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Product Development and *Maqāṣid* in Islamic Finance: Towards a Balanced Methodology

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Abstract

Islamic finance and its adherence to the core objectives of Sharī'ah *(*maqāṣid*) has been a controversial issue for some time. However, this debate has intensified in the last few years. Two particular issues have been widely argued. These are the overuse of debt-based instruments by Islamic financial institutions and the strict compliance of large number of* ṣukūk *structures with* Sharī'ah *principles. The current reliance of the industry on debt-based instruments is considered to be a failure and not in line with* maqāṣid al Sharī'ah*. This paper argues against this conclusion, as it is unwarranted and based on shaky grounds. In correspondence to this issue is the* ṣukūk *market and, despite its resounding success, suffers from some structural shortcomings. These defects are illustrated in this paper by the absence of 'true sale' in most* ṣukūk *issues in the market. This flaw casts real doubts regarding the transfer of the ṣukūk' assets from the balance sheet of the originator to that of the issuer, and as a result becomes the source of misgivings regarding the* Sharī'ah *compliance of some ṣukūk structures and their conformity with* maqāṣid al Sharī'ah*. The paper argues that if these shortcomings are not addressed then it can be argued that these structures are not in full conformity with* maqāṣid al Sharī'ah*. Some suggestions and recommendations are proposed to address these critical issues.*

Keywords: Islamic finance, *Ṣukūk*.
JEL Classification: G00, Z120.
KAUJIE Classification: B2, K13.

The debate about Islamic finance and its adherence to the core objectives of *maqāṣid al* Sharī'ah is not new. However, this debate has intensified in the last few

years with regards to two particular issues: the overuse of debt-based instruments by Islamic financial institutions, and the strict compliance to Sharīʿah principles of a large number of *ṣukūk* structures. Specific issues within this debate are generally being highlighted by the critics. These include concerns, among other the apprehension that the reliance of the industry on debt-based instruments was at the expense of profit-loss sharing products, and the marginal role of Islamic financial institutions in fulfilling their social responsibilities, specifically poverty reduction. These concerns are the outcome of the legalistic methodology promoted by Sharīʿah scholars in approving or disapproving some industry products. The debate is sometimes explained as differences between Sharīʿah scholar influences: i.e. by the juristic and legalistic approach or the economists' approach, that focuses on the social needs of the society or, in other words, the macro-*maqāṣid* and micro-*maqāṣid*. It is also sometimes described as a conflict between idealism and pragmatism or as a clash between Islamic finance and Islamic economics. Others portray it as a conflict between the individualistic *maṣlaḥah* methodology and the *maqāṣid* way, or a debate between analogical reasoning and empiricism. Based on this debate a new classification of products is advanced by some researchers such as Sharīʿah based products, Sharīʿah compliant products, and pseudo Islamic products or Sharīʿah compliant products in form and others in substance.

The paper argues that there is a need to be clear whether the *maqāṣid* of Sharīʿah as a general concept differs from the *maqāṣid* of Islamic economics on one hand, and the primary purposes and objectives of Islamic finance on the other. An accurate conceptualisation of *maqāṣid* with regard to these three spheres of Islamic law will shed light on the current debate and its ramifications. The need for a demarcation is prompted by the fact that if the objectives of Sharīʿah or *maqāṣid* in these three areas are not the same, then, demanding Islamic finance to fulfil some of the *maqāṣid* of Islamic economics or those of Islam as a whole is unwarranted. Moreover, putting such demarcations in place will allow valuable efforts to be preserved and not wasted in a vain debate due to confusion and misunderstanding. The paper further argues that the bases of the above classifications with regards to Sharīʿah compliance are debatable and need to be assessed from a Sharīʿah perspective given the fact that these classifications are not concerned with the permissible and non-permissible.

Some critics maintain that equity or profit sharing financing products are superior to debt-like financial instruments. They consider them the ideal instruments for Islamic finance while debt-based instruments should be the exception. It is also asserted that equity based financial products are in line with the spirit of the Sharīʿah and its objectives while other instruments are not. Some have gone to the extent of describing the debt-based instruments as kind of "stratagem" or "interest in disguise"

and therefore, the solution, for some, will be through the removal of debt-based instruments from the list of permissible instruments.

Yet, the present paper argues that the Sharīʿah foundations for the above contentions are shaky. Therefore, it is imperative to be clear, from the outset, whether Islamic finance is a Sharīʿah compliant financial system where debt-based products and profit and loss sharing instruments cohabit harmoniously or a profit-loss sharing industry where debt-based instruments are used as necessity? There is no evidence to support the claim that Islamic financial institutions have to limit themselves primarily to profit and loss sharing instruments such as *muḍārabah* and *mushārakah*. Looking at the primary and secondary sources of Islamic law, the message is clear that the industry is free to use any Sharīʿah complaint instrument including debt-based instruments such as *murābaḥah, istiṣnā, salam, ijārah, tawarruq* or any other developed products or to be developed as long as it does not contradict any explicit text or principle.

It is worth noting that the case against conventional interest based debt instruments is well argued by Muslim economists based on the fact that it is against Sharīʿah principles and its contractual arrangements. At the same time, the conventional financial system is rejected as it leads among others to instability, creates room for gambling, speculation, and increases disparities in the distribution of income and wealth. However, the question is whether the use of Sharīʿah debt-based instruments have negative results similar to those observed in the conventional financial system or whether any comparison between the two debt-based instruments is unwarranted? We argue that the concept of debt and its use in the two systems are diametrically different and therefore, judging one based on the negative effects of the other is unjustifiable.

On the other hand, the paper examines if a financial system based mainly on profit loss sharing is sustainable in the current environment. Can the risks involved in over reliance on profit loss sharing be easily mitigated given the characteristics of profit loss sharing products on the one hand, and the absence of regulatory regimes that promote the use of such products on the other such as the unfair taxation treatment or lack of regulations?

Moreover, the paper argues that the debate in favour or against debt-based instruments would not be clarified unless we refer to the fact that Sharīʿah considers the existence of debt-based instruments as part of its objectives and *maqāṣid* and a number of evidence from the primary sources support this.

Thus, the paper argues that it is unfair to consider the Islamic finance industry as a "failure" due to the marginal use of profit loss sharing instruments. Instead, it is argued that it will be useful if all efforts are directed towards innovation of new products that will increase the share of exiting profit loss sharing products such as private equity and venture capital and the design of institutional settings where other non-monetary financial intermediaries would be best placed to use profit loss sharing modes of finance. In short, presenting practical alternatives to the use of debt-based instruments would be the best way forward rather than the call for the rejection of debt-based instruments.

It has also been contended by the critics that the primary goal of Islamic financial institutions is not profit-making, but the endorsement of social goals such as socio-economic development and the alleviation of poverty. Therefore, Islamic financial transactions should not be solely profit-oriented, but aimed at serving the overall needs of society. Mere maximisation of profits cannot be a sufficient goal and therefore, according to the critics the current Islamic finance industry is not particularly interested in economic development and social welfare but driven by profit maximisation.

The present paper argues that it is critical to be clear whether Islamic financial institutions are profit driven institutions or charitable organizations. Thus, we submit that wisdom requires proving first to the world, beyond reasonable doubt that, a Sharī'ah compliant financial system can be just as profitable as the conventional and capable of freeing humanity from the injustice of *ribā*. It is based on this legitimate aim that it is upheld that Islamic financial institutions are under obligation to compete with conventional institutions using all permissible means in order to prove the viability of the system without neglecting the use of profit loss sharing instruments while laying down the foundations of a more equitable financial system. Moreover, the paper argues that, is it possible to eradicate poverty just because a profit-loss sharing system is implemented or such a goal is not reachable unless the entire Islamic economic system is implemented or more realistically when there is a complete Islamic system in place? Therefore, is it fair to consider Islamic finance as a failure as it has not been able to eradicate poverty in four decades of its existence?

One of the practical approaches in highlighting the role of Islamic financial institutions in corporate social responsibility should be by allowing Islamic financial institutions to take the lead towards directly distributing their *zakāh*. *Zakāh* is the third pillar of Islam and one of the foundations of an Islamic economic system. Unfortunately, it is thus far poorly implemented across the Muslim world. Even within the Islamic finance industry *zakāh* is generally left to discretionary power of

individual shareholders and not distributed by the institutions. In order to avoid some of the existing shortcomings in *zakāh* distribution and to stress the social responsibility of Islamic financial institutions, *zakāh* distribution should be directly effectuated through Islamic financial institutions and not left to the discretionary powers of individual shareholders.

On the other hand, if the concept of *maqāṣid al*-Sharī'ah is used by some to justify their criticisms against debt-based instruments, the same concept is used by some practitioners to overlook certain obvious Sharī'ah shortcomings in certain Islamic financial products particularly the so called "asset based *ṣukūk*". These infringements are generally justified on the ground of gradual implementation of Sharī'ah principles or the aim of preserving the hard gained achievements of the Islamic finance industry and its noble's objectives. However, the paper argues that overlooking these non-Sharī'ah structural issues in *ṣukūk* contravene one of the important features of Islamic law that "contracts are judged by their essence and meaning, not by their form and structure". Such an approach will not help in providing a financial service that adds value to the real economy or strengthen the linkage between Islamic finance and productive economic activities. Overlooking these shortcomings will not fit with the necessity for appropriate due diligence on the viability of business proposals and the requirement for transparency and disclosure considered all to be genuine *maqāṣid* of Islamic finance. Moreover, these shortcomings in *ṣukūk* structuring are against the juristic approach promoted by practitioners given the fact that some basic conditions of a valid contract are being compromised. In short, overlooking these shortcomings will be against *maqāṣid al*-Sharī'ah.

