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PRIMARY RESEARCH

Maqāṣid Realisation in Islamic Finance: Components of Framework for Measurement Index

Muhammad Ayub
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"And We did not create the heaven and earth and that between them in play (mere for play)" [Qur'ān, 21:16; 44:38]

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Abstract. While Islamic finance has developed impressively across the globe, efforts have been initiated to measure the growth, its socio-economic impact and realizing the objectives for which the new system has been introduced. Some spade work has been done by experts from the platform of Islamic Research and Training Institute (IRTI), Islamic Devloping Banks (IDB), while Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and some individual researchers have made efforts at preparing rating scales/indices for measuring overall performance, Sharī'ah Compliance (SC) and governance. IRTI is considering about the comprehensive Socio-Economic Development that is multidimensional in nature and may involve other institutions like the State institutions and the Non-Governmental Organisations (NGOs) working for poverty alleviation or socio-economic development. This paper, however, focuses on developing the scales for measurement of the objective achievement by Islamic banks and financial institutions. Indices and rating scales are necessary to enable the stakeholders to make an opinion about any Islamic Banking and Financial Institutions (IBFIs') adherence to Sharī'ah principles and its performance in fiduciary capacity. As SC is the *raison d'etre* of Islamic finance, the paper suggests two separate streams for the rating, one for measuring the SC level and the other for governance and fiduciary responsibilities. The both have been given weightage of 100 separately. Ultimate rating could be calculated by adding the score of the both streams. It has been suggested that in case any IBFI fails to get a certain minimum benchmark for SC, say 51 per cent, the rating assigned could be 'non-satisfactory', although it might get relatively good rating for the Governance stream. For the purpose of rating scale, the paper suggests weightages for various modes/instruments/products keeping in view their level of SC as also their role in realizing *maqāṣid al*-Sharī'ah. Practically, however, it has been suggested that AAOIFI may like to constitute a Panel of Sharī'ah Scholars and Finance Professionals to decide the weightages to be given to various products for deciding Sharī'ah and governance based rating of the IBFIs. The paper concludes that introduction of suitable rating scales would be helpful in disciplining the IBFIs in terms of SC, governance and performance.

KAUJIE Classification: B1, B4, H47, I23, L2, L26
JEL Classification: D63, G24, I32, Z12

GROWTH AND STRENGTHS OF ISLAMIC FINANCE- RECOGNITION WORLDWIDE

Having crossed the milestone of 40 years, Islamic Finance is in the process of strengthening its appeal in the global finance. The Executive Board of the IMF noted in its recent meeting (IMF Executive Board, 2018) the continued growth of Islamic finance in terms of size and complexity, with Islamic banking offered in more than 60 countries. The Board also noted that Islamic banks undertake distinct operations with risk profiles and balance sheet structures that differ in important respects from conventional banks, with associated financial stability implications. Keeping in view the above features of Islamic finance, the IMF Directors accepted that its growth presents important opportunities to enhance financial inclusion, deepen financial markets, and mobilize funding for development by offering new modes of finance and attracting "unbanked" populations that have not participated in the financial system.

Earlier, the World Bank, in its 2030 Agenda for sustainable development, accepted the emphasis of Islamic finance for promoting responsible and risk sharing based finance. The WB Agenda seeks to eradicate poverty in all its forms, promote sustained and inclusive economic growth and ensure social development; and Islamic finance best suits for realizing the objectives of the agenda (World Bank and Islamic Development Bank Group, 2017).

MAQĀṢID AND ISLAMIC FINANCE

The opportunities to which the two largest multilateral finance institutions, and of course, the experts in Islamic economics and finance generally refer, pertain to the '*maqāṣid al*-Sharī'ah' for realization of which the emerging alternative of conventional finance is being suggested over last four and half decades. Islamic finance is based on Sharī'ah rules while the Sharī'ah is concerned with promoting justice and welfare in society (*al-'adl* and *al-iḥsān*) (Haniffa & Hudaib, 2007). Accordingly, the Islamic Development Bank that has been working for promoting Islamic economics and finance for over four decades, has declared in its new brand identity to adopt pioneering policies to help achieve the Sustainable Development Goals of the UN.

Islamic finance that avoids *ribā* in all its forms, *gharar*, short selling and gambling has the capacity of providing framework for achieving the objective of sustainable growth with increasing social inclusion. Based on above prohibitions, Islamic finance is fundamentalňly about disciplining the institutions for efficient and effective distribution of capital for benefit of the real economy. For IBFIs, therefore, social goals are at least (if not more) as important as making profit (Hannifa & Hudaib, 2007). They operate for risk sharing, and have to avoid creating interest bearing money and credit due to its negative impact on income distribution.

As all business operations of the IBFIs have to be risk based for *ḥalāl* earnings, even the *bai'* and *ijārah* based modes, when practiced as per their essential principles with justice and equity, may be helpful in achieving the objective of broad based development.

Keeping the above discussion in view, it is quite natural to think about developing the framework, factors and tools of the framework, scales and indices for measuring the performance of Islamic banks and financial institutions that have successfully drawn the attention of the global finance as one of the change agents in the current global economic and finance scenario. Below, first we briefly discuss the *maqāṣid al*-Sharī'ah.

The Status of *Maqāṣid* in Islamic Worldview

Maqāṣid al-Sharī'ah that lead to a standard worldview within the context of Qur'ān and Sunnah are the basis of all human activities that refer to the purposes of human beings, while without purpose and direction life would be meaningless[1]. Purposefulness is the basic norm of Sharī'ah which aims at five objectives for people; that is to protect their religion (faith), life (*nafs*), intellect (*'aql*), progeny (*nasl*) and property (*māl*). Being comprehensive in nature, *maqāṣid* pertain both to the social as also economic aspects of human life. However, the relative importance of various *Maqāṣid* might be different for different groups in a society. While *ḥifẓ al-dīn* is relevant for both rich as well as poor, *ḥifẓ al-māl* is more relevant for rich and affluent people. Again, justice in distribution of income and resources, the disclosure requirements in exchange contracts, and the right of information and knowledge are relevant to all human beings.

