

Case for Standardization of *Fatāwá*, Products Approval and Shari‘ah Certification Processes in Islāmic Finance

“.....And if you disagree over anything, refer it to Allah and the Messenger, if you believe in Allah and the Last Day. That is the best [way] and best in result. (Qur‘an 4:59)

“ they strive in the cause of Allah and do not fear the blame of a critic. (Qur‘an 5:54)

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JEL Classification: G2, G39, K12, N20

Islām finance, often attributed to Uzair (1955¹) that focused on a mutual-fund style two-tiered partnership model, has developed on totally different models, the latest being the ‘*Financial Engineering*’ model that “provides Muslims with permissible analogues of conventional financial services and products that are generally deemed impermissible in Islāmic jurisprudence” (El Gamal, 2007²). Besides unwarranted use of ‘organized *tawarruq*’, Islāmic financial institutions (IFIs) are increasingly taking excessive risks (e.g. by investing in shorting-based hedge funds) to maximize their profits without actually investing even, using the tool of *muqāshah* (netting-off). Some of them also offer ‘*protected capital mutual funds*’ with payoff structures, generated by derivative securities, without themselves trading in those securities, by allowing an option-like payment to non-Islāmic partners or advisers as management or advisory fees.

Although Islāmic banking and finance has witnessed an amazing growth during last four decades; yet it is faced with a number of weaknesses and challenges, the most striking of which is declining integrity mainly on account of the loopholes in the Shari‘ah governance framework and the role of jurists and Shari‘ah committees. Many of its advocates who worked for evolution of Islāmic economics and finance in

¹ Uzair, M. *An Outline of Interestless Banking*. Karachi, 1955. Other earliest writings on the subject are of Baqir Al-Sadr (Al-Bank la-Rabawi fi al-Islām, Kuwait, 1969) and Sami Humud (*Tatwir al-A`mal al-Masrifiyya ...-Shari‘ah al-Islāmiyya*. Cairo, 1976).

² El-Gamal, *Incoherence of Contract-Based Islāmic Financial Jurisprudence in the Age of Financial Engineering*; May, 2007.

20th century have expressed their disappointment and frustration³. IFIs are often accused of merely replicating conventional financing facilities, by adding a number of intermediaries for the purpose of non-interdependence as *hilah*, with the Sharī‘ah compliance involving form rather than substance. Generally, the *ṣukūk* market is considered as the “Islāmic bond market” (David Bassens, et al. 2011). Even ‘artificial *ṣukūk*’ are created just to facilitate investment of liquidity (the issue was discussed in AAOIFI’s annual meeting, 2011). All these efforts aim at finding alternatives to debt structuring to compete with conventional institutions for profiteering. The more pinching reality is that the capital mobilized by IFIs for Sharī‘ah based businesses is diverted to the interest based conventional system by way of *tawarruq* both at national and global levels with approval, of course, of the respective Sharī‘ah boards or advisors. El-Gamal observes in this perspective:

“In addition to loans, many other contemporary financial transactions (e.g. forward and futures trading, options trading, etc.) have been banned by the majority of Islāmic jurists. Some of those jurists then proceeded to certify "Islāmic" alternatives that are synthesized from simple sales, leases, and other premodern contracts..... Derivatives were no exception..... A swap may now be easily synthesized with two forwards.... using the methods of financial engineering, we bundle or unbundle various contracts, possibly using multiple steps, to synthesize the ostensibly forbidden practice” (2007 May).

The most of the managerial level practitioners in Islāmic finance view it merely a business opportunity trying their hard to maximize the returns for the shareholders / employers to get, in turn, higher salaries and perks without due regard to the aspect of Sharī‘ah compliance. Conventional products are used as building blocks for the ‘Islāmic’ products for approval by the Sharī‘ah scholars who certify compliance on legal grounds without giving due weightage to the end result of the approved products. They have not been able to practically ensure distinction between “asset-backed” Islāmic financing on the one hand, and conventional finance based on “renting money”. While “*we need a finance sector that facilitates the channelling of funds to the productive sectors instead of*

