AAOIFI
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PEER-REVIEWED

Application of precious metal-backed cryptocurrency in Islamic finance

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By Faizal Bhana
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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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MESSAGE

AAOIFI UPDATE

EDITORIAL

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TECHNICAL ARTICLE

INDUSTRY UPDATE

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بسم الله الرحمن الرحيم

MESSAGE OF
THE SECRETARY GENERAL, AAOIFI

Mr. Omar Mustafa Ansari
Secretary General, AAOIFI

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

The world is experiencing inconceivable hardships and loss of lives since the outbreak of the COVID-19 pandemic. The recent news on its vaccine and antibody trials showing efficacy of more than 95% has raised hopes of likely epidemiological end of COVID-19 by Q3 or Q4 of 2021. There are nevertheless fears of a second or third wave of the pandemic with newer variants of the virus that may potentially cause more damage to people and the world economies at large. As we know, reliable vaccines and effective implementation of public health programmes, together with development of novel ways of treatment and diagnostics will be the key to overcome this pandemic.

Leveraging on technology, international cooperation and promoting practices of risk-sharing advocated by Islamic finance are among the solutions that may be needed to drive a robust recovery from this distress. Fintech wave that began about a decade ago is making a huge change with startups maturing into bank-like institutions, and conversely, banks inching towards fintech to prove their relevance to the financial industry.

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 been highlighting the role and opportunities that Fintech offers to the stakeholders of Islamic finance industry and discussed in its conferences and events. Another aspect that Islamic finance stakeholders should consider is to link their financial products and services with the real economy.

We are also pleased that we launched the first ever AAOIFI Footprint Report that assesses the footprint of AAOIFI standards and captures the level of adoption of its standards by various regulatory jurisdictions around the globe. As per the report findings respective AAOIFI standards (Shari'ah, accounting, auditing, governance and ethics) are adopted in not less than 27 countries and 40 regulatory jurisdictions within them, either fully or partially, as guidelines or reference material, on supplementary reporting basis, or base their local standards / regulations on AAOIFI standards.

With increasing significance of cryptocurrencies in the past few years, there has been many discussions in terms of its Shari'ah validity and applicability. This issue of JOIFA presents a related issue of application of precious-metal-backed cryptocurrency in the sphere of Islamic finance, and argues its position for its sustainable development and practical implementation.

Islamic finance is based on unique set of Islamic laws of contracts. This issue of JOIFA also discusses the enforceability of Islamic finance contracts under the English law, and argues that there are provisions to accommodate Shari'ah law despite the absence of case law for arbitration, and a possibility to explore arbitration by adopting Shari'ah as the choice of law.

This issue also seeks to investigate whether Maqasid, Hikmah, and purposes of law are a valid criterion to judge the Islamicity of Islamic banking products and transactions and whether Maqasid are valid paradigm for Shari'ah opinion in Islamic finance, while analyzing some structured products used by Islamic banks.

We are pleased that despite the pandemic, AAOIFI has worked hard to withstand the implications on its operations, and were successful in carrying out its mandated activities. In addition, AAOIFI Accounting Board (AAB) and AAOIFI Governance and Ethics Board (AGEB) provided guidance and issued statements to the industry stakeholders in the application of AAOIFI standards in response to the implications of COVID-19 pandemic.

We welcome the readers to provide their constructive feedback to this issue of JOIFA, and thank the researchers and scholars for choosing this platform to publish their papers. Inculcating the practice of research is one of the most important tasks at hand for further development of the Islamic finance industry and I urge researchers both from academia and the industry to use JOIFA as a platform to publish their work.

Wish you an insightful read, and hope for a healthy and safe future.

AAOIFI technical boards update

AAOIFI issued FAS 38 on "Wa'ad, Khiyar and Tahawwut"

AAOIFI issued Financial Accounting Standard (FAS) 38 "Wa'ad, Khiyar and Tahawwut" after AAOIFI Accounting Board (AAB) conducted extensive deliberations including multiple industry consultations where comments were received through public hearing events as well as in writing. This standard shall be effective for the financial statements beginning on or after 01 January 2022, while earlier application of the standard is permitted.

The objective of this standard is to prescribe the accounting and reporting principles for recognition, measurement and disclosure in relation to Shari'ah compliant Wa'ad (promise), Khiyar (option) and Tahawwut (hedging) arrangements for Islamic financial institutions. Wa'ad and Khiyar are used by institutions in various forms. Some are ancillary to other transactions, whereas a few are used as primary products. This standard intends to provide accounting principles for both of these, as well as the Tahawwut transactions which are normally based on Wa'ad or Khiyar, or a series or combination thereof.

AGEB approved work plan for the term 2020-2023

AAOIFI Governance and Ethics Board's (AGEB's) strategy in the development of standards takes into consideration both the market needs as well as the long-term best interest of the industry. Taking into consideration the revolution in the global Islamic finance ecosystem and the recent developments in FinTech with its associated opportunities and risks, the board approved a new comprehensive project on FinTech. The board also approved the initiation of a standard on the governance mechanism of an alternative benchmark rate as the global pressure surges to find new benchmarks replacing LIBOR. The development of standard on Zakah Institutions governance was put as priority as the board believes that it is necessary to boost confidence of the payers on Zakah institutions.

AGEB elaborated on various other new projects and approved developing new governance standards with special considerations on Islamic windows, mutual funds, and Takaful.

The strategy the board adopted in its last term will continue in its current term of working proactively and engaging with industry stakeholders at different levels to ensure that the new standards are developed in line with the actual market needs and in collaboration with the stakeholders.

AAOIFI issued FAS 36 on "First time adoption of AAOIFI Financial Accounting Standards"

AAOIFI Accounting Board (AAB) issued financial accounting standard (FAS) 36 "First time adoption of AAOIFI Financial Accounting Standards". This standard was finalized by the board after extensive discussions and due deliberations involving multiple industry consultations.

The standard has practical significance and has been developed to address challenges faced by institutions adopting AAOIFI FASs for the first time. FAS 36 prescribe principles of financial reporting carried out for the first time, especially in jurisdictions that are adopting, or considering adopting, AAOIFI FASs. The standard accounts for these issues with regard to the transitional process, as well as, to financial reporting requirements applicable to the financial statements prepared for the first time in accordance with AAOIFI FASs.

This FAS supersedes the AAOIFI Accounting Guidance Note No. 1 "Guidance Note on First Time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution" and should be read together with AAOIFI Shari'ah Standard (SS) 6 "Conversion of a Conventional Bank to an Islamic Bank".

AAB principally approved ED on "Presentation and Disclosures in the Financial Statements of Takaful Institutions"

AAB had initiated the comprehensive revision project for FASs on Takaful in 2018. This revised FAS shall supersede FAS 12 "General Presentation and Disclosures in the Financial Statements of Islamic Insurance Companies". The board approved the exposure draft with minor corrections. The second part of the project shall include the accounting treatments for Takaful products and shall replace the three existing FASs i.e., FAS 13, 15 and 19. The board agreed that the exposure draft will be preliminary in nature due to complexity of the project and will be re-evaluated once the second part of the project, relating to accounting treatments, is complete and comments from the market participants received subsequent to the public hearings.

AAOIFI issued FAS 37 on "Financial reporting by Waqf institutions"

AAOIFI issued Financial Accounting Standard (FAS) 37 "Financial reporting by Waqf institutions". The standard addresses the accounting and financial reporting requirements Waqfs and similar

institutions that aim to ensure compliance, in form and in substance, with Shari'ah principles and rules. The implementation of this comprehensive standard is expected, in turn, to contribute towards improving effectiveness and efficiency of operations of Waqfs, maximizing benefits to the beneficiaries and encouraging proper accountability and management.

This standard is the culmination of the Waqf comprehensive project for the revision and development of the Shari'ah, governance and accounting standards on Waqf, which was launched by AAOIFI in 2017. The initiation of the development of a financial accounting standard on Waqf was documented and effected by an agreement that was entered into by and between AAOIFI and Future Investment (Istithmar al-Mustaqbal- Saudi Arabia). The working group and the board worked extensively on fine-tuning the structure and content of the draft, taking into consideration the feedback gathered at multiple public hearings and industry interactions.

This standard is also expected help in improving the level of transparency in operations as well as establish a better foundation for demonstrating financial performance of Waqf institutions.

Standards and statements issued recently

Accounting standards issued

- FAS 36 "First Time Adoption of AAOIFI Financial Accounting Standards"
- FAS 37 "Financial reporting by Waqf institutions"
- FAS 38 "Wa'ad, Khiyar and Tahawwut"
- Revised AAOIFI Conceptual Framework

Governance standards issued

- GS 13 Waqf Governance
- Guidance Note on Waqf Governance (GS 13)

Statements issued

- Application of AAOIFI governance, ethics and auditing standards in view of the impact of COVID-19 pandemic
- Accounting Implications of the impact of COVID-19 pandemic

Extension of the effective date of AAOIFI FASs

AAOIFI Accounting Board (AAB) deliberated on the feedback received from the Islamic financial institutions working in various markets, about the potential constraints in adopting and implementing the recently issued FASs in the wake of the COVID-19 pandemic. The members agreed that institutions are facing practical difficulties in making the procedural shift in their operations, specifically in the modifications required in the IT systems, and the training of relevant staff. In view of that, the AAB decided to provide one year extension of the effective date of the recently issued AAOIFI FASs, namely, FAS 30 'Impairment, credit losses and onerous commitments', FAS 31 'Investment agency (Al-Wakala Bi Al-Istithmar)', FAS 33 'Investments in Sukuk, shares and similar instruments', and FAS 34 'Financial reporting for Sukuk-holders'; from 1 January 2020 to 1 January 2021. The AAB emphasized that institutions are still encouraged to early adopt these standards.

The extension of effective date shall not be applicable to institutions which have already completed the process of implementation, or where regulatory requirements do not allow such extension.

Clarification on applicability of FAS 30 to Takaful entities

AAB considered the effect of FAS 30, "Impairment, credit losses and onerous commitments" on Takaful entities. The members discussed that a project on revising the Takaful standards is in progress and considered the fact that an extension of one year has already been provided and reflected in the effective date of FAS 30 in the same meeting.

The Board, considering request from numerous Takaful / Islamic insurance entities operating in various countries and jurisdictions, clarified that till the project of revising the Takaful standards is complete, the Takaful / Islamic insurance entities remain subject to FAS 15 that is specific to them. In respect of investments accounted for under FAS 25, these entities are subject to impairment requirements under the same standard. However, for matters not covered under these standards, these institutions are encouraged, but not obligated, to develop, for the time being, their accounting policies according to FAS 30.

AAOIFI issued exposure draft on FAS on "Financial Reporting for Zakah"

AAOIFI issued exposure draft of Financial Accounting Standard (FAS) on "Financial Reporting for Zakah". In addressing the growing needs of the Islamic finance industry, the revision of FAS 9 on "Zakah" was on the agenda of the newly appointed ABB constituted in 2015, with a broader scope revision under consideration.

This standard improves upon and supersedes FAS 9 on "Zakah" and aims at setting out the accounting treatment of Zakah in the books of the institutions, including the presentation and disclosure by an Islamic financial institution.

The exposure draft aims to establish the principles of financial reporting related to Zakah

attributable to different stakeholders of an Islamic financial institution. This was also done keeping in view the additional accounting and computations related matters are already set out in the Shari'ah standard 35 "Zakah".

AAOIFI issued statement on "Application of AAOIFI governance, ethics and auditing standards in view of the impact of COVID-19 pandemic"

AAOIFI has been closely monitoring the current economic situation during COVID-19 pandemic and is aware that IFIs may require some clarifications and interpretations, as well as flexibility options for the application of AAOIFI governance, ethics and auditing standards.

AGEB formed a COVID-19 response taskforce with a mandate to examine and provide guidance in the application of the relevant standards. After due deliberations, AGEB has issued a statement "Application of AAOIFI governance, ethics and auditing standards in view of the impact of COVID-19 pandemic" to provide clarifications and interpretations of the relevant standards as well as to allow deferment of effective date of certain AAOIFI governance, ethics and auditing standards.

Since ethics forms one of the most important aspects on which Islamic finance is based on, and distinguishes IFIs from their conventional peers, IFIs shall stand out in this testing time by taking all possible measures to address various matters of importance such as payment moratoriums, dealing with employees, deployment of charity funds and others, in line with Shariah's ethical spirit. The scope of this statement is to provide clarifications and interpretations of the relevant standards in respect of certain significant issues rising amid COVID-19 pandemic and the consequential economic factors and regulatory interventions.

AAOIFI issued statement on "Accounting implications of the impact of COVID-19 pandemic"

AAOIFI Accounting Board (AAB) formed a COVID-19 response taskforce with a mandate to monitor and provide guidance in the application of FASs as soon financial implications of the pandemic started appearing. After due deliberations AAB has issued a statement "Accounting implications of the impact of COVID-19 pandemic" to provide clarifications and interpretations on accounting treatments in line with the relevant FASs arising in these challenging times. The due deliberation process included multiple meetings of the taskforce, consultation with various key stakeholders, including leading IFIs, audit firms and regulators from various jurisdictions, through written as well as via a focused workshop, in addition to review by the AAOIFI Committee of the Shari'ah Board for Review of Accounting and Governance Standards to ensure conformity with Shari'ah. AAB sees that AAOIFI FASs are robust and flexible enough to address the challenges posed by the prevalent uncertainty in the environment. However, it is important for the IFIs to faithfully represent financial information to all stakeholders and provide confidence to the industry worldwide. The statement is meant to guide the IFIs in this process and address specific issues that are unique to the IFIs, and its scope is to provide clarifications and interpretations of AAOIFI FASs and the Framework in respect of certain significant issues identified by the taskforce that may be effected as a direct result of the COVID-19 pandemic.

AAOIFI conferences and events

AAOIFI concluded global Islamic Finance Virtual Forum on COVID-19

AAOIFI successfully organized its first Islamic Finance Virtual Forum on "Covid-19 Economic Implications, Islamic Finance and the Way Forward" in collaboration with Islamic Research and Training Institute (IRTI), College of Banking and Financial Studies (CBFS) and Minhaj University. The half-day virtual Forum was organized over three sessions with two keynote speakers and was attended by more than 1,200 people while thousands more joined by live streaming on multiple online channels from no less than 40 countries from around the world. The forum received institutional support from more than 15 globally well-established and well-known institutions. In addition, the Forum was graced by more than 20 distinguished speakers and leaders from different parts of the globe. Shaikh Mufti Taqi Usmani, Chairman of the AAOIFI Shari'ah Board delivered his keynote speech which highlighted the importance of riba-free system. The Chairman of AAOIFI Board of Trustees, H.E. Shaikh Ebrahim bin Khalifa AlKhalifa addressed the sense of opportunity of Islamic finance industry to take advantage of the current global situation to reiterate the relevance of Islamic finance principles to overcome the impact of the coronavirus pandemic. Mr. Omar Mustafa Ansari, Secretary General, AAOIFI reiterated that in these times of distress Islamic finance must demonstrate its values and ethics to strengthen its faith to its stakeholders and updated the attendees on AAOIFI's work plan. The role of social finance via technology was reemphasized in response to the idea that economic shocks accelerate innovation and when fintech curve flattens, the role of Islamic finance will become more evident.

AAOIFI 18th Annual Shari'ah Boards Conference held on 25th and 26th October 2020 virtually

AAOIFI held its 18th Annual Shari'ah Boards Conference under the auspices of Central Bank of Bahrain on 8-9 Rabi Al-Awwal 1442H, 25-26 October 2020. Due to COVID-19 restrictions this year the conference was held on a virtual platform.

The two-day conference had keynote speeches in addition to four panel discussions with renowned Shari'ah scholars, leaders and experts in Islamic finance industry. Shaikh Mufti Muhammad Taqi Usmani, H.E. Mr. Rasheed Mohammed Al Maraj, Governor, Central Bank of Bahrain (CBB), and H.E. Dr. Ahmed bin Abdulkarim Alkholifey, Governor, Saudi Arabian Monetary Authority (SAMA) were among the keynote speakers. The panel discussions at the conference deliberated upon some of the significant and current issues, including AAOIFI Shari'ah standard 36 "impact of contingent incidents on commitments" in the light of COVID-19, impact of adopting an alternative indicator to LIBOR for Islamic financial transactions, Shari'ah standard 59 "Sale of Debt" (Bay'al-Dain) and its impact on Islamic finance industry, and the role of Fintech in the post COVID-19 world. H.E. Shaikh Ebrahim Bin Khalifa Al Khalifa, Chairman, AAOIFI Board of Trustees thanked CBB and other stakeholders for their support and participation.

AAOIFI successfully holds virtual launch event of AAOIFI Footprint Report 2020

AAOIFI launched its AAOIFI Footprint Report 2020 at an event held virtually on 27 October 2020.

President of Islamic Development Bank Group, H.E. Dr. Bandar M. H. Hajjar; H.E. Mr. Khalid Hamad Al-Hamad, Executive Director – Banking Supervision, Central Bank of Bahrain; and H.E. Dr. Ishrat Hussain, Advisor to the Prime Minister on Institutional Reforms and Austerity, Pakistan gave special addresses at the event which was supported by Jersey Finance. Secretary General, AAOIFI, Mr. Omar Mustafa Ansari presented the summary of the report to the event attendees.

H.E. Dr. Hajjar during the special address at the launch event said, "Specifically for the Islamic financial services industry, it is my immense pride to note that the Islamic Development Bank is the founding member and active supporter and contributor of all six Islamic finance infrastructure institutions (IIIs) which exist today for providing the best-practices standards for the global Islamic financial services industry." H.E. further added, "The IsDB supports the adoption of AAOIFI and other IIIs standards in the various transactions and contracts of the Islamic financial services industry." The launch event also featured a panel discussion which examined the role of Islamic finance standard-setting bodies and the importance of adoption of their standards. AAOIFI Footprint Report 2020 assesses the footprint of AAOIFI standards and captures the level of adoption of AAOIFI standards by various regulatory jurisdictions around the globe. As per the report findings respective AAOIFI standards (Shari'ah, accounting, auditing, governance and ethics) are adopted in not less than 27 countries and 40 regulatory jurisdictions within them, either fully or partially, as guidelines or reference material, on supplementary reporting basis, or base their local standards / regulations on AAOIFI standards.

On this occasion of the launch of the report, Chairman of AAOIFI Board of Trustees, H.E. Shaikh Ebrahim Bin Khalifa Al Khalifa said, "It gives me utmost pleasure to present this first ever AAOIFI Footprint Report. Only through the rigorous efforts of the team and an unparalleled support by the regulators and market players, as well as, the scholars, professionals and experts in the field of Islamic finance, it has been able to achieve a great feat in the development, growth, standardization and harmonization of Islamic finance in light of the divine guidance and the best industry practices. This study has been conducted to measure such impact that AAOIFI has made to the Islamic finance industry to a reasonable, measurable degree.

H.E. further stated that, "Adoption and implementation of standards require years of advocacy, outreach, partnership, scholarship and capacity building, among others, AAOIFI is glad that in nearly three decades of its existence it has been successful in all these fronts." The report is downloadable from http://aaoifi.com/foot-print-report-download/?lang=en.

AAOIFI - IsDB 15th annual conference successfully concluded virtually

AAOIFI and Islamic Development Bank Group successfully organized 15th AAOIFI – IsDB annual conference. The two-day virtual conference was organized over four sessions with five keynote speakers and was attended by more than 1400 online industry participants from more than 46 countries. More than 25 distinguished speakers from different parts of the globe participated in the two-day event. The conference was jointly organized by AAOIFI and IsDB and conducted under the auspices of the Central Bank of Bahrain.

The conference had keynote addresses by H.E. Shaikh Ebrahim bin Khalifa Al Khalifa, the Chairman, AAOIFI Board of Trustees, H.E. Dr. Bandar Hajjar, President, Islamic Development Bank Group (IsDB), Mr. Khalid Hamad Al-Hamad, Executive Director, Banking Supervision, Central Bank of Bahrain, Bahrain / Member, AAOIFI Board of Trustees and Guest

of honour Dr. Qais Al Yahyai, the Executive Vice President, Central Bank of Oman.

The title of this year's conference, "Adaptability of Islamic finance post COVID-19: navigating through unprecedented times", was broken down into three key theme areas: the Covid-19 pandemic, social finance, and Maqasid Al Shari'ah. The conference called for the industry stakeholders to use this pandemic as an opportunity for strengthening stakeholder confidence in Islamic finance. The conference which was spread over four sessions, with five keynote speeches, and two special presentations discussed issues, including ideas for IFIs to relook at their existing business models, suggested measures for IFIs to sustain and strengthen the social dimension of Islamic finance and how social finance institutions such as Waqf, in particular, can be instrumental to boost Islamic economies. The conference also discussed the role of IFIs in promoting Maqasid Al Shari'ah and stakeholders' expectations, and its link with UN's Sustainable Development Goals (SDGs).

Ms. Taliya Minullina, CEO of Tatarstan Investment Development Agency gave a special address on the impact of COVID-19 on Islamic finance in CIS countries and what future holds for the region. Ms. Sabeen Saleem, CEO of Islamic International Rating Agency (IIRA), gave a presentation on the impact of COVID-19 on the rating of Islamic financial institutions.

Professional development update

AAOIFI conducted series of online technical workshops

AAOIFI concluded a series of online technical workshops covering all areas of standard-setting: Shari'ah, accounting, auditing, governance and ethics. The workshops were attended by more than 100 participants from around the global who received more than 65 hours of training based on lectures, comprehensive case studies, concept checkers, MCQ-style online quizzes, brainteasers, group activities, and Q&A. The workshops were led by the Secretary General, members of the AAOIFI Shari'ah board (ASB), the governance and ethics board (AGEB), and the education board (AEB) as well as by the head of capacity building programs and AAOIFI master trainers. The workshops were organized to help Islamic Financial Institutions (IFIs) offer their employees a highly optimized and effective learning opportunity especially during the COVID-19 pandemic when routine work and productivity has been significantly impacted.

CBB recognizes AAOIFI's CIPA and CSAA fellowships in its Fit and Proper criteria for various controlled functions

The Central Bank of Bahrain (CBB) has formally recognized the two professional fellowships offered by AAOIFI in its Fit and Proper criteria of the Training and Competency section of the Rulebook.

The two AAOIFI fellowships recognized by CBB include the 'Certified Islamic Professional Accountant' (CIPA) and the 'Certified Shari'ah Advisor and Auditor' (CSAA), respectively. By virtue of CBB's recognition of AAOIFI fellowships, all Islamic finance professionals currently assuming or aspiring to assume identified 'controlled functions' (mentioned below) are mandated to acquire good knowledge and understanding of AAOIFI standards. Such core competency may be demonstrated by them through various related academic / professional qualifications and minimum years of experience, including CIPA and CSAA fellowships. The positions / controlled functions for which the AAOIFI CIPA fellowship is recommended as part of the Fit and Proper criteria include: Chief Executive or General Manager and their deputies; Chief Financial Officer/ Head of Financial Control; Chief Risk Officer / Head of Risk Management; Head of Internal Audit; as well as Heads of other specialist functions. Similarly, AAOIFI CSAA fellowship has been recommended for the positions / controlled functions of Shari'ah Officer and Head of Internal Shari'ah Audit function, respectively. There are about 1,700 AAOIFI Fellows from around 40 countries / jurisdictions. AAOIFI Education Board directs and supervises all capacity building programs and activities of AAOIFI.

AAOIFI issued CPD Policy for its CIPA and CSAA Fellows

AAOIFI Education Board (AEB) approved the issuance of the Continuing Professional Development (CPD) policy for its CIPA (Certified Islamic Professional Accountant) and CSAA (Certified Shari'ah Advisor and Auditor) Fellows.

The objective of the CPD policy is to enhance professionalism and competency levels of the AAOIFI fellows (those who have passed the CIPA and/or CSAA professional fellowship programs) by requiring them to complete minimum 60 CPD hours in relevant activities in a reporting year, out of which minimum 10 hours will be devoted towards building knowledge and improving skills in ethics. The CPD requirement will be applicable to all AAOIFI Fellows after one year of their acquiring of CIPA and CSAA fellowships.

Strategic relationships

AAOIFI and UNHCR signed MOU for joint initiatives and collaboration to enhance Islamic social finance

In a bid to strengthen collaboration and governance in the area of Islamic social finance, AAOIFI and the United Nations High Commissioner for Refugees (UNHCR) signed a three-year memorandum of understanding (MoU). This initiative marks the beginning of a long-term partnership between both parties, with the aim of further developing Islamic finance tools for the benefit of the world's most vulnerable refugees and internally displaced persons (IDPs). AAOIFI's collaboration with UNHCR aims to exchange areas of expertise, create Zakat governance standards for international humanitarian organizations and develop other areas of Islamic Philanthropy for UNHCR. This will include Waqf, Sadaqah, Sukuk and purification funds, through creating relevant avenues for Islamic banks to engage with UNHCR. Building awareness through the joint organization and hosting of seminars and forums on areas of mutual interest is also part of the collaboration.

In addition, AAOIFI also signed MoUs with other industry stakeholders including, Bahrain Institute of Banking and Finance (BIBF), the Participation Banks Association of Turkey (Türkiye Katılım Bankaları Birliği (TKBB)), Bakai Bank, iPORTAL to strengthen industry participation to fulfil its mandate.