The classical jurists who made the most significant contributions to the *maqāṣid* theory, between the fifth and eighth Islamic centuries are Abu al Maali al-Juwayni (D. 478 AH/1085 CE), Abu Hamid al- Ghazali (D.505 AH/1111 CE), al-Izz ibn Abd al-Salam (D 660 AH/ 1209 CE), Shihab al-Din al-Qarafi (D.684 AH/1285 CE), Shamsuddin ibn al-Qayyim (D. 748 AH/1347 CE) and, most significantly, Abu Ishaq al-Shatibi (d.790 AH/1388 CE). Al-Shatbi started his volume on *maqāṣid* in *Al-Mawafiqat* by quoting the Qur'ān to connote that Allah Almighty has purposes in his creation, sending his messengers, and ordaining laws. Hence, he considered al- *maqāṣid* to be the 'fundamentals of religion, basic rules of the law, and universals of belief' (Auda, 2008; p. 22)[2]. Ibn-al-Qayyim (D. 748 AH/1347 CE) summarized his juridical methodology in the words, "*Islamic law is all about wisdom and achieving people's welfare in this life and the afterlife. It is all about justice, mercy, wisdom, and good. Thus, any ruling that replaces justice with injustice, mercy with its opposite, common good with mischief, or wisdom with nonsense, is a ruling that does not belong to the Islamic law, even if it is claimed to be so according to some interpretation*" (Auda, 2008).

Starting from the classical jurists, as indicated above, to the contemporary jurist, Auda (2008) doing widely accredited work on *maqāṣid*, Sharī'ah is considered to be aiming at welfare of the people in this life and in the life hereafter, and for this purpose it has advised

[1]Allah Almighty has not created anything in vain, "We created not the heavens and the earth and all that is between them for a (mere) play" [21:16 and 44:38]; We created not the heavens and the earth and all that is between them except with truth, and for an appointed term (46:1-2). "....Our Lord! You have not created (all) this without purpose...." (3:190-91).

[2]Professor Jasser Auda is Al-Shatibi Chair of *Maqāṣid* Studies at the International Peace College South Africa, the Executive Director of the *maqāṣid* Institute, a global think tank based in London, and a Visiting Professor of Islamic Law at Carleton University in Canada.

people to adopt such means and measures that may give advantage benefit/well-being to them and may ward off evil/injury/loss, from them.

As the compliance with the principles of the Sharī'ah is the *raison d'etre* or the justification for existence as a separate system, Islamic banking and finance must be fulfilling this, the pre-emptive and essential objective of Sharī'ah in all respects, while the remaining objectives, i.e., protection of Life/Self, Intellect, Progeny, and that of Wealth might be served indirectly and automatically as all Sharī'ah tenets are for the betterment of the human beings. Hence, depositors and finance seekers in Islamic banking and finance need to feel confident that the business is being conducted ensuring their religious and financial needs.

It is crucial to indicate here that *maqāṣid* are the anticipated end-results of the human beings' actions, and not the sources of the Sharī'ah, implying that *maqāṣid* cannot be positioned as the sources of the Sharī'ah. *Maqāṣid*, however, have to be kept in view while issuing pronouncements as every action has to lead to fulfillment of the *maqāṣid al*-Sharī'ah. In other words, validity, or otherwise, of various contracts and business/economic activities would be adjudged in the light of Qur'ān and Sunnah, but necessarily considering the aspect of achieving the *maqāṣid*. The Sharī'ah compliant products/instruments would be differentiated from the non-Sharī'ah compliant products on the basis of a set of rules taken principally from Qur'ān and Sunnah, and in turn, from *ijmā'* based on *ijtihād* (juridical effort to derive *ḥukm* of any emerging issues) and *qiyās* (analogy). For the purpose of *ijtihād* and *qiyās*, '*illah* - the legal cause of any *ḥukm* or the basis for applying analogy for determining permissibility or otherwise, of any act or transaction, an event or a contract would be kept in view while applying the tenets of the Sharī'ah[3].

However, solitary pronouncements by any bank's Sharī'ah board(s) or any Sharī'ah scholar(s), not the end result of well thought-out *ijtihād*, would not be acceptable, if against established *ijmā'* or the general consensus regarding the matter reached by any competent body of jurists or larger groups representing majority view, particularly including Makkah or Jeddah based Islamic *Fiqh* Councils and the Sharī'ah Board of AAOIFI.

Maqāṣid al-Sharī'ah and the Objectives of Islamic Finance

Based on the *maqāṣid al*-Sharī'ah, the objectives of Islamic finance have been indicated as avoiding the prohibitions like *ribā* and *gharar* and achieving the well-being within the framework of the moral norms of the Sharī'ah, eliminating exploitation and creating cooperation and harmony. It is to uphold universal brotherhood and justice to attain equitable distribution of income and social welfare (Mohammad & Shahwan, 2013).

Over the years, there has been a widening gap between the objectives of Islamic economics and that of Islamic banking and finance. Mohammad and Shahwan (2013) have suggested, while taking argument from renowned contemporary Islamic economics and finance experts, that Islamic banks might promote the objectives of Islamic economics thus incul-

[3]It is pertinent to observe that '*illah*/'*illat*' as legal reasoning could be different from the *ḥikam*, the rationale for prohibition of something, although rationality and legal reasoning are considered one and the same. Moghul (1999) contends, "There has to be a relationship and 'interplay' among the '*illah*, the *ḥikam* [sing., *ḥikam*), and the *maqāṣid al*-Sharī'ah, are so as to promote certainty and accuracy in determining the '*illah*, the law, and its applicability".

cating *maqāṣid al*-Sharī'ah in their holistic direction. They have concluded that although theoretically the objectives of Islamic economics and Islamic banking are in align with five elements of *maqāṣid al*-Sharī'ah, practically the Islamic banking institutions mostly turned out to be profit-oriented rather than social-based entities.

Auda (2008) articulates in this regard that "validity of any *ijtihād* should be determined based on its level of achieving 'purposefulness,' or realizing *maqāṣid al*-Sharī'ah". Auda (2008) further says, "Sharī'ah is all about wisdom and achieving people's welfare in this life and the afterlife. Thus, any ruling that replaces justice with injustice, mercy with its opposite, common good with mischief, or wisdom with nonsense, is a ruling that does not belong to the Sharī'ah, even if it is claimed to be so according to some interpretation"[4].

