

Sharī'ah Legitimacy of Islamic Banking Practices in Pakistan - An Evaluation

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Abstract

Currently, the legitimacy of Islamic banking practices is restricted to the compliance of Islamic banks operations with the procedures and contractual requisites as approved by the Sharī'ah boards while ignoring the Islamic economic philosophy of promoting equity, fairness and distributive justice. Since the Islamic banking ought to follow ethical values drawn from tenets of Qur'ān and *Sunnah*, the overall goal of Islamic law to which the Islamic banks, too, are subservient, is to promote *maṣāleḥ* derived from *maqāṣid al-Sharī'ah*. Given this, the Islamic banks are obliged to extend welfare for the benefit of the society in addition to watching their business interests. In their juristic personality, Islamic banks are bound to undertake the welfare objectives on behalf of all those who provide them the financial resources. It, therefore, becomes worthwhile to evaluate the practices of Islamic banks in terms of their contribution to the society based on well-defined theoretical parameters. In order to extract such parameters, this paper attempts to develop a theoretical framework that provides holistic approach, including welfare pursuits, to help evaluating Sharī'ah legitimacy of Islamic banking practices in Pakistan. The framework is expected to be helpful outlining future outlook of Islamic banking in the country by enhancing legitimacy of their practices.

Keywords: Islamic banking, Sharī'ah legitimacy, *Maqāṣid al-Sharī'ah*, Welfare objectives, *ṣukūk*, Running *mushāraka*.

KAUJIE Classification: B4, L0, K1, N0

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1. Introduction

‘Legitimacy’ refers to the state of being legitimate (Merriam Webster). A normative concept of legitimacy sets out some objective criteria, like justice and prudence against which the legitimacy of an institution might be judged (Mayntz, 2010). Therefore, legitimacy of certain framework is established through its compliance with the legal prerequisites which, at the same time, must meet the normative standards for those for whose benefit the framework has been provided.

The Sharī‘ah legitimacy broadly means conformity to the Islamic Law that has been revealed in the best interest of the mankind. The legitimacy of Islamic banking refers to the compliance of operations and activities with the precepts of Sharī‘ah in terms of the pronouncements and their implementation, requisites of various contracts, as well as, fulfilment of the welfare objectives. Therefore, the Islamic banks, besides following business interests, ought to render value based services aimed at *maṣāleḥ*¹ determined for the mankind (Ahmed 2006; Laldin 2013; Dusuki and Nurdianawati, 2007; Ahmed, 2011; and Mohammed *et al.*, 2008; etc.). These distinguishing features establish identity of the Islamic banks and distinguish them from their conventional counterparts and require pursuing normative values of Islamic injunctions instead of mere profit maximization. The legitimacy of Islamic banking practices should, therefore, be perceived not only through compliance of the approved procedures but also taking into account the provisions of the *maqāṣid al-Sharī‘ah*, alongside (Rosly, 2010). Consequently, the Islamic vision requires that all economic and financial dealings should focus *maṣāleḥ ‘āmmah* by affording benefit and removing harm (*jalb al-maṣāleḥ* and *daf‘ al-mafasid*) in greater interest of the society. Therefore, there is need to evaluate the legitimacy of Islamic banking practices in line with the assertion of Usmani (1998) and Khan (1991) that equity and distributive justice should be the primary concern to evaluate the efficiency of Islamic banks and their role in establishing just economy in the contemporary world.

Accordingly, the primary focus of this paper rests with evaluating the practices of Islamic banks in Pakistan in terms of their value oriented contributions to the society in addition to the legal requirement of *Sharī‘ah* compliance. The paper attempts at framing future outlook of

¹ *Maṣlaḥah* (pl. *maṣāleḥ*) literally means benefit or interest (preserving public interest at large). The *Ijtihād* based on *maṣlaḥah* helps achieving benefit through fairness and justice and removing hardship that represents the core of *maqāṣid al-Sharī‘ah*.

Islamic banking by enhancing efficiency and impact in terms of some socio-economic services. Accordingly, the policy implications for Islamic banking industry have been drawn in line with Islamic values to help achieving legitimacy of Islamic banking practices in the aforementioned context.

The Islamic finance represents one of the fastest growing industries in the world. As indicated by the IFSB (2015), the double digit growth (17-18%) represents the Islamic financial assets of around USD 1.87 trillion. There is also rising interest about Islamic finance in non-Muslim countries like the UK, Luxembourg, South Africa, Hong Kong, etc. Especially, in post financial crisis period, the significance of Islamic finance has emerged owing to inherent stability mechanism linking financial sector with real economic activity. Islamic banks in Pakistan, too, have built 10.4% share in country's banking assets and 1.2% of the global market (SBP, 2015). The deposits and net financing and investments, respectively, have fetched the share of around 12% and 8%. The number of branches has grown to 1,597 operated by 22 Islamic banking institutions.

The literature suggests that public opinion provides important basis for legitimizing the actions of any organization (Berrone et al., 2009; Hough et al., 2013, for example). Various stakeholders understand that such actions could be approved only when they meet the criteria of appropriateness within a framework of social norms, values, and beliefs (Suchman, 1995). Therefore, the organizations / institutions are obliged to operate in line with expectations of the concerned stakeholders (Ozkan et al., 2014 and Rafay and Sadiq, 2015). In case of Islamic banks, these stakeholders include chiefly the customers, both on deposits and financing sides, for whose benefit the financial services are offered, the jurists (*'ulamā*), traditionally considered the source of legitimacy and guardians of Shari'ah (El Fadl, 2001), and employees of Islamic banks who become responsible to operate Islamic banking in terms of its logical foundations and interact directly with the users of financial services. Particularly, the Shari'ah knowledge of employees about the financial services and their logical foundations is considered crucial for the success of Islamic banks and legitimizing their operations (Buchari et al. 2014). We understand that the opinion of the stakeholders about validity of the financial practices carries significant value to help evaluating the legitimacy of the Islamic banking practices.

Keeping this background in view, this paper is meant to develop the criteria that are helpful to evaluate the legitimacy of current practices of

Islamic banks in Pakistan in two respects, whether i) the financial instruments meet the compliance of the relevant Islamic injunctions; and ii) the normative concerns of Islamic law are sufficiently observed beyond mere compliance with the prescribed standard operating procedures. More particularly, the research has focused the following objectives:

1. To build Sharī'ah legitimacy framework for Islamic banks to help conform their operations to the Islamic injunctions.
2. To suggest policy guidelines for Islamic banking industry enhancing their scale of legitimacy.

The rest of the paper is structured as follows. Section 2 presents the theoretical framework providing orientation about and evaluation of Islamic banking practices in light of the principles of Sharī'ah. This section is further divided into four sub-sections. While Sub-section 2.1 sets out the requisites for Sharī'ah legitimacy of Islamic banking practices, Sub-section 2.2 presents Islamic banking model. Sub-section 2.3 evaluates Islamic banking operation in the light of *maqāṣid al-Sharī'ah*. Finally, the operational issues have been discussed vide Sub-section 2.4. The conclusions have been drawn in Section 3.

2. Theoretical Framework

The main objective of this Section is to elaborate the concept of Islamic Law (Sharī'ah) as distinguished from the positive laws in terms of legitimacy, origin, comprehensiveness, and universality. The instruments of Islamic banks and their practices have been evaluated to assess their legitimacy in the light of Sharī'ah injunctions that have helped to formulate policy implications for the Islamic banking industry in Pakistan, in particular, and elsewhere in general.

2.1 Sharī'ah Legitimacy

2.1.1 The Positive *versus* Islamic Laws

The positive laws have been developed based on human philosophy and as a result of need based phenomenon that is subject to change due to internal and external factors and the manner by which any society might behave. Such laws which can be replaced, omitted or modified, cannot stand to the test of the time and, as such, are unable to demonstrate universality in their application and may transform, at times, into prejudiced governance owing to vested interests. Consequently, the belief is harmed and legitimacy questioned.

Since the Islamic Law revealed to the holy Prophet (PBUH) is divine in origin and is reckoned to be complete, comprehensive, and perfect in all

respects and for all times, it remains universal in nature and application. The sources, objectives, and procedures of Islamic law, interchangeably understood as Sharī'ah, become the prime when meaning of legitimacy is perceived. Allah (SWT) is the source of all laws as enjoined in Qur'ān that “*The ḥukm² belongs to Allah (SWT) alone*” [6:57]. This rule also provides direction for all interpretations and *ijtihād*³ (Nyazee, 2006). The jurists have classified the sources of Islamic law in two broad categories viz. (i) primary or material sources – Qur'ān and Sunnah and (ii) secondary or rational sources. As regards the first category, the Qur'ān is the Book revealed by Allah (SWT) to the Prophet Muhammad (PBUH) and, in turn, transmitted to us through *tawātur* (an authentic continuous narration without doubt)⁴. Its authenticity is definitive and contains *aḥkām* concerning both aspects of mankind i.e. *ibādah* (acts of worship and ritual) and *mu'āmalāt* (civil obligations: business and civil acts or dealings) (Nasir, 1990). The *Sunnah* literally means ‘well-trodden path’ and is to be followed repeatedly and is defined as what has been transmitted from the Prophet (PBUH) in the form of his words, actions and (tacit) approvals. *Sunnah* derives its authority from and is secondary and illustrative to Qur'ān.

