Aligning the Institutional Framework of Islamic banking and finance with the Maqasid al Shariah

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ABSTRACT

One of the prevailing issues facing the development of an Islamic financial system is that financial structures remain biased towards debt-based contracts over risk-sharing contracts. The main reason is that policies, regulatory frameworks, tax and legal environment are not yet fully developed to adequately support and promote risk-sharing contracts. The objective of this paper is to focus not only on objectives of Islamic commercial contracts, but to expand the focus onto a broader picture of the underlying institutional framework and supporting structures that will be required to support Islamic financial products which are based on risk sharing principles. This study examines how modern institutional structures can be aligned with fundamental objectives of the Shariah to strengthen the existing setup of Islamic banking and finance by creating a better balance between equity-based and debt-based Islamic instruments. This paper is an exploratory qualitative study that will explore how the present institutional framework can be further developed within the framework of Maqasid of Shariah, to facilitate the implementation of Islamic financial contracts in line with these objectives. The study will propose improvements that could be made to the existing institutional structures and regulatory environment to remedy present challenges in the Islamic financial system.

Keywords: Institutional framework, Risk-sharing, Aligning, Maqasid al Shariah, Islamic banking & finance

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I. INTRODUCTION

The optimal functioning of an Islamic financial system requires the underlying economic and legal institutions as well as the financial structures to be designed in such a way as to reinforce and support the objectives of the system. Fundamentally, an Islamic financial system can be characterized as a rule-based system that prescribes rules concerning property rights, contracts, expected behaviour of transacting agents and social capital according to the teachings of Islam. Any effort to build a financial system that complies only with partial aspects of Islam can face difficulties in implementation and result in suboptimal performance (Askari, Iqbal and Mirakhor, 2009). Hence, for the effective functioning of the Islamic financial system, the underlying institutional structure should also be designed to enable and ensure conformity with Islamic objectives.

The overall aim of Shariah is to enhance the welfare and benefit (*maslahah*) of mankind and prevent harm (*mafsadah*). In Islam, contractual and commercial transactions are ‘encouraged and sanctified so long as they preserve, enhance and support property and progeny’ (Hallaq, 2004). Moreover, Muslims are encouraged to engage in any lawful and legal profitable transactions, investment, business and trade. With these ultimate goals, an Islamic financial system has an inherent social orientation and can be considered as a part of a larger Islamic economic system (Ahmed, 2011). Furthermore, the overall goal of this Islamic economic system is to realize the Maqasid al-Shariah in order to foster an economy that enables growth, stability and justice (Siddiqi, 2004).

There are numerous gaps in the development of a complete Islamic financial and economic system in Muslim countries that fully embody the Maqasid of Shariah. There is much room for further developments in Islamic financial infrastructure, economic and financial policies and the overall institutional framework to diverge from a highly debt-based system towards a greater risk-sharing model. The Maqasid cannot be limited only to products and contracts of Islamic financial institutions, but need to be inherent within the institutional framework that facilitates and supports Islamic financial products to ensure that the objectives of Islam are manifest in its outcomes.

The objective of this paper is to examine how the institutional environment can be further improved so that it is conducive to the implementation and proliferation of Islamic financial products based on risk-sharing principles. The study also examines how to align the development of institutional frameworks, regulatory and governance infrastructure with the Maqasid al Shariah. The research is exploratory in nature and uses content analysis and an inductive method to achieve the research objectives.

II. LITERATURE REVIEW

Maqasid al Shariah is defined by Al-Ghazali as the safeguarding of religion, life, intellect and mind, as well as dignity and wealth (Al-Ghazali, 1973). From Abu Zaharah’s point of view, Maqasid al Shariah can be explained as educating the individual, establishing justice and attainment of public interest (Mustafa and Ahmed, 2013). Within the domain of Islamic finance and banking, as stated by Omar and Shahwan (2013), Maqasid al Shariah can be considered as a pillar and base, while the operation of banks is the manifestation of the pillar.