To illustrate the weakness in *ṣukūk* structures and the criticisms against it on the basis of *maqāṣid*, the present paper discuss the issue of 'true sale' and the transfer of the *ṣukūk* assets from the balance sheet of the originator to that of the *ṣukūk* issuer. This fundamental Sharī'ah contractual requirement is not observed in a very large number of *ṣukūk* issues. Despite various criticisms against these practices and their obvious detrimental effects to the industry in the end and more importantly their disregard to *maqāṣid al*-Sharī'ah, the practice continues.

Thus, the overuse of debt-based instruments and the structural defects in *ṣukūk* and the relation of both issues with *maqāṣid al*-Sharī'ah form the focus of this paper. The paper calls for a balanced methodology and concludes that to consider the use of debt-based instruments as against *maqāṣid al*-Sharī'ah *is* unfair and counterproductive. On the other hand, to continue structuring *ṣukūk* despite their obvious infringements of some contractual requirements is against *maqāṣid al-*

Sharī‘ah. The present paper is an attempt to critically analyse the marred and misunderstood relationship between Islamic finance and *maqāṣid al*-Sharī‘ah with particular reference to the above issues and how this debate is guided to benefit the industry and not to ruin its hard gained achievements. The first part of the paper will discuss the issue of *ṣukūk* and *maqāṣid al*-Sharī‘ah while the second part will focus on the issue of debt-based instruments and *maqāṣid al*-Sharī‘ah.

Ṣukūk and *Maqāṣid al*-Sharī‘ah

As mentioned above, some practitioners disregarded some of the fundamental jurisprudential and contractual principles in *ṣukūk* structuring. This group argues that in order to preserve the existing *ṣukūk* market and sustain its growth, the prevailing structuring mechanism should continue. Growth and development should take precedence over compliance with specific contractual requirements. Thus, despite an obvious recognition of these shortcomings the trend is continuing. According to the proponents of this opinion, insisting on some of the details might lead to the disappearance of the system as a whole. Therefore, preserving the system is much more important than fixing the details and this is in line with *maqāṣid al*-Sharī‘ah. Despite obvious and unequivocal resolutions from different institutions such as AAOIFI and the Islamic Fiqh Academy on the necessity to abide by the contractual requirements in *ṣukūk* structuring, unfortunately a large number of *ṣukūk* in the market are structured without due consideration to these principles.

The present paper limits itself in highlighting the above concern by discussing one of the core issues that could have a negative impact on the *ṣukūk* industry as a whole. This is the issue of ownership of the *ṣukūk* assets and whether there is a ‘true sale’ in a particular *ṣukūk* structure and the implications of such an arrangement in case of default in protecting the right of the *ṣukūk* holders. There is a need to establish whether the concept of beneficial ownership as widely used in *ṣukūk* structuring complies with the basic conditions of a valid sale contract in Islamic law. Whether the condition of preventing the purchaser from selling the purchased assets or to dispose of it contradicts any Sharī‘ah principle of a valid sale contract or not? Whether the lack of due diligence or even inquiry regarding the purchased assets will be considered a case of *jahālah* and *gharar* and by consequence renders the contract null and void or not?

'True Sale' and Asset Backed *Ṣukūk*[1]

The global *ṣukūk* market continued its steady growth momentum in 2014 with expectations that the primary *ṣukūk* market will once again register a new record as the industry continues to attract new jurisdictions and players into the fastest growing segment of the Islamic finance industry. However, if *ṣukūk* market growth is recording new heights, changes in terms of structures seem to be slower than expected particularly with regard to the adoption of asset backed *ṣukūk* based on 'true sale'.

Despite the fact that the debate over "asset backed" and "assed based" *ṣukūk* started several years ago, it is still relevant nowadays not only because it represents one of the most contentious issues in terms of *ṣukūk* structuring and restructuring, but also because it constitutes a defining criteria that determines the unique nature of *ṣukūk* as an alternative to conventional bonds. It also embodies the clearest substantiation and tests whether Islamic finance in general, and *ṣukūk* in particular, is not another variation of a conventional debt financing mechanism but a genuine alternative that is linking finance to the real economy and a suitable mechanism for raising capital to finance critically needed funds for infrastructure projects. At the same time, the issue of 'true sale' in *ṣukūk* structuring is still passionately debated given the fact that no substantial change has occurred since the deliberation started.

Based on the definition[2] of *ṣukūk*, it is clear that *ṣukūk* does not create indebtedness and the certificate is not a proof of investor's loan to the *ṣukūk* holders as is the case in conventional bonds. On the contrary, the certificates are evidence of ownership of an underlying asset, usufruct, or services of the *ṣukūk*. Therefore, *ṣukūk* is an investment facility and not a loan arrangement.[3] *Ṣukūk* must be certificates that represent co-ownership of an asset or business venture[4] and should grant particular investors a share of an asset or business venture along with the cash flows and risk commensurate with such ownership.

Thus, the theoretical bases for an asset backed *ṣukūk* structure are obvious from the Sharī'ah standards and resolutions on *ṣukūk* while its benefits are acknowledged

[1] For further details please see, Muhammad al-Bashir Muhammad al-Amine Al-Amine, Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation (Brill's Arab and Islamic Law Series) Leiden; Boston: Brill, 2012.
[2] See AAOIFI Standard on Sukuk
[3] Akram Laldin "Sharī'ah and Legal issues in *ṣukūk*", International conference on Islamic Business and finance held at National Institute of Banking and Finance (NIBAF) Islamabad, Feb, 8-9, 2011, p.1.
[4] Paul Wouters, "Asset-backed *ṣukūk* — Islamic Finance Going its Own Way" *Islamic Finance News*, March 30, 2011 pp.22-24.

by all players including by Sharī'ah scholars, economists, and regulators. Thus, a leading regulator stressed that:

> "Asset-backed *ṣukūk*, has profit and loss sharing elements that thus offers investment sustainability. The possibility of a default is minimized, as investors of asset-backed *ṣukūk* are not guaranteed to receive income or capital gains, and profits are paid by the issuers only when the underlying assets earn profits"[5].

Thus, the problems with asset-backed *ṣukūk* are not related to its theoretical bases or beneficial advantages but with the practical implementation and the absence of a favourable legal environment. The non-existence of modern Sharī'ah compliant securitisation law, trust law, favourable tax legislations, or secured transactions legislations in many Muslim countries is obvious indication of this legal vacuum. However, the pillar and defining characteristic towards an asset-backed *ṣukūk* structure resides on the necessity of structuring *ṣukūk* on the basis of 'true sale' and the legal transfer of the underlying assets of the *ṣukūk* from the originator to the issuer. Such a transfer needs to be grounded on a genuine and thorough due diligence about the assets underlying the *ṣukūk* and practically substantiated and verified by the transfer of the sold assets from the balance sheet of the seller to that of the purchaser.

Ṣukūk Structuring and 'True Sale'

By "true sale" we mean a sale that complies with Sharī'ah principles and observes AAOIFI standards and resolutions on *ṣukūk*. The main requirements for such a sale are: (a) a genuine due diligence according to custom and modern practices about the underlying assets to avoid any possibility of *jahālah* and *gharar*; (b) a legal transfer of ownership of the assets sold from the buyer to the purchaser; (c) the assets sold are transferred from the balance sheet of the seller to that of the purchaser; (d) non-existence of any condition or clause that prevents the purchaser from exercising his rights to sell the asset or dispose of it; (e) return of the *ṣukūk* are based on the actual performance of the asset underlying the *ṣukūk*; and (f) the purchaser has direct recourse to the asset in case of default.

In a "true sale", the underlying asset has been validly transferred to the SPV and that this transfer cannot be re-characterised as a secured loan or otherwise avoided

[5] Zeti Akhtar Aziz: "Islamic finance - financial stability, economic growth and development, Speech" by the Central Bank of Malaysia (Bank Negara Malaysia), at the Islamic Development Bank (IDB) Prize Lecture on "Islamic finance - financial stability, economic growth and development", Jeddah, 27 November 2013. http://www.bis.org/review

upon an insolvency of the originator. The concept simply addresses whether the SPV has ownership of the asset. The essential test of true sale is whether the assets will be available to the originator's creditors on its insolvency. A primary objective in most securitisation transactions is to separate the underlying asset from the credit risk of the originator and invest it in the SPV.[6]

The issue of 'true sale' is one of the first steps in structuring a *ṣukūk* transaction. It is not limited to specific types of *ṣukūk* such as *ijārah* or *wakala ṣukūk* but is present in almost all *ṣukūk* structures. Its importance is born out of the fact that if the first step is wrong, then the following steps will definitely be erroneous. If the sale and purchase of the asset underlying the *ṣukūk* structure do not reflect a Sharī'ah compliant 'true sale', then, the presence of assets in the whole structure will not reflect the real status of an authentic *ṣukūk* structure. At the same time, the profit or return of the *ṣukūk* will not be based on the actual performance of the asset but that of the credit worthiness of the originator. Moreover, if the presence of the asset in the *ṣukūk* structure is not based on a 'true sale' it will be difficult to rebut the claim that the transaction is akin to a conventional credit based operation. In addition, such a structure could not be marketed unless supported by the widely criticised "purchase undertaking" to guarantee the repayment of the capital at maturity. Finally, if the legal transfer and enforcement of the underlying assets of the *ṣukūk* is not ascertained, it could be the source of dispute in case of default. Thus, the issue of 'true sale' is central to all other Sharī'ah issues in *ṣukūk* structuring.

In addressing the issue of 'true sale' and the controversy surrounding the issue of asset-backed and asset-based *ṣukūk* the AAOIFI 2008 resolution is very clear. The resolution states:

> *Ṣukūk*, to be tradable, must be owned by *Ṣukūk* holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of Sharī'ah, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI Shari'ah Standard (17) on Investment *Ṣukūk*. The Manager issuing *Ṣukūk* must certify the transfer of ownership of such assets in its (*Ṣukūk*) books, and must not keep them as his own assets.[7]

One of the important classifications of *ṣukūk* that has dominated discussions in recent years is the division into asset-backed and asset-based *ṣukūk*. This division

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[6] Adrian Dommisse & Wasif Kazi, *Securitisation and* Sharī'ah *Law*. Fitch Ratings www.fitchratings.com. 24 March 2005, (1-8).

