators for Islamic finance contracts;
- Manner of references for mediation and/or arbitration for Islamic finance contracts by the concerned parties and timelines ensuring timely outcomes for stakeholders.
- Provisions for preservation of confidentiality and relationships, ensuring the protection of parties' interests and maintaining business relationships.
- Integration with other existing frameworks to streamline processes and enhance awareness of the Islamic finance contracts-specific ADR mechanism.

**(c) Standardized Contracts:** Include clear ADR clauses in the standardized or illustrative contract templates for Islamic finance transactions, specifying the use of the proposed

mechanism for dispute resolution. Presently, illustrative agreements for two Sukuk structures and standardized agreements for Modarabas are in place that can be augmented while ensuring such ADR clauses in new illustrative contracts/agreements.

**(d) Awareness and education:** Conduct workshops and seminars for stakeholders in the Islamic finance industry to raise awareness about the benefits and procedures of the ADR mechanism.

## **7. Conclusion and way forward**

The establishment of an Islamic finance contract-focused ADR mechanism is deemed essential for the sustainable growth of Islamic finance in Pakistan. By providing a tailored approach that aligns with Shariah principles and rules, this initiative will enhance the efficiency and effectiveness of dispute resolution, ultimately fostering greater confidence in Islamic finance transactions.

This concept paper invites stakeholders to review and provide feedback on the subject for developing a robust framework for ADR in Islamic finance contracts, paving the way for a more resilient Islamic finance framework in Pakistan. We believe that together we can address the unique requirements of Islamic finance contracts through a tailored ADR mechanism for a complete Islamic finance ecosystem in Pakistan.

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