Maqasid al-Shari‘ah has been categorized by scholars into three levels - daruriyyat (essentials), hajiyyat (complementary needs) and tahsiniyyat (the desirable). Daruriyyah refers to the interests of life which people essentially depend upon. It involves the preservation of faith and religion, life, posterity, property, and intellect or reason. These are considered as essential interests that are vital for human welfare. Its damage or collapse would lead to chaos and disorder of the functionality of society. Dusuki and Bouheraoua (2011) describe the second category as interests that supplement the essentials. Without these needs, people will face hardship, but it will not generate the total disruption of the order of life. The third level is defined as interests whose realization leads to enhancement of people in the society and improvement of their life.

By incorporating the objective of attaining the basic elements or needs of societal preservation into the Islamic financial system, it will serve to remove from Islamic society the social harms of excessive debt, leveraging, speculation and financial volatility created by the interest-based system. In order to embody these objectives in the operation of the banking and financial system, the institutional environment has to provide the basic foundation with the above goals in mind. In contrast to the objectives of conventional institutions, the objectives of an Islamic financial institution are not only to maximise wealth of individuals or banks. An Islamic financial system places an emphasis on public interest over the individual profit-making interests of investors, creditors or bankers. At the same time, it also fully preserves the rights and property of those individual parties, encourages profit-making activities and protects wealth through beneficial means that creates a balance within the economy and society. Hence, the agenda of Islamic finance takes into consideration the wider effects and consequences on society, such as stability of the economy, equitability of wealth distribution, social justice and upholding the rights of all concerned. However establishing these objectives in practice, requires the development of enabling structures and the development of more comprehensive legislation for Islamic banking and finance.

Ahmed (2011) noted two conditions in the Maqasid al Shariah for Islamic banking and finance. The first is the legal aspects of transactions, which fulfil the objectives of exchange and complying with the relevant legal maxims, not only in words and form but more importantly its object and meaning. The second condition, which is the social requirement, consists of social responsibilities. It focuses on the social orientation, the purpose and level of need of people. The social aims of the Islamic banking and finance in achieving interest-free transactions and ethical participation also goes hand-in-hand with the objectives of an Islamic economy. According to Omar and Shahwan (2013), the objectives of an Islamic economy are divided into philosophical and operational objectives. In order to achieve the philosophical objectives, it is essential to consider the value of *khilafa* (humans as His vicegerent), *Tauhid* (acknowledging the unity and sovereignty of Allah), *rububiyyah* (awareness of Allah), and *tazkiyyah* (purification of human soul). These objectives often summed up as *al-Falah*. The operational objectives are based on economic objectives (eliminating poverty and deprivation), social objectives (promoting brotherhood and unity), justice (equitable distribution), harm elimination (eliminating exploitation) and state participation (achieving al Falah in political survival) (Omar and Shahwan, 2013).

Keeping with these objectives, Islamic finance has a crucial role to play, especially in establishing justice. For instance, dignity, brotherhood and freedom can only be achieved by ensuring the alleviation of poverty, fulfilment of needs and equitable distribution of income and wealth. The role of the financial system in promoting development of the community and establishing justice could be achieved even within the role of financial intermediation whereby savings are mobilized to make them available to users in need of funds. In this instance, justice requires the sharing of risk by both financier and the entrepreneur as per the ‘no risk, no gain’ principle. As Chapra (n.d) points out, the application of this principle will not only achieve the objective of justice, but will also help inject discipline into the financial system, thereby promoting health and stability of the financial system.