³ The writings of M. N. Siddiqi, Monzer Kahf, Mahmoud Amin El-Gamal, Sheikh Saleh Kamel (speech at IBD, 1996), M. Fahim Khan, M. Akram Khan and many others over last decade highlight this harsh reality. El-Gamal says, “*However, growth in Islāmic finance over the past three decades has been led by rent-seeking Sharī‘ah arbitrageurs, whose efforts continue to be focused on synthesizing contemporary financial products and services from classical nominate contracts, without regard to corporate structure of financial institutions*”(Mutuality as an Antidote to Rent-Seeking Sharī‘ah-Arbitrage in Islāmic Finance, 2005); “*Limits and Dangers of Sharī‘ah Arbitrage*”, May, 2007.

attracting funds and other financial and human resources from the productive sectors to speculation" as contended by Monzer Kahf (2011).

Tawarruq was prohibited by the Islāmic *Fiqh* Academy in 2009. AAOIFI still allows it, but a number of studies made afterwards underlined that fulfilment of the conditions suggested by AAOIFI for valid *tawarruq* was simply impossible⁴. There is no moral argument supporting the proposition that *tawarruq* is better than a conventional overdraft; rather such practices result in damage to the reputation of the Islāmic finance industry and wider skepticism⁵.

In Pakistan, the State Bank of Pakistan (SBP) had been doing excellent to promote Islāmic banking with clear emphasis on Sharī'ah compliance. Even before prohibition of *tawarruq* by Islāmic *Fiqh* Academy in 2009, its use was minimal in Pakistan. SBP advised IBIs in 2008 to take prior approval for use of *tawarruq* [Annexure 1, IBD Circular 2 / 2008]. The situation has been changing for about a year and now the SBP is not only implicitly allowing *tawarruq* in the form of 'šukūk *murabaha*' by the IBIs but has recently facilitated the IBIs to do *bai' mu'ajjal* / out-right sale of (near to maturity) *ijārah šukūk*⁶ which serves as a means to generate return for IBIs from liquidity. It could effectually be a sale of debt with return, (as contract of *ijārah* comes to an end at maturity of *šukūk* while Islāmic bank continues earning for the period of *bai' mu'ajjal* that could be any period - if jurists allow for one year, why not for 10/20 years). While sale of *šukūk* before maturity is not tenable as all IBIs tend to hold them till maturity, money moped up by the SBP through purchase of near to maturity *šukūk* is injected in the market simultaneous through purchase of conventional securities from interest based banks. If that is the case, then what is the objective of 'Islāmic' banking? It may damage the credibility of Islāmic banking in Pakistan which so far was carrying better position by dint of better Sharī'ah governance standards implemented by the Central Bank.

At the level of multilateral institutions, IIFM that had issued about five years back ISDA/IIFM *Taḥawwut* Master Agreement for transacting 'Sharī'ah compliant derivatives' has quite recently published an innovate

⁴ Salman H (2010); Organised Tawarruq in Practice: A Sharī'ah Non-compliant and Unjustified Transaction; NewHorizon, October-December.

⁵ Wilson, Rodney; "The Determinants of Islāmic Financial Development and the Constraints on its Growth", IFSB 4th lecture on financial policy and stability, 2011.

⁶ SBP, DMMD Circular No. 17 Oct. 15, 2014; only the bidding formats have been given without any underlying basis; not issued by the Islāmic Banking Department even.

'Master Collateralized Murābahah Agreement' (MCMA) for 'better using Islāmic securities portfolio particularly *ṣukūk*', to help increase demand for *ṣukūk*, unlock hold-to-maturity *ṣukūk* portfolios and to provide an alternative to 'non-Shari'ah compliant repo'⁷. While the *Taḥawwut* (hedging) agreement has not been accepted by the mainstream Islāmic finance industry, the MCMA based on '*Rahn*' is practically a commodity *Murābahah* transaction and a stratagem to get returns on debt instruments.

Islāmic finance with its value based features can become the basis for financial discipline not only on regulatory interventions, as being done at global level, but also on the solid underlying foundations. A visible move by the IFIs towards the values based procedures and practices may be useful in attracting global cooperation needed for the purpose of developing finance for the service of human beings as a whole. The policy makers at States and institutional levels in all areas relating to money, banking and finance have to do something solid for benefit of the poorer and less powerful who have, at least, to be provided their 'generic rights' and 'basic goods'⁸.

Issues in *Fatāwá* and Products Certification

As no direct guidance is available on the innovative products of conventional finance in the original sources of the Shari'ah, the methods of *ijtihād* and *qiyās* are applied by the Shari'ah scholars/ jurists individually or as members of the Shari'ah boards to approve and certify the products. In case of boards / committees, this is generally done on 'majority' principle because any of the members might have different view. Hence, the banks are able to assure the customers that their practices are 'truly Islāmic'. However, the problem is that jurists / Shari'ah committees' members do not have sufficient time, and in many cases competence, to review thoroughly the process and their application by the banks. Even many of the resident Shari'ah advisors of the banks might not be in position to give full-time due to other responsibilities outside the bank. Conduct of Shari'ah review may require face-to-face meetings with the relevant officials in Product Development, Shari'ah, Treasury and Credit Departments within a bank; and with customers, brokers, accountants and auditors, outside the bank. Ensuring proper screening and monitoring of stocks of the investee companies is another important area.

⁷ <http://www.iifm.net/news-updates/iifm-publishes-0>
<http://www.elexica.com/en/legal-topics/banking/18-iifm-master-collateralised-murabaha-agreement>.

⁸ For detailed discussion on the rights and the needs, see Abdullah, Daud Vicary and Abbas Mirakhor, *Moral foundation of collective action against economic crime; masiroel*, June, 2013.

This requires ample time and, of course, expertise to examine the complicated structured products submitted by the practitioners for approval.

Other related issues include: i) the 'market demand' - IFIs tend to employ out of some renowned scholars to sit on their Sharī'ah committees; ii) fee depending on a deal going ahead and "the right price" - thus, the critics came up with the term "rent-a-sheikh"⁹ and iii) conflicts of interest like advisory firms owned by any of the members, student-teacher or senior-junior relation, membership in other IFIs, and difference of sect (*madhāhib*). In many cases, a contagion effect is witnessed whereby the banks' management require their jurists to approve the products 'similar' to the approved by the jurists of other boards or scholars accredited at global level. All this has led to what El-Gamal calls 'Sharī'ah *arbitrage*', the reengineering of conventional products and getting their approval by esteemed scholars, or as Hassan and Dicle (2007¹⁰) call it '*Fatwá shopping*' when IFS firms simply seek quick recognition for their products.

Impending Subversion of Islāmic Law of Contracts

The above trend leads to danger of approving and eventually codifying hiyal based products of the IFIs, which could create serious problems for future generations of jurists in maintaining the substance of Islāmic Law as we find in the classical jurisprudence. El-Gamal apprehends, "*Sharī'ah arbitrage-based Islāmic finance threatens to cause religious harm, by subverting Islāmic Law, as well as worldly harm, by exposing the industry to abuse and scandal* (2007). David Bassens *et al.* (2011¹¹) comment in this regard in the following words: "*Sharī'ah scholars who hold highly specialized Sharī'ah knowledge and skills, lend their services to IFS firms and so doing, boast high levels of authority, since they make and break the rules of Sharī'ah-compliance*".

Possible Implications for Islāmic Finance

Trust of the public and integrity should be the main area to be focused by Islāmic institutions, more than the conventional financial institutions. Even the West is considering seriously that restoration of trust in financial

⁹ Syed Asad, Dawn, Karachi <http://www.dawn.com/news/342476/issues-in-islamic-banking>

¹⁰ Hassan, M. K., Dicle, M. F., 2007. Basel II and corporate governance in Islāmic banks. In: Nazim Ali, S. (Ed.) Harvard Law School, Cambridge Massachusetts, pp. 31-50.

