Current Practice of Islamic Finance: A Trade-off between Maqasid al-Shari'ah Orientation and Profit Maximization

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Many Islamic economist have asserted that Islamic banking and finance is a subset of the overall Islamic economic system that strives for a just, fair and balanced society as envisioned and deeply inscribed in *Maqasid al-Shari'ah* (objectives of the *Shari'ah*). *Maqasid al-Shari'ah* provides the philosophical foundations for the overall direction of Islamic finance, the guidelines for its operations and its very raison in contemporary times. Recognition of this reality is driving the increasing interest in applying the *Maqasid* to the development of Islamic finance. It is generally acknowledged now that meeting legal requirements through comprehensive and systematic technical procedures is not sufficient. This paper attempts to highlight the main reasons that lead Islamic financial institutions far away from Maqasid al-Shari'ah Orientation.

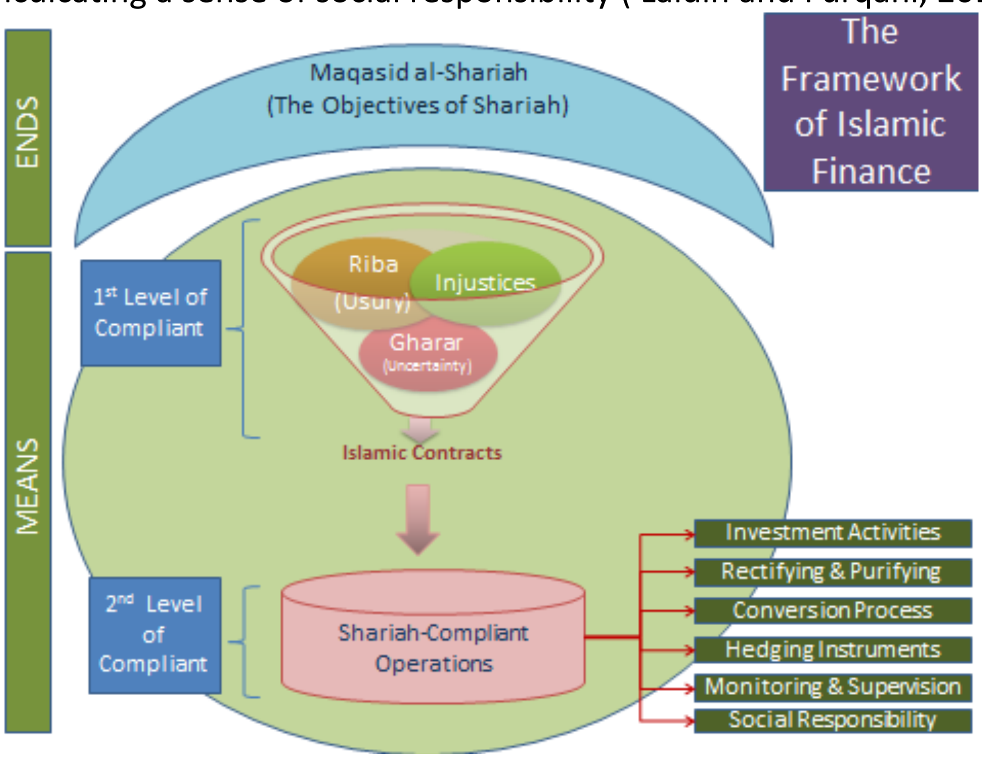
Introduction

A comprehensive examination of the Islamic rulings entails an understanding that Shari`ah aims at ensuring human`s well-being (*Falah*) by acquiring public interests (*Maslahah*) in all aspects and segments of human life and preventing harm (*Mafsadah*). *Maqasid al-Shari'ah* takes into consideration the various dimensions of human needs i.e. protection of religion (*din*), life (*nafs*), lineage (*nasl*), intellect (*'aql*) and property (*mal*). Their fulfilment will create balanced satisfaction in human life at the micro-level of individuals and the macro-level of societies. In addition, the discipline of *Maqasid al-Shari'ah* permits flexibility and creativity in the application of detailed Islamic law (Chapra,2008).

With regard to Islamic finance in particular, *Maqasid al-Shari'ah* refer to the overall goals and objectives that *Shari'ah* aims to achieve from its principles and rulings related to financial activities and transactions. These objectives provide a grand framework and direction for how financial transactions should be arranged in an Islamic economic system.