Debt-based versus Equity-based structures

The Shariah also emphasizes risk-sharing as a salient characteristic of an Islamic financial system. The characteristic of risk-sharing is not only limited to equity-based contracts like Musharakah and Modarabah, but even within exchange contracts such as sales and leasing, where risk is shared by virtue of possession. However, the emphasis on use of profit-and-loss-sharing (PLS) modes is not manifest in the practice of Islamic banking, as they are not used as predominantly as debt-creating sales-based modes of financing. Sales-based or lease-based modes (such as Murabahah, Ijarah, Salam and Istisna) play a greater role in the current practice of Islamic banking for several reasons. One reason is that the institutional infrastructure necessary for the movement into PLS modes is not fully developed yet. Another reason is that Islamic banks may not wish to get exposed to risks they cannot manage effectively at this early stage of development. Sales-based modes are usually less risky compared to PLS modes because the rate of return in sales-based modes get fixed in advance and have comparatively lower risk. Furthermore, sales-based modes can provide a similar financing effect as interest-based transactions. However, sale and lease-based financing is quite different from pure lending and borrowing on interest because it is asset-based and require the financier to share in the risk to some extent. Many scholars feel that even though sales-based modes are different from interest-based financing and is permissible within Shariah, the socioeconomic benefits of the prohibition of interest may not be fully realized until there is a substantial rise in the share of PLS-modes in total financing (Chapra, 2007).

In contrast to the Islamic financial system, the conventional system is characterized by risk transfer and risk shifting in exchange contracts. From an Islamic perspective, this is against the Shariah principle that liability is inseparable from the right to profit (IIBI, 2012). The conventional institutional framework is built on the basis of interest-based transactions and its regulatory environment is designed to mediate the effects of risk transfer and risk shifting. In order to move away from risk transfer contracts and replace it with risk sharing, the setup of Islamic financial institutions must be designed very differently from conventional structures in such a way that it provides incentives that promote risk sharing.

Even though the Shariah recognizes the permissibility of debt, it does not encourage excessive debt because of the detrimental effects it has on society. Historically, it has been observed that prior to the rise of debt financing, equity financing was the more dominant form of financing. However, according to Askari et al (2011), a host of factors and developments has shifted favour towards debt-financing in the modern financial system. For example, government deposit insurance schemes, tax treatments, rules and regulations have all heavily favoured debt-based contracts over risk-sharing contracts. It has been observed that this ultimately results in promoting risk-transfer and under-utilizes the benefits of risk sharing. Consequently, risk sharing is still at an early stage of development and requires further developments, particularly in the institutional environment in order to be able to gain a greater share in total financing. All of these factors have given rise to a financial system that is presently dominated by instruments that create debt or liability. Therefore, it has perpetuated a system that economists have deemed to be detrimental to growth, development, equitable income and wealth distribution (Askari, Iqbal, Krichene and Mirakhor, 2011).

As mentioned earlier, one of the basic principles of Islamic finance is "no risk, no gain," which implies that anyone who wishes to gain a profit must bear a risk as well. Laldin and Smolo (2010) cite this as one of the main reasons why some Muslim scholars insist on promoting equity-based modes of financing such as Modaraba and Musharaka. In addition, Mohieldin et al (2011) also mentions that Islam requires mandatory risk-sharing with the poor, the deprived, and the handicapped based on its principles of property rights.

However, the emphasis on greater reliance on equity does not necessarily mean that debt financing is completely ruled out. This is because all financial needs of individuals, firms or governments cannot be made amenable to PLS. Thus, debt is indispensable for financing needs. Islam is a practical religion that has not entirely ruled out debt in its effort to bring about greater reliance on equity. Debt is created in the Islamic financial system through the sale or lease of real goods and services via sales-based and lease-based modes of financing. In this case, the rate of return is stipulated in advance and becomes a part of the deferred-payment price. The rate of return is fixed in advance and the debt is associated with real goods or services (Chapra, 2012). In fact, this form of financing is predominantly higher in the current operation of Islamic banks compared to the share of PLS modes.

It is believed that introducing more PLS instruments in the financial system can make both financial institutions and entrepreneurs (borrowers) more responsible, as they will assess the risks more carefully and efficiently. This can lead to stability and justice in the market, though the promotion of risk-sharing, justice, fairness and stability. However, it is important to note that from the Shariah perspective, both debt and equity modes of financing are permissible. Laldin and Smolo (2010) states that there is no indication showing that one mode is preferred over the other. At the same time, Kahf (2006) points out that since debt-based financing is solely based on credit-worthiness of the user of funds regardless of their purpose, a PLS model would create a better social-justice environment. A PLS model can help foster co-operation, unity, interdependence and brotherhood by involving everyone in both production and investment. It also does not burden low income groups, thereby promoting welfare. Due to these reasons, it can be suggested that risk sharing structures are much more compliant with the greater Maqasid of Shariah.