GiveZakat App
by the Refugee Zakat Fund

1- **Calculate your Zakat** easily and simply on our new App.

2- **Choose the location** of the families you want to help with your Zakat.

3- **Give your Zakat.**
Most of your donation reaches eligible families.

4- **Track your Zakat.** Donation will be matched your chosen beneficiaries.

5- **See the impact of your Zakat.** Get closer to the families you help.

EDITORIAL

COVID-19 and global finance: Islamic financial institutions need to give befitting response

Muhammad Ayub[1]

The coronavirus (COVID-19) pandemic has greatly affected the human life and wreaked havoc to almost all businesses, finance and economies of the world. It has caused an unprecedented damage to the economic systems both at the national and international levels. While at the individual level hundreds of thousands of people have died and millions of them became jobless, at the macro level, production, businesses, trade, supply chain, banking and finance systems among others, have suffered a severe setback. Many countries are struggling to contain the losses to human lives due to the continued effect of the pandemic. While the second wave is worrying Australia, Japan and Hong Kong (The Economist, August 01, 2020), it may imply living with this virus as the new normal at least for a few years to come.

With regard to worsening situation in global economy and finance since the global financial crisis of 2007-08, serious efforts had been initiated, even prior to COVID-19, to offset the impacts of neoliberalism in the form of growing economic inequalities and non-sustainability of the systems. In 2013, the World Bank adopted "promoting shared prosperity" as one of its twin overarching goals – the other being to end extreme poverty. In 2015, world leaders agreed to a sustainable development agenda to tackle the issues of growing inequalities at national (within the countries) and the global levels. But these efforts might have to face low chances of success due to some built-in flaws in the systems.[1]

The United Nations' World Social Report 2020 documents a deep divide within and across countries despite an era of extraordinary economic growth and widespread improvement in living standards[2]. According to the report, social and regional inequality, both at national and global levels, is becoming an increasingly serious threat to sustained and shared growth and development in the world. "In North and South alike, mass protests have flared up, fueled by a combination of economic woes, growing inequalities and job insecurity. Income disparities and a lack of opportunities are creating a vicious cycle of inequality, frustration and discontent across generations". Unless progress accelerates, the core promise of the 2030 Agenda for Sustainable Development – to leave no one behind – will remain a still distant goal by 2030, the report says. Further, there are environment related issues haunting the future of human beings and the cosmos. Hence, even in the conventional finance, banks are under increasing pressure to finance the transition to a greener, more sustainable future, while remaining profitable at the same time (The Banker, July 31, 2020).

The finance sector involving the use, creation and investment of money, and direct and indirect financial intermediation procedures and processes have a huge impact on almost all members of the society. The last three decades of financialization[3] have led to recurring global crises. A paradigm shift and concentrated efforts would be needed at the theory, policy making and operational levels. Equity, participation, ownership with related risk, risk-sharing, possession and sanctity of contracts are

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2- UN, The World Social Report 2020 https://www.un.org/development/desa/dspd/wp-content/uploads/sites/22/2020/02/World-Social-Report2020-FullReport.pdf

3- 'Financialization' is a common narrative currently in modern finance, "typically cast in part with specific reference to the "real economy". It refers to the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies, and is a pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production' [Getting Real about Islamic Finance, by Larry Beeferman and Allan Wain (Harvard Law School, Harvard University), 2016, Available at https://lwp.law.harvard.edu/files/lwp/files/getting_real_about_islamic_finance_corrected_final_070116.pdf

the key features of Islamic economy and finance. It has capacity to deliver better in such circumstances by dint of its built-in strengths, the philosophy of risk and reward sharing, and mutual mitigation of the impacts of losses.

The AAOIFI has provided a sound basis for the above framework by providing Shariah, accounting, auditing and governance standards, also including the Code of Ethics. It keeps on urging Islamic financial institutions (IFIs) and the financial regulators and supervisors to go for adoption of its standards in their true spirit. In this pursuit, it organized an Islamic Finance Virtual Forum that was addressed by the top ranking experts of Islamic economics and finance. Among other things, emphasis was suggested on providing equity-based finance to tackle the impact of COVID-19. Debt-creating contracts can of course be used provided their underlying essentials are implemented in letter and spirit, and each and every transaction is backed by the genuine real sector activity.

According to a statement issued by AAOIFI's Accounting Board (AAB) on implications of COVID 19, the IFIs have multiple stakeholders who share the profit or loss of the institution. Their transactions, in contrast to conventional finance transactions, are based on trade, giving assets on rent, or partnership. The Statement provides clarifications and interpretations on accounting treatments in line with the relevant FASs arising in the challenging times. As per the Chairman of the AAB, "the FASs are robust and flexible enough to address the challenges posed by the prevalent uncertainty in the environment. However, it is important for the IFIs to faithfully represent financial information to all stakeholders and provide confidence to the industry, worldwide." The Secretary General, Mr Omar Mustafa Ansari reiterated that the IFIs must pay attention to their unique features, characteristics and risk exposures and consider the effects on their financial reporting practices and related financial statement disclosure.[4] AAOIFI's Governance and Ethics Board (AGEB) also indicated, in a similar Statement, that the IFIs must maintain the true spirit of Islamic finance and demonstrate the universal ethical values and good governance practices. The Secretary General added that the appropriate reaction of IFIs during these difficult times would be the acid test for demonstrating the uniqueness of IFIs and their activities".[5]

AAOIFI would also invite the international financial institutions and stakeholders such as the World Bank, International Monetary Fund, Basel Committee on Banking Supervision (BCBS) and the global leaders in monetary and finance supervision to come to the real point of eliminating the basic tools of exploitation from the world of finance, namely the interest, short-selling and other means of earning risk-free returns. Further, beyond market economy and institutions like Waqf will have to be evolved for shared prosperity and sustainable growth. It's only then that human beings could jointly realize the Sustainable Development Goals (SDGs), adopted by the UN to help build a better future for the world.

In the wake of the current pandemic, equity-based finance is already being suggested even in the conventional finance. For European economies, Boot et al. (2020) suggest that there has to be any new schemes to provide funding to firms without increasing their leverage and default risk. They have suggested a pan-European risk and reward-sharing scheme for firms, mostly SMEs and privately-owned firms having no access to capital markets. "The implied risk sharing equity-like payment structure has positive risk-sharing features for firms, without impinging on ownership structures"[6]. They have suggested the establishment of a European Pandemic Equity Fund (EPEF). The scheme that is akin to equity-based Islamic capital market instruments, could also work for larger firms, which, of course, have easier access to capital markets.

As such, Islamic finance has to give a response befitting its principles and potential to the chaos created by the pandemic, and demonstrate that it is indeed resilient vis-à-vis the conventional finance. It is up to the IFIs to come up with proper solutions and packages useful for production and business processes in the short, medium and the long run. The equity-based crowdfunding and peer-to-peer Takaful are expected to be more useful for realizing the objectives of shared prosperity. As of now, IFIs have not been completely successful in providing an effective link between the finance and the real economy. Going forward, the objective has to be the sustainability and profitability while managing the business risks properly, taking care of all stakeholders' interests, and implementing the divine business values to realize the objective of shared and prosperous economy.

4- http://aaoifi.com/announcement/aaoifi-accounting-board-issues-a-statement-on-accounting-implications-of-the-impact-of-covid-19-pandemic/?lang=en

5- http://aaoifi.com/announcement/aaoifi-governance-and-ethics-board-issues-a-statement-on-application-of-aaoifi-governance-ethics-and-auditing-standards-in-view-of-the-impact-of-covid-19-pandemic/?lang=en

6- Boot, A; Elena C., Hans-H. K., J. P. Krahnen; Loriana P., and Marti S. (2020); Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small [Column, 03 April]. Available at the link https://voxeu.org/article/try-equity-coronavirus-and-financial-stability

There has to be a collaborative framework between conventional and Islamic systems and the public and private sectors. The UN report (2020) recommends that while the governments at national levels should play key role in creating more equitable societies, international cooperation in the increasingly interconnected world is also important than ever for safeguarding the future of mankind. Policymakers and the regulators need to understand the natural phenomenon requiring shared growth and prosperity. Mainly three domains of ethics and norms are crucial with regard to evolving governance principles in this perspective: morals related to individuals (and society), ethics belonging to groups including organizations, and laws governed and implemented by entities with legal and regulatory authority. The financial sector regulators need to take care of all such aspects while introducing the regulatory structures.

Islamic finance is necessarily a rule-based system providing detailed guidelines for doing profitable business and maintaining good governance, of course with justice to all stakeholders, respect for human rights, freedom of choice in the light of the road map provided by Qur'ān and Sunnah. As a part of the World Bank's SDG's 2030 agenda, the emerging concept of Value-based Intermediation (VBI) encompassing Corporate Social Responsibility (CSR), Sustainable and Responsible Investing (SRI); Environmental, Social and Governance (ESG) aspects, etc. suit IFIs more than their conventional counterparts. This requires, in turn, fulfilling the finance needs of SMEs and micro business in production sectors, and taking care of the rights of other stakeholders.

The concepts of project financing in agro-based industries and SME sectors, private equity including venture capital and angel investments, and close and open-ended mutual funds for channeling savings to production and business projects could frame the possible structure of Islamic finance to realign the current business models. Besides, the emerging business structures like "crowd funding", "platformisation", "cooperative Takaful and re-takaful" working on the model of 'mutuals' could be the most suitable tools for realizing shared prosperity, sustainability and the other SDGs.

As the banking and other financial institutions use community's savings for their business, they must pay the society, in turn, by rendering just and CSR related services to depositors, fund users, employees and other stakeholders. It would require a new and independent approach and CSR friendly policy and regulations to be introduced and implemented by the regulators. Of course, no model of governance can be a panacea for the greed of humans; hence the societies must nourish better values by introducing and implementing fool-proof regulations to ensure justice with the stakeholders and realize broad-based prosperity. In this perspective, the willingness at the regulators, practitioners and the Shariah advisory levels is of utmost importance so that the principles of Islamic finance are implemented in letter and spirit for the benefit of mankind.

PEER-REVIEWED

Application of precious metal-backed cryptocurrency in Islamic finance

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Abstract

Finance industry has become an essential part of the digital transformation in the perspective of Industry 4.0. The objective of this research is to find out the prospects of applying precious metal-backed cryptocurrency (PMBC) to Islamic finance by exploring its application to the different Islamic finance contracts for structuring Islamic finance products. A qualitative methodology is employed in conducting this research where relevant literature on the subject matter was reviewed. By using doctrinal approach, the paper presents Shari'ah compatibility of and issues in application of PMBC to Islamic finance contracts. The outcome of the research reveals that there is scope to use PMBC backed by gold to replace the function of fiat currency in Islamic finance contracts. However, there are specific Shari'ah rules applicable to each of the contract as derived from AAOIFI's Shari'ah standard No. 57 published in 2016. For the sustainable development and practical implementation of PMBC in Islamic finance, it is observed that there are certain inhibitions that need to be eliminated such as lack of political will in acknowledging it as a legal tender and development of an adequate and effective infrastructure with legal, regulatory and governance frameworks. It is anticipated that the outcome of this research will assist the policymakers and stakeholders of Islamic finance to prepare themselves to utilize PMBC in Islamic finance industry and to conduct further research in resolving the issues identified for adoption of PMBC backed by gold in a Shari'ah compliant way.

JEL Classification: E49, G30 and Q01
KAUJIE Classification: Q5, Q11, Q31, Q42
Keywords: Cryptocurrency; Gold standard; Islamic finance; Precious metal-backed cryptocurrency; Sharī'ah.

1.0 Introduction

The failure of riba-based fractional reserve monetary system to withstand the turmoil of the past financial crises in providing stability in the global and domestic economic systems has forced to find alternatives to the system (Ahmed, et.al., 2018). The recent development of cryptocurrency, currently used with fiat currencies, is predicted to be replaced in future provided that it is accepted as a legal tender. The fiat money today is no longer backed by gold or any real assets, it is rather backed by debts. It is described as a system of money where a government in a specific jurisdiction has announced to be a legal tender without backing of any physical commodity (Ajouz, et.al., 2019; p.4).

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In 2008, just after the financial crisis, the first form of cryptocurrency, Bitcoin was invented (Abubakar, et.al., 2019) by mysterious Satoshi Nakamoto. He believed that decentralized currency control on a distributed-ledger technology or blockchain technology would be the solution for the economic instability caused by the fiat money craeting an air bubble that could burst any moment. The supply of Bitcoins was limited due to a specific way of coin mining. More cryptocurrencies, thereafter, entered the market.

Billah, M.M. (2018) has described cryptocurrency as a "non-typical legal tender" which may remove the tripartite manipulation, control and influence of any government. But the reality is that cryptocurrency is still not accepted as a legal tender like fiat money. There is still on-going debate with regard to this among the central banks and the regulatory authorities of currencies in different parts of the world. Instead of accepting it as a legal tender, some jurisdictions like Malaysia and Japan have legally recognized it as a crypto asset only (Sherin & Muneeza, 2020; Wright, 2020).

It is difficult to provide a precise definition for cryptocurrency (Zulkhibri, 2019), while digital currency is also a term used to describe it, as digital cryptographic algorithms are used for its minting (Dwyer, 2015; Zulkhibri, 2019). There are four key features of cryptocurrencies as identified by Baur, et.al., (2015): (i) absence of external regulatory barriers; (ii) establishment of peer-to-peer functions; (iii) usage of public Internet infrastructures; and (iv) implementation of private-public-key cryptography for secure transactions (Zulkhibri, 2019; p.36).

The blockchain technology ensures the operation of cryptocurrencies on a distributed ledger across numerous computers network thereby eliminating the need for a central authority. In addition to the significant mitigation of risks, another useful mechanism is elimination of intermediation costs, especially the processing and transaction activities. In the midst of this astonishing feature of cryptocurrencies came about an upsurge in the volume of its transactions. As of 9 June 2020, it was found that the total market capitalization for cryptocurrency stood at USD$275,796,316,996 while there were 5,563 types of cryptocurrencies with 22,688 markets (coinmarketcap, 2020). It is anticipated that the cryptocurrency market will further grow and as such it is relevant to study this market.

Lately, it has been realized that cryptocurrencies also have failed in providing stability in the financial systems as they are susceptible to exchange rate fluctuations resulting in speculation akin to the fiat standard of money. According to Abd Rahman, (2017), gold value is stable compared to value of bitcoin that displays instability as much as seven times. Hassan, et.al. (2021; p.16-17) indicated the unreasonable price fluctuations in the cryptocurrency market by referring to the market capitalization of all active cryptocurrencies between January 6 2017 which stood at USD 18.188 billion and January 18 2018 which stood at USD 583.16 billion showing that within the span of a year, there had been an approximate growth of 3106% creating greatest bubble in the history of modern economy. Therefore, precious metal-backed cryptocurrency (PMBC) with valued coins and tokens have been developed and perceived as a stable type of currency as it leverages on the underlying asset.

The objective of this research is to find out the prospect of applying PMBC to Islamic finance by exploring its application to the different Islamic finance contracts and products. A qualitative methodology is employed in conducting this research where relevant literature on the subject matter was reviewed. Via doctrinal approach, the paper presents Shari'ah compatibility and issues in application of PMBC to Islamic finance contracts.

This paper is divided into five sections. Followed by this introduction, section two presents the literature review on the subject and section three presents feasible areas of application of PMBC and the key issue of PMBC applications in Islamic finance contracts. Section four discusses the issues in the implementation of PMBC as a hedge to currency depreciation in any form of economic slowdown followed by conclusion.

2.0 Literature review

According to AAOIFI (2016), gold is a widely known valued element as a precious metal. Gold being a precious metal had previously served as commodity money and is used in the production of jewellery, coins, medals, and as electronic component among other uses. Ibn Khaldun believes that gold and silver are two kinds of metals that could be used as a measure of value and it is found that these metals are accepted by all as forms of money and its value is not subject to conjured fluctuations (Boulakia, 1971). A fundamental difference between gold and cryptocurrencies is that while gold enjoys less volatility with better liquidity in markets, cryptocurrencies are known for the reverse of this.

One of the most recent research conducted on the Shari'ah compliance of cryptocurrency is made by Zulkhibri (2019; p.43) where he observes that from a general perspective, Shari'ah scholars allow anything used by people as money which are gold, silver, wheat, barley, salt, dates etc.; paper currencies and coins; and electronic money and cryptocurrencies. However, he observed that when the money exchanges occur, the Islamic rules of Bai al sarf will be applicable. If the rule of sarf is breached in this case, Riba will trigger affecting the

validity of the transaction from Islamic perspective (Zulkhibri, 2019). The rule of Islamic jurisprudence that ought to be followed in exchange of currencies is that no form of currency is allowed to be used as a commodity or a good that could be leased for a rent. However, all jurists unanimously agree, as observed by Zulkhibri (2019), that money ought to be a medium of exchange as supported by scholars like Imam Ghazali (A-Ghazali, 1993) and Ibn Taymiyyah (Ibn Taymiyyah, 1995).

Zulkhibri (2019) also explains two types of money acceptable in Islamic jurisprudence; the first is Al -Thaman -ul -Khilqi' or Al -Nuqood -ul -Khilqiyyah: it is a type of currency which is created to work as a medium of exchange in contracts and trades. Their value is natural not based on tradition or agreement, as well as custom; gold and silver are in this class. The second is Al-Thaman-ul-Istilahi or Al-Nuqood-ul-Istilahiyya: its value is established through common agreement, tradition or custom, hence artificial or token and its validity is not constant as the validity is subject to the government's decision. All fiat monies in physical paper or electronic form, as well as cryptocurrencies, fall into this category.

Oziev and Yandiev (2017) have stated eleven requirements for a cryptocurrency to be Shari'ah compliant and they are: "the process of money emission, its supply, and withdrawal from the market should be free from Riba; money can be made of any material (metal, wood, plastic, etc.); the money emitter and the monetary regulator may be two different entities/organizations; the money emitter is a risk-free institution; the money emitter should not enter into transactions with financial institutions aimed at obtaining income; it is not forbidden to use the currency/money of other countries; money does not necessarily have to be backed by real assets; money must be emitted in a sufficient quantity to serve the needs of the economy; no prohibitions and or restrictions on monetary transactions, as well as for exchange and transfer of money (not clear); money and monetary circulation should facilitate the life of the people; and ownership right of a person over money should be transparent" (Bedoui & Robbana, 2019; p. 271).

Muneeza and Mustapha (2019; p.72) indicated the Shari'ah compliance of blockchain technology and observed that many people get confused about use of blockchain technology for cryptocurrencies such as Bitcoin whereas in reality the scope of its application is much wider than that. They have concluded that generally Islam welcomes innovation and creativity as long as it complies with Shari'ah requirements and does not breach any of Shari'ah rules. As such, they believe that blockchain technology aligns with Shari'ah as it allows transaction in Islamic finance to be performed in a transparent manner by creating trust and reliability between the parties by dispelling room for fraud or any unethical business behaviours (Muneeza and Mustapha, 2019; p.99).

Hassan, et.al., (2021) presented a Shari'ah analysis of Bitcoin and cryptocurrencies whereby they observed that the main features of Bitcoin include: it has no intrinsic value, it has only a digital but not a physical form; its supply is not determined by a central bank; it is neither issued nor controlled by a company, an individual, an organization; and it has no central point to address failure and when compared with fiat money, it does not qualify the functions of wide acceptability as a medium of exchange. According to Hassan, et.al., (2021), there are total six features found in fiat money: money should be scarce to obtain; money should be widely acceptable as a medium of exchange; money can be divided into small parts to facilitate small transactions; transactions using a specific form of money should be less expensive; money's value should remain reasonably stable over time; and money is issued by a trusted central authority. Out of these six features, only two functions are fulfilled by Bitcoin and cryptocurrencies: which is scarce to obtain feature and feature of it being able to be divided into small parts to facilitate small transactions only (Hassan, et.al., 2021).

As mentioned earlier, PMBC is simply designed as an electronic reflection of a physical precious metal secured in a vault across the globe. As in the case of the gold standard, the encrypted electronic units would continue to exchange for goods and services, as well as store value. Another characteristic of the cryptocurrencies is the blockchain distributed ledger technology that keeps an open record of every consummated transaction across the network. The technology enables tracking the currency's pathways right from its mining point through its multiple exchanges with absolute transparency and security.

The extent of the authenticity of the blockchain technology is embedded in its real time and published products, as detailed as capturing the serial numbers. This attribute makes blockchain consistent with the architecture of mining and refining of precious metals, as well as the distribution. To buttress this fact, James (2020) reported that currently there are not less than 62 companies that are promoting gold-backed cryptocurrency. The first firm to receive Shari'ah compliant certification for gold backed cryptocurrency is the Malaysia-based firm HelloGold who received it in February 2018 for their product GOLDX (Vizcaino, 2018A). This was followed by Dubai based OneGram listing Islamic cryptocurrency on its own virtual exchange in September 2018 claiming that "its cryptocurrency adheres to shariah directives as each OneGram unit is backed by physical gold stored in a vault, a

feature that aims to address speculation and price volatility" and that their tokens are paired now for trading against Bitcoin (Vizcaino, 2018B). GOLDX of HelloGold is different from other metal-backed cryptocurrencies in that it "involves the issuance of a token backed by physical gold stored in a Singapore vault, and transactions must be completed within a defined time period" (Vizcaino, 2018A).

HelloGold is certified Shari'ah compliant by Amanie Advisers whereby it is stated that the operation of HelloGold is in compliance with Shari'ah standard on gold which is the AAOIFI Shari'ah standard No. 57 on Gold and its Trading, as developed by AAOIFI, the World Gold Council and Amanie Advisors (HelloGold, n.d.). It is stated that since gold is a Ribawi commodity, to ensure that riba does not trigger in the transaction, there are certain conditions that ought to be fulfilled and these conditions are: HelloGold PMBC shall be backed by physical gold that is fully allocated and the process of buying and selling physical gold is completed in the time allowed by the standard (HelloGold, n.d.). Paragraph 3/4 of AAOIFI Shari'ah standard No. 57 on Gold and its trading states about sale of gold ingots for currencies:

When gold ingots are sold for currencies, the counter values must be exchanged during the contracting session. Possession of the ingot by the buyer, or his agent, is realized either physically or constructively. Constructive possession is realized by allocation of the ingot and by enabling the buyer to dispose of, or by holding a certificate that represents ownership of a specified ingot that is distinguishable (an allocated ingot) from others, by serial numbers or other distinct marks from other ingots, provided the certificate is issued the day the contract is concluded (Trade Date "T+0), by officially or customarily recognized agencies, enabling the buyer to take physical possession of the purchased ingot at his request. Hence, it is not permissible to sell an unspecified ingot (technically known in the market as unallocated ingot) without physical possession.

The fatwa for permissibility of HelloGold application offered in Malaysia was issued by Amanie Advisors on 6th December 2016 (Amanie Advisors, 2016). This fatwa was issued for the application where the customer in Malaysia is allowed to purchase physical gold stored at Singapore vault on spot and customer purchases and sells gold via the application from HelloGold (Amanie Advisors, 2016). However, there is no fatwa found for their cryptocurrency, GOLDX found in the website. IFN Fintech (2018) reported that GOLDX is also given Shari'ah compliance endorsement by Amanie Advisors and GOLDX is an Ethereum ERC20 token backed by 99.99% investment-grade gold, where this type of distinction is made in the first time in the world. It is essential to observe that in GOLDX, tokens are issued only to the amount of gold physically held where the access to this information is given publicly and it is confirmed and verified independently from its vaulting partner (IFN Fintech, 2018).

As for OneGram, it has been given Shari'ah endorsement by Dubai-based advisory firm Al Maali Consulting; and to limit speculation in OneGram, "each OneGram cryptocurrency unit is backed by at least a gram of physical gold stored in a vault" (Torchia & Vizcaino, 2018). The similarities and differences between OneGram and Bitcoin have been described by Ullah (2018; p.49) as both OneGram and Bitcoin are digital currencies; but if any of them crashes, the value of Bitcoin will be zero while OneGram backed by gold would leverage on the value of the underlying asset which is gold.

Asif (2018) belongs to the group of proponents of the permissibility of cryptocurrency where he states that cryptocurrencies and tokens in itself are Shari'ah compliant, but due to the nature of the underlying commodities used or due to the modus operandi of them, further research might be needed to find out whether it is shari'ah compliant or not. PMBC could be described as an asset backed token which is similar to sukuk that "represents claim on an underlying asset, and to claim the underlying asset, one sends the token to the issuer" (Shariyah,

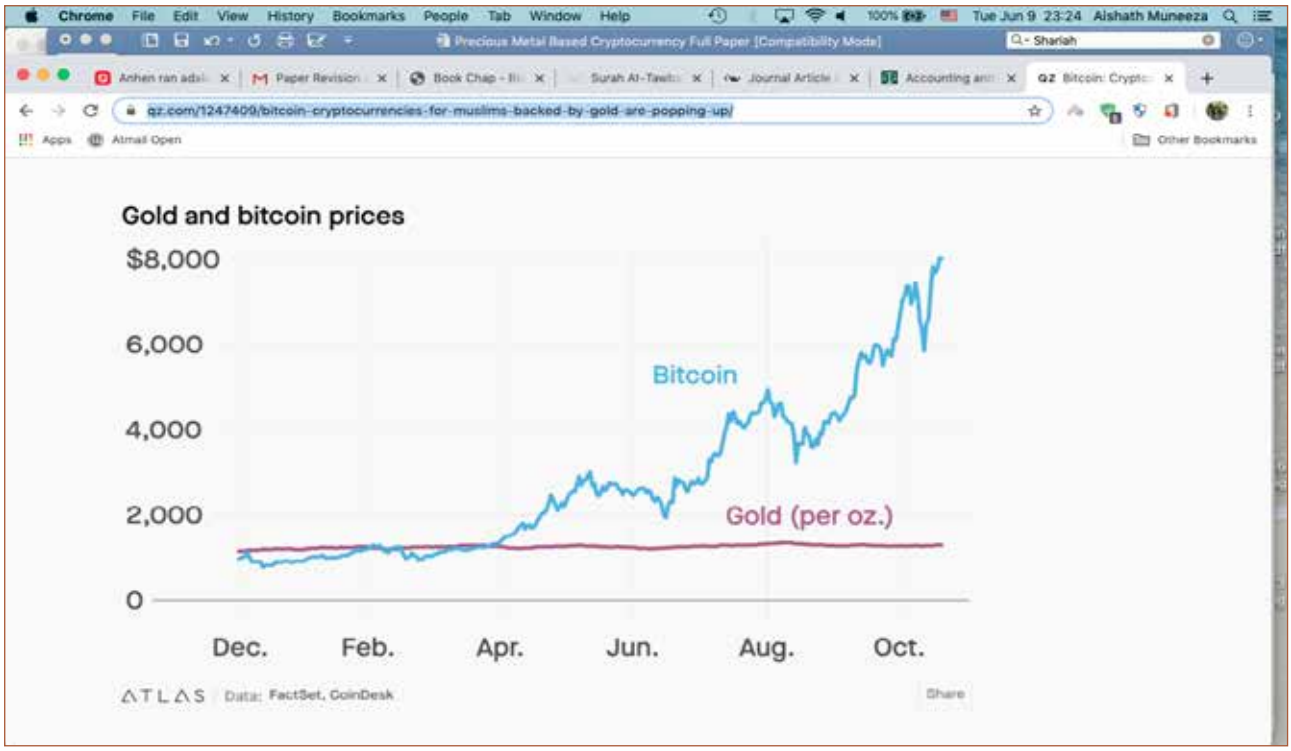

Figure 1: Fluctuation in Gold and Bitcoin Prices. **(Source: King "2018")**

Review Bureau, 2018; p.11). In the past, money has been used in different forms where precious metals to stones, shells, furs, animal skins, and tobacco have been used as a medium of exchange (Sanusi, 2002). As such, gold backed PMBC has no issue to be used unlike the cryptocurrency without underlying assets of which the "prices soaring and plummeting on a weekly basis, there is a fast buck to be made, but also a lot to lose—and quickly" (King, 2018). Figure 1 below illustrates the price stability of gold compared to bitcoin.

It is evident from figure 1 (above) that the price of gold is relatively stable compared to bitcoins which is not backed by any asset. The price of gold in the past year kept fluctuating between USD$1,200 and USD$1,350 while the price of bitcoin has been fluctuating continuously throughout the year without any control. This evidence proves that from a Shari'ah perspective, gold backed PMBC is Shari'ah compliant unlike bitcoin. The asset backed tokens have assets to back with intrinsic value. Instead of using the hard gold, the reason why it is important to go through the tokenization process in PMBC is to improve liquidity "facilitating fast, secure, and low-fee trading of real-world assets on the blockchain" (ICOMALTA, n.d.). Improving liquidity here simply refers to how quick and easy it is for an asset to be bought or sold, and liquidity has a direct strong correlation with the asset's trading volume. In this regard ICOMALTA (n.d.) states that "liquidity enhances the value of the underlying asset because it mitigates the risk attached to not being able to exit quickly. A 24/7/365 token trading market improves price discovery, minimizes price volatility, and reduces "flash crash" risk."

3.0 The prospective use of PMBC in Islamic finance contracts

The following discussion focuses on the use of PMBC backed by gold in different Islamic finance contracts followed by the discussion on the findings of the analysis made in this regard.

3.1 Use of PMBC backed by gold in Islamic finance contracts

3.1.1 PMBC backed by gold in Wadi'ah contract

Wadi'ah is a safekeeping contract that is used in Islamic finance to structure deposit products without a fixed return. It is equivalent to a conventional bank's current account type of a product. There are two types of Wadi'ah contracts in Shari'ah: Wadi'ah yad Amanah (safekeeping as a trust) and Wadi'ah yad Dhamanah (safekeeping with guarantee). In this contract, the person who intends to keep the money safe will deposit the money with the trustee and then the trustee keeps it until the former comes and takes it. The difference between Wadi'ah yad Amanah and Wadi'ah yad Dhamanah is that in the first type money kept is not guaranteed even if it is lost while in possession of trustee without his negligence and the money kept in trust cannot be used by the trustee during the time it is kept with the trustee. In the latter type, money kept as trust

can be used by the trustee, as in that case it becomes a loan, it shall be guaranteed to be returned the exact amount one deposited. In relation to PMBC backed by gold, the question here is whether a deposit could be made using PMBC backed by gold. The answer to this is yes, as provided in the AAOIFI Shari'ah standard no. 57. Further, there is no Shari'ah prohibition to do so.

According to paragraph 5/4 of the said AAOIFI Shari'ah standard, the gold kept as a deposit by the trustee shall be managed as a trust without co-mingling it with trustee's own gold. However, if the depositor allows the trustee to use the deposited gold with him and in this case, the co-mingling of gold of depositor with the trustee's gold have to be made in accordance with what has been stated in paragraph 3/5 of the said Shari'ah standard that deals with Shari'ah ruling for joint ownership of gold, where it is explicitly stated inter alia that in case of loss or damage, each co-owner shall bear loss/damage on pro rate basis. This simply indicates that in this case Shari'ah rule of Wadi'ah yad Dhamanah is applicable as explained above. In case the physical gold has been deposited, the trustee is allowed to charge a fee as safekeeping cost of the gold that could be a lump sum amount or as a percentage of value of the deposited gold. However, if the gold is kept as a rahn (collateral) to secure a loan given, then the fee charged for safekeeping of the gold kept as collateral shall not exceed the actual cost incurred in safekeeping the gold in a particular case. There is no specific formula provided in the Shari'ah standard on how to calculate the actual cost incurred in this case and as such, it is up to the trustee to use a reasonable standard to do so. According to paragraph 5/4/3 of the standard, if the gold deposited is "damaged or defected due to misconduct, negligence, or violation of the contractual terms and conditions by the depositary, the depositary shall be liable to indemnify the depositor with equivalent gold amount of the same kind, if possible. Otherwise the indemnification shall be of the value of the damaged or defected gold at the time of occurrence of the damage or defect."

An issue that needs to be discussed here is whether the fee paid for the safekeeping cost by the depositor to the trustee could be paid in gold backed PMBC. A direct answer for this is not provided in the discussed Shari'ah standard. However, it is common sense that in this case where gold backed PMBC is being taken as a currency to replace the fee paid in fiat money, there is no Shari'ah issue in this case. This is why, the Shari'ah standard might not have dealt it under the designated paragraph, due to being obvious.

3.1.2 PMBC backed by gold in Ijarah contract

Ijarah is a leasing contract of a known, Shari'ah compliant asset or service for a defined and agreed rent/wage between the lessor and lessee. There are two types of Ijarah based on the subject matter of the contract: Ijarah of an asset and Ijarah of a service.

From a conventional point of view, leasing of an asset can be divided into operating lease and financial lease. Operating lease is where the ownership of the asset from the beginning of the lease contract and after it ends, remain with the lessor. There is no expectation nor agreement between the lessor and lessee to transfer the ownership of the leased asset. However, in case of financial lease, the lessor and lessee agree to transfer the ownership of the leased asset at the end of the last rental payment. From the Shari'ah perspective, operational lease is the only type of valid lease as Shari'ah does not allow to combine a lease and sale contract in one and even the end result of both contracts is different and contradictory. Therefore, AAOIFI has issue the standard on Ijaraj munnthiah bil Tamleek meening that the lease and the ownership aspects need to be kept separate and independent. As such, it is a hybrid Shari'ah compliant product by combining Ijarah and bai' (sale) or hibah (gift). In a lease or ijarah contract, what is transferred is not the ownership of the asset from the lessor to lessee during the lease period; but it is only the usufruct or the right to use that is transferred. Therefore, consumables cannot be leased as the moment the same are used, the subject matter is destroyed.

In both types of Ijarah, Ijarah of an asset and Ijarah of a service, PMBC backed by gold can be used. Hence, the rental or the wage could be determined and paid using PMBC backed by gold. However, in both of these cases, the lessor and lessee/ hirer and hiree shall determine the amount without ambiguity and shall agree on a proper period of lease. Provided that all other Shari'ah rules applicable to a lease contract are adhered to, there is no Shari'ah issue in replacing the fiat money used in Ijarah contract with PMBC backed by gold. This is as provided in the AAOIFI Shari'ah standard no. 57.

According to paragraph 5/3 of the said AAOIFI Shari'ah standard, there is no Shari'ah issue in leasing gold as jewelry or ingots provided that the leased gold during the lease period would not be converted into cash or Dinar. In this case the rent could be paid in advance or in arrears whether the lease is a normal lease or a forward lease. In the case of Ijarah Muntahia bil Tamleek, at the end of the lease contract, the price of ownership transfer could be made using gold on spot to buy the asset under the independent sale contract. It is also expressly stated that there is no Shari'ah issue in the payment of rent or the wage in the form of gold.

3.1.3 PMBC backed by gold in Musharakah, Mudharabah and Wakalah contracts

Musharakah and Mudharabah contracts are equity contracts, while Wakalah is a service based contract used in Islamic finance. In a Musharakah contract, all parties contribute capital or/and labor or/and both as equity towards conducting a profitable Shari'ah compliant activity where the parties pre-agree to a profit sharing ratio, while loss, if any, has to be borne by the parties according to capital contributions. In a Mudharabah contract which is also known as a money management partnership contract, one party contributes the capital and the other party agree to manage the Shari'ah compliant business activity and they pre-agree to a profit sharing ratio. In case of loss, except in case of negligence on the part of mudarib, all the business loss has to be borne by the capital provider while the managing partner loses in terms of unpaid services during the period. One important rule in both of these equity contracts is that no profit can be guaranteed to any other partner(s), and a fixed amount cannot be agreed between the parties to be paid as profit. In case of Wakalah, one party who is the principal appoints another party as his agent to perform a Shari'ah compliant activity on his / her behalf for a fee, or for free. If the service is agreed to be performed for free, then the contract is non-binding.

According to paragraph 4 of the AAOIFI Shari'ah standard on gold, in equity based contracts: Musharakah and Mudharabah; and investment Wakalah, gold can be used as capital on the condition that at the time of the contract, the parties participating in the contract shall determine value of the gold contributed as capital and its monetary value in currency shall be determined. If valuation of gold in this case is impossible, then it is prohibited to use gold as capital for the said contracts. The parties to the contract are permitted in Shari'ah to distribute the profit in gold at the market value of gold as decided at the time of profit distribution. If not, it is no allowed. In case of liquidation, the parties also can redeem their capital in gold at the market value of gold at the time of redemption. It is also permitted to buy shares of a company that deals with extraction of gold as long as the relevant Shari'ah parameters that ought to be followed in this regard are adhered to such as AAOIFI Shari'ah standard no. 21 on financial papers.

3.1.4 PMBC backed by gold in the contracts of Salam and Istisna'

Salam and Istisna' are exceptional contracts under Shari'ah as in these contracts a sale contract can be executed without the existence of the subject matter at the time of entering into the contract. Salam is a forward sale contract where homogeneous goods are suitable to be used as the subject matter with the exception of gold, silver, precious rocks and animals. At the time of the contract, the forward buyer and the seller agree to the quantity, quality, price, the delivery time, and the buyer pays the full price of the commodity to be delivered in future, at the time of the contract in a lump sum. Istisna' on the other hand is entered only to manufacture any items where the person who requests to manufacture gives the specification and agrees to the price, the payment terms, delivery time. Unlike in Salam contract, in Istisna' contract it is not mandatory to pay the price on spot in a lump sum. The way the payment could be made in an Istisna' contract can be agreed between the parties in any manner they like as long as both parties consent.

According to paragraph 4 of the AAOIFI Shari'ah standard on gold, if the subject matter of Salam is not gold, silver or currencies, then gold is allowed to be used as capital of salam. In case of Istisna', it is allowed to enter into an Istisna' contract in gold as long as the price of the contract is not in gold, silver or currencies. This is to oust Riba from the transactions.

3.2 Analysis

From the foregoing discussion, it is clear that PMBC backed by gold is compatible to be used in Islamic finance contracts to replace the fiat currency that is used today. However, there are certain rules that ought to be observed in this regard depending on the type of the contracts and the specific Shari'ah rules applicable to them. This is illustrated in Table 1.

As illustrated in the table 1 the Shari'ah contracts discussed are compatible to be used with PMBC backed by gold. However, there are some rules ought to be observed in this regard. One may question about the purpose of using PMBC backed by gold in the Shari'ah contracts in a quest to understand the advantage of using it. The answer is simple. Fiat money has no underlying asset except debt and in case of a financial crisis or any situation that devalues the currency, the value of it falls as it has no intrinsic value in it. However, if PMBC backed by gold is used, the value of gold in the market will determine its value and it is not created out of thin air or in vacuum (Ajouz, et.al., 2019). Ajouz, et.al., (2019) refer to the Quranic verse 9:34 which states: "O you who have believed, indeed many of the scholars and the monks devour the wealth of people unjustly and avert [them] from the way of Allah. And those who hoard gold and silver and spend it not in the way of Allah - give them tidings of a painful punishment." By referring to this verse they intended to prove that gold and silver had been used as money in Islamic framework. As such, since PMBC backed by gold would have intrinsic value in it, it is more appropriate from a Shari'ah perspective to acknowledge as money than the current fiat money that is used. The advantage gold backed PMBC has could be explained based on their intrinsic value in gold.

Type of Contract	Is it Compatible with PMBC backed by Gold?	Rules
Wadi'ah	Yes	- It is permissible to deposit gold.
Ijarah	Yes	- Leasing of gold as jewelry or ingots is allowed as long as it is not converted into cash or Dinars during the lease period. - In Ijarah Muntahia bil Tamleek, the asset could be purchased via gold on spot. - Rent and wage can be paid in gold.
Salam	Yes	- As capital of Salam: if the subject matter of Salam is not gold, silver or currencies, then gold is allowed to be used. - As subject matter of salam: It is also allowed to purchase gold via Salam contract provided that the capital of Salam is not gold, silver or currencies.
Istisna'	Yes	- It is allowed to enter into an Istisna' contract in gold as long as the price of the contract is not in gold, silver or currencies.
Musharakah, Mudharabah & Investment Wakalah	Yes	- Gold can be used as capital on the condition that at the time of the contract, the parties to the contract shall determine value of the gold contributed as capital and its monetary value in currency shall be determined. - The parties to the contract are permitted in Shari'ah to distribute the profit in gold at the market value of gold as decided at the time of profit distribution. - In case of liquidation, the parties also can redeem their capital in gold at the market value of gold at the time of redemption. - It is also permitted to buy shares of a company that deals with extraction of gold as long as the relevant Shari'ah parameters are accomplished.

Table 1: Compatibility of Using PMBC Backed by Gold with Islamic Finance Contracts in the light of Shari'ah Standard No. 57 on Gold and Its Trading Controls of AAOIFI **(Source: Author's own)**

4.0 Issues in the implementation of PMBC backed by gold

In the practical implementation of PMBC, there are various challenges facing it. In this regard, Ajouz (2019) observes that the biggest obstacle is lack of political will. This is true as without the required political will and support, replacing or adopting a new currency is impossible. A currency is required to be recognized as a legal tender by the governments. As such, if PMBC backed by gold is to be used in Islamic finance, recognition by the government(s) would be a mandatory requirement. The lack of political will and support to introduce and recognize PMBC backed gold leads to another issue of lacking infrastructure required to implement gold backed PMBC. This includes not having the proper legal, regulatory and uniform governance standards that ought to be followed in implementing PMBC backed by gold with the hope of boosting the confidence of its users and stakeholders. It is not sufficient merely to have a Shari'ah standard being enacted on gold; but rather the mechanisms to establish a transparent system disclosing in a timely manner all the material information related to it need to be put in place to build trust in the system.

The mechanisms to ensure Shari'ah compliance need to be publicly disclosed rather than having an opaque system where only a news publishing the name of the Shari'ah advisory firm is revealed. The modus operandi of a transaction and the reasons why it is considered as Shari'ah compliant must be published in a way that the public would be aware of the reasons why they should use it. In this regard, the industry needs to learn from the experience of the existing players in the market and the regulatory authorities need to enact standards by learning from the experience. For instance, the efforts taken by GOLDX tokens to publicly make aware that they adhere to the rule of issuing only to the amount of gold physically held is commendable as they publicly make this information available and this information is confirmed and verified by independently from its vaulting partner (IFN Fintech, 2018). Mullan (2016) observes that it is difficult for some companies to offer PMBC under the existing financial regulations. The reason for this most probably could be due to the fact that the existing regulations are not enacted in

contemplation of PMBC and as a result, the existing regulation might not have provisions to facilitate the developments of PMBC. As such, regulatory authorities need to give room for PMBC to be developed under regulatory sandbox initiatives or in any way they could be sustainably developed.

There are some operational inhibitions that could be contemplated as an issue in developing PMBC backed by gold. As discussed by Muedini (2018), it is observed that storing large quantity of gold could be an issue not only in terms of high cost; but finding adequate space and even transportation of it could be problematic. Furthermore, there might be a situation where gold is not backed properly with PMBC as required by Shari'ah, due to lack of management of physical gold. It could trigger a Shari'ah risk of non-compliance leading to breach of the trust of all those who believed and dealt with the system.

Muneeza, et. al., (2018) observe that development of digital financial technologies like blockchain is viewed as a new way to reach out to economically vulnerable groups including poor. However, the challenge in relation to PMBC is that when it comes to financially excluded population, access to technology and required gadgets to use PMBC could be an issue that might not be resolved easily making PMBC something that is not compatible with financial inclusion.

As proposed by Billah (2018), a properly planned Shari'ah compliant cryptocurrency shall be guided by ethical principles of its management at all levels and stakeholders – market players (advisors, operators, and facilitators) and regulators (decision makers). Such principles include honesty, transparency and taking care of rights and obligations. Billah (2018) also mentions that Shari'ah compliant cryptocurrency operations require participants with real-valued assets and producing real-valued goods and services. As such, it is imperative to develop a professional code of ethics for all stakeholders involved in PMBC backed by gold to ensure that Shari'ah compliance is not merely a stamp used; but rather it has a deep effect in the transaction where highest standards of ethical principles are followed.

5.0 Conclusion

With increase in use of technology in finance, a pertinent question is: how compatible is technology with Islamic finance? One aspect that is emerging in this regard is the use of cryptocurrency in financial transactions that could be replacing the fiat money being used today. Since all Islamic finance transactions ought to be compliant with Shari'ah, there was need for the Shari'ah scholars to deliberate and declare the Shari'ah compliance status of financing by using cryptocurrencies. Since, there is no clear-cut answer to this issue in the primary sources of Shari'ah, using the secondary sources of Shari'ah has become necessary to decide about the issues involved in cryptocurrencies. Though Shari'ah scholars have divergent views on the permissibility of it as a currency, there is a much tolerant view on using it as a crypto asset provided that the underlying assets and the operation of it adheres to the rules of Shari'ah.

However, the undeniable truth is that the cryptocurrencies are here to stay and there is need to conduct research to find out the prospects of using PMBC in Islamic finance especially in relation to the different kinds of Shari'ah contracts used to structure Islamic finance products without breaching the Shari'ah rules. This research has explored its potential, while the discussion covers merging of PMBC with major types of Islamic finance contracts with special emphasis on the Shari'ah rules applicable to such transactions. There are also some issues highlighted in this paper which are required to be resolved for the sustainable development of PMBC backed by gold. It is anticipated that it will pave way to conduct further research on resolving the issues identified to fuse PMBC with Islamic finance contracts. Indeed, via innovation and forward thinking, there is nothing that could not be achieved and Islamic finance has the flexibility in enhancing it using technology with Shari'ah parameters.

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PEER-REVIEWED

The enforceability of Islamic finance contracts in view of English law: Challenges and recommendations

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Abstract

Case laws adjudicated in British courts indicate multiple issues arising when implementing Shari'ah contracts. The main reasons concern the "choice of law" clause where the court reverts to English law rather than adhering to Shari'ah stipulations outlined in the contracts. Shari'ah being a non-jurisdictional or state law is considered problematic. However, with the advent of the Rome 2 Convention, provisions exist to accommodate Shari'ah law despite an absence of case law. Many academics have also debated the application for arbitration as a solution to mitigate the Shari'ah and legal risk faced by the Islamic finance industry. This paper argues that arbitration provides a viable solution bearing in mind that most matters heard in the UK courts Shari'ah were not accommodated. Under international public law based on the United Nations Commission on International Trade Law (UNCITRAL) convention, it might be possible to explore arbitration by adopting Shari'ah as the choice of law. It also advocates that the AAOIFI Shari'ah Standard 32 on arbitration does provide a framework to arbitrate within the Shari'ah parameters, which the Islamic finance industry may adopt.

Key words: Case laws in English courts, Choice of law, Rome Convention 1 and 2, Arbitration.

Introduction

Ongoing debate ensues regarding the enforceability of Islamic Finance law in jurisdictions such as the European Union (Ongema, et al, 2013), Malaysia (Yakoob, 2012), and India (Haque et al, 2014). In light of English case law the main issue in incorporating Islamic finance law seems to rest on the fact that Shari'ah is not jurisdictional/state law, while legal issues require resolution to allow its implementation under private international law and the Rome convention (1980). This paper argues that despite the "fair level playing field" principle operating in the UK's legal system, concerns are still raised by British courts when presented with Islamic finance contracts and Shari'ah law. Three main case laws will be discussed to show that the common problem in implementing Islamic finance rests with the concept of "choice of law" primarily. It is argued in this paper that some judgements were given under the Rome convention of 1980 and existing common law principles which recognise state law as the only "choice of law." However, under the new Rome Convention 2 of 2005, there is a possibility for reinterpreting whether the choice of law can embrace other laws besides state laws, such as customary law or Shari'ah law, which are non-jurisdictional. It will be demonstrated that under the Rome Convention 2, Islamic Finance derived from Shari'ah can be accommodated as a source of private international commercial law.

Alternatively, the industry could consider the law of arbitration to enforce any Islamic finance

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contracts. This is because under the Arbitration Act of 1996, parties may opt for any law they wish to apply as arbitration, which is quasi-judicial. This solution needs to be explored, as it is observed even under the Rome Convention 2 that courts are reluctant to accept Islamic law. If certain legal principles are observed, then Islamic finance can be accommodated under English law via the arbitration mechanism. The paper also presents a new approach for resolving Islamic finance disputes in UK courts by giving the AAOIFI's Shari'ah Standards similar status to the Lex Mercatoria, i.e. an independent set of law adopted by a group of people for running their own business and to which they abide to. This is recognised under English law. A search for an alternative solution via the arbitral award is also justified. The main legal issue is that some immutable jurisprudential principles will be violated if Shari'ah law is neglected by the courts.

Initially, the concept of a fair level playing field will be analysed positioning Islamic finance in the taxation arena to secure endorsement of products from the Treasury. Thereafter, the problems of applying Shari'ah under English law in view of academic findings and case law will be discussed. Finally, Rome Convention 2 and arbitration as potential solutions will be explored in light of the AAOIFI's relevant Standard.

The legal ethos underpinning the fair legal playing field principle in the UK

The legal principle for adopting Islamic finance under English law is the 'fair level playing field.' (Ainley et al, 2007; HMRC, 2015), as Islamic law does not originate from the common law and is a non-jurisdictional body of law. Authorities, such as, HMRC[2] will apply the same laws for all financial institutions and products. Under this principle justice requires levelling the playing field by rendering everyone's opportunities equal in an appropriate sense and then letting individual choices and their effects dictate further outcomes (Stanford Encyclopaedia of Philosophy, Oct 2, 2002). The 'level playing field' is a concept about fairness, not stating that each player has an equal chance to succeed, but that they all play by the same set of rules (Bond et al, 2013:xvii). A symbolic playing field is said to be level if no external interference affects the ability of the players to compete fairly (Boyes, 2014).

Government regulations tend to provide such fairness, since all participants must abide by the same rules. Examples of such regulations are: taxation, conveyancing, protection of clients and capital adequacy. Islamic finance institutions have to compete with their conventional counterparts. Competition becomes 'fair' when there is a level playing field, and, players are subjected to the governance by the same / similar rules, which are enforced in a coherent manner (Pablo Mendes de Leon, 2012). Ainley (2007:18) interpreted this concept as 'no favour and no hurdles.' This means that to operate an Islamic financial institution the same set of rules of tax, licensing etc. need to be followed just like for the conventional financial institutions.

Despite this interpretation, amendments to the law bring certain levels of competitiveness in favour of Islamic finance. For instance, the Double Stamped Duty was removed for Islamic mortgages in 2002 (Lescher, 2015). HMRC defined ijārah and did not impose the word 'lease' (Blom case, 2009).

Unfortunately, while rhetoric is voiced in favour of Islamic finance a marked lack of political commitment provides a barrier to developing Islamic finance in Britain. Gordon Brown as Chancellor of the Exchequer facilitated this process to some extent (BBC News, Tuesday 13 June, 2006; Housby, 2013). While the subsequent Conservative/ Liberal Democratic coalition government did not initially favour it until later a task force for Islamic finance was established. Political uncertainty influences the extent to which a fair level playing field can be applied. Hence, a 'fair' level playing field adopted by the government and HMRC must demonstrate that fairness prevails, along with necessary legal infrastructure to realise objectives of making the UK an Islamic financial hub.

So far selective approaches, rather than providing appropriate legislation for the smooth running of Islamic finance as an industry, have been adopted by the authorities. They identified certain types of transactions widely used in Islamic finance and ensured that those types of transaction received appropriate tax treatment. This is echoed in the Financial Act 2005 section 47 "Alternative finance arrangements". Mohammed Amin (2010) writes 'Reading section 47, it is clear that it was designed to facilitate murabaha (cost plus sale) and tawarruq (monetisation) transactions. However, it nowhere uses those terms and nothing in section 47 limits its application to Islamic finance. If a transaction falls within section 47, the tax treatment follows automatically, regardless of whether the transaction is (or was intended to be) Shari'ah compliant.'

From the discussion on the fair level playing field and tax issues, it can be argued that, should an Islamic product be developed, there will not be much expectation as far as the tax regime is concerned, which might impact on the competitiveness of Islamic finance.

In the following section some case laws are highlighted in order to identify the legal issues faced

3- Her Majesty's Revenue and Customs that is a non-ministerial department of the UK Government.

by Islamic finance industry. Thereafter potential solutions are provided.

Problems in application of Shari'ah in British Courts

Bälz (2008, p.6) developed the hypothesis that present-day Islamic finance does not implement Islamic law, but rather is a product of transnational law and not only state law. Islamic finance cannot be explained exclusively as an 'application of Islamic law.' Instead, it must be seen as a contractual practice that evolved in international finance. This argument of Bälz fails to contain the idea that Shari'ah is a dynamic legal system, which consistently militates to accommodate market operations and does not stifle progress in market development. It is not a mere application of few contractual rules. For instance, the Prophet (pbuh) did not intervene in the price mechanism when asked to do so by his companion (Tirmidhi: Hadith no. 1314). The Prophet's approach encouraged an open market policy. However, that does not imply that Islam is oblivious to rules and regulations for the market. For instance, Umar (the second caliph) did not allow people to sell in the marketplace if they did not know commercial rulings (Tirmidhi: Hadith no. 487). The purpose of this ruling was to protect consumers and to build confidence in the marketplace. Additionally, there are many literary works on the concept of hisbah (Mawardi, 1996; ibn Taymiyyah, 1992; Al-Shayzari 1310 (AH); al-Ghazali, 1982). Hisbah is the institution of a market inspectorate in an Islamic economic system established to smooth not only market transactions but also ensure morality. Therefore, from an Islamic legal perspective, ensuring morality and protection of customers' rights in the marketplace is the focus, and not intervention in the price mechanism. It rather takes care of market imperfections. Hence, the application of law is a reality under Islamic law. However, if the authorities do not abide by these principles then Islamic law per sé is not to be blamed, as misrepresented by Bälz.

Secular law has the function to provide transactional security, thereby safeguarding financial/commercial transactions, which can be enforced in court. Whereas, in the case of Islamic finance, the role of Islamic law is essentially different. It aims to satisfy Shari'ah compliancy first, then to facilitate its enforceability. However, it is observed that through various court cases it becomes apparent that reference to Shari'ah rules can endanger the enforceability of the transaction. This can be inferred from three important case laws in the UK. The dominating case laws are highlighted here.

Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others

The first case is the Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others ([2002] All ER (D) 171 Feb)[3]. The Islamic Investment Company [ICC, the Claimant) and Symphony Gems (the first Defendant, the second and third defendants served as guarantors). The seller (The Islamic Investment Company) granted the purchaser (Symphony Gems) the facility. The seller agreed to purchase rough diamonds from a supplier and immediately sell these to Symphony Gems on deferred payment terms pursuant to purchase agreements. Two purchase agreements were made, each equal US$7,500,000 in rough diamonds. According to the purchase agreements Islamic Investment Company transferred US$15 million to the account of Precious Ltd, based in Hong Kong and was to receive US$7,917,450 in payment for each advance. However, IIC did not receive payment and sought to retrieve these monies, accrued interest and damages, minus US$7.5 million pursuant to a bank guarantee.

The case turned on the defence's claim that the outstanding balance required delivery of diamonds to the purchaser, i.e. whether the sale price is due in the absence of delivery? Tomlinson J. took note of the fact that the defendant did not raise the issue of absence of delivery to the claimant prior to the proceedings, a fact that assisted the Lord Justice in reaching his conclusion. Pursuant to clause 4.3, those purchase agreements required the purchaser 'to enter into arrangements with the supplier to the effect that the seller will purchase the supplies from the supplier,' or else the agreement will be automatically terminated. Based on his interpretation of the relation to clauses 4.4, 5.1, 5.2 and 5.6 of the agreement, Tomlinson J. concluded that 'all of the arrangements concerning the acquisition of goods by the seller from the supplier fail to be made by the purchaser, for the very good reason, that this is a financing agreement facilitating or apparently facilitating the purchase of supplies by the purchaser.' The honourable judge further writes pertaining to the same clauses, 'if therefore there has been no delivery of goods from the supplier to the seller and thus from the seller to the purchaser, that can only be because the purchaser has not made the necessary arrangements.'

A point of lesser importance, but nonetheless central to the strategies of the defence, concerned expert evidence given to the court regarding the Islamic legal definition of a murabaha contract. Tomlinson J. ruled that the issue on which the court was to decide, however, was strictly a matter

3- It is to be noted that this case had further ligations and judgment in 2014. It dealt primarily on some documentational fraud and failure to abide to court judgement etc. This discussion is outside the ambit of this research as it does not deal with Islamic law as such. See for instance https://www.maitlandchambers.com/information/recent-cases/islamic-investment-company-of-the-gulf-bahamas-ltd-v-symphony-gems-nv-ors-2

of English law 'since it is a contract governed by English law.' While the governing law clause in this case was not a principle concern of the court, however, the Beximco Pharmaceuticals v Shamil Bank of Bahrain (the second case discussed below), established a persuasive precedent as to the way in which the Shari'ah will be treated in relation to "governing law clause".

The next argument relied upon by the defence was an ultra vires argument. With respect to this particular contract an ultra vires argument asserts that the "contract is out with the objects stated in the claimant's Memorandum of Association, which includes the limitation to carry out in a manner which is consistent with Islamic laws, rules, principles and traditions the following objects". Referring to the expert testimony provided by Yahya al-Samaan, Tomlinson J. agreed that the essential characteristics of the murabaha had not been met in this transaction. Yet the application of the ultra vires doctrine depended on the law of the Bahamas, the jurisdiction in which IIC of the Gulf was incorporated. The capacity of corporate entities is determined by the place of incorporation rather than the governing law of the contract. This is a principle of private international law accepted under English law. With regard to the law of the Bahamas, Tomlinson J. ruled that it did not prevent the IIC of the Gulf from acting out with its objects. Ultra vires could not be relied upon by the defence.

In IIC v Symphony Gems case Tomlinson's J judgment for the claimant highlights an English tradition of freeing the hands of commercial parties and thus upholding the bedrock of party autonomy. From an Islamic perspective a legal view needs to be qualified because under Islamic law the prohibitive elements have already been predetermined and as such parties cannot develop products having a free reign to consent on them on the basis that it is allowed under secular law. The Qur'an (4:29) emphatically says: "O you believers do not devour your wealth unjustly and in a void manner except that there is trade by mutual consent". By Ishārah al-Nass'' it can be deduced that the verse has clarified firstly, that whatever is bā'til that is void ab initio; and secondly, there should be mutual consent in a given halal transaction, if not, ab initio it will considered as void. In other words whatever Allah (SWT) has prohibited is void ab initio (batil). So even if parties do consent to a deal, despite the consent, if in Islam it is void that consent will not be valid. In the Symphony Gem case the court's primary concern was in respect of the sanctity of the contract by respecting the terms and conditions to ultimately safeguard the commercial interest. The implication of this approach was the preservation of the historically consistent existence of English courts upholding reasonable business practices provided that these are not otherwise coerced by the rules of mandatory legal provisions or public policy (Ercanback, 2015). The common law practice is that the business community is granted adequate discretion to formulate the terms of contracts.

In this case the court refused to concede that murābaha is a sale despite expert evidence submitted by the both parties. What is interesting to note is that the parties opted for a" choice of law" or "governing law" clause giving jurisdiction to English court to hear an Islamic matter and at the same time there was the issue of choice of Shari'ah law. The court did not entertain the Shari'ah clause aspect. However, the Court said that it would enforce a properly drafted agreement, if it is governed by English law.

This main legal principle to be retained from this important judgement is that the court is expressing its willingness to accommodate the Shari'ah, provided that parties should not use the Shari'ah in vague terms but should instead stipulate clearly in simple English language the Islamic contractual conditions. In that case, the court will see if these terms and conditions can be accommodated based on the freedom to contract in common law.

Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain E.C

The second case is the Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain E.C. ([2004] EWCA Civ 19). The facts of the case concern whether the contract was to be interpreted according to Shari'ah or not? This is due to a clause stipulating that 'to stipulate as a condition precedent (to the choice of English law) that the contract is only enforceable insofar as it is consistent with the principles of Shari'ah.' Again, in this case, it was held that the Shari'ah defence was a 'lawyer's construct.' Shari'ah law was not a system designed to trump the application of English law as the governing law. The Shari'ah issue was not entertained on the premise that it did not fit into the Rome Convention, as state law.

Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd was an appeal from the High Court, in which Morrison J. found in favour of the respondent, Shamil Bank of Bahrain, and made an award of US$49.7 million. Appeal to the higher court was granted on a single point 'in relation to the construction and effect of the form of the governing law clause contained in the financing agreements.' The clause in question reads: 'Subject to the principles of the Glorious Shari'ah, this agreement shall be governed by and construed in accordance with the law of England' The Appeal Court's ruling illustrates two key principles: first, the Rome Convention of the Law Applicable to Contractual Obligations – an EU treaty with provisions, in

general, established the law governing contractual relations in the UK, including the time in which the case was heard – made clear that a contract could only be governed by the law of a country so that a contract which sort to incorporate a non-state law or body of principle, such as, the lex mercatoria or the Shari'ah would not be recognised as an applicable law of the contract. Second, the judgement demonstrates the English doctrine of incorporation in which party may incorporate specific "black letter" terms of a foreign law, general legal principles or non-state law into an English contract, but which can only serve as a source of law, from which the governing law may draw. 'Incorporation' is a shorthand method of including a limited set of terms to avoid laying out the articles of a foreign law in full. The court would construe an English contract, 'reading into it as if they were written into it the words' of the foreign law. In such a case where there existed ambiguity or doubt as to the effect of such rules, the court would rely upon the testimony from experts in foreign law. However, the courts are not bound to expert evidence on foreign law, as they are 'interpreting the terms of an English contract and not applying foreign law,' as established under the authority of Stafford Allan & Sons Ltd v Specific Steam Navigation Co. It can be argued instead of the black letter interpretation, that if a 'socio- legal' approach was used by the court, would the judgment have been the same? The socio-legal approach is often seen to bring other dynamics into interpretation and research in law, whereby, not only pure law is considered, but other social impacts of the law (Banakar, et al, 2005). A social construct of Islamic finance applied to the UK, strengthens the argument for reconsidering legal pluralism as argued by Menski (2006).

The appellants did not dispute the fact that there can only be one governing law in respect of the agreements, and the proper law of these agreements was English law. Article 1.1 of the Rome Convention requires the parties to choose the law of a country to govern their contract. It stipulates that 'the rules of this convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries.' On the face of it Article 1.1 is not 'applicable to a choice between the law of a country and a non-national system of law, such as the lex mercatoria, or 'general principles of law,' or as in this case, the law of Shari'ah.' Article 3.1 of the Rome Convention which provides that 'the contract shall be governed by the law chosen by the parties' with reference to choice of a 'foreign law' in conjunction with Article 3.3, makes it clear that the convention as whole only contemplates and sanctions the choice of the law of a country.

At this point it can be argued that just as the lex mercatoria, which is not an official law per sé, but a law of commercial customs as agreed by a group of people, then we might ask why the court has refused to consider the AAOIFI standards which are also agreed standards adopted in many jurisdictions, such as, Bahrain, Sudan, Mauritius and South Africa? Should the relevant AAOIFI Standard be accepted by the court, it would have given another twist to this judgment.

Yet, the appellants contended that the financing agreements were only enforceable in the event that both the Shari'ah and English law were complied with. The principles of the Shari'ah should be given relevance. Further, it was argued that the construction of the governing law 'produces a result no different from the incorporation by reference to a codified system of rules, such as the Hague rule or the Warsaw Convention into a contract governed by English law.' For example, the case of Nea Agrex SA v Baltic Shipping Co Ltd ([1976] QB 933) rejected a lower court's conclusion that a 'paramount clause provision was to be treated as ineffective to incorporate the Hague rules into a charter party.'

In the Beximco case, the Court of Appeal held that the court should strive to give meaning to an incorporated clause if possible, rather than rendering it meaningless. Hence, the defence argued specifically that the rules relating to interest and the nature of the murabaha and ijarah agreements should be read into the agreement in accordance with the 'principles of the Glorious Shari'ah' governing clause.

However, the court ruled that the doctrine of incorporation can only function where the parties have identified the terms of their contract in 'specific black letter provision of a foreign law,' international code or set of other rules such as the Hague rules, which are amenable to incorporation as 'terms' of the relevant contract. The doctrine enables parties to an English contract to agree a contract which is construed in accordance with the relevant articles of a foreign law or non-state law. The effect of it would not make a non-state or foreign law the governing law of the contract, rather the specific articles of such a law would be incorporated as contractual terms into an English contract.

Unlike Nea Agrex v Baltic Shipping Co. Ltd, in the present case, 'the general reference to the principles of the Shari'ah…' affords no reference to, or identification of, those aspects of Shari'ah law which are intended to be incorporated in to the contract, let alone the terms in which they are framed.' Thus, the court agreed with the general consensus among experts that the reference to the Shari'ah does not afford the court with a direct reference to specific terms or other legal rules intended to be incorporated into the contract. This prevented the court - even if the court was able to do so - from determining the dispute

based on religious principles. However, if specific provisions of the Shari'ah had been included in the parties' agreements with respect to riba and the contractual essentials of the murabaha and ijarah, the defendants would have been likely to succeed.

Some observers have perceived this judgement as a slight to Islamic jurisprudence and relegation to second class status. Ercanbrack (2007) argues that some Muslims have taken offence at Morison J's comments in Beximco to the effect that the Shari'ah was unfit to govern modern commercial or banking transactions as its provisions are difficult to specify or assert. They view this as a capitis diminitio, a diminution of the Shari'ah and contextualise the courts' findings in the light of early arbitration, such as, Sheikh Abu Dhabi v Petroleum Ltd, Ruler of Qatar v International Marine Oil Company Ltd, and the well-known 1958 Aramco v Government of Saudi Arabia award. In each of these cases, British judges held that Shari'ah could not 'reasonably said to exist,' or it 'contains no precise rule' concerning a contract, so that Islamic law could not 'reasonably' be used as a governing law. Furthermore, they assert that many legal systems entail similar difficulties, and that the legal system in Saudi Arabia is the Shari'ah.

However, Shari'ah is an internationally recognised body of law. The International Court of Justice recognises Shari'ah as belonging to the general principles recognised by civilised states (Nadvi Habibul Haq, 2009). The objection centres on why the problem of ascertaining the law arises, when, it is applied in international commercial arbitration? This appears to discriminate against Islamic law.

Consequences of this case can be summarised as follows:

Religious risk will arise from non-compliance to Shari'ah. Murabaha was construed as a loan transaction and the entire debate of form over substance was raised.

The case has encouraged the development of waiver clause whereby the Shari'ah issues are not to be litigated. This is reflected in some documents such as the Tahawwut contract per clauses 3 (h) and (i) (IIFM, 2010), and the UK sovereign Maiden Sukuk prospectus of 2014. The question is how do we develop Islamic finance at the expense of not developing an Islamic jurisprudence for Islamic finance? Interpreting Islamic finance law through the prism of another legal system will lead to unwarranted results.

The case also creates an awareness to have a standardised and reported case law. It is to be observed that the AAOIFI's Shari'ah standards can fill in this vacuum as many countries have endorsed it. These will play a seminal role just like the Lex Mercatoria. However, English courts have made it very clear that they will not play the role of Shari'ah Supervisory Boards (SSBs) in determining the Shari'ah-compliance of financial transactions (see the doctrine of entanglement below). Hence, the judgment is a very important marker for IFI's in terms of legal expectations. The burden of ascertaining Shari'ah-compliance of products lies in the approval of products by the SSBs, preparation of contracts and internal Shari'ah audit and review systems and controls.

Another recent English Court case regarding incorporation of non-national laws was the Court of Appeal case of Halpern v Halpern [2008] QB 195. Although that case related to a dispute between Orthodox Jews under Jewish law, the Court stated that 'it may be that for actual incorporation it is necessary to identify 'black letter' (well-established as per common law) provisions, but that seems to be another way of saying that there must be certainty about what is being incorporated'(Yunis, 2002).

What these court decisions tell us is that, so far as the English Courts are concerned (i) the governing law of a contract must be either English law or the law of a country, therefore, Shari'ah law cannot be the governing law of a contract; and (ii) it may be possible to incorporate as a term of the contract certain principles of Shari'ah law, provided there is certainty as to what is being incorporated.

The above case laws demonstrate that, whilst there has been a tendency to favour court litigation as a means of resolving disputes in Islamic finance, English courts have at times encountered difficulties in dealing with contracts where the parties have, at least to a certain extent, sought their disputes resolved in accordance with Shari'ah or other non-national laws or principles (Jonathan, 2010).

The Investment Dar Co. KSCC v Blom Development Bank SAL

The third case was The Investment Dar Co. KSCC v Blom Development Bank SAL ([2009] EWCH 3545 Ch). In this case the Shari'ah issue was also raised regarding the enforceability of a master wakalah contract. The court originally showed an interest to consider the fiqhi issue during the summary judgment. But in the final judgement this was discarded, and the parties came to a settlement. From this case too it can be deduced that the court will not entertain Shari'ah risk.

One can understand that under the "doctrine of entanglement" judges are not supposed to be involved in religious law (Helfard, 2013). Although, there are major changes to this approach in other jurisdictions, such as, the USA, Canada, France and Germany, as discussed by Pascal Fournier (2010). She explains how different jurisprudential theories

have been developed by judges to accommodate Islamic law in these jurisdictions. The three approaches she identified are: 1. The liberal-Legal Pluralist Approach, 2. The Liberal-Formal Equality Approach, and 3. The Liberal-Substantive Equality Approach[4]. The case laws discussed above reflect the approach of the doctrine of entanglement except that in the Blom case, there was a tendency to move towards the doctrine of neutrality in spirit. The most recent case law was the Dana Gas Sukuk case [2017] EWHC 2928 (Comm). Dana Gas obtained an injunction from the English High Court of Justice in London restraining holders of its US$700 million of sukuk from taking any hostile action against the company in relation to the Islamic investment certificates (sukuk in this case). The court did not evaluate Shari'ah issues per sé, and just allowed the issuer the right to freeze the payment which was due in October that year.

The matter, ultimately, went on appeal, whereby the judge of the High Court gave judgement in favour of the sukuk holders. However, the argument of Dana Gas was that the English court should stay the proceedings in favour of Sharjah court and the question of the contract's validity under Shari'ah should be left to the Sharjah court. The court refused to accept this point.

The problem in this case is that the document was governed by the United Arab Emirates laws but the 'purchase undertaking" which was part of this contract is governed by English law.

In a globalized world, legal transplant is becoming a norm (Manjoo, 2012). Different legal systems tend to be blended. Therefore, if the UK wants to remain a centre for adjudicating Islamic finance it will need to reconsider its stance as some decisions pronounced are clearly not in line with Shari'ah law.

Proposed solutions

In light of the above legal conundrum regarding implementation of Shari'ah law, few suggestions have been made by academics. These are discussed below.

Doctrine of Incorporation

The adaptation of the Doctrine of Incorporation from Private International Law: Mohamad and Trakic (2012) argue that through this principle, clearly identified Shari'ah principles of a contract could be enforced as contractual terms because Recital 13 of Rome 1 Regulation allows for non-state law now. However, this doctrine is just a platform and not a combination of choice of law. Hence, just as the English law is respected, it is expected that if a transaction is of an Islamic nature then one should respect that as well. Unfortunately, all the cases heard so far in English courts pertaining to Islamic finance, have not been given a chance for Shari'ah law to evolve within English common law. Without development of jurisprudence via the court, Islamic finance will be stifled because there will always be legal uncertainty.

Combination of choices of law (combined law approach)

Julio Colon (2011) has advocated for allowing a combination of choice of law. The court can consider both Islamic law and Shari'ah law, as intended by the parties, as per Article 3 of the Rome Convention and Rome 1 Regulation, based on the 'party autonomy' principle. In fact, there is precedence to this effect. For instance, in Sanghi Polyesters Ltd. (India) v The International Investor KCFC (Kuwait) [2001] 1 Lloyd's Rep. 480, where the choice of law provided that the contract of istisna' would be "governed by the Law of England except to the extent that it may conflict with Islamic Shari'ah, which shall prevail.' The English court upheld the arbitral award, and the validity of the combined-law clause was not questioned. In other words, this case shows that there is nothing to prevent tribunals in western jurisdictions from using the combined-law approach, according to Julio C. Colon (as quoted from Mohamad (2012, p. 60). British courts may not be willing to accept the combined choice of law, although other jurisdictions are willing to do so. Hence, the Shari'ah risk and the legal risk remain a bone of contention. To offer legal certainty, legislation might be required, or alternatively, develop case laws in court.

Another issue regarding Shari'ah risk is whether a non-Muslim judge can interpret Shari'ah. In Saudi Basic Industries Corporation v Mobil Yanbu Petrochemical Company, Inc. and Exxon Chemical Arabia, Inc., {866 A.2d 1 (2005) No. 493, 2003; Supreme Court of Delaware}. In section 5 of the judgment one can read the frustration echoed by the court with this approach:

'What troubles the Court even more is that Dr. Vogel opines that this Court cannot credibly engage in the ijtihad process. According to Dr. Vogel, 'ijtihad requires for its credibility qualifications which on the very face of things, neither Prof. Hallaq, myself or, with respect, any U.S. Court possesses.' If Dr. Vogel is correct, then why did SABIC choose to file this dispute in a United States Court? If Dr. Vogel is correct in that neither he nor Dr. Hallaq possess the qualifications to engage in the ijtihad process, then

4- A deeper analysis of these approaches is beyond the scope of this paper. The main point is that secular courts have developed their own jurisprudence to accommodate the issue of dowry (mahr) despite nikah is recognised. So why other form of Islamic contracts cannot be recognised?

what Saudi law 'expert' would be able to assist this United States Court in determining the applicable Saudi law?'

This is a problematic area as the trend both academically and legally is to overrule Shari'ah by secular law. A restatement of contract law basically fulfils two functions: If there is any ambiguity in contracts the law of contracts has principles to address this issue, and secondly it provides remedies in case of breach. The AAOIFI, which is widely acknowledged in the industry, does not provide 'secondary rules' for unforeseen circumstances or non-performance of either party to the transaction, but only sets out criteria that must be met by Islamic financing transactions so that they meet Shari'ah requirements. No real remedies for contracts are provided. This is another area that the AAOIFI might need to consider to develop standards to fill in this vacuum because application of Islamic law seems to be problematic in courts.

All these cases show that when law and regulation do not cater for recognition of Shari'ah, this causes confusion and legal uncertainty. The question remains, 'Why does religion need to be regulated and why there is resistance to it?' From most regulators' perspectives, they are not willing to regulate religion as they are secular in nature. Even the Saudi Arabian Monetary Agency does not have a Shari'ah Governance framework[5], while Saudi Arabia is considered potentially as the largest Islamic finance market (Zawya, 2012). If the function of regulators is mainly to protect confidence in the market, and the market is highly driven by religious laws, then this defeats the purpose of saying that they are secular in nature. If the said religious philosophy has a potential to create a systemic risk, then, it is the duty of the regulators to intervene. Salman Syed Nadvi (2005) has argued on these lines, contending that regulators can make a concerted effort to uphold Islamic law so that the industry shows willingness to abide by these regulations. Case law in the UK provides clear cut proof that there is a serious element of uncertainty prevailing when parties intend to enter Islamic financial deals.

British courts have displayed some reluctance in adjudicating Shari'ah clauses in Islamic finance cases, as discussed above. Consequently, academics and the industry are reconsidering the validity and reliability of English courts for Islamic Finance. For instance, Tun (et al, 2011) has advocated that Malaysia is a better international forum to hear Islamic finance cases; and Yacoob (2011) has expressed mistrust in the way the court has refused to acknowledge Shari'ah, despite providing expert evidence in court.

This level of uncertainty will definitely affect the industry (Khan, 2012). When some Shari'ah issues are well established, but the court does not give effect to them, this creates legal uncertainty. This situation needs to be handled with care in order to have market stability. Dealing with financial instruments brings in elements of legal construction (McCornick, 2010), which in turn creates antagonism between the two legal systems. This is why Muhammad and Trakic (2012) advocate that the incorporation by references under the Rome Convention 2 need to be reconsidered so that Shari'ah as a non-jurisdictional law can be applied. The case laws as discussed do not seem to endorse such an approach for the time being. Hence another system to mitigate Shari'ah risk would be to consider arbitration process.

Arbitration

Another approach debated as a potential solution to address the legal and Shari'ah risk within Islamic finance is arbitration (Jonathan (2000); Lawrence (2012), and Yacoob (2010). Professor Andrew White, Associate Professor at the International Islamic Law and Finance Centre in Singapore, stated at the Asia Pacific Regional Arbitration Group Conference 2011 that litigation is not geared towards solving Islamic finance disputes, as judges often lack the education in many industry principles. In this context, some would say that arbitration is well placed to deal with these issues as arbitrators can be selected that have the requisite knowledge both of Shari'ah and the relevant commercial transactions. The International Islamic Centre for Reconciliation and Arbitration (IICRA) was established in 2005 and is based in Dubai. It has more than 70 Islamic Financial Institution from the Arab and non-Arab countries affiliated to it. Its existence resolve disputes in the Islamic Finance Industry based on Shari'ah[6].

At the Asia Pacific Regional Arbitration Group Conference 2011, Hakimah Yakoob contended, based on a survey she conducted of 10 Islamic banks and 12 takaful operators in Malaysia, that there was a 'credit policy' in many of these institutions not to include alternative dispute resolution clauses in their contracts, but to opt for litigation instead. This was said by the financial institutions to have been done, in many cases, in order to avoid credit risks for legal uncertainty. The preference for litigation was further confirmed by enquiries made of arbitration centres in Malaysia for this report (Lawrence, 2012). Hence, it is of paramount importance to create that confidence in the market to adopt arbitration which is widely accepted in the commercial world.

In the case of Sayyed Mohammed Musawi vs R.E. International (UK) Ltd and others: [2007] EWHC 2981 (Ch)] the English High Court enforced an arbitration award based on Shia law despite

5- A recent Sharī'ah governance guidelines for the Sharī'ah board has just been issued in April 2020 by SAMA. However, these will need to be tested still.

6- https://www.iicra.com/about-iicra

objections raised by the defendant that arbitration should only be in line with English law. Al-khamees (2011) also discussed few cases where English courts had jurisdiction over arbitrating matters involving Saudi companies, whereby, the application of Islamic law was intended.

Secondly, the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (commonly referred to simply as the New York Convention), seeks to provide common legislative standards for the recognition of arbitration agreements and for court recognition and enforcement of foreign arbitral awards. The Convention's principal aim is that foreign arbitral awards will not be discriminated against. It obliges parties to ensure such awards are recognised and generally capable of enforcement in their jurisdiction in the same way as domestic awards. Grounds for non-recognition of a foreign award are very limited. These include awards that are contrary to public policy; where the parties to the agreement were under some incapacity; the agreement is not valid under the law to which the parties have subjected it; or the absence of proper notice of the appointment of the arbitrator or of the arbitration proceedings. An ancillary aim of the Convention is to require courts to give full effect to arbitration agreements by requiring courts to deny the parties access to court in contravention of an arbitration agreement.

The developments made in this field are noted as the establishment of an International Islamic Centre for Reconciliation and Arbitration based in Dubai. It has framed its arbitration rules for disputes arising out of commercial agreements that are based on Shari'ah principles. However, despite this development, there is a reluctance by Islamic finance institutions to refer matters to arbitration as discussed above. There can be many reasons explaining this reticence to arbitrate Islamic finance disputes, like legal and Shari'ah uncertainty, lack of Islamic procedural law, arbitration might be viewed as untested for them, and that court review might extend the litigation further due to lack of expertise in Shari'ah, Hence, to bring more certainty and confidence in the system, something needs to be done.

To consolidate the arbitration channel, it should be mentioned that the doctrine of Kompetenz-Kompetenz is recognised under English law as also Shari'ah. Accordingly, this legal doctrine gives jurisdiction to the arbitral tribunal to decide whether it has jurisdiction to hear the merits of the dispute where one party alleges invalidity or termination or non-existence of the contract which is said to have given rise to a dispute. The doctrine of separability is specifically recognised in section 16 (1) of the UNCITRAL Model Law. The House of Lords decision in Premium Nafta Products Limited (20th defendant) and others (respondents) v Fili Shipping Company Limited (14th claimant) and others (appellants) [2007] 4 UKHL 40], recognised the fact that the arbitral tribunal was the proper forum in the first instance to deal with the validity or enforceability of the contract. It also recognised the doctrine of separability in arbitration, as well as, Kompetenz-Kompetenz. These international legal concepts are strong proof that arbitration can be used to bring more certainty in Islamic commercial law by co-opting Shari'ah as the choice of law.

Once this legal certainty regarding approval of arbitral award is accepted, the next stage is to have procedural and substantive law certainty. Regarding the substantive and procedural law aspects of arbitration, it is submitted that the AAOIFI's Shari'ah standard no. 32 has provided ample provisions to facilitate arbitration for the industry at a global level. There are generic provisions that will need to be readjusted as required in each jurisdiction. Most of its provisions fit in with modern arbitration law. There are some areas which might need some reconsideration due to the global dimension of commercial disputes being arbitrated:

It is recommended that a specimen of an arbitration clause be provided for section 5/1 (a) of the standard. The "arbitration agreement" or "terms of reference" is of paramount importance and should be properly drafted.

Section 10 of the standard encompasses a wide spectrum of provisions regarding the method or procedures and how to write the award. However, often non- Shari'ah issues are disputed such as determination of quantum of damages in a takaful claim. The question is whether we should separate these two issues, i.e. Shari'ah and conventional issues? This discussion also concerns section 7 i.e. Scope of arbitration.

Section 8 might need some further consolidation when dealing with a multi-trillion dollar industry. Arbitrators should be properly trained, for example the provision does not stipulate the techniques of arb-med, where parties can break into caucus after arbitration starts in order to reconsider their positions. This is a practical technical issue to be resolved. There are various aspects of managing an arbitration process in modern day commercial world. Hence, such provisions would be required to ensure that arbitration for Islamic financial litigation to be at par with international norms. This approach will mitigate the reluctance we witnessed in the industry. In fact, one of the grounds for review plea to the court is when an arbitrator is not adequately qualified and displayed bias. To mitigate this risk, the arbitrators should be trained in the field of ethics to ensure that there is proper due process; parties may avoid unnecessary review or even appeal against the award. The Code of

Ethics for Arbitrators in commercial disputes has been adopted and welcome by the courts especially in the USA. Though it does not have the force of law, nevertheless it is a good step in the right direction to bring in more confidence in Arbitration for the Islamic finance industry. This could further be amalgamated with AAIOFI's latest Code of Ethics for Islamic Finance Professionals.

Regarding the procedural aspect of the arbitration, section 11 has adequate provisions to meet most of modern requirements, though certain sections can be improved further. For instance, section 11/5 provides for partial award or leaving a matter without stipulating the indemnification. Or even section 11/6 which provides that not mentioning the ratio decendi will not affect the validity of the award is crucial. Practically this is needed because it establishes a sort of precedence and brings in more certainty. This is what the financial institutions require. It is an accepted principle that arbitration does not have the same effect like a judgment; but at least such recordings create an atmosphere of professionalism. Or else the risk is that the matter might go to review, which defeats the very objective of arbitration. Hence, to avoid review and secure the arbitration principles, parties can incorporate rules from the International Center for Reconciliation and Arbitration. For instance, the rules negate the right to court appeal or review. However, it does provide mechanisms to double check the soundness of awards before issuing them. Another solution could be the adoption of the rules of UNCITRAL. However, it will not be practical for AAOIFI to incorporate all these rules in its Standard, but it might refer to these as guidance. This will bring more confidence in the system due to the recommendation of well-established rules.

Another area which might be considered is the methodology of appointing a panel of arbitrators. This is not adequately discussed in the standard. Section 8/1 is vague and the the industry needs clarifications. Usually banks or insurance companies need high level of expertise in arbitration. For instance, often we see provision such as the bar council will appoint the arbitrator. Transparency on the mechanism for the appointment of such panel is very important. Some Islamic banks unfortunately tend to appoint their own Shari'ah board to arbitrate. This may lead to an image of partiality and may be conflict of interests. Clients should be given confidence in the system proposed. This is where the Code of Ethics for arbitrators mentioned above would become relevant.

One issue which is not well explained in the standard is: if someone is not happy with the award what is the remedy? How one will access the remedy if there is one? The problem is that a pure arbitration can stand on its own, but if a party feels that there has been injustice what will be the recourse to it. In conventional arbitration there is provision for court Review. Under s. 69 of the English Arbitration Act of 1996, the award issued can also be appealed the award issued can be reviewed by the court and can also be appealed against on substantive law matters. However, there are limitations for appeals which apply to some limited circumstances. It is an area which the industry still needs to work on. May be to establish a reputable international panel.

Despite the encouragement for the adoption of arbitration, it will not substitute the court's authority even one might argue in favour of Rome 2 Convention. More work needs to be done to create a well-established system. For instance, proper recordings of the cases to be made available to the public. Though awards do not have the status of *stare decisis*; however, it does show the trend for arbitral award. In jurisdictions where appeals are allowed such as in England, scholars should look deeper into the process to minimise such appeals; if not we will be back to square one as the court will not endorse Shari'ah¡ as discussed above. Hence, one solution would be for parties to opt out of appeals to ensure that Shari'ah law is being applied wherever possible.

Conclusion

The financial industry is underpinned by a fair level playing field in the United Kingdom. However, looking at the courts cases it seems that the approach to Islamic commercial law has met with a resistance at the court level; either rejected at the expense of applying English law or re-interpreted. The court tends to use its own legal principles. This approach brings in uncertainty for the Islamic finance industry. Refusal to accept Shari'ah law in the court can be resolved by either relooking at the Rome convention with a more global view to adopt non-state law or exploring arbitration as a more robust alternative. Research shows that there is reluctance by Islamic financial institutions to go for arbitration. One of the main reasons is the lack of confidence in the system. This paper argues that the Kompetenz-Kompetenz concept does bring procedural stability when coupled with UNITRAL. The AAOIFI Shari'ah standard no. 32 on Arbitration provides guidance for the substantive law and can be given the same status in law as the lex mercotaria. It can be used for starting arbitration. However, certain practical issues need to be considered to consolidate the process so that the industry can consider arbitration as a robust alternative dispute resolution (ADR) mechanism to enhance proper Shari'ah implementation.

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PEER-REVIEWED

Maqāsid al Shari'ah: A valid paradigm for Shari'ah opinions in Islamic finance

Prof. Dr. Muhammad Tahir Mansuri[1]

Abstract

Shari'ah legitimacy of Islamic banking and finance has been subject of debate for the last many years. The scholars advocating the supremacy of maqāsid in Islamic finance, entertain doubts about Shari'ah legitimacy of Islamic banking products and operations on the ground that they have failed to achieve Shari'ah values of justice, fairness, equity in dealings, transparency and common welfare of mankind. On the other hand, the Shari'ah scholars of Islamic banks assert that maqāsid al-Shari'ah are not a valid criterion to judge the Islamicity of Islamic banking and that general reliance has to be made on the famous jurisprudential principle, "Shari'ah rulings are based on 'illah, not on hikmah". This paper seeks to investigate whether maqāsid, hikmah, purposes of law are a valid criterion to judge the Islamicity of Islamic banking products and transactions and whether maqāsid are valid paradigm for Shari'ah opinion in Islamic finance. While analyzing some structured products used by Islamic banks, it discusses the treatment of hikmah, maslahah and maqāsid in early Islamic jurisprudence and proves that scholars have always given prime consideration in their rulings to maqāsid, hikmah, rationale of law, motivating cause of transaction and the general proposition of law giver. It also discusses the issues in 'form driven approach' in Islamic finance versus 'substance' issues in Islamic banking. The paper argues that any ruling and opinion in Islamic banking, that fails to consider maqāsid, hikmah and intention of law-giver, would lead the decision to be defective and it would be a type of fulfilling the requirements of form rather than substance and essence of the contract. The paper concludes that endurance of Islamic finance depends only on compliance with maqāsid and ethical values as well as observance of spirit of Islamic law, otherwise Islamic banking and finance will lose its distinct identity.

Keywords: Islamic finance, maqāsid, 'illah, hikmah, organized Tawarruq, running musharakah.

Introduction

Shari'ah legitimacy of Islamic banking and finance has been subject of debate between Islamic economists and Shari'ah experts of Islamic finance industry for the last many years. A considerable number of prominent Islamic economics assert that current Islamic finance has ignored maqāsid al-Shari'ah in its agenda. Maqāsid are technically defined as: "Essential benefits of human beings pertaining to this world and the world hereafter" ('Allal al-Fasi, 1983). The Maqāsid include: preservation and protection of faith, life, progeny, intellect, property; establishment of justice and equity; promotion of well-being of society, circulation of wealth and its equitable distribution; protection of human rights and liberties, enabling peace and security, human fraternity and cooperation among members of human community etc. (Ibn Ashur, 1973; Atiyyah 2007). These maqāsid

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are the higher purposes of Shari'ah and may also be termed as macro objectives of Shari'ah. Besides this popular nuance of maqāsid, the term maqāsid al-Shari'ah is also described as: "The purposes and wisdom behind the enactment of the Shari'ah rulings" (Raysuni, 2005; 'Atiyyah, 2007).

The term hikmah is also used in this meaning. It is purpose, rationale and motivating cause of a law and thus it is a maqsad al-Shari'ah behind the enactment of a particular ruling. The scholars advocating the supremacy of maqāsid in Islamic finance use maqāsid in both the meanings. In their opinion a mufti, while approving a product or transaction should see whether it serves the above purposes and that the purpose and the motivating cause is lawful, and it is not a Hilah to circumvent certain Shari'ah prohibitions.

On these two accounts, these scholars entertain doubts about Shari'ah legitimacy of Islamic banking products and operations. They assert that these products and transactions have failed to achieve Shari'ah values of justice, fairness, equity in dealings, promotion of common welfare, transparency, consideration of substance in transactions, avoidance of subterfuges, and similar other values and ideals which are integral part of Shari'ah, its ethos and value system.

In the opinion of these scholars, mere reliance on contract mechanics or compliance with the requirement of a formal contract, or mere avoidance of riba, ignoring the values and objectives that Shari'ah seeks to realize through its financial system, is not sufficient evidence to declare it an Islamic banking. These scholars suggest that Islamicity of Islamic banking should be judged against the above values and objectives of Shari'ah (Maqāsid al Shari'ah).

As opposed to it, the Shari'ah scholars of Islamic banks assert that current Islamic banking is Islamic as the banking transactions meet the requirement of a valid contract. In the opinion of these scholars, Maqāsid al-Shari'ah and Shari'ah values represent hikmah (rationale, wisdom or motivating cause of law) while ahkām are constructed on 'illah i.e. apparent underlying cause which is stable, constant, consistent and measurable attribute. The Shari'ah scholars assert that Maqāsid al-Shari'ah are not a valid criterion to judge the Islamicity of Islamic banking. Similarly, hikmah cannot be made the basis of fatwa. For this purpose, general reliance is made on the famous jurisprudential principle: "Al-Ahkam Tubnaa 'Alaa al-'illah doona al-hikmah" (Shari'ah rulings are based on 'illah not on hikmah). The 'illah in the above jurisprudential principle refers to: "An apparent and stable attribute that is either coterminous with the underlying rationale or the rationale is usually present when the attribute exist". The word hikmah conveys the meaning of rationale, wisdom behind the Hukm. The above principle suggests that in case of analogical and deductive reasoning, the deduced ruling will be constructed on 'illah, apparent underlying cause, not on Hikmah, i.e. motivating cause or rationale of Hukm. For example, Shari'ah allows Shuf'ah (right of pre-emption) for neighbor. The rationale of this law is aversion of any expected harm from an unwanted neighbor. But the ruling is not based on hikmah that is possibility of harm to the neighbor. Here 'illah is neighborhood and hikmah is to avoid harm. If a property is sold in the neighborhood of a person, he is entitled to use this right, regardless of whether he is harmed from this sale on not, because harm is not a stable, consistent and static cause. It may vary from person to person. Similarly, shortening of prayer (Qasr) has been instituted in case of journey. The rationale of this ruling is removal of hardship from traveler. But while applying the ruling, hardship is not taken into consideration. The traveler is entitled to Qasr, regardless of whether he has suffered hardship in the journey or not.

In case of riba, the rationale underlying the prohibition of riba is zulm as the Qur'an says: "But if you repent (from dealing in riba), then you are entitled to your principal sums, neither you do injustice, nor injustice be done to you". Thus, zulm is hikmah i.e. rationale and motivating cause of prohibition of riba. The 'illah of prohibition is increase on principal amount of loan or debt. The hukm of prohibition is linked with this apparent cause irrespective of the fact that the transaction involves some injustice or not, as anyone may consider at any point of time. In other words, law (prohibition) will come into effect by mere existence of 'illah. From this, the Shari'ah scholars of Islamic banks conclude that maqāsid are not valid criterion for judging Shari'ah legitimacy of Islamic banking because they argue that hikmah is always changing and, hence unmeasurable.

This paper seeks to investigate whether mere compliance with contract form, is a reliable criteria to judge the validity of the transaction and product. What was the methodology of the early jurists in legal reasoning (fatwa and ijtihad)? While declaring a transaction or juridical act valid or invalid, did they look into the resultant benefits, end results, underlying purpose and motivating cause of transaction, or they relied only on the compliance of an act with external form. Whether hikmah and purposes of law are a valid criterion to judge the Islamicity of Islamic banking products and transactions, and whether maqāsid are valid paradigm for Shari'ah opinion in Islamic finance. It will address the following questions:

1. Is a ruling in Shari'ah always based on 'illah?
2. Can fatwa be constructed on hikmah and consideration of motivating cause?

3. Is mere adherence to contractual requirements of a contract in its form and structure without looking into substance and spirit of contract sufficient to declare banking transactions and products, a valid methodology from the perspective of Shari'ah?
4. Does Islamic law acknowledge hiyal (stratagems) for the purpose of formulating Shari'ah ruling?
5. Are maqāsid a valid criterion to judge Islamicity of Islamic finance?
6. Should the validity of a transaction or product be judged against the 'form' or it should be judged against the 'substance'?
7. What are the implications of form-driven approach for the credibility of Islamic finance?

These issues will be discussed in the following three sections:

Section 1: Treatment of 'illah, hikmah, maslahah, maqasid in early Islamic jurisprudence

Section 2: Form and structure of a contract versus motivating cause of the contract

Section 3: Principle of consideration of end-results of juridical act (Ma'alaat al-Af'aal) in Maliki legal discourse

Section 4: Legality of motivating cause in transactions

Section 5: Issues in form-driven approach in Islamic finance

Section 1: Treatment of 'illah, hikmah and maslahah and maqasid in early Islamic jurisprudence

As stated earlier, the general principle in analogical and deductive reasoning is that ruling has to be based on 'illah not on hikmah. But it is also an acknowledged principle that only that 'illah is suitable for ruling, which is consistent with hikmah, and serves the purpose and rationale behind the law. This goes without saying that hikmah is a motivating cause for any Shari'ah hukm. This is the hikmah which gives birth to the law. Any 'illah that is inconsistent with hikmah does not qualify to be a valid 'illah for hukm. Take the example of wine. It may have many attributes. (i) It is liquid (ii) It has red or black color (iii) it is intoxicant. The first two attributes are irrelevant for the purpose of prohibition. Wine has not been prohibited because it is liquid or reddish. Thus, these attributes do not qualify to be 'illah. Third attribute i.e. to be intoxicant is an appropriate 'illah, on which hukm of prohibition is constructed. It is suitable 'illah because it is directly linked with the hikmah i.e. purpose of prohibition of wine, which is 'preservation of human mind and intellect'.

An example of unsuitable and inappropriate 'illah is weighability of gold and silver in riba al-fadl rather than currency-value (thamaniyyah). A group of scholars maintains that the cause or 'illah for gold and silver is similarity of species, i.e. the exchanged articles belong to the same genus and both are weighed. This 'illah suggests that since modern paper currency is not weighable (not sold by weight), riba will not run into it. According to a fatwa of a leading scholar of subcontinent, both excess and delay are permissible in paper currency because it is countable, not weighable. According to another popular fatwa, excess is not lawful, but delay is permissible. Thus, in case of exchange of dollars and rupees, spot exchange is not necessary. Majority of scholars, on the other hand, hold the view that the dominant attribute of gold and silver is that they serve as money and medium of exchange. It is the mainstream view which also accepted by the Islamic Fiqh Council and AAOIFI. Thus, the 'illah for gold and silver is thamaniyyah i.e. price-worthiness and currency-value i.e. to be the medium of exchange. Consequently, the ahkam of riba al-fadl and bai' al-sarf apply to modern paper currency because it is similar to gold and silver in all respects.

It is evident that the weighability of gold and silver is not a suitable 'illah for the prohibition of riba-al-fadl. Is excess and delayed exchange of gold and silver prohibited because gold and silver are sold and bought through weight? Obviously, the Shari'ah has not prohibited riba al-fadl for this reason. It is prohibited because exchange with excess or exchange with delay (non-simultaneous exchange between gold and silver or dollars and rupees) brings undue benefit for one party at the cost of other party. In exchange contracts, if one party gives $100 to the other, who could use the same for consumption or investment purpose, the counter party must give its equivalent rupee-value then and there, so that the latter may also be in position to use the same for any consumption or investment purpose. The Islamic law is very clear and particular about this and the delay is not allowed in the exchange of ribawi goods as ordained in the well-known hadith on exchange of six ribawi items namely gold, silver, wheat, barley, dates and salt (Muslim, Shahih, vol. III, p.1211). Shari'ah has closed the door in front of this exploitation and undue benefit. This purpose can be served only when the thamaniyyah or price-worthiness is considered as 'illah for gold and silver.

From this we may conclude that 'illah in Islamic law, must be compatible and consistent with hikmah, because hikmah is the very purpose of the law. It is the very cause that brings the law into existence. The Muslim jurists emphasize hikmah not only in the debates on qiyas but in the other evidences of Shari'ah as well.

It would not be out of place to mention here that among the early jurists, Imam Ghazali is a strong advocate of hikmah and maqāsid-based rulings in

the Islamic law. For this purpose, he uses a number of terms such as qiyas al-Ma'na (analogy based on inherent meaning and substance), al-qiyas al-wasi' (extended analogy) and tasarrufat al-Shara'i (general dispositions and propositions of the law giver) and qiyas al-qawai'd (analogy based on general principles). Qiyas al-Ma'na or Qiyas al-hikmah refers to a situation where analogy is built on rationale, wisdom and purposes of law. Here consideration is given to general propositions and dispositions of law-giver (Shaari'). Qiyas al-Ma'na or qiyas al-hikmah suggests that ruling should be based not on a single particular text, but on the general propositions of the Shari'ah derived form a large number of texts. Qiyas al-Ma'na (general meanings and propositions of Shari'ah) in the example of wine would suggest that new ruling should not be constructed on prohibition of wine but on "preservation of intellect". By this extended analogy, we will prohibit everything and act that harms and affects human mind, even though it is not intoxicant. In modern times, brain washing is a suitable case for invoking Qiyas al- Ma'na and extended analogy and declaring it prohibited on the basis of the Shari'ah objective of Hifz al-'Aql (preservation of intellect).

Imam Ghazali, in his celebrated work on Usul Fiqh, Shifa al-Ghalil has discussed many situations where 'illah is abandoned in favour of hikmah and consideration is given to hikmah (wisdom, rationale and purpose). His understanding and interpretation of maslahah mursalah is also reflective of his hikmah based reasoning in Islamic law. Maslahah mursalah is generally defined as an interest or maslahah which is neither rejected by the Shari'ah, nor has been explicitly attested by the Shari'ah, but it conforms to the purposes of Shari'ah (Maqāsid al-Shari'ah). In the analysis of Imam Ghazali, maslahah mursalah is an interest that is acknowledged by the law-giver at the level of genus i.e. it is in conformity with the genus of the dispositions of the Shari'ah. Thus, a ruling or verdict based on maslahah should find support and endorsement from large number of Shari'ah evidences. Shari'ah rulings in case of maslahah mursalah are largely based on hikmah and purposes of Shari'ah (Maqāsid al-Shari'ah). This goes without saying that maslahah mursalah is an acknowledged mode of legal reasoning (ijtihad & fatwa) in Maliki School. The ruling in maslahah mursalah is deemed to be stronger than Qiyas (analogy), because in analogy, ruling is based on a particular single text, whereas in case of maslahah, ruling (fatwa) is based on large number of texts collectively. Further, it conforms to maqāsid al-Shari'ah. Needless to say that Maqāsid are also derived from a large number of texts.