[7] AAOIFI 2008 Resolution on *ṣukūk*, www.aaoifi.com

seeks to replicate the conventional classification into asset-backed securities and debt-based bonds or simply secured and unsecured securities. Once again, the main feature distinguishing the two concepts is the fundamental concept of 'true sale'. The *ṣukūk* structure is asset-backed if there is a 'true sale' as defined above, while it is asset-based when there is no legal transfer of the asset even if the *ṣukūk* holders have a beneficial ownership. It is extremely important to differentiate between the two distinct concepts of "legal transfer" and "legal registration" that are sometimes confused. Legal transfer of rights is a fundamental requirement in any Sharī'ah compliant sale while the simple official legal registration is not and can be compromised for reasons of high tax cost or practical delay as long as it is possible to craft a way out without contravening the legal regime in place.

A random survey and review of the Offering Circular of a number of *ṣukūk* structures issued between 2008 and 2013, the period that followed the AAOIFI resolution and guidance on *ṣukūk*, shows that despite the presence of an asset in the sale and purchase agreement in these *ṣukūk* structures, the transfer of ownership in such sale/purchase agreements are based on beneficial ownership that does not include the full transfer of the legal title. AAOIFI's 2008 resolution on *ṣukūk* as quoted above clearly rejects this practice which is acceptable under English law. Accordingly, if the transfer of ownership is not legally achieved, it would not be based on 'true sale' and as a result all other observations mentioned above such as the originators keeping the asset on their balance sheet rather than transferring it to that of the issuer, the lack of genuine due diligence regarding the asset from the issuer when purchasing it or the provision that the *ṣukūk* holders have no rights of disposal over the assets or right of direct recourse to the assets in case of default or insolvency will be present.[8]

It has also been observed that if *ṣukūk* investors have no recourse to the assets, the transaction does not focus on the underlying asset but rather on the credit worthiness of the sponsors or originators of the *ṣukūk*. These types of *ṣukūk* do not grant the certificate holders the right to cause the sale or other disposal of any of the trust assets upon default of the issuer. *Ṣukūk* holders can only cause the trustee to call a meeting of the certificate holders and exercise their rights under the transaction documents including issuing a notice to the originator pursuant to its undertaking to repurchase the assets on maturity or default of the *ṣukūk*. Such is an asset-based *ṣukūk* structure.[9]

[8] Sukuk "Back on Tract" Kuwait Finance House, July 20, 2010,

[9] Fawaz Elmalki & Dennis Ryan "*ṣukūk*: An Evolution", www. conyersdillandpearman.com January 2010

Under an "asset-backed" *ṣukūk*, legal title to the underlying assets will typically pass by way of a 'true sale' from the originator to the issuer SPV and therefore, in case of default by the issuer, *ṣukūk* holders would be able to exercise full ownership rights and control over such assets. In such a structure, if the underlying assets are performing well while the originator is facing bankruptcy, the *ṣukūk* holders' payment will not be interrupted. However, if the underlying assets are incurring losses, the *ṣukūk* holders must bear the risk of the non-performance of the assets as the real owners of the asset. It would be clear provisions in the *ṣukūk* documents that *ṣukūk* holders will be exposed to market and credit risk of the assets and not that of the originator.[10]

It is clear from the above that asset-backed *ṣukūk* are arguably closer to an equity position or asset securitisation mechanism whereby *ṣukūk* holders own the underlying assets and are exposed to the risk and performance of the *ṣukūk* assets and have no recourse to the originator in the event of a payment shortfall. Asset-based *ṣukūk* on the other hand, are closer to debt-based transactions and have some features of conventional bond because the *ṣukūk* holders have direct recourse to the originator if there is a shortfall in payments.[11] To reiterate, in asset-backed *ṣukūk*, there is a 'true sale' between the originator and the special purpose vehicle (SPV) that issues the *ṣukūk*. Assets are owned by the SPV, returns are derived from assets, and asset prices may vary over time.[12] On the other hand, the asset-based structure normally results in debt creation. The debt that is created represents the receivables which will be distributed to the entitled parties. Thus, in asset-based *ṣukūk* structures, the debt represents the coupon plus principle investment via a right in the obligor's cash flow.[13] In asset-backed *ṣukūk* (ABS) on the other hand, the *ṣukūk* holders are actually buying undivided shares of the underlying asset which will be represented by way of transfer of legal title. They have the full ownership rights over the asset and are thus entitled to revenues generated from it. At the same time, they will also share the risks that come with ownership such as loss or damage to the underlying asset.[14]

Thus, it is widely observed that in most *ṣukūk* issuers are trying to avoid a common law 'true sale' and instead entering into what appeared to be a sale, but was not a perfect sale from a Sharī'ah perspective. The issuer was able to transfer only

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[10] Asyraf Wajdi Dusuki and Shabnam Mokhtar, "Critical Appraisal of Sharī'ah Issues on Ownership in Asset-Based *ṣukūk* as Implemented in the Islamic Debt Market", *ISRA Research Paper (No. 8/2010)*
[11] Usman Hayat "Islamic Finance's *ṣukūk* explained", *Financial Times*, April 11 2010.
[12] Ibid.
[13] Kuwait Finance House, *ṣukūk* "Back on Tract", Kuwait Finance House, July 20, 2010.
[14] Ibid

the 'beneficial ownership' of the asset or business venture to a common law trust-SPV.[15]

Thus, the main issues surrounding *ṣukūk* structures which require further scrutiny so that *ṣukūk* structure are in full conformity with AAOIFI requirements revolve around the absence of criteria enumerated in the definition of 'true sale' are: (a) a genuine due diligence according to custom and modern practices about the underlying assets to avoid any possibility of *jahālah* and *gharar*; (b) a legal transfer of ownership of the assets sold from the buyer to the purchaser; (c) the assets sold are transferred from the balance sheet of the seller to that of the purchaser; (d) non-existence of any condition or clause that prevents the purchaser from exercising his rights to sell the asset or dispose of it; (e) return to the *ṣukūk* are based on the actual performance of the asset underlying the *ṣukūk*; and (f) the purchaser has direct recourse to the asset in case of default.

All these requirements seem to be lacking in a large number of *ṣukūk* structures and therefore, such structures are not strictly complying with the requirement of 'true sale' and asset-backed *ṣukūk*. The following are some direct quotations from the offering circulars issued between 2009 and 2013. Given that such statements are common in these *ṣukūk* structures, we preferred not to give any specific reference to a particular *ṣukūk* issue but to establish the case and look for future actions on how to improve. At the same time, these Offering Circulars can be easily accessed at www.zawya.com.

Sometimes the certificate holders purchasing the *ṣukūk* assets will not perform any due diligence or enquire regarding the asset. Sometimes they have no right to do so:

> No investigation or enquiry will be made and no due diligence will be conducted in respect of any of the constituent assets comprised in the Portfolio … the Certificate holders shall have no ability to influence this selection. Only limited representations will be obtained … in respect of the Portfolio of any Series of Trust Certificates. In particular, the precise terms of any of the constituent assets comprised in the Portfolio will not be known (including whether there are any restrictions on transfer or any further obligations required to be performed …to give effect to the transfer of any of the relevant constituent assets comprised in the Portfolio). No steps will be taken to perfect any transfer of any of the relevant

[15] Paul Wouters, "Asset-backed *ṣukūk* — Islamic Finance Going its Own Way" *Islamic Finance News*, March 30, 2011 pp.22-24.

constituent assets comprised in the Portfolio or otherwise give notice of the transfer to any lessee or obligor in respect thereof.

In another offering circular the following was stated:

No investigation will be made to determine if the Purchase Agreement will have the effect of transferring any beneficial interest and rights in and to the assets described therein. No investigation has been or will be made as to whether any interest and rights in and to any of the Portfolio Assets may be transferred as a matter of the law governing the contracts, the law of the jurisdiction where such assets are located"

Another offering circular states the following:

No investigation has been or will be made as to whether any Relevant Lease Asset may be transferred as a matter of the law of the jurisdiction where such assets are located or any other relevant law. No investigation will be made to determine if the relevant Purchase Agreement will have the effect of transferring the Relevant Lease Assets of the relevant Series.

The question that arises is that why investors do not ask for a genuine due diligence about the assets and why such a right is denied although they are investing hundreds of millions of dollars. Why are they not allowed to investigate whether the ownership of the asset they are purchasing is legally transferable or is valued at the cost price? More importantly, why are investors not asking if the asset would continue having a value in case of default in order to protect their rights? Answers to these questions seem clear. Investors in such structures are relying on the credit position of the originator and are depending on the purchase undertaking for the return on their capital. They have no right to dispose of the asset and therefore, there is no need for legal or financial due diligence over the asset.

A Sharīʿah question that will arise based on the above is that considering the absence of a due diligence and inquiry about the asset purchased, does this constitute a kind of *jahālah* and *gharar* that will affect the Sharīʿah compliance of the sale? Based on Sharīʿah principles, the *ṣukūk* holders should be able to deal freely with the asset they purchased and the seller should not have any claim over the asset after its sale. This means the *ṣukūk* holders should have priority claim over the asset if there is default and the right to sell it or place it as a security. They are the real owners of the asset and should thus have full control over it. However, the reality is that the *ṣukūk* holders cannot dispose of the asset and can only enforce the purchase

undertaking. They have to rank *pari passu* with other unsecured creditors of the obligor in case of default. Moreover, the transfer of ownership would not be perfected and the underlying assets of the *ṣukūk* will remain on the balance sheet of the obligor.

Thus, it is clearly stated in some of these offering circulars that:

> "Taking enforcement action in the name of the Trustee against the Obligor for all amounts due to be paid or shares to be delivered under the Purchase Undertaking provided always that, for the avoidance of doubt, such enforcement action shall not include the right to sell *Muḍārabah* Assets".

In another offering circular the following was stated:

> "Under no circumstances shall any Certificate holder, the Trustee or the Delegate have any right to cause the sale or other disposition of any of the Trust Assets except pursuant to the Transaction Documents and the sole right of the Trustee, the Delegate and the Certificate holders … shall be to enforce the … obligations under the Transaction Documents.

The above seems to be the common position of all *ṣukūk* structured as asset based *ṣukūk* whereby *ṣukūk* holders have no real ownership over the asset and therefore, have no right to sell the asset to a third party or dispose of it or otherwise. It has been rightly asked if such a contract is a genuine sale and purchase from a Sharī'ah perspective[16] if the buyer cannot pledge or resell the purchased asset, while the seller maintains control over the assets and has it on its balance sheet. [17]

It is also upheld by rating agencies that without evidence of a legal 'true sale', there is little or no benefit to the assets in an 'asset-based' *ṣukūk*. This is based on the fact that the 'form' of the risk and return may appear to be that of assets but the 'substance' may be purely that of the corporate or bank originating the *ṣukūk* and not that of asset risk. More importantly, in most cases, this is exactly what the borrowers

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[16] See, AbdAllah Al Muslih "Haqiqat bay al Sukuk lihamiliha" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011, Mohamed El-Gari "Bay' Al *ṣukūk* Lihamiliha" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011; Ali Al Quradaghi , "Bay' Al *ṣukūk* Lihamiliha Dirasah Fiqhiyyah Iqtisadiyyah" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011; Asyraf Wajdi Dusuki and Shabnam Mokhtar, Critical Appraisal of Sharī'ah Issues on Ownership in Asset-Based *ṣukūk* as Implemented in the Islamic Debt Market,

[17] Ibid

and investors want. Many, with full knowledge and understanding, are content to transact on this basis.[18]

However, the question from Islamic law will be if the purchaser has no right to dispose or to sell the assets does he have full ownership? If the buyer would not be given full access to the goods purchased without restriction based on the principle of *takhliyah* and *tasarruf*, does the contract continue to be valid? What if the buyer does not undertake any effort to see whether the legal title of the purchased goods would be transferred to him? Is the contract really intended to be a sale contract?

The above clauses and provisions are generally discussed by early Muslim scholars under conditions that are incompatible with the objective of the contract (*al shurut allati tunafi muqtada al-ʿaqd*). The conclusion of the jurists' discussion regarding the issue is that such conditions would render the contract null and void according to some while a second group maintained that the contract is still valid but the condition is void and therefore should be dropped automatically.[19] The main argument is that a sale contract by definition entitles the purchaser to have free and full control over the purchased asset; however, such kinds of conditions restrict it and rather go against its spirit (*Yunafi wa yunaqidu maqsud al-ʿaqd*).

It is extremely pertinent to reiterate that moving from legal ownership to beneficial ownership is not simply an issue of registration. Registration of ownership transfer in the Land Register, for instance, is not a pre-condition for the compliance and validity of a sale and purchase contract under Islamic law. A sale and purchase contract is valid through offer and acceptance and there is no Sharīʿah requirement that this must be registered. Registration is a modern legal formality that needs to be observed for reasons of public interest and submission to the legal system in place. Thus, a sale and purchase contract is valid even without registration and the legal ownership is automatically transferred by the sale contract. In addition, under a Sharīʿah compliant sale and purchase contract, the buyer has the right to keep the goods purchased or to resell them to a third party as when he wishes and he has the right to undertake a due diligence over the asset and perform all necessary inquiries about it. Thus, portraying the difference between legal transfer and beneficial

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[18] Khalid Howladar The future of *ṣukūk*: substance over form?

[19] Al-Kasani, Abu Bakr Ibn Mas'ud, *Badai Al-Sana'I fi Tartib Al-Sharai*, Dar al-Kutub al-Ilmiyyah, Beirut, second edition 1406 H vol.5, p.165. *Hasiyat Ibn Abidin* vol. 4 p.121. Al-Hattab, *Mawahib al - Jalil* vol.4, p.373. Al-Buhuti *Kashaf al-Qina* ʿvol.3 pp.193-194; Al-Mirdawi, *Al-Insaf* vol.11, p.233; Hasan Ali Al-Shazali, *Nazariyyat al-Shart Fi alFiqh Al-Islami*, Qunuz Ishbilyya, 1st edition, 2009, pp. 230-232; 266-269; 300-303;384-385;487-477.624-626. Muhammad Al-Yamani, *Al-Shart Al-Jazai fi al-Uqud al-Muasirah*, Qunuz Ishbilyya, 2006 pp.86-105.

transfer of ownership in *ṣukūk* structure as just an issue of registration is deceptive and misleading.

The crux of the construction was based upon a nuance between the Sharī'ah and the common law legal systems upon the definition of a 'sale' and the acceptance of 'beneficial ownership' in the Islamic legal system which was perhaps intended to be a temporary 'way out', but unfortunately it seems to becoming a norm.[20] Some have gone even further highlighting that "the structural 'substance' of many existing unsecured *ṣukūk* to be a deliberate construction whereby many companies do not want to sell their quality assets to investors while many investors do not actually want asset risk, but want the equivalent of conventional bonds.[21]

Thus, it has been observed that although AAOIFI guidelines are clear, market participants can, and will, make their own decisions in *ṣukūk* structuring. More importantly, despite the lapse of several years since the controversy over asset-backed and asset-based *ṣukūk* started and the issuance of AAOIFI's resolution in 2008 with the aim of clarifying some of the issues, the successful issuance of *ṣukūk* since then without adoption of these recommendations shows that there is still diversity of opinion and no single agency, institution or individual can really hope to unilaterally resolve the issue. Therefore, there is a need for more coordinated efforts.[22]

Recommendations on *Ṣukūk* structures and *Maqāṣid al*-Sharī'ah

The following are some of the issues that need further clarification and a common position from all Islamic finance players including Sharī'ah scholars, lawyers, accountants, finance specialists, regulators and legislative bodies.

- The pivotal role of the concept of 'true sale' in *ṣukūk* structuring is still a moot point and therefore, it is important to clarify this concept, through collective *ijtihād*, in light of modern securitisation principles and how it is compatible with the Sharī'ah principles of valid sale contract.

[20] Paul Wouters, "Asset-backed *ṣukūk* — Islamic Finance Going its Own Way" *Islamic Finance News*, March 30, 2011 pp.22-24
[21] Khalid Howladar, "The future of *ṣukūk*: substance over form?" Special Comment, Moody's Investors Service, *Special Report* May 6.
[22] Ibid.

- The concept of "beneficial ownership" is still very much contested particularly among Sharī'ah scholars [23] and there is a need to resolve the issue with particular reference to *ṣukūk* and the direct involvement of not only Sharī'ah scholars but also lawyers and accountants.
- The insistence of the originator in some *ṣukūk* in keeping the underlying asset of the *ṣukūk* sold in its balance sheet is an issue of genuine concern. Does this reflect in practical reality that these assets were sold or not? Does the mere reference in the 'notes' by the auditors that these assets are 'used' for *ṣukūk* issuance is a clear indication that these assets are owned by the *ṣukūk* holders and they are no longer the property of the originator? Again, the issue is not purely a Sharī'ah issue but has accounting and legal dimensions and therefore, cooperation among these parties is highly needed in resolving the issue.
- Does the reference in *ṣukūk* structures that the *ṣukūk* holders "have no right of recourse to the asset in case of default" is in line with Sharī'ah principles or is it a non Sharī'ah compliant provision and condition that could render the whole transaction null and void.
- Despite the fact that rating agencies have clear distinct methodologies in rating debt-based bonds and asset-backed securities and the concurrence by these agencies that these methodologies are also viable to Islamic structures,[24] the distinction has not found its way with regard to *ṣukūk* rating whereby the vast majority of *ṣukūk* in the market are rated based on the credit profile of the originator and not based on the asset underlying the *ṣukūk*. Therefore, it seems that the issue is not that of rating methodology but unjustified preference of *ṣukūk* based structures by issuers.
- Perhaps one way to address the issue could be a request by the Sharī'ah Board approving *ṣukūk* structures to demand a parallel rating of the assets underlying a *ṣukūk* structure besides that of the originator. This will result in

[23] See, AbdAllah Al Muslih "Haqiqat bay al Sukuk lihamiliha" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011, Mohamed El-Gari "Bay' Al *ṣukūk* Lihamiliha" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011; Ali Al Quradaghi , "Bay' Al *ṣukūk* Lihamiliha Dirasah Fiqhiyyah Iqtisadiyyah" *Nadwat Mustaqbal al Amal Al Masrafi Al Islami Al Rabia*, National Commercial Bank Saudi Arabia held in Jeddah 13-14 December 2011

[24] See, Mohamed Damak & Emmanuel Volland (2008) The *Ṣukūk Market Continue to Soar and Diversify Holt Aloft by Huge Financing Needs* Standard & Poor's March 11. pp.1-10; Philip Smith & Others (2007) *Fitch's Approach to Rating Ṣukūk*, Fitch Rating, Criteria Report . Corporate Finance. March 5. pp.1-5; Dominique Gribot-Carroz & Khalid Howladar (2009) "Method Behind the Madness". *Islamic Business and Finance.* October 2007 Issue 23. pp. 27-28.

a genuine due diligence about the assets and show that they constitute a fundamental part of the structure. Indeed this will be an added cost but justified for compliance purposes.