The present image of Islamic finance in terms of credibility as Sharī'ah compliant is because of neglecting the *maqāṣid* approach. According to Wajdi (2009), innovative products like some sorts of *ṣukūk* or tools/structures, which try to achieve the same economic outcome like that of conventional instruments, distort the vision of Islamic economics based on justice and equity. Hence, Sharī'ah scholars and the finance experts need to contemplate to actualize the *maqāṣid al*-Sharī'ah in business in modern times.

Islamic Finance and the Elements of *Maqāṣid al*-Sharī'ah

As discussed above, Islamic finance has to be integrated with Islamic economics to lift up both sub-disciplines within the margins of Sharī'ah as indicated in Qur'ān and Sunnah. All elements of *maqāṣid* need to be given due attention when dealing with the directions of Islamic finance and Islamic economics. These elements precisely include: i) SC, ii) Profitability, and iii) Socio-economic development/inclusion. These, in turn, pertain to governance, both corporate and Sharī'ah, reporting systems, Sharī'ah advisory and review, internal and external Sharī'ah audit, by involving an enabling regulatory framework. The ultimate impact in the form of SC is necessarily of greater relevance with more of a belief and psychological nature.

While profitability has been accepted as a prime objective of any business, it has been restricted with the concepts of *ḥalāl* and *ḥarām*, fair dealing with the stakeholders, and the socio-economic requirements in a society. Dusuki (2013) indicated in an exploratory study that the IFIs should uphold social objectives, promote Islamic values towards their staff, clients and the general public and contribute to the social welfare of the community, promoting sustainable development projects and alleviating poverty. According to Khan and Nor Saeran (2017), Islamic banks, while doing business for genuine profit, are required to pursue *maqāṣid al*-Sharī'ah. These, inter alia, include promotion of broad-based economic growth and development and well-being of the society they operate in.

Accordingly, the Vision, Mission and Objectives (VMO) of Islamic banks in many parts of the world indicate achieving the objective of value based development. In Pakistan, SBP's strategic plan (2014-18) (State Bank of Pakistan, 2014), IBIs' objectives are to en-

[4]However, Auda (2008) adds, "some people in influential political and/or intellectual positions mistakenly use Sharī'ah as means for political control. Thus, they publicize a certain understanding of the Sharī'ah in order to gain some worldly gains. These people give the Sharī'ah a bad name and harm Islam more than its enemies".

suring 'risk and reward sharing' and equitable and broad based distribution of economic gains. SBP's SGF-2015 (Islamic Banking Department, 2015) resolves "to strengthen the overall SC environment of IBIs" while the SC is for realizing the *maqāṣid al*-Sharīʻah. Major Islamic banks operating in Pakistan, particularly including the premier Islamic bank of Pakistan-Meezan Bank, and Al-Baraka Bank, have indicated the same objectives in their vision/mission statements[5].

In respect of Malaysia, Mohammad and Shahwan (2013) referred to three main goals of Islamic banks, namely i) to implement the value system of Qur'ān and Sunnah in the realm of the Muslim socio-economic system, ii) to foster the growth of the economy; and iii) to create stability by promoting risk-sharing instruments whose payoffs are strictly contingent on profitability of a firm or project at a micro level. "The whole idea of VBI (value based intermediation) is in maximizing benefit while minimizing harm, which is also what Islamic banking tries to achieve. Not harming the society is a requirement in Islam," affirmed Ali (2018), the director/regional head of Sharīʻah and Governance at CIMB Islamic Bank, Malaysia. Similarly, UOB Bank Malaysia is working on a program called the UOB Islamic banking community engagement program, encompassing three stages, namely community engagement, advisory and VBI. In a recently held IFN Asia Finance Forum 2018, Islamic finance industry players have been urged to assess the development of Islamic finance in Malaysia, including the adoption of benevolent, risk-sharing and *mushārakah*-based products and the implementation of initiatives such as sustainability and value-based intermediation (Ali, 2018).

In line with such vision, an important function of Islamic banks is to provide Sharīʻah compliant financing to the SMEs and commodities sector like agriculture that leads to linkages with the basic producing units in any economy, providing jobs to a major part of the population. Nevertheless, as the industry has been focusing on convincing people to leave interest-based finance, Islamic financial institutions have not prioritized the implementation of VBI until today (Ali, 2018).

We come to the conclusion in this regard that *maqāṣid al*-Sharīʻah in respect of Islamic banking and finance comprise SC in letter and spirit, profitability, promoting fair dealing, justice and VBI leading to socio-economic development and inclusion. Hence, all five *maqāṣid* are covered under the objectives of Islamic finance.

MEASURING *MAQĀṢID* REALIZATION

Performance of IFIs in terms of *maqāṣid* achievement has to be measured by constructing various indices and/or rating scales. The purpose is accomplished by considering the following: i) Why measurement and rating are needed, and this sets the foundational basis of the index/scale; ii) whether the practices and operations of any IFI are consistent with Islamic principles in letter and spirit, and iii) whether the practices are playing role in enhancing human welfare and protections at broader level.

[5]Meezan bank's vision is to facilitate the implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind.

Measurement and ratings scale are needed to help various stakeholders make an opinion about any IFI's adherence to Sharī'ah and its performance in fiduciary capacity and thus to decide about availing of its services for investment or financing services. It could also help in improving market discipline and enhancing the level of transparency in Islamic finance industry (AAOIFI-GSIFI-10).

Some specific terms pertaining to measuring broad based development have been used over the last decade even in the conventional finance, particularly since the eruption of global financial crises in 2008. The terms and expressions like social responsibility, socially responsible investment, governance and environmental measures and value-based intermediation are now widely utilized alongside their acronyms like ESG, PRI, SRI and VBI. All these terms are relevant more to the emerging discipline of Islamic banking and finance.

For constructing the indices we need to indicate the factors and assign them weightages keeping in view their relative importance and linkage/relevance to serve the purposes of the Sharī'ah. Some spade work towards constructing such indices and scales has been done by some experts from the platform of IRTI, IDB Jeddah, while AAOIFI and some individual researchers have also made efforts at preparing rating scales for measuring overall performance, SC, governance and fiduciary responsibilities.

IRTI has been discussing the matter for some years in broader spectrum. A number of research based workshops have been organised on the related areas. One such research based workshop was held jointly by the IRTI and the Riphah Centre of Islamic Business (RCIB) at Islamabad in October, 2018. This Workshop reiterated the need for a comprehensive *maqāṣid al*-Sharī'ah based Index on socio economic development of human societies along with sub-indices for different aspects of human life. A study by Hasan, Ali and Muhammad (2018) that was presented in the IRTI's Islamabad event suggested an inclusive framework and applied Alkire-Foster counting methodology to construct *maqāṣid al*-Sharī'ah Index using World Values Survey data for Pakistan.

Nevertheless, the IDB and IRTI are concerned more about the comprehensive Socio-Economic Development that is multidimensional in nature and may involve other institutions like the Government, the State institutions working for poverty alleviation and public-private partnership for socio-economic and scientific development. Accordingly, the IDB's new strategy, as announced on June 6, 2018 includes putting the necessary infrastructure in place to enable the people to fulfill their potential leading ultimately to achieving the UN Sustainable Development Goals.

We, however, are concerned more about the unit of the comprehensive index to measure the performance of Islamic financial institutions providing direct or indirect financial intermediation facilities. Hence, here we will be focusing on developing the scales for measurement of the objective achievement by the IFIs and for their rating.

Developing Scale for IFIs' Rating

The researchers have so far considered the IFIs' performance as one package comprising SC, profitability and various levels of governance to serve respective *maqāṣid al*-Sharī'ah. For example, Zaheer and Rasool (2017) have suggested Weights (α) to four objectives, namely:

ḥifẓ al-māl-50%; *ḥifẓ al-īmān*-35%; *ḥifẓ al-nafs*-10%; and *ḥifẓ al-'aql*-5%; the Index such suggested is: $Index = \sum_{t=1}^{n} \alpha_t X_t$

Thus, to them the index is defined as: 0.5* *ḥifẓ al-māl* rating + 0.35* *ḥifẓ al-īmān* rating + 0.1* *ḥifẓ al-nafs* rating + 0.05* *ḥifẓ al-'aql* rating. The fundamental flaw of the proposed index is that the Sharī'ah that is the basic reason as to why Islamic banking and finance should exist, has been given lower weightage than wealth protection or profitability. If profitability is to be considered more important than the conformity with the Sharī'ah principles, then the choice would be the existing conventional finance, warranting no need for evolving any new system.

The factors included by Zaheer and Rasool (2017) for SC (*ḥifẓ al-īmān*), in turn, are i) compliance of products with documentation and process approved by the respective Sharī'ah boards; ii) disclosure of relevant information; and iii) review of bank's policies and practices by the Sharī'ah boards. Here again the basic issue is that the Sharī'ah boards of IFIs that comprise generally the heavily paid members, have been accorded freedom and not been suggested any bases for pronouncements or decisions regarding approval and conformation of financing and investment products[6]. This could be highly problematic given the difference in Sharī'ah interpretations and flexibility allowed by various boards, causing harm to integrity of the emerging Divine system.

For ensuring SC, the IBFIs have to have Sharī'ah board, Sharī'ah review, internal Sharī'ah audit, and external Sharī'ah audit-a different governance system. At institutional level, AAOIFI is in the process of finalizing its Governance Standard No. 10 on SC and fiduciary ratings for IBFIs. Some public hearings events have taken place to elicit the suggestions of respective area experts. Based on all these factors, AAOIFI is developing a 'Rating System' which could enable the investors to decide about financing and investment, keeping in view the SC and the care for fiduciary responsibilities. But, here again the basic flaw is that SC has been considered a part of performance in terms of profitability and governance related aspects.

As per AAOIFI's exposure draft (ED) of GSIFI-10, rating of IBFIs has been suggested to be made on the basis of six aspects, namely i) compliance with Sharī'ah principles and rules; ii) Sharī'ah governance framework; iii) corporate governance practices related to Sharī'ah governance; iv) transparency and disclosure; v) ethics and values; and vi) fiduciary responsibilities and performance.

Parameters of Sharī'ah Compliance

The most important of the elements suggested by GSIFI-10 ED is the Sharī'ah Compliance that is supposed to be measured on the basis of five parameters for deciding relative state of compliance and rating of any IBFIs. These parameters and the weightages suggested in ED are:

a) Compliance with Sharī'ah principles and rules (30-35 weightage);

[6]It has been witnessed that the IBIs have been replacing the SB members providing free services with heavily paid members known for their flexible approach in approving almost any replicas of conventional products suggested by the banks management.

b) Sharī'ah governance framework (15-20);

c) Corporate governance practices related to Sharī'ah governance (10-15);

d) Transparency and disclosure (10-15);

e) Ethics and values (10-15); and

f) Fiduciary responsibilities and performance (15-20).

The suggested relative weightages for the above parameters of SC are subject to some serious objections. In the Public Hearing program held at Islamabad on 30th April, 2018, almost all participants were of the view that Sharī'ah being the cause of justification for developing the new system, SC might be considered as a separate stream, while the other parameters, the other stream, meaning that the former may separately be given weightage of 100, while the others might collectively be given the weightage of 100. Dr. Muhammad Qaseem, well recognized Sharī'ah scholar in Islamic finance and former member of the SBP's Sharī'ah Board, observed that SC and fiduciary duties were two different areas and, as such, it might not be prudent to assess the performance of an IFI in both areas under a single rating mechanism. Moreover, when a rating score is allocated to an IFI both for SC and fiduciary responsibility, the latter may pale the relevance of SC which is the most significant feature of any IFI. He strongly recommended separate ratings based on the two areas.

It was apprehended by the AAOIFI's representative, however, that separate scale for Sharī'ah rating might not be acceptable for the IBFIs that currently are taking a lot of liberty in Sharī'ah interpretations. It was reiterated, however, that for sustainable development of Islamic finance, IBFIs will need to be provided rational rating scales which they might be adopting, though slowly, in competitive environment. The stakeholders will be increasingly choosing the better IBFIs in terms of rating and this would play crucial role in disciplining the market in terms of SC.