Besides hikmah and maslahah, the classical Muslim jurists have also considered maqāsid al-Shari'ah for the purpose of fatwa and Ijtihad. Imam Ghazali, Imam ibn-Taymiyyah and Imam Shatibi have frequently emphasized the significance of Maqāsid for legal reasoning (Ghazali: 1993; Ibn Taymiyyah: 2005; Shatibi; 1994). The modern Muslim jurists like Tahir ibn Ashur, Yusuf al-Qaradawi, Allal al-Fasi, Ahmad al-Raysuni, Hamid al-Alam and many other prominent Shari'ah scholars have also emphasized the centrality of Maqāsid al-Shari'ah in Ijtihad and legal reasoning (Ibn Ashur, 1978) Dr. Wahba Zuhaili (1986) a renowned contemporary Shari'ah scholar of Islamic law also endorses the above view that Maqāsid al-Shari'ah are a valid paradigm for fatwa and Ijtihad. In his view a particular Maqsad al-Shari'ah is suitable for legal reasoning when it meets the following three conditions:

1. It is established by the Shari'ah evidences such as Quran and Sunnah.

2. It is clear and manifest in its meaning in such a way that its meaning and contours could easily be determined.

3. That it is constant and stable objective (Zuhaili, 1986).

On certain issues, renowned Shari'ah scholar Mufti Muhammad Taqi Usmani, has also taken maqasid-based position for evaluating Islamic finance products. In a working paper presented before the Shari'ah Board of AAOIFI, Mufti Taqi Usmani describes many current Sukuk inimical to objectives of Shari'ah. He observes:

'If we consider the matter from the perspective of the higher objectives of Islamic law, or the objectives of Islamic economics, then Sukuk in which they are to be found nearly all of the characteristics of conventional bonds, are inimical in every way to these purposes and objectives. The whole objective for which riba was prohibited is the equitable distribution among partners of revenues from commercial and industrial enterprise. The mechanism used in Sukuk today, however, strikes at the foundations of these objectives, and renders the Sukuk exactly the same as conventional bonds in terms of their economic results'[2].

The passage clearly establishes that Mufti Taqi Usmani endorses maqasid based evaluation of Islamic banking products and transactions.

In early Islamic legal history, we find that in many cases, fatawa and rulings were issued exclusively on the basis of hikmah, maqāsid and general propositions of Shari'ah. For instance, Pious Caliph Umer (RA) decided to kill a large number of persons by way of relation who participated

2- Usmani:alqalam.org.uk.

in killing of a single person in Yamen. His ruling was based on "Preservation of life", which is an objective and purpose of Islamic law. The companions (Sahabah) decided to hold the artisans such as tailors, cobblers, carpenters etc. liable for the goods of people destroyed in their custody. This decision was based on "preservation of the wealth of community" which is a purpose of Islamic law. Pious Caliph Umar (RA) abolished the share of mu'allfah al-Qulub (those whose hearts have been reconciled with Islam) considering the hikmah, i.e. rationale and wisdom behind the law of Zakah for Mu'allafah al-Qulub.

The early Hanafi jurists ruled that sadaqa al-fitr can be given in monetary equivalent. The other scholars were of the view that it should be given in kind in form of dates, wheat etc. as required in the Haidth. The position of Hanafi jurists is based on the consideration of the rationale of Zakat al-fitr. Since the purpose of this Zakah is to satisfy the needs of the poor, the issue of payment in kind becomes irrelevant. The purpose can be achieved by payment in any form. We observe here that this fatwa is based on the consideration of hikmah and purpose for which zakat al-fitr is instituted.

Prophet Muhammad (PBUH) has prohibited tas'ir (price fixation), but the latest jurists ruled for its fixation when they saw that the traders are exploiting the rule of non-fixation of price for reaping exorbitant profit. Imam Ibn al-Qayyim says "Tasi'r or price fixation sometime amounts to injustice and sometime it is just. If the purpose of price fixation is to force traders to sell their goods at an unjust price, which does not suit them, then tasi'r is unlawful. But, if it promotes justice like forcing them to sell at a just market value then such price fixation is permissible". We observe here that the main consideration in this ruling of Imam Ibn al-Qayyim is the hikmah or rationale and the purpose behind the law.

From the above discussion it can be easily concluded that the classical Muslim jurists and the prominent modern Shari'ah scholars have given prime consideration to hikmah, maslahah, general proposition of the law giver and Maqāsid al-Shari'ah in legal reasoning. They have generally opposed the form based approach in the formulation of opinion on Shari'ah matters. The Maliki and Hanafi jurists even goes one step further and suggest that a Mujtahid (person who does ijtihad or legal reasoning) while interpreting a text, should interpret in the light of the wisdom and rationale underlying the text, instead of following the outward meaning of the text. It is worthy to mention here that jurisprudential principle: "Ruling is based on 'illah and not on hikmah" is confined only to the cases of Qiyas and analogical deduction. The discourse on hikmah in our study, is not confined to the cases of Qiyas where ruling is generally based on 'illah, being a manifest, stable and constant attribute of the text. It extends to all cases of rule-making, whether it is a new rule or it is an interpretation of the existing rule. The study argues, that while formulating any ruling the purposes of the Shari'ah and motivating causes of the ahkām should always be taken into consideration.

Section 2: Form and structure of a contract versus motivating cause of the contract

Can a transaction be declared valid by its mere compliance with technical requirements of a contract or it should be declared valid when the purpose and motivating cause is also valid and consistent with the intention of lawgiver?

Majority of Muslim jurists maintain that a contract is valid only when the object and underlying cause is valid. If the parties, through the contract, intend to achieve the aims and objective that are contrary to the intention and purposes of lawgiver, then the transaction is invalid and disapproved in Shari'ah. Some examples of the consideration of underlying and motivating cause of contract for judging the validity and invalidity of contracts are as follows:

Nikah tahleel (halalah or intervening marriage), for instance, although meets the requirement of a valid contract in terms of Arkaan and Shuroot, yet, it has been declared unlawful and prohibited by majority of Muslim scholars (Maliki, Shafie, Hanbali jurist, also including Hanafi jurist Imam Abu Yousuf). The Maliki and Hanbli jurists always emphasize the role of maqāsid and purposes (Ma'ālāt wa maqāsid) in contracts, transactions and judicial acts. To them Qasd Faasid i.e. improper and unlawful intention, makes a transaction invalid. Thus, they have ruled the invalidity of transaction where a person sells grapes to a person who buys it with the objective to extract wine from it when the seller knows about its use. In the same way selling weapons to a habitual criminal is not allowed because of strong likelihood that he will use it to kill innocent people. The authentic book on Maliki fiqh, Al-Mi'yaar al-Mu'rib wa al-Jami' al-Mughrib ann Fatwaa ahle Afriqiya wa al Andalus wa al-Maghrib by Al-Wansharisi has discussed these instances in detail. Maliki jurist even emphasize the principle of Sadd al-drāi' (prohibition of what may lead to committing sins) which suggests that even if a thing in its nature is permissible, but it leads to some evil (such as it opens door of riba), will be declared unlawful.

Section 3: Principle of consideration of end-results of juridical act (Ma'ālāt al-Af'āl) in Maliki legal discourse

So far we have discussed that scholars have never ignored Maqāsid, purposes of Shari'ah, rationale

and purposes of Shari'ah, and the rationale and spirit of Shari'ah in their rulings. In other words, form driven methodology in reasoning (Ijtihad) was generally rejected by the early Islamic scholars especially the Maliki and Hanifi jurists. They even interpreted the text in the light of maqāsid, and maslahah i.e. the benefit to be drawn and the harm to be averted from it. In the absence of text, they resorted to the aims and purposes of the Shari'ah, and the intention of the law-giver. Most of the rulings of Pious Caliph Umar (RA) belong to this category.

Under the current title, we will discuss an important Maliki principle of 'Consideration of consequences and end-results of act' (I'tibār ma'ālāt al-Af'āl) which suggests that ruling on certain matter should be given, considering the benefit drawn and harm averted from it. Thus, it requires that the mujtahid and mufti should possess high level of judgmental ability to weigh with accuracy the benefit and harm. The principle also implies that he should constantly watch the end-results and consequences of his ruling. Principle of ma'ālāt al-Af'āl in Shari'ah opinions, has been strongly advocated by Imam Shatibi: He says: "The consideration of end-results of act is an acknowledged and approved rule in Shari'ah, regardless of whether the act is that of commission or omission" (Shatibi, 1994 vol. 4, p.194). He suggests that a mujtahid and a mufti, while forming Shari'ah opinion on certain act (certain banking product, for instance) should see what are its possible consequences? Will it bring benefit and will it give rise to mafsadah. In the opinion of Imam Shatibi, the investigation of future consequences of act, is a difficult task for mujtahid, but it is very much desired in Shari'ah since such activity is the best way to protect maqāsid al-Shari'ah (Shatibi, 1994).

The implication of this principle in Islamic finance is that a mufti, after giving the Shari'ah opinion on certain product or operation, should constantly monitor its effects and consequences. For instance, if he had allowed, for the purpose of Shari'ah screening, interest-based borrowing up to 37% for a company 15 years back, he should now revisit it, to see whether this has strengthened interest based system, or the borrowing companies have used this ruling only for transitional period when these companies did not have access to Islamic banks or other financial institutions, for financing. Similarly, if he has allowed for the subscription to sukuk by conventional banks on the plea that sale to both Muslim and non-Muslim is permissible, now, on the basis of above principle, he should revisit his ruling. He should examine the harm this act of sale of sukuk to conventional banks as it not only strengthens the conventional interest-based system, but also reduces the investment opportunity for Islamic financial institutions. He may ask himself: Has this product strengthened riba-based conventional financial system? Whether or not, this is an act of cooperation in sin?

The above principle also requires that consequences and end-results of RM (Running Musharakah) should also be checked in the light of end results.

In case of bancatakaful, high commissions have been paid to the banks selling bancatakaful product to the customers even without making necessary disclosures, thus leading to exploitation of the clients (JIBM, 2016). The above principle requires a Mufti to issue Shari'ah ruling and putting ban on such commissions.

Thus, the consideration consequences of act is an obligation of Mufti. He is not absolved of his duty by mere issuing of a Shari'ah opinion.

Section 4: Legality of motivating cause in transactions

The classical scholars have extensively discussed the role of intention in juridical acts. They heavily lay emphasis on substance of contracts and hold it supreme over form. Emphasizing the role of intention in juridical acts, Imām Ibn al-Qayyim (1349), an eminent Hanbli jurist, writes:

> "The evidences and rules of the Shari'ah reveal that intentions are taken into consideration in the contract. These intentions affect validity and invalidity, and lawfulness and unlawfulness, of a contract, but more seriously, that they affect the action, which is not a contract, with respect to making it lawful, or unlawful. The same item becomes lawful, sometimes, and unlawful, at other times, depending on the variation of intentions and intended objectives."

Imam Ibn Hazm has also emphasized the significance of intention in juridical acts. He asserts that if a person sells grapes, or dates, to a person about whom he is certain that he will extract wine out of it, or sells a weapon knowing that buyer will use them against the Muslim public, such a sale is invalid, for Allah says: "Help one another in righteousness and piety, but help not one another in sin and rancor" (Ibn Hazm, 1347 H)

Another renowned scholar of Islamic law, Imām Shatibi, (d. 790/1388), emphasizes the role and significance of objectives and intentions in determining the validity and invalidity of dispositions. He says:

> "Deeds are to be judged by intentions, and objectives are taken into account in dispositions, such as rituals and dealings. Roots of that are innumerable. Objective and motivating cause differentiate a ritual from transactions and

dealings - that is, contracts and dispositions. They also determine the validity, or invalidity, of these acts. Thus, when an ultimate objective of an act is unlawful, the act is also unlawful. For instance, when a sale is intended to be a means for ribā, such sale is invalid." (Shatibi, 1994)

Muslim jurists have declared many such transactions invalid, whose objectives were inconsistent with the intention of the lawgiver. Thus, a contract of 'intervening marriage to facilitate re-marriage between a divorced couple is invalid because the parties to this contract do not intend a life-long companionship from this 'intervening marriage'. It is worth mentioning that in Islamic law, marriage has been instituted for life-long companionship, which is the objective intended by the lawgiver. Similarly, selling weapons to habitual criminals, who may use them to kill innocent people, or to sell them during any period of turmoil, is invalid if the seller has knowledge about the intended use of weapon. Based on similar analogy, the Muslim jurists have held that a gift of Zakatable amount used as a legal device to escape the obligation of Zakah is invalid: For example, a man makes gift of his Zakatable property shortly before completion of the year with the intention to take it back in order to evade the paying of Zakah. This gift will be invalid.

The theory of intention and substance has been emphasized in Islamic law through a number of maxims. One maxim provides: Al-Umooru bi maqāsidihā", i.e. basis of all acts is objective thereof. Another maxim is: "In contracts, effect is given to objective and meaning (substance) not to the words and phrases. (Majallah, 1968)

Section 5: Issues in 'Form' driven approach in Islamic finance

It is worthy to mention here that ignoring maqāsid, hikmah, rationale and intention of the law giver leads either to shakaliyyah or to hiyal (subterfuges) as well as dominance of form over substance as we observe in the modern Islamic finance where heavy emphasis is laid on Form and structure of transaction, and contract mechanics. Less consideration is given to substance, and end results of transactions. Fatwas are given in isolation without maqāsid consideration, and general proposition of Shari'ah as advocated by Imam Ghazali. The dominance of form over substance has become a point of concern, not only for economists like Umer Chapra, Monzer Kahf, Nejatullah Siddiqui etc. but also for prominent Shari'ah scholars. Renowned Shari'ah scholar Mufti Taqi Usmani has shared his concern on the phenomenon with Dr. Yousuf al-Qaradawi. Dr. Qaradawi in his book "Qawaid Fiqhiyyah Maliyyah writes: "Renowned Shari'ah scholar of sub-continent Shaikh Muhammad Taqi Usmani has drawn my attention to the increasing emphasis on form (Shakliyyah) at the cost of substance in Islamic banks. He asked me to exercise my influence and call upon the Shari'ah scholars associated with the banks to take measures to curb this trend". (Qaradawi, 2009)

Dr. Yousuf al-Qaradawi in the above book has severely condemned the use of subterfuges (Hiyal), in Islamic banks that have badly frustrated the substance and spirit of Shari'ah. Dr. Sami Suwailem has also expressed similar views in his writings.

In Pakistan, the volume of Hiyal and form-based transactions has immensely increased in the last few years. Here we take up some products and analyze them in the light of the criterion of hikmah (wisdom and rationale of law), maqāsid al-Shari'ah, substance of transaction, and general propositions of lawgiver (Tasarrufat al-Shara'i) etc.

I. Bai' Mu'ajjal of Ijarah Sukuk – A kind of organized Tawarruq

This is a popular treasury product whereby Islamic banks provide their excess liquidity to conventional banks and earn profit on it while the conventional banks also earn profit by way of arbitrage. It is practiced in the following way. 'A' an Islamic bank sells its Sukuk on credit on musawama or murabahah basis to 'B', a conventional bank. A, sells Sukuk worth Rs. 10 million for Rs. 10.5 million on credit of 3 months. 'B' immediately sells these Sukuk to 'C' a conventional bank for Rs. 10 million on cash. 'C' then immediately sells these Sukuk to A on cash for Rs. 10 million. Sukuk now have returned to A. B now owes Rs. 10.5 million to A. the whole transaction is completed in two to ten minutes. A similar procedure adopted is that an Islamic bank purchases sukuk from a conventional bank 'U' on cash payment basis, say Rs. 10 million, and sells to another conventional bank 'H' on deferred payment basis for Rs. 10.5 million. 'H' is required to sell to any 3rd bank in the market, but practically it sells the same to 'U' for Rs. 10 million, and uses the money for arbitrage activity by investing in interest based treasury bills. Needless to say that the whole transaction is prearranged and a tripartite 'inah. To 'halalize' the deal simply a sentence is written in the deal structure that bank 'H' at its discretion could hold the sukuk or sell to any other bank in the market, which practically never happened. As the process took the form of a commercial practice ('urf) without any value addition for the economy or the clients, it turned out to be a fake process with ultimate objective of getting return on money.

The process of fake buying and selling is so arranged and quick that even the central bank, as public debt manager, does not transfer the sukuk ownership from the selling bank (s) to the purchasing bank in the 'Statutory General List' (SGL). In other

words, even the legal requirement of taking / giving possession is not fulfilled although Islamic banks call it a sale transaction. They claim that A, as per the first example above, has sold commodity with its free will to B. but, in fact, A has lent Rs. 10 million to B, with the mark up of Rs. 0.5 million. A, is lender, B is borrower. C, is router, and facilitator for this transaction. It generally receives service charge and commission for this facilitation role. We may look at this transaction form two perspectives: perspective of the form of contract and perspective of intention, purpose and motivating cause of transaction. From first perspective, it might be a valid contract, because apparently it is a sale not loan. B, with his free consent sells it to C. C, with his free will sells it to A. It is not the customary bai' al-Inah, because B is not selling again to A, but to C, but it is tripartite 'inah, a trick to circumvent prohibition of riba. From the perspective of substance of contract, it is lending, not sale because conventional bank never intended to buy Sukuk. It needed money for arbitration which it obtained thorough cash sale to C. C, never wanted to be owner of Sukuk. It only facilitates the transaction between A and B, and takes commission for this service. From the perspective of maqāsid and substance, it is only a heelah transaction to circumvent the prohibition of riba. The general propositions of Shari'ah require us to investigate the possible dispositions and treatment in other similar matters. We know that Shari'ah cursed ashab al-Sabt. Shari'ah cursed the facilitator (muhallil) in halaalah marriage and termed him a "borrowed bull" that facilitates remarriage between divorced couple by entering into an intervening marriage with divorced woman and establishing sexual relation for a short period. Shari'ah has prohibited every trick intended to evade obligations and to commit prohibition, such as gift of zakat to avoid zakah, or to undertake bai'al-Inah to obtain or give usurious loan from back door. Shari'ah has prohibited cooperation in act of sin. In the instant case, Islamic banks cooperate with conventional bank and strengthen it through providing liquidity for their interest based business. The matter becomes even more serious as the deposits mobilized by Islamic banks from the public for the purpose of Shari'ah compliant businesses is transferred to the conventional banks for their arbitrage activities. State Bank of Pakistan, after many years took notice of this transaction and asked the Islamic banks to ensure that the money given by the Islamic banks to conventional banks is not used in Shari'ah-non-compliant business. But, even this is against the AAOIFI's Shari'ah standard no. 30 that prohibits Tawarruq with interest based financial institutions (Clause 3/2). Hence, the action by the State Bank of Pakistan seems to be having no effect for improving the Shari'ah compliance level.

Now the question is: should the above transaction be judged form the perspective of contract mechanics from the perspective of substance? On what basis its permissibility be examined? The Shari'ah standard No. 30 (Monetization) requires that the subject matter of Tawarruq i.e. commodity should not revert back to the first seller i.e. the initiator through collusion, agreement or urf. It also requires that Tawarruq should not be performed for the benefit of the conventional banks. "The institution should not perform monetization for the benefit of conventional banks when it discovers that such banks are going to use the liquidity for interest based lending instead of Shari'ah compliant operations" (Article 3/2). The article 4/5 states: "The commodity (object of monetization) must be sold to a party other than the one from whom it was purchased on deferred payment basis so as to avoid Inah which is strictly prohibited. Moreover, the commodity should not return back to the seller by virtue of prior agreement or collusion between the two parties or according to custom and usage". (Articles: 4/5, also see 4/6 for more clarity).

It is an undeniable fact that the above Sukuk transaction violates both the articles of Shari'ah standards. The liquidity is given to conventional banks. Besides it involves a pre agreed arrangement and collusion between the parties. The custom and usage also proves that in all cases sukuk /commodity returns to the first seller.

II. PMEX Murabahah transaction - organized Tawarruq

In 2017, a product "PMEX Murabahah Transaction" was introduced by SBP and SECP in the market. The purpose of the product was to manage interbank liquidity. Through PMEX Murabahah transaction, high speed diesel worth Rs. 8 million was sold by the lender bank (the bank with excess liquidity) to the borrower bank (the bank short of liquidity) on the basis of cost plus profit basis. The product still exists but not in practice for the time being. Following is the process of transaction.

a) HASCOL, an oil marketing company, sells diesel say, worth million on cash to A, an Islamic bank on cash.
b) A sells it immediately to B, an Islamic bank for Rs. 1.1 million on credit, say for 6 months.
c) B sells it immediately on cash for Rs. 1 million to HASCOL, acting as agent of hundreds of dealers and distributors.
d) Neither A nor B is allowed to take physical possession of the oil and dispose it of at its free will.
e) HASCOL and PMEX receive commission from A for this service, as they have facilitated this transaction.

From the perspective of contract mechanics, or form of transaction, PMEX Murabahah transaction might be meeting requirement of a valid contract, but it certainly frustrates the substance and spirit

of Shari'ah. Some maqāsid based issues involved in the transaction are as follows:

a) It is a fictitious sale transaction. No party involved in the transaction is interested in the high speed diesel. Oil is irrelevant for banks. Banks are not users of oil. Above all, the law of land does not allow banks to involve in storage for business in and trading of POL products.
b) It is in substance a lending transaction in which Islamic bank, has earned interest in specific amount.
c) The transaction does not generate any economic activity.
d) From the perspective of end-results of transaction, it is just a heelah for interest based lending.
e) Purchase of oil by HASCOL as agent of dealers, is only a heelah to avoid apparent indulgence in bai'-al-'inah.

It seems illogical that a party created for sale of oil (OMC), after 15 minutes of first sale to primary bank, becomes buyer or buyer's agent without any reason. It is pertinent to note that whole transaction (Sale of oil worth one million by HASCOL to primary bank 'A' (lender) and from A to B, secondary bank (borrower) and from B to HASCOL, is completed in 15 to 18 minutes. Can a real sale of a commodity of this size, be undertaken in 15-20 minutes?

III. Salam in currency

A group of Muslim scholars in sub-continent hold the opinion that modern paper currency is not money. Thus, the Shari'ah rules for the exchange of gold and silver (dinar and dirham) do not strictly apply to it. Some of these scholars even allow salam in currency. Some Islamic banks in Pakistan, on the basis of this fatwa, use salam in currency as an alternative to discounting of trade bill. They buy the dollars evidenced by the bill at a lower price, pay the money in Pak rupees in advance, as a capital of salam, to the presenter of bill and then get delivery of dollars at a prescribed future date. Please note that Dollars in this case are the muslam fih' or the salam commodity. For example, the Islamic bank enters into salam with holder of bill, for the purchase of 1000 dollars at the rate of 140 rupees per dollar to be delivered after one month. The Islamic bank pays Rs. 140,000 as price of commodity i.e. 1000 dollars in advance at the time of contract. It receives the delivery of dollars on specified date and sells it in the market say for Rs. 150,000 and thus earns a profit of Rs. 10,000. Here we observe that paper currency has been equated with fulus and not with gold and silver and thus the exchange has been exempted from the requirement of prompt possession of counter- values. It is worthy to note that AAOIFI in its standard on salam has clearly prohibited salam transaction in modern paper currency. Can modern paper currency be equated with fulus of past time? Here we attempt to answer this question.

If we examine the position of fulus in the early Islamic legal literature, we will be led to the conclusion that there is no point of similarity between fulus (copper coins) of the past and paper money of today. The status of fulus as a currency has always been matter of dispute among the early jurists. A majority of them did not recognize them as a legal tender comparable to gold and silver currency. According to Abu Hanifah and Abu Yusuf sale of one fils for two is permissible. They also dispute their eligibility as capital of partnership. Imam Muhammad al-Shaybani attaches the status of currency to the circulating fulus only. Imām Shafie does not treat them as currency even if they are in circulation. He, argues that the circulation of fulus is merely a convention among people, a convention that changes from time to time.

Abraham Udovitch (1970) has discussed in detail the reasons which made fulus a disputed currency among the scholars'. He writes: "unlike gold and silver coins, the minting of copper coins was decentralized and was entrusted to local authorities. There was no single standard governing the size, shape, or weight of the coins. Their value and acceptance varied widely from place to place. It was for this reason that the jurists casted doubt on the validity of their use in the conduct of commercial operations." As such fulus were not fungible to be covered under the definition of a currency strictly.

Paper money, on the other hand, is fungible and carries a nominal value, which does not vary from place to place. It is a legal tender which is acceptable by all, in commercial transactions. It commands the authority of the state. It meets all the requirements of money. Hence, there is no point of similarity between fulus and the paper money. Paper currency is a legal tender. It has a binding force. A seller cannot refuse to accept it when presented by the buyer as price or consideration in sale transaction. Nor, can a lessor refuse to accept money as rental in lease arrangement. As regards fulus, a seller could insist to receive price in dirham and dinar only, because fulus did not have any binding status. The acceptance of fulus as medium of exchange merely depended on the agreement of the parties. Fulus were used for small transactions only. For example a person wanted to buy 100 grams of sugar, he would pay price in fulus. It never meant for high value transactions. Fulus were used as fraction of dirham, like paisas in relation to rupees. Besides, fulus were supporting money, not the original money. Thus, there is no point of similarity between fulus of past time and dollars and riyals of modern age. All the prominent fiqh academies and AAOIFI consider the modern paper currency as gold and silver. The modern paper currency like dirham and dinar of

old times, possesses full characteristics of money. It cannot be relegated to the position of fulus. Dr. Yusuf al-Qaradawi writes:

> "We pay prices of goods, wages to workers, dower to wives, diyat in qatl al-khata' in this paper money. If someone steals it, he is subjected to the punishment of theft in all codes of criminal law. Then why should we deny it the status of legal money?
>
> Keeping all these facts in view the Fiqh Academy of Makkah in its meeting held in October, 1986 maintained that paper money has all the characteristics of gold and silver. It is thaman from the point of view of the Shari'ah and consequently it is subject to all the rules of the Shai'ah pertaining to riba, zakah, salam, etc., which are applicable to gold and silver".

The salam in currency clearly shows that Islamic banks using this product are negating the real purpose of money i.e. medium of exchange and unit of account etc. They are treating it like commodity as the conventional banks do. This is negation of whole philosophy of Islamic banking that does not acknowledge money as commodity.

IV. Running Musharakah – Shirkah al 'Aqd for 'Running Finance'

A prominent product in which substance has been compromised for contract mechanics is 'Running Musharakah' (RM) practiced by Islamic banks in Pakistan. RM is an Islamic banking product that was introduced as an alternative to interest based product for running finance. As indicated in an article published in JOIFA (Ali, S.M., 2020), five full-fledged Islamic banks and around 11 (out of 16) Islamic banking windows in Pakistan were using RM as a mode of working capital finance. In RM, an Islamic bank joins the business of client as sleeping partner through contractual partnership (Shirkah al 'aqd). Islamic bank specifies a credit limit up to which a client can withdraw cash that is considered Islamic bank's investment. Two stage profit ratios are determined in RM. For the first stage, Islamic bank gives the client its target rate/profit ceiling linked to the KIBOR rate. It is mutually agreed that up to the profit ceiling, profit would be distributed according to investment shares of bank. For second stage i.e. profit over and above the required rate on bank's investment, Islamic bank agrees to reduce its profit share as low as .00001% in additional profit, while 99.99999% would be given to the client. Usually this remaining profit, in absolute term, is more than the total profit that is distributed between Islamic bank and corporate client at first stage.

It appears that Islamic bank wants to give the remaining profit as hibah (gift) to corporate client but since Shari'ah does not allow pre-agreed hibah in favour of any partner, it does not resort to this solution. To circumvent such prohibition, Islamic bank adopts heelah. The heelah is that it distributes remaining profit according to .00001% and 99.99999% between Islamic bank and client. In form it might be profit sharing ratio, but in substance bank agrees in the contract that it is interested in getting the target rate, and as such gives the addition, if any.

Here we observe that RM, in its meaning, purpose, effect and end results is not substantially different from running finance of conventional bank, where the bank gets a fixed return i.e. interest on its investment, which is actually pre-fixed in the form of target rate. The only difference is that Islamic bank, under running musharakah receives additional amount of Rs. 230, for example if there are three zeroes in the PSR, and Rs. 2.30 if zeroes are four as have been the case in recent years. The amount is insignificant for the bank. This goes without saying that musharakah in Islamic law is a partnership to share real returns of business to the partners. If this purpose is frustrated by some fictitious profit sharing ratio such as 99.99999% and 0.00001% then in substance it is not real musharakah but a transaction that is called conventional overdraft (OD) for running finance. In addition to the fact that Shari'ah boards of five IBIs have still not approved RM as Shari'ah compliant, many Shari'ah related issues continue to frustrate other banks Shari'ah boards who have allowed it.

As mentioned earlier, the primary objective of musharakah in Shari'ah is to give opportunity to the partners to share real returns of business in just and fair manner. The fuqahā (Islamic scholars) are so sensitive about this objective that some of them do not allow a profit ratio which is not strictly in proportion to the investment. According to Maliki and Shāfiī jurists, both the profit and loss should follow the investment of the parties. In the instant case, a large portion of profit goes to the corporate client without any counter value, defeating the purpose of Shari'ah behind instituting mushārkah. This arrangement clearly frustrates the objective of fair distribution of returns. So, from the perspective of form, it might be mushārakah, but by substance and meaning it is not the mushārakah or more specifically shirkah al-'inān, as contemplated by early jurists.

The proponents of RM generally place their reliance on the clause of Shari'ah Standard on mushārakah which allows Islamic bank to allocate its share of profit to the client, if the profit of bank is beyond the desired rate. The article 3/1/5/9 of Shari'ah standard no. 12 on Sharikah and Modern Corporations provides: "Taking in to account the provisions of item 3/1/5/3, it is permissible to agree that if the profit realized is above the 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". To them, it is permissible that if the bank wants 7% return on its capital, then whatever profit is above this rate, may be allocated to the other partner, and even then it will be deemed as mushārakah.

The above argument may not be accepted on the ground that here the bank has entered into partnership with corporate client as mudarib for the rabb al-māl. So, all the rules relevant to mudarib are applicable to the transaction. One of such rules is that mudārib cannot withdraw or surrender any financial right belonging to rabb al māl. How Islamic bank deprives depositors of their due right in profit, may be judged from a running musharakah transaction of an Islamic bank which earned a profit of say Rs.100 million, over and above the desired profit i.e. KIBOR related rate (say, 7% of bank's capital). The bank would receive from this amount Rs.10 only with PSR (profit-sharing ratio) of 0.00009:99.99999; and Rs. 100 only with PSR of 0.0001:99.9999. All the remaining profit (Rs. 99,999,990.00) would go to the client in line with the second stage of PSR. A negligible amount of Rs.10 out of 100 million extra profit is only a deception and heelah intended to prove that there was a profit sharing structure and that it was a mushārakah, but the fact of the matter is that it is just running finance arrangement. The client at the inception of contract knows clearly that he has to pay 7% of bank's financing. This is how the parties agree at the time of contract. If the client pays Rs. 100 out of the total extra profit of Rs. 100 million, and the bank considers it shirk al aqd, it's ironic.

Another argument given is that as the banks undertakes to share the loss, if any, it could be considered as mushārakah, at least legally. But this also is not tenable on two grounds. The adjustment for profit-sharing is made on the gross profit in which case the loss is almost impossible as the limits are sanctioned based on the performance of the past three years. Secondly, the corporate client who is getting huge amount of financing with the OD feature at a relatively cheaper rate would never be inclined to put himself under the scrutiny by reporting loss to the bank. It can be concluded therefore, that RM cannot be considered as mushārakah in substance.

The above are only a few of many instances of frustration of substance and spirit of Islamic law in Islamic banking. The above transactions may be valid from the perspective of form (Shakliyyah), but certainly not valid from the perspective of purposes of Shari'ah, consideration of hikmah (rationale and wisdom of law), general propositions and dispositions of Shari'ah (tasarrufat al- Shara'i).

Maqāsid-based evaluation of the products

In the preceding discussion we have attempted to prove that a "Shari'ah ruling" on certain product cannot be held Shari'ah ruling if it:

1. Contradicts the higher purposes of Shari'ah such as Hifz ul-mal, justice, fairness especially in distribution of returns of business.
2. It frustrates the true spirit of Shari'ah and serves only as heelah to circumvent any Shari'ah prohibition. In other words, in forming opinion, regard has been given only to the 'form' not to the 'substance'.
3. Its motivating cause, intention, hikmah, wisdom and purpose behind that ruling is to achieve some impermissible and unlawful purpose.
4. When through end-result analysis (ma'alat al-Af'aal) its mafsadah and abuse is proved.
5. When in most of the cases it amounts to Shari'ah violation. In other words its harm (harm from Shari'ah perspective) is greater than its benefit (a Shari'ah benefit).

We have established here that higher purposes of Shari'ah, motivating cause of a contract, hikmah, ma'alat al-Af'aal (end-results), Sadd al-dara'i, consideration of substance not mere 'form' etc., all these concepts fall under Maqāsid al-Shari'ah.

We have attempted to prove that maqāsid cannot be ignored in Shari'ah opinion on the plea that they resemble hikmah, while Shari'ah ahkam cannot be based on hikmah. We have established that it is the hikmah, motivating cause of Shari'ah ahkam, which is the valid basis of ahkam.

Conclusion

Based on the evidences from the classical Islamic jurisprudence, we may conclude that scholars have always given prime consideration in their rulings to Maqāsid, hikmah, rationale of law, motivating cause of act as general proposition of law giver. Thus, a ruling which appears to be a "Shari'ah ruling" in its form but frustrates the spirit and substance of Shari'ah is not a Shari'ah ruling in their opinion.

Imam ibn al-Qayyim says: "Shari'ah is based on wisdom and achieving welfare in this life and life hereafter. Shari'ah is all about justice, mercy, wisdom and good. Thus, any ruling that replaces justices with injustice, mercy with its opposition, common good with mischief, or wisdom with non-sense is a ruling that does not belong to Shari'ah, even it is claimed to be so according to some

remote interpretations". In this passage Imam Ibn al-Qayyim emphasizes that fatwa and ruling should be based not on external form but on justice, hikmah (rationale, wisdom), maslahah, values of mercy. This is the only criterion to judge validity of a transaction. The survival of Islamic finance depends only on compliance with maqāsid and ethical values as well as observance of spirit of Islamic law, otherwise Islamic banking and finance will be losing its separate / distinct identity.

We should bear in mind that it is the adherence to maqāsid, not mere compliance with external form of contract that has the potential to preserve and protect the true spirit of Shari'ah in Islamic finance products. As against form-driven approach, maqāsid based approach suggests that process of Shari'ah legitimacy of Islamic banking products and transactions should go beyond contract mechanics. Some of the norms and values to judge Shari'ah legitimacy of Islamic banking practices and operations are as follows:

1. Islamic bank distributes fair returns to depositors.
2. It does not give preferential treatment to corporate clients by giving them high rate as depositor, as Islamic banks are currently doing by assigning higher weightage to the accounts of bigger amounts (with same tenor), and by charging at lower rate while proving them facility vis-à-vis the consumers and SMEs / micro businesses.
3. The banking transactions generate real economic activity.
4. The bank does not make money on money.
5. The banking transactions do not cause concentration of wealth in the hand of rich segment of the society.
6. It provides financial services to adequate range of affordable services to disadvantaged and other vulnerable group including SMEs and micro business as well as small farmers.
7. It contributes in enhancing social well-being of the society.
8. The bank avoids fictitious and Heelah based transactions.

These are some Shari'ah acknowledged norms and values in the context of Islamic finance, which are equally important in Islamic law as the compliance with the external form of contracts. If these values are violated and resultantly the same injustice, exploitation, concentration of wealth as in the case of conventional banks persists in the Islamic banking industry, it would only mean that Shari'ah has not been observed in its true spirit. We believe that there is some flaw in the understanding and interpretation of Shari'ah. How is it possible that riba is eliminated from Islamic banking transactions, yet the depositors and other stakeholders do not reap the advantages and benefits to be drawn from the elimination of riba. A musharakah which has been described as a source of barakah in a Hadith and which has been praised and admired by prophet Muhammad (PBUH) does not bring the desired fruits to the poor depositors of Islamic banking. It means there is flaw in the understanding of Musharakah by the practitioners. We should bear in mind that Musharakah is the only transaction which has been mentioned in a Hadith-e-Qudsi. It is the transaction which enjoys the blessings and favor from Allah (SWT) and His messenger. Allah says: I am third of the two partners as long as they do not cheat one another. But when one of them cheats the other, I leave them" (i.e. they are deprived of the blessing and favour from Allah (SWT). Is the current mushārakah (RM) the same mushārakah of Hadith Qudsi? Is the current organized and structured Tawarruq the same as allowed by some Hanbali scholars, or as trading allowed by the Almighty in Quran? This is high time to revisit Islamic banking transactions and products in the light of maqāsid to restore the true Shari'ah legitimacy to Islamic finance. The survival of Islamic finance depends only on compliance with maqāsid and ethical values as well as observance of spirit of Islamic law, otherwise Islamic banking and finance will lose its distinct identity.

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TECHNICAL ARTICLE

External Shari'ah audit

Ernst & Young[1]

Abstract

The last five decades have seen Islamic finance evolve as an important sector in the finance and banking industry. Effective Shari'ah governance (SG) had been instrumental in stimulating this growth. One of the building blocks of Shari'ah governance is Shari'ah compliance and therefore the role of external Shari'ah audit (ESA) cannot be overlooked. ESA attests to the soundness of the principles of Shari'ah governance framework covering its various facets - Shari'ah Supervisory Board (SSB), Shari'ah compliance review and internal Shari'ah audit. To be effective, external Shari'ah auditor would need to demonstrate an audit methodology that comply with International Standard on Assurance Engagements (ISAE), 3000 (Revised) issued by IAASB and Auditing Standard for Islamic Finance Institution (ASIFI) No.6 issued by AAOIFI. In addition, specialization in Shari'ah matters, professional acumen and practical banking knowledge is also necessary. This article covers a brief of history of ESA and its importance and effectiveness along with an overview of methodology to conduct ESA's. It also discusses challenges and constraints in executing an effective ESA based on practical experiences.

Keywords: Islamic banking, Auditing, Independent External Shari'ah Audit, Shari'ah law, Taqwa, Shari'ah governance.

Background

Banking is a necessity of commerce and trade. The global banking system has evolved since last three centuries. However, the change over the last five decades has been phenomenal and Islamic banking is not an exception. Islamic banking has been able to find its niche, albeit with its own range of peaks and troughs. A strong push towards this type of banking was from the market participants looking to alternative avenues due to prohibition of interest in Divine law or variants of banking, especially after the 2008 financial crisis that flexed conventional financial institutions on economic and regulatory aspects. Post-crisis, while the Islamic banking sector to a certain extent also suffered a similar blow, recovery set in there led to renewed focus on Islamic banking arena as well. Given this background and the fact that the global banking sector is going through increased regulatory scrutiny, the Islamic banking sector has also been increasingly pushed by regulators and stakeholders for better corporate governance standards, stronger mechanisms underpinning fiduciary responsibility and more transparent reporting to shareholders and wider stakeholders.

The fundamental business model of an Islamic bank (Islamic bank includes Islamic windows or branches, wherever applicable) is to enable and promote the sharing of risks and rewards with its customers and investors in line with the principles laid down by the Islamic Shari'ah (Islamic law). An Islamic bank pools financial and human resources to generate halal (or permissible) returns, without involvement of riba (interest) and with the avoidance of gharar (excessive uncertainty or speculation). Primarily because of this risk and reward sharing or profit and loss sharing model, Islamic banks pose special corporate governance challenges for regulators as watchdogs.

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Aside from the practical aspects of regulating Islamic banks, it is important to note that corporate governance comprises self-governance and statutory regulation. If we take a step back and explore governance as a principle under Shari'ah, it is abundantly clear that governance in Islam is primarily self-governance due to the inherent notion of "taqwa" (consciousness and cognizant of God), which is a sought-out trait for every Muslim. This entire notion of self-governance is worth exploring since a large number of areas in the Islamic banking arena and application of Shari'ah laws, standards and guidelines by banking professionals might be difficult to legislate and even more difficult to audit as the auditor has to rely on the rulings of the bank's SSB, composed of Islamic scholars.

A strong SG framework caters to the above challenges and lays down an effective system of Shari'ah compliance as observed in various banking jurisdictions. However, the finer details of the SG framework can differ from one jurisdiction to another depending upon their local regulation and desired operating model. This is where standard setters such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are instrumental in harmonizing various practices with respect to the SG framework. An ESA attests to the application of the principles of this SG framework and requires a specialist skill-set and professional acumen to balance various aspects, challenges and nuances of Shari'ah Governance with the requirements of the various stakeholders.

History of ESA

Shari'ah governance has been at the core of the Islamic finance industry since inception. However, it was formalized approximately during the last decade as part of Islamic finance framework. Many regulators took a step forward and made an ESA mandatory. An overview of ESA requirement introduced in some of the regulatory Shari'ah governance frameworks is given below:

a) Islamic banking was formally initiated in Oman in 2012 through the introduction of Islamic Banking Regulatory Framework (IBRF). Requirements laid down under IBRF together read with the circular issued by the Central Bank of Oman (CBO) in 2013 necessitate the Islamic banks to engage the external Shari'ah auditor to carry out an ESA on an annual basis in accordance with ISAE 3000 (Revised), the standard issued by IAASB for assurance engagements other than audits and reviews of historical financial information. After the adoption of ASIFI 6 issued by AAOIFI, a complementary standard to ISAE 3000 (Revised), effective for the year ended 31 December 2019, the ESA has now to be conducted as per ASIFI 6.

b) Islamic banking has been in existence in Pakistan since late 1980s. However, State Bank of Pakistan (SBP) issued a draft Shari'ah Governance Framework for Islamic Banking Institutions in 2014, refined and introduced in 2015 and mandated its licensed Islamic banks to engage an external Shari'ah auditor for a compliance audit. This SG framework was further amended in 2018. Although the ESA requirement was introduced in 2015, but there was a regulatory requirement for the audit of "distribution of profit and loss by Islamic banks" since 2008.

c) Islamic banking in the Kingdom of Bahrain started long time ago and the Central Bank of Bahrain (CBB) had issued Rulebook Volume 2 in 2005 that covered rules and guidance to regulate the Islamic banks. Since then, these regulations are updated from time to time to cope with the changing trends in the Islamic banking industry and perform enhanced supervision and oversight. In 2017, CBB issued Shari'a Governance (SG) Module and made a commendable effort to make the Islamic banks more reliable and accountable. SG Module lays down the foundation of SG framework which has the four components namely, SSB, Shari'ah Compliance Function (SCF) (also referred to as Shari'ah Coordination and Implementation Function (SCIF)), Internal Shari'ah Audit Function (ISAF) and ESA. After the introduction of SG Module, ESA was performed for the first time in the Kingdom of Bahrain for the year ending 31 December 2019. The components of SG framework are discussed in the forthcoming section in detail.

d) The Central Bank of Kuwait (CBK) followed suit by mandating ESA in 2019.

We understand that discussions have been going on in other countries of GCC as well to make ESA mandatory.

In addition to the specific SG requirements set out by the central banks as explained above, IFSB has issued various standards on the governance of Islamic financial institutions including IFSB 10, Guiding Principles on Sharī`ah Governance Systems for Institutions Offering Islamic Financial Services emphasizing the importance of Shari'ah board, Shari'ah pronouncements or resolutions issued by Shari'ah board, internal Shari'ah compliance unit or department, internal Shari'ah compliance review or audit and an independent external Shari'ah compliance review or audit. Among other things, IFSB outlines the requirements and protocols for appointment of external Shari'ah auditor, requirement to conduct ESA, interaction

and communication of external Shari'ah auditor with SSB, recording, disseminating and archiving minutes of the meetings.

To read further on the SG framework, Shari'ah governance standards such as Governance standard for Islamic financial institutions (GSIFI) 1-Shari'a Supervisory Board: Appointment, Composition and Report, GSIFI 9-Shari'ah Compliance Function and GSIFI 11-Internal Shari'ah Audit standard issued by AAOIFI may be referred.

Shari'ah governance framework and the role of ESA

The SG framework typically consists of SSB, SCF, ISAF and ESA that tends to ensure Shari'ah compliance at governance and operational levels.

SSB is assigned to issue Shari'ah decisions as and when asked by the management of an Islamic bank but it will be the responsibility of management to ensure compliance with "Shari'ah rules and principles". Members of SSB need to be well qualified and experienced in the field of Islamic banking and finance. For instance, the SG Module requirement of the CBB regarding SSB members mandates having at least three scholars specialized in fiqh al muamalat (Islamic jurisprudence). SG framework of SBP also requires at least three scholars having either Shahadat ul Aalamiyyah Degree (Dars-e-Nizami) or Post Graduate Degree in Kuliyyatush Shari'ah or Kuliyyah Usooluddin L.L.M. (Shari'ah) with specified years of experience. SBP has also introduced the concept of Resident Shari'ah Board Member (RSBM) to be appointed from among the SSB members other than chairperson of SSB. RSBM is a full-time employee of an Islamic bank and cannot serve on the board of any other Islamic bank in Pakistan. Another interesting aspect about SBP's SG framework is that the SSB members, other than RSBM, cannot serve on more than three boards of Islamic banks in Pakistan. Of course, RSBM can function for maximum two micro-Islamic banks or non-banking Islamic finance institutions.

Shari'ah Compliance Function (SCF) as in Bahrain, comprises the management of an Islamic bank. The role of SCF comes at the design and development stage; primarily it involves assisting the SSB in the issuance of pronouncements, guidelines and directives about the products and services offered by an Islamic bank. Internal Shari'ah audit (ISAF) is an independent function and conducts periodic post-disbursements audits of various functions of the bank and expresses its opinion on the extent of Shari'ah compliance of the Islamic bank. In a typical SG framework, both functions report functionally to the SSB and administratively to the CEO to ensure independence.

The last component of SG framework is ESA. External Shari'ah auditor is an independent party, external to the Islamic bank being audited. External Shari'ah auditor attests the application of the Shari'ah rules and principles as well as compliance with SG framework and provides an independent opinion on their compliance. The result of implementing this robust framework is a seamless mechanism of ensuring adherence to a set of principles and rules – regulatory as well as those set by the standard-setter bodies. Secondly, it provides comfort to various stakeholders that the Islamic bank is complying with the principles of Shari'ah in letter and spirit. The SSB, SCF and ISAF have existed in Islamic banks for a very long time. Their roles have evolved over the last several years as influenced by some of the factors highlighted in the background section. On the other hand, ESA is a relatively new requirement that is being increasingly considered as a fundamental facet of the SG framework.

ESA Framework

External Shari'ah auditors are required to comply with the relevant auditing standards and standards of quality control within audit firms, as well as ethics and other regulatory requirements. Identification of auditing framework is thus the cornerstone of every audit. ESA could be conducted in accordance with:

a) International Standard on Assurance Engagements (ISAE) 3000 (Revised) Assurance Engagements Other Than Audits or Reviews of Historical Financial Information issued by International Auditing and Assurance Standards Board (IAASB)

b) Auditing Standard for Islamic Financial Institutions (ASIFI) No. 6 External Shari'ah Audit (Independent Assurance Engagement on an Islamic Financial Institution's Compliance with Shari'ah Principles and Rules) issued by AAOIFI

ISAE 3000 (Revised) provides detailed guidance on assurance engagements other than audits or reviews of historical financial information. Therefore, an independent external Shari'ah auditor would need to develop a methodology to comply with this standard and at the same time apply its banking, regulatory and Shari'ah skills to conduct such a compliance audit.

By comparison, ASIFI 6 offers two types of external Shari'ah audits. The second type known as "Attestation external Shari'ah audit" is a close comparison to ESA being performed under ISAE 3000 (Revised). The following table illustrates how an external Shari'ah auditor would perform ESA under both regimes:

ISAE 3000	ASIFI 6
1. Objective	
The objective of ISAE 3000 (Revised) is to obtain reasonable or limited assurance about the subject matter information and to express an independent conclusion based on the evaluation of an underlying subject matter against the suitable criteria. This conclusion enhances the confidence of stakeholders on the entity being audited.	The objective of ASIFI 6 is restricted to providing detailed guidance on the performance of independent assurance engagements to ensure compliance of an Islamic bank with "Shari'ah principles and rules." The underlying subject matter information under ASIFI 6 is, therefore, very specific and precise.
2. Auditor's responsibility	
The auditor's responsibility is to measure the underlying subject matter information against the criteria specified and to express independent conclusion as to whether the underlying subject matter information is free from material misstatement or not.	The auditor is responsible to express an opinion on compliance of an Islamic bank's contracts, arrangements and transactions with the applicable criteria, i.e., Shari'ah rules and principles.
3. Quality considerations	
The auditor is required to comply with the system of quality control that ensures compliance with applicable professional standards and ethical requirements. These professional standards require competence in assurance skills through extensive training, practical experience and sufficient knowledge of the underlying subject matter. Under ISAE 3000 (Revised), the system of quality control should provide compliance equal to or more than the compliance required by International Standard on Quality Control (ISQC) 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.	In addition to ISQC 1 requirements, an external Shari'ah auditor shall have the diverse team of professionals with the knowledge and capability of accounting, auditing, Islamic banking and Shari'ah rules and principles. To demonstrate competence in Shari'ah rules and principles, an external Shari'ah auditor shall not only have knowledge of international standards such as AAOIFI and local SG framework, but also has to ensure compliance with the code of ethics issued by AAOIFI. An external Shari'ah auditor should also be able to understand and interpret the fatwas issued by an Islamic bank's SSB.
4. Management's responsibility	
The management's responsibility may vary by jurisdiction but will include preparing the subject matter information and presenting it to the auditor.	In the second type of ESA, which is "Attestation external Shari'ah audit", it is the management's responsibility to prepare the underlying subject matter and evaluate it against the applicable criteria established, i.e., compliance with Shari'ah rules and principles. ESA requires management's competence in designing and implementation of effective and efficient internal control system to ensure Shari'ah compliance.
ISAE 3000	**ASIFI 6**
1. Eligibility criteria	
Eligibility criteria depends on the nature of assurance engagements and may significantly vary by jurisdiction and by entity.	Under ASIFI 6, applicable criteria are specified for compliance with Shari'ah rules and principles which include five elements, namely; AAOIFI Shari'ah standards, local regulations, rulings of Central Shari'ah Board, compliance of Shari'ah-related requirements contained in applicable Financial Accounting Standards (FASs) issued by AAOIFI and rulings of SSB. However, elements covered under the applicable criteria and their hierarchy may vary from one jurisdiction to another depending on the local SG framework.

2. Opinion	
After performing the audit procedures to evaluate the subject matter information against the applicable criteria and concluding on the matters of professional judgment, the auditor makes an independent conclusion based on the results obtained from audit procedures. This opinion may be clean or qualified depending on the nature and magnitude of non-compliance.	This will also include evaluation of subject matter information against the applicable criteria but will require significant qualitative and quantitative assessments. It requires external Shari'ah auditor to look into the Shari'ah aspects from an Islamic bank, customers and other stakeholders' perspectives as well as evaluate normal auditing aspects.
3. Deliverables	
ISAE 3000 (Revised) left it to the auditor's judgment to choose from short-form or long-form reports to facilitate effective communication to stakeholders. ISAE 3000 (Revised) does not illustrate the assurance report format but only specifies the minimum contents required as per ISAE 3000 (Revised). The assurance report is addressed to the engaging party or parties.	ASIFI 6 illustrates both report formats – short-form and long-form. Under ASIFI 6 both reports are mandatory to be issued by external Shari'ah auditor. Since both reports are mandatory, the long-form report is more detailed and comprehensive and requires additional efforts from the external Shari'ah auditor. However, ASIFI 6 was effective for ESA covering periods beginning on or after 1 January 2019. Keeping in view the difficulties faced by external Shari'ah auditor, AAOIFI has provided a one-time optional deferment for issuing long-form reports. Before issuance of ASIFI 6, ESA was conducted under ISAE 3000 (Revised) and the requirements were adapted as necessary. The addressee of the Short-form report is shareholders of an Islamic bank unless the local regulations require otherwise, while the Long-form report is addressed to "Those charged with governance" under ASIFI 6.
ISAE 3000	**ASIFI 6**
1. Regulatory considerations	
Since ISAE 3000 (Revised) is a generic standard, it requires application of other ISAE, if applicable.	ASIFI 6 is complementary to ISAE 3000, therefore it enhances the regulatory oversight and provides greater guidance to the ESA and a greater level of confidence to the stakeholders.

Conducting the audit and nature of findings

Audit firms have their own methodologies and strategies of conducting ESA depending on the SG framework and the firm's internal requirements, but the broad steps of an ESA remain the same. Each stage has its unique considerations to conduct ESA effectively and efficiently.

- **Step 1 – Pre-engagement procedures:** Pre-engagement activities take place before the auditor accepts the ESA engagement. These activities are performed when the auditor has to decide whether to accept a new client or engagement or continue with an existing relationship. Before accepting the ESA client, auditor evaluates a number of factors such as integrity of the shareholders and those charged with governance, competency and necessary capabilities of the engagement team for the engagement to be undertaken, audit firm's compliance with relevant ethical requirements and significant matters that have arisen during the current or previous audit engagements and their implications for continuing the relationship. The auditor also reviews the subject matter as part of competency evaluation exercise. Subject matter of ESA is the "management's Shari'ah compliance and governance report" where management specifies the extent of compliance with Shari'ah rules and principles and the controls implemented to achieve the level of Shari'ah compliance. The auditor is required to provide an opinion on the management's Shari'ah compliance and governance report and the statement of compliance provided by the management. After considering the all relevant factors, official contract between the auditor and client is signed to be called "engagement letter".

- **Step 2 – Planning and risk assessment:** Planning involves the understanding of the service requirements, confirmation of the engagement scope and team considerations and requires identification of regulatory framework and applicable guidelines, obtaining understanding of the Islamic bank being audited and its control environment. This will further include performing risk assessment (including consideration of risks of material non-compliance with "Shari'ah principles and rules" either by way of fraud or error) and setting quantitative and qualitative materiality and types of sampling considerations. Assessment of usability of work of internal Shari'ah auditor, necessity of use of an expert and nature, timing and extent of audit procedures is also determined at this stage. Obtaining written representations from management is also one of the significant audit procedures of ESA. In the first year of audit, early preparations are required in the form of a communication with client about the regulatory requirements of ESA, expectations from management, fixing schedules of audit execution, agreeing on reporting formats and contents, etc.

- **Step 3 – Execution:** Audit procedures designed at the planning stage are executed at this stage. Audit procedures may be the test of controls or substantive procedures. The objective of these procedures is to obtain sufficient appropriate audit evidence and derive results to reach an independent conclusion. Some auditing areas may be more complex requiring application of professional judgment based on the rationale appropriate in the given circumstances. This will involve applying Shari'ah knowledge and experience, in addition to general auditing and banking knowledge. For example, practices around syndication and credit card transactions usually differ from one bank to another and are more complex in nature. Therefore, reviews of syndication and credit card transactions are highly customized. Audit programs for these transactions are developed after carefully studying the structure of the transaction, considering the requirements of AAOIFI Shari'ah standards and the bank's internal policies and procedures, and conducting interviews of process owners. Detailed walkthroughs are also performed as part of audit procedures. The outcomes of audit procedures are documented as audit evidence and may result in non-compliance or deviation from Shari'ah rules and principles known as audit findings. Audit findings and the nature of risks associated with them are further elaborated below.

- Audit findings exposing Shari'ah risk may be divided into two:

  - Low risk observations – may include missing ancillary documents and/or signatures on those documents, enhancements required in policies and procedures established by an Islamic bank, missing audit trails for activities carried out, improper checklists, etc.

  - Medium-to-high risk observations – may include missing approvals and disclosures on new products and services launched; improper procedures followed for transactions having sensitive Shari'ah implications, such as complex restructuring transactions and syndication transactions with conventional banks; and inadequate segregation of duties resulting in impairment of independence.

- **Step 4 – Conclusion and reporting:** A summary of the audit findings and conclusions are officially communicated to the Board of Director's (BOD) Audit committee, SSB and the management through a document called "communicating deficiencies in internal control to those charged with governance and management". An Islamic bank submits its response on the audit findings, and discussions among relevant process owners, Shari'ah teams and external Shari'ah auditors are held to verify the legitimacy of management's response and its compatibility with the audit evidences obtained during the execution stage. Auditor then evaluates whether the audit findings and corroborative evidences warrant clean or qualified audit report and/or opinion. Considering the impact of subsequent events that occur between the year-end date and the date the management report is signed, and the signing of the auditor's report is the important step that needs to be performed. Furthermore, written representations are obtained from the management of the bank confirming certain matters or supporting audit evidences, called management representation letter.

The whole performance of ESA should be sufficiently and appropriately documented to enable an independent experienced Shari'ah auditor or an experienced assurance professional to understand the pre-engagement, planning and audit procedures performed, results and conclusions reached and the basis of conclusions. The documentation should also include the basis of the judgements used and estimates applied during the audit. The documentation should be archived and retained for a period as per the regulatory and firm's internal requirements.

Challenges and constraints for ESA

An external Shari'ah auditor may face a lot of challenges because ESA is a relatively new development to the SG framework and requires

a niche skillset, notwithstanding the inherently subjective nature of Shari'ah governance. Challenges that are usually faced during ESA are as follows:

- Management may not understand its responsibilities and requirements under ESA.
- ESA findings may be perceived by the Shari'ah team members of the bank as a challenge to their competence rather than a value-add.
- Application of the Shari'ah module requirements is mired with judgment.
- It is difficult to challenge the substance of certain decisions taken by the management that are backed by SSB fatwas without detailed rationale, requiring that the SSBs must provide the rationale for fatwas.
- Lack of coordination between various departments and at various levels of management makes the ESA ineffective.
- An Islamic bank may not have the required policies and procedures, or the policies and procedures may be outdated or inadequate.
- An Islamic bank may not have the proper checklists relevant to Shari'ah controls.
- An Islamic bank may not have the proper audit trail of activities carried out, making it difficult for an external Shari'ah auditor to obtain sufficient appropriate audit evidence.
- The management may not have a clear chain of communication established about how to implement regulatory requirements relating to ESA.

Conclusion

To overcome the given challenges, the landscape of ESA may continue to evolve and standard setters are expected to provide more detailed guidance in this regard. Given the recent momentum in this arena and the activity of respective regulators, it seems like an inevitable outcome in the next few years.

There are various opinions from Shari'ah and banking experts and practitioners, about what the future steps should be in this regard and what ESA should look like. Some say that it should not be a simple opinion; instead the introduction of a scale of compliance in the form of a rating could be a better value addition. Interestingly, a rating mechanism is not a new concept; there is already a concept of "management quality ratings" issued by various rating agencies for fund managers and fiduciaries alike. A similar "rating" for Islamic banks, either issued by the ESA teams or any other professionals, would help not only to provide a backdrop against which the status of compliance with best practices could be assessed, but also to provide a more objective measurement criteria and a global standard for Islamic banks to aspire to, just like AAA ratings are sought by any issuer of debt instruments.

All these measures will require more competent Shari'ah auditors and demand a greater mix of skills within the Shari'ah audit team. This may result in putting auditors in a more advantageous position to meet the expectations of regulators and other stakeholders. These good governance practices will not only change the way Islamic banks interact with their customers, but also enhance the overall reputation and image of Islamic banking industry in the global financial system.

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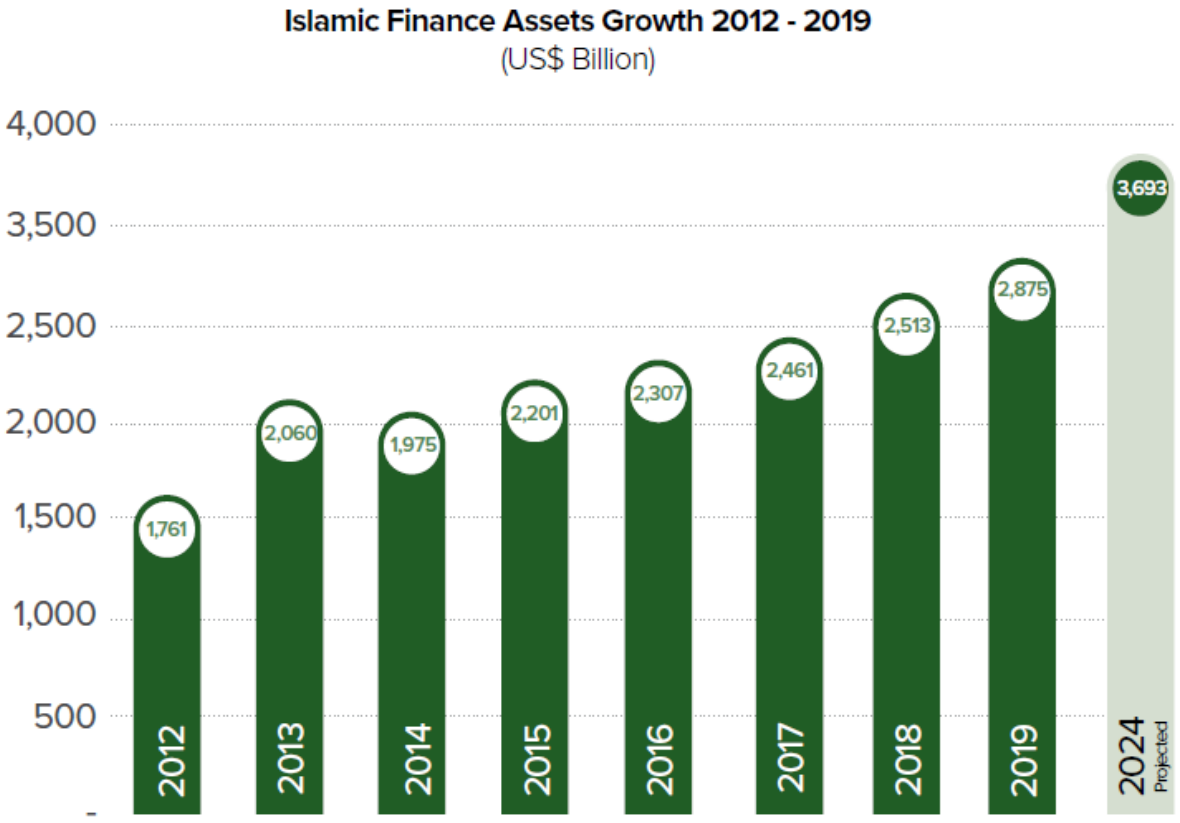
INDUSTRY UPDATE

Islamic finance development in 2020: Progressing through adversity

Shereen Mohamed[1]

According to the latest edition of the Islamic Finance Development Report[2], the Islamic finance industry saw double-digit growth of 14% in 2019 at $2.88 trillion in assets, and it is expected to reach $3.69 trillion by 2024. The industry returned to strong growth after the slowdown in 2018, when the industry expanded by a more moderate 2%.

This growth is despite the uncertainty felt across the largest Islamic finance markets over the past few years due to sustained low oil prices and subdued industry growth in previous years.



Islamic capital markets, funds and banking were main drivers of assets growth

The 14% growth in global Islamic finance industry assets was due in part to elevated levels of sukuk issuance in the traditional markets in the GCC and Southeast Asia. Green and SRI (socially responsible investment) sukuk grew in prominence in the UAE and Southeast Asia and have continued to grow in popularity in 2020 with the entrance of new issuers such as Saudi Electricity Co.

Authorities in Kazakhstan and Uzbekistan are also preparing regulations that will allow green

1- Shereen Mohamed is a Senior Research Analyst – Islamic Finance, Refinitiv

2- The report is produced annually by the Islamic Corporation for the Development of Private Sector (ICD) and Refinitiv. To learn more about IFDI 2020 and download the Islamic Finance Development Report, please visit http://bit.ly/IFDI2020

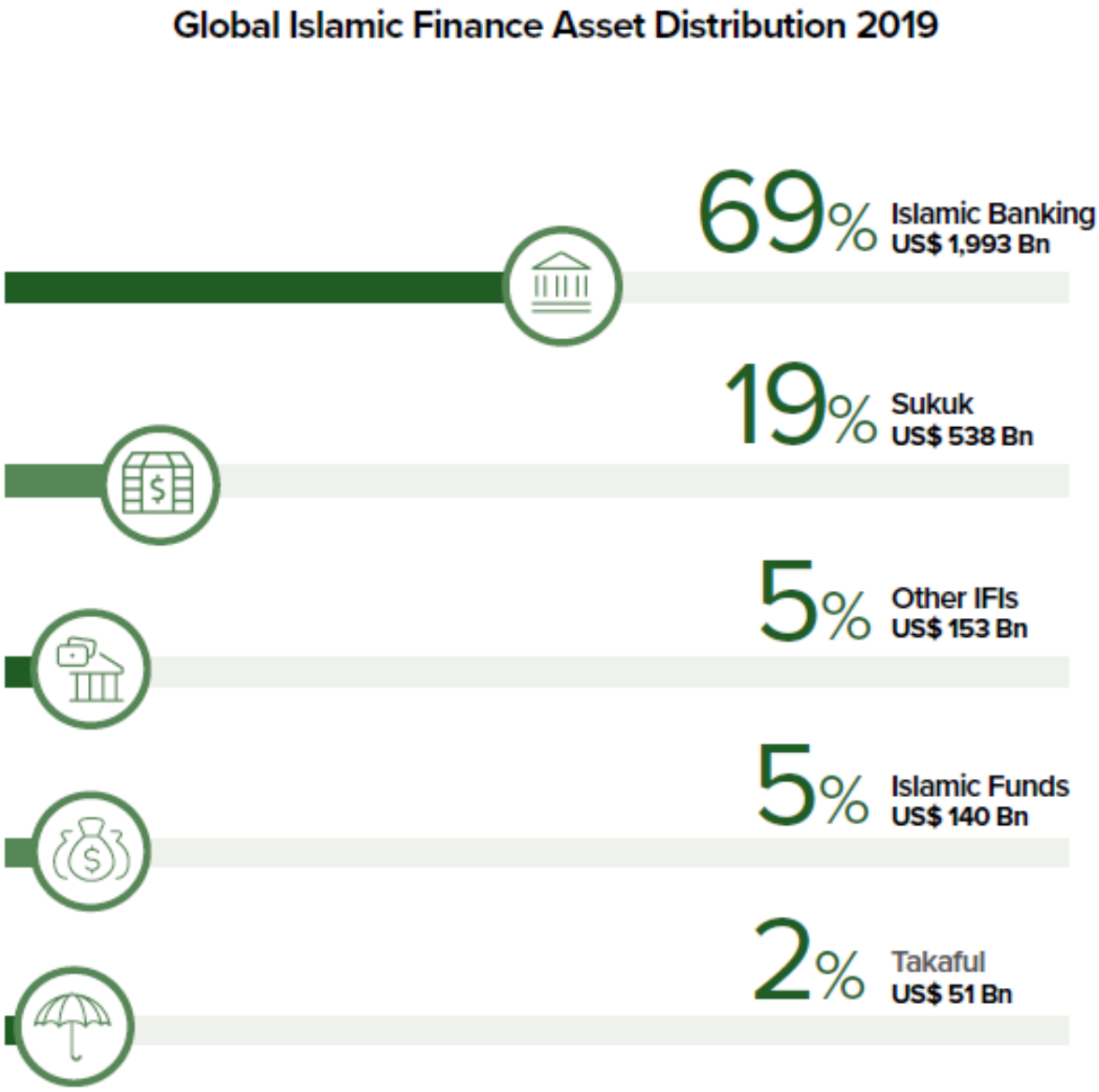
sukuk to be issued there too. Other industry firsts include Egypt entering the sukuk market for the first time in 2020 and the issuance by Qatar Islamic Bank of the first-ever Formosa sukuk in Taiwan.

Islamic funds also made a significant contribution to the industry's growth. The asset class rose 30% in 2019, mainly in the GCC, with new launches of Islamic exchange traded funds (ETFs) in a number of countries and of ESG-related investment assets made available through digital media that appeal in particular to millennials.

The strong growth in industry assets was also driven by continued growth in Islamic banking assets, which account for most of the industry's assets. The fastest expansion was seen in the non-core markets such as Morocco, where 'participatory banking' was introduced in 2017. Other markets likely to see further expansion in Islamic banking include Turkey and the Philippines. A new Islamic banking law passed in the Philippines in 2019 will allow domestic and foreign banks alike to establish Shariah-compliant banking windows.

Global takaful assets grew 10% to $51 billion in 2019. Takaful operators in other GCC markets saw even higher growth in 2019, rising by 14% over the year. Growth was seen across several business lines and there was an improvement in profitability of investments.

The 'other Islamic financial institutions', or OIFI sector, saw a 6% increase in total assets in 2019, to $153 billion. This sector consists of financial institutions other than Islamic banks and takaful operators, such as financing, mortgage, leasing and factoring companies. The fastest growing OIFI market in 2019 was the Maldives, with its total assets rising 62% to $44 million.



Islamic finance assets remain concentrated in Iran, Saudi Arabia and Malaysia and they accounted for 66% of global assets in 2019.

Malaysia retains its commanding lead in Islamic finance development while Indonesia jumps to second

The report also provides a detailed look at the current state of the industry based on the Islamic Finance Development Indicator (IFDI) which considers five key indicators in the development of Islamic finance: Quantitative Development; Knowledge; Governance; Corporate Social Responsibility; and Awareness. The indicator is assessed across 135 countries around the world.

TOP TEN IFDI MARKETS FOR 2020

Country	Ranking	IFDI 2020	Indicator Value: Quantitative Development	Knowledge	Governance	Awareness	CSR
Malaysia	1	111	94	185	86	149	41
Indonesia	2	72	27	181	67	60	23
Bahrain	3	67	38	68	88	103	38
United Arab Emirates	4	66	31	67	79	91	60
Saudi Arabia	5	64	59	52	41	50	119
Jordan	6	53	14	75	51	29	99
Pakistan	7	51	18	80	74	53	31
Oman	8	45	14	46	66	73	25
Kuwait	9	43	48	13	63	48	42
Qatar	10	38	28	19	63	52	29

Malaysia remains to lead the indicator globally and there remains a wide gap between Malaysia and other countries with a presence in Islamic finance in terms of IFDI value. This is reflected in the country holding the highest value in three of the five main indicators (Quantitative Development, Knowledge, and Awareness) and being the second highest in Governance. There are also wide gaps between Malaysia and the second-ranked countries in individual indicators, suggesting it could take years for others to catch up.

There are much smaller gaps between the other countries in the top five, however, meaning some are capable of improving their rankings if they can show improvement in their lagging indicators. Saudi Arabia has the biggest opportunity to improve on its ranking, currently number 5, if it attends to the areas where it falls behind such as Governance.

Indonesia already showed one of the most notable improvements in the IFDI country rankings, moving into second spot for the first time, ahead of Bahrain and the UAE. This reflects the ongoing implementation of the Islamic Economic Masterplan 2019–2024 introduced by the government's National Sharia Economy and Finance Committee (KNEKS) which improved both its Islamic finance education, research and events.

Outside the top ten, other notable improvers in the IFDI country rankings were Syria, the United States, South Africa and Thailand.

Outlook uncertain while COVID-19 pandemic remains

Despite the strong expansion seen in 2019, industry growth is forecast to slow to the single digits, reaching US$3.69 trillion by 2024, as the world attempts to deal with the Coronavirus pandemic that erupted on a global scale in the first quarter of 2020. Several Islamic financial institutions including Islamic banks had reported losses or a drop in profits caused by a Covid-related increase in loan impairments.

The pandemic has, however, led to growth in some areas of the industry. Some regulators have turned to Islamic finance to mitigate the economic impact, such as Algeria, which plans to use it to attract local savers. Sovereign sukuk are also being used to aid financial recovery in the GCC and Southeast Asia. Corporate sukuk issuance has also picked up after a cautious halt in the first quarter of 2020, as companies seek to take advantage of low borrowing costs to shore up their finances while the pandemic continues to batter trade and economies. Quasi-sovereigns such as Islamic multilateral organizations have also stepped in to support countries reeling from the pandemic.

Sustainability has also become a more important consideration during the pandemic, and new product launches reflect this, such as ESG-based Islamic investments targeting social issues such as mass unemployment.

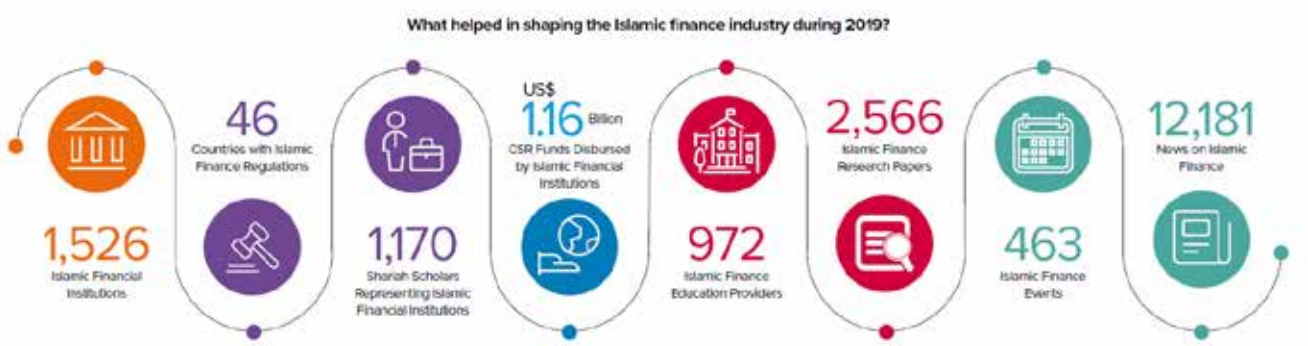
Pandemic leading rapid growth in digital solutions

The pandemic has also been a game changer in that several Islamic financial institutions have moved to offer their products via digital platforms so as to better serve their locked-down customers, thereby speeding the advance of technology within Islamic finance. Although Islamic FinTech had already been making headlines in recent years, digital-based financial institutions have become much more popular during the pandemic, just as digital solutions have leapt ahead in other economic sectors around the world.

For example, Islamic challenger or digital-only banks are emerging in non-core markets such as the UK, Malaysia, Kenya and Australia. Demonstrating both technology and the rise in social finance, a new insurance technology, or InsurTech, development in Malaysia uses blockchain to channel waqf funds towards making takaful more affordable to lower income consumers.

Sovereigns such as Malaysia also issued first digital sukuk though online channels such as mobile platforms while Indonesia also issued retail sukuk that can be subscribed through online channels to appeal to the young generation.

Digital-based Islamic financial institutions other than banks and takaful operators are also accelerating the evolution of the industry in Africa and Southeast Asia, including Islamic wealth management services targeting the millennial investor.



The online transformation of the industry is not limited to its institutions, but to its surrounding ecosystem as well. Islamic finance education is being increasingly offered online or through distance learning as the Covid pandemic makes it harder for students to attend classes, while events such as conferences and seminars are also being hosted increasingly online. These developments also make it easier for students or industry stakeholders from other countries to take online courses or attend Islamic finance events, which will help the industry to grow further and wider in the future.

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