AAOIFI

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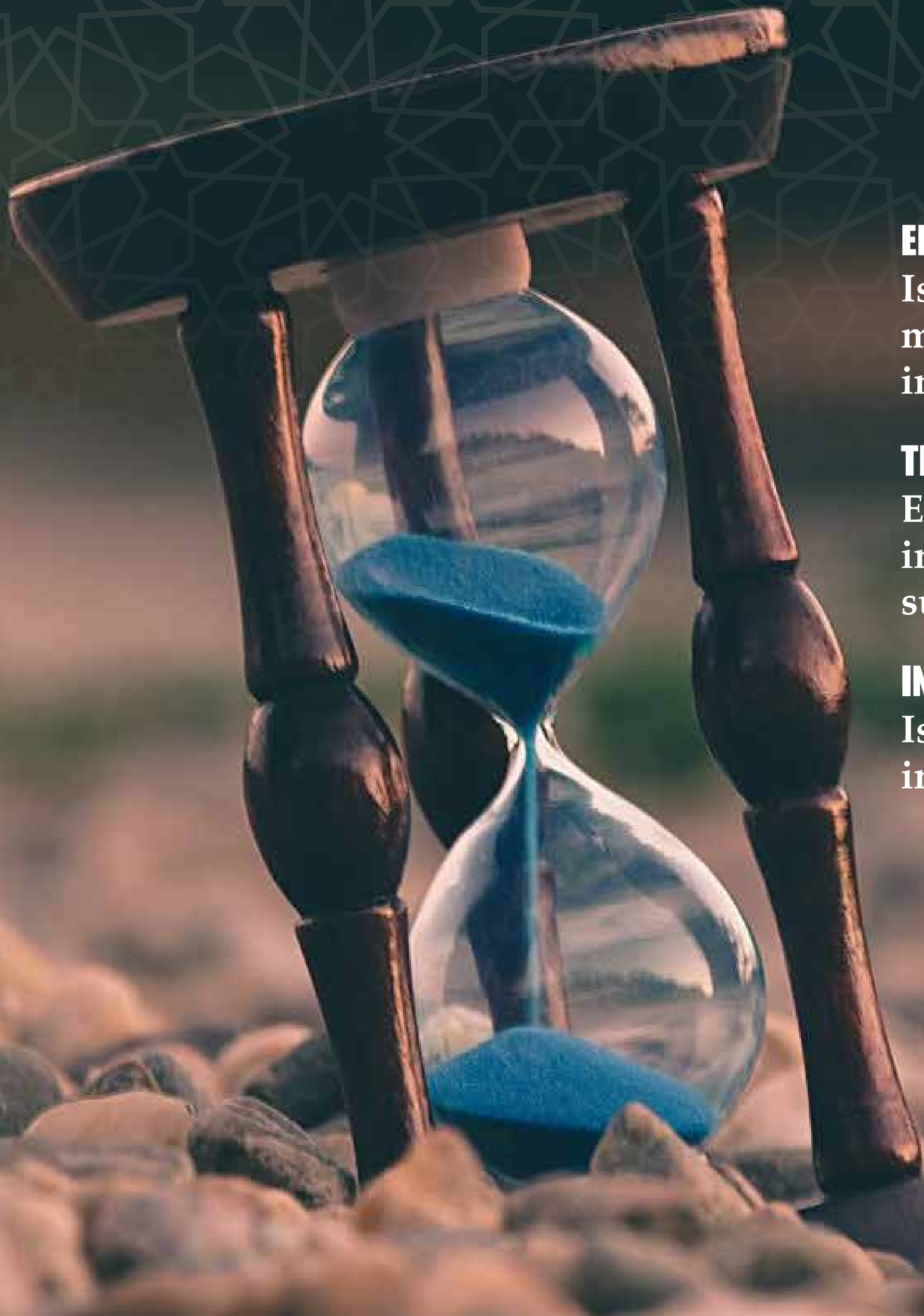
PEER-REVIEWED

Concept of materiality for financial reporting in Islamic financial institutions: An Islamic perspective



EDITORIAL

Islamic financial institutions must now move to value-based intermediation system

TECHNICAL ARTICLE

Ethics / Values and Shari'ah in the perspective of form and substance debate

INDUSTRY UPDATE

Islamic finance development in 2019: Shifting dynamics

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MESSAGE

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TECHNICAL ARTICLE

INDUSTRY UPDATE

AAOIFI´s Technical Bulletin

JOIFA is interested in publishing original theoretical or empirical research papers in English, reports from conferences and symposiums, developments in the field of Islamic accounting and related areas including auditing, Shariah auditing, governance, tax, corporate laws, ethics etc., (collectively mentioned as accountancy) and book reviews, as well as, documents and archives related to Islamic finance accountancy.

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بسم الله الرحمن الرحيم

MESSAGE OF
THE SECRETARY GENERAL, AAOIFI

Mr. Omar Mustafa Ansari
Secretary General, AAOIFI

It gives me great pleasure to welcome you to this issue of JOIFA.

A new wave of fintech cycle that began approximately a decade ago is all set to make a huge change with startups maturing into bank-like institutions, and also conversely banks mastering fintech. While technology is Shari'ah-neutral, Islamic banking industry must lead technology to play a greater role in its development. On its part, AAOIFI has highlighted the role and challenges that this industry poses and discussed in the last AAOIFI-World Bank conference, and will continue to do so in future, including in the upcoming AAOIFI Shari'ah conference looking at it from a Shariah perspective. We have also initiated developing a governance standard on crowdfunding, a sub-set of fintech. Certainly, it will be interesting to see how Islamic finance industry stakeholders leverage the role of technology in shaping its future. Islamic financial institutions must realize that in order to counter the current economic situation and changing business environment, a robust and well-rounded Shari'ah compliance aided by technology would be a prerequisite.

We are also pleased to note that in October 2019, Banque Centrale de Tunisie (central bank of Tunisia) issued a circular stating that its banks and financial institutions would be required to comply with international standards adopted in Islamic banking, in particular the standards issued by AAOIFI in respect of Islamic banking contacts and operations. AAOIFI is humbled at this development as it continues to increase its footprint with mandatory adoption of its standards, either fully or partially, by more than 34 Regulatory and Supervisory Authorities (RSAs) in over 22 countries around the globe. This is in addition to more than 17 RSAs that use AAOIFI standards as guidance, or develop their local standards / regulations based on AAOIFI standards.

Fostering research and providing a platform for the Islamic finance stakeholders, both from academia and the industry to publish good quality research papers based on empirical or scholarly research work has been the aim of JOIFA.

Many authors and researchers approached us on indexing details of JOIFA. Given the infancy stage that JOIFA is presently in, it is being planned that it will initially be listed in open source databases before aiming to get indexed in reputed academic databases. Notwithstanding, JOIFA will continue to lay emphasis on methodological rigor and healthy academic debate to ensure that the conclusions reached from the publications contained in JOIFA are valid, reliable and benefit the overall development of the global Islamic finance industry, both in short and long terms.

Peer review remains a vital component of our assessment of the submitted papers and articles. There have been criticisms of this process, including delaying publication, overly industry-biased approach or rejecting the papers that are too generic and / or those not directly falling under AAOIFI's mandate or JOIFA's scope. It is, however, strongly believed that finally accepted papers are improved by peer reviews which remain focused on developing the industry for the good of it, and that criticisms are dealt with respect and due professionalism. This endeavor may face challenges due to multiple factors, including the evolving nature of the products and perception about the industry, Shari'ah interpretations, regulatory provisions, wisdom / reasoning behind approving or disapproving a product / concept, etc. This appraisal process also helps to promote trust of the reader and instill confidence about JOIFA as an unbiased journal promoting research and development in Islamic finance.

We would like to thank all our submitting authors who have toiled in the production of their work and have chosen JOIFA as the journal to publish their papers, and also the stakeholders who have contributed to the success of this issue. We look forward to your further support for the cause of Islamic banking and finance through this initiative.

Lastly, we are pleased to see that AAOIFI's technical boards - Shari'ah Board, Accounting Board, and Governance and Ethics Board are shortly completing their respective four-year terms. AAOIFI sincerely appreciates and acknowledges their unstinted efforts in contributing their knowledge and expertise for the cause of AAOIFI, and in developing (and revising) standards that are needed for the industry to support its future growth.

AAOIFI technical boards update

Completion of AAOIFI Technical Boards' terms

AAOIFI technical boards - Shari'ah Board, Accounting Board, and Governance and Ethics Board has in November 2019 completed their respective four-year terms. Consequently, nominations were invited for the boards' next terms from the industry, including AAOIFI institutional members, central banks, regulatory and supervisory authorities, Islamic financial institutions, accounting, auditing legal and advisory firms, higher learning institutions, as well as other stakeholders that have interest in Islamic finance.

The nominations were submitted to AAOIFI Nomination Committee, which sent its recommendations to AAOIFI Board of Trustees for its final approval. AAOIFI technical board members are tasked to carry out development and revision of AAOIFI standards and presents an opportunity to contribute directly towards development of Shari'ah, accounting and governance standards for Islamic finance industry that can support its future growth.

AAOIFI Technical Boards' performance summary (Sep 2015 – Dec 2019)

#	Description	Shari'ah Board	Accounting Board	Governance and Ethics Board	Total
1	Number of Board meetings	18	16	13	49
2	Working group / Shari'ah Board committee meetings	124	96	85	305
3	Final standards issued	6	7	7	20
4	Exposure drafts issued (including FS)	9	5	0	14
5	Exposure drafts in final stages (approved not issued yet)	0	2	0	2
6	Standards in progress	6	8	3	17
7	Public hearings of exposure drafts	7	27	34	68

Shari'ah Board

Standards issued

1. SS 55: Competitions and Prizes
2. SS 56: Liability (Dhaman) of Investment Manager
3. SS 57: Gold and its Trading Controls
4. SS 58: Repurchase
5. SS 59: Sale of Debt
6. SS 60: Waqf

Exposure drafts issued

1. Real Estate Usufruct Right
2. Debit and Credit Card
3. Conversion of conventional bank to an Islamic bank
4. Sukuk
5. Ijara Mawsufa fi al Dhima
6. Fees and Commissions
7. Build Operate Transfer Contract (BOT)
8. Ijarah and Ijarah Muntahia Bittamleek
9. Special Purpose Vehicle (SPV)

Standards in progress

1. Khayrat account
2. Contracting and FIDIC contracts
3. Purifying mixed shares from non-permissible profits
4. Agricultural participations and their contemporary applications
5. Financial custody
6. Ownership risk in financing

Key initiatives

1. Shari'ah terminology book
2. Conference research compilation
3. Revision of the Shari'ah standards - Basis of Conclusions (BOC)
4. Translation of standards

AAOIFI Accounting Board (AAB)

Standards issued

1. FAS 28: Murabaha and Other Deferred Payment Sales
2. FAS 30: Impairment, Credit Losses and Onerous Commitments
3. FAS 31: Investment Agency (Al-Wakala Bi Al-Istithmar)
4. FAS 32: Ijarah
5. FAS 33: Investments in Sukuk, Shares and Similar Instruments
6. FAS 34: Financial Reporting for Sukuk-holders
7. FAS 35: Risk Reserves

Standards in final stages of issuance (approved but not yet issued)

1. FAS 29: Sukuk Issuances / Sukuk in the Books of the Issuer

Exposure drafts issued

1. Wa'ad, Khiyar and Tahawwut
2. First time adoption of AAOIFI Financial Accounting Standards
3. General Presentation and Disclosures in the Financial Statements of Islamic Banks and Financial Institutions (Revised 2020)
4. AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions (Revised 2020)
5. Financial reporting by Waqf institutions

Exposure drafts in final stages of issuance

1. Tawarruq and Commodity Murabaha
2. Revision of FAS on Zakah

Standards / Technical releases in progress

1. Illustratives of Waqf accounting
2. Illustratives of FAS 1 illustrative
3. Revision of FAS on Takaful

AAOIFI Governance and Ethics Board (AGEB)

Standards issued

1. ASIFI 6: External Shari'ah Audit
2. GSIFI 8: Central Shari'ah Board
3. GSIFI 9: Shari'ah Compliance Function
4. GSIFI 10: Shari'ah Compliance and Fiduciary Rating for Institutions
5. GSIFI 11: Internal Shari'ah Audit
6. GSIFI 12: Sukuk Governance
7. Code of ethics for Islamic finance professionals

Standards in final stages of issuance

1. Waqf Governance

Standards in progress

1. Islamic Crowdfunding
2. Shari'ah Decision Making
3. Shari'ah Compliance and Fiduciary Rating for Instruments.
4. Joint standard development with IFSB on Revised Guiding Principles on Shari'ah Governance Framework for Institutions Offering Islamic Financial Services

Other events / engagements

1	Sukuk workshop – Malaysia, Bahrain, Saudi Arabia
2	Ijarah roundtable – Bahrain
3	Standards revision roundtable – Bahrain
4	Board members meetings with governors / industry – Jordan, Lebanon, Pakistan, Oman
5	Internal Shari'ah audit workshop – Pakistan
6	Accounting workshop - Turkey
7	Event with IFSB - Bahrain
8	Directors' sensitization programme - Bahrain
9	AAOIFI Shari'ah standards refresher workshop - Bahrain
10	AAOIFI Accounting standards refresher workshop - Bahrain
11	AAOIFI Accounting standards sensitization session at TKBB - Turkey

AAOIFI conferences

17th AAOIFI Shari'ah Conference

The 17th Annual Shari'ah Boards Conference, was held on 7 and 8 of April 2019 in the Kingdom of Bahrain under the auspices of the Central Bank of Bahrain. The event featured participation of a distinguished group of speakers, consisting of 33 experts from around 16 countries. The conference involved two-panel sessions as well as presentations of a number of research papers across seven sessions over a span of two days. This included sessions on: Importance of regulatory requirement of mandatory adoption of Shari'ah standards by Islamic Financial Institutions (IFIs); Regulatory imposition of obligatory reduction of the amount of debt due to prepayment; Validation of defective contracts and its impact on stability of transactions and its modern applications; Panel session on coordination amongst central Shari'ah boards; Sukuk listing in global financial markets and compatibility of listing requirements with Shari'ah structures; Methods to safeguard against risks associated with ownership in Ijarah Muntahia Bittamleek financing mode. AAOIFI's annual Shari'ah Boards conference is a key event across the global Islamic finance industry that tackles Shari'ah issues and topics in the area of Islamic finance, both in theory and practice.

14th AAOIFI – World Bank Conference

The 14th Annual AAOIFI – World Bank conference was held on 7-8 November 2019 and was attended by more than 800 people from not less than 30 countries. The conference was organized under the patronage of the Central Bank of Bahrain in cooperation with the World Bank and was supported by Islamic Development Bank Group (IsDB), central banks, other commercial banks and financial institutions.

The conference was attended by the guest of honours H.E. Dr. Bandar Hajjar, President – Islamic Development Bank (IsDB), H.E. Shaikh Khaled Bin Ali Bin Abdulla Al Khalifa, Minister of Justice, Islamic affairs and Awqaf, Kingdom of Bahrain, H.E. Shaikh Ahmed Bin Mohammed Al Khalifa, President, National Audit Office, Kingdom of Bahrain, H.E. Shaikh Mohammed Bin Khalifa Bin Ahmed Al Khalifa, Minister of Oil, Kingdom of Bahrain, H.E. Mr. Aymen bin Tawfeeq Al Moayed, Minister of Youth and Sport, Kingdom of Bahrain, H.E. Mr. Mohammed Abdullah Al Kuwaiz, Chairman of Capital Markets Authority, Saudi Arabia, H.E Mr. Rasheed Mohammed Al Maraj, Governor, Central Bank of Bahrain and the Chairman of AAOIFI Board of Trustees H.E. Shaikh Ebrahim Bin Khalifa Al Khalifa together with many other dignitaries and guests from around the world.

To strengthen collaboration with AAOIFI, IsDB has confirmed their support to AAOIFI's invitation to rebrand this conference and include IsDB's name. Several MoUs were signed between AAOIFI and other infrastructure bodies, banks and financial institutions.

A separate special event was also organized on Food Security and Islamic Finance: Connecting Russia with Muslim countries in conjunction with HSE-Skolkovo Institute of Law and Development, Russia. The keynote speech at this event was delivered by H.E. Shaikh Mufti Taqi Usmani, Chairman of AAOIFI Shari'ah Board and was attended by leading Shari'ah scholars in Islamic finance, agricultural and trade experts from Russia in addition to the attendance from government and private institutions from the GCC region and Russia.

Strategic relationships

AAOIFI and Komite Nasional Keuangan Syariah (KNKS) signed MoU for joint collaboration

AAOIFI and Indonesia's National Committee for Islamic Finance (Komite Nasional Keuangan Syariah (KNKS)) signed a Memorandum of Understanding (MOU) at the 14th IFSB Summit in Jakarta on 14th November 2019. Under the agreement, both AAOIFI and KNKS will aim to work in the areas of common interest that support the development of Islamic finance industry. This includes meaningful exchange of information, conducting joint capacity-building programmes, related to AAOIFI standards in Indonesia, etc. AAOIFI and KNKS also seek to host events focused on areas of mutual interest and promote their activities to their respective networks and local industries. KNKS has tasked itself of being a coordinator in the implementation of Islamic Economic Master Plan (MEKSI 2019-2024) with an aim to make Indonesia a hub for Islamic economy.

Other MoUs signed for mutual co-operation

In order to facilitate and strengthen industry relationship and engagement of key industry players, AAOIFI signed a host of Memorandums of Understanding (MoUs) to pave the way for greater collaboration and industry commitment towards AAOIFI and its mandates. These MoUs were signed on various occasions including at AAOIFI annual conferences. These included MoUs between AAOIFI and Dubai Islamic Economy Development Centre (DIEDC), UAE; MoU signed between AAOIFI and International Islamic Centre for Reconciliation and Arbitration (IICRA), UAE and between AAOIFI and Jumhouria Bank, Libya. Two other MoUs were signed to translate the AAOIFI's capacity building program – Certified Islamic Professional Accountant (CIPA) into Russian and French languages. In April 2019 an MoU was signed with Central Shari'ah Board of Bangladesh for mutual cooperation and translation of AAOIFI standards in Bengali language. MoU was also signed with Salaam Centre of Djibouti. The aim of these MoUs is to collaborate in enhancing awareness of AAOIFI standards, capacity building programs and organizing joint events and workshops.

Other Initiatives

AAOIFI launched CIPA and CSAA scholarship program

AAOIFI launched the Scholarship Program for its 'Certified Islamic Professional Accountant' (CIPA) and the 'Certified Shariah Advisor and Auditor' (CSAA) fellowship programs. The objective of the AAOIFI scholarship program is to provide need-based, market-based, and merit-based scholarships to students and professionals comprising the global Islamic finance industry so that they may pursue the fellowships of their choosing. In total, 100 scholarships are made available ranging from 25% to 75% reduction in total program fees. This program was launched with an aim to invest in and develop the current and future leadership of the industry, especially in the field of Islamic accountancy as well as Shari'ah advisory and auditing and ensure its long-term sustainability and growth. The decision to award the scholarship rests with AAOIFI Education Board (AEB) which is deemed final, binding, and uncontestable.

EDITORIAL

Islamic financial institutions must now move to value-based intermediation system

Muhammad Ayub[1]

With considerable growth over the last three decades Islamic finance has become a global reality having its footprint in many economies of the world accumulating nearly US$2.5 trillion in total assets in 2018 from US$2.4 trillion in 2017, a rise of three percent. This growth is slower than that of the previous years, and is particularly noticeable in the industry's biggest sector, Islamic banking, which grew at two percent from US$1.72 trillion in 2017 to 1.76 trillion in 2018 (IFDR, 2019). This slow down requires us to analyze the situation carefully.

At the time when Islamic banking and finance emerged about half a century ago, the conventional finance was moving towards 'financialization' focusing primarily on maximization of returns on the capital. The pioneers of Islamic finance invoked Islam's value-based system for justice to all stakeholders, disclosure and transparency of all such information that may have an impact on rights and liabilities of the contracting parties, fairness, equity, compassion and cooperation, even with the competing parties. Evolving any system based on these values was considered necessary to resolve the real world problems. The lately-emerging concepts like Corporate Social Responsibility (CSR), Sustainable, Responsible and Impact investing (SRI) and the Value-based Intermediation (VBI), encompassing value-based banking, ethical, responsible / impact investing; Environmental, Social and Governance (ESG) aspects, etc. did not even exist at that time[2]. As there are many similarities and historical connections between SRI investing and Islamic finance, the latter is genuinely expected to move to responsible and ethical investing and financing.[3]

VBI can be defined as the intermediation aimed at achieving the intended outcomes of Shari'ah through practices, conduct and offerings that generate positive and sustainable impact to the community, economy and the environment, consistent with the shareholders' sustainable returns and long-term interests of all stakeholders. VBI focuses on entrepreneurial functions to support SMEs, micro businesses, financing projects of community welfare, self-governance for taking care of society's welfare and creating Ihsan culture, and treating all stakeholders with Ihsan. The key difference between VBI and initiatives such as ESG, Ethical Finance and Sustainable, Responsible Impact Financing (SRI) is the reliance of VBI on Shari'ah in the determination of its values, moral compass and priorities[4] (BNM, Nov. 2019).

Islamic finance: The spirit is missing

Practically, as the Islamic finance industry evolved, it occasionally seemed to have adopted legal stratagems to 'Islamize' the conventional financial products and services using technicalities of jurisprudence. The legal compliance was considered sufficient for replicating conventional products. "The charge of putting legal form over economic substance is pervasive in Islamic finance"[5]. For this, a strictly jurisprudential mindset was adopted rendering many products into mere legal stratagems without any spirit of the Shari'ah principles that could make a real difference.

1- Mr. Muhammad Ayub is the Editor of JOIFA. He is also the Director Research and Training at the Riphah Centre of Islamic Business (RCIB), Riphah International University, Islamabad, the Editor of Journal of Islamic Business and ManagmentN(JIBM), and Secretary of International Conference on Islamic Business (ICIB).

2- The CSR and VBI are the post GFC (2007-8) recipes introduced by the global infrastructural institutions in global finance to generate positive and sustainable impact of financial intermediation to the economy, community and environment; consistent with the shareholders' sustainable returns and long-term interests.

3- CFA Institute, Sustainable, ,Responsible and Impact investing and Islamic finance -similarities and differences; 915 East High Street, Charlottesville, Virginia 22902, ISBN: 978-1-942713-80-7

4- BNM (2019); Value-based Intermediation Financing and Investment Impact Assessment Framework Guidance Document; November, 01.

5- Usman Hayat, Islamic Finance Is Growing Fast but Faces the Form-Versus-Substance Debate," Enterprising Investor blog (11 June 2013); Reported by CFA Institute, 2019.

Reliance only on legal technicalities to develop banking and finance products led to serious concerns about the reputation of the emerging system and creating a wrong perception in the minds of the general public. Some examples of compliance in form, without spirit, are i) Islamic prize draw schemes for investment account holders of Islamic banks offered in certain markets that are generally perceived by the public as 'Islamic lottery schemes'; ii) organized Tawarruq / commodity Murabahah, both on deposits and financing sides, without fulfilling in spirit the conditions required by AAOIFI (Shari'ah Standard no. 30) for its adoption; iii) Bai al muajjal of near-to-maturity sukuk, culminating into sale of debt practically; iv) Shari'ah conversion technology to legitimize return on conventional bonds, commercial papers and other fixed income securities; v) financial derivatives with a series of Tawarruq, Wa'd and netting-off technique; vi) acceptance of 'sale of debt', 'buy-back' and currency Salam contracts that are considered prohibited in mainstream Islamic finance theory; vii) 'Running Musharaka' which closely resembles conventional overdraft facility; etc. Some even argued that sukuk were not different from the conventional bonds (Mumtaz H. et al; 2015, IMF WP/15/120)[6], which was also observed by Sheikh Taqi Usmani in 2007 that about 85% of sukuk did not really comply with Islamic law[7].

Global finance turning to value-based intermediation

In the meantime, conventional financial institutions that are not known for their adherence to values and ethical standards were seen turning to ethics and values-based business in the backdrop of the global financial crises of 2007-08. These banks and financial institutions are being asked to move beyond financial profits to include other considerations in their decision-making like ethically defensible business proposals. The "Global Alliance for Banking on Values" (GABV) that is striving to deliver sustainable economic, social and environmental development, has suggested the principles of value-based banking including serving the real economy, long-term relationships with clients, resilience to outside disruptions, and transparent and inclusive governance.

The GABV is striving to change the banking system so that it is transparent, supports economic, social and environmental sustainability, and is composed of a diverse range of banking institutions serving the real economy. They are also adopting the "Principles for Responsible Banking / Investment" issued by United Nations Environment Program (UNEP) – Finance Initiative[8]. These principles align the banks' business strategies with individual's needs and society's goals, impact and target setting, clients and customers, stakeholders, governance and culture, and transparency & accountability. Thus the focus is on giving increasing importance to ethics and values, beyond the financial return.

The move to VBI continues to grow at a rapid pace. The UN-supported document "Principles for Responsible Investment" has now collected as signatories the asset owners and investment managers overseeing US$81.7 trillion using ESG integration strategies. A major milestone for the banking sector was reached in 2018 when the UN Environment Program – Finance Initiative (UNEP FI) established the Principles for Responsible Banking. As per ESG Outlook, 2019, 45 banks from around the world had committed to aligning their business strategies with society's goals. This shows a fast-growing trend of responsible finance around the world.

The 2030 agenda aspires to achieve the 17 high-level SDGs and 169 specific targets, encompassing the social, economic and environmental dimensions of development. These aspirations for human dignity, and 'to leave no one behind', is fully in line with the principles and objectives of development from an Islamic perspective (Maqasid Al-Shari'ah)[9].

Similarly, the Business Roundtable[10] has revised the "Statement on the Purpose of a Corporation" to broaden the scope from the shareholders to the stakeholders. The document signed by 181 CEOs, calls for companies to serve all stakeholders by delivering value to customers, investing in employees, dealing fairly with suppliers, supporting the communities in which companies operate, protecting the environment and generating long-term value to shareholders.