The *aḥkām* derived from *Sunnah* are considered explanation of meanings in the Qur'ān⁵. The secondary sources, based on human reasoning but in conformity with the rules set by primary sources, are formulated through *ijmā'*⁶ (consensus of opinions) that presents agreement of *ahl al-ḥal w al-'aqd* (people qualified to organize *ijtihād*) in the matters not expressly mentioned through primary sources. The methodologies of deducting rules through secondary sources include *qiyās* (analogy), *istehsān* (juristic preference), *istiḥāb* (presumption of continuity), *maṣlahah mursalah* (extended analogy), *sadd al-dharī'ah* (blocking the lawful means to an unlawful end), *qawl al-Ṣaḥābī* (Copanion's opinion),

² *Ḥukm* pronounced as *ḥukm al-Sharī'* (pl. *aḥkām*) is a communication from Allah (SWT) related to the acts of the subject (man) revealed through a demand or option or through declaration. (Nyazee, 2006; p.47)

³ *Ijtihād* –Technically, the meaning of *ijtihād* refers to the effort made by the *mujtahid* (independent jurist) in seeking knowledge of the *aḥkām* of Sharī'ah through interpretation. *Ijtihād* is obligatory (*wājib*) for *mujtahid* (a person who possesses the necessary qualifications to conduct *ijtihād*) (Nyazee, 2006, p.265 and 269).

⁴ Ibid Nyazee, 2006, p.156

⁵ Ibid Nyazee, 2006, p.162 and 177

⁶ *Ijmā'* – The consensus of *Mujtahids* from the *Ummah* of Muhammad (PBUH), after His death in a determined period upon a rule of Islamic law (*ḥukm*) (Nyazee, 2006, p.183).

and *ʿurf* (custom) (See for details on the Sources of Sharīʿah, Nyazee, 2006; Pp 214-260).

2.1.2 *Maqāṣid al-Sharīʿah* and *Maṣāleḥ*

Maqāṣid al-Sharīʿah refer to the higher purposes of *Sharīʿah*. In the words of *Ibn al-Qayyim*, “the Islamic Law is structured and founded upon wise purposes and the best interests of God’s servants both in this world and the Next. The Law is pure justice, pure mercy, pure benefit, (and) pure wisdom. Hence anything which embodies injustice rather than justice, cruelty rather than mercy, harm rather than benefit, or folly rather than wisdom, does not originate from the Law, even if it happens to have been interpolated therein by means of interpretation” (Attia, 2007).

The theory of *maqāṣid* is supported by an inductive analysis of the Islamic Law. Philosophically, the term, *maqāṣid al-Sharīʿah*, embodies facilitation of benefit and repulsion of harm. The work of Al-Shatibi, in “*Al-Mawāfiqāt fī uṣūl al-Sharīʿah*” is reflective of inductive process stating that the Law has been established to serve human interests in both the life in this world and the hereafter (al-Raysuni, 2005). He divides the objectives, in order of priority, into three categories: (i) essentials (*al-darūriyāt*) representing the absolute desire of the Lawgiver to abide by the interests that include *ḥifẓ al-dīn* (preservation and protecting of religion), *ḥifẓ al-naḥs* (preservation and protecting of life), *ḥifẓ al-nasl* (preservation and protecting of progeny), *ḥifẓ al-ʿaql* (preservation and protecting of intellect), and *ḥifẓ al-māl* (preservation and protecting of wealth) and that without protection of these interests, there will be anarchy, misbalance, and chaos in the society; (ii) needs (*al-ḥājīyāt*) which support *darūriyāt* so as to enable the latter’s accomplishment to the highest standard and represent certain exemptions that bring relief to the hardship in the lives of the people, for example, relaxation in *ṣalat* while travelling and permission to undertake business transaction of *salam* in exception to the possession; and (iii) embellishments (*al-taḥsīniyāt*) which represent the interests of lesser importance than the other two but enhance the capacity for their fulfillment and include the acts like commendable habits and customs, observing etiquettes and a high moral standards. These interests provide additional decency and reward, for example, voluntary *ṣadaqah* and a number of moral rules and reinforce and protect *ḥājīyāt* (al-Raysuni, 2005: 108, 109). The *maqāṣid* pertaining to each of the category lower in priority complements and protects the *maqāṣid* of the category higher in priority, ultimately strengthening the *darūriyāt*.

The inductive examination of *ahkām* reveals that the rules prescribed by the *Sharī'ah* are based on inner reasons that ultimately benefit the society and individual (el-Mesawi, 2006). In the words of Ibn Ashur, “*all-purpose principle of the Sharī'ah is to achieve righteousness and goodness in the world and remove corruption from it*” (el-Mesawi, 2006)⁷. That is why, the *maṣāleḥ* based *ijtihād* has led to expand the scope of Islamic Law to extensively cover the normative obligations. In the same perspective, *maṣāleḥ mursalah*⁸ imply preservation of the objectives of the *Sharī'ah* and are deemed valid through juristic argument for a new universal good for the community. There is also consensus of the majority regarding *maṣāleḥ mursalah* and their applicability as valid evidence (Kharoufa, 2000). In view of their vast applicability, it becomes necessary for a jurist to keep in view the basic guidelines and principles for careful usage of *maṣāleḥ* (Lahsasna, 2013).

The Prophet (PBUH), considering need of the people, allowed practice of *salam*, *istiṣnā'*, *ijārah*, *muzāra'ah*, and *musāqah* to the exception of existence of saleable commodities (Kharoufa, 2000)⁹. Although these are the permissions granted by the Prophet (PBUH) himself out of *ḥikmah* (wisdom) conferred by the Lawgiver, but such exemptions tend to establish the significance and applicability of *isteḥsān* for the benefit of mankind. Auda (2007) refers to *ibn Ashur's* contributions in the philosophy of *maqāṣid* to uphold orderliness, equality, freedom, facilitation, and preservation of pure natural disposition (*fiṭrah*) and even includes freedom of thought, belief, and expression. These examples provide sufficient ground where the rules have been altered in changing circumstances to achieve ultimate ease, justice, and welfare for the people, in general. Therefore, it becomes essential to achieve what is beneficial, and to avoid what is harmful for the community under all circumstances, especially when facing unprecedented problems and pressing diversity. Several studies, such as Dusuki and Nurdianawati (2007), Yusof et al. (2009), Bedoui and Mansour (2013), and Austay and Harningtyas (2015) have discussed the significance of *maqāṣid* in achieving social values through operation of Islamic finance. Hence, the rationalization of *maqāṣid al-Sharī'ah* cannot be ruled out. As such, the question about validity and sustainability of Islamic banking arises and requires their review against the *Sharī'ah* precepts.

⁷ Ibid, El-Mesawi, 2006 p.94 and 126

⁸ The *maṣāleḥ* that the Divine Lawmaker did not specifically mentioned.

⁹ Ibid, Kharoufa, 2000 p.48

On the basis of *maṣāleḥ*, as discussed above, Islamic finance is principally believed to cultivate just economy by ensuring equity, fair distribution of resources, and providing equitable opportunities for all. While such values are opted by choice in conventional finance, these are essentially required in Islamic finance. The literature referred to as above supports the normative concerns which should be fulfilled by Islamic financial institutions in conformity with the standards of natural justice, good conscience and approved social custom. Therefore, a visible relationship between Islamic financial practices and the Islamic values should be established.

2.1.3 Sharī'ah Legitimacy of Islamic Banking Practices

Sharī'ah legitimacy refers to compliance of activities to the principles of Sharī'ah in letter and spirit. This compliance is pertinent to all areas, including the financial/business transactions (*mu'āmalāt*). Particularly, for Islamic banking practices, legitimacy refers to the conformity of the *fatāwá* (pronouncements) pertaining to the financial transactions to the Sharī'ah requisites and their application, in letter and spirit, to such practices and related procedures and processes, as well as, observing the moral virtues as enjoined by the Sharī'ah being the principle base of its philosophy. Accordingly, this holistic approach takes into account both the compliance with contractual mechanism and the normative concerns of the society.

2.2 Islamic Banking: Operational Framework

2.2.1 Sharī'ah Requisites for Islamic Financial Intermediation

In principle, both Islamic and conventional banks serve the purpose of financial intermediation; however, the means to achieve this objective are different (Hamoud, 1986). Primarily, the contracts entered to raise the resources and effecting investments in the two systems are based on different foundations and are materialized through different operational procedures.

Prohibition of *ribā* attains paramount importance as ordained in Qur'ān (2:275-276) and elaborated in various *aḥādīth*. The scholars have identified the religio-ethical implications of *ribā* based transactions. In its entirety, prohibition of *ribā* enforces the sense of brotherhood and cooperation among Muslims. Kahf (2013) excludes the transactions/contracts where form and substance are not aligned, sanctity of people's rights is not upheld, virtual assets (derivatives, options, indexes, etc.) have been created, valueless activities are performed, debt discounting is done, and rescheduling against increment is affected as all

such transactions turn either directly into or follow the indirect course leading to *ribā*. Certain *aḥādīth*¹⁰ extend the prohibition to the specific exchange of commodities when the rules are violated. Accordingly, all such transactions like trading of currencies through future contract, cheating with regard to prices or quality, transactions involving exploitation of buyer or seller should be prohibited (Chapra, 2007).

Financing in Islam is based on real assets and inventories as a result of production process and exchange / trading in the economy. Money is termed as sterile and produces no return, and remains the medium of exchange (Ghazanfar and Islahi, 1997; Ahmed and Hassan, 2006). The recent financial crisis evidences the absence of real assets on the back of credit default of swaps/derivatives traded in the market as the major bases for instability (Ayub, 2012; Chapra, 2009).

Because interest is prohibited, the providers of financial capital become investors who share business risks in return for the right of profit in the light of *ḥadīth* '*al-kharāj bi-damān*'¹¹ (entitlement of gain is linked with liability of loss). Therefore, the application of the principle of flexible rate of return and bearing the risk of loss is representative of fair treatment to the contracting parties. From *maqāṣid* point of view, too, the equity or risk based financing not only increases access of the poor to institutional finance but also the returns is shared between financier and the financed fairly.

The Islamic Financial Services Board (IFSB) also holds that the *Sharī'ah* compliance is not enough without responding to the ethical issues of poverty alleviation, financial inclusion, and responsible investments (IFSB, 2013)¹². IFSB expects that policy move should be embarked to link previously neglected market niches (particularly, socially excluded) by the commercially oriented financial institutions. Not only the initiative would increase the number of customers but also broaden the financial base.

2.2.2 Islamic Financial Instruments

In general, the Islamic financial contracts can be grouped into sale, lease and partnership categories. As against the credit lines being provided by

¹⁰ For example, "From Ubada ibn al-Samit: The Prophet (PBUH), said: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand" (*Muslim and Tirmidhi*).

¹¹ *Sunan Abu Dawud*, No. 3508

¹² Islamic Financial Services Industry Stability Report, 2013

conventional banks to meet short term working capital needs, the Islamic banks fulfill this requirement of the customers by using *murābahah*, *salam*, *istiṣnā'*, etc. The long term requirements are met through variety of semi-debt and equity instruments such as *ijārah* and purchase of equity or agency type business arrangement as in case of *muḍārabah*. Islamic banks also take benefit of *takāful*, the Islamic alternative to insurance, to cover the market and commodity risks by entering into the arrangement with *takāful* companies. Islamic banks have devised a number of other contracts, too, which fulfill the banking needs of the customers and include L/Cs, *salam* in currencies, *mushārahah* based running finance, currency exchange, sale and lease back, *ṣukūk murābahah*, etc. State Bank of Pakistan has also facilitated Islamic banks and their customers by devising certain products e.g. Islamic export refinance scheme based on *mushārahah* and Open Market Operation through *bai' al-mu'ajjal* (credit sale) of *ṣukūk*. The investments of Islamic banks are also directed towards *ṣukūk*, Islamic funds, Sharī'ah compliant stocks, various types of Islamic certificates/units, etc. In all, Islamic banks have developed a range of products to provide nearly all services to the retail and corporate customers which are currently being provided by the conventional banks.

The liabilities of Islamic banks turn in different way, too. Only current accounts, obtained through *qard*, constitute liabilities and do not share any reward while the saving and investment accounts, obtained through *muḍārabah* share the profits and bear losses, if any, in business results of the banks. Islamic banks, in their capacity as *muḍārib* (manager) of funds provided by the investment account holders (IAHs), are generally exposed to displaced commercial risk turning into withdrawal risk as Islamic banks operate in a conventional environment. Such risk is mitigated either by donating part of their own profit (earned as *muḍārib's* share) to the depositors through gift or maintaining profit equalization reserve (PER) for the purpose. The risk on account of loss of investment can also be mitigated by providing for the Investment Risk Reserve (IRR). However, some scholars, like Nienhaus (2007), view that such practices are eroding the Islamic distinctiveness and creating opaqueness in the image of Islamic banks. To look into this issue and to bring transparency and standardization in profit and loss distribution system and pool management for *muḍārabah* based deposits collected by Islamic banking

institutions, SBP issued necessary instructions vide IBD Circular No. 03 of November 19, 2012¹³.

2.3 Islamic Banking Operations versus *Maqāṣid al-Sharī'ah*

This section reviews the Islamic banking operations and their relevance to the *maqāṣid al-Sharī'ah* with a view to ascertain compliance with value judgements. As depicted from Table 1, the major part of resources (73.34% of total financing) had been invested in fixed return instruments, i.e. *murābahah*, *ijārah*, and Diminishing *mushārahah*. The volume of *murābahah* and *ijārah* increased by 12.30% and 46.71%, respectively, from 2006 to 2014, however their share in total financing has decreased by 10.23% and 21.50% respectively that has mainly been picked by Diminishing *Mushārahah* and *Running Mushārahah*, both of which are fixed return contracts as being used. An increase in the share of *salam* and *istiṣnā'* has appeared due to increased demand of the corporate sector for these products. *Mushārahah* has increased from all the time low (about 0.5%) to 9.37% due to new instrument of 'Running *Mushārahah*' developed for the corporate sector clients. However, practically running *mushārahah* by the banks in Pakistan has turned into fixed rate financing as will be discussed in Section 2.3.1. The *muḍārahah* covered only 0.16% of total financing. However, the share of *qard al-ḥasan* has been reduced to zero, reflecting indifferent attitude of banks towards social conduct for the weaker segments of the society.

A sectoral analysis of financing reveals that the share of corporate sector (77%) in total financing by Islamic banks in 2014 was higher as compared to this sector's share of banking industry in Pakistan being 66.4%. The share of agriculture sector remained only at 0.3% as against industry's share of 5.7% (SBP, 2013). On the other hand, the deposits of the scheduled banks (including Islamic banks) were substantially contributed by the small accounts constituting 92% of the total number of deposits, that is, up to Rs. 300,000 (including 45% accounts keeping up to Rs. 50,000), represented 33% of the total deposit base. However, the financing up to this amount (Rs. 300,000) constituted only 5.39% of the total financing (SBP, 2013)¹⁴. The contrast can only be translated into net resource transfer from lower and middle classes to the affluent. Although

¹³ A framework is to be devised by each Islamic bank for creation of different pools based on specific objectives, investment plan, and risk characteristics, as well as, assigning weightages to different types of deposits, determining profit sharing ratio, and any planned movement of assets among various pools; See Ayub and Hameed; 2013.

¹⁴ SBP, Financial Supplement of Annual Report 2013.

the data pertain to all scheduled banks, Islamic banks cannot be made exception as their share of corporate sector in total financing is even higher than the industry's trend.

Table 1: Modes of Financing and Respective Share in Total Financing

Financing through	Year 2006		Year 2014	
	Amount (Mn. Rs.)	Share in total financing (%)	Amount (Mn. Rs.)	Share in total financing (%)
<i>Murābahah</i>	26.51	40.00	100.90	29.77
<i>Ijārah</i>	19.63	30.00	28.80	8.50
<i>Mushārahah</i>	0.53	1.00	33.00	9.73
<i>Mudārahah</i>	0.00	0.00	0.50	0.16
Diminishing <i>Mushārahah</i>	10.60	16.00	118.90	35.08
<i>Salam</i>	0.46	1.00	15.00	4.43
<i>Istiṣnā'</i>	0.90	1.00	22.40	6.60
<i>Qard al-ḥasan</i>	0.01	0.00	0.00	0.00
Others	7.10	11.00	19.40	5.74
Total	65.74	100.00	338.90	100.00

Source: SBP Islamic Banking Bulletins-February 2007 and June 2014.

Unfortunately, the Islamic banks have not found ways and means to invest their funds in avenues like small and micro enterprises which currently are grossly neglected and, despite being the most productive in terms of efficiency and repayment; have not been perceived as business case by them. The statistics presented by SBP (Quarterly Compendium: Statistics of the Banking System – December 2014, Offsite Supervision and Enforcement Department) exhibit greater cash and balances to total assets (8.28%) than the banking industry (7.21%) due to lower financing to deposit ratio (38.2%) as compared to that of the industry (48.2%). This situation provides strong reason to invest in small and micro enterprises in the presence of huge amount invested in commodity *murābahah* by the Islamic banks, that too to the benefit of conventional banks and through a controversial transaction (*commodity / ṣukūk murābahah*).

The aforementioned stylized facts imply that Islamic banks are not putting in sufficient effort towards equitable distribution of resources. Not only the share of *qard al-ḥasan* has been reduced to zero, but also, most of the resources have been invested in fixed return modes for benefit of the corporate sector. In the same context, the SBP Governor in his speech delivered to industry executives on 29th January 2015 advised Islamic banks to promote equity instead of debt financing by adhering to the profit and loss sharing principle of Islamic finance. He also pointed out that

Islamic banks were not rewarding their depositors with due share out of the rising profits which doubled only in a period of one year i.e. from 3rd quarter 2013 to 3rd quarter 2014 (Dawn, 2015)¹⁵.

The position, as aforementioned, endorses Chapra (2007)'s assertion that Islamic banks have not been inclined to realize justice as commanded by *maqāṣid al-Sharī'ah*. Thus, the true vision of Islamic finance focusing removal of distress of the disadvantaged by circulating wealth more equitably does not seem to be realized.

2.3.1 Operational Issues of Islamic Banks

This section describes the operations of Islamic banks and their compliance with Sharī'ah in two respects viz. whether the form of the contracts is aligned with the substance and the banking practices are adept to the *maqāṣid* to help assessing their legitimacy through the holistic approach as explained earlier in Section 2.1.2. A number of products involve Sharī'ah issues in their operation. Examples include running *mushārakah*, commodity *murābaḥa*¹⁶, and liquidity management product of SBP i.e. *bai' al-mu'ajjal* of Government of Pakistan *ijārah ṣukūk* effected through open market operation (OMO). The 'running *mushārakah*' has virtually become a fixed return wholesale product where huge 'Limit' is approved as in case of conventional overdraft (OD) and the bank and client agree on the profit sharing ratio and the bank's desired profit rate (KIBOR i.e. Karachi Interbank Offer Rate used as benchmark for corporate lending). However, the amount realized over and above the desired profit is returned under prior agreement to the client rendering the transaction a fixed rate debt contract. *Majlis al-'Ulamā* of South Africa, Port Elizabeth, pronounced in this regard in December 2013 the following *fatwā*:

"Running *Mushārakah*" is a weird 'partnership' scheme conjectured ... to promote the interests of the capitalist banks. It is a scheme which has no relationship with any kind of valid *Shirkah* modes. The account-holders who are deceptively proclaimed the 'partners' in business ventures are paid pure, unadulterated interest (*ribā*) in the guise of 'profit'. Interest is imagined to be profit, and with this imaginary 'profit'

¹⁵ Dawn, 29th January 2015. <http://www.dawn.com/news/1160211>

¹⁶ Commodity *murābaḥa* is excess liquidity management technique of Islamic banks where a *murābaḥa* transaction is entered with a conventional bank and a commodity is purchased, through broker, and sold to the conventional against a price to be paid at a later date. The conventional bank sells the commodity in market and fulfils its liquidity requirement. In fact, the commodity neither is needed by the conventional bank nor are the necessary conditions of *bai'* fulfilled.

theory the depositors are duped into believing that the gains they are receiving are *ḥalāl* profit when in reality it is nothing but interest¹⁷.

The commodity *murābaḥah* tantamount to advancing liquid resources by the selling bank and realizing with increment at a later date and hence allows Islamic banks to legitimate the illegitimate transaction where the outcome is based on nothing but *ribā* (Mansoori, 2012). The Guidance Note of IFSB (2010)¹⁸ also restricts trading any standardized commodity with intention to provide and/or obtain funds and generally does not involve physical delivery; hence has become a speculative tool for banks and the interested customers. Similarly, the OMO of GoP *ijārah ṣukūk* has helped selling these *ṣukūk* (nearing maturity) held by the Islamic banks to SBP through credit sale (*bai' al-mu'ajjal*) by adding T-bills related rate as one year's cash flow, even beyond the date of maturity. The transaction is neither valid in letter nor spirit (JIBM Discussion Forum, 2015) as the profit is earned on receivable after the date of maturity. These transactions turn against the spirit of the Sharī'ah Maxim '*al-umūro b maqāṣidhā*' (basis of all acts is objective thereof), derived from *ḥadith* of Holy Prophet (PBUH) "*Verily, the acts are judged by intentions*" and 'effect is given to the objectives and meanings and not to the words and phrases' (Mansoori, 2012).

In case of sale and lease back in *ijārah ṣukūk*, the seller of asset requires the buyer to allow repurchasing the same underlying asset at original price at a later date. The transaction neither meets the requirements of sale (possession remains with originator) nor *ijārah* (for example, all major / minor maintenance charges are borne by the lessor). Such transaction is similar to *bai' al-wafā'* and International *Fiqh* Academy has declared it as invalid (Mansoori, 2011). Similarly, the guaranteeing of the capital in all types of *ṣukūk* to the *ṣukūk* holders as a requirement from rating agencies, giving loan by the manager when profits are lower than expected, etc. have also been termed as invalid (Usmani, 2008). All such transactions defeat the purpose of law circumventing Sharī'ah prohibitions on *ribā*. *Al-Suwailem* (2015) has also raised certain Sharī'ah issues in *ijārah* based *ṣukūk* and stated that the investors do not legally own the asset and that is why such *ṣukūk* are

¹⁷ "Invalidity of Running *mushārahah* Scheme" A booklet downloadable from: http://themajlis.co.za/books/INVALIDITY%20OF%20THE%20RUNNING%20MUSHARAKAH%20SCHEME_Ebook.pdf