- The confusion on the above issues and others seems to be based on the lack of some key legislation that could shed light on the above controversial issues, such as the nonexistence of a modern legal framework dealing with issues such securitisation, trust law, secured transactions mechanisms or favourable tax legislations in order to create a level playing field.
- Although the promulgation of the above legislations would be primarily based on government initiatives, it is important to stress that for a genuine asset-backed *ṣukūk* to a reality, there is a need for some sovereign benchmark asset backed issuances as was the case with the early global *ṣukūk* that were dominated by sovereign ownership during its early days. Similarly, the Islamic Development Bank (IDB) as a multilateral institution can be a catalyst in driving such initiatives by having its first asset backed *ṣukūk*.
- Although the presence of such legislations is crucial, what is most important is the market desire to move towards assets backed *ṣukūk*. For this shift to take place, it is believed that the presently selected legal systems to govern *ṣukūk* issuance and dispute resolutions such as English or American law must recognise and differentiate between an asset-based *ṣukūk* and an asset-backed *ṣukūk* and the example of the Cameron *ṣukūk* is a testimony to this end. When the transaction defaulted, investors were given the right of direct recourse to the asset by the American court, for the simple reason that the transaction was structured from the beginning as asset-backed and not asset-based transaction. Therefore, it is incumbent upon the industry to make a genuine move towards asset-backed *ṣukūk* based on 'true sale'.
- Some might have reservations over the transfer of the asset to a Special Purpose Vehicle given the fact it is a shell company, however, to mitigate such a risk it is important the SPV is audited or explore the possibility of having banks play the role of trustee rather than SPV.
- Securitisation and asset-backed *ṣukūk* opportunities abound in countries with Sharī'ah legal and financial systems. Such a move will allow smaller companies and sovereigns with no investment grade the highest rating if they have strong good assets. This rating can be even higher than the issuer or government. For instance, a company or a sovereign with an overall "B" rating with "AA"-rated assets on its books might be able to raise funds at an "AA" rather than "B" rating by securitising those assets.

- A sudden shift towards asset-backed *ṣukūk* is not feasible and not advisable. However, in order to be much closer to the principles of Sharīʿah and maintaining the main characteristics that distinguish Islamic finance, a systematic move towards asset-backed and securitisation based *ṣukūk* is a must.

If the first part of this paper focused on one of the deficiencies in *ṣukūk* structuring and its relation with *maqāṣid al*-Sharīʿah, the second part will shed light on the continued debate of labelling the Islamic finance industry as a "failure" in line with *maqāṣid al*-Sharīʿah based on the assumption that the current Islamic financial system is emphasising the legalistic or contractual approach that ignores the *masalih-mafāṣid* dimension. It is also grounded on the claim that the ideal way for financing in Sharīʿah should be financing on the basis of partnership and profit sharing while debt-based Islamic instruments are a kind of stratagem or the contention that debt-based products are meant to be temporary. The critics have also maintained that the current Islamic finance has deviated from the objectives of Islamic economics and social justice.

Maqāṣid al-Sharīʿah and Debt-based Contracts

As noted above, one of the widely cited features of the relation between Islamic finance and *maqāsid* is the so called legalistic or contractual approach. Proponents of this position maintain that the legalistic methodology ignores *maqāṣid al*-Sharīʿah. The juristic discussion focused primarily on the contractual aspects with little attention to the *masalih-mafāṣid* dimension. As an example, critics maintain that even the AAOIFI standards are oblivious to this essential dimension of Islamic law.[25] It is also asserted that the legalistic-rational method applied by the Sharīʿah scholars should be considered as an important part of the social failure of Islamic finance as currently applied ignores the 'substance' and prioritize the 'form.' Substance according to the critics requires looking at the consequences and outcomes while in the 'form' oriented approach, the emphasis is relegated to the process of constructing a product by ignoring the outcomes of the product.[26]

The level of frustration by some Muslim economists towards the current Islamic finance has reached the level whereby they are considering its inability to access

[25] Mohammad Nejatullah Siddiqi, "Economic of *Tawarruq*: How its *Mafāṣid* overwhelm the Masalih A position paper to be presented at the Workshop on *Tawarruq*: A Methodological issue in Sharia-Compliant Finance February 1, 2007.

[26] Mehmet Asutay, "Conceptualizing and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance", *Asian and African Area Studies*, 11 (2): 93-113, 2012.

certain markets as a blessing. It is in this sense that one well respected economist commented on the Indian court's ruling disallowing Islamic finance saying:

> The court ruling may perhaps turn out to be a blessing in disguise for India's 150 million Muslims, a large majority of whom are poor and whose financial needs are certainly not going to be taken care of by the large NBFCs/ banks practicing the "spurious" variety of Islamic banking and investments. The so-called mainstream Islamic banking and finance is a sham, targeted at high-networth individuals and corporates, against true Islamic ideals and spirits, a poor attempt to disguise conventional products in Islamic garb and no wonder, is getting popular in UK, USA, Germany, France and elsewhere in the developed world. What Indian Muslims need is provision of finance and other inputs for micro-enterprise and livelihood development.[27]

It is argued that the overall goal of this system is to realise the objectives of Islamic law which should manifest in the economy as enabling growth, justice, and equity. This implies that other than fulfilling the legal requirements, an Islamic financial system should also cater to the social needs of the society. In doing so, the legalistic forms of contracts are fulfilled but the substance and spirit are not. [28]

1. Islamic Finance Should be Profit Loss Sharing

A number of economists backed by some Sharī'ah scholars hold the opinion that Islamic finance should be based on profit loss sharing and avoid possible debt-based instruments. It has been argued that if Islamic finance transactions are based on debt-based products, then they are not different from products offered by conventional banks. It is also upheld that the use of debt-based instruments created a suspicion amongst unconvinced Muslims as they did not see any difference between Islamic and conventional finance since the net result of both systems are almost the same.[29] Critics also emphasised that the distinguishing features of Islamic finance from its conventional counterpart are entrenched in its vision to move away from debt-based financial intermediary to an equity based and risk-sharing arrangement. In other words, an ideal Islamic financial system is reflected through its balance sheet

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[27] Ahmed, Habib. 2011. *Product Development in Islamic Banks*. Edinburgh: Edinburgh University Press.

[28] Ibid

[29] See, Asyraf Wajdi Dusuki, "The Ideal of Islamic Banking Chasing a Mirage", Paper presented in INCEIF Islamic Banking and Finance Educational Colloquium, Bank Negara Malaysia. Kuala Lumpur, 3rd-5th April 2006, p.1.

structure that is dominated by profit-loss-sharing on both assets and liabilities.[30] Thus, the bulk of financing by Islamic banks has to be equity oriented.[31] Islamic finance in its purest form should be based on *mushārakah* and *muḍārabah*. An Islamic bank is conceived as a financial intermediary mobilising savings from the public on a *muḍārabah* basis and advancing capital on a partnership basis.[32] Unfortunately, according to the proponents, Islamic financial institutions deviated in practice from the two-tiered profit and loss sharing system. Most funds on the deposit side are raised on the basis of a *muḍārabah* contract or deposits made on a loan basis and guaranteed by the Islamic banks. On the asset side, however, profit and loss sharing instruments are rarely employed. Instead, a variety of debt or quasi-debt financing modes are used.[33] It is also upheld that Islamic financing should be on the basis of partnership as it is the best method that incorporates fair distribution of wealth among the people and guides the excess of money from the rich to the general public while the expansion in the use of debt-based instruments will narrow the scope of partnership operations and encourages the usurious mentality, which aims at profit seeking without bearing any risk and this will not bring about any genuine change in the current prevalent capitalistic system."[34] Some have gone even further and considered Islamic products such as *murābaḥah*, deferred payment sale, *bay' al salam, bay' al- istiṣnāʿ, ijārah* and other debt-based instruments as an exception and maintained that these modes of financing cannot be expected either to remove the injustices of the interest-based system or to contribute to the achievement of socio-economic objectives which Islam seeks to achieve."[35] Moreover, these modes of financing are regarded immoral since they operate in a similar fashion as the conventional products.[36] Some have gone to the extreme by suggesting that *"Bai' mu'ajjal* is removed from the list of permissible methods altogether" because even if we accept its permissibility from a legal perspective, we have the overriding legal maxim that anything leading to something prohibited stands prohibited and

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[30] Ibid

[31]Shahid Hasan Siddiqui "Islamic Banking: True Modes of Financing" New Horizon, 2001, pp 15-20. ;, Siddiqui, Shahid Hasan "Islamic Banking: True Modes of Financing" Journal of Islamic Banking & Finance 19(1), Jan-March 2002: p.11-24

[32] M Kabir Hassan and Mervyn K. Lewis, "End and Means in Islamic Finance" *Review of Islamic Economics*, Vol.11, Special Issue, 2007

[33] Ibid.

[34] Taqi Usmani "Ahkam Al Tawarruq wa Tatbiqatuhu al-Masrafiya" paper submitted to the nineteen session of the Islamic Fiqh Academy, United Arab Emirates.

[35] Shahid Hasan Siddiqui "Islamic Banking: True Modes of Financing" New Horizon, 2001, pp 15-20. ;, Siddiqui, Shahid Hasan "Islamic Banking: True Modes of Financing" Journal of Islamic Banking & Finance 19(1), Jan-March 2002: p.11-24.

[36] Asyraf Wajdi Dusuki, "The Ideal of Islamic Banking Chasing a Mirage", Paper presented in INCEIF Islamic Banking and Finance Educational Colloquium, Bank Negara Malaysia. Kuala Lumpur, 3rd-5th April 2006, p.

therefore, it will be advisable to apply this maxim to *al bay' al mu'ajjal* in order to save interest-free banking from being sabotaged from within."[37]

2. Debt-Based Products are Temporary

To justify the continued existence of debt-based instruments in the Islamic finance industry and their approval by Sharī'ah scholars, the critics contend these contracts have been currently approved by scholars on temporary basis. It has been argued that Fiqh academies and Sharī'ah boards of Islamic financial institutions approved the permissibility of these products in consideration of the conditions that faced Islamic financial institutions at their inception and the dominance of interest based transactions and the difficulty of conducting financing activities purely on the basis of *mushārakah* and *muḍārabah* debt-based instruments are allowed to avoid clear and explicit *ribā*.[38] Thus, it has been pointed out that:

> "Undoubtedly, Sharī'ah supervisory boards, academic councils, and legal seminars have given permission to Islamic banks to carry out certain operations that more closely resemble stratagems than actual transactions. Such permission, however, was granted in order to facilitate, under difficult circumstances, the figurative turning of the wheels for those institutions when they were few in number". Once the normal question will be how to approve a number *Ṣukūk* structures based on the assumption that they could be made more Sharī'ah compliant once the market had grown[39].