If all the parameters are to be included in one stream, then the weightage to SC may be increased to 51%; for satisfactory rating. It may also be provided that in case any IBFI fails to get a certain minimum benchmark for compliance with Sharī'ah principles, say 51 per cent, the other 5 parameters might not be considered for calculating the rating. It is worth mentioning that the higher benchmark weightage rationally required for SC is also reflected in the suggested indicators for rating scale (ED, para 36). The highest rating (iAAA) to any IBFI is given in case it uses only preferred products/options, avoids the controversial products; and there is no material non-compliance instances noted.

The AAOIFI's ED also indicates sub-parameters for all of the above benchmarked parameters (paragraphs 20 to 26). For compliance with Sharī'ah principles, the following sub-benchmarks have been suggested (**in hierarchy**):

1) AAOIFI's Sharī'ah Standards;

2) The regulations issued by the respective regulators regarding Sharī'ah;

3) Central Sharī'ah Board's rulings in respective jurisdiction;

4) AAOIFI's applicable Financial Accounting Standards entailing Sharī'ah related requirements; and

5) Approvals and rulings given by the Sharī'ah Board of the IBFI.

The Rating entities and committees have to ensure the relevance of phrase "hierarchy" as provided in the Standard. It implies that provisions/pronouncements/regulations resulting from the latter sub-benchmarks cannot be contradictory to that of the former benchmarks.

With regard to the category of products, the ED refers to the '*preferred options*' and the 'controversial products'. These categories need to be elaborated to mean compliance with overall spirit of the AAOIFI Sharīʻah standards. Otherwise, Sharīʻah scholars in various jurisdictions may devise their own set of preferred and controversial products/contracts causing misinterpretation and misperception about Islamic finance around the world.

Assigning Weightages to various Modes

As the SC, purposefulness and equitable benefits to various stakeholders are the major concerns of the Sharīʻah, some aspects have to be kept in view while deciding about the weightage to various modes. These are: i) All categories of modes, *shirkah*, trade or leasing based, have their role in achieving the *maqāṣid* provided applied in the light of their Sharīʻah requirements; ii) Nearer to Islamic principles, and greater the role in CSR/purposefulness; greater the weight, and iii) If a mode or instrument of any category is not applied properly, it would carry lower or little weight.

We are suggesting here weightages, just as a hint, for various products, both preferred and controversial, keeping in view the above aspects. [Introduction of these modes is given in the Annexure.] To proceed ahead practically, however, AAOIFI may like to constitute a *Panel of* Sharīʻah *Scholars and Finance Professionals* to decide the weightages to be given to various products for deciding Sharīʻah based rating of the IBFIs. The Panel may comprise members of AAOIFI's Sharīʻah Board, representatives of IRTI and IFSB, IIRA, Moody's, Fitch Ratings, Islamic banking and finance practitioners and experts in Islamic financial reporting.

Specific weightage has been suggested here for each product out of 100. It means that in case a bank might be using 10 products, the total weightage would be 1000, while the weight earned would be the total weight calculated on the basis of suggested weightage to be used for rating. For example, if an Islamic banks has financed/invested Rs. 100 million each in *murābaḥah, ijārah, ijārah ṣukūk, muḍārabah/mushārakah ṣukūk*, Sharīʻah compliant stocks, diminishing *mushārakah*, *salam/istiṣnāʻ*, *qarḍ al-ḥasan*, currency *salam* and organized *tawarruq* to the conventional financial institutions (OTCFIs), it will earn the total SC score of 635 out of 1000 or 63%. For comprehensive rating, score may also be calculated for CSR and Corporate Governance elements. In case a bank gets 70 score in CSR, the total score earned would be 133/200 on the basis of which rating would be decided like iBB[7].

Another proposition is that to start with, the Sharīʻah based ranking could be of two types: Global Ranking and the Country-Specific Ranking. It is because Sharīʻah scholars in different jurisdictions have adopted different interpretations of the principles of Islamic law of contracts and their application, or are using *maṣlaḥah*, and '*umūm balwa* for justifying the

[7] It's just an initial effort, the weightages suggested for various modes/contracts have to be finalized, as suggested here, by the Panel of Sharīʻah scholars, IF practitioners and accounting professionals.

conventional finance replicas[8]. Accordingly, AAOIFI and the regulators at national levels may introduce the procedures to issue ratings according to national as also global standards. For the time being, it is up to the regulators they make AAOIFI's standard on rating mandatory or not; or might be doing so after some years when the market pressure comes based on global Sharī'ah based rating. The factors for *maqāṣid al*-Sharī'ah achievement index and their suggested weightages are given in the Table and the Structure below:

TABLE 1
Modes/products and suggested weightages (out of 100)

Modes	Wt. Range	Modes	Wt. Range
Mus/Mud	85-95	OTCFIs	2-5
SC Stocks, PTCs, Mus/Mud *ṣukūk*/Cert, Isl. Funds,	80-90	OTIFIs	30-40
Murābaḥah/*Musāwamah* (Gen)	60-70	Currency Salam	5
Salam	70-80	RM	2-10
Istiṣnā'	60-70	Fin Der	2-5
Ijārah (genuine)	60-70	*Bai' al-Dayn*	2-5
Ijārah ṣukūk	60-70	*Bai' al-'Inah*	2-5
Al-Tijārah	50-60	Debt based *ṣukūk*	2-5
Qarḍ al-Ḥasan	95-100	'*Inah* based Credit Card	2-5

Note: Acronyms have been defined in Table-2

A critical factor for ensuring SC is knowledge and experience of the IBFIs' Sharī'ah board members both in Islamic jurisprudence and the modern finance, and their selection criteria. The most crucial factors in this regard are the process of selection, "Fit & Proper" criteria, education, training and experience, the pay package/honorarium payments system, and the level of effective independence. It is generally apprehended that for the commercial reasons and earnings maximization, the banks, Fund Managers or the corporate firms might be inclined to appointing only such persons, though comparatively at higher salaries, that are deemed to be more flexible in allowing replicas of the conventional products.

[8]For example: In Pakistan, IBIs Sharī'ah board have freedom to approve any product according to their own interpretation, bills discounting is allowed in disguise of Currency *Salam*; *bai' al-'Inah* is formally prohibited, but practically, many IBIs are circumventing this prohibition while doing *ṣukūk* based *tawarruq* through which the *ṣukūk* are returned to the originally selling bank in 5-15 minutes by way of a technique '*ghumana*'; sale of debt is formally prohibited, but practically conducted in the form of *murābaḥah* based sale of near to maturity *ijārah ṣukūk*; In Malaysia, *bai' al-'Inah*, sale of debt, organized *tawarruq* and some financial derivatives are allowed, while the AAOIFI Standards are not accepted even as guideline.

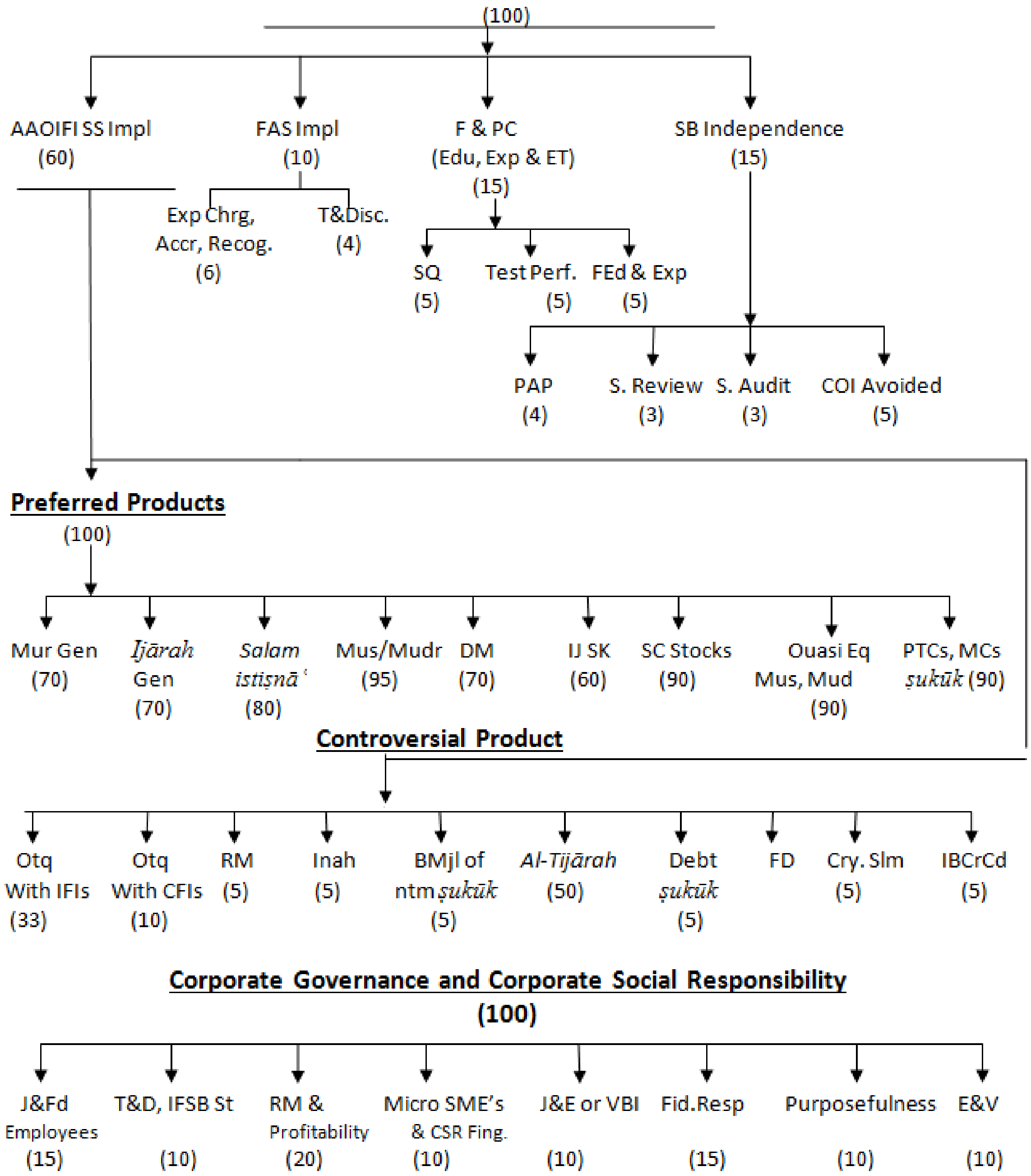

FIGURE 1. IBFIs' ***Maqāṣid al*-Sharīʿah** achievement index-rating scale factors and their weightage Sharīʿah compliance and governance framework

TABLE 2
Acronyms and the terms used in the rating framework

BMjl.Sk	*Bai' al-Mu'ajjal* of *Ijārah Ṣukūk*	PTCs	Participation Term Certificates
COI	Conflict of Interest	Accr	Accruals
DM	Diminishing *mushārakah*, *Shirkah al-Milk* based	F&PC & Fit	Proper Criteria
Eq	Equity	SQ	Sharī'ah Qualification
ET	Eligibility Test	PAP	Product Approval Process
Exp Chr.	Expense Charge	Test Per.	Test performance
FEd& Exp	Finance. Edu. and experience	QH	*Qarḍ al-Ḥasan*
Gen	Genuine	CFIs	Conventional financial institutions
IFAS	Isl. Fin. Acctt. Standards (AAOIFI)	Cry. Slm	Currency Salam
Ij Sk	*Ijārah Ṣukūk*	MCs	*Muḍārabah/Mushārakah* certificates
Impl	Implementation	T&Disc	Transparency and Disclosure
Mur (Gen)	*Murābaḥah* Genuine	IBCrCd	'*Inah* based credit Card
Mus/Mud	*Mushārakah/Muḍārabah*	DBS	Debt based *Ṣukūk*
ntm	Near to maturity	J&FD	Just and fair dealing
SC	Sharī'ah Compliance	SGF	Sharī'ah Governance Framework
SS	Sharī'ah Standards (AAOIFI)	FD	Financial derivatives

According to a study published on line, heavily paid scholars allow any transactions and this trend ultimately distorts the market and all other IBFIs in a market have to follow the suit to remain in the market[9]. "*Islamic finance could be a fruitful, thoughtful and even moral alternative to Western banking, if it can overcome its scholar problem*", says Sophie McBain. This way, almost all IBIs in Pakistan are providing running finance by way of '*Running Mushārakah* - ditto replica of the conventional Over Draft facility. McBain (2013) accordingly observed that economic potential of Islamic finance may never be fulfilled because of its serious governance problems, with power concentrated in a small, ageing and reticent elite. Likewise, Amuda (2015) has sought-after that the Sharī'ah scholars should not play with Islamic law.

Sharī'ah governance must start from the basic unit of the Sharī'ah scholar, the 'Fit and Proper' criteria and the remuneration policy. Otherwise, the whole Sharī'ah governance process might become non-effective in realizing the objective of ensuring SC of Islamic banks business. The AAOIFI, and in turn, the regulators may specify a benchmark in respect of education, experience and training, and specific fit & proper criteria for appointing Sharī'ah

[9]See McBain (2013), an award-winning features writer and an experienced editor based in New York; Islamic finance's 'Scholar Problem': Why are Sharī'ah Scholars Paid So Much? https://www.spearswms.com/islamic-finances-scholar-problem-why-are- Sharī'ah-scholars-paid-so-much/

advisors and policy of paying them remuneration/honorarium. For example, more weightage be given, if the remuneration/salary is paid by involving the regulator or by any third party consultancy/advisory firms for ensuring independence of the Sharīʻah committees.

On account of the above, it is recommended that the nature of 'Fit & Proper' criteria, process of selection, level of experience of financial products, knowledge of financial reporting, the remuneration system for Sharīʻah scholars, the level of effective independence of Sharīʻah boards, separation of Sharīʻah audit from Sharīʻah advisory & review and commitment for implementing AAOIFI's Standards may also be considered for rating of the IBFIs. Accordingly, the elements of pre-entry test, finance related education and knowledge of the potential members of the Sharīʻah boards, and procedure of their remuneration payments have been included in the suggested framework of Sharīʻah governance.

We conclude the discussion by reiterating that Islamic banking and finance must be aiming at achieving certain objectives based on the *maqāṣid* al-Sharīʻah. Different indices and rating scales are necessary enabling the stakeholders to make an opinion about any IFI's adherence to Sharīʻah principles and its performance in fiduciary capacity. Introduction of suitable rating scales would be helpful in disciplining the IBFIs in terms of SC and business performance. Otherwise, the emerging system will be increasingly losing credibility leading to convergence with the conventional system.

While developing the comprehensive scales for measuring socio-economic development is the job of multilateral institutions like IDB/IRTI, rating scales for measuring performance of the IBFIs have to be developed by AAOIFI and Islamic finance experts jointly. For this, two separate scales are required for measuring the level of SC, and performance in respect of fiduciary responsibilities and implementation of initiatives such as sustainability and value-based intermediation. For implementing 'Fit & Proper' criteria, the level of knowledge and experience of innovative finance products and the financial reporting involved may also be tested by giving a comprehensive test before selecting the Sharīʻah board members.

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ANNEXURE

Brief on some Modes of Islamic Finance as used by the IBFIs[10]

Bai*' *al*-'*Inah: A buy-back contract. This is a double sale by which the borrower and the lender sell and then resell an object between them, once for cash and then for a higher price on credit, with the net result of a loan with interest. This transaction is prohibited according to mainstream approach of Islamic finance.

Bai*' *al-Dayn: Sale of debt or debt instruments, e.g., discounting/rediscounting of debt based securities, collatoralised debt obligations, the provision of debt based capital by way of sale/purchase of debt instruments and papers. It is prohibited according to AAOIFI, Jeddah based Islamic *Fiqh* Council and the mainstream Islamic finance theory.

Bai*' *al-Mu*'*ajjal: A credit sale. Technically, a financing technique adopted by Islamic banks that takes the form of *murābaḥah-mu*'*ajjal*. It is a contract in which the seller earns a profit margin on purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in instalments. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price, but generally it is higher than the spot price.

Bai*' *al-Mu*'*ajjal* of (near to maturity) *Ijārah Ṣukūk: According to SBP's DMMD Circular No. 17 Oct. 15, 2014, Islamic banks in Pakistan were provided opportunity to invest the amount of GoP *ijārah ṣukūk* to be redeemed for another period of one year by way of selling the *ṣukūk* to SBP a few days prior to maturity. The seller banks added one year's T-Bills related rate to the face value and the rental receivable by the date of maturity. SBP, as manager of the public debt system also evolved a procedure through which the money moped up by it from the IBIs was adjusted in the public debt system. Islamic banks knowing that after 1 or 2 days the lease would terminate and their right to rental cease to exist, so they would not have any right to add rent for the period afterwards. As the objective here is to continue earning on liquidity after termination of *Ijārah* and maturity of *ṣukūk*, it practically is return on receivables. The intention is continue getting return on money, which renders the return ḍ*aram*.

(Inter-bank) *Bai*' *al-Mu*'*ajjal* of *Ṣukūk* for *Tawarruq*: In this transaction, a treasury broker makes arrangements of deploying excess liquidity of an Islamic Bank (IB) to generally a conventional bank that wishes to get liquidity for arbitrage by involving a bank (also conventional) who has the *ṣukūk*. For example, bank A sells the *ṣukūk* on cash to IB; IB sells same day the same to bank B on *bai*' *al-mu*'*ajjal* basis, with return, that resells the same on spot payment to get cash for arbitrage, practically back to Bank A through a technique

[10] For further details about the modes/instruments, please see: Glossary on Islamic modes and the other on technical terms as published in the JIBM, Vol.2, No. 2 (2012); and Vol. 5, No.1 (2015). www.jibm.org For further details, see JIBM Discussion Forum on "*bai*' *al-mu*'*ajjal* of GoP *ijārah ṣukūk*" published in Vol.5, Issue. 2 (2015)

named “Ghumana”. [Evidence to the *bai*‘ *al-‘īnah* type process is that the *ṣukūk* remain in the SLR limit of Bank A during the process that may take about half an hour]. Brokers work as ‘market makers’ for deployment of funds by Islamic banks with the interest based banks that benefit by way of arbitrage by investing in interest based public debt securities.

Bai*‘ *Murābaḥah: A sale with bargaining on profit margin; sale based on cost price and mutually agreed profit margin, where the cost price, the profit margin and other costs to the seller are made known to the buyer at the time of the contract.