The *Maqasid al-Shari'ah* in Fianancial transactions and business activities originates from the concept of wealth protection (*hifzu al-mal*). For instance, the main objective of finance is basically how to allocate resources from surplus sectors (capital providers) to deficit sectors (capital users) so that wealth is smoothly circulated and human welfare is realized. As finance deals with wealth allocation and appropriation (from mobilization until utilization), the *Maqasid* in *hifz al-mal* should therefore be understood by looking at the nature, function and role of wealth in relation to the primary objective of realizing human wellbeing, individually and collectively (Dusuki and Abozaid, 2007).

The *Maqasid* in Islamic banking and finance (IFB) would include smooth circulation of wealth, fair and transparent financial practices, and justice and equity at both the micro- and macro-levels. In order to realize those objectives, the means instituted by the *Shari'ah* include facilitating financial contracts, establishing values and standards as well as inculcating a sense of social responsibility (Laldin and Furqani, 2013) .



Over the last three decades, IBF has been achieving the main and upmost (macro) *Maqasid-al Shari`ah* i.e. public interest and the prohibition of *riba*. However, the micro *Maqasid-alShari`ah* such as equity based financing, profit and loss Sharing contracts financial inclusion and other benefits that are related to macro-economics of the country is yet to be achieved. IFs are not really successful to achieve those objectives due to the following reasons:

1. Validity VS Permissibility

One of the most important issues in IBF business is to develop products and services that are *Shari'ah*-compliant and genuine from Islamic viewpoint without reducing the importance of the business features of being competitive, profitable and viable in the long run. However, there are several issues that should be addressed and one of the most pressing is what should be the foundation in justifying whether a product is *Shari'ah* -compliant or not? What are the genuine methods in Islamic law when resolving whether a contract is legal and allowed from *Shari'ah* perspectives? In other words, the importance should be given to the form or substance?

Muslim jurists have diverged opinions on the concern of establishing the base of contract legality. Some stress on its permissibility and legal structure while others emphasize on its substance and the intention of contracting parties. According to *Hadhis* "matters are determined by intention", Based on this *Hadhis*, validity of all contracts must be determined by *niyyah* (intention), i.e. the purpose or substance of the contract, not by just looking at its form or structure alone. However, some scholars like *al-Imam al-Shafi* found it impractical to determine the validity of contracts by means of intention, as it is difficult and sometimes impossible to identify the intention of the contracting parties. Moreover, they found some Shari'ah texts suggesting that judging things must be based on their form and appearance (Ahmad, 2000).

To reconcile between these two conflicting texts in a practical way, scholars distinguished between two types of *Hukam* (ruling): *Hukam Qadhan*, and *Hukam Diyanatan*. The former is concerned with contracts that comply with merely *Shari'ah* conditions and legal requirements pertaining to a contract in its form and structure, while the latter is concerned with compliance of the substance or contract purpose which must be in line with the *Shari'ah*. In other words, if a contract is fulfilling all legal requirements, it could be termed as a valid contract. On the other hand, beside the validity, if the purpose of the contract, i.e. the substance, is Shari'ah compliant, then it is termed as permissible. Consequently, a valid contract does not constitute necessarily to be permissible(Dusuki and Abozaid, 2007).

It is important to note that jurists only differ in terms of determining the validity of a contract. Majority of scholars agreed that if the substance and objective of a contract is against the *Shari'ah*, it would be deemed as impermissible even though the contract is valid. Such as selling of grapes to a winery, or selling arms to the enemy (whose intentions is to attack the Muslims).

From the above discussion it can be concluded that merely fulfilling the legal requirement of a contract does not guarantee achieving the noble objectives of *Shariha*. Scholars generally agree that for an Islamic financial product to be deemed as *Shari'ah* compliant, the contract must be both valid and permissible. In the case of

Islamic finance, some contemporary practices have maintained the legality of the form but neglected the legality of the substance. While the fact is that the objective of form is to support ensuring the compliance of the substance not for itself. For instance, many financial products are based on a controversial contract i.e. *Bayl Inah* (buy back), such as Islamic credit card, Islamic private debt securities (IPDS) and Islamic overdraft facility. In all these applications, if an Islamic bank is using *Bayl Inah* as a legal device (*Hilah*) to circumvent *Riba*-based financing, the contract will be considered non *Shari'ah* compliance despite being valid. This is because the legal form is not sufficient to certify and justify the permissibility of a contract. Therefore, to claim permissibility by merely referring to the legal form of the transaction is definitely undermining *ijma* (consensus of jurists) and goes against the very principles of *Shari'ah.*

2. Profit maximization

Undoubtedly the ultimate goal of finance is profit maximization. Islamic finance as its counterpart emerged as a key player in the competitive and comprehensive market striving for the same objective of economic development and profit maximization. Tempting marketing slogans such as 'Can't afford to go on holiday to Europe? We are glad to offer you a *tawarruq* facility no security needed' or 'Why wait for tomorrow when you can live the life of your dreams today with our *tawarruq* facility?' have been employed by Islamic banks to promote their credit card business. In some instances, the banks have even promised to approve the facility within 60 minutes, failing which the customer receives a discount on the facility (Kasari and Muhammad, 2013).