¹⁸ IFSB. 2010. "Guidance Note in connection with the Risk Management and Capital Adequacy Standards: Commodity *murābaḥah* Transactions." http://www.ifsb.org/standard/eng_GN- Guidance Note on Commodity Murabahah.pdf

turned from 'asset backed' to 'asset based'. It is, in fact, the Special Purpose Vehicle (SPV) that is involved to whom the asset is sold with a promise to lease back. Such process in *shukūk* can be considered hardly different from conventional bonds. Moreover, the underlying asset is not transferred from balance sheet of the originator/seller because of the undertaking to buy back against pre-agreed nominal value that is not allowed in accordance with the rules of *shirkah* or Islamic sale. The asset appearing on the balance sheet of the originator that has been formally sold out is nothing but illogical. He also states that in many cases the underlying asset is non-productive and unrelated to the economic activity and construe only as debt creation. He quotes further Sharī'ah ruling of Islamic *Fiqh* Academy (resolution No. 188 of 20th conference in 2012) and Sharī'ah board of AAOIFI (Para 3/2 of Sharī'ah standard No. 9) where sale and lease back is prohibited owing to *'īnah*.

The weightage system used to help distribute profits to the deposit account holders is also turning to benefit the affluent customers more than the middle and low income segments. The weights are set to represent the amount in addition to the term of deposit. Certain Islamic banks¹⁹ also offer priority banking to the current, saving, and fixed deposits where the account holders keeping the balance equivalent to or exceeding certain amount, for example, Rs. 3.00 million, are rewarded with higher cash withdrawal limit through debit card, special discounts and privileges at selected retail outlets, restaurants, international CIP lounges, hotels, etc. Such practice of committing extra benefit, especially, to the current account holders, is discriminative at the cost of small depositors whose money has been invested to earn profit wherefrom the shareholders and the priority customers are benefitted. Two *ahādīth*; *Ibn Majah-2423* and *Bukhari-3530* reported by IIIE (1999) restrict, respectively, the lender to accept any gift or a ride and a sickle, barley or grass from the borrower. The Para 4 and 5 of Sharī'ah Standard No. 19 regarding *qard* (loan) also does not allow the lender to take any benefit or tangible property from the borrower (AAOIFI, 2010).

We can, therefore, understand that not only the lapse of any standard operating procedure of the Islamic banking practices, breach of trust and failure of internal processes lead to Sharī'ah non-compliance and fiduciary risks, as prescribed by IFSB (2005), but also the structure of certain instruments and related practices, intentions behind certain transactions, and the impermissible material and immaterial outcome lead to the

¹⁹ Websites of Islamic banks refer.

<http://www.meezanbank.com/premiumbanking.aspx> and <http://www.insignia.deeandzee.net/faqs.html>

conflict with the said holistic concept of legitimacy of Islamic banking practices. There is strong need on part of the Sharī‘ah and legal experts and banks’ managements to review such practices and come out with legitimate solutions, free from such violations.

3. Conclusion

The discourse on relevant literature suggests that the Sharī‘ah legitimacy of Islamic banking practices should be understood in a holistic perspective rather than mere adherence to the compliance requirements applicable to the products’ structures, process flows, and contracts/documentation of the related transactions. Not only the *fatāwá* for permission of any products and their procedures must be based on the accepted principles of the Sharī‘ah, but also their impact and implications must lead to achieve the socio-economic objectives as enjoined by the Islamic injunctions. A number of normative concerns prescribed by Sharī‘ah should be considered integral part of the Sharī‘ah legitimacy framework. The application of the Islamic law has to be rationalized through *maqāṣid al-Sharī‘ah* and reflected through intent of the Lawgiver focused on welfare of the subjects. This foundation leads to the theory of *maṣlahah* whereby the benefit is realized and the harm is prevented. That is why, the Islamic banks should be pre-occupied with wellbeing of the society by instilling socially responsible behavior and altruism as against self-centered conventional finance.

The statistics related to banks operating in Pakistan support that the banking industry (including Islamic banks) has become the means of net resource transfer from lower and middle groups to the affluent. Islamic banks seem least interested in equitable distribution of wealth. Neither, these banks have shown any inclination towards poverty alleviation nor any examples of support to the microenterprises could be found. Moreover, a number of issues arise regarding operation of certain Islamic banking practices that do not serve any tangible purpose while benefitting the parties through prohibited gains, hence raise question about their legitimacy.

The conclusions suggest that Sharī‘ah legitimacy for Islamic banks requires Islamic banks yielding to *maqāṣid al-Sharī‘ah*, taking care of value judgements and meeting the goals of distributive justice. The regulators may consider requiring Islamic banks to fulfill their obligation towards normative concerns of the society instead of leaving the same to their choice.

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