Bai*‘ *Musāwamah: Sale without any reference to the cost price to the seller; sale with bargaining on the price, not the profit margin as in *murābaḥah*.

Bai*‘ *al-Salam: A contract in which a seller undertakes by way of a contract to deliver specific good(s) to the buyer at a future date in exchange of an advance price fully paid at the time of the contract. The objects of *Salam* sale are *mithlī* (fungible) goods generally available in the market, and cannot be gold, silver or currencies covered under rules of *Bai*‘ *al-ṣarf*, i.e., exchange on both sides has to be hand to hand without delay. Hence Currency *Salam* is not allowed as per Islamic law of contracts, as also AAOIFI’s Sharī‘ah standards.

Commodity *Murābaḥah* (Organised *Tawarruq*): ‘*Commodity murābaḥah*’ is organised *Tawarruq* or reverse *Tawarruq* conducted by Islamic banks; a transaction where the Islamic bank purchases a commodity through brokers on spot and sells it for a deferred payment, also through brokers for the purpose of getting liquidity. Islamic banks have been using it for liquidity management by involving brokers. As trade with all its essentials does not take place, it was declared in 2009 as invalid by the Jeddah and Makkah based Islamic *Fiqh* councils. The most serious outcome of this product is that resources mobilised by the IBFIs for Islamic business are generally transferred to the conventional system for arbitrage by the latter.

Forward Contract: In forward contracts, counterparties are bound by a non-standardized obligation to buy (or sell) an asset at a future date for contracts of real assets; delivery of assets generally takes place. *Salam* is a kind of Forward contract, allowed by the Holy Prophet (PBUH) with certain conditions; price is paid at spot while the delivery of goods is deferred to specified future date. As per *Islamic* law, forward contracts are allowed with the conditions of a valid *Salam* contract.

Futures Contract: Futures are standardized contracts between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today (the futures price) with delivery and payment occurring at a specified future date. In Futures market, which does not visualize physical delivery of any commodity, generally derivatives of forward market contracts are traded. Settlements are made through clearing houses-dealers pay into or receive from the clearing house without even knowing the name of the other party - it is a zero-sum game - Losses of the one are gain for the other. It may also involve over-exposure larger purchases than the actual number of shares/instruments. One can operate with a small margin, the subject matter being non-existent, no delivery/transfer; hence, the gearing ratio is very high. Short and Long position in futures: For each "short" hedger there is a 'long' speculator and vice versa - speculators facilitate the hedgers to hedge - they assume the risk which the hedgers want to shed. Futures markets operate to the benefit of powerful "insiders" or professional speculators and not to the society at large. Real benefit is reaped by professional speculators who assume the reverse position which hedgers adopt.

Ijārah Muntahīyah bi al-Tamlīk: Lease culminating into transfer of ownership to the lessee in such a way that lease and sale contracts are kept separate and independent transactions. Use of this term for Islamic leasing is better than *Ijārah wā iqtinā*ʻ as the latter tends to give impression that *Ijārah* and sale are working side by side without observing the relevant rules, while actually they have to be two separate deals *Ijārah* as adopted in AAOIFI's Sharīʻah Standard. A similar term is *Ijārah Thumma al-Bai*ʻ.

Islamic Forex Swap: *Islamic* FX swaps are based on the structures of either *tawarruq* and/or *wa*ʻ*ad*. The *tawarruq* based structure normally involves two *tawarruq* transactions at the beginning and the end that allows the same effect as achieved in conventional FX swap. Problem arises when the parties involved want to exchange currency at some time in the future but fix a rate today when the contract is concluded. This contravenes the *bai*ʻ *al-ṣarf* rule that it must be transacted on a spot basis. To avoid the prohibition, the concept of *wa*ʻ*ad* is used along with *tawarruq*.

Islamic Cross-Currency Swaps: It involves a series of commodity v transactions, not one as in case of FX swap, because it not only involves the principal value at the beginning and end, but also the stream of cash flow during the lifespan of the product.

Musāwamah: *Musāwamah* is a general kind of sale in which price of the commodity to be traded is bargained between seller and the purchaser without any reference to the price paid or cost incurred by the former.

Financial Derivatives: Many IFIs are investing in derivatives like options, futures, forward, profit rate swaps, cross-currency swaps, credit default swaps, repos, fund index-linked derivatives and other toxic instruments using the concepts of *wa*ʻ*ad*, *tawarruq* and *muqāṣṣah* (netting-off) [For details: Ayub and Paldi; JIBM, Vol.5 No.2, 2015; Pp: 85-89]

Profit Rate Swap: In profit-rate swap, cash flow from a floating rate is changed with a fixed rate. The "*Islamic* Profit Rate Swap" seeks to achieve SC by using bilateral *wa*ʻ*ad* and multiple *murābaḥah* transactions. If the company wishes to cancel the *wa*ʻ*ad*, it must pay compensation of the cost that is borne by the bank, if any. Hence, the company is again exposed to a risk for which it might not have a real need and against which it intended to hedge. No party pays the price of the commodity and only netting-off is made as happens in conventional profit rate swap. 'Actual' cost to the bank is nothing but the rate differential and the speculative gain or the loss of expectation.

Running *Mushārakah* (RM): RM has been introduced as an alternative to interest based product for running finance for corporate sector. RM is accomplished by agreeing on the two-stage Profit Sharing Ratio (PSR). While in the first stage, the ratio of investment by the client and the Bank is the PSR for getting the target rate of profit by the IBI on its investment, say KIBOR +1; but as and when the target profit rate is achieved, the PSR changes drastically to favour the client. Thus Islamic bank agrees to reduce its profit share as low as 3 or even 4 zeros after decimal, giving the 99.99999% of additional profit to the client. Thus, the bank's share in additional profit is only a few Rupees (e.g., Rs 2 or 0.02 Dollar in one RM case of an IBI) that practically have no value in multi million rupees of banks investments. The client has to pay fix charge as in case of OD.

Al-Tijārah: *Al-Tijārah* is a product for financing Corporate/SME/Commercial sector involving trading, agency and guarantee. Customers sell the finished goods to banks on a cash basis, and then sell the same to their clients on credit basis as agent of the bank. Customers also become surety to the bank receiving the proceeds of credit sale. Thus banks manage the credit risk.

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