In recent years some individual institutions including non-financial companies have also initiated ESG related activities. The ESG scores from Refinitiv's EIKON database of over 5,000 non-financial companies suggested a direct correlation between Shari'ah compliance and higher ESG scores[11]. The 'ESG Outlook' aims at encouraging Islamic banks to re-evaluate their connections with

6- Mumtaz H; Asghar and Rima Turk (2015); An Overview of Islamic Finance; IMF; WP/15/120.

7- He told Reuters, "For current sukuk, risk is not shared and reward is not shared according to the actual venture proceeds. About 85% of sukuk are structured this way," https://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html

8- https://www.unepfi.org/banking/bankingprinciples

9- https://www.isdb.org/what-we-do/sustainable-development-goals

10- https://www.businessroundtable.org

11- REFINITIV (2019), Islamic Finance ESG Outlook 2019: Shared Values.

the real economy and to address risks and seize opportunities that Islamic finance would create for them. The report also highlights the roles and initiatives of governments, financial and non-financial institutions towards a better world.

IFIs must turn to VBI

Islamic finance principles can enhance resilience in financial system and positively contribute for achieving SDGs, particularly for financial inclusion. But it needs a paradigm shift and coming out of straightjacket of incremental innovations of replicating conventional products of earning money from money. The implementation of VBI would necessitate a comprehensive review of the existing business environment, essentially going beyond the current Shari'ah compliance culture and innovating new policies and systems that could deliver the value proposition of Shari'ah.

As the global finance is being continually reshaped by innovation, particularly in the areas of financial technology and sustainability, IBFIs also need to move to VBI for realizing the objective of shared development. They may also explore the potential of Fintech and Blockchain that could go long way in enhancing financial and social inclusion. It is also in line with the UN's Sustainable Development Goals (SDGs). Otherwise, Islamic finance industry will be at a risk of becoming irrelevant and outdated, if not aligned with value-based and Fintech related intermediation effectively.

AAOIFI deems it essential for all categories of IFIs to re-evaluate their approach to strengthen the link between finance and the real economy as also the nature / environment. It is pertinent not only to realizing the higher objectives of Shari'ah, but also to seize the opportunities that it creates for them.

AAOIFI provides a basis for intermediation based on Islamic principles in the form of its Shari'ah, governance and accounting standards, and is in the process of reviewing the same in the light of changing priorities at the global level. AAOIFI has also provided the Governance Standard No. 7 (CSR, Conduct and Disclosure for Islamic Financial Institutions) that lays out mandatory and voluntary conduct and serves as a common reference point in Islamic finance. The Standard covers most of the CSR related factors. It's up to IFIs to adopt and implement the standards in their true spirit in terms of CSR measures including the disbursement of Qard al hasan and Zakah, along with disclosure on activities including employees' welfare, zakat policy, and waqf policy.

A variety of sectors that IFIs serve, including manufacturing, agriculture, utilities, transport, healthcare and extractive industries face significant ESG risks. The risks are perhaps more relevant to Islamic banks than they are to conventional banks. Among the most important ESG risks identified in this report are those created by investee companies.

Among the regulators in Islamic countries, Bank Negara Malaysia (BNM) issued after due consultation process a 'Value-based Intermediation Financing and Investment Impact Assessment Framework - Guidance Document' (VBIAF) in November 2019. We appreciate the BNM for this move. The VBI strategy necessitates more involved Shari'ah governance in accordance with development of the IFI's business and risk strategies. The banks boards need to determine the roles and responsibilities of the Shari'ah governance functions in respect of the VBIAF. The IFIs have been suggested to establish a dedicated VBIAF implementation team initially or embed selected and trained VBIAF leaders within each function until the intended outcome of full integration is achieved.

As per VBIAF, IFIs are required to integrate Shari'ah into their business strategies. This integration must extend beyond the compliance approach to affect real change in behavior and culture of IFIs towards embracing the VBI strategy. Further, the design of policies and procedures and capacity development should aim to enable Shari'ah compliance mind-set, which focuses on impact, rather than merely Shari'ah compliance checklist. The document also contains guidelines regarding fairness and transparency, constructive and inclusive collaboration with stakeholders, risk governance and Shari'ah governance.

The VBIAF emphasizes upon Islamic banks to meet the higher Shari'ah objectives on which the Islamic finance is founded. It is to facilitate implementation of an impact-based risk management system for assessing the financing and investment activities of IFIs in line with their respective VBI commitments. The VBIAF also serves as a reference for other financial institutions intending to incorporate ESG risk considerations in their own risk management system. Its implementation will necessitate a comprehensive review of the existing business environment by innovating new policies and systems that could further deliver the value proposition of Shari'ah.

To conclude, Islamic finance promotes risk sharing, social and economic justice, and shared prosperity. It is ethical finance in real sense, strengthening the linkage of finance with real economic activity, thus increasing stability of financial system and supporting the pursuit of mutual gains and prosperity. Islamic finance industry has come of age, and now it must move from the letter (form) to the spirit (substance) of Shari'ah-based contracts.

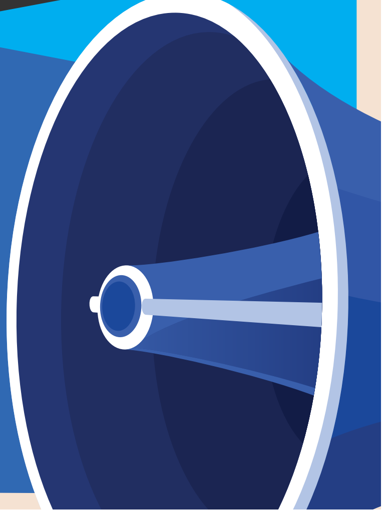
As suggested by Habib Ahmed[12] and Mergaliyev et al,[13] we reiterate a 'robust Shari'ah governance regime' to strengthen internal Shari'ah supervisory bodies of the banks through the respective national Shari'ah bodies and the regulators. It would help in enhancing the social, ethical, environmental and financial performance of the IBFIs rather than just being limited to Shari'ah compliance in form, and serving only the shareholders.

The Governance Board of AAOIFI may like to move towards implementation of VBI by the IBFIs, also including the ESG factors, to protect the environment and generate long-term value to shareholders and the societies. It may further strengthen its CSR guidelines to banks and financial institutions for delivering value to customers, ensuring fair treatment with employees, suppliers and other parties in contracts, and supporting the communities in which companies operate.

In the perspective of accepting the value of morality and ethics at the global level, IFIs must move to a value-based system of financial intermediation, at least, along with their conventional counterparts. Islamic banking and finance movement needs a paradigm shift that can reinvent its ethical and social principles, to be Shari'ah compliant in a real sense. Money capital has to be aligned with social objectives for a broad-based sustainable development. All activities in Islamic finance must result in genuine economic transactions through trade finance, leasing, partnership, securitization vide asset-backed investment instruments, equity take-ups and fund management. In that way, it could directly contribute to a stable socio-economic growth and shared prosperity, also acclaimed by the SDGs related 2030 agenda. Financial intermediation as an instrument for realizing economic and social objectives would also be in line with the objectives of society in terms of Islam's substantive morality.

12- Ahmed, H. (2011). Shari'ah governance regimes for Islamic finance: Types and appraisal. Economia Internazionale, 64(4), 393–412.

13- Mergaliyev, A; Asutay, M; et al. (2019); Higher Ethical Objective (Maqasid al Shari'ah) Augmented Framework for Islamic Banks: Assessing Ethical Performance and Exploring Its Determinants; Journal of Business Ethics; https://doi.org/10.1007/s10551-019-04331-4.



PEER-REVIEWED

Concept of materiality for financial reporting in Islamic financial institutions: An Islamic perspective

Khairul Mukminin[1]

Abstract

It has been more than five decades since the concept of materiality is applied in the auditing practice. However, a unanimous method towards consistency is evidently a bridge too far. The most important in this context is question whether the materiality applied by auditors for decades complies with Shariah. This paper aims to explore the concept of materiality from Islamic perspective. By the use of method of Maslahah Mursalah, the study develops and applies three presumptions of legal reasoning: first is between materiality and preservation of wealth (mal), second is between materiality and uncertaintity (gharar), and third is between materiality and goods-found (luqathah). With regard to the former, stakeholders of Islamic Financial Institutions (IFIs) such as Islamic banks, government, auditors, and accountants should be mindful of practicing materiality. In the most stringent point of view, the concept of materiality may be placed as a devaluation of Maqasid al Shariah (purposes of Shari'ah) in terms of wealth. Nonetheless, the Shariah might accommodate the materiality with certain size, degree, and agreement whereby this endorsement could be traced under virtues of hukm for gharar and luqathah. Moreover, this study suggests that IFIs should put their heads together to instill consistency and reliability in the implementation of materiality for financial reporting. Thus, the most possible way is the legislation of materiality in which the IFIs are governed.

Keywords: Accounting, Auditing, Maqasid Shariah, Maslahah Mursalah, Maxim, Islamic Jurisprudence

Introduction

Lakis and Masiulevičius (2017) exhibit a concise fact in which it has been around half of a century for the expertise to form a unanimous conception and threshold concerning materiality. Studies have been conducted since 1967 by various researchers, different methods, and multifarious findings along with future suggestions, "but the situation still has not changed and the problem remains" (Lakis and Masiulevičius, 2017). In other words, the more studies, the more thresholds put forward.

One study conducted in 2003 shows that there are large disparities on the understanding of immateriality whereby in a thorough examination, the disparity could reach 50 times up to 250 times among the users and the auditor (Cho, Hagerman, Nabar, & Patterson, 2003). For example, whilst an auditor considers immaterial misstatement on profit before tax ought to be 10 per cent, the threshold of immateriality expected from the users go around 0.1 – 0.2 per cent (Lakis & Masiulevičius, 2017).

It is significant as well to bring the case of Arthur Andersen and Enron in 1997 to mind. According to Berardino (2001), the managing partner and chief executive officer of Arthur Andersen insisted on reporting accounting adjustments of almost half of the net income worth US$51 million to be

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immaterial for the fiscal year. In other words, the adjustment of US$51 million was perceived to have no substantive value in influencing the decision making of financial statement users.

Baldacchino, Tabone, and Demanuele (2017) state that minimum achievement of an auditor in the compass of materiality encompasses three subjects, namely overall materiality, performance materiality and clearly trivial misstatement (CTM). Nonetheless they looks identical, in actual fact, each of the thresholds are hardly hypothetical measures.

Baldacchino et al. (2017) precisely pronounce that even the named thresholds exist on many standards and guidelines, yet in terms of method on how they are mathematically calculated, the thresholds brought by every single auditor is apparently an antithesis. Brody, Lowe, and Pany (2003) additionally highlighted that the materiality threshold which employs variable rules might give rise to a "grey area" of materiality. This means, in spite of the fact that the method employed in the field may have an inclination towards similar financial indicator of accounts on financial statements, it might be different in terms of numerical calculation and interpretation.

It is expected that the mainstream accountant and auditor to be more innovative in developing materiality through non-traditional approach (Jumua'h, 2009). Unfortunately, besides Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the research is scarce in discussing materiality within Shariah. Additionally, it seems that AAOIFI mainly takes into consideration international auditing standard of International Auditing and Assurance Standards Board (IAASB).

From Shariah point of view, the stand-alone reasoning of humankind with their temporal affairs is objectionable and impermissible unless it is explicitly derived from general principles of primary sources namely, the Quran and the Sunnah. Besides that, the principles have a source from underlying hikmah of the text and from what jurists introduce (Nyazee, 1995).

Al-Shatibi had stated that harm and benefit from human reasoning is continuously relative as they have no universal and ultimate goals. However, Nyazee (1995) emphasizes remarkably that all Muslims across the globe are devotionally embraced by an ultimate aim i.e. the purpose of the Hereafter within the bounds of preservation of Din. As one of the most supreme preservation within the Shariah that takes precedence over all worldly affairs, the Western scholars in fact put this in the lowest precedence over other worldly matters. Therefore, in Islamic perspective, the broad gap of materiality threshold might be narrowed.

In the emerging market nowadays, Islamic banks or other financial institutions elsewhere are largely required to disclose relevant and reliable information which includes compliance to Shariah. Hence, the question which might arise is "What is the state of the Shariah upon the materiality applied by the external auditors for decades?"

The significant objective of this study is to provide application of materiality within the boundary of Shariah. Materiality which is the main concern of the study could become a guiding principle in several compasses namely Shariah non-compliance risk events in the sphere of auditing of financial statements and compliance audit on organization. All in all, by providing application of materiality within Shariah, this study could narrow the gap especially between the users and auditors that is up to this present time, is a bridge too far towards the threshold of materiality. However, the gap may be broader while it is not legislated. It is then extremely important that this paper attempts to provide legal justification and proposed framework to legislate the materiality in which the institution is governed as a legal person.

Research methodology

To achieve research objectives of this study, the paper thoroughly conducts exploratory research analysis. It may bring a fresh perspective on the development of the conceptual framework, theories through a pragmatic approach. In terms of documentation, the author incorporated information from varied sources either based on Shariah principles or conventional principles. The information is mostly taken from related previous research, articles, and financial forensic results. With regards to underlying legal guidelines, rules, doctrines, and established cases, this study relies on classical books of Islamic jurisprudence.

2- Overview of materiality concept and literature review

2.1. The conception of materiality in the context of auditing and accounting

2.1.1. International Auditing and Assurance Standards Board (IAASB): ISA 320

It is widely known that IAASB and its International Standard on Audit (ISA) including ISA 320 plays a crucial role in the compass of practical auditing globally. In its ISA 320, therein the standard recognizes generally accepted materiality concept as underlined below:

"Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements" (ISA 320, para. 2).

The other important things in this standard are that it encompasses several deliberations. First, it clearly states that the determination of materiality is the responsibility of auditors that possess perception, assumption, and professional judgements. As such, instead of integrating the value of materiality from diverse users as a whole, the IAASB effectively secures the service of the audit through engagement of users as a group and hence disregard "the specific individual users" (ISA 320, para. 2).

As far as the benchmark is concerned, IAASB (ISA 320, A7) specifies certain percentages for different clients, for example, five (5) per cent of profit before tax for profit-oriented client in manufacturing industry or one (1) per cent of total revenue or total expense for non-profit client. Yet, again, the determination of the percentage whether higher or lower is dependent on the professional judgments of the auditor.

2.1.2 American Institute of Certified Public Accountants (AICPA)

The outlook of AICPA comes into the picture of the study because of its significant capacity. As derived from its website, "the American Institute of CPAs is the world's largest member association representing the accounting profession, with more than 431,000 members, and a history of serving the public interest since 1887".

AICPA (2013) precisely states that: "a matter is material if it is of such relevance and importance that it could substantively influence the assessments of providers of financial capital with regard to the organization's ability to create value over the short, medium and long term." (AICPA, 2013).

Notwithstanding AICPA clearly states the providers of financial capital are the central substance of materiality, it also states that public interest, social, environmental, and political reasons should be embraced without compromising the value of capital providers (AICPA, 2013).

Additionally, AICPA presents technical courses on some issues. For instance, in terms of those who should decide the materiality inside the corporation. It alludes that senior management and those that hold accountability for governance are two parties that would execute thoughtfulness as well as sensitivity of the substance of the appropriate matter towards the institution's strategy, the resilience of business model, and the sustainability of financial, social, economic, and environmental systems (AICPA, 2013). Again, as the preparer of financial statements, those governance characters would have possibly dissenting opinions concerning materiality, for at the year end, the appointed external auditors apply and maintain their own judgmental materiality.

2.1.3 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) : Statement of Financial Accounting No.1, Conceptual Framework for Financial Reporting by Islamic Financial Institutions

Moving on the prominent international standards development bodies that develop and issue accounting, auditing, governance, ethics, and Shariah standards for IFIs globally, AAOIFI defines the materiality of information similar to IAASB as follows:

"Information is material if its omission or misstatement could influence the decisions that users make on the basis of an IFI's financial information" (Part 9 of Conceptual Framework for Financial Reporting by Islamic Financial Institutions, AAOIFI)

Apparently, AAOIFI also surrenders its sovereignty with regard to materiality to the interest of users. AAOIFI acknowledges primary users and secondary users of financial statements. The primary users include present and potential capital providers, equity holders, and investment account holders. Besides that, the secondary users comprise providers of funds, those transacting with the bank, those charged with governance, Shariah supervisory boards, employees, regulators, tax and zakat bodies.

Moreover, as opposed to IAASB and AICPA that expressly state that auditor and senior management and governance authority are those charged with governance if a matter is material, AAOIFI is silent regarding this issue. Nevertheless, as its foundation, therein AAOIFI embarks on the issue of materiality by annexing some concepts from the point of view of Islamic jurisprudence.

This autonomous body explicitly prescribes general principles of priority (darurat, hajat, tahsiniyat) which is discussed regularly within the Maqasid al-Shariah Maslahah Mursalah. It also advises the notion of Islamic legal maxim in most cases. For example, the "principle of choosing the least detrimental alternative" (AAOIFI). In all important aspects, it obviously exhibits that it conforms to one important Shariah maxim i.e. "A greater harm may be avoided by enduring a lesser harm" (Mansoori, 2012).

2.2. Possible models towards consensus materiality

According to McKee and Eilifsen (2000), there are four models for the auditors to express materiality on financial statements, namely single rule, size rule, average rule, and formula method. Although every single model may possess inclination towards similar financial indicator of accounts on financial statements, it might be different in terms of numerical calculation and interpretation. In other words, the more studies, the more thresholds put forward.

One study from Lakis and Masiulevičius (2017) employs the formula method to accommodate the interest between the users and the auditors. The originator states that the suggestive component of this formula is located on two constructors viz., determination of CTM (clearly trivial misstatement) and 'price' for the planning materiality. In respect of CTM, it is independently prescribed by the client firm and the auditor as a comparison. The arrangement of planning materiality is estimated solely by the auditors.

The originator of this formula also alluded that, if the expectation of the client could not be met, the auditor may: a) select a smaller materiality; b) ascertain the needs of the users of financial statements and materiality tolerance in more detail; c) consult with another auditor. These measures will minimize the risk of making wrong professional decision (Lakis and Masiulevičius, 2017). However, while the named presumptions are applied, the spirit of consistency of materiality will always keep hanging in the air. In other words, what amount or amounts are supposed to be immaterial or material will not be achieved appropriately. Predictably, Jumua'h (2009) suggested that "accountants and auditors should be more innovative and try to apply non-traditional method" in developing consensus materiality

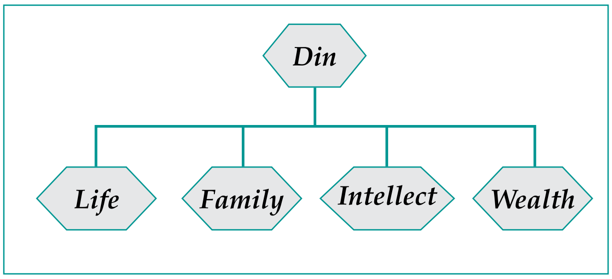
3. Conceptual framework

Rocco and Plakhotnik (2009) state that the purpose of conceptual framework is to make the theoretical and empirical work relevant to the research objectives. Thus, this section covers several 'tools' of Shariah, namely Maqasid al-Shariah in order to seek the essential relevancy of the concept of materiality. As the Maqasid al-Shariah is one of the fundamental elements to derive a law that is unmistakably unavailable in the text, it is important to introduce how to procure legal reasoning in applying materiality within Maslahah Mursalah.

3.1. Maqasid Al-Shariah: Relationship between Din and temporal objectives

Maqasid al-Shariah or the purposes of Shariah is a larger doctrine that is employed to discover a law through rational sources (Nyazee, 2000). Technically, it is divided into two main categories, namely the purposes of the Hereafter and the purposes pertaining to worldly affairs.

As shown in Figure 1 below, while the definite principle of dunyawi is divisible into four general dimensions namely nafs, nasl, 'aql, and mal, as a matter of fact, it is mindful as well that these four dimensions come into the scene of Maqasid with the aim that they ought to be profitable for the sole dini i.e. the afterlife purposes.



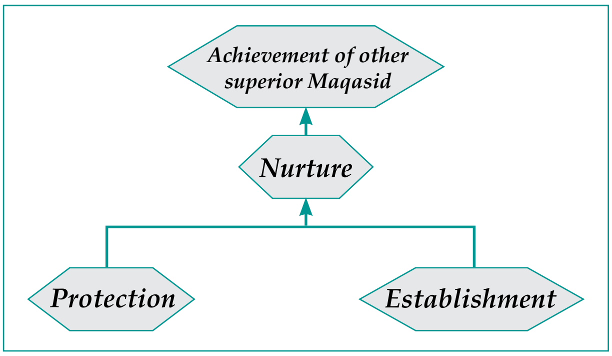
- *Figure 1: Relationship between interest of Din and Dunyawi matters in the structure of Maqasid al-Shariah (Source: Nyazee, "2000")*

Nyazee (1995) extracted significant issues regarding relationship between the temporal gain and the improvement of the next-world from two great contemporary Shariah scholars namely Al-Ghazali and Al-Shatibi. It is important to note that neither of them deny that the presence of inferior purposes on the compass of Maqasid must affirm the foremost firmness of Maqasid Al-Shariah, namely the preservation of Din. As a result, IFIs are expected to set the world alight through diverse innovative approaches of earthly Maqasid without compromising the intention of the hereafter prescribed by the Lawgiver over human beings. For instances, maximizing the financial profit with intention to maximize the contribution of sadaqah, waqf, and zakat.

3.2. Information of financial reporting: A reflection of Maqasid Al-Shariah and established Maslahah Mursalah

As for the implementation of Maqasid al-Shariah, Al-Ghazali (cited from Nyazee, 1995) revealed that Maqasid Shariah consists of two sides of a coin that has been derived from Shariah. With regard to wealth (mal), protection of wealth could be defined as an assurance that the fund is legally protected against detrimental events, for example, embezzlement, whereas an agreement that the fund would lawfully grow in number could be simplified as an establishment of wealth.

In light of IFIs practices, mostly managing both establishment and protection over the public's fund are inevitably bound to happen as the inherent nature of the entity is profit-oriented. Thereafter, as a positive result of both protection and establishment, the subsequent stage that inevitably comes to the arena of the Maqasid is nurture, for instance, zakat and taxation. As shown in Figure 2, the achievement of higher-level elements of Maqasid, especially the Din (zakat), endorses the success of lower Maqasid (in this case is wealth) by offering a set of stages or ladder of achievement.



- *Figure 2 Achievement of Maqasid Al-Shariah*

It should be borne in mind here that there is nothing new in these conditions. The origin of the nurture, in fact, could be traced under the subject of hukm wad'i (declaratory rules) in the discussion of Islamic jurisprudence. As mentioned by Nyazee (1995), the aim of hukm wad'i is "…to either inform the subject that a certain thing is a cause of (sabab), condition for (shart), or obstacle (mani') to a hukm". Pragmatically expressing, "it is a situation where a non-obligated act becomes a means to perform obligated act". (Masud, 1995 p183-184)

According to Qian and Velayutham (2017), profit distribution in Islamic banking could generally be divided into five categories: allowance for impairment of financing; income attributable to depositor; expenses / costs; zakat, taxation; and profit to shareholders.

Haniffa and Hudaib (2011) put the matter of zakat in Din confidently. It should be clear that zakat consists of three main objectives. They are gratefulness, purification from miserliness, and devotion to the divine duty of the Lawgiver. One sceptical question may arise, "Is the amounts of zakat and other accounts of financial statements information reported by the bank absolutely true in nature?" Recall that within the materiality, it grants for waiving certain amount or amounts misstated, due to fraud or error, provided that the amount(s) is / are professed to be immaterial. Again, the case of Arthur Andersen and Enron in 1997 is a good learning whereby the adjustment of US$51 million was perceived to have no substantive value in influencing the decision making of financial statement users.

Through careful interpretation, this study encapsulates that the distributions of wealth must be reflected and accommodated inside the truthfulness of financial statements. In other words, the protection, the establishment, and the nurturing within the Maqasid and Maslahah are genuinely reflected in the financial statements at an appropriate time and place.

3.3. Deriving Maslahah Mursalah and its compatibility with Maqasid Al-Shariah

With regard to Maslahah, it is literally defined as "the acquisition of manfa'ah (benefit) or the repulsion of madarrah (injury, harm)" (Nyazee, 1995). In practical terms, Maslahah means "the preservation of the purpose of Shariah in the settlement of legal issues" (Al-Ghazali, cited from Nyazee, 1995). Practically, between the two, the derived law and the purpose should be in accordance with each other, otherwise "it may be rejected".

The root of formulation in employing the method of Maslahah Mursalah could be traced from the great Imam, Al-Ghazali. Al-Ghazali (cited from Nyazee, 1995) highlights that the newly discovered or formulated principle must meet the following conditions:

1. The formulated principle must be in accordance to a text without intending for alteration of implication of a text.
2. The formulated principle must act in accordance with the existing or the established principles and propositions of Shariah.
3. The formulated principle must endorse Maqasid al-Shariah.
4. The resulting consequence must be certain and definitive (qat'i).
5. The resulting consequence must influence the entire Muslim ummah and the public interest.

In Islamic jurisprudence, jurists take precaution of seeking the application of Maslahah Mursalah in several cases, for instance, in the matter of the preservation of Din (the compilation of the Qur'an after the death of the Prophet (pbuh) by the companions), the preservation of wealth (the new rule rendered and shifted to artisans who made negligence), the preservation of life of the Muslim (it is permitted to impose taxation), and last the preservation of 'aql (rules formulated for those who drink wine since the Qur'an does not expressly specify the penalty). For the last mentioned case, the logical thought would be:

"He who drinks is intoxicated; he who is intoxicated raves; he who raves slanders; therefore, he who drinks is to be awarded the penalty for slander."