¹¹ David Bassens, B. Derudder and F. Witlox; Setting Sharī'ah standards: on the role, power and spatialities of interlocking Sharī'ah boards in Islāmic financial services (2011) GEOFORUM. 42(1). p. 94-103; <https://biblio.ugent.be/publication/1080332>

system can be achieved only by comprehensive and far-reaching reforms in the system. In one of such moves, directors of all banks in the Netherlands have been asked to swear an oath. Similar steps have been taken in some UK and USA based banks. For the Sharī‘ah advisors of the IFIs, however, the nature of the responsibility is much more than what is required in the so-called ‘*Hippocratic Oath*’ in medicine or political fields or recently designed ‘banker’s oath’.

Imperatives of *Fatāwá* in present day Finance

The unpleasant situation discussed above calls for serious measures by the regulators and the Sharī‘ah scholars themselves. The bottom line of the reforms should be that if interest is prohibited, as has been accepted by all jurists associated with IFIs, it must be evidenced in Sharī‘ah certifications and implementation thereof, that money is a bearer of risk in business activities conducted with money. IFIs have to add value through financing the real sector and expound that divine law and the contracts based on it can help the human beings better in establishing a just and coherent system by giving ‘generic rights’ and providing ‘basic goods’ to all members of human society¹². It implies the need for enhancing Sharī‘ah review capabilities and developing unified Sharī‘ah certification, product approval and *fatāwá* pronouncement processes. Such standardization also needs to consider issues like i) how often the contracts and processes are reviewed keeping in view the practices of the IFIs; and ii) how the inconsistencies between *fatāwá* and the actual practices are addressed?

Regulating the Sharī‘ah Scholarship and Supervision

One such effort for regulating the Sharī‘ah scholarship and supervision was said to be initiated by AAOIF which announced in 2011 that they would be setting new standards on the number of board memberships and regulate scholars' shareholdings in financial institutions and advisory services provided by companies and their conduct on banks' Sharī‘ah boards with the objective of removing conflicts of interest. There is a big question, however, whether AAOIFI alone can implement a serious code of conduct for renowned Sharī‘ah scholars, many of whom are at its own Sharī‘ah committee? For joint efforts, therefore, there has to be close coordination between *Fiqh* Council of the OIC, IRTI, AAOIFI, IFSB and CIBAFI and the research institutes like ISRA, Malaysia. There must be transparency and wider disclosure on underlying bases of the structured

¹² For detailed discussion on the rights and the needs, see Abdullah, Daud Vicary and Abbas Mirakhor, Moral foundation of collective action against economic crime; masiroel, June, 2013; <http://www.inceif.org/download/PaperonMoralFoundationofCollectiveActionAgainstEconomicCrime%28Final%29.pdf>.

products. We could not find any reference in traditional books of jurisprudence for majority based decisions. Rather, many references were found to prefer any view on the basis of strength of the argument for conformity with Qur'ān and Sunnah. Decisions on the basis of mere *ẓann* (conjecture) have no place in Islāmic jurisprudence¹³. Detailed explanatory note must be given on Sharī'ah basis in case a structured product is approved by the Sharī'ah committee on majority basis, in addition to the dissenting note(s) by any members. Such note has not only to explain the Sharī'ah compliance level of the approved product, but also prove that the majority decision is rational, allined with *maqāṣid al-Sharī'ah* directly or indirectly, and closest to the principles of Qur'ān and Sunnah.

It is vital to observe that such moves are not against the jurists or the Sharī'ah scholars. It is rather for their benefit; enhancing integrity of Islāmic finance would mean enhancing their own credibility that would be helpful in dispelling the terms like “*rent-a-sheikh*” or “*Fatwá shopping*”.

Training and Education of the Sharī'ah Advisors

Many Sharī'ah related problems arise because of lack of proper expertise in the jurists associated with banks. Apprehension is shown in many studies that the Shari'ah board members might not understand all aspects of the products relating to finance, accounting, auditing and implications for monetary policy (Wilson, 2011). According to a recent study by the SBP officials (KAP Study, Sic.), “It is imperative that Sharī'ah scholars are trained in Islāmic banking so that they would be able to offer concrete perspectives on issues related to the field”...“Majority of those who are doing Islāmic banking feel that it is the Sharī'ah board that makes a bank Islāmic”. Besides, the role of Sharī'ah scholars needs to be further enhanced and made more public in promoting Islāmic banking and finance. [Executive Summary and P. 64]

Maximum Clarity & Guidance Needed

Industry practitioners need detailed guidance and advice on the procedures and documentation of the structured products like *ṣukūk* or other liquidity management tools for bringing reforms to the approach and the system in vogue. Lack of such advice could be the main reason for failure in achieving *maqāṣid al-Sharī'ah*. In case any sort of ‘limited’ permission is given in main contractual arrangements or in their processes, as in case of *tawarruq*, or use of a series of *wa'ad* in derivatives structures; the

¹³ Qur'ān, 10: 36; Al-juvani, Al-Burhan, Vol 2, P, 176; Ghazāli, Al-Mustasfa 1 / 375, 1993

فَهَلْ يُجُوزُ أَنْ يَجْتَمَعَ عِلْمٌ وَظَنٌّ؟ فَلْنَا: لَا

practitioners exploit such permissions and do not take into consideration the limitations imposed, if any, by the Sharī'ah scholars. "If you tell us that the contract is permissible, that is all that we need to hear", the bankers' practice seems to suggest (El-Gamal, 2007). Hence, the Sharī'ah scholars, in their position as legatees of the holy Prophet (pbuh), need to be vigilant taking it an oath with Almighty. In case of any issue they have to invoke 'Qur'ān and Sunnah' as per the verse 4:59 and may not depend on what is reported or told to them as in the case of publishers or external auditors.¹⁴

In recent years, sorts of oaths have been introduced in the conventional finance to safeguard against crimes, as for example: "I hereby swear ... I will treat my clients at all times as I would wish to be treated. ... I will not, however, pursue these returns to the extent that my actions will knowingly harm others."¹⁵ However, in case of complicated financial products like swaps, it is rather impossible to expect that the banker / hedger will treat the counterparty in a way as 'would wish to be treated' as the basic deals tantamount to gambling giving profit to only one party. Hence, the reformists need to go further in redefining the bases for banking and non-banking financial intermediation and redesigning the products rendering finance as a facilitator for the real sector, instead of making it separate field having no link with the real sector.

Enhancing Sharī'ah Review Credibility

For the Sharī'ah scholars commissioned by the IFIs, knowledge of contemporary finance, engineered products and their impact on various categories of stakeholders and the economy is a pre-condition, in addition to firm knowledge of Islāmic jurisprudence. Sharī'ah scholars must be cautious about the delicate responsibility of approving or rejecting the new products. They may accept responsibility if and only if they have knowledge of all related aspects of the products, their processes and the role in achieving *maqāsid al-Sharī'ah*. Lack of knowledge or ignorance of any person in deciding is not an excuse accepted by the Sharī'ah.¹⁶ The

¹⁴ Hence, normally a note is added to the audit reports, for example, Taylor and Francis add the following note: The accuracy of the Content should not be relied upon and should be independently verified with primary sources of information. (John R. Boatright, *Swearing to be Virtuous: The Prospects of a Banker's Oath; Review of Social Economy*; Volume 71, Issue 2, 2013; http://www.tandfonline.com/doi/full/10.1080/00346764.2013.800305#_i12.

¹⁵ Thomas and Barnes 2010; c.f. John R. Boatright, 2013.

¹⁶ According to a *ḥadīth* reported by *Abū Dāwūd*, "...a man who commits mistake while judges the people and he is ignorant, will be in the Fire". Nasiruddin Albani termed this *ḥadīth* as *Ṣaḥīḥ* (*Abū Dāwūd, ḥadīth 3573, See in Maktāba Shāmilah*).

conditions of *iftā'* have been comprehensively discussed by a large number of jurists. Recently, a group of jurists and muftis working on the platform of *Al-Şuffah Trust for Education and Research*, Lahore prepared guidelines for Sharī'ah conforming business and also discussed the conditions for conducting *ijtihād* for achieving *ijmā'* (Sep. 2014; Vol. 1). What can be derived from their research and relevant writings of the jurists is that a *muftī* for the purpose of *ijtihād*:

- i) must be well-conversant with the principles of Qur'ān and Sunnah, the methods of deriving arguments from the sources of the Sharī'ah and the contemporary knowledge on the respective subjects;
- ii) must also be aware of the possible ruses that people may use for exploitation of the *fatwá* for unwarranted gains (5 / 359 شامى);
- iii) should consider thoroughly with utmost care, taking it a religious responsibility, not be in hurry for any reason whatsoever;
- iv) must consider the ultimate purpose of serving Islām as a *dīn* to please Almighty and not for worldly gains (اتباع الهوى¹);
- v) should avoid doubts (شبهات) in terms of his pronouncements;
- vi) should be impartial avoiding all conflicts of interests¹⁷
- vii) must take the *fatwá* back in case some contrary problem emerges afterwards or it transpires that the pronouncement is being misused for worldly gains. (*Baihaqī, Sunan al-Kubra*, 10/204)

According to Kuwait's banking law of 1968, if there is conflict of opinion between Sharī'ah board members, this should be referred to the *Fatwá* Board of the Ministry of *Awqāf* and Islāmīc Affairs, which is empowered to provide the definitive ruling. No such provision has been made in the most of the jurisdictions also including Pakistan where decisions by the Sharī'ah board of the State Bank of Pakistan, whether unanimous or majority based, are considered final. Same is the case with Sharī'ah board of the IBIs with the difference that IBIs Sharī'ah boards may like to refer any case to the SBP for decision by its Sharī'ah board.

A universal code needs to be agreed upon under the auspices of IRTI / IDB and AAOIFI to serve as the procedural foundation of collective judgments on products approval and Sharī'ah certification: The following could be the bases of *fatwá*/decision making:

- a) All judgments, fatawa and certification must have Sharī'ah based moral and rational foundations in addition to fulfilling the legal requirements.

The '*abath* (useless /vain) transactions that create no effect on goods and

¹⁷ نووى رحمه الله: قال الشيخ أبو عمرو ابن الصلاح وينبغي أن يكون كالراوي في أنه لا يؤثر فيه قرابة و عداوة وجر نفع ودفع ضرر لأن المفتي في حكم مخبر عن الشرع.

services available to human beings be excluded from the IFIs' kitty of products (Kahf, *Objectives -- prohibition of ribā*, 2006).

- b) The human and material resources have to be diverted from speculative / exploitative activities to the real economy to enhance and help wealth creation activities in real terms.
- c) Islāmic finance personnel have not to become part of the conventional financial hegemony and must stick to moral and rational principles for prevention of harm to the human beings. Only then, we can persuade the global community to work for universal values for application of the 'golden rule' and equitable fair dealing. Islamic finance practitioners should not become a part of the self-centered business model, which as argued by Zuboff, "*made it easier to operate in one's own narrow interests, without the usual feelings of empathy that alerts us to the pain of others and define us as humans.*" (cf, Abdullah and Mirakhor, 2013)
- d) Short selling, except with the conditions applicable to *salam* sale, must be kept in the prohibited activities of the IFIs.
- e) All contracts relating to commodities and stock must be intended for delivery and transfer of risk and reward.
- f) Some sort of General Assemblies (GA), Think Tanks or any similar forums, need to be constituted at national and global levels comprising representatives of all stakeholders, particularly the depositors whose money IFIs use on *mudārabah* principle, and the jurists / scholars who understand the basis and features of finance products in vogue. All products subject to difference of opinion in Sharī'ah committees or among public might be considered by the GA and approved or rejected.

To conclude, we would like to suggest that the Sharī'ah scholars may themselves ask the central banks / regulators at national levels, and AAOIFI or IRTI / IDB at global level, to take a step forward for approval / disapproval of the criticised products currently in practice in respective jurisdictions or anywhere in the world; to disseminate all such products with all details of processes for eliciting views from GAs as suggested above, or experts / academia and jurists not associated with IFIs and then finally pronounce about their valid use or discontinuation. Joint efforts of countries like Indonesia, Malaysia, Bangladesh, Pakistan, UAE, Qatar, Kuwait, Bahrain and Saudi Arabia could go a long way in standardizing the products and thus enhancing credibility of Islāmic banking and finance.