3. Islamic Finance *Maqāsid* and Social Responsibility

Another criticism to the current practice of Islamic finance is labelled as a tension between Islamic finance and Islamic economics. Islamic debt financing does not support, nor is it supported by the normative assumptions of Islamic economics. The current pragmatic approach according to the critics has opted for a more profitable Islamic financing such as *murābaḥah* at the expense of *mushārakah* and as a result the Islamic finance industry has deviated from the aspirational stand of Islamic economics. Thus, according to the proponents of this view, Islamic finance should relate to the social and economic ends of financial transactions, rather than just focusing on the mechanics of the contract. Therefore, correcting the failure of

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[37] Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking*. Leicester: Islamic Foundation, p.139.
[38] Taqi Usmani "Ahkam Al Tawarruq wa Tatbiqatuhu al-Masrafiya" paper submitted to the nineteen session of the Islamic Fiqh Academy, United Arab Emirates.
[39] Usmani, Muhammad Taqi, "*Ṣukūk* and their contemporary applications, pp.1-16. Kuwait Times, "*Ṣukūk* Market in Compliance Row" January 12, 2008.

Islamic finance, which has deviated from the aims of Islamic economics, would be through the introduction of robust social justice oriented principles into Islamic finance, and by restructuring and redirecting its operational strategies towards that of social banks.[40] Thus, despite the successful financial performance of the industry so far, this accomplishment has been at the expense of the 'social and economic' aspirations of Islamic moral economy.

The debate in recent years around the issue of social responsibility has been framed around phrases such as 'form vs substance' or 'Sharī'ah compliant finance vs the Islamic based finance'. Some contend that the legitimacy of the current practices in the Islamic finance industry has been brought into question. Failure of the Islamic finance industry in the social dimension resulted in a convergence between the Islamic and conventional systems. Thus, it has been concluded that considering the fact that some products in the conventional system are responsible for its failure, the fear of their impact on the Islamic finance industry is important to consider.

Critics also stressed that an Islamic economic system is equity or profit-and-loss sharing financing based and superior to debt-like financial instruments. Therefore, having Islamic financial institutions involved in more debt-like financing is an indication that Islamic financial institutions have deviated from their aspirational origins. Islamic financial institutions have opted for profitability and efficiency over equity and value propositions of the Islamic Moral Economy and this is evidenced by the lack of Corporate Social Responsibility initiatives in the Islamic financial system.[41] These critics stressed that the contribution of Islamic financial institutions to economic development is elusive, as these institutions preferred to opt for short-term financing which brings a much higher return.[42]

Critics maintain that "the legalistic-rational method applied by the Shari'ah scholars should be considered as an important part of this observed social failure, which by definition ignores the 'substance' by prioritizing the 'form'" and can lead to unethical practice as it ignores the broader issues related to moral teachings of

[40] Asutay, M. "Conceptualization of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus." *IIUM Journal of Economics and Management* 15, no. 2 (2007). & Abdul Rahim Abdul Rahman "ISLAMIC BANKING AND FINANCE: BETWEEN IDEALSAND REALITIES" IIUM Journal of Economics and Management 15, no. 2 (2007).

[41] Mehmet Asutay, "Conceptualizing and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance", *Asian and African Area Studies*, 11 (2): 93-113, 2012.

[42] Ibid

Islam.[43]. More drastically, some have gone to the extent of considering the failure in human development in countries where Islamic finance is practiced to be a testimony of the failure of Islamic finance. Thus, it have been upheld that when examining the Human Development Index as well as other social indices, it is clear that the ranking of these countries is very low.[44]

4. Need for a New Classification of Sharī'ah Compliance

Another issue highlighted by the critics of Islamic finance and the claim that it is not fulfilling *maqāṣid* Sharī'ah is the proposition to differentiate between "Sharī'ah-compliant" and "Sharī'ah-based Islamic products". Although there is an acknowledgement from the advocates of this classification that there are no clear definitions as to what these terms entail or the fact that some scholars did not see difference among these terms. However, proponents maintain that there is still a need to distinguish between different nuances of Islamic finance in terms of legal and social Sharī'ah requirements.[45] Elaborating on this classification, three type of products have been identified: "pseudo-Islamic product", "Sharī'ah-compliant Products" and "Sharī'ah-based Products".

1. A pseudo-Islamic product conforms to the legal form only but does not fulfil the substance of the Sharī'ah or serve the social needs. It is the outcome of using stratagems to develop products that fulfil the legal form of the contracts, but in substance represent an illegal transaction. It is worth noting that according to the proponents of this classification in certain cases when no Sharī'ah-compliant alternatives are available to serve a pressing need; the maxim of necessity can be invoked. Under such situations, the prohibitions can be relaxed to satisfy the dire need. However, once the need ceases to exist or alternatives are available, the lawful ruling due to necessity becomes void. Thus, it has been stressed that using a *tawarruq* when other Sharī'ah-compliant alternatives are not available may be legitimate. However, using *tawwaruq* when Sharī'ah-compliant alternatives are available would make it a pseudo-Islamic product.

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[43]Habib Ahmed, "Defining Ethics in Islamic Finance: Looking Beyond Legality" Paper presented at 8th International Conference on Islamic Economics and Finance , Center for Islamic Economics and Finance, Qatar Faculty of Islamic Studies, Qatar Foundation

[44] See, Mehmet Asutay, "Searching for Ethics in Islamic Finance: Islamic Moral Economy Foundations, Islamic Finance & Ethics Society" presentation at the School of Oriental and African Studies (SOAS) 20th March 2014, www.the-ifes.org.

[45] Habib Ahmed 2011. *Product Development in Islamic Banks*. Edinburgh: Edinburgh University Press

2. Sharīʿah-compliant Products: Sharīʿah-compliant products would satisfy the form and substance of Islamic law, but did not pay attention to the social goals. Specifically, a Sharīʿah-compliant product will not meet the survival and security financial needs of the poor and that of small enterprises adequately. An example mooted by the critics is that of a mutual fund that sets very high minimum investment requirements targeting only the affluent segment of the society. Such a fund would be Sharīʿah-compliant but does not meet its social goals as it does not serve the middle class and poorer sections of the population.
3. Sharīʿah-based Products: A Sharīʿah-based product is a Sharīʿah-compliant product that fulfils the legitimate needs of all market segments. Such a product will not only satisfy the form and substance of Islamic law, it will also satisfy the survival and security needs of all sections of the population including the poor and small entrepreneurs. Thus, a Sharīʿah-based product is a Sharīʿah-compliant product that fulfils the social goals. For instance, a home financing product that targets all segments of the population, including the poor, would be Sharīʿah-based.[46]

It is maintained that fulfilling the social goals of Sharīʿah would firstly entail serving the financial needs of all market segments in general and the poor in particular. These social responsibilities can be ascertained by examining the extent to which the various financial needs of different groups in a society are satisfied. New terminologies such as survival, security, and growth have been invoked in replacement of widely used terminologies in classical Islamic jurisprudence such as necessities (*daruriyyat*) ,complementary (*hajiyyat*), and luxury (*tahsiniyyat*). Thus, survival needs would rank higher than serving the security needs which in turn will rank higher than the growth needs.[47]

Comments and Recommendations

Based on the discussion and issues raised above, it might be observed that the debate over *maqāṣid al* Sharīʿah and Islamic finance needs to take into consideration the following:

1. The concept and principles of *maqāṣid al*-Sharīʿah have a different scope and understanding when discussed in relation to the implementation of the

[46] Habib Ahmed "Maqasid al- Shariah and Islamic Financial Products: A Framework for Assessment" ISRA International Journal of Islamic Finance, Vol. 3, Issue 1, 2011, pp. 149-160.
[47] Ibid , pp.163-164.

entire principles of Sharī'ah or just with regards to the application of Islamic economic principles. This scope of differences would be much wider if it is extended to the implementation of Islamic finance. Any confusion in this area could create greater misunderstanding rather than resolving unsettled issues. The widely held definition of *Maqāsid al*-Sharī'ah is that it aims in safeguarding faith (*dīn*), self (*nafs*), intellect ('*aql*), posterity (*nasl*), and wealth (*māl*). However, it is also recognised that while these five may be considered as the primary objectives of Sharī'ah, other equally important purposes can serve as pre-conditions and upshot of the major or primary objectives. These auxiliary objectives could include among others principles such as justice and equal treatment, security of life, individual freedom, education, minimisation of crime and others.[48] If these are the objectives of the Sharī'ah as a complete system of life, Islamic economics has its objectives which are much narrower than the above. Although there is no single understanding of the objectives of Islamic economic concepts such as *falāḥ* has been selected as the fundamental objective of an Islamic economics. Chapra as one of the leading Muslim economists highlighted four Sharī'ah frameworks as *Maqāṣid* or goals of Islamic economics. The four are to achieve the economic well-being within the framework of the moral norms of Islam, to uphold universal brotherhood and justice, to attain equitable distribution of income and to accomplish freedom of the individual within the context of economics emerged since the prophetic period from the social welfare.[49] The main objective of Islamic economics are to establish social justice, elimination of poverty, tangible reduction in economic disparities, free of corrupt society, institutionalisation of *zakāh*, interest free system, and moral and ethical instruments of Islamic teachings.[50] The primary objective of Islamic finance is to free Muslims and non-Muslims alike from non-permissible financial arrangements and their associated negative consequences. These non-permissible elements could include among others explicit, *ribā*, *gharar*, gambling, dealing in non-permissible goods and services as well as other non-permissible activities in whatever forms and structure they are presented. These are some of the major principles that Islamic finance stands for.