- *Figure 3 Legal reasoning between drinking wine and penalty for slander (Source: Nyazee "1995")*

Another example of how the legal reasoning could be derived from Shariah is as follows:

> ***"He who sleeps becomes ritually impure; he who becomes ritually impure performs ablution; therefore, he who sleeps is to perform ablution (for the next prayer)."***

- *Figure 4 Legal reasoning between sleep and performance of ablution (for the next prayer)(Source: Nyazee "1995")*

It is important to note the above deliberation. The first matter is that there are no newly discovered rules for new cases. As stated by Nyazee (1995), for example, the penalty or the act is provided and specified in Qur'an or the Sunnah so the rest is up to how the jurist forms his legal reasoning. Moreover, Shariah would straightforwardly reject the offer of legal reasoning that comes up with recent rulings. Secondly, the stance of legal reasoning in respect of Maslahah is a mere legal aid with the aim that it assists the jurist in interpreting the text and adopting the suitable hukm.

4. Discussion and analysis

4.1. Application of materiality within the boundary of Shariah

This section discusses the application of materiality within the boundary of Shariah with aim that it could provide inferences to respond to the research objectives of this study. Lakis and Masiulevičius (2017) point out that there are at least two essential stages towards a unanimous method of materiality: 1) Determination of trivial misstatement; 2) Planning materiality.

4.1.1. Determination of clearly trivial misstatement (CTM): Employing Maslahah Mursalah

The formulation of trivial misstatements in this study employs the method of Maslahah Mursalah. It is stated that preservation of wealth is one type of Maslahah that is legally acknowledged by the Lawgiver at the level of the genus (Nyazee, 1995). The genus (jins) here refers to the five classes of the Maqasid al-Shariah whereby one out of the five is wealth. In order to employ Maslahah Mursalah, the utilisations of the state of **'penalty for devaluing the preservation of wealth', 'gharar' and 'luqathah'** under the principles of Shariah are discussed.

4.1.1.1. Presumption 1: Materiality and preservation of wealth

The correspondence between materiality and 'penalty for devaluing the preservation of wealth' are because in the conceptual and practical materiality, it grants for waiving certain amount or amounts misstated provided that the amount(s) is / are professed to be immaterial. Therefore, the logical thought would be verified in Figure 5.

> ***Presumption (1)***
>
> *He who declares materiality to be applied deliberately trivialize certain amount of the preservation of wealth (in the course of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or error;*
>
> *He who deliberately trivializes certain amount of the preservation of wealth (in the course of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or* ***error devalue the objective of the Lawgiver (Maqasid) and public interest (Maslahah) concerning the preservation of wealth;***
>
> ***He who devalues the objective of the Lawgiver concerning the preservation of wealth is to be awarded the penalty for devaluing the preservation of wealth.***

- *Figure 5 Presumption 1: Legal reasoning between materiality and preservation of wealth*

While the trivial misstatement is concerned, the first presumption apparently does not substantiate the presence of materiality. It is obvious that from the legal reasoning suggested above, the derived law becomes very strict in respect of the materiality concept. Thus, this study would move on the following presumption with the objective that it could acknowledge the materiality within Shariah guidelines.

4.1.1.2. Presumption 2: Materiality and Gharar

The correspondence between materiality and gharar for both contains entanglement. This means that, due to the reason of hardship or cost-versus-benefit, there leaves uncertainty of misstatement whether fraud or error, or a mix of both.

Nehad and Khanfar (2016) state expressly that the concept of gharar nowadays is not solely limited to the event of risk or uncertainty, but also pertinent to negative situations such as misrepresentation, fraud, cheating, deceit, and lying. In detail, gharar may give rise to the change of certain facts that again is extremely relative between one who gives information and those who obtain the information. Therefore, the logical thought would be verified in Figure 6:

> ***Presumption (2)***
>
> ***He who declares materiality to be applied deliberately trivializes certain amount of the preservation of wealth (in the course of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or error;***

He who deliberately trivializes certain amount of the preservation of wealth (in the courses of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or error falls under position of entanglement concerning the absolute truthfulness of the information;

He who is under the position of entanglement concerning the absolute truthfulness of the information is to be rewarded the hukm of gharar.

- *Figure 6 Presumption 2: Legal reasoning between materiality and gharar*

Pursuant to the aforementioned circumstances, the gharar may provide and accommodate the concept of materiality. Under the hukm of gharar, materiality may be acceptable and tolerable, provided that it will not cause any dispute in the future. For practical purposes and intents, it is therefore significant to make reference on two deeper classifications of permissible gharar, namely mandatory gharar and gharar due to quantity of the object (Al-Saati, 2003).

Al-Saati (2003) states that the former type literally means "prerequisite to the validity of the contract". The established example of this stipulated gharar is easily traced under the postulation of musharakah, mudarabah, and ijarah. The similar underlying of the three named contracts are they originally were born from the value of Maslahah and Istihsan. At least three Shariah maxims support their presence so that the presence of gharar in the form of prerequisite is permissible under Shariah:

1. Removal of hardship.
2. Damage and benefit goes together.
3. Revenue goes with liability.

Although this type of gharar does not specifically mention numerical reference, the key point of this gharar seemingly is located on its literal meaning. Therefore, the concept of materiality may be limitless in consideration of the related parties in the scope of financial statement give the institution their consent upon the application of trivial misstatement of materiality.

Trivial misstatement within the hukm of gharar (1) =

Limitless (as long as legally accepted by the related parties)

- *Figure 7 Clearly Trivial Misstatement within the hukm of gharar (1): Limitless (with consent from related parties)*

With regard to the latter type i.e. gharar due to quantity of the object, the event of Bay al-Araya comes into the picture (Al-Saati, 2003). In technical terms, it shows the selling of the 'araya (fresh dates on the tree) in return for the dried dates by means of estimation and condition that the amount less than five awsuq and the future evaluation against the estimation is unquestionable.

However, as far as the sources referred by this study, it is not clear whether the requirement of five awsuq in the context of Bay al-'Araya due to the matter of religious act i.e. zakat threshold (nisab) for agriculture crops or equal by coincidence. Thus, the research would moderately come into two possibilities under the hukm of gharar due to quantity of the object. Whereas it is approved to be adopted and adapted from the zakat threshold, the IFIs may use the local or customary practice of nisab of zakat.

Trivial misstatement within the hukm of gharar (2) =

< Nisab of Zakah

- *Figure 8 Clearly trivial misstatement within the hukm of gharar (2): Nisab of Zakat*

Yet, if it is coincidentally employed without regard to agricultural zakat, this study cautiously suggests that in the environment of Islamic Financial Institutions and under derivation of Maslahah Mursalah on gharar, the ceiling amount of clearly trivial misstatement of materiality must strictly be five awsuq of agricultural crops. Al-Qardhawi (cited from Rosele, Abdullah, & Ramli, 2003) states that the amount of the five awsuq may be adapted and based on the socio-economic variables in each country. For example, the Malaysian Islamic bank may employ certain monetary unit that is equal to average price of five awsuq of rice in Malaysia. In mainstream weight standard, five awsuq is around 653 kg (USA International Business Publication).

Trivial misstatement within the hukm of gharar (3) =

≤ Five Awsuq (653 kg) of agriculture crops

- *Figure 9 Clearly trivial misstatement within the hukm of gharar (3): Five awsuq of agriculture crops*

4.1.1.3. Presumption 3: Materiality and Luqathah

The correspondence between materiality and Luqathah or 'the goods-found' for both legally allow to tolerate misstatement (in the context of materiality concept) and to take another person's property (in the case of hukm for luqathah) provided that the economic value of the goods is very insignificant.

As opposed to principle 'no one is allowed to take another person's property unjustly', the hukm of luqathah apparently states otherwise.

Notwithstanding it seemingly allows discharging from above 'wrongdoing', the hukm, in fact, put several restrictions so as not to contravene the Shariah. The underlying reason of this permissibility is the hukm requires responsibility for that 'wrongdoing' risk due to acquiring the benefit from the property. It is therefore, the legal reasoning between materiality and luqthah can be verified in Figure 10:

Presumption (3)

He who declares materiality to be applied deliberately trivializes certain amount of the preservation of wealth (in the course of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or error;

He who deliberately trivializes certain amount of the preservation of wealth (in the course of protection, establishment, nurture) to be misstated, either understated or overstated, due to fraud or error should be responsible for the misstatement risk and possibility of financial evaluation in the future, either occurrence of liability or acquiring the benefit;

He who should be responsible for the misstatement risk and possibility of financial evaluation in the future, either occurrence of liability or acquiring the benefit is to be rewarded the hukm of 'goods-found or luqathah'.

- *Figure 10 Presumption 3: Legal reasoning between materiality and luqatah*

According to Mahfudhan (2016), the essential quality of the luqathah could be rooted as follows:

It may be acquired, if:

1. It falls under the following categories: wajib or sunnah (the finder of the goods is trustworthy).
2. It is publicly disclosed and declared for the whole of 1 year.
3. The typical goods is ephemeral and may spontaneously be consumed (e.g. a piece of cake). In other words, the economic value of the goods is very insignificant.
4. The finder pays the actual cost if the owner/ beneficiary knows about it later)

It may be acquired or may not be acquired (disposed), if:

1. It falls under the following categories: makruh or haram (the finder is doubly untrustworthy).
2. The goods would easily be found by the true owner in a short time.

Irrespective of the categorization of the hukm, from the aforesaid circumstances, it can be inferred that there is a range or interval value between the ephemeral property (rock-bottom amount), the vulnerable stuff (middle amount) and the self-sustaining asset (ceiling amount).

Trivial misstatement within the hukm of luqathah=

Short-lived asset < vulnerable asset < self-sustaining asset that possess utilization more than one year

- *Figure 11 Clearly Trivial Misstatement within the hukm of luqathah*

As an additional perimeter, one year is the next important thing. It is supported by Imam As-Syafi'i and Imam Abu Hanifa whereby the finder may utilise the luqathah if and only if after one year of declaration, there is no lawful assertion of the right of the asset or the owner could not make the assertion - unless there is a witness (Ibn Rusyd, cited from Mahfudhan, 2016).

4.1.2. *Planning materiality*

The next concern moves on the planning materiality. Planning materiality or overall materiality is a set of sum of materiality from the auditor, which "in his/her opinion, may influence economic decisions made by the users" (Lakis & Masiulevičius, 2017). IAASB (2009) implicitly defines that overall materiality is an integral part of overall audit strategy whereby its amount or amounts should be determined for the financial statements as a whole. Inside this study, the author puts the zakat and/ or the taxation forward as a feasible financial indicator because of some factors:

4.1.2.1. Preservation of Din – Zakat

Planning materiality is a set of sum of materiality from auditor, "in his/her opinion, may influence economic decisions made by the users" (Lakis & Masiulevičius, 2017). With regard to planning materiality, the study suggests the value of zakat. Recall that in the stages of Maqasid al-Shariah, zakat is an ultimate achievement resulting from the success of both protection and establishment of wealth. By the same token, zakat is also classified as one of the preservation of the highest-ranking of Maqasid i.e. Din. It takes precedence over all temporal objectives. Haniffa and Hudaib (2011) enhances the matter of the Din of zakat confidently in which it should be clear that zakat consists of three main objectives. They are gratefulness, purification from niggardliness, and devotion to the divine duty of the Lawgiver. Therefore, it is advocated that this account of Din-zakat is put into account remarkably under the planning of materiality.

Logically, any unlawful activities and any amount(s) that damage the preservation of this obligatory alms in the sphere of financial statement should be prohibited.

Planning materiality-Zakat = Amount of zakat paid for the current FY

- *Figure 12 Planning materiality and preservation of Din: amount of zakat paid for the current financial year*

4.1.2.2. Preservation of life - established Maslahah (taxation)

Taxation initially was not advocated under the Islamic legal system. It becomes a recommended conduct under Maslahah as the right of state prevails to protect wide-ranging public interests. Simply put, it is part of Maqasid al-Shariah in the genus of life. Moreover, it is widely known that it comes as one of the biggest part of an organization's contribution to society for it commonly costs the organisation tremendous expenses and even much higher than zakat literally. It is an undeniable fact that the information should be assessed truthfully to secure the public interest. Hence, the amount of taxation must be secured and preserved under the application of materiality for their involvement in Maslahah.

Planning materiality-Taxation = Amount of taxation expense for the current FY

- *Figure 13 Planning Materiality and safeguarding Maslahah: amount of taxation expense for the current financial year*

4.2. Legality of the presumption of Maslahah Mursalah

In order to ensure that the formulated principles for the concept of materiality above act in accordance with Shariah, it is then extremely essential to compare it with the given guidelines of Maslahah Mursalah by Al-Ghazali:

1. In all suggested legal reasoning towards materiality concept, they are under the existing rules. Legally mentioning, there are no newly-discovered hukm for the application of materiality.

2. The formulated principles for the concept of materiality do not clash with well-established principles of Shariah. In case of preservation of wealth, the major principle specifies that no one is allowed to take another person's property unjustly and unlawfully. Consequently, whether it is the hukm of gharar or hukm of luqathah, both provide legal mechanism by stages. For instance, within the rules of luqathah, therein there is assurance of a legal process starting from decision making, declaring, disclosing, acquisitioning, and adjusting.

3. All aforementioned discussions of materiality are concerning protection, establishment, and nurturing of wealth. Unmistakably, it is served and acknowledged by the primary elements of Maqasid al-Shariah. Moreover, the discussions also substantiate the strong relationship between the wealth and other higher-level Maqasid al-Shariah, especially life and Din.

4. The concept of materiality is not a hypothetical case. It has been put into practice even before the first Islamic bank was established.

5. The accounting and auditing services could not be separated from materiality practices on providing information of financial statements. The Islamic banks in particular come to prominence as an integral part of financial institutions in the global arena. Consequently, the assurance whether the business activities of the bank is working fairly requires the both services. As such, materiality predominantly influences the Muslim ummah and public interest as a whole.

While the five perimeters are logically accepted, it may be concluded that the supposition examined in the study is in line with the holistic virtues of Maslahah Mursalah specified by the great Imam Al-Ghazali.

4.3. Legal justification to legislate materiality in the ecosystem of IFI: Concern of Shariah maxims

4.3.1. Authority in respect of people's affairs must be exercised for their welfare

Mansoori (2012) alluded that usually the government would mediate essential issues in dispute for the sake of national interest. This impression stems from the Shariah maxim "Authority in respect of people's affairs must be exercised for their welfare". In case of the Islamic bank, for instance, the source of fund in the form of financing facilities dominantly originated from the public. In this manner, any consequence such as lack of liquidity would bring implications to the public at large. This means that public interest should be the prime concern compared to private interest.

Therefore, it is important for the legislators to decide whether the information/ facts are material or immaterial. In other words, an act or related act may settle the materiality threshold. The reasoning behind this is the financial statement items come up with functional tools to produce statistical assessment or regulatory ratios such as the leverage ratio, liquidity ratio and capital adequacy ratio (Basel Committee, 2013 Para 64). Moreover, the Basel Committee forewarns of "a small change in asset valuation may have a substantial impact on the adequacy of a bank's regulatory capital" (Basel Committee, 2013). The followings are other concerns on why the government should legislate materiality for Islamic Financial Institutions in general and banking sector particularly:

1. The government and its entities are unmistakable users of financial reporting information that act on behalf of greater interest.

2. In the commencement of the financial crisis in 2008-2009, the banking sector that was labelled as obtaining the highest ranking audit opinions from the Big 4 accounting firms, in actual fact sought for state backing (Vîlsanoiua & Buzenche, 2014).

3. History has exhibited that being an unknowledgeable policymaker over risks and potential of fraud along with its systemic consequences due to a mere motivation for profits had caused financial crisis. For instance, the Savings and Loan (S&L) crisis in 1980 and the Subprime mortgage crisis.

4. The nature of the materiality concept can be termed as 'gray nature' whereby it acknowledges that misstatements may be due to accidental and/or deliberate conduct.

5. Three issues between the inconsistent method of working, the concealment of materiality process, and the performance of financial statements apparently refresh our minds with regards to rationalization, opportunity, and pressure inside the bounds of fraud triangle.

6. The banking and financial institution itself is prone to the potential of varied fraud due to its inherent nature of business (Sanusi, Rameli, & Isa, 2015).

7. The 2011 survey by KPMG (2011) brings to public attention that top level management namely senior management together with board members that focus on finance task or finance-related tasks remain as key players in fraudulent business dealings in both periods of survey in 2007 and 2011.

8. KPMG also revealed that in committing the fraudulent action, the fraudsters usually do it with another fraudster (collaborating).

9. Potential failure of third-party assurance providers such as auditor, corporate secretary (internal-external), lawyer, and other professional advisors that transform into 'Gain-keeper' and contribute to corporate scandal (Salin et al., 2017).

10. There is both ineffectual and inefficient law-making (legislation) and law proceedings (litigation), whereby the intervention of politician into industries is more powerful than an enactment of rules and regulation itself (Salin et al., 2017).

It should be borne in mind that, without consideration of the likelihood which could materialize from different persons, the primary purpose of this study is to urge the Islamic Financial Institutions to put their heads together to instil consistency and reliability in the implementation of materiality. Thus, the most possible way is the legislation since it is the closest manner, regardless of the latter's occurrences.

4.3.2. *Repelling evil supersedes securing benefit*

The Shariah maxim "Repelling evil supersedes securing benefit" prevails while facing the tricky situations in which preventing harm is preferable than taking temporal gain (Mansoori, 2012). From legal perspective, the protection takes precedence over the establishment in due course.

It is advocated that the financial institutions bring enhancements in terms of materiality threshold (as part of auditing expense) equal to the other significant expenses in the context of safeguarding the assets (for instance, IT System). It is because the lower the materiality, the lower the possibility of both understatement or overstatement of financial information, due to fraud or error, on financial statements. Eventually, the lower the likelihood of fraud, the lower the potential debacle. In other words, the protection, the establishment, and the nurturing of wealth within the Maqasid and Maslahah are genuinely reflected and preserved in the financial statement at the appropriate time and virtue.

4.3.3. *A Greater harm may be avoided by enduring a lesser harm*

From an Islamic perspective, in order to strike a balance between cost and benefit, one Shariah maxim may cross the threshold whereby "A greater harm may be avoided by enduring a lesser harm" (Mansoori, 2012). Moreover, the maxim adds that the resulting decision between the greater harm and the lesser harm should seize wider interest such as public loss, nationwide climate of business activities, and regulators' concerns that subsequently bearing the lesser harm with the premise that it could obstruct massive damage.

While there are two harms conflicting with each other, Mansoori (2012) further makes an analogy on a customer loses his/ her personal possession in a slot machine. With aim to resolve the mentioned case, the consideration might look into both the actual price of the customer's item and the actual cost of dismantlement of the machine.

Hence, there may be three circumstances:

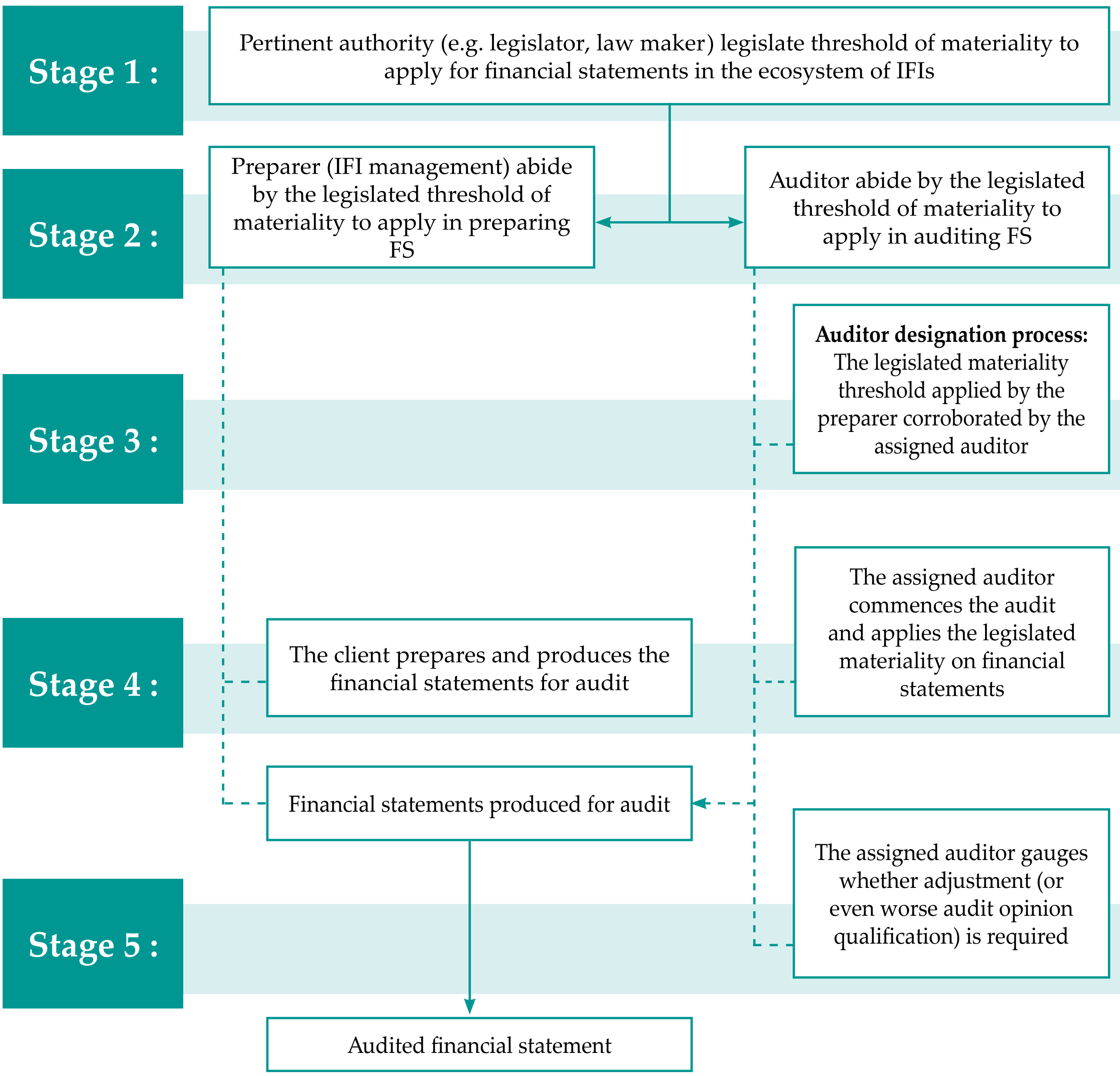
1) the item value is higher than the dismantlement cost; 2) the item value is equal to the dismantlement cost; 3) the item value is not that expensive so that disassembling and reassembling the appliance would be costlier.

In the above illustration and in the event of materiality, 'the dismantlement cost' is undeniably on the auditing cost as a whole. The next issue is whether 'the item's value' is a sole cost and benefit from the outlook of the organization as the client entity. However, while it is derived from the aforesaid maxim, the greater extent of stakes such as public interest, are positioned on the upper layer. It means the interest of the private entity i.e. the IFI is prior to the public interest.

4.4. Proposed framework to legislate materiality in IFIs

Stage 1 - In most jurisdictions, Islamic Financial Institutions are treated as legal person. Undeniably, as Figure 14 shows, the proposed framework begins by a pertinent authority (law maker) that legislates a uniform threshold of materiality to apply for financial reporting in the ecosystem of Islamic Financial Institutions.

Implementing this proposed framework would not bring a great deal of extra anxiety, especially to auditors. As mentioned on ISA 200, para. A57 and ISA 320 para. A2), they may be anticipated to provide a broader-ranging scope of services such as to requirement of law, regulation of other authority (ministerial directives, government policy requirements, or resolutions of the legislature.



- *Figure 14 Proposed five-stage materiality decision processes in Islamic financial institutions (Source: Adapted from Brennan and Gray (2005) and developed by the author)*

Stage 2 - After enacting the law, preparer (IFI management) and auditor abide by the legislated threshold of materiality to apply in preparing and in auditing the financial statements, respectively. Meaning that, instead of choosing the level of materiality independently, the preparer is obliged on embarking and maintaining the legislated materiality for entire fiscal year.

Similarly, the auditor will learn and employ the legislated materiality to apply in audit testing and opinion formation. It is believed that the auditor could work effectively in future as Brennan and Gray (2005) highlighted that "materiality is critical in determining the amount of work carried out during the audit. It also influence the nature of the audit opinion".

Stage 3 - At the designation process, the assigned auditor will corroborate the legislated materiality threshold applied by the preparer. This is to ensure that either the client or the assigned auditor fall under the same threshold specified by the law.

In the context of common practices, Nelson, Smith, and Palmrose, (2005) found that "…auditors are more likely to require their client to book the misstatement under the approach that makes the misstatement appear more material". Accordingly, it is possible there is a 'negotiation' between the assigned auditor and the client in the determination of materiality level (Gibbin, McCracken, & Salterio, 2003). By the use of the framework, it may prevent the above allegation.

Stage 4 - Thereafter, the client prepare and produce the financial statement for audit. During the audit process, the auditor might be faced with error and (or) fraud in the field. In case of error, it is obvious that the auditor will ask the management to render certain adjustments.

It is significant to note that the laws may give a two-sided safeguard for the appointed auditors. On one side, the auditor could keep silent in the name of confidentiality of the client on the assumption the law is silent or absent. On the other hand, the auditor may cooperate to protect public interest and communicate the finding(s) when the law specifies them to do further actions (IAASB, 290, ISA 240 para. A65-A67). Therefore, the law should provide the soundest mechanism for the assigned auditor to initiate a report.

Stage 5 - At last, the auditors assess whether any adjustment (or even worse audit opinion qualification) is required. This leads to the materiality decision process that embrace broader horizon within Islamic Financial Institution.

5. Conclusion

This study employs Islamic view on deliberating the concept of materiality. It reveals that the concept of materiality in the Islamic point of view is not solely related to user's economic value, yet, beyond that, it works in parallel with divine values.

In terms of application of materiality, this study mainly makes references to the Maqasid al-Shariah and Maslahah Mursalah whereby the preservation of wealth is the primary concern. It is found that the Shariah could be stringent and at the same time be less strict on making rules of materiality. Even so, the Shariah puts emphasis through several conditions and stages so as to ensure, protect, and benefit from the wealth legally and justly.