According to Rafe Haneef (CEO of HSBC Amanah, Malaysia), the *tawarruq* facility is a highly profitable business where customers often end up paying an effective profit rate based on APR of 12% to 28%! Hence, it is natural for banks to actively promote this type of financing that reaps such huge profit margins. Likewise, this has resulted in marketing strategies in which only the lower flat rates are highlighted to entice customers, as opposed to educating them about the eventual high APR of this facility.

Another product of Islamic banks that bears marks of questionable ethics is the Islamic hire-purchase *(ijarah muntahiya bittamlik*) facility. One of the requirements for a genuinely *Shari'ah*-compliant agreement is that parties must mutually agree to the terms of the agreement. However in practice, almost all agreements related to the Islamic banking retail business are drafted and prepared by banks, with highly limited room for customers to negotiate terms that are more favourable to them. For instance, one of its terms stipulates that the customer bears the cost of Islamic insurance (*takaful*) for the vehicle. However in Islam, the burden to maintain the vehicle should be on the lessor, which is in this case the Islamic bank not the customer.

By imposing this burden on the customer, the profit enjoyed by the Islamic bank is no longer *Shari'ah* compliant as it is incurred without having to bear the corresponding lessor risk.

Profit maximization is not against *Maqasid Al Shari'ah.* Islam precisely exhorts Muslims to engage in the material pursuit of trade and profit accumulation as these are considered to be Allah s.w.t. bounty. However, Islam does regulate the manner in which profit should be acquired. Profit gained must be free of elements of *riba* (usury), *gharar fahish* (excessive uncertainty), *ghabn fahish* (over-pricing) and should not be derived from *ihtikar* (hoarding) activity. In essence, profit must be acquired or gained in an ethical manner.

The International Council of the OIC Fiqh Academy issued a resolution (No. 46.8/5) stating that (i) there is no specific maximum profit margin. The profit margin is determined by the market trend and commercial norms. However, the ethics of the *Shari'ah*, such as leniency, contentment, generosity and facilitation, must be taken into consideration (ii) the transactions must be free from all elements of fraud, trickery, falsification of the actual price (iii) the political authority is not allowed to interfere by imposing price controls, except when a manifest imbalance is discovered in the market, as a result of artificial factors. In that case, the political authority should interfere through just means capable of eliminating those factors and the causes of the imbalance.

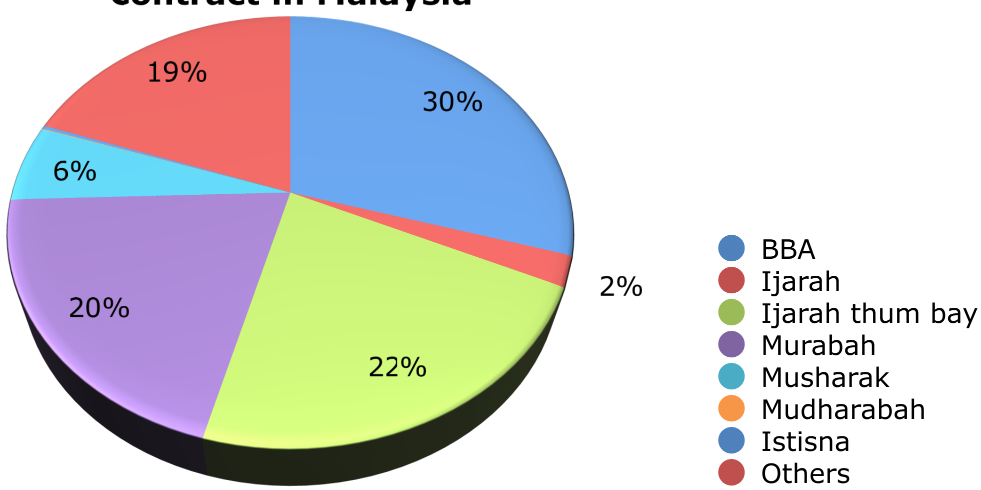
Profitability of Islamic banks should not be based solely on financial returns but also on economic and social returns. Essentially, this proposition embodies the very spirit of Islamic economics, whereby a bank's performance must not only be measured by the profits it generates but must also take into consideration the impact of its profitable business on the environment and society as a whole.Unlike conventional finance, Islamic finance is supposed to consider maximisation of the holistic good of society, rather than profit maximization. Logically speaking, profit maximisation can be ploughed back for the development of Islamic finance, but it would be more prudent to make Shari'ah compliance as the purpose of Islamic finance. Without it, Islamic finance will lose its core customer base.