However, the use of debt or equity financing ultimately depends on the needs of the market to determine which mode is to be utilized. Having noted that, there are general principles in the Shariah which obliges the prevention of any potential harm. Laldin and Smolo (2010) state that if the over-usage of one mode might adversely affect the market or the society at large, certain control mechanisms must be put in place in order to prevent the harm. Moreover, it can also beneficial to achieve balance between the two, since each has its own role to play in the current financial system. Nonetheless, it is recommended that any shift in the current structure in order to balance the two modes, should be done gradually as a drastic change might affect the market and the industry adversely.

Institutional frameworks in Islam

There are differing views on the question of whether there needs to be an institutional framework or regulatory structures for Islamic finance, as well as about the nature of such an institution. For example El Sheikkh (2000), mentions that “the widely held view by Islamic jurists is that Islamic banks should not be regulated or supervised by any authority”. While acknowledging this view, Chapra and Khan (2000) provided various arguments for the need for regulation of Islamic financial institutions (IFI), for the purpose of serving the public good, protecting investors and the integrity of contracts.

Generally, most IFI’s have looked towards the conventional financial institutions as an established and proven example of an institutional framework, supporting and regulatory structures that are required for efficient functioning of a financial system. This is due to the perceived lack of an Islamic version of a viable modern framework or structure that can be utilized for Islamic financial institutions. To address this perceived issue, this study will examine some of the earlier examples of Islamic institutional structures that served commercial or financial purposes and examine their possible functions and application to suit the current needs of a contemporary financial system.

Financiers in early periods of Islam were known as *Sarrafs* (Arabic word meaning creditors, bankers, moneychangers, brokers) who undertook many of the traditional and basic functions of a conventional financial institution. This included functions such as intermediation between borrowers and lenders, operation of a secure and reliable domestic and cross-border payment system and offering services such as issuance of promissory notes and letters of credit. *Sarrafs* operated through organized networks and well-functioning markets, which established them as a sophisticated intermediary given the tools and technology of their time. There is also evidence that some of the concepts, contracts, practices and institutions developed in the Islamic legal sources of the late 8th century provided the basis for similar instruments used in Europe several centuries later (Iqbal and Mirakhor, 2011). From this, it can be understood that the operations and functions of '*Sarrafs*' are not only similar to some of the modern commercial banking functions, but they may also have provided the early foundations for the development of contemporary financial instruments used later in western banking systems. It also indicates that a more thorough examination of Islamic history can provide viable and Shariah-compliant tools and structures that can be applied within modern commercial financial institutions.

Another key Islamic institution that requires mentioning is the *Bayt al-Māl*, which in its original context is a treasury house where public funds were kept. One of the fundamental objectives of the *Bayt al-Māl* was attainment of socio-economic justice. Some of the sources of revenue of the Bayt al Mal were Zakat, Tax and Wakf (Trusts), among others. The application of a Bayt-al Mal system in the modern context can be practicable within the domain of public finance, to achieve the objectives of financial inclusion and re-distribution through the institutionalization of functions such as Sadaqat and Awqaf (in addition to zakat which is already performed by the State). The extension of *Qard al Hasan* (benevolent loans) to needy persons is also a possible additional function of the bayt al mal. This would enable the redistribution functions to be performed through an institutional structure that is separate from the Islamic commercial banking and investment institutions. The latter could then perform commercial banking functions related to mobilization of savings, profit and risk sharing activities.

An essential Islamic regulatory institution that also needs to be highlighted is Al-Hisbah, which is one of the earliest economic institutions of Islam. The precedent is set by the Prophet (pbuh) himself, who used to inspect the market and give instruction for just and fair dealings. Subsequently, his rightly guided caliphs followed the practice and performed this duty personally. In later periods when government affairs became more complex and multi-faceted, a special officer was appointed to perform the duty of *Muhtasib* (who was in-charge of al-Hisbah department). The literature related to al-Hisbah generally discusses socio-economic control, moral and market supervision, prevention of monopolies, check on cheating and fraud and other corrupt practices, standardization of products, facilitation of the supply of necessities etc. (Islahi, 2006).

In terms of the institutionalization of Hisbah, it is broadly organized around safeguarding the prescription and implementation of Allah's injunctions and preventing His prohibitions from being violated. This includes protecting the honour of the people, ensuring public safety, monitoring the marketplace and manufacturing concerns to make sure that the laws of Islam are upheld by these entities (Lahsasna, 2012). The Hisbah carries out these responsibilities in conjunction with the appropriate government agencies and other relevant establishments. Thus, with the proper implementation of the institution of al-Hisbah, many of the goals of Maqasid Al- Shariah can also be achieved.

In the present context of the Islamic financial services industry, the regulatory organs of the state refer to the statutory bodies enacted under the Ministry of Finance or equivalent, which vary among jurisdictions. It would also include the financial authorities such as the Central Banks, Monetary Authorities and Securities Commission. Additionally, it would comprise all other relevant institutions that are vested with the power to implement the legislation through the establishment of guidelines and requirements. Application of the Hisbah by the mentioned organizations would also entail the monitoring of statutory compliance through supervision, physical inspection and examination of documents, as well as enforcement and punitive measures for non-compliance. In addition to regulatory bodies, corporate governance organs such as the Auditors, Shariah boards, Shariah Audit committees and risk management committees can provide supervisory functions (Lahsana, 2012). Authorities such as the Shariah Advisory Council would play an important role in providing advice to other bodies of the regulatory system on implementation, monitoring, enforcement and corrective measures. However, it can only be effectively advocated and implemented if the Shariah Advisory Council is given free hand to provide verdict or fatwa on any contemporary issue. They must be legally and constitutionally empowered to control the central bank and not be controlled by the central bank.

Introducing a contemporary version of the institution of al-Hisbah in the Islamic financial services industry can provide an enabling structure to fulfil the commandment of Allah (s.w.t). The strategy to establish such a system requires a careful study of existing regulatory mechanisms and organs of governance. In addition, it requires financial industry literacy in terms of understanding and implementing the Shariah principles and rules at all levels of the organizational structure (Lahsasna, 2012).

III. FINDINGS AND DISCUSSION

On the whole, Islam offers a rich set of institutions and financial instruments, which if implemented in its true spirit has the potential to reduce inequality, achieve economic justice, while eliminating the harms of excessive debt and leveraging in the current financial system. However, to utilize the potential of Islamic institutions in achieving this goal, there has to be a focus on improving the regulatory and financial infrastructure to promote an enabling environment. This requires institutional and governing structures that internalize the objectives of Shariah into its overall purpose and goals.

Once the Maqasid al Shariah is internalized into the institutional framework, one of the key objectives of the Islamic financial system would be to achieve *al-Falah*, which requires that all activities of a financial institution are for the sake of Allah, to fulfil human needs, attain moral and material development and to circulate wealth in the system. To fulfil these requirements and to bring the financial system more in line with the Shariah, it is important to promote a wider application of equity-based and risk-sharing instruments in such a way that it benefits all of society.

However, this is difficult to implement in the current context for many reasons. One reason is that in designing the Islamic banking and financial institutions, owing to its infancy and lack of an existing workable model for Islamic finance, most institutional structures were based on a template of the conventional structure. As a result, the Islamic institutional framework is essentially a ‘Shariah-compliant’ version based on the conventional institutional framework. While this was the path of least resistance, since the conventional system is a well-established model that is familiar to both bankers and customers, it has also placed limitations on the potential of Islamic financial system.

It has also exposed Islamic banks to the disadvantages of the conventional institutions which should not theoretically exist in a purely Islamic system. For instance, instead of enabling the use of risk-sharing instruments, the system propagates wider use of instruments that are closer in function to debt-based instruments. Thus, it has resulted in a financial system that provides partial benefits, but does not fully take advantage of the benefits and advantages to society that would be provided by an Islamic financial system. Therefore, it is pertinent to develop an institutional infrastructure that is more representative of Islamic objectives and closely aligned with the Maqasid of Shariah, to reap the true benefits of an Islamic financial system.

In an Islamic financial system, there is an emphasis on sharing of resources, social justice and inclusion, to eliminate many of the harms associated with unequal wealth distribution, injustice in financial dealings and the practice of usury. For example, Islamic finance addresses the issues of social justice and financial inclusion, through risk-sharing contracts that provide an alternative to conventional debt-based financing and through specific instruments that enable redistribution of wealth among the society.

Notably, elimination of interest from the financial sector is one injunction that has been prescribed by Islam to remove harm from society and this has also been one of the main objectives for establishment of Islamic banking. The development and growth of Islamic banking and finance around the world has been fairly successful in serving this purpose and providing interest-free financial instruments. However, as argued by Tag el Din (2002), the elimination of interest alone, cannot perform the re-distributional function in Islam. As evidenced by the prevailing institution of Islamic banking and finance, the social benefits of Islamic finance are not fully evident by only eliminating interest ostensibly. The reduction in the percentage of debt and debt-financing is also necessary. Moreover, it is imperative that the institutional framework provide incentives that encourage and enhance financial inclusion. For example, incentives that encourage financial institutions to offer lower denomination instruments, will allow people from all income-levels to benefit from the financial system.

Finally, the rationale for regulating an Islamic financial system should constitute a regulatory framework that ensures not just legal compliance of contracts and prudential regulations that ensure stability, but which also incorporate additional regulations that ensure achievement of the greater objectives of Shariah. An ideal regulatory framework would be the establishment of a set of rules-based incentives, such that, compliance with the said rules ensures the preservation of social justice and order in society. This would entail the design of institutions and rules that encourage banks, managers or financial institutions to internalize the welfare of society. The different levels of Maqasid al Shariah mentioned previously, can also be used as a filter mechanism for regulation, policy making, as well as an ethical framework for the corporate governance structures of Islamic financial institutions.

Two parties that play an essential role in governance of Islamic financial institutions are the Board of Directors (BOD) and the Shariah Supervisory Board (SSB). It is important that all members of BOD and SSB understand and implement the Shariah in all their policies and strategies. The main objectives of these two parties should be consistent with the wider goals of the Shariah, in addition to the commercial objectives of Islamic finance. Often, BOD and SSB members have differing objectives, which are not always consistent with each other or with the objectives that have been discussed here. Therefore, one recommendation would be that these two institutions internalize the interests and objectives of both in order to complement and implement the Maqasid al Shariah.

IV. CONCLUSIONS AND RECOMMENDATIONS

It is important to develop a sound institutional framework closely guided by Shariah rules and regulations that promotes risk-sharing to a greater extent than at present. Islam creates a balance between the roles and functions of the public sector and the market, both of which are institutional in nature. Thus, returning to this institutional approach of Islam can enable the achievement of the Maqasid of Shariah, by allowing more effective utilization and implementation of the institutions of risk-sharing, profit-sharing, interest-elimination, Qard al-Hasan, Zakat, and Awqaf etc.

The institutional frameworks of *Bayt al Mal* and *Hisbah* can provide a framework for establishing Islamic institutional structures for banking and finance that serve a wider range of functions and objectives. For example, the institution of *Bayt al mal* can be applied within a modern framework to achieve the objectives of social justice, welfare and re-distribution. Such an institution can take over the redistributive functions of the Islamic financial system. At the same time, commercial banking and investment banking structures requires a shift towards greater reliance on profit-sharing and risk-sharing. To regulate the whole system, the institution of Al-Hisbah can be formally integrated into current objectives and contemporary needs of Islamic banking regulation. This will help to align the regulatory and governance objectives of Shariah with the goals, activities and outcomes of Islamic financial institutions.

On the whole, there has to be a paradigm shift in the approach and objectives of Islamic banking and finance, in terms of closer alignment of the industry's development with the Maqasid of Shariah. This may be achieved by developing more innovative financial structures and institutions that support the *Maqasidi* dimension and objectives of Islamic finance that would ultimately create wider benefits for society.

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