The study also exhibits that it is highly possible to achieve uniformity and reduce the gap of materiality threshold while the employed general principles could be derived from the holistic value. However, it would be meaningless as it is not accommodated under both moderate legal systems i.e. Shariah and the regime in which an organization is operating and complying with. In the discussion of Islamic jurisprudence, Islamic banks and other organizations are treated as a fictitious person. Several hukm which arose from this study may not be implemented fully due to the assertion. Even so, the presence of IFI is very dependent on the local government as it comes into the scene as a legal person.

The commencement of this study could not be separated from the scarce source of materiality concept from Shariah outlook. In other words, limitations of this initial discussion on materiality are undeniable. This study also is limited on developing legal reasoning over materiality, instead of testing numerical constructors of formula suggested by Lakis and Masiulevičius (2017).

Several suggestions could be conducted in the future. For instances, re-examining the presumptions of legal reasoning that comes to light in this study along with its legal, Shariah, accounting and auditing issues. Afterwards, conducting a test to examine the underlying trivial misstatement and planning materiality by putting each component into the formula invented by Lakis and Masiulevičius (2017). As consequences, it is very possible that the result should be compared with actual practice in the IFIs. Furthermore, since the Shariah is not made impossible and beyond capability of subject of the hukm (Al-Shatibi, cited from Masud, 1995 p184), it is worthy to conduct a research that reveals the altitude or the ceiling capability of Islamic Financial Institutions and auditing service provider firms in terms of fiscal matters, time, and other relevant resources. Therefore, future and further discussion to present high-level assurance of financial statements' information particularly and with regard to Islamization in general is inevitable and extremely expected

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PEER-REVIEWED

Reconstruction of Islamic legal thought in 21st Century: Analysis of AAOIFI's approach in legal reasoning

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The importance and significance of Ijtihad i.e. independent reasoning in reconstruction of legal thought in Islam can hardly be overemphasized. Ijtihad has played a significant role in the development and expansion of Islamic law in the early period of Islam especially between eighth and tenth centuries. The Muslim jurists of this period greatly and effectively contributed towards the enrichment of Islamic law through the use of rational and logical modes of opinion anchored in the sources of Quran and Sunnah sustained by the spirit of Ijtihad. They exercised independent reasoning to seek solutions to every given existential problem confronting Muslim Ummah, and formulated rules for new situation derived from the principles laid down in the Quran and the Sunnah. Thus, they generated a rich Fiqhi tradition characterized by constructive variety of opinions. However, in subsequent periods of Islamic history, especially during the periods of decline of Muslim rule, the interpretative activity slowed down till it reached the point when the scholars of different legal scholars felt that all essential questions had been thoroughly and finally settled. Consequently, a great deal of future legal and interpretative activity became limited to taqlid (imitation) and dedicated to replacing and applying the doctrines of accepted scholars and authorities. Hence, some scholars declared the "closing of the door of Ijtihad". As a result, the interpretative activity in the Islamic world appeared to remain suspended for centuries. This was the situation which led the celebrated Muslim scholars of twentieth century like Dr. Muhammad Iqbal to invite Muslim scholars to revive the activity of Ijtihad in the Islamic world so that the Islamic law could keep pace with the changing needs of the society.

Keywords: Reconstruction of Islamic legal thought, AAOIFI›s Shariah Standards, Ijtihad, Methodology of deriving Ahkam, Hiyal.

In the last three decades of twentieth century, Muslim ummah witnessed emergence of an intellectual movement for revival of Ijtihad and reconstruction of Islamic legal thought in the Muslim society. As part of this movement, a number of Fiqh councils and institutions such as OIC's International Fiqh Academy, World Muslim League's Fiqh Academy, European Fiqh Council, Auditing and Accounting Organization of Islamic Financial Institutions (AAOIFI) emerged in different territorial jurisdictions that effectively contributed in the movement for the expansion and enrichment of Islamic law to cater to the changing needs of the Muslim society. Collective intellectual deliberations and discourses on legal problems facing the Muslim society started throughout the Islamic world. It is pertinent to note that the present day legal problems are so complex and diverse that their solutions may not always be found in doctrines of classical schools.

Cognizant of this fact, the modern Fiqh councils and institutions do undertake the task of Ijtihad through collective efforts exploring solutions to existential problems from different schools of law without binding themselves with a particular school of thought. Thus, these Fiqh councils and institutions have developed a new methodology for the present day Ijtihad activity, different from the one suggested by old jurists.

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AAOIFI is one of such prominent Fiqh institutions which has a significant contribution to the revival of Ijtihad and the renewal and expansion of Islamic law in the field of Fiqh al-Muamalat i.e. contracts, transactions, Islamic banking, insurance, capital market etc. After the Ottoman code of civil law known as Al-Majallah, AAOIFI's Shariah standards are perhaps the first comprehensive compendium of commercial law that covers broad spectrum of issues of Fiqh al-Muamalat. Contrary to the methodology of Al-Majallah, the present compendium accommodates all the Fiqhi schools without confining itself to a particular school of law. AAOIFI is not bound in its legal opinion by a particular school nor does it follow methods and principles of Ijtihad of a particular Fiqhi Madhhab. Thus, it works as an independent Mujtahid both in Usul (principles and methods) and Furu' (derived rules). It has developed a methodology of legal reasoning different from the methodology of classical jurists. It has introduced many new principles of Fatwa and modes of Ijtihad not contemplated and employed by the classical jurists in their legal opinions. Because of the robust methodology and well-thought-out opinions and rulings, AAOIFI has received wide acclamation and unprecedented recognition by the Muslim ummah during the last few decades. In some spheres and jurisdictions, the rulings of AAOIFI have assumed the status of binding verdicts, a status that is generally assigned to court's judgment and legal statutes.

This paper intends to study and examine the methodology of AAOIFI in legal reasoning (Ijtihad) and issuing legal opinion (Fatwa). It also discusses characteristics of AAOIFI's Ijtihad and Fatwa by comparing modes and principles of Fatwa observed by AAOIFI with the modes and principles employed by the classical jurists. The article has been organized in two sections. Section 1 deals with the characteristics of AAOIFI's Ijtihad and Fatwa, while section 2 explains and analyzes methods and principles of Fatwa.

Section 1: Characteristics of AAOIFI's Ijtihad and Fatwa

AAOIFI's Ijtihad in Shariah standards has many distinguishing features which make its verdicts and their underlying methodology different and distinct from the methodology and rulings of classical jurists.

Three main attributes are discussed here.

1- Collective and institutionalized Ijtihad

In the past, Ijtihad was predominantly a private activity. A mujtahid would undertake Ijtihad in his individual capacity which was accepted on its individual merit based on the strength of evidence. AAOIFI's Ijtihad and Fatwa is a product of a collective intellectual endeavor by a group of qualified jurists who collectively deliberate on legal issues and derive juridical rulings from different sources of Shariah in the context of prevailing circumstances of the society. This form of Ijtihad obviously carries more weight and authority than the Ijtihad undertaken by a Mujtahid, in his individual capacity. Collective Ijtihad derives its legitimacy and authority from a Hadith of Holy Prophet (PBUH). Hadrat Ali (May Allah be pleased with him) narrates that he asked Holy Prophet (PBUH): "If we confront as issue (legal issue) on which we do not find any prescriptive or proscriptive injunction in the Quran and Sunnah, then what is your instruction for us". He replied: "Consult the pious, (God fearing) jurists (Fuqaha abidun) and do not enforce individual opinion."[2]

The Hadith requires that in novel and complex situations, recourse should be made to collective and consultative Ijtihad. Such Ijtihad should be practiced by the pious and God-fearing scholars who are competent and qualified for the task of Ijtihad. Individual Ijtihad should not be implemented in such situation.

The rightly guided Caliphs strictly followed this instruction. Maymun Ibn Mehran reports about Hadrat Abu Bakr (RTA) that when a legal question was presented to him, he resorted to the Quran. If he did not find solution in it, he looked into Sunnah. If he did not find applicable text of the Quran or Sunnah, he gathered the jurist-Companions and consulted them about the matter. If they agreed on a rule, he decided the case by it.[3]

Hadrat Umar (RTA) also practiced the methodology of collective and consultative Ijtihad during his rule. Hadrat Umar Ibn Abdul Aziz (May Allah's blessings be on him), as a governor of Madinah, constituted a committee of ten eminent Shariah scholars to deliberate collectively on the legal issues presented to them and to provide legal Fatwa with consensus opinion.[4] Imam Abu Hanifa's Fiqh council consisting of fifty prominent Shariah scholars is also an example of collective and consultative Ijtihad.[5] Unfortunately this practice remained suspended for many centuries.

2- Al-Haithmi, Majma ʿ al-Zawaid, Berut: Dar ul Kitab al- Arabi, 1982, vol 1, p.178.

3- Ibn al-Qayyim, I'lam al-Muwaqq'in, vol, 1, p. 62

4- Darmi, al-sunan, Multan: Nashr ul Sunnah, Jami Bayan ul Ilm wa Fazlihi, vol,2, p. 80.

5- Muwaffaq Makki, Munaqib al-Imam al-A'zam, Quetta Maktabah Islamiyyah, 1407 vol,2, p. 24.

AAOIFI's Ijtihad and Fatwa is a classic example of collective and consultative Ijtihad instructed by the Holy Prophet (PBUH). Shariah standards (Shariah verdicts) of AAOIFI are product of collective deliberations by the Shariah Board comprising Shariah scholars well versed with Fiqh al-Muamlat. The practitioners and finance experts also participate in the deliberations to assist the Shariah scholars to comprehend the issue under study. They, however, have no role in issuing Shariah verdict. A particular Shariah standard passes through a thorough consultative process till it is adopted by the consensus or majority opinion. AAOIFI explains this process in the following words:

> "The development process is carried out through more than ten stages, commencing with the commissioning of consultants to prepare the exposure drafts. The exposure draft is then submitted to the respective Shariah standards committee which discusses and reviews it, and then forwards it to the Shariah Board to further discuss and review it, coming up with the draft standard. The draft standard is then presented at a public hearing (one or more) where the Islamic finance institutions can discuss it with Fuqaha, experts and professionals hailing from these institutions in order to make certain the draft standard is meticulous and of high quality, covering all practical aspects and emerging practices faced by the industry practitioners. The remarks and comments presented at the public hearing are discussed by the Shariah Board to introduce the changes it deemed suitable and finally adopt the standard. At this stage, the standard is presented to the drafting committee to edit its text for publication."[6]

Thus, it is a collective and consultative Ijtihad both in its form (process) and the substance (derived rule).

2- School non-specific Ijtihad or Ijtihad beyond school boundaries (Ijtihad La Madh'habi)

In pre-modern period, mujtahid or mufti belonging to a specific school, was bound to give legal opinion (fatwa) on the basis of principles (Usul) formulated by the founders of his school and in conformity with the popular and acknowledged opinions of the elders of the fiqhi school. He was not allowed to deviate from this methodology except under dire necessity. Ibn Abidin Shami writes: "Our considered opinion is that when Abu Hanifah and his two disciples agree on an opinion, it is not permissible to deviate from it except under necessity"[7]. AAOIFI has deviated from this popular trend and practice in Islamic legal history. It treats all schools of law as one school. No Madhhab or school has any precedence over other Madhhab. AAOIFI borrows from all these schools. This approach has been approved and endorsed not only by the leading modern Shariah scholars but also by some prominent Fuqaha of pre-modern period.

Renowned Hanafi jurist Ibn al-Humam in Al-Tahrir writes: "A Muqallid (non-mujtahid) has the right to follow any opinion he wishes. To follow easy view from different views is permissible. No evidence from revealed sources or reason is available to prohibit such practice".[8]

Prominent Maliki jurists Imam Qarafi writes: "It is permissible to practice the concessions of different schools, because no Shariah evidence proscribes it. Every person wants to practice what is easier for him to practice".[9]

Prominent modern Shariah scholar Dr. Wahbah Zuhaili writes: "In the field of muamlat (civil transactions), it is imperative to borrow from each school and adopt the opinion that serves most the interest of people and their wellbeing even if this practice entails talfiq i.e. eclecticism.[10]

Zuhayli does not find any Shariah justification for prohibition of borrowing between schools. He writes: "The assertion that Shariah forbids talfiq and eclecticism" is against the Shariah principle that suggests that "Difference of opinion among Ummah is mercy". It also contradicts the principles of ease, and removal of hardship on which Shariah Ahkam are built".[11]

Moulana Rashid Ahmad Gangohi, a renowned religious scholar of the subcontinent observed, "Contemporary legal issues have become complex. As a result, faith sensitive and God-fearing people are in difficulty. I suggest that in the field of civil transactions and sale and purchase transactions Fatwa may be issued on the easiest opinion of Fiqhi schools".

Moulana Khalid Saifullah Rahmani, another leading scholar of the sub-continent says:

"If the Muslim society in certain period suffers from difficulty by acting upon a particular opinion of a school, such society is allowed to act upon the

6- Shariah standards, introductory part, introduction by Dr. Hamed Meerah.

7- Rasm al-Mufti, p.70

8- Ibn Humam, Fath-al-Qadir, Beirut, Dar al-Fikr vol, 07, p.758.

9- Al-Qarafi, Anwar al-buruq fi anwa'al-furuq, Beruit: Dar al-Kutub al-Ilmiyyah, 1481H, vol 7, p.48.

10- See, Zuhayli, Usul al-Fiqh al-Islami, Beruit: Dar al-Fikr 1406H, vol, 02, p. 1155.

11- Ibid, p.1155.

ruling of other school that may remove hardship from them and bring ease and facilitation for them"[12]

The methodology of AAOIFI in Ijtihad and Fatwa is school non-specific. AAOIFI scholars do not confine themselves to a particular school. They freely move between schools and choose from relevant opinions the one best suited to the needs of time. The fatwa regarding binding nature of unilateral promise, for instance, is based on the opinion of Ibn Shubrumah, a Maliki jurist. Fatwa on mandatory charity originated in the opinion of Muhammad bin Ibrahim bin Dinar Maliki. The permissibility of earnest money sale is based on Hanbli opinion. This methodology and AAOIFI's Fatawa based on this methodology will be discussed in detail in next section.

3- Specialized Ijtihad (Ijtihad Takhassusi) based on the notion of Tajazzu al- Ijtihad

A distinct feature of AAOIFI ijtihad and fatwa is that it is a specialized ijtihad and fatwa. It is not a general ijtihad. It is specific to Fiqh al Muamlat. The scholars participating in this ijtihad are required to have attained mastery over the field of Islamic law of commercial and financial transactions. The concept of Tajazzu al-Ijtihad or compartmentalization of ijtihad derives its legitimacy from the opinions of some classical jurists (Fuqaha) and Theorists (Usuliyyun) who allow ijtihad in particular branch of Islamic law to the exclusion of other branches. It is pertinent to note that the Fuqaha allowing field specific ijtihad have not practiced this form of Ijtihad. This is for the first time the concept has been translated into reality under the umbrella of AAOIFI.

Here are some views of classical jurists on Tajazzi al-Ijtihad. According to Ibn-al-Qayyim (751H) if mujtahid does not fulfill all conditions of ijtihad in different fields, but he is specialized in one particular field, he is eligible to undertake ijtihad in that field[13]. This goes without saying that Specialization in Fatwa and ijtihad (Tajazzi fi al-fatwa wal-ijtihad) is solution to the problems of this age. According to Amdi (631H), if Mujtahid has enough knowledge regarding certain matter (subject) and does not know about other fields of knowledge he is allowed to undertake Ijtihad and that his ignorance of other fields will not affect his ability of Ijtihad, because it is not necessary for a Mufti to know about all the fields.[14] Imam Razi (606H) says that if one fulfills the stipulated qualification of a mujtahid, he is Mujtahid, but if he fulfills qualification of Ijtihad in a specific subject, it is permissible for him to make ijtihad in that specific subject.[15] AAOIFI Shariah standard in this regard mentions that issuing fatwa to institutions does not require competence in all areas of Fiqh. Fatwa can be issued by a scholar who is competent only in the area of financial transactions performed by institutions.[16] AAOIFI though this specialized Ijtihad has been able to successfully develop and formulate a comprehensive Shariah and universal Shariah based civil code for the whole Muslim world.

Section 2: Principles and methods of Fatwa

In this section we will study and analyze AAOIFI's methodology in deriving ahkam from the Quran and Sunnah. We will also discuss principles and methods employed by AAOIFI in ijtihad and fatwa.

1- Methodology in deriving Ahkam from the Qu'ran and Sunnah

AAOIFI in giving legal opinion (fatwa) resorts first to the primary sources i.e. the Quran and Sunnah and constructs fatwa on the texts that have explicit indications, and interprets the text according to acknowledged principles of interpretation (Tafsir al-Nusus) and rules of derivation Qawaid al-Istinbat). AAOIFI's methodology in deriving rules from the Quran and Sunnah has been explained in Shariah standard no. 29 "Stipulation and Ethics of Fatwa in the institutional framework". Article 7.1 states: "Fatwa should basically be founded on what has been explicitly stated in the Quran and the Sunnah". Article 8.1 prevents from assigning remote interpretations to sacred texts. It states: "Assigning meanings to the text that go contrary to the principles of interpretation of text, contained in Usul Fiqh (Tafsir al-Nusus) and rules of derivation (Qawaid al- Istinbat) or, on unattested and unestablished Ahadith, should be avoided". Article 7.2 prevents a Mufti from issuing Fatwa which is not supported by proper Shariah evidence, or which conflicts with explicit texts of the Quran in terms of indication (Sarih al-Dalalah) or the general principles derived from the Quran & Sunnah.

12- Rehmani, Khalid Saifullah, "Islamic Fiq Academy India: Naye Masail k Hal k Silsilay mai Uska Nuqtai Nazar, Tareeqi Kar aur Khidmat", in Tahir Mansuri, Ijtemai Ijtehad, Tasawur, Irtiqah aur Amali Sooratain., p. 256.

13- Ibn al-Qayyim, I'lam al-Muwaqq'in, Cairo: Idara al-Tiba'an al-muniriyah, vol 2, p.35. Also See, Abu Zahra, Usul al-Fiqh, Cairo: Dar ul Fikr, p. 274.vol,4 p,1376

14- Al-Amdi, al-Ihkam fi-Usul al-ahkam, Beirut: Al Maktab al Islami, vol4, p164

15- Razi, Al-Mahsul, KSA; Maktabah Nazar Mustafa Al-Baz ,1996, vol,04, p.1376.

16- AAOIFI (2010), Shariah standard no. 29, Article 5/2

The above provisions explain the methodology of AAOIFI in dealing with the Quran and Sunnah for the purpose of deriving Ahkam from these sources.

AAOIFI accepts every authentic and established Hadith regardless of whether it is Solitary narration (Khabr wahid) or a continuous narration (Khabr mutawatir). It also does not stipulate for Khabr wahid that it should be consistent with general rules (Qawa'id Ammah). Thus, AAOIFI upholds the supremacy of Sunnah in its legal verdicts. Many instances of the supremacy of Sunnah can be cited from Shariah standards.

Shariah standards on Murabahah and Guarantees give the creditor in credit sale to get back sold asset from the client / debtor if he becomes bankrupt and the asset is still in its original form and has not been altered. (See, Art. 7.9.7, Shariah standard No. 5: Guarantees).

This ruling or fatwa is based on a Hadith of Holy Prophet (s.a.w.s): "If one sells commodity and the owner therefore becomes bankrupt, and then he finds it without being altered, he has priority right over the creditors". [Bukhari, Sahih, Hadith no. 2402; Muslim, Sahih, Hadith no. 1559]

The Hanafi jurists do not act upon solitary tradition if it does not meet conditions prescribed by the founders of the school. In their opinion, a solitary tradition which conflicts with the general rules, is unacceptable. The general rule implies that the commodity should not be taken out of the ownership and custody of its owner. The commodity, through sale contract, has moved into the ownership and liability of the buyer. Now to take it back from him is to deprive him of his ownership right. The Hanafi jurists interpret this Hadith and apply it to a situation where the commodity is in the custody of another person as commodate loan (Ariyah) or deposit (Wadi'ah). Some Hanafi scholars assert that the Hadith applies to a situation where the buyer becomes bankrupt before he takes possession of commodity. The fact of the matter is that Hadith is very clear in giving creditor right to repossess in case of insolvency of the debtor. AAOIFI heavily relies on authentic traditions. Many of its Fatwas are directly based on the Sunnah of Holy Prophet (s.a.w.s).

2- Methods and principles of Ijtihad and Fatwa

As stated earlier, AAOIFI has not only contributed to the development and enrichment of Islamic law on Muamalat, but also to the revival and reconstruction of Usul Fiqh and methodology of legal reasoning. Thus, it has undertaken ijtihad not only in the applied fiqh but also in the theory of Usul i.e. methods of legal reasoning and principles of construction of fatwa. It has, for the first time invoked Maqasid al-Shariah as a source of fatwa, which were so far, unutilized for fatwa and were on the margins of the legal theory of Usul. AAOIFI has also introduced Qawaid Fiqhiyyah as source in the traditional books of Usul. Many Fatwa of AAOIFI are based on Shariah maxims. AAOIFI, has also used some Fiqh al-muamlat specific principles for fatwa such as the original rule of permissibility in contracts and transactions. This principle has been frequently employed by AAOIFI in its legal opinions. Avoidance of Hiyal (subterfuges and stratagems is a permanent policy principle for fatwa. In Shariah standards, Hiyal have been strictly discouraged. AAOIFI has not referred to Hiyal in Shariah standards in passing but has given detailed list of possible Hiyal practices throughout Shariah standards which signifies its concern for Hiyal and its adverse and harmful implications for the industry.

In the following line, we will discuss prominent and popular methods and principles used by AAOIFI in its legal opinion (fatwa).

1- Eclecticism or eclectic choice (Takhayyur, Talfiq)

It is the most popular and prominent method practiced by AAOIFI in its legal reasoning. AAOIFI chooses from variant juristic viewpoints the one which is more suited to the need of the society considering ease, facilitation and removal of hardship. The Shariah scholars of AAOIFI in the search for relevant legal opinion, move freely between schools and do not confine themselves to a particular school. From this aspect, AAOIFI acts as Mujtahid tarjih i.e. a mujtahid who uses his skills and expertise to decide about the preferred opinion from various juristic opinions on the issue. The methodology of AAOIFI in selecting one view from different views, is different from the classical concept of Ijtihad Tarjih. The Ijtihad Tarjih or ijtihad for the purpose of choosing preferred view for fatwa in classical period, was confined to a single school. A mujtahid used to examine views of the masters of his school and would decide about the preferred view of the school. The preference activity undertaken by AAOIFI goes beyond school boundaries.

Some Shariah scholars in subcontinent entertain doubts about the permissibility of this methodology. They consider it in nature of following one's caprice and whim. An objective examination of the methodology of eclecticism reveals that early fuqaha also practiced eclecticism. Many a times they abandoned their school on a particular issue and gave fatwa according to the acknowledged opinion of another school. Their prime consideration in this departure from their school was removal of hardship and realization of public interest. Here we cite some examples. The early Hanafi jurists did not allow charging fee for teaching Quran because they considered it a religious duty of the teacher for which he could not seek remuneration. The later Hanafi jurists of 18th and 19th century, keeping in view the changing needs of time, and in the best interest of religion, abandoned the ruling of their predecessors and ruled in favour of charging fee for teaching of Quran. In the same way, they allowed remuneration for leading obligatory prayers.[17]

In recent past, the Hanafi jurists of sub-continent endorsed the position of Maliki school on dissolution of Muslim marriage and adopted a law based on Maliki opinion. In Hanafi law a woman cannot apply for judicial separation on grounds of non-payment of maintenance by the husband, while according to Maliki law, she is admitted for dissolution of marriage through the court of law. The Dissolution of Muslim Marriage Act, 1939, originally proposed by the Hanafi scholars, contains many such grounds which were not recognized as valid grounds of dissolution of marriage in the Hanafi law. This is an evidence of the fact that jurists do not prohibit from moving between the schools.

The jurists have, however, laid down certain conditions for eclecticism and moving between schools:

1. It should not go against some established ijma i.e. consensus of jurists.
2. It should serve public interest.
3. It should not be result of one's whims and caprice.

The last rule can be explained by the help of following two examples:

- In Shafi'i school, when a person sells a house, his neighbor cannot invoke his right to first buy or refuse (pre-emption right) because Shafi'i school does not acknowledge this right (pre-emption right) for neighbors. The Hanafi school, on the other hand gives right of pre-emption to neighbors. Now it would not be lawful for a person to invoke pre-emption right when a house is sold in his neighborhood acting upon Hanafi opinion, and refuse this right to his neighbor when he himself sells house acting upon Shafi'i law. Hence we observe that he has taken two contradictory positions on the same issue. In first case, he acts upon Hanafi opinion and in second case, he acts upon Shafi'i School. This is clearly a case of personal whims and caprice.
- A person divorces his wife thrice in one session and treats it as a single repudiation. He divorces his other wife in the same manner but treats it as irrevocable divorce of major degree. This is not allowed. He is under obligation to treat both the cases in a similar manner. The lenient rule adopted by him in the first case should also be applied to the second case.

17- See Ibn Abidn, Sharh Sharh Uqud Rasm al-Mufti, 1/29

Some Ulama have laid down some extra conditions for validity of eclecticism and moving between schools for the purpose of selecting a lenient view:

1. The purpose of adopting lenient view of other school should be to remove severe hardship.
2. The permission to adopt lenient view and concessionary rule of other school should issue forth from the experts of Shariah, and the people of upright character. They should have done this through collective Ijtihad.

Here we discuss some examples of methodology of borrowing between schools and selecting a particular opinion for fatwa on the basis of ease and facilitation and removal of hardship, Sadd al-dharai (blocking the means to evil) commercial urf, practiced by AAOIFI.

a. Benefit from the pledged property

Hanafi scholars allow the creditors to benefit from pledged property with the permission of debtor, the owner of property. Hanbli jurists prohibit this benefit even with the consent of owner, the debtor. The Shariah standard on Guarantees on the basis of Sadd al-dharai has opted for the opinion of Hanbli jurists.

b. Fixation of period for repayment of loan.

Hanafi and Shafi'i jurists do not allow fixation of period for repayment of loan. In their opinion, Qard (loan) is basically an exchange of money for money. The hadith on exchange of money for money requires that exchange should be hand to hand. But this requirement is ignored keeping in view the need of people. So non-simultaneous exchange in case of loan is permissible, however, period of repayment cannot be fixed. According to this view, the lender can demand his amount any time he wants, even if the period for repayment is fixed in the contract. According to Maliki jurists, loan is a form of dayn which is recommended to be for a "fixed period" as mentioned in the verse 282 of Surah al-Baqarah. Shariah standard on Qard has preferred the opinion of Maliki school, over other opinions. Article 6 of Shariah standard no. 19 (Qard) states: "It is permissible to stipulate a period in Qard. The borrower is, therefore, under no obligation to return it prior to the termination of the period nor can the lender demand it back prior the end of the period. It, however, no period is stipulated, it is binding upon the borrower to return it"

Here we observe that the convenience of the people and the prevailing usage has been taken into consideration in choosing Maliki view of Fatwa.

c. Binding status of promise

According to the majority of Muslim jurists, promise is not judicially binding and enforceable. According to some Maliki jurists, promise is legally binding and enforceable if the promisee has incurred some financial liability as a result of that promise. This last opinion is suited most to modern day commercial transactions and activities. AAOIFI has issued Fatwa on the basis of Maliki opinion. Thus, Maslahah and benefit of the society have been given consideration in in this Fatwa.

d. Stipulation of exemption from defect of the sold goods.

According to Hanafi and Shafi'i jurists if a seller stipulates in the sale contract that he will not be responsible for the defect in the commodity, such stipulation is permissible and has to be honored.[18] By putting such condition he in fact, wants the buyer to exercise due diligence and proper vigilance while buying goods. According to Maliki and Hanbli jurists such stipulation is not valid. Keeping in view, the prevailing custom, and need for stability of contracts, AAOIFI has allowed sale with the stipulation of exemption from the liability of defect. This however applies to a situation where the seller himself was not aware of the defect in the goods at the time of sale.

2. Avoidance of Hiyal (stratagems) in Fatwa

Hilah literally means an artifice, device and stratagem. Technically, it may be described as the use of legal means for extra-legal ends that could not, whether by themselves legal or illegal, be achieved directly within the means provided by the Shari'ah. Thus, Hiyal (legal artifices) constitute legal means, by which one can arrive at judicial results otherwise prohibited by the law."

Unlawful Hilah (singular of Hiyal) is used either to circumvent a prohibition, or to evade an obligation. An example of Hilah intended to circumvent Shari'ah prohibition on riba is Bay al-Inah. Bay' al-Inah is to sell a property on credit for a certain price, and then to buy it back at a price less than the sale price on prompt payment basis, both transactions take place simultaneously, in the same session of the contract.

The majority of Muslim jurists consider this transaction invalid, because the intended objective of the transaction opposes the objective laid down by the lawgiver. This form of transaction, in their view, is nothing more than a legal device, aimed at circumventing the obstacle posed by the prohibition of riba. It is a fictitious deal in usurious loan transaction, as it ensures a predetermined profit, without actually dealing in goods, or in sharing any risk.

A Hilah affected on a debt transaction is generally treated as unlawful hilah, because it intends to give some extra benefit to the creditor. Buy-Back Agreement (Bay' al-Inah) and sale with right of redemption (Bay bi al-wafa), belong to this category. A famous maxim states: "Hilah affected on debt is a Hilah for Riba". Some examples of Hiyal on debt transaction are: to mortgage a house with the creditor and allow him to stay in it, or to sell an object to the prospective debtor for an exaggerated price and then immediately lending him some money, or to buy from him certain commodity at a lower price, or to lease to him some asset, at a rental higher than its prevailing market rate.

Despite the fact that the word Hilah is a value-neutral word and it does not necessary mean subterfuge, playing around law, wile trick, deception, circumvention of prohibitions etc., nonetheless, this meaning and nuance is prominent, both in the classical and modern Islamic legal usages of the term. Ibn Taymiyyah explains that when the word Hilah is used unqualified, then it conveys the meaning of subversive Hiyal ie the legal devices whereby Shari'ah prohibitions are circumvented, like the legal devices used by Jews." Ibn al-Qayyim holds the view that in the common usage of Fuqaha', hilah means unlawful and reprehensible tricks.

Avoidance of Hiyal (Stratagems and subterfuges) occupies pivotal position in AAOIFI's methodology of legal reasoning (Ijtihad) and Fatwa. It is prominent policy principle for Fatwa which dominates the whole fatwa activity of AAOIFI. AAOIFI frequently alludes to the forms of Hiyal and warns against Hilah based fictitious transactions in Islamic finance industry. Some examples of the principle of prohibition of Hiyal in Shariah standards are as follows:

1. Shariah standard no. 8: "Murabahah to purchase orderer" identifies many situations of occurrence of Inah in Murabahah. This goes without saying that Inah is Hilah to circumvent the prohibition of Riba. Articles 2.2.1 to 2.2.5 exclusively deal with Hiyal in Murabahah.
2. Shariah standard no. 9 on Ijarah also identifies cases of Inah in Ijarah. Articles 3.3 and 3.4 deal with prohibited Inah in Ijarah. In sale and lease back, Shariah standard requires passage of reasonable period between the first sale and last sale with a view to avoid Inah.
3. In Istisna, AAOIFI verdict is that Istisna transaction should not be concluded in a way that they becomes a Hilah for Riba.
4. In the standard on Combination of Contracts, AAOIFI has prohibited many such combinations which may lead to Riba or Gharar.

18- Sarakhsi, Al-Mabsut Beruit; Dar al-Ma rifah, vol. 31, p 91

5. The standard on Tawarruq clearly prohibits the return of commodity to the first seller either through agreements, collusion or Urf, because it is a form of Inah
6. The standard on Shares and Bonds clearly prohibits two binding promises in futures and forwards, because this is Hilah to circumvent the prohibition of bay'al-kali' bil-kali (sale of debt for debt, or sale of one obligation for another obligation)

AAOIFI is so concerned about Hiyal that it has adopted prohibition of Hiyal as permanent principle for its legal opinions. It would not be out of place to mention here that AAOIFI does not oppose Makharij Shar'iyyah or genuine alternatives: "that do not frustrate the Maqasid al-Shariah, do not lead to mafsadah (evil consequences) or conflict with clear Shariah evidence".

3. Observance of Maqasid al-Shariah

AAOIFI recognizes Maqasid al-Shariah as a source of fatwa beside other sources. In a number of its rulings, it has relied on Maqasid i.e. Maslahah, wellbeing of the society, values of justice and fairness in transactions and has issued value-oriented judgments and verdicts. AAOIFI rules that: "if the lease asset is destroyed or if the continuity of the lease contract becomes impossible up to the expiry without the cause being attributable to the lessee in either case, then the rental is adjusted based on prevailing market value. That is the difference between the prevailing rate of rental and the rental specified in the contract. This difference must be returned to the lessee if the latter rental is higher than the former. This is to avoid loss to the lessee who agreed to higher rental payment compared to the prevailing rate of rental in consideration of the lessor's promise to pass the title to him up to expiry of the lease term".[19]

Here we observe that it is a value-oriented verdict meant to avert harm from the lessee and to uphold justice in transactions. The Shariah standard on Istisna'a providers in construction contracts that the loss of constructor will be compensated in intervening contingencies (force majeure), through agreement, or arbitration.[20] In many standards, aversion of harm has been prime consideration of AAOIFI in fatwa. Shariah standard on Ijarah provides that Ijarah continues even after expiry of lease period when the lessee suffers harm if terminated immediately with expiry of lease period such in case of late arrival to the place intended in the lease of the transportation vehicle, or in the case of late harvesting of crop land leased for crop cultivation.[21]

AAOIFI's concern for aversion of harm to the parties is also observable in the standard no 36 on force majeure and its impact on obligations. This standard deals with the unforeseeable, contingent and extraordinary circumstances which make the performance of contractual obligation oppressive for the obligator and threaten him with exorbitant loss. In such circumstances the Shariah standard allows the parties to reduce oppressive obligation to a reasonable level, in accordance with the dictates of justice and equality the Shariah standard has identified four such instances in which contractual obligations may be refixed. (See, Art. 4, Shariah standard no. 36). Form this, we may conclude that the values of justice, equity and fairness have been fully observed by the AAOIFI in its fatwa and legal reasoning.

4. Principle of Sadd al-Dharai (blocking of ways)

The principle suggests that a mean which leads to an evil or an unlawful end, will be regarded unlawful, though it otherwise be valid and permissible. According to eminent scholar Hashim Kamali, the concept of Sadd al-dharai, is founded in the idea of preventing an evil before it actually materializes.[22]

Many of the verdicts of AAOIFI are based on the principle of Sadd al-Dharai. AAOIFI, for instance, does not allow customer's agency in Murabahah except under dire need, because such agency may pave way for fictitious Murabahah transaction. It does not allow the creditor to benefit from mortgaged property. Bay al-wafa has also been prohibited so that it may serve as a means for interest-based lending. AAOIFI has prohibited Salam and deferred Murabahah in modern paper currencies. It also does not allow to take remuneration on letter of guarantee. Sadd al-dharai is a widely practiced principle of fatwa by the Shariah scholars of AAOIFI.

5. Principle of original permissibility

This principle suggests that all beneficial transactions and stipulations in the contracts are permissible unless these transactions and stipulations have been explicitly prohibited by the Quran, Sunnah and valid Ijma. Thus, the principle is: Every transaction is permissible unless prohibited by clear Shariah evidences". It is an overriding principle of Fatwa practiced by AAOIFI. A considerable number of AAOIFI's verdicts and

19- Shariah standard no. 9: Ijarah & Ijarah Muntahia Bittamleek, Art. 8.8

20- 19 See Shariah standard no. 11: Istisna'a and Parallel Istisna'a, Art. 4.2.1

21- See, Shariah standard no. 9, Art. 7.2.5

22- Hashim Kamali, Principles of Islamic Jurisprudence, p. 394

rulings are based on this principle. According to a verdict, if client defaults, in payment of an installment on time, all remaining installments will become immediately payable. AAOIFI allows to insert stipulation in the contract that creditor bank is allowed to sell pledged property without recourse to the court. The stipulation that the Sani in Istisna contract will be responsible for maintenance of manufactured commodity has been held as a valid stipulation by AAOIFI. Replacement and substitution in Salam commodity with the consent of both parties, is also held as a valid stipulation.

On the basis of the principle of permissibility, AAOIFI has adopted many modern legal concepts for its Fatawa and verdicts. The Shariah standard on documentary credit is largely based on international trade and international legal regime on trade. Scholars at AAOIFI have borrowed all beneficial clauses and stipulation which did not contradict any explicit text of the Quran, Sunnah or valid Ijma (consensus). Article 2.4.4 of Shariah standard no. 14 on Documentary Credit states:

"Interpretation of the duties and obligations of the parties to documentary credit are subject to International Commercial Terms (INCOTERMS 2000) and practices for documentary credit (UCP 500) when reference is made to INCOTERMS in the sale contract and to UCP in documentary credit". Article 3.2.3 of the said standards emphasizes that such borrowing is subject to condition that this trade regime is contradictory to the specific rules of Shariah.

It states: " when the contract stipulates that its interpretation is subject to INCOTERMS (issue 2000) or the United Nations Convention in respect of the international sale of goods or any other reference, then such potential interpretation is circumscribed with a condition that it must not violate the rules of Shariah". In the same view AAOIFI has examined the law of commercial papers i.e. bill of exchange, promissory note and cheque and has largely declared it Shariah compliant except certain clauses that are contradictory to the explicit rules of Shariah. Here again, the verdicts of AAOIFI are based on the principle of original permissibility (Ibahah Asliyyah). AAOIFI has also benefited from modern concepts of legal and constructive possession in Shariah standard on Possession (Qabd) for documents e.g. bills of lading, warehouse receipts in the name of possessor, acknowledging his interest is tantamount to constructive, if the assets are ascertainable, and there is no hindrance i.e. the possessor is able to transact. Thus, we observe that AAOIFI, invoking the rule of original permissibility, has attempted to align its standards with the modern legal concepts.

It is pertinent to mention here that Federal Shariat court, Pakistan has also relied on the principle of permissibility in its verdicts and legal reasoning.

The basis of the rule of original presumption of permissibility is hadith of Holy Prophet (s.a.w.s) which states: "Muslims are bound by their stipulations except the stipulation that renders a prohibited thing permissible and a permissible thing prohibited".[23]

In line with the above Hadith Imam Ibn Taymiyyah says: "The acts and deeds of individuals are of two types: Ibadat (devotional acts) whereby their religiousness is improved and 'adat (transactions) which they need in their worldly matters. An inductive survey of sources of Shariah establishes that devotional acts are sanctioned by express injunctions of the Shariah. Thus, what is not commanded cannot be made obligatory. As for transactions, the principle governing them would be permissibility, and absence of prohibition. So nothing can be prohibited, unless it is proscribed by Allah and His Messenger". He also writes:

"Regarding contracts and stipulations there are two positions. The first states that, the rule in contracts and attached stipulations is prohibited (al-asl fi'l-'uqud wa'l. shurūt fihā. al-hazr), unless, the contract is specifically permitted by law. Many of the principles of Abu Hanifah exemplify this position. The second position is that the rule in contracts, and stipulations, is admissibility and validity, unless specifically forbidden and invalidated by text, or analogy. Our judgment is that the rule in contracts and stipulations is admissibility (al-asl fiha 'adam al-tahrim), so they are admissible, unless there is a proof of prohibition.

6. Qawaid Fiqhiyyah as a source of Fatwa

Qawaid Fiqhiyyah or Shariah maxims were never used by the classical jurists as a source of Islamic law or as a principle of legal reasoning (Ijtihad), nor has it been a part of the books of Usul Fiqh. AAOIFI has used Qawaid as basis of Fatwa in many of its verdicts and rulings.

AAOIFI, for instance, allows ignoring the rules of Urf in trading of shares where the assets of investee company are composed of tangible assets, cash and debt, and the tangible assets are in considerable quantity. This ruling is based on the Shariah maxim: "A matter that may not be ignored in independent contracts may be ignored in subsidiary contract". The standard on the rules of Gharar provides that "trifling Gharar not related to primary object is permissible". The standard makes distinction between commutative contracts and gratuitous contract. It does not allow Gharar in commutative contracts while it allows Gharar in gratuitous contracts. For this ruling, AAOIFI has invoked the

23- Tirmidhi, Sunan, Kitab al-Ahkam, Bab ma'Zukira an Rasool Allah (S.a.w.s) fi al-Sulh I, Hadith no. 1352.

maxim: "Gharar invalidates commutative contracts but does not invalidate gratuitous contracts". Considering the complexity of the legal issues in modern Muslim society, it is imperative that the list of principles to be used for fatwa and Ijtihad should be enlarged and expanded, to include a number of new modes and principles.

Significance of AAOIFI's juristic work and its implications

"The significance of AAOIFI's juristic work lies in the fact that it has standardized Islamic law of Muamalat for the Muslim society. The Shariah standards today have practically assumed the status of civil law for the Muslim society. AAOIFI's standards are in fact an extended, refined and updated version of Majallah al-Ahkam al- Adliyyah of the Ottoman regime.

AAOIFI has greatly influenced fatwa activity in Muslim society. Eclecticism and borrowing between the schools of thoughts has become a popular methodology of fatwa practiced by the fiqh institutions, in the Muslim society. This tendency has gained prominence and popularity especially in the Arab world.

AAOIFI has boosted the movement for standardization of Fiqh for Muslim world. Such standardization has already been achieved in the field of Halal food where specific Shariah standards have been developed and implemented. Islamic family law or Fiqh al-Munakahat has already been standardized through family law codes in the Muslim world. The distinct features of these codes are that its rulings and doctrines are very much identical in substance with each other. A similar approach may be observed in al-Fiqh al-Tibbi i.e. Islamic medical jurisprudence. There is a need that Fiqh in other fields should also be standardized under the umbrella of International Fiqh Academy. The proposed fields include Islamic criminal law, Islamic constitutional law and Islamic administrational law, International law, Fiqh of minorities etc. International Fiqh Academy may issue Shariah standards for each these fields on the pattern of Shariah standards for Muamalat and Islamic finance. The juristic work of AAOIFI has paved the way towards the development of a cosmopolitan, uniform and standardized Fiqh for the whole Muslim world.

AAOIFI has introduced a culture of respect and tolerance for all schools, the Fuqaha and their Juristic contribution. In the past, a Mufti of a particular school was not allowed to give fatwa according to the opinion of another school. The imitation (Taqlid) and bias for one's own school was so strong and pervasive that other school was treated as rival and opponent (Khasm). All the focus of a religious scholar was to establish the superiority of his school over other schools. It sometimes involved degrading of opponent school. Now after the advent of institutionalized collective Ijtihad, this tendency has been subsided and it is almost non-existent especially in the Arab world. There is a growing tendency in the Muslim world that Fatwa on complex and sensitive issues concerning the whole Muslim ummah should not be left to individual Muftis. It should be rather undertaken by the institutions of collective Ijtihad and fatwa. The reliance on the Fatawa of prominent Fiqh institutions has increased manifold in the last two to three decades. The role and relevance of individual Fatawa has significantly decreased. Perhaps the individual Fatwa in future will be confined to the field of Ibadat or some social matters concerning individuals in the society.

Some observations on AAOIFI's work:

While acknowledging the utility and significance of AAOIFI's juristic work, it seems pertinent to share some observations concerning AAOIFI's work. It may help the authorities to chalk out their course of action in future.

AAOIFI has issued 60 Shariah standards that cover a broad spectrum of issues of modern Fiqh al-Muamalat in Islamic finance. These Shariah standards have not been arranged according to any recognized academic scheme. There is a need that these standards should be arranged following some logical scheme. Presently they have been organized in a chronological order. The Shariah standards start with the standard of trading in currency then a standard on credit and debit card. This is not an appropriate arrangement. If we look at Majallah we observe that it starts with the formation of contract, offer and acceptance, valid, void and voidable contracts. This seems to be a logical scheme which facilitates the reader to understand the code and benefit from its various provisions in a systematic manner. Now that a great amount of issues of Fiqh al-Muamalat have been addressed by AAOIFI, the Shariah standards may be produced with proper organization into chapters and sections on the pattern of modern legal codes. The book may be divided into two parts. In the first part the principles of Ifta and Ijtihad observed by AAOIFI in its rulings may be provided.

For this purpose, the Shariah standard on Fatwa should be further strengthened to include the discussion on Hiyal, Makharij, Talfiq, Rukhas (concessions and relaxations) etc. These terms frequently occur in the Shariah standards but no explanation of these terms and their area of application have been provided by the AAOIFI. The Shariah standard on Fatwa and principles of Fatwa and Ijtihad should be given first and be treated as a preamble like a preamble of any constitution. The second part may consist of Shariah standards on different issues. This latter part should also follow some logical scheme for division into chapters and sections such as chapter on essentials and general principles of contract, chapter on modes of financing, chapter on guarantees, chapter on capital market etc. Following suggestions may also be taken into consideration:

1. Modern legal codes such as Contract Act, Transfer of Property Act, Partnership Act etc. contain illustrative examples in the body text of the code such illustrations facilitate the reader to understand the provisions in its true perspective. Many provisions of Shariah standards need illustrations by AAOIFI. This will close the door for arbitrary interpretations in different territorial jurisdictions.
2. An established principle of Usul Fiqh is that fatwa may change with the change of circumstances. In line with this principle, some Shariah standards may be revisited especially the standards on sukuk, shares and bonds. The present application of sukuk has raised many new Shariah issues which need clear Shariah verdict from AAOIFI. The benchmark of 30% for interest-based borrowing and lending may also be revisited in view of the fact that the companies now may obtain financing facility from Islamic banks instead of recourse to interest-based borrowing.
3. AAOIFI has gained credibility because of its original and true Shariah positions. Now if under market pressures, the true spirit of Islamic law and Maqasid al-Shariah are compromised, AAOIFI may lose its religious authority and credibility as a representative Fiqh institution of the Islamic finance industry.

Conclusion

AAOIFI has a very significant contribution to the development and expansion of Islamic commercial law that covers a broad spectrum of issues of modern commercial transactions such as civil contracts, trade, finance, banking, insurance, capital market etc. It has also addressed classical nominate contracts and attempted to align these contracts with modern needs. AAOIFI has also been concerned with the development and renewal of legal theory of Usul to enable it to respond effectively to the needs of Muslim society for finding solutions to Fiqhi issues and legal problems. While developing a new theory of Usul Fiqh, AAOIFI's focus has been on prohibition of Hiyal, observance of Sadd al-dharai besides other principles and modes. The above two principles, in fact, represent a negative list of principles of Fatwa.

AAOIFI has also observed Maqasid and supreme values of Shariah in its Ijtihad and Fatwa, which shows the concern of AAOIFI for promotion of value oriented Islamic finance. AAOIFI's verdicts have been widely acclaimed by the Shariah scholars and the practitioners of Islamic finance. Shariah standards of AAOIFI are a commendable effort for standardization of Islamic injunctions in the field of Fiqh al-Muamalat as well as for bringing uniformity in the doctrines and practices of Islamic finance industry in the world. The distinct feature of AAOIFI's work is consistency and absence of inherent contradictions in Shariah standards. AAOIFI has remained consistent in its position throughout its 60 Shariah standards issued so far which has added significant legal value to the global Shariah standards for the Islamic finance industry. The credibility of AAOIFI's juristic work owes greatly to its observance of purposes and objectives of Islamic law and preserving true spirit of Shariah in its rulings. If AAOIFI surrenders this approach in its verdicts, and makes compromises under finance industry pressures, it may lose its credibility and authority.

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PEER-REVIEWED

Running Musharakah – A realistic analysis of the contentions raised

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Abstract

While Islamic banking has grown it also has had its more than fair share of criticism from various circles. One such critique has been published in the Journal of Islamic Finance Accountancy (JOIFA) in volume 3, Issue 1 / with the title 'Running Musharakah-based working capital finance case study from Pakistan'. The purpose of this paper is to review the objections raised against the product of Running Musharakah (RM) in the above-mentioned paper with a detailed analysis of the reasons and evidences given to support the objections. The methodology adopted for this purpose is the review of the academic and Fiqh literature related to the mode of Musharakah, the author's own experience in the development and implementation of RM, review of industry practices and opinion of Shariah scholars regarding its structure. This paper aims to review and judge the correctness of the claims made against the product of RM by analyzing the strength of the evidences given. The paper limits itself with the viability and Shari'ah compliance of the product concept of RM and its implementation. It concludes that the RM structure has been found to be in compliance with Shari'ah rulings as outlined by AAOIFI, especially the two-stage profit ceiling (profit distribution mechanism) which is a valid condition and neither void nor a form of Hiba. The objections and claims which have been associated with RM either do not exist in reality entirely, or have been assumed by wrongly associating it with Shariah issues not directly related to the structure and practice of RM, either due to misunderstanding of such references or of the practice of RM. Keeping in view the both articles, the readers may like to form their opinion about the unique product innovated by Islamic banks in Pakistan.

Keywords: Running Musharakah, profit ceiling mechanism, AAOIFI, Shari'ah, Hiba, Murabahah

1. Introduction

Islamic banking is an evolving field, the last 20 years have witnessed a significant growth in Islamic banking and finance across the globe. The industry continues to see the proliferation, development and innovation of Islamic financial products across all of banking and non-banking finance. A major driver of this healthy evolution and innovation is the adaptability of Islamic finance modes to address financial issues of the current era. While Islamic banking has grown, it also has had its more than fair share of criticism from various circles. Objective criticism backed by verifiable evidences and research leading to improvement in service quality, product efficiency, compliance enhancement and other performance measures is the hall mark of all human progression. However, at the same time it is necessary to decipher criticism from objectivity to bring clarity to all the stakeholders.

One such product which has gathered quick acceptance among Islamic banks (IBs) in Pakistan is the product of Running Musharakah (RM). The

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Note from the Editor's desk

In the last Issue of the JOIFA [volume 3, Issue 1 / 2019], a paper namely, "Running Musharakah-based working capital finance - case study from Pakistan" was published. This paper namely, "Running Musharakah: A realistic analysis of the contentions raised" has been written as a rebuttal to the original paper. As indicated by the author of the original paper, its objective was to illustrate what practically is happening in the market at large (not specifically criticizing any bank in question or their respective Shari'ah scholars) in respect of the lately innovative Musharakah-mode-based product.

The editorial board believes that although certain peer review comments have not been properly incorporated by the author, this rebuttal is being published to allow a fair chance of sharing of the alternative views on the matter. The editorial board further believes the certain issues raised in the original paper e.g. (i) the issue of two stage profit sharing in which substantially there is no or virtually no profit sharing in the second stage, and (ii) the issue of accounting records and selection and application of appropriate accounting policies, etc. are not clear. However, the editorial board has allowed publishing the rebuttal paper with a conclusion to not encourage further discourse on this matter.

Of course, it is highly recommended that the matter is taken up by the Shari'ah boards of the respective institutions, the central Shari'ah board of the jurisdiction and the regulator that all the requisites of the product are accomplished to be legally Shariah compliant in their true spirit.

The aspect of proper financial reporting and keeping accounting records and the selection and application of the accounting principles for the product is a very important, which is closer to the theme of JOIFA. It has far reaching effects for this product as well as any future product offerings based on Musharakah and other participation modes to finance the micro, small and medium sized enterprises. Hence, the editorial board would welcome any research or technical papers on the subject.

product has been subject to criticism by some academic circles recently and a paper in this regard was published in this journal in volume 3, Issue 1 / 2019 of the AAOIFI with the title 'Running Musharakah-based working capital finance case study from Pakistan'. This paper is to review the objections raised against the product of RM in the above-mentioned paper with a detailed analysis of reasons and evidences given to support the objections. The methodology adopted for this purpose is the review of the academic and Fiqh literature related to the mode of Musharakah, the author's own experience in the development and implementation of RM, the review of industry practices and opinion of Shariah scholars regarding its structure. It aims to review and analyze the arguments given against the product. The paper limits itself with the viability and Shari'ah compliance of the concept of RM and its implementation. The operational level process of the product may differ from bank to bank and being out of scope of this paper is not discussed.

2. Brief history of the development of RM

RM is a product based on the mode of Shirkatul Aqd, much praised by scholars, academicians and bankers as the original mode of financing promoted by Islam. Islamic banking was relaunched in Pakistan in 2002 and received quick acceptance along with a strong market growth in a short period of time. During the initial years Murabahah, Ijarah and diminishing Musharakah have been the most favored modes for IBs as well as their customers for financing purposes. During this period continuous research and attempts were made to develop a product structure based on the concept of Musharakah which should be Shari'ah compliant, commercially viable, practical to execute and in line with the risk appetite of the depositors and IBs. Hence as early as 2004-2005 the first concept of RM was developed and presented in the Shari'ah Supervisory Board (SSB) meeting of one of the Islamic banks. However, as is the case with the usual product development process the product required further improvements before it could be made viable for market offering. After successive efforts, the structure of the product currently in practice was presented in 2010 and was approved by the SSB of the same Islamic bank. Subsequently the required SOPs, product programs, risk procedures, system development, accounting treatment, legal documentation, etc. were put in place and the product was available for market offering in 2011. The first transaction of RM was done with a local corporate on a test basis in 2011.[2]

Following this initial launch, the product was used selectively with large corporate clients for their working capital requirements. Within short span of time of this successful launch, the product structure was adopted by other IBs and approved by their Shari'ah boards. As of now, the same

2- Meezan Bank Limited Annual Report 2018 page 124. https://www.meezanbank.com/wp-content/themes/mbl/downloads/annualreport2018.pdf product structure has been adopted by around five full-fledged Islamic banks and around 11 Islamic banking windows. It can safely be stated that the product structure has been thoroughly reviewed and approved by the Shari'ah boards of all these institutions prior to implementation, Shari'ah concerns raised have been rigorously discussed time and again with practitioners as well as Shari'ah scholars. With the structure and process of RM being reviewed approximately by around 16 Shari'ah boards and about 50 Shari'ah scholars officially, it will not be wrong to state that it is the most Shari'ah reviewed and scrutinized product to be launched in the market. Even more so than Murabaha, Ijarah and Diminishing Musharakah (DM) based products, since the basic structures of these products never required any financial engineering to start with and were based on agreed structures implemented across the globe over the years, while RM was a completely new innovation with no previous studies, benchmarks or examples in any other jurisdiction.

3. Analysis of criticism and evidences put forward:

In this section we will review each of the objections raised against RM in the paper being analyzed, which we shall refer to as the Subject Paper (SP) for the purpose of brevity.

3.1. Profit sharing ratio not known in RM

The SP states in the 'Introduction': "Neither the capital (share) of the partners, nor the profit sharing ratio (PSR) is agreed / known at the time of agreement. This contradicts the AAOIFI's Shari'ah Standard (SS) on Musharakah [3/1/5/2 (2015; P.332, 357)] according to which PSR must be agreed while concluding Shirkah contract."

Two issues are identified in the above statements:

1. Capital share of the partners is not known / decided / agreed at the time of agreement
2. Profit sharing ratio of the partners is not known / decided / agreed at the time of agreement

Regarding the first issue we will discuss it later in this paper. As far as the second claim is concerned it is not factually correct. In the basic structure of RM, the profits are to be shared in two tiers one below the profit ceiling and the other above the profit ceiling. For below the profit ceiling, the ratio of profit sharing is agreed, at inception of Musharakah, to be pro-rata or as per the capital contribution of each partner. This is mentioned in the RM legal agreement that is signed between the customer and the bank before the start of RM. An extract from RM legal agreement of one of the bank's is as follows:

"At the inception of each Musharakah period it is agreed between the bank and the customer that the Musharakah profit below the profit ceiling amount will be distributed in the investment ratios. The profit amount above the profit ceiling amount will be distributed in the profit-sharing ratios as agreed in the Appendix C of the agreement."

Hence it is clear that when the RM agreement is signed at the inception of the Musharakah, the PSR is decided below the profit ceiling amount while concluding the Shirkah contract in RM. This leaves us with the issue of PSR over and above the profit ceiling rate. The paper itself states that such ratio is agreed between the bank and the customer while criticizing that this ratio is highly tilted in favor of the client, e.g. 99.999 and 0.0001 for the client and the bank respectively. Hence, the claim of not fixing the PSR does not hold its ground.

3.2. RM not complying with the statement of scholars

In the second section, the SP while discussing the rationale for RM makes a claim regarding Shaikh Taqi Usmani's statement regarding Musharakah for running finance. The paper states:

"While discussing the rationale of using Musharakah for running finance, Justice (R) Shaikh Taqi Usmani contended in his book (2000), that the borrowers in conventional system generally earn enormous profits and only a small part of that is given to the bank as interest…".

To support this statement again an example from the Shaikh Taqi Usmani's book is quoted as follows:

'As a result, "the profits of the enterprise is earned by the persons whose own capital does not exceed 10% of total investment in a business or project, while the people owning 90% of the investment, get no more than the fixed rate of interest".

The above statement has been mentioned by Shaikh Taqi Usmani in the introduction to the concept of Musharakah as a mode and not specifically while discussing the use of Musharakah for running finance. Shaikh Taqi Usmani has himself suggested the concept of RM as an alternate to Running Finance which has been discussed two chapters following this quoted discussion. No such text has been mentioned while discussing the concept of RM specifically as has been stated in the SP.

3.3. Extensive use of RM

The SP subsequently claims that the RM concept came into application in the years 2008-09 and now almost 25% of the Islamic bank (IB) financing is done through RM. This impressive proliferation of RM is being stated to give the impression that RM has been used extensively by IBs only for their own benefit and for large corporates at the expense of the depositors by fixing its rate of profit in contravention to the rules of Musharakah.

As mentioned in the beginning, the first transaction of RM was done on test basis in the year 2011 and not in 2008-2009. Secondly, we did a brief review of the financing of all major Islamic banks and windows from the annual accounts of the year 2018 and found the following status of RM at each bank.

Name of the institution	RM financing (PKR millions)	Total net financing (PKR millions)	Share of RM
Meezan Bank Limited	158,863	512,564	30.99%
BankIslami Pakistan Limited	24,404	118,087	20.67%
AlBaraka Bank (Pakistan) Limited	650	72,605	0.90%
Dubai Islamic Bank Pakistan Limited	10,480	152,424	6.88%
MCB Islamic Bank Limited	19,441	62,897	30.91%
HBL Islamic Banking	4,871	103,483	4.71%
Total	**218,709**	**1,022,060**	**21.40%**

This data shows that as of year-end 2018, the total share of RM as a percentage of financing among the five full-fledged IBs and the largest Islamic window was 21.4 %. The remaining windows have not been taken due to their portfolio size being small which can askew the data either way. From the above data only two banks have the RM financing size above 25%, the rest of the four major players in the market are well below this percentage. While this shows that the usage of RM varies significantly from one bank to another, it also proves that RM is certainly not the most favored mode of financing as is evident from the data. Moreover, even if it becomes the most favored mode, merely this fact does not make any transaction void. Regarding the claim that the rate is fixed in RM we will discuss this in detail later in the paper.

3.4 Why does a client get a higher profit share?

The SP continues its criticism of RM by giving an actual example of one RM transaction quoted from Ayub (2016), the SP states:

"As indicated by Ayub (2016), "One RM contract entered into by a major Islamic bank with a company during 2008-09 revealed that the Bank contributed 75% of the total RM investment and the company, with only 25% investment, took 97.5% of the Musharakah profit giving only 2.5% profit to the Bank, despite the fact that the target rate agreed at that time was 14.40% (1.00% over the KIBOR of 13.40%.)'

The above example is being presented as a case evidence against the Shari'ah soundness of RM. We are not aware of the source from where the author referred in the SP has commented on an RM finance executed in 2008-9, since as mentioned earlier the product of RM was launched in 2011. Secondly, as per the rules of Musharakah, the partners can agree on any profit-sharing ratio mutually. Hence a partner agreeing on pro-rata sharing ratio up to the ceiling level and getting a share of 2.5% from the total profit (which includes below ceiling plus above ceiling profit) is quite possible and perfectly in line with the Shari'ah requirements if the above ceiling profit is higher than the below ceiling profit of Musharakah.

One practical operational reason for the client getting a higher profit share in the total profit is that in such Musharakah transactions bank is becoming a partner only in the operating business of the company and that too for a very short period. Hence the Musharakah is limited to the following operating business of the company which involves the following activities:

a) Purchase of raw materials - input cost
b) Conversion into finished goods – input cost
c) Sale of finished goods in the market – output revenue

The business of Musharakah in RM is not related to other activities, businesses and operations of the company which involve the following; as an example:

a) Investments in shares, sukuk, bonds, etc.
b) Liquidity placements in banks
c) Investments in subsidiaries
d) Gain or loss on sale of fixed assets.
e) Purchase, repairs and depreciation of plant and machinery
f) Royalties, rental and fee Income
g) And other indirect operations, costs and expenses.

If a company has a number of businesses or income generating activities, it is allowed as per the rules of Musharakah for the partners to agree to limit the Musharakah to one type of business of the company. Similarly, it is also allowed for partners to limit the Musharakah to one or two selected products and not all.

When we limit the Musharakah to a certain set of businesses it is of prime importance that only the cost and income directly related to that business or activity is taken into account when calculating the profit or loss of that Musharakah at period end. Hence when using the annual or quarterly accounts of companies for the purpose of RM these direct costs need to be identified separately from the indirect costs. For the purpose of RM, the direct costs are all costs which are solely incurred for running the operations and generating the revenue of RM business. All indirect costs are costs related to activities which are not solely undertaken for the business of RM.

Hence fixed assets like plant, machinery, office furniture, office building etc. are indirectly used for the purpose of RM business but they are also used for other purposes and are assets having a long-term life which far exceeds the limited tenor of RM. Hence, it is not justified to add the whole cost of repairs, depreciation, additions of these assets to the income statement pertaining to RM. Similarly, the cost of indirect human resources like security guards, accountants, HR personnel, etc. are required for the activities of RM but are not directly or solely related to the functioning of RM business. In other words, these are shared assets / services by different sub-businesses of the company, hence also shared between RM and other businesses of the company.

The question that arises is how to take costs of these shared assets / services into account while calculating the profit of such types of limited Musharakah transactions. To resolve this, following three options are possible:

1. First option; an estimate should be made for the cost of utilization of these shared services and assets on cost per day basis or the cost per rupee revenue generated basis. On the maturity of Musharakah the tenor of Musharakah in number of days or the total revenue of Musharakah should be calculated and then the per day cost or per rupee revenue cost should be applied to calculate the cost applicable for Musharakah.

2. Second option; as suggested by Shaikh Taqi Usmani (1998: P 66 - 68) accurate identification of such costs might be difficult which may lead to disputes, hence the Musharakah partners can agree that for these services and assets utilized by Musharakah, the company shall be paid a fixed rental or fee amount by the Musharakah business.

3. The third option has also been suggested by Shaikh Taqi Usmani (1998: P 66 - 68) which is to give the company or the customer a higher share in Musharakah profits as a compensation. Hence while commenting on the rationale for using gross level income for such Musharakahs and all indirect expenses being borne by the company voluntarily, he states, 'But since the industrialist is offering his machinery, building and staff to the Musharakah voluntarily, the percentage of his profit may be increased to compensate him to some extent'

The third option is the one used by Islamic banks for RM transactions. Hence gross level income is used for calculating RM income which takes into account the direct costs and revenue of Musharakah.

As per practice, prior to RM limit approval a thorough review of customer's annual accounts is done taking into consideration each item on the income statement to ascertain the direct cost and revenue items. This is because the accounts, business and practice of each company is different from the other and as per practical experience it has been observed that some of the indirect costs which may be mentioned below the gross level might actually be direct costs as per the requirements of Musharakah, for instance clearly identified marketing costs for the products of the Musharakah. Similarly, some costs mentioned at the gross level might actually be indirect in nature for the purpose of Musharakah. Hence, to take care of this it is a practice of IBs to review, identify and agree on the list of direct costs which shall be part of the RM income calculation. This list is approved by the Shari'ah compliance department, customer and the business team of the bank prior to the start of RM.

Hence even if we assume, although highly unlikely, that the said transaction really took place between 2008 -2009 the higher share of profit of the company to the customer does not render the transaction of Musharakah void nor it is against the rules and principles of Musharakah as explained above.

3.5. Does RM structure constitute giving of Hiba to the customer?

In the third section of the SP titled 'Shari'ah Basis of Running Musharakah' the author has forwarded various evidences from AAOIFI Shari'ah Standards and other sources to prove the inherent flaws in the RM concept as far as Shari'ah rules related to Musharakah are concerned.

The first observation in the SP made in this regard flows from an earlier claim of the SP that RM involves giving Hiba to the customer over and above the profit ceiling. In this instance the SP suggests that Islamic banks defend the giving of Hiba by referring to AAOIFI Shariah standards. The SP mentions the following: "it is claimed in this regard that the AAOIFI's standard on Musharakah allows such Hiba to the other partner(s). But the case is not as simple as it is being presented"

The fact is, IBs have never claimed that the structure of RM is based on the giving of Hiba to the customer and neither the giving of Hiba in RM has ever been justified as is being suggested in the SP. The structure approved for RM in which the profits above the ceiling have a different ratio does not involve any Hiba. It's a profit-sharing mechanism and even though the above ceiling profit may be in favor of the customer it cannot be stated that it involves Hiba as we will see this further in this paper.

To indicate the inherent weakness of the RM structure, the following is mentioned in the next paragraph of the SP as a quote from AAOIFI's SS.12:

"According to AAOIFI, any stipulation in the partnership agreement that "one partner will get as profit share a lump sum from the profit or a percentage (e.g. 5%) of the capital renders the Shirkah void" (SS.12; 3/1/5/8). [Practically, this is presently practiced in RM by IBIs in Pakistan]."

First of all, based on our experience no RM agreement has come to our notice where a lump sum amount of profit or percentage of capital investment is mentioned or agreed with the customer. While making such a claim, the author of the SP should have presented the extract of any such clause from an actual RM agreement as an evidence without naming the bank. No such evidence has been mentioned.

Secondly, this is not what practically is happening in RM contracts as has been suggested in the SP. As mentioned earlier in all RM contracts a pro-rata profit sharing ratio is agreed below the profit ceiling and a different PSR is agreed for above the ceiling profit. This has also been accepted by the SP author (P. 60). Hence there is no question of lump sum profit or a fixed percentage of profit being agreed in the agreement upfront.

Thirdly, the clause 3/1/5/8 does not state what the SP has mentioned. The correct text of this clause states: "Taking into account the provisions of item 3/1/5/3 it is permissible to agree that if the profit realized is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling the distribution will be in accordance with their agreement."

This clause clearly allows the profit calculation mechanism of giving the profit above a certain ceiling to a particular partner to be agreed prior to the start of Musharakah in the Musharakah agreement. More importantly this mechanism is not termed as Hiba by AAOIFI, but rather mentioned as a profit calculation mechanism agreed by partners prior to the start of Musharakah in the Musharakah agreement. If this was considered as a form of Hiba then agreeing to it at the start of Musharakah would make Musharakah void.

3.6. Is the profit mechanism of RM only applicable in case of a sleeping partner?

The next paragraph of the SP has tried to give the impression that the profit-sharing mechanism mentioned in AAOIFI SS 12 clause 3/1/5/8 is related specifically to the case of sleeping partner and not to any other scenario of Musharakah. Hence the paper states:

"Actually, this clause pertains to PSR for sleeping partner (3/1/5/3) and allows agreeing that "if profit realized is above a certain ceiling / ratio (نسبة معينة) P 177, SS Arabic, 2010), the profit in excess of such ratio belongs to a particular partner."

Is this mechanism and clause 3/1/5/8 only related to the case where there is a sleeping partner involved? The answer to the question rests in reviewing both the clauses together hence we give the AAOIFI SS12 clause 3/1/5/3 below:

"In principle the shares of profit may be in proportion to the percentage of each partner's contribution to the Sharikah capital. Nevertheless, the partners may agree to make profit sharing not proportionate to their contributions to capital provided the additional percentage of profit over the percentage of contribution to the capital is not in favor of a sleeping partner. If a partner did not stipulate a condition that he be a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work".

The crux of the above clause is that the PSR can be according to capital contribution and partners can also agree on any other PSR different from the capital contribution ratio, provided, the pre-disclosed sleeping partner does not get a PSR more than his capital contribution ratio.

Hence, when clause 3/1/5/8 refers to this clause it is also referring to all cases of agreeing the PSR and not specifically limited to the case of a sleeping partner. Assuming that the case of agreeing a profit-ceiling is only related to the case of a sleeping partner is not a correct understanding and explanation of these two AAOIFI SS 12 clauses.

3.7. Is the profit mechanism of RM a form of 'relaxation'?

Apart from the forceful manner in which the profit ceiling mechanism has been explained in the SP to be categorized as Hiba to the client throughout the SP, it has also brought in other claims through which an attempt has been made to suggest that the use of profit ceiling mechanism is not justified, the SP states the following:

"But, all such relaxations are circumscribed with a condition that any sharing method must not contravene any Shari'ah principle – should not preclude a party from sharing in profit (P. 357). Otherwise, it would imply one party getting any fixed return as in case of riba."

The above text of the SP apparently claims that the profit ceiling mechanism, as given in Clause 3/1//5/8, is a form of relaxation and must not violate any principle of Shari'ah namely it should not preclude a party from sharing in profit.

First of all, AAOIFI has not mentioned anywhere in the whole SS 12 that this is a form of relaxation to the original principles of Musharakah. The paragraph on page 357, which gives the Shariah bases of the Standard, starts with the following text "the basis for the permissibility of partners agreeing on any method for allocation of profit, whether fixed or variable...". This bullet point ends with the following text which the author has mentioned in his claim above "method adopted should not contravene any Shari'ah principle, which means the method should not preclude a party from sharing in profit".

As we understand, this para actually refers to the method specifically discussed in clause 3/1/5/5 which states the following "It is permissible for the partners to agree on the adoption of any method of allocation of profit either permanent or variable...". The content referred from page 357 by SP does not relate to clause 3/1/5/8; which allows all the profit over the ceiling to be given to one partner; which the SP has tried to suggest.

Further, in RM there is no question of the bank being precluded from sharing profits since the bank is not only getting profits below the profit ceiling amount but also a portion of profit above the ceiling amount, even though it may not be a high amount. If the actual profit is lower than the ceiling, even then the sharing between parties will be as per the pro-rata ratio of their capital investments. Hence in no circumstances any partner is being precluded from profit sharing at the time of execution of Musharakah agreement nor being excluded at the time of actual profit distribution.

Even if any bank agrees in the initial agreement to give all the profits to the customer above the ceiling level, it would still be allowed as per the AAOIFI SS 12 clause 3/1/5/8 and will not result in the Bank being precluded from sharing of profits since total Musharakah profit is the sum of below ceiling profit and above ceiling profit, and the Bank will still be getting its pro rata share of profits up to the ceiling amount. However, the structure of RM goes one step ahead in terms of Shariah compliance by making it mandatory of having an above ceiling PSR as well, even though this is not a mandatory requirement as per AAOIFI standards. Hence, the Shariah scholars who have made this requirement mandatory have taken a precautionary approach while approving this product.

3.8. RM's profit ceiling mechanism is a valid condition

AAOIFI SS 12 Appendix B states, 'The Shari'ah basis for the Standard' page 358, bullet point number three is the one which is related to clause 3/1/5/8 and explains the Shari'ah permissibility of PSR with ceiling in clear terms as: "The basis for the permissibility of an agreement that if the profit realized is above a certain ceiling, the profit over such ceiling belongs to a particular partner, is because this constitutes a valid condition that is not inconsistent with profit sharing. Moreover, the capital provider is the one who will bear losses."

Therefore, there remains no room to state that such an arrangement results in a fixed profit, a partner is being precluded from profit sharing, it is an artificial device against the principles of profit sharing and Musharakah, etc. More importantly the above clause has stated that this is 'a valid condition that is not inconsistent with profit sharing'. Hence it is clear that AAOIFI does not consider it as Hiba because the condition of Hiba in the agreement is inconsistent with the principal of profit sharing and the contract of Shirkah. Which is why the condition of Hiba makes the contract of Musharakah void; since it is a well-known rule of Islamic law of contract that a condition which is against the basic purpose / principle of the contract is a void condition and void conditions in contracts of Muawadah (i.e. contracts of compensation) like Musharakah make the whole contract of Musharakah void ab initio (Imran Usmani 2015, P 86-87).

Hence it is clear in the light of AAOIFI's standard that it is a valid mechanism and in line with the principles of Musharakah and profit-sharing.

3.9. Comparison with Islamic Export Refinance Schemes (IERS) and Musharakah TFC.

The SP states that this mechanism could be used in individual cases such as Shirkah based sukuk or State Bank of Pakistan's (SBP's) Islamic Export Refinance Schemes (IERS) since (i) assets are identified, (ii) CB provides funding, (iii) the amount is negligible and (iv) to provide level playing field. The question that arises is, if as per the SP, the mechanism of profit ceiling in which one partner gets all the profit above ceiling makes the contract of Musharakah void due to fixed rate and is against the principle of Shirkah, then how can the reasons from (i) to (iv) turn this void condition into a valid condition and the Musharakah contract from being void to valid.

The fact is the IERS scheme does not use the mechanism mentioned in AAOIFI SS 12 Clause

3/1/5/8. Even though if it used this mechanism it will still be Shariah compliant since this is not a void condition. The mechanism used in IERS scheme is the weightage mechanism under which CB's Musharakah share is assigned a weightage based on future income forecasts of the IERS Musharakah pool of each bank.

3.10 Profit Ceiling mechanism is claimed as void – review of the references given

To still enforce the point that the profit ceiling mechanism used in RM is void, the SP has quoted a reference from Shaikh Taqi Usmani, the SP states:

"As per the principles of Musharakah, "all partners should be sharing the profits, meaning that one partner cannot say that after certain earnings and profit distributed at that level, he will be getting all profit over and above that level" (Usmani, M. Taqi; 2000: 35-37). Such stipulation, as per AAOIFI's Standard renders the partnership contract void (clause 3/1/5/7 and Appendix B, Shari'ah basis)."

We have reviewed Shaikh Taqi Usmani's book page 35 -37 and are of the opinion that it relates to the issue of fixing lump sum amount and profit rate in Musharakah for one partner and does not relate to the mechanism of profit sharing through profit ceiling, which the SP has suggested.

Clause 3/1/5/7 has already been discussed in detail earlier.

3.11 Investment of partners in Running Musharakah's capital is not known

In section four of the SP, the main focus of criticism is that the bank's investment in RM is not known at the start, and the SP attempts to prove that due to this reason, the contract of Musharakah in RM transaction is a void contract / transaction. The SP claims that "Partners' capital in Shirkah al-'aqd has to be known and mixed, as joint capital, before starting the business." The SP adds that in RM as being practiced, "there is a lack of clarity about the joint capital and identification of Musharakah assets, the income of which has to be distributed. The nature of investment of joint capital remains ambiguous over the period."

SP also indicates that the proponents of RM sometimes argue that identification of partners' share in capital does not take place even in case of Mudarabah / Musharakah based deposit pools. In response, the SP argues, "But this argument is not valid because in deposit pools although the investment by each depositor is calculated by daily balances, but specific assets based on Murabahah, Salam, Ijarah, Istisna, diminishing Musharakah, etc. are identified and assigned to the pools. Similarly, the joint assets' pools in SBP's Shirkah based 'Export Refinance Scheme' have identified assets of the banks and the equivalent investment by the State Bank. But no such identification is possible in RM and removing jahalah in this regard is almost next to impossible" (Ayub, 2016)."

The reason that the SP has given that the problem of identification of investment by each partner at the start of Musharakah does not arise in Mudarabah / Musharakah-based deposit pool is because the assets of the pool 'are identified and assigned to the pools'.

The big question that arises is that how does the identification of the assets of the pool resolve the problem of identification of equity share of each partner at the start of the Musharakah or even during the course of the Musharakah as claimed by the SP. Like all businesses the Mudarabah / Musharakah deposit pool comprises of a balance sheet having an asset side and an equity side. The question is if the assets on a balance sheet are identified, does this fact automatically result in the identification of the share of each partner in the business on the equity side, especially when no partner has stated its existing or proposed share in monetary number terms. The answer is, it does not, neither at the start nor during the course of the Musharakah. At the most, the total equity of the business or Musharakah can be calculated based on the book value of the identified assets on the asset side of the balance sheet but the equity of each partner is impossible to be known contrary to what the SP has stated.

Moreover, even though the assets of the Musharakah / Mudarabah-based deposit pool are identified, the asset size of the pool is not static. The size of the asset pool is changing every minute with the booking of different assets by the IBs across its branch network. This issue of constant change is more drastic when it comes to the equity side of the Musharakah / Mudarabah-based general pool. With each deposit, withdrawal, account opening, account closing, pay order issuance, etc. the size of the equity of the pool and hence the share of each partner changes constantly. Even the number of equity holders in the pool is not constant, it changes every time an account is opened or closed in any of the branches of the concerned Islamic bank. Hence, one can just imagine that how frequently the size of the pool and the number of equity holders are changing if the concerned IB has between 100 to 500 branches across the country. Moreover, with the advent of internet banking and mobile banking this change happens more frequently in a given day. Hence with this constant change in the number of equity holders and equity capital, it is clearly not known what will be the share of each partner, how much each partner will contribute at what stage, how many number of partners will be there or even who will be the partner in the Musharakah / Mudarabah deposit pool? Given these facts how can one even think that the issue of identification of share of each partner at the start of Musharakah does not arise in the case of Musharakah / Mudarabah deposit pool?