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[48] Chapra, *The Future of Economics: An Islamic Perspectives*, (Leicester: The Islamic Foundation), 2000

[49] Chapra, *Objectives of The Islamic Economic Order*. The Islamic Foundation, Leicester, 1979.

[50] See, Mehmet Asutay, "Searching for Ethics in Islamic Finance: Islamic Moral Economy Foundations, Islamic Finance & Ethics Society" presentation at the School of Oriental and African Studies (SOAS) 20th March 2014, www.the-ifes.org.

2. Islamic finance is a Sharī'ah compliant or based system and not just a profit loss sharing industry. Therefore, there is no limitation to innovation and creativity as long as there are no clear infringements of Islamic principles. Thus, using *muḍārabah, mushārakah* and *wakālah* instead of sale and *ijārah* in a specific transaction has the same preference as *maqāṣid al* Sharī'ah and the industry has to choose what best fulfils its objectives. It is based on such an understanding that some of the scholars who are calling for greater use of profit loss sharing instruments acknowledge that:

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable. Debt does not, however, get created in a truly Islamic financial system through direct lending and borrowing but rather through the sale or lease of real assets via the sales- and lease-based modes of financing (*murābaḥah, ijārah, salam, istiṣnā'* and *ṣukūk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his ability to make the payment later. The conditions, however, are that the asset which is being sold or leased must be real and not imaginary and that the transaction must be a genuine trade transaction with the full intention of giving and taking delivery. In the case of such sales or leases, the rate of return gets stipulated in advance and becomes a part of the deferred payment price. Since the debt is associated with real goods or services and the rate of return is fixed in advance, it will be less risky and, therefore, more attractive for banks, as compared with equity and PLS financing.[51]

1. There is no explicit text from the Qur'ān or the *Sunnah* that prioritise profit sharing products over debt-based instruments. The position of some early scholars in the early days of the emergence of the idea of modern Islamic economics or Islamic finance that give preference to profit loss sharing products is just an *ijtihād* and has nothing to do with *maqāṣid al*-Sharī'ah and therefore, these early opinions have no binding effects. On the contrary, these positions need to be revised and adjusted.
2. Indebtedness is by itself a valid Sharī'ah objective in financial transactions. It is so, as Ibn Ashur explained that the prohibition of *ribā* should not be considered to cover and reject all legitimate indebtedness. It is one of the great means of business expansion as a good entrepreneur may not have the capital he needs and therefore, he has to resort to indebtedness to develop

[51] Chapra, M. Umer, "Innovation and Authenticity in Islamic Finance", a keynote Forum lecture delivered at the inaugural session of the Eighth Harvard University Forum on Islamic Finance held on 19-20 April 2008 in the Harvard Law School.

his skills in business, industrial activities, and agriculture.[52] It is also worth noting that the indebtedness we are referring to here does not include indebtedness that is trigged by a drive towards over spending on luxury and extravagance which is definitely discouraged by the Sharīʿah.

3. If Islamic debt-based instruments are permissible, then this permissibility should not be limited to a certain time and conditions and if the opposite is true, then, it should be rejected from day one.
4. Eradicating poverty and other social responsibilities are the objectives of an Islamic economy and not the primary aim of an Islamic financial system. Yet, Islamic finance can contribute towards that objective but its role will be secondary. More importantly, poverty will not be eradicated and social justice will not prevail unless Islamic economic principles are fully implemented and the principles and values of Islam are realised. Expecting Islamic finance to eradicate poverty under the current conditions is unfair and might be based on a misunderstanding of *maqāṣid al*-Sharīʿah.
3. Any attempt to create two different methodologies with regards to Sharīʿah compliance one for Sharīʿah scholars and another one for economists will not help in moving forward but could be the source of futile and unnecessary debate and discussion that would only create confusion among ordinary persons.
4. The notion of *maqāṣid al*-Sharīʿah is primary a juristic concept and therefore, is better understood by *Shariah* scholars. However, this does not deny the fact that it has its economic dimensions and therefore, a close cooperation between *Shariah* scholars, economist and financiers is a must and any attempt to discuss the issue of *maqāṣid al*-Sharīʿah by one group in isolation of the others will be counterproductive.
5. Despite the criticism of the methodology of Islamising and adopting some existing conventional products, it is by no means a sign of weakness in Islamic law and finance but a testimony of its strength, flexibility, and adaptability. It is a methodology that existed since the early days of Islamic law and will continue. Even if contracts such as *muḍārabah* and *mushārakah* are considered to be the preferred products of Islamic finance these are not products of Islamic jurisprudence but adopted from early practices from the pre-Islamic era after being refined and scrutinised. This was the methodology adopted by the Prophet (PBUH) in approving the *salam* contract. The same needs to be followed.

[52] See Mohammad Al Habib Bin Khojah, *Bayna Ilamy Usul Al Fiqh Wa al Maqasid*, Ministry of Awqaf State of Qatar, Vol. 2. p.445

6. Although it is acknowledged by the critics that some scholars did not see any difference between Sharīʿah-compliant and Sharīʿah-based products, it should emphasised that if products are classified based on Sharīʿah rulings of permissible and non-permissible, it is believed that a consensus could be easily obtained among Sharīʿah scholars that a product that is permissible and Sharīʿah -compliant should also be Sharīʿah-based. Sharīʿah principles will not declare a product or a contract to be permissible if it is against its objectives and *maqāṣid*. If a product is in substance illegal, how can it be accepted in cases of dire need? Perhaps what is intended by the critics is dire necessity. However, if it is true that what is meant here is dire necessity, then, necessity will be a ground for easiness not only with regards to these types of contracts but even the explicitly prohibited contracts.
7. Although new classifications of Sharīʿah compliance such as Sharīʿah-based products, Sharīʿah-compliant products and pseudo Islamic products or the classification of Sharīʿah compliant-products by form and others by substance are advocated by some, a clear scrutiny of Islamic jurisprudence would not accommodate such classifications. A product is either Sharīʿah-compliant or not and there is no possibility of having a product which is half Sharīʿah-compliant. Preference of one product over the other due to specific circumstances has never been an issue of permissibility. As such, some of these classifications are creating confusions rather than solving outstanding issues.
8. Claiming that financial products that set very high minimum investment requirements as non- Sharīʿah-compliant because it is targeting the affluent segment of the society only and not serving the middle class and poorer segments may not be easily accepted by any Sharīʿah scholar. It is possible to say that it is not the ideal structure for an Islamic fund but declaring it not Sharīʿah-based is unwarranted.
9. Criticisms against specific products should not be generalised as non-compliance or failure of the entire Islamic finance industry. Unfortunately, some of the critics' conclusions have been drawn based on the rejection of certain products by some Sharīʿah scholars or intuitions and concluded that Islamic finance has failed to abide by Sharīʿah principles. Thus, it is upheld that the rejection of some products such as "total return swap", "*bayʿal-ʿīnah*" or even "*tawwaruq*" will not condone the unwarranted conclusion that contemporary Islamic finance does not fulfil *maqāṣid al*-Sharīʿah. Moreover, the rejection of these contracts by scholars is based on the contractual jurisprudential methodology criticised by those who consider it one of the reasons for the deviation of current Islamic finance.

10. The claim that by using debt-based instruments Islamic finance is just another version of the interest based financial system is lacking the minimum evidence to support it given the fact that the difference between the current Islamic financial system and the conventional are obvious and cannot be denied. Islamic finance is not about trading debt at discount or through Credit Default Swap (CDS), nor is it about gambling and speculation through derivatives or short selling and other type of products not permissible in Islamic finance and considered to be the main reasons behind the recent and financial and economic crisis. It is because of these differences that the Islamic finance industry has been less affected by the crisis compared to its conventional counterpart. It is also because of these differences that the two systems are regulated differently, preferred by growing customers and forcing conventional financial institutions to convert into Islamic or as least have Islamic windows. In short, Islamic finance is about prohibiting and avoiding *ribā*, *gharar*, and *maysir* which are the pillars of the conventional financial system.
11. The differences between products such as *murābaḥah, ijārah,* and *tawarruq* on one side and a loan with interest on the other from a Sharī'ah perspective are obvious and explained in details by Sharī'ah scholars. It is beyond the scope of this paper to repeat what is widely considered to be common knowledge. Even from an economic perspective as Chapra explained, the predetermined rate of return on sales and lease-based modes of financing may make it appear like interest-based instruments. It is, however, not so because of significant differences between the two for a number of reasons. First, the sales and lease-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real assets. Secondly, the Sharī'ah 'ah has imposed a number of conditions for the validity of these transactions such as the condition that the seller (or lessor) must also share a part of the risk to be able to get a share in the return. Thus, the seller or lessor is required to own and possess the goods being sold or leased. When the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. All speculative short sales, therefore, are ruled out automatically. Financing extended through Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets. Thirdly, the price of the good or service sold, and not the rate of interest that is stipulated in the case of sales or lease-based modes of finance. Once the price has been

set, it cannot be altered, even if there is a delay in payment due to unforeseen circumstances.[53]

12. One of the distinctive feature of Islamic finance is that it is an entrenched system into the real domain of the economy. Actual involvement and transfers of the real good in the relevant transactions is strongly required as an essential condition. Thus, *murābaḥah* for instance, is legitimised because it is neither monetary, nor nominal transaction, but is a transaction based on the actual buying and selling of goods. The source of legitimacy of profit in *murābaḥah* is considered to be an opportunity cost of the real goods in the relevant market. In contrast, the source of prohibition of interest in conventional interest-based loans is regarded as an opportunity cost of the monetary good. Thus, any profits in debt-based instruments are legitimised because all the relevant parties appropriately bear the market risk of the relevant real good.
13. Although some advocate the adoption of community banking, microfinance, socially responsible investment, and similar financial arrangements to replace the existing model of Islamic banking, the fact is that such ideas are always welcome and strongly recommended if the objective is to enhance and complement the existing model. However, no one could claim that the existing model is against *maqāṣid al*-Sharīʿah and therefore we need to adopt a new one close to it.
14. Although some criticise Islamic finance and its social role in relation to *maqāṣid al*-Sharīʿah, it is worth noting that it is also acknowledged even by the proponents of this opinion that:

    "While Islamic economists and scholars assert the inclusion of *maqāṣid* and social goals in the operation of Islamic financial institutions, there are no specific discussions on how this can be done at the operational level[54]
15. The practical way towards the expansion of the use of profit loss sharing instruments will be by shifting the focus towards minimising and mitigating the risks involved in these products rather than calling for the Islamic finance industry to be based on these products. This is based on the fact that the limited use of profit and loss sharing products can be explained through different reasons and grounds such as their inherent vulnerability to agency

[53] Chapra, M. Umer, "Innovation and Authenticity in Islamic Finance", a keynote Forum lecture delivered at the inaugural session of the Eighth Harvard University Forum on Islamic Finance held on 19-20 April 2008 in the Harvard Law School

[54] Habib Ahmed , *Maqāṣid al*-Sharīʿah and Islamic Financial Products: A Framework for Assessment" ISRA International Journal of Islamic Finance, Vol. 3, Issue 1, 2011, pp. 149-160p.163

problems, the requirement of well-defined property rights for an efficient functioning of such products which is unfortunately not available in most Muslim countries where property rights are not properly defined or protected or the fact that Islamic banks and investment companies are forced to offer less risky modes of financing particularly debt-based financing products in order to remain competitive compared to their conventional counterpart. Moreover, profit sharing products are less attractive as to the restrictive role of investors in management makes them non-participatory in nature and allows a sleeping partnership or the fact that equity financing may not be suitable for funding short-term projects due to the high degree of risk which forces Islamic financial institutions to rely on debt-based products to ensure a certain degree of liquidity. Furthermore, Islamic financial institutions lack the necessary liquidity management tools available to conventional institutions including the facility of lender of last resort due to their avoidance of *ribā*. Finally, the unfair treatment in taxation is also considered a major obstacle in the use of profit sharing products and makes them less reliable as a tool for reward sharing. [55]

16. Given the above impediments in the implementation of profit sharing products, it is clear that the avoidance of equity financing in contemporary Islamic finance is not an indication that Islamic financial institutions are not interested in economic development and social welfare as claimed, but due to genuine hurdles that require Islamic economists to double their efforts to find solutions to such obstacles. Mitigating the risks of profit sharing products is needed if we take into consideration that even equity financing products such as *muḍārabah* and *mushārakah* as they have been heavily criticised by some Muslim economists on the grounds that they have failed in internalising socio-economic justice and the value of work or the claim that sharing profits through them has been non participatory.[56]
17. We need to adjust to reality and think about an Islamic economic system not only based on profit loss sharing instruments but also to genuinely consider debt-based instruments as fundamental components of the system. These instruments are part of the Islamic financial system from day one and they are here to stay.

[55] See, Dar, Humayun and Presley, John. "Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances", *International Journal of Islamic Financial Services*, 2 (2), 2000 pp.1-18.
[56] Masudul Alam Choudhury, "Islamic Venture Capital A Critical Examination", Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pp. 15-27

18. Criticising both attempts of describing Islamic finance as a profit loss sharing industry or the focus only on Sharīʿah compliant debt-based mechanism some scholars stressed that both approaches are suffering from some shortcomings. The comprehensive feature of Islamic finance is the harmony and cohesion between partnership-based and debt-based instruments. Implications from the above analyses show that financial instruments in Islamic finance support the fact that all the relevant parties appropriately bear the market risk of the relevant real good or business. This is the source of legitimacy for each instrument. Considering this insight from the perspective of the economic system as a whole, it can be said that the financial system highly depends on the real domain in the Islamic economic system.[57] It is based on such findings that it has been concluded that:

    The emergence of Islamic finance opens a new page in the history of both Islam and finance. .., the comprehensive financial systems did not exist in the pre-modern Islamic world. Therefore, the current practice of Islamic finance is an unprecedented experiment in the history of Islam. On the other hand, structured banking without interest has never existed in the history of finance, too. Therefore, although Islamic finance stays on the genealogy of the ―embedded‖ universal financial system, the modern novelties of Islamic finance can be observed.

19. One can also question, how to build an Islamic economy system when corruption is rampant in Muslim countries not only at the governmental level but when it has become part of the culture of individuals. Similarly, we must ask how to build an Islamic economic system when concepts such as *zakāh* are equated with charity and when important economic notions of an Islamic economy such as *bait al mal* becomes just ideological concepts without any practical value.

20. Creating an Islamic financial system that balances between equity or profit loss sharing instruments and debt-based products would not be through the rejection of debt-based instruments but through the development of equity based investment alternatives such as venture capital, private equity, asset management and deep stock markets which all are still underdeveloped. As it is rightly articulated by the governor of the central bank of Malaysia, the concept of risk-sharing in finance is not new or peculiar to Islamic finance. Even in the conventional system and despite the fact that currently risk-transfer activities dominate the system, risk-sharing in the form of equity has

[57] Nagaoka, Shinsuke *Islamic Finance in Economic History: Marginal System or Another Universal System?* A paper presented at Second Workshop on Islamic Finance: *What Islamic Finance Does (Not) Change*. March 17th, 2010, EM Strasbourg Business School.

long been a cornerstone of capital markets with vibrant stock exchanges. Techniques used by venture capital financiers share similarities with risk-sharing contracts in Islamic finance. The development of a more equity-based financial system where risk-sharing takes place reduces over-reliance on debt funding, thus avoiding excessive debt and speculation and thus financial system fragility. In Islamic finance, this is further reinforced by Sharī'ah principles that strongly discourage excessive debt given its detrimental effects on society. The use of risk-sharing transactions and undertakings under participatory finance models in Islamic finance thus offers the potential to reinforce the links between finance and the real economy. The contractual arrangements between the financier and the entrepreneur place strong emphasis on the value creation and economic viability of the enterprise. This results in a close link between the growth of the financial sector and real sector activities in which the expansion or contraction of credit is dependent on developments in the real sector. This would provide a restraint on financial engineering and innovation, as financial transactions need to be supported by real assets, thus aligning innovation to productive economic activities. As a result, the dangers of unbridled innovation are also substantially reduced. The move to embrace the risk-sharing dimension of Islamic finance also presents new opportunities for financial management. The profit sharing and risk-sharing characteristics of Islamic financial transactions strengthen the incentives for Islamic financial institutions to undertake the appropriate due diligence on the transactions to ensure that the profits are commensurate with the risks assumed. The explicit risk-sharing element between the financier and customer instils greater discipline and responsibility, given the obligation and economic incentives created for participants to the contract to evaluate the risk profile of the product or investment proposition, the underlying trends in earnings and cash flows, and its income-producing potential. Such a process strengthens safeguards against the widespread mispricing of risks. The strong incentives for financial institutions to understand the nature and level of risk and leverage embedded in the Islamic financial instruments would in turn lead to more responsible innovation.[58]

[58] Zeti Akhtar Aziz: Islamic finance – financial stability, economic growth and development, Speech by Dr. Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Islamic Development Bank (IDB) Prize Lecture on "Islamic finance –financial stability, economic growth and development", Jeddah, 27 November 2013.

Conclusion

The paper argued that the claim that the overuse of debt-based instruments by Islamic financial institutions is not in line with *maqāṣid al*-Sharīʿah is unjustified and needs to be revised. The paper stressed that Indebtedness is by itself a valid Sharīʿah objective if it is practiced within Sharīʿah parameters and therefore, criticisms should be directed against its forms involving explicit non- Sharīʿah compliant elements and not against the concept itself. On the other hand, eradicating poverty and other social responsibilities are the objectives of the entire Islamic economic system and not the primary aim of an Islamic financial system. Moreover, Islamising and adopting some existing conventional products, is by no means a sign of weakness or mimicking but was and will continue to be part of the Islamic law methodology of product development and the evidence from the early days of Islam are overwhelming. Furthermore, it has been stressed that deficiencies in the mechanisms of implementing specific product should not be construed as deficiencies in the product itself or the industry as whole as it is claimed by some regarding *tawarruq*, *murābaḥah* and other debt based products. Therefore, it is submitted that the best way to strengthen the use of profit and loss sharing products is to innovate the best equity based investment alternatives which are still below their potential such as venture capital, private equity, asset management and to work towards deepening the stock markets which all are still underdeveloped.

At the same time, it is maintained that the continued used of some *ṣukūk* structures despite their shortcomings is contravening some important Sharīʿah contractual requirements and therefore are not in full harmony with *maqāṣid al*-Sharīʿah. To address the issue the pivotal role of the concept of 'true sale", "beneficial ownership" in *ṣukūk* structuring need urgent clarification and resolution through collective *ijtihād*. Similarly, the rights of *ṣukūk* holders at times of default and insolvency require further elucidation and clarification so that they are in line with the principles of justice and fairness in Islamic of law and its objectives.

It seems that the debate on the issue of *maqāṣid* is not a mere methodological discourse. It is the logical outcome of a lack of cooperation between Sharīʿah scholars and Muslim economists. It is a problem due to absence of a favourable political and regulatory environment. The lack of a systematic and institutionalised approach to product development is another shortcoming. This is sometimes manifested through contradicting opinions by the existing Fiqh Academies and institutions as is the case with *tawarruq* which is acceptable under AAOIFI standards while the Islamic Fiqh Academy declared it non-permissible as currently practiced by Islamic financial institutions. Perhaps the language gap is also a cause. Sharīʿah

opinions are generally expressed in Arabic while economics research is generally presented in English. The limited efforts that are currently afforded to make good translation available are not sufficient. Thus, it is strongly: opined that for a viable discussion on *maqāṣid al*-Sharī'ah a direct interaction and discussion between the different stakeholders is necessary.

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