3. Debt based financing VS Equity based financing

The principle of profit and loss sharing element under equity-based financing represents the true spirit of Islamic banking practice toward achieving *Maqasid Shari'ah*. Despite the strong tendency in the literature to emphasise the theoretical superiority of Islamic banking based on PLS over conventional banking, the practices of Islamic banks are found to diverge in significant ways from the intellectual doctrines underpinning their role in the economy. Almost all Islamic banks across the globe today resort to the second line fixed return techniques or debt-based instruments. Observers point out that the use of PLS instruments, namely *Mudharaba* and *Musharaka* financing have declined to almost negligible proportions. According to Malaysian Islamic Finance Report 2015, *Musharakah* and *Mudharabah* are only representing 6% of total financing in Malaysian Islamic financial Institutions. The Islamic banks are presently concentrating more on the debt-based financing, particularly *Murabahah*, *Ijarah* and *Istisna* contracts (Farooq, 2007).

Several reasons could be contributing to the hesitation of the Islamic banks to adopt the equity based financing in the current context of banking. First, it is argued that the credit risk of the equity based financing is relatively higher than that of the debt-based financing. Second, issues also arise in the monitoring and supervising aspects, in which *Musharakah* in particular requires more commitment and effort from the banks compared to other forms of financing as the bank assumes business as well as credit risks. Third, the issue of collateral renders equity-based financing as having greater risks compared to debt-based financing. Lastly, the existing legal frame work in many countries is not supportive in terms of equity based financing (Kassim, 2015).

Islamic Financing by types of Contract in Malaysia



Source: Malaysian Islamic Finance Report 2015

4. Extensive use of the principle of Necessity (*Dharorah*)

There is a tendency in some Islamic banks to conveniently use *Dharoah* as an excuse to legalise certain activities such as bay *Inah* and *tawarruq*-based transactions. Based on this controversial contract, they provide credit card and holidays financing. Finance is designed to serve its purpose: facilitating trade and production, while in a mode of financing that is based on "*Inah*" and "*Tawarruq*" trade is facilitating finance(Al-Suwailem,2009).

Dharorah which means necessity unanimously renders the prohibited things permissible as this constitutes a well-established *fiqh* maxim “Necessities permit the forbidden”. However, when jurists discussed and explained the applications of this *fiqh* maxim they mentioned conditions and guidelines for the functionality of this maxim. The jurists’ approach to the concept of *Dhurorah* can be summarized by saying that *Dhurorah* is something which is indispensable for the preservation and protection of the five essential values: Faith, Life, Intellect, Posterity and Wealth. In other words the principle of *Dhurorah* will facilitate to come out of difficult situation by providing legal excuse to commit the forbidden; provided it is indispensable for his survival, spiritually and physically. Legalizing a forbidden thing on the grounds of *Dhurorah* is supposed to solve a problem, not to create a bigger one (Dusuki and Abozaid, 2007).
Islamic banks have been in the business for more than three decades, and so far they still offer the same excuses of *Dhurorah* and the impracticality or impossibility of adopting lawful business contracts, due to the existence of certain obstacles and deterrents. Do these obstacles and hindrances still exist after more than three decades of Islamic banking? Are there any indications to suggest a possible change?

Conclusion

The next stage in the development of Islamic finance must comprise a *Shari’ah* compliant proposition that is more genuine (reflecting *Shari’ah* principles), solid (having a true *Shari’ah* basis) and comprehensive (encompassing the objectives of the *Shari’ah*). In structuring Islamic financial products, the ‘mechanical approach’ of paying attention to the structure and form rather than the substance and spirit of Islamic law and its objectives (Maqasid al-Shari’ah) should be re-examined. *Hiyal* (legal tricks) and *Dhurorah* cannot be a justification for any product where there is no dire need. The current practice of Islamic financial engineering will not only divorce morality from technicality, but also annihilate the very spirit of the Islamic ethos. The creation of pseudo-Islamic instruments that are consistently questioned on their Islamicity will defeat the objective of developing real Islamic finance.
Fulfilling minimal Shari’ah legal compliance in product structuring is viewed as insufficient. Indeed, if the Islamic Banking industry aspires to be a viable alternative form of banking, then it should adopt *Maqasid al-Shari’ah* as the indispensable framework for structuring Islamic financial contracts and as the directional guideline for further development of the industry.

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