The truth is that the share of each Musharakah partner is not clear, known or identified at or before the start of the Musharakah neither in the Musharakah / Mudarabah-based deposit pools nor in RM. Though the issue of constant change is less drastic in the case of RM due to limited known number of partners (only two in case the customer does RM with one Islamic bank), a fixed RM limit given to the customer and very limited channels of withdrawals and deposits.

The question that arises is whether it is even a Shari'ah requirement for the validity of Musharakah that the equity of all the partners need to be known, identified and quantified at or before the start of the Musharakah business. This requires the opinion of Shari'ah scholars and for this purpose we will refer to the same book which the SP has frequently referred to. Shaikh Taqi Usmani (Usmani 1998, p 71-72) while discussing the case of RM has observed that in RM "nobody has undertaken to contribute any specific amount" and hence "the capital contribution of each partner is unknown at the time of entering into Musharakah". By quoting Al- Kasani; he has observed that Hanafi scholars are unanimous that this is not a pre-condition for the validity of Musharakah. We state the text of that quote as follows:

"According to our Hanafi School, it is not a condition for the validity of Musharakah that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that Jahalah (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of Musharakah does not lead to disputes, because it is generally known when the commodities are purchased for the Musharakah, therefore it does not lead to uncertainty in the profit at the time of distribution" (Badi-us-sanai v.6 p.63)."

Hence it is clear that the uncertainty of capital contribution at the start of Musharakah does not make it invalid. The only condition is that there should not be any uncertainty at the time of distribution of profits. This is exactly what is happening in RM transactions where the profit distribution is done on the basis of the ratio of investment of each partner in the business at the end of the Musharakah. Moreover, in RM while the share of each partner is not clear prior to the start of the Musharakah the share of each partner can easily be calculated at any point in time during the course of Musharakah through the following formula:

- Bank's Musharakah investment: Average of daily RM finance outstanding up to that date.
- Customer's Musharakah investment: Cost of goods sold up to that date (adjusted for receivable and inventory turnover) less Bank's Musharakah investment.

The above information along with the below ceiling profit sharing ratios, above ceiling profit sharing ratio, ceiling rate, ceiling amount of profit and above ceiling amount of profit is available at every point in time during the course of RM up to that date. This ensures that capital ratios, profit sharing and loss sharing can be calculated at any point in time. This effectively resolves the issue of jahalah (uncertainty) since both partners are well aware of these vital points of information at all times and the pieces or mechanism to arrive at this calculation is mutually agreed between the partners in the RM agreement in very clear terms.

Other claims that have been made in the SP are: i) Musharakah assets are not identified (ii) Profit is calculated on the basis of daily products of net financing just like interest based OD; and iii) It may be that multiple IBs provide financing on the same inventory in which case Shirkah arrangement of all banks involved may become invalid.

3.12 Musharakah assets not identified

While discussing SBP IERS scheme the SP author has stated "SBP's Shirkah based 'Export Refinance Scheme' have identified assets of the banks and the equivalent investment by the State Bank.' The process that the author is referring to is actually executed in the following manner: Islamic Bank gives a limit to various exporters for IERS financing. Based on that limit exporters utilize that limit and avail Murabaha financings. This Murabaha financing is initially disbursed by Islamic banks using their own funds, hence they become the owner of these Murabaha receivables (assets) generated by these Murabaha transactions. These Murabaha receivables are part of the pool in which the Islamic bank also transfers some of its ijarah transactions, hence bringing in the required ratio of tangible assets to the pool to fulfill the requirement of tradability of share of such pools. Subsequently, SBP invests in this pool by purchasing the share of Islamic banks in the pool by paying an amount equivalent to the Murabaha financings disbursed earlier by the Islamic bank. This process continues until the end of each quarter on which date the profits of Musharakah are calculated and distributed as per the weightages and ratios agreed under the IERS Musharakah.

Exactly is the case that happens in RM. The RM customer, being the manager of the business, runs the operations of the business and generates pool of assets of the business namely accounts receivables, inventory of finished goods and work in process (WIP) inventory. Now from time to time as and when the customer feels that his own liquidity or working capital position becomes constrained, he requests the IB to inject its funds in the business as a partner. The IB injects the funds thereby purchasing a share in the pool of assets of business comprising of accounts receivable, inventory and WIP inventory. These assets; i.e. account receivables, inventory and WIP inventory are identified and available on customer's daily balance sheet numbers and operational records on a daily basis without any ambiguity. From the liquidity that is generated by the sale of this share to IB, the customer further generates inventory assets and injects the same as his additional equity into the RM pool. Any return/ repayment of Islamic bank's funds by the customer is the purchase of Bank's share in the pool by the customer. This goes on until the end of the agreed RM period on which date; just like SBP's IERS; the actual profit of the pool is calculated and distributed as per the agreed profit-sharing mechanism and PSR.

Another important thing to mention here is that it is necessary that the RM pool should have at least some assets in the form of tangible inventory if all other assets are accounts receivables. This is because, in case all assets are accounts receivables the injection and withdrawal of capital by IB bank will result in sale of debt which is not allowed by Shari'ah. Hence, it is not allowed to do RM transactions where the customer is a service-oriented company with no inventory and the only assets available are accounts receivables. However, if the bank and such customer agree to create a pool by including certain tangible assets; like fixed assets; to the RM pool of assets and subsequently the receivables are generated for that pool the RM seems to be possible. However, this is a case which needs to be discussed and approved by the Shariah board of the respective Islamic bank if such a need arises.

3.13 Use of the daily products calculation mechanism

Another objection that is raised in the SP is that in RM profit is calculated on the basis of daily products of net financing just like interest-based OD. As observed by Usmani (1998, P 73), even though in the concept of RM the partners withdraw and inject equity from time to time and the profit calculation on daily product basis is not found in classical books of Islamic Fiqh, merely this fact cannot render the Musharakah invalid if it does not violate any basic principle of Shari'ah. Moreover, if all parties agree to this and no injunction prohibits it; it will come under the general guidelines given in the Hadith the meaning of which is: "All the conditions agreed upon by Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful".

3.14 Multiple IBs become part of RM making all transactions invalid

Another claim made in this section is that multiple IBs may provide Musharakah financing on the same inventory and this will result in Shirkah arrangements of all banks as invalid. We have discussed before the case of Musharakah / Mudarabah deposit pool where millions of depositors enter and exit as equity holders with share in the underlying assets of the general pool. The same can happen in the case of RM where different IBs can participate in the same RM pool having their own share along with the share of the customer. However, a case can seldom arise that the underlying assets of the pool are less than the total financing provided by IBs since all IBs are aware of the type of financing provided by other banks through the SBP's ECIB report, customer's debt / financial ratios and customer accounts.

3.15 Limit calculation of RM

The SP further discusses the process of RM and the method of calculating the limit for RM as a percentage of stock in trade and receivables. SP states "As in the case of Over Draft (OD) limit in conventional finance, RM Limit is calculated by getting a certain percentage, say (75) % of the average value of Stock-in-Trade and Trade Receivables appearing in the (3) years◎ statement of the applicant company". Of course, the SP has nowhere objected to this method of calculating the Limit. This author would like to indicate in this regard that mere use of the method does not make anything non-compliant or compliant since it is basically a method of calculating the cash cycle of a trade-based business.

3.16 Example of RM with numbers

While giving an example of the RM process, the SP mentions, that the IBs indicate a target profit rate related to KIBOR, say 7 %. The SP author adds, "It implies that Islamic bank will take an amount that would be equal to the 7% of its investment. After getting target rate, remaining profit will be distributed according to the second stage ratio: 0.0001% and 99.9999% between Islamic bank and the client".

In practice, Islamic banks state a target profit ceiling rate which is defined in terms of KIBOR. What is important to note here is that this does not result in fixed or guaranteed rate since upon the actual results of the business this rate is used to calculate the ceiling profit amount if and only if the RM business has earned the profits up to that level, which is then shared between the partners on pro rata basis. If as per actual results this ceiling profit amount is not achieved (i.e. the actual profits are less than the profit ceiling amount), then the partners will share whatever the profits have actually been earned on pro rata basis and in such cases Islamic banks will not get the target return. In case of loss Islamic banks will lose their investment.

Next the accounting entries of RM are shown in the SP in which daily profit is accrued based on the outstanding amount of RM financing. While IBs do use the accrual-based accounting method, it is not the final recording of accounts, it is subject to final settlement at each quarter end and maturity based on actual results of Musharakah. This is in line with AAOIFI SS 12 clause 3/1/5/11 which allows to allocate funds during the tenor of Musharakah but subject to final settlement.

Subsequent to the explanation of the process, the SP goes on to claim that this process is applied arbitrarily to businesses of different nature. As has been discussed earlier in this paper that prior to approving the limit for RM for any client, Islamic banks thoroughly review the financials of the company to ensure: (1) the RM pool will have sufficient tangible asset ratios, (2) identification of direct costs, (3) calculate inventory cycle and cash cycle of the company, (4) review past three year levels of gross profit, etc. Hence to protect their own interests as well as ensuring Shariah compliance of the transactions Islamic banks conduct the required due diligence for each and every case of RM rather than applying a fixed template arbitrarily.

3.17 Does RM use Mudarabah funds to give Hiba as claimed

The SP argues that since the bank provides the funds of depositors to the corporate client by way of RM financing, it acts as Mudarib for the depositors, and hence has no right to withdraw from the right of the Rabbul Maal by giving RM profits as gift to the corporate customer. As discussed in detail earlier that the arrangement under RM does not involve any Hiba or gift. It is a profit-sharing mechanism, which is agreed by the bank as part of its right as Mudarib to deploy Mudarabah funds in a manner which fulfills the depositors' risk appetite as well as earns an expected return desired by them which is consistent with that level of risk.

In the last para of section 5 the SP states "Although it may be Musharakah in form, but by substance and meaning it is not a partnership or more specifically Shirkah al-Inan, as contemplated by early jurists". It is difficult to understand that why this issue has even been raised, since AAOIFI and contemporary scholars agree that Shirkah al-Inan is not the only acceptable form of Shirkah. Usmani (1998) has noted that Hanafi Fiqh allows the other forms of Shirkah as well.

3.18 Loss sharing in RM is not real

Section 6 discusses the case of loss sharing by suggesting that even though parties agree to loss sharing in RM, "but it is not the real case". Has there been any case; which has come to the knowledge of the SP's author; where there was a loss but the Islamic bank refused to take such loss and still got the profit at the fixed required rate of return? In the absence of any case evidence, making such claims is not appropriate. In this context, the SP makes following two observations; "Further, claim for any loss is subject to availability of audited accounts that may take a couple of months. Besides, any client might be hardly prepared to offer its books of accounts for scrutiny while it has availed of the bank's capital at so cheap rate".

Regarding the audited accounts, it is pertinent to mention that the profit in RM transaction is also subject to availability of quarterly and audited annual accounts. Hence the time it would take for final profit realization is the same as for loss recognition. Secondly to safeguard the risk of depositors and of the client both, it is best to check the results which are verified by a 3rd party and hence the audited accounts ensure this transparency. Not taking such precautions could result in cases of willful misconduct resulting in losses for the bank and depositors.

Regarding the second observation; almost all RM transactions are done with blue chip or listed corporate companies. These clients already publish their audited accounts which are publicly available; hence there is no question of clients not submitting their accounts. Secondly submission of audited and quarterly accounts is not only a requirement of RM transactions, it is a requirement for other types of transactions in banking as well.

Is RM worse than Murabahah, Ijarah and other modes?

In the last section the SP has raised two major issues. Firstly, the SP has compared RM with Murabahah, Ijarah and other such modes and stated that RM may prove to be worse than genuine Murabahah, Salam and Ijarah. To prove this claim, the SP has outlined the following reasons:

1- 'flexibility available with regard to use of funds with almost no documentation' in RM.

2- In Murabahah or Ijarah, financing is related to the identified items, and as such a link between real economy, business and finance is established as required under the Islamic Law of contract.

3- Share of Ijarah and Murabahah has come down sharply and RM has increased

Indeed, there is more flexibility in RM with less documentation compared to Murabahah and Ijarah. However, does this reason make any transaction non-compliant or deficient in terms of Shari'ah? Certainly not! Islamic banking has been criticized most often due to complex documentation of Murabahah, Ijarah and sukuk transactions. The reason for this is that these modes are either modes of sale or rental and not originally the modes of financing in Shari'ah (Usmani, 1998). However, to be used as modes of financing the Shari'ah scholars have outlined certain steps which if executed in careful sequence will help in achieving the goal of financing as well as comply with the rules of sale and

Ijarah as outlined by Shari'ah. If the correct sequence is not followed in such transactions it can result in Bai Inah (buy back), sale of non-existent goods, etc. (Usmani, 1998) making a transaction void.

Similarly, in almost all Murabahah (and Ijarah) transactions the client is made agent to procure assets on behalf of the bank. Again, extreme care is required due to this, since client's capacity as agent needs to be distinguished from his capacity as a buyer (Usmani, 1998). In order to fulfill the required conditions, following process and documentation are followed in Murabahah by Islamic banks:

1- Execution of master Murabahah agreement
2- Execution of master agency agreement
3- Submission of purchase order upon requirement of Murabahah.
4- Disbursement of funds to client as agent
5- Acquisition of goods by client as agent
6- Declaration of purchase along with evidences by the agent.
7- Offer to purchase by customer
8- Acceptance by bank

Any deviation from the above process may result in Murabaha being void resulting in loss of income for the bank and the depositors. Requirement of strict adherence to the above process flow not only results in inflexibility and complex web of documentation but also a higher risk of Shariah non-compliance.

Now coming to RM, it is to be noted that Musharakah is by its nature a real mode of financing . In that sense it only requires one partnership agreement to be signed and the disbursement of equity can be made under that one contract. There is no need for an agency agreement. Moreover, as discussed in earlier sections, all disbursements under RM result in IBs immediately purchasing customer's share in the underlying RM pool, assets of which are identified. Hence the funds are immediately utilized in an identified manner in the operating process of the business which results in an economic activity resulting in profit or loss. This also resolves the second reason that the SP has given, that RM is not done on identified items as compared to Murabahah and Ijarah. Due to these reasons the process of RM is considerably less vulnerable to Shari'ah non-compliance risk resulting in less documentation requirement which in turn results in more flexibility.

This clearly shows that when it comes to execution of transactions, RM ranks higher than Murabahah and Ijarah in ensuring a higher level of Shari'ah compliance. Hence to state that RM is worse than Murabahah and Ijarah is probably a statement assumed without taking into account practical considerations and the underlying nature of 'Murabahah to the purchase orderer' and 'Ijarah Muntahia bittamleek'.

3.19 RM and Maqasid Al Shari'ah

The SP concludes that RM should be given a lower ranking in terms of Shari'ah compliance and Maqasid Al Shari'ah as compared to Murabahah, Ijarah, etc. As far as ranking in terms of Shariah compliance is concerned we have already discussed all the Shariah issues raised by SP along with evidences clearly showing that the structure of RM does not have the defects which the SP has claimed.

There is no specific reason given by the SP for asserting that RM fails on Maqasid Al Shari'ah grounds. One of the biggest Maqsad of Shari'ah is the 'Protection of Iman and Shari'ah'. As such, all Muslims should strive to abstain from haram and attain the halal. Hence, one of the most important Maqsad of Shari'ah while practicing Islamic finance is to save the Ummah from the curse of riba. The product of RM effectively does that by not only giving an alternate to riba-based financing, but also giving a solution which achieves, a higher level of Shari'ah compliance compared to Murabahah, Ijarah and other debt-based modes when it comes to practical execution.

Secondly, Musharakah is considered as the mode which leads to equitable distribution of income due to the following two reasons:

1- Return is only given to the financier when there is profit and not when client makes a loss.
2- Loss is also shared with the financier.

We have seen in RM that profits are shared both below and above ceiling levels. While it is true that the share of profits above ceiling is highly skewed in favor of the client and bank only gets a limited share, there is no denying the fact that the profit will not be given to the bank in case the business does not earn any profits. Similarly, bank will get less than its required rate of return in case the profits are below ceiling and in fact share in losses in case of loss. This is certainly not the case in Murabaha, Ijarah, Salam and other debt-based modes where the bank will still get the profit even in cases where the client or the business makes a loss. Hence given this sharing aspect, claiming that RM ranks lower in terms of Maqasid Al Shariah is out of place.

4. Conclusion

In this paper we have reviewed the various claims and objections raised by the SP on the structure and practice of RM. Based on this review and analysis it can be said that the defects and claims associated with RM do not exist in reality entirely, or have been assumed by wrongly associating it with Shari'ah issues not directly related to the structure and practice of RM, due to either misunderstanding of such references or of the practice of RM. The RM structure has been found to be in compliance with Shari'ah rulings as outlined by AAOIFI, especially the two-stage profit ceiling profit distribution mechanism which is a valid condition and neither void nor a form of Hiba as claimed by the SP. We encourage all readers and stakeholders to do their own review of these evidence and references which have been mentioned in this paper for better understanding and clarity. Moreover, it is most important to understand that to claim that any product or structure is void in terms of Shariah it needs to be backed by valid Fiqh evidences, merely making personal judgements that the structure fails on Maqasid Al Shariah grounds does not result in the product being void in Shariah. Lastly, it is acknowledged that like in all other processes there is still room for improvement in the product of RM, however at the same time it has to be admitted that it is an attempt by IBs in line with the following advice by Sheikh Taqi (Usmani 1998, P 240) who observes that given the practical difficulties in implementing Musharakah "Islamic banks should have gressed towards Musharakah in gradual phases and should have increased the size of Musharakah financing". It must be stated that product of RM is that gradual step towards embracing Musharakah financing and we expect IBs to continue their efforts in increasing the use of Musharakah-based financing products.

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TECHNICAL ARTICLE

Ethics / Values and Shari'ah in the perspective of form and substance debate

Sohaib Umar[1]

The Islamic finance industry started out with negative screening and fulfilling bare minimum Shari'ah compliance requirements. Approximately 50 years later, the emphasis on negative screens is still there. On the other hand, there are important developments in the conventional finance industry, mostly voluntary initiatives, which are encouraging banks to progress towards positive screening beyond just financial returns. Value-Based Banking, Responsible Banking, Impact Investing and focus on broader stakeholders through the ESG lens (Environment, Social, Governance) have become the catch-phrases even in mainstream conventional finance. The Islamic finance industry is at risk of becoming irrelevant and outdated if it does not align itself with contemporary value-based issues. It is ironic for an industry that claims its roots in the Shari'ah but restricts itself to the letter (form) and not the spirit (substance) of Shari'ah by resorting to a strictly jurisprudential / technical interpretation.

The Quranic perspective

The Holy Quran reminds us time and again that the spirit and the substance of one's deeds is extremely important and cannot be sacrificed or be held inferior to the form or technical correctness. The God Almighty says in the Holy Quran: "And those who avoid the worship of the idols and turn to Allah, for them is good news. So give good news to My servants, who listen to the Word (of Allah), then follow the best of it. Such are they whom Allah has guided, and such are the men of understanding" (39:17 & 18). These verses make it clear that Muslims are duty-bound to follow the right spirit of the law and the purpose for which it is intended. Instead, if the entire emphasis is on following the technical or legal form, while carefully avoiding the spirit or substance of the law, then this approach cannot be justified as "Islamic" or "Shari'ah compliant" in the light of the above verses.

There are other verses, which reassure believers that as long as their overall direction remains correct, and they don't commit major sins, Allah will ignore their minor misdeeds and forgive their minor sins. The God Almighty says in the Holy Quran: "If you avoid the great sins which you are forbidden to do, We shall expiate from you your (small) sins, and admit you to a Noble Entrance" (4:31). Again, the emphasis is on the big picture, on treading the right path and not indulging in anything that takes one away from the superhighway of righteousness.

There is a reminder in the incident of Ashab us Sabt – The People of Saturday as mentioned in the Holy Quran. These were the people of Bani Israel (children of Israel) who were tested with the Sabbath, the day when they were ordered to leave their worldly affairs in order to devote themselves to the worship of Allah. Throughout the week, they would not get much fish but on Saturdays, when they were required to put aside their activities, the fish would come in abundance. Some of them devised a clever scheme to bypass Allah's commandment. They would put out their fishing nets on Friday, and then on Sunday they would come and pick the nets up. Technically, they did not breach Allah's commandment, but in essence, they did through

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the use of a stratagem. How did Allah respond to this? "And indeed you know of those amongst you who transgressed on the Sabbath, so We said to them, 'Become apes, despised and rejected!' And We made it a lesson for (those of) their own times and those (of their posterity) who came after them and a guidance for those who guard against evil" (2:65-66). Hence, the lesson is clear, destroying the spirit of Shari'ah while preserving its form can bring no good.

What does the Hadith say?

Prophet Muhammad (SAW) has said:

«بُعِثْتُ لأُتَمِّمَ حُسْنَ الأَخْلاَقِ»

"I was sent to perfect good character.[2]"

In another Hadith reported by Anas ibn Malik, the Prophet declared:

«لَا إِيمَانَ لِمَنْ لَا أَمَانَةَ لَهُ وَلَا دِينَ لِمَنْ لَا عَهْدَ لَهُ»

"There is no faith for one who cannot be trusted. promise[3]."

Therefore, in the light of the above Quranic verses and Ahadith, it will be appropriate to state that the morals are the spirit of Shari'ah. One cannot claim conformity to the letter and spirit of Shari'ah in the absence of good ethics.

Islamic finance's overwhelming focus on jurisprudential technicalities – is it desirable?

A strictly legal and jurisprudential mindset may result in rendering the whole of Shari'ah into a set of prescriptive rules of Halal and Haram. However, the religion of Islam is much more than a set of do's and don'ts, something that a serious student of Quran and Sunnah will not miss noticing. In many instances during the life of Prophet Muhammad (SAW) and later during the time of the rightly guided caliphs, we see that the broader principles of justice, fairness, equity, compassion and brotherhood are invoked to resolve real world problems, instead of relying on technicalities of jurisprudence to justify the status quo. In other words, the overall spirit / substance / objectives of Shari'ah were maintained when resolving new issues of everyday life. Let me quote two instances, one from the life of the Prophet (SAW) and the other belonging to the caliphate of Umar (RA).

Ibn Kathir's account is notable for the La-haraj (no hindrance) pronouncement which the Prophet (SAW) made on a number of issues. These pronouncements were given as responses to those of his companions asking whether it was permissible to do things which appeared doubtful to them. On his Farewell Pilgrimage, the Prophet (SAW) almost always gave positive answers to those questions; he would typically answer: "Yes, you could do such and such, with no hindrance (La-haraj) to you." Or he would simply say: "La-haraj (all right)". Ibn Kathir relies here on the authority of Sahih al Bukhari and Sahih Muslim (authentic books of Ahadith). Both these books reported that whilst the Prophet (SAW) was addressing the pilgrims on the day of slaughter, a man stood up and asked: "I thought that doing so and so comes before doing so and so." Another man, then, also stood up and asked a similar question. To both men the Prophet (SAW) replied: "Do it - no embarrassment - la-haraj." Imam Muslim added: The Prophet (SAW) was not asked about any matter, being done before or after its ordained time, to which he did not give the answer: "All right, no embarrassment. You can do it in that way, nothing is incumbent upon you[4]."

During the caliphate of Umar (RA) the famous issue of Umm al Walad (female slave who gives birth to her master's child) took place. One day Umar (RA) heard someone cry aloud. Upon investigation it turned out that the mother of a slave girl had been sold (which made her cry). Umar called together the seniors from among the Muhajirun (the emigrants from Makkah) and Ansar (the residents of Medina). He framed the question to them in this way, "In the religion that Prophet Muhammad (SAW) had brought do you find any space for the separation of family?" They responded in the negative. He recited a verse from the Holy Quran that supported the bonds of family, then declared, "What greater breaking of kindred could there be than the sale of a mother of one of your children, [especially since] God has advanced your fortune!" The crowd replied that Umar should do what he thought was necessary, so he decreed that it was forbidden to sell the female slave who gives birth to her master's child[5].

In both the above instances, the spirit of substance of the religion was emphasized and upheld and the technicality was ignored or sacrificed in the process. Unfortunately, we see a totally different approach by some contemporary Shari'ah scholars (read Fiqh experts) in the Islamic finance industry. Instead of upholding the higher morals of Shari'ah keeping in mind the bigger picture, they have generally focused on ways and means (legal stratagems) to 'Islamize' contemporary conventional products and services using technicalities of jurisprudence. This is analogous to an expert lawyer using the wordings

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2- al-Muwatta Book 47, Hadith 1643

3- Musnad Aḥmad 11975

4- https://archive.org/stream/TheFarewellSermonOfProphetMuhammadSAWInternationalIslamicUniversity/The%20Farewell%20Sermon%20of%20Prophet%20Muhammad%20%28SAW%29%20-%20International%20Islamic%20University_djvu.txt

5- https://www.academia.edu/35506982/Remembering_the_Umm_al-Walad_-_Ibn_Kathirs_Treatise_on_the_Concubine-Mother of the law and legal loopholes to plead the case of a criminal, leading to his acquittal.

This is indeed a sad state of affairs, given that the consideration of Mafasid and Masalih (negative and positive impact) of a policy or tool for the overall economy or society has been an integral part of the jurisprudential discussions and debates since the early Muslim era. As Ibne Qayyim puts it, "Everything that lapses out from justice into injustice, and from mercy to its opposite, and from Maslahah to Mafsadah, and from wisdom into the frivolous, does not belong to Shari'ah, even if it is inducted into it by interpretation (ta'wil)."[6] "Sadd-e-Dharai" is a widely acknowledged Shari'ah principle, which is used in cases where something, while being Halal itself, is causing to create something else that is against the higher objectives of Shari'ah. Also, in Shari'ah, as in public policy, if something is proved harmful for the society as a whole, its benefits for individuals are ignored.

Common sense demands that if the Islamic economic and financial system is different from the conventional system then these differences ought to be real and tangible rather than cosmetic and technical. After all, every system is based on certain higher objectives whose fulfillment is the primary goal of that system. If the difference between the Islamic and the conventional systems is diluted or blurred, the very basis of the former will be (rightfully) challenged.

Focus on form while ignoring substance – leading to products of dubious Shari'ah legitimacy

The approach to rely solely on Fiqh technicalities to design Shari'ah compliant products leads to unhealthy product innovation, raising serious concerns on the reputation of Islamic financial institutions using them and creating the wrong perception in the minds of the general public. Two products can be discussed as examples.

Example 1: Organized Tawarruq / Commodity Murabaha

Tawarruq, also known as Commodity Murabaha, is perhaps one of the most commonly used products in the Islamic banking industry globally. It is also, arguably, one of the the most controversial products. It is used both on the asset side and on the liability side (called Reverse Murabaha) of the balance sheet of a typical Islamic bank. It is also a popular product for inter-bank financing.

Commodity Murabaha ought to be differentiated from a normal Murabaha. A normal Murabaha is a genuine transaction in which a real economic need (e.g. purchase of raw material by a factory) is fulfilled by the Islamic bank by first purchasing the required item and then selling it onwards to the customer for a declared cost and profit, to be repaid over a period of time. In Commodity Murabaha comprising an organized process, another leg of the transaction is introduced whereby the customer sells the commodity onwards to obtain cash. In fact, there is no intention to purchase a commodity for use from the outset; the objective is to get cash, and to this effect, a commodity is used as a means to achieve the monetary objective. The entire transaction is typically 'arranged' or 'organized' by the brokers for the Islamic bank.

Personal finance is perhaps the most commonly used Commodity Murabaha application that concerns the average customer. Let's assume that a customer needs US$9,000 in cash for consumption purposes (e.g. to spend on marriage or holidays) rather than asset formation and he goes to an Islamic bank seeking the financing. Since the Islamic bank cannot lend money and charge interest, it has to involve a trade transaction to legitimize profit from it. So, for example, the bank buys diamonds (or any other commodity) from a designated supplier on cash for US$9,000; and sells the diamonds on credit the same day to the customer at a price of US$10,000 to be paid in one year. The customer then sells these diamonds to another supplier (also arranged by the bank) at a market price of US$9,000 in cash. The net result is that the customer receives US$9,000 cash while the bank has a receivable of US$10,000 from the customer that is to be paid after one year.

The various buy and sell contracts are signed almost simultaneously by the customer, the suppliers and the bank in one sitting and the dealings between the customer and the suppliers are facilitated by the bank. In most cases the commodity typically does not move an inch from the shop or store room. A Shari'ah-compliant Commodity Murabaha transaction is thus completed.

What are the issues with this transaction? First and foremost, Commodity Murabaha creates a disconnect between the real and the financial economy, unlike other Islamic financial products, which are unmistakably linked to asset formation in the real economy (e.g. in Murabaha where a bank buys a product from the market and then sells it onwards to the customer after adding its profit, or Ijarah in which a bank buys a car or a house and then gives it to the customer on rent). A one-to-one correlation between real and financial economies is a hallmark of Islamic banking but Commodity Murabaha does not have this characteristic, as there is no intention of using the Commodity; it is simply a conduit for monetization.

A related point which is a natural consequence

6- I'lam Al Muwaqqin, Egypt, Matbaa Muniriyah, volume 3, page 1, also see volume 4, pages 309-11 of the above mentioned disconnect is the piling up of debt as a result of Commodity Murabaha, which is out of line with the growth (or lack thereof) in the real economy. If debt is created without a commensurate growth in the economy, there will be a negative wealth effect in the long-run for the economy as a whole. This means that the average person in the economy will be poorer and the wealth will be redistributed in favor of the creditors (because the debts have to be repaid regardless).

As we have seen in the example of Commodity Murabaha-based personal finance, the debt created is larger than the cash obtained. The use of Commodity Murabaha helps one fulfill the immediate cash need but how will he/she repay the debt? If the cash were obtained for consumption purposes then he would either have to draw upon his savings, or sell an existing asset, or borrow more in order to repay this debt. None of these options is a good scenario for the customer and would typically lead to a transfer of wealth to the creditor in the long term. It is interesting to note that Commodity Murabaha is almost identical to the conventional interest-based system in terms of consequences – unfair, inequitable and eventually leading to instability in the system.

The proliferated use of Commodity Murabaha could hinder healthy innovation in Islamic finance industry, as it is cheaper and not dissimilar to existing conventional products. Its parasitic growth, if left unchecked, can lead to Commodity Murabaha replacing genuine existing Islamic financial products and eventually making them redundant. Indeed we have already seen it happen to some institutions and some countries, where Commodity Murabaha was initially used by Islamic banks for interbank transactions, then it was increasingly used for asset-side transactions (e.g. personal finance, auto finance, working capital finance) and eventually made entry into liability-side products as well (savings and investment accounts based on Commodity Murabaha). The structured finance products like many types of derivatives have been structured using Commodity Murabaha arrangement.

The above negative effects will hold true even if a proper Commodity Murabaha structure is followed including the involvement of different suppliers for the buyer and the seller and / or other such measures recommended by Shari'ah scholars. We know, however, that abuse is a commonplace in such transactions. A constructive or actual possession of the commodity is rarely obtained by the customer. The right sequence of buy / sell transactions is often not adhered to, potentially resulting in Shari'ah violations that may or may not be captured due to the volume of transactions.

Some experts are of the opinion that Commodity Murabaha is linked to the real economy as the cash obtained through the transaction is inevitably pumped into the economy, thus generating economic activity. This is an invalid argument as the same can also be said about interest-based conventional banking loans, since the cash obtained in a conventional loan is typically used either for asset formation or for consumption purposes, and in either case, it generates economic activity. Yet it did not stop the creation of a global financial economy, which at its height was more than ten times the size of the real economy globally. The key point here is that if there is no one-to-one correlation between a real economy transaction and its corresponding financial economy transaction then the link between the two is broken, which can result in a financial bubble. This one-to-one correlation exists in all genuine Islamic finance products, but not in Commodity Murabaha.

Example 2: Islamic prize draw schemes

Another example of unhealthy product innovation ignoring the substance of Shari'ah is Islamic prize draw schemes for Islamic banks' investment account holders. These are generally perceived by the public as 'Islamic lottery schemes'. From a strictly technical perspective, it has to be said that no Shari'ah rules appear to have been broken by these schemes. The Mudarib is allowed in a Mudaraba arrangement to gift a part or all of its share of the profit to some or all of the Rabb ul Maal / investors. However, if the Shari'ah is not just about the letter of the law and also the spirit, then the product is potentially problematic. The spirit of Shari'ah compliant prize draw schemes is the same as conventional lottery schemes. They appeal to our gambling instinct, which is very strong in humans. Customers are lured to put their moneys into the Islamic bank's saving / investment accounts not so much because of the reputation or service of the bank or expected return, but because of the attraction of the prize (which only one or few of the customers will get). The same incentives and appeals are at work in conventional lottery schemes.

The net result of favoring the form over the substance of Shari'ah is that the Islamic finance industry is regressing, instead of progressing, in terms of responsible product innovation. The two largest markets for Islamic finance – Saudi Arabia and Malaysia – are overwhelmingly indulged in Commodity Murabaha on both asset and liability side. Similarly, in many markets Islamic prize draw schemes are allowed and are flourishing. The nature of business is such that when a new product is launched by an Islamic bank, which is attractive to customers due to its relaxed Shari'ah considerations, the competition makes sure that every other Islamic bank also follows it, even though they may be aware of its questionable Shari'ah authenticity. Hence, it becomes a race to the bottom (with respect to Shari'ah authenticity).

Conventional finance and ethics

With respect to ethics and responsible practices in conventional financial sector it is traditionally not known for its adherence to high ethical standards. Money lenders have historically been known for their cruel ways to get their money back from debtors. The Shakespearean character of Shylock is the epitome of this phenomenon. After the institutionalization of the lending business in the 19th and 20th centuries, the public perception of banks started to improve but not significantly. Banking scandals such as rogue trading (UBS, 2011), discriminatory lending practices (Wells Fargo and Bank of America, 2012), LIBOR fixing (Barclays and 20 big banks, 2012), money laundering (HSBC and Standard Chartered, 2012), etc. did not help to improve the image of the industry.

After the global financial crisis of 2007-08 in which the lack of ethics played a major role in creating and/or exacerbating the crisis there is a renewed vigor in addressing the issue. Codes of corporate governance have been around for some time and regulators worked hard to improve and implement them. There are a number of initiatives, mostly voluntary, emphasizing business and financial sectors to move beyond financial profits and include other considerations in their decision making. Some of these have been there for decades, but the financial crisis served as a trigger to expedite their implementation. We briefly discuss the more prominent initiatives below:

- ***Three lenses of economics, law and ethics*** - Codes of corporate governance universally acknowledge that every major decision by the management / board of an institution has to pass through three lenses or filters – economics, law and ethics. In other words, one needs to ascertain if an initiative is economically profitable, legally permissible and ethically defensible. Failing in any one of these lenses can cause trouble subsequently[7].
- ***Value-Based Banking*** principles issued by the Global Alliance for Banking on Values (http://www.gabv.org). The five principles of value-based banking are triple bottom line approach, serving the real economy, long-term relationships with clients, resilience to outside disruptions, and transparent and inclusive governance. All these principles ought to be embedded in the culture of the bank.
- ***Principles for Responsible Banking*** issued ***by United Nations Environment Program (UNEP) – Finance Initiative*** (https://www.unepfi.org/banking/bankingprinciples/). These principles were launched by 130 banks from 49 countries, representing more than US$47 trillion in assets, in September 2019 in New York City, during the annual United Nations General Assembly. The principles for responsible banking are related to the alignment of business strategy with individual's needs and society's goals, impact and target setting, clients and customers, stakeholders, governance and culture, and transparency & accountability.
- ***Principles for Responsible Investment*** – Responsible investment is an approach to managing assets that sees investors include Environmental, Social and Governance (ESG) factors in i) their decisions about what to invest in; and ii) the role they play as owners and creditors.

These aim to combine better risk management with improved portfolio returns, and to reflect investor and beneficiary values in the investment strategy. It complements traditional financial analysis and portfolio construction techniques (https://www.unpri.org/pri). Today, the UNPRI is a thriving global initiative with over 1,600 members representing over US$70 trillion assets under management.

- ***Impact Investing*** – refers to investments made with the intention to generate positive, measurable, social and environmental impact alongside a financial return. The initiative has reached a market size of over US$500 billion (https://thegiin.org/research/publication/impinv-market-size). Some consider Impact Investing to be a subset of Responsible Investing.
- ***Statement on the purpose of a corporation*** – has been revised from a narrow focus on the shareholders to a broader focus on stakeholders by The Business Roundtable (https://www.businessroundtable.org/), the organization for chief executive officers of large U.S. corporations. The document, signed by 181 CEOs, calls for companies to serve all stakeholders by delivering value to customers, investing in employees, dealing fairly with suppliers, supporting the communities in which companies operate,

7- 1. Ethics, Law, and Economics: Legal Regulation of Corporate Responsibility by Jonathan Rothchild, Journal of the Society of Christian Ethics, Vol. 25, No. 1 (Spring/Summer 2005), pp. 123-146

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3. What Ethics? An Integrative Economic Ethics Approach to Corporate Social Responsibility by Dr Sigmund Wagner-Tsukamoto, School of Management, University of Leicester, UK https://lra.le.ac.uk/bitstream/2381/39380/6/BAM%202016%20-%20CSR%20ethics%20and%20economics%2022-02-2016.pdf

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5. Ethics in Economics: An Introduction to Moral Frameworks by Jonathan B. Wight

protecting the environment and generating long-term value to shareholders.

While there is considerable overlap of content among the above initiatives, the emphasis is unmistakably on ethics and values beyond financial return. Since the concept is still evolving, many questions are yet to be answered (e.g. which Key Performance Indicators or KPIs will be used to objectively discern ethical businesses from unethical ones). Nevertheless, the trend is well established as to where the industry is headed.

Islamic finance industry and ethics/ values debate

When the first Islamic bank was established in 1970s and Islamic funds were launched, the concept of negative screening was introduced (no financing of projects engaged in manufacturing or supply of alcohol, tobacco, pornography, arms etc. or involved in gambling, conventional financial business, etc.) as a key requirement of Shari'ah. At the time, the conventional financial industry was focused on financial returns and ESG, responsible investing, impact investing, etc. were non-existent. Nearly five decades later, the Islamic finance industry continues to follow negative screens, and has not progressed towards positive screening (e.g. promoting businesses that generate a positive outcome whether environmental, social, governance, etc., leading the debate on contemporary issues such as climate change, inclusiveness, poverty, etc.). During this time, the conventional financial industry has come a long way, as reflected by the above-mentioned initiatives.

It is tempting to claim that Islamic financial institutions, by virtue of their Shari'ah compliance, should be considered ethical and value-based. However, the reality may not verify this claim. Shari'ah and legal compliance are the bare minimum requirements, which set the floor but not the ceiling. There is significant room to achieve higher. The acid test is, can we name a single Islamic bank that is considered the go-to institution for any of the contemporary ESG requirements?

This author would like to conclude by posing the following questions that stakeholders of the Islamic finance industry should reflect upon and answer:

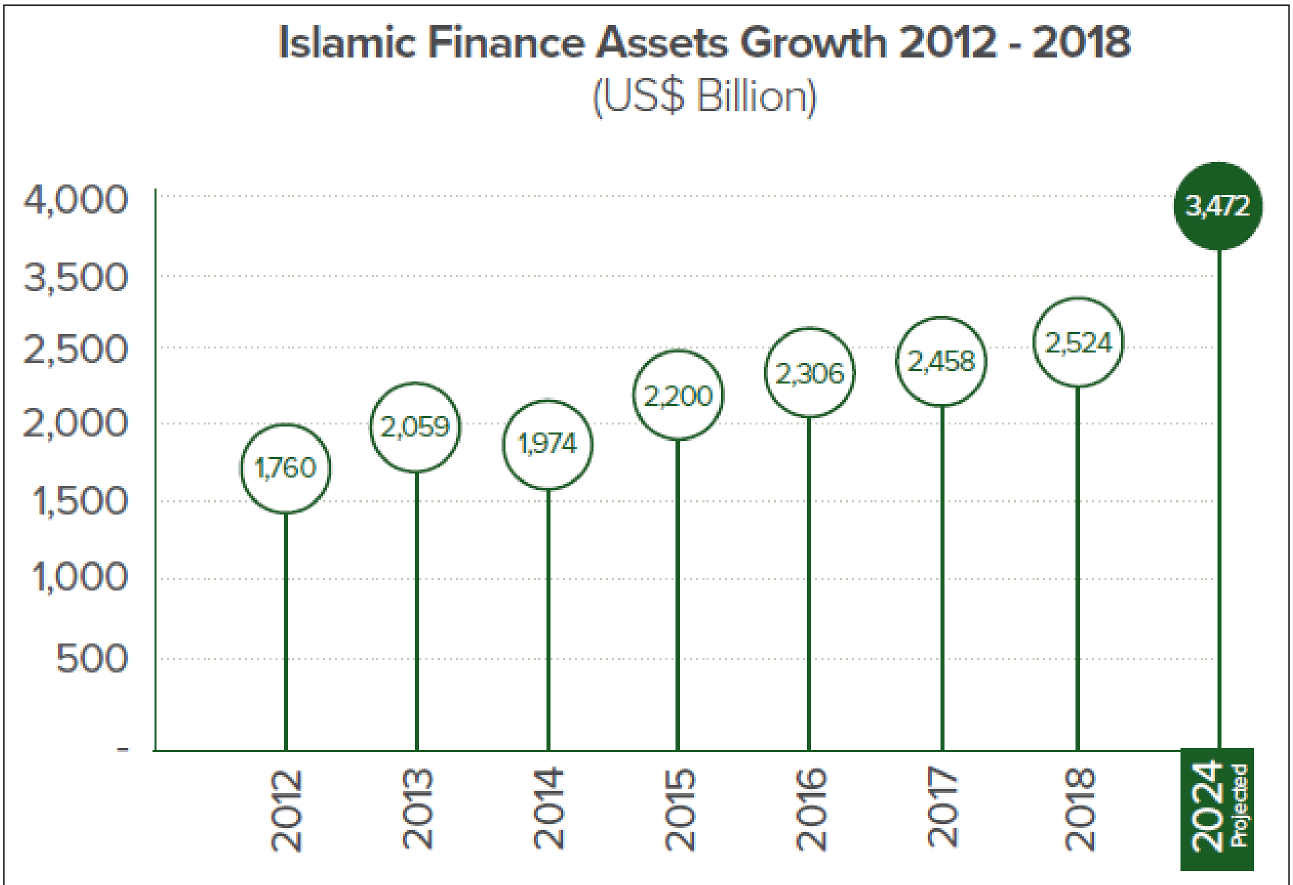
- If the Islamic finance industry does not align itself with contemporary value-based issues (for which Maqasid al Shari'ah provide an excellent starting framework), would it not be facing the risk of becoming irrelevant and outdated in the medium term?
- As more and more millennials become customers of the banks, what kind of institutions they would want to associate themselves with – the ESG-agnostic Islamic banks or ESG-compliant conventional banks?
- Is it not about time that Islamic banks' managements, boards, Shari'ah scholars and regulators put their minds together and come up with real value-based differentiators for the industry instead of cosmetic, technical and theoretical ones?
- If Islamic banks fail to elevate the level of their ethics and values, should the regulators step in and enforce some of these on them?

INDUSTRY UPDATE

Islamic finance development in 2019: Shifting dynamics

Shereen Mohamed[1]

According to the Islamic Finance Development Report 2019[2], the Islamic finance industry's assets grew to US$ 2.5 trillion in 2018 from US$ 2.4 trillion in 2017, a rise of 3%. This growth was slower compared to previous years, and was particularly more noticeable in some of the industry's main markets where the wider economy is sluggish.



Iran, Saudi Arabia and Malaysia were the largest markets of the 61 countries that reported Islamic financial assets, with all three recording more than US$ 500 billion in assets. The countries which saw the fastest growth in assets were Morocco, Cyprus and Ethiopia.

Industry development slows, particularly in leading markets

The report collates an annual score measuring the health and performance of the industry across the globe. The Islamic Finance Development Indicator (IFDI) aggregates scores across five component

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2- To learn more about IFDI 2019 and download the Islamic Finance Development Report, please visit http://bit.ly/IFDI2019 areas – Quantitative Development, Knowledge, Governance, Corporate Social Responsibility, and Awareness – for 131 countries. There was a small gain in the IFDI scores in line with the growth in Islamic finance assets. Governance, Knowledge and Awareness improved the most in value, while growth in CSR and Quantitative Development was less strong.

Malaysia, Bahrain and the UAE continue to spearhead developments in the industry, while Uzbekistan and Ethiopia are among the biggest risers in the rankings as a result of improvements in their financial and supporting ecosystem metrics.

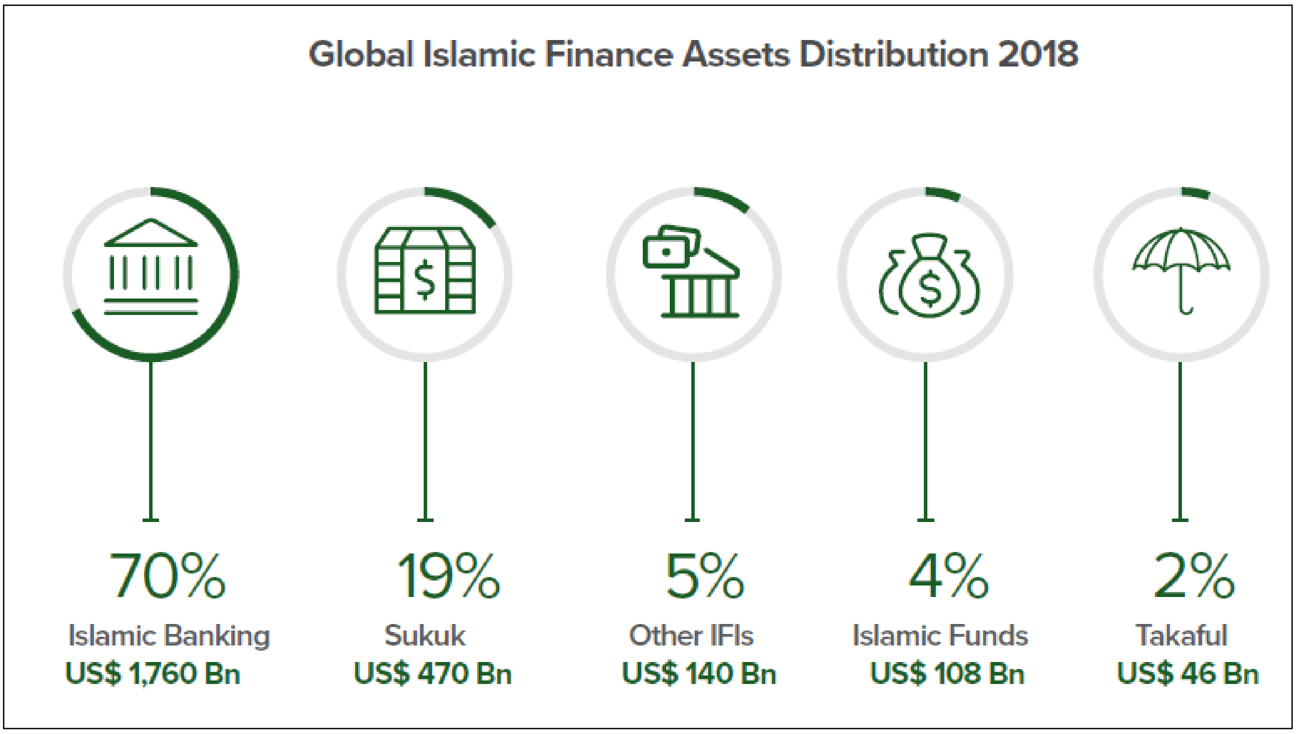
Despite slowing growth in other sectors, sukuk continue to power ahead

Growth in the industry's leading sector, Islamic banking, slowed to 2%, largely in line with slowing growth for the global economy. Islamic banking assets totaled US$ 1.76 trillion by the end of 2018. Many Islamic banks and windows are undergoing continuous transformation through either reorganization or consolidation. Despite the slowed growth, new banks and markets continue to enter the market, as seen in Ethiopia, Algeria and Afghanistan. Also, new liquidity tools are being developed to help grow existing Islamic banking markets, as seen in the UK, Oman and Pakistan.

Takaful and other Islamic financial institutions (OIFIs) account for the remaining share of Islamic financial institution assets with a respective US$ 46 billion and US$ 140 billion reported for 2018. Although, takaful grew by a mere 1% and OIFIs even declined in 2018, both sectors are seeing transformational activities in their main markets that should lead to improved growth in coming years, particularly in Saudi Arabia and the UAE. Moreover, both sectors are taking in new entrants in new markets. Developments in InsurTech and FinTech are also set to transform these sectors.

In contrast, the global slowdown did not impede the sukuk asset class from continuing its strong growth, rising 10% in 2018 to US$ 470 billion. Sukuk issuances during the year reached US$ 125 billion, a similar figure to the previous year. New innovative sukuk forms and structures emerged in 2018 and 2019 such as waqf, blockchain-based and gold-based sukuk. This is apart from green sukuk, which emerged in Malaysia in 2017 and has since expanded into new markets.

Islamic funds, which had a strong performance in 2017, declined to US$ 108 billion in 2018 as result of negative performance for most of the funds managed, in line with the global economic slowdown.



Government initiatives to expand industry continue

Governments also played their part in developing roadmaps and regulations in order to advance particular sectors of the industry and their supporting ecosystems. One such example is Indonesia's Masterplan of Shariah Economy 2019-2024, which encompasses a development framework, strategies and action plans designed to help the Islamic finance industry play a larger role in the country's economy. One particular focus of this strategy is Islamic finance education, where Indonesia already leads the world.

In terms of governance, governments are also enhancing their regulatory frameworks to benefit the industry. The UAE, for example, is working to improve Shariah oversight in areas such as Islamic banking and sukuk, while Malaysia is revising its takaful framework. Morocco, the Philippines and Bangladesh have introduced new Islamic finance regulations in 2019.

Much is being done to increase awareness in the industry with the emergence of 'Islamic Finance Week' programs, where several Islamic finance-related professionals are brought together to increase participation in these events. Such events were held in 2018 in the UAE, the UK and Kazakhstan.

Cross-border collaborations on Islamic finance between governments are becoming increasingly important. A few notable partnerships were announced in 2019 between Turkey, Qatar and Malaysia and between Indonesia and Suriname.

What supported the growth of the global Islamic finance industry in 2018?

1,447	44	1,166	US$ 639 Million	968	2,550	439	13,095
Islamic Financial Institutions	Countries with Islamic Finance Regulation	Shariah Scholars Representing Islamic Financial Institutions	CSR Funds Disbursed by Islamic Financial Institutions	Islamic Finance Education Providers	Islamic Finance Research Papers	Islamic Finance Events	News Items on Islamic Finance

FinTech continues to shape the industry, with new developments in digital social finance

FinTech is another area that is actively changing the dynamics of the industry, as seen, for example, in the issuance of blockchain-based micro-sukuk and in the role of Islamic FinTechs in promoting the industry in the UK and the U.S. during 2018. Crypto-assets are also being looked into by Shariah scholars and regulators in developed Islamic finance markets such as Bahrain and Malaysia.

Digital platforms are also beginning to be developed for applications in Islamic social finance, which can help in achieving the UN's Sustainable Development Goals as seen in UNHR's successful collection of zakat funds digitally. In addition, Indonesia's National Committee for Islamic Finance has partnered a centralized QR code payment platform owned by four Islamic units of state-owned banks to develop a digital platform for distributing Islamic social finance funds and to help Islamic finance cooperatives better manage the funds from zakat and waqf payments. Indonesia also saw the launch of the world's first blockchain-based crowdfunding waqf.

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