Towards Achieving a Maqasid Shari’ah oriented Islamic Banking

Shahul Hameed bin Mohamed Ibrahim
Visiting Associate Professor
Qatar Faculty of Islamic Studies
Hamad bin Khalifa University
Doha, Qatar
mishahul@hotmail.com

Ebaad Momin
PhD Candidate,
International Centre for Education in Islamic Finance
Kuala Lumpur, Malaysia
ebaadmomin@gmail.com
Towards Achieving a Maqasid Shari’ah oriented Islamic Banking
Abstract:

Despite achieving phenomenal asset and deposit growth and extending geographical reach almost globally, Islamic Finance has failed to make a dent in achieving the objectives of its earliest proponents; equitable distribution of wealth, poverty reduction or eradication, financial inclusion and achievement of socio-economic justice. This is due to many reasons including the entrenched riba-based financial system together with its champions, the erstwhile conventional bankers and conventional lawyers spearheading its growth. There is also the lack of government and fiscal support in many Muslim jurisdictions, the continuous effort to replicate and compete with conventional product offerings to prevent deposit outflows and lack of innovation as opposed to financial re-engineering of stale products. Although Islamic Finance is a success story of technical compliance to the Shari’ah in letter, it is a failure in terms of its spirit and intended outcomes. Islamic Finance has great potential in achieving social justice by “risk sharing” financing the growth of innovation through SMEs, financing infrastructure and waqf properties, reduction in public debt, as well as financing social and charitable causes by managing Qard Hasan professionally.

In this paper we review the failures and success of Islamic finance in relation to the Maqasid al- Shari’ah, operationalize the Maqasid Shariah for Islamic banking and finance, suggest some initial steps to achieve these objectives and finally propose mechanisms to monitor the performance of Islamic financial institutions towards achieving the socio-economic objectives of the Shari’ah in Islamic finance.
I. Introduction:

The realization that an Islamic banking alternative can be developed to the then only current riba-based banking system can be seen in the writings of early 20th Century Fuqaha such as Sayyid Abu Alaa Maududi, Syed Baqir al Sadr and their disciples, the pioneer Islamic economists such as Umar Chapra, Khurshid Ahmad and Nejatullah Siddiqui. The earlier classical Fuqaha (the four imams of the Sunni school) had developed Fiqh muamalat or Islamic law of transactions derived from the Qur’an and Hadith and the discipline of Usul ul Fiqh (Islamic jurisprudence Eg. Imam al Shafii, Imam Jaafar as Sadiq, Imam al Ghazali) as well as the theory of the Maqasid al- Shari’ah (Imam Al Shatibi, Imam Al Ghazali). The 20th Century Fuqaha, through their comparative economic philosophical thoughts, wove the outlines of a contemporary Islamic economic and financial system in contemporary terminology and thought viz a viz capitalist, socialist and communist systems of the 20th century. The pioneering Islamic economists who had a secular western economics education but a strong love for Islamic teachings added to the philosophy through more detailed work on the objectives and methodology of Islamic finance through the modern terminology of Islamic finance and banking.

Nejatullah Siddiqui’s (1983) book ‘Banking without interest’ is probably the first book on Islamic banking propounding the theory of risk sharing banking compared to the interest based banking. Things began to take shape with the general demand of Islamization after the failed development experiments of Nasserite socialism and Pan Arabism, Yemeni communism and Pehlavi capitalism in the post-colonial era.

Although cooperative Islamic banks existed in Hyderabad Deccan (India) and Karachi (Pakistan) in the 1940s and 1950s, the first commercial Islamic bank was certainly the savings bank in Mit Ghamr, Egypt 1963 which was really run on the Maqasid al- Shari’ah principles until President Nasser converted it to the Nasser Social Bank. This bank actually followed on the footsteps of Lembaga Urusan dan Tabung Haji (Pilgrims Management and Fund Board) of Malaysia, which was established in 1962 and became a full statutory body in 1969 with its own Act of Parliament. Unlike the Egyptian experiment, the Malaysian pioneering Islamic financial institution was an astounding success (ironically the concept was blessed by the Grand Mufti of Egypt Sheikh Muhammad Al-Shaltout). Tabung Haji in 2013 had grown to US$7 billion in revenue and US$15 billion in deposits. Although not a commercial bank, it is an Islamic financial investment institution with retail depositors who not only save for their haj but increasingly use it as a good investment vehicle for retirement and wealth management. On the financing side, Tabung Haji has besides equity, property development, real estate, trading companies, service companies etc. However it does not provide loans or financing to its retail customers, corporates or others. It is a very good example of a real economy based Islamic financial institution.

The first modern commercial Islamic bank was the Islamic bank of Dubai established in 1975 along with the OIC’s (Organization of Islamic Co-operation) multilateral development bank, the Islamic Development Bank. Early pioneers included Abu Dhabi Islamic Bank (1976), Faisal Islamic Bank Sudan 1977, Darul Maal Al Islami (1981), Bank Islam Malaysia and Bangladesh Islamic Bank (1983). Meanwhile Sudan and Iran went steps further and by decree, converted their whole banking systems to Islamic in 1980s and 1990s along with Pakistan.

Since 1975, Islamic Banking Institutions have expanded to 75 countries globally including 45 Muslim and 30 Non-Muslim countries; these include 250 standalone Islamic Banks and 114 Islamic banking windows. The Global Islamic Finance industry has had a continuous double digit growth rate of 16.94% for the last 5 years and is approximately USD 1.9 trillion in size, with expectations for it to surpass the USD 6.5 trillion mark by 2020. The Islamic Banking sector dominates the Islamic Finance
industry with an estimated figure of USD 1.53 trillion i.e. approximately an 80% share of aggregate assets. (GIFF 2014, Sept’14).

In comparison with conventional banking which has been around since the 17th century (i.e. close to 500 years), Islamic Banking in its modern form is relatively very young and is only 39 years old. However the industry has achieved great heights and remarkable ground over these years, which are shown by the statistics above.

It can be clearly seen that in such a short period of time the industry has expanded at a remarkable pace to all corners of the globe and has received wide acceptance by both Muslims and non-Muslims alike (Iqbal and Molyneux, 2005). Although this feat is commendable in terms of keeping people away from riba, however the million dollar question still remains: Is this what Islamic Banking had set out to achieve? Or is the industry even on the right path towards its goal?

Islam harbours an economic vision that holds the key to a social order capable of providing social justice along with economic prosperity (Dusuki and Abozaid, 2007). This vision is built in the objectives of Shari’ah or Maqasid al-Shari’ah that aims at promoting welfare (jalb al-masalih) and avoiding evils (dar’a al-mafasid) (Ibn Ashur, 1945[2006]).

Islamic Finance had set out to modify or if needed, change the state of financial practices to fall in line with the principles and teachings of Shari’ah. Islamic Banking and Finance was meant to be different from its conventional counterpart not only in business practices but more importantly in the value system which drove its operations. These values were and are meant to propel the industry towards the core objectives of Shari’ah (Maqasid al-Shari’ah).

The true spirit of Maqasid al-Shari’ah entails that there is an intense commitment from both the individual and the organisation to realise justice, brotherhood and social welfare, which would eventually lead to a society where all members cooperate with each other to obtain falah (ultimate happiness). Thus in commerce or financial transactions, mere maximisation of profits or even wealth cannot be a sufficient goal for a Muslim society. The seeking of profits must be accompanied by efforts directed to ensure spiritual health and consciousness, as well as justice and fair play at all levels of human interaction. Only development of this kind would be in conformity with the Maqasid al-Shari’ah (Chapra, 2000).

Considering the above, the Islamic financial practices were intended to focus towards achieving goals such as equitable distribution of wealth, poverty reduction or eradication, financial inclusion and achievement of socio-economic justice. However over the years it is evident that the industry has opted to take a myopic view of the understanding of Shari’ah and has focussed its energies towards the legal form rather than the spirit and substance. This myopic view of only focusing on the legal form of a contract needs to be changed to one where the spirit or substance of the Shari’ah assumes more importance. Otherwise, Islamic banks are just an exercise in semantics; their functions and operations are no different from conventional banks, except in their use of euphemisms to disguise interest and circumvent the many Shari’ah prohibitions (Dusuki and Abozaid, 2007).

It can be comfortably stated that although Islamic Finance is a success story of technical compliance to the Shari’ah in letter, Islamic Finance seems to have failed in spirit. It has disappointed in achieving or even moving towards the objectives laid out by its earliest proponents in achieving maslahah or human wellbeing. Today, if one were to closely look at the industry, one is not left with a feeling of achievement over the expansion of Islamic Finance but a feeling of an Islamic Finance Industry gripped with a notion of ‘Shari’ah Compromise’ – in the sense of Shari’ah technical
compliance. Hardly a dent has been made in achieving the socio economic objectives of the Shari’ah except, perhaps, in blocking the financing of unsocial prohibited activities such as gambling and liquor industries.

The paper has been structured to proceed as follows:

In the following section, the literature on Maqasid al-Shari’ah focusing on Islamic economics and finance will be reviewed followed by the third section where we make suggestions for Islamic Banks to realign their practices in line with the Maqasid al Shari’ah. In the fourth section we briefly discuss the methodology of deriving dimensions, elements and variables from concepts, using the method by Sekaran (2013) and proceed to derive the Maqasid al-Shari’ah dimensions, elements and concepts and variables in Islamic banking. In the fifth section we offer some proposals on using Maqasid performance measurement tools, discuss the issues of obtaining data in the annual reports and propose new disclosures in annual reports to be able to measure Maqasid al-Shari’ah performance. In the sixth section we highlight the role of Shari’ah auditing in monitoring Shari’ah performance, before presenting the conclusion to the paper.

II Literature Review

Maqasid al-Shari’ah is often translated as the goals of Shari’ah, it is considered to be the set of all objectives of the Islamic Law.

According to Chapra (2000), Imam Al Ghazali states that “The objective of the Shari’ah is to promote the well-being of all mankind, which lies in safeguarding their faith (din), their human self (nafs), their intellect (aql), their posterity (nasl) and their wealth (mal). Whatever ensures the safeguard of these five serves public interest and is desirable.”

Al-Shatibi approves Al-Ghazali’s list and sequence, thereby indicating that they are the most preferable in terms of their harmony with the essence of Shari’ah. Generally, Shari’ah is predicated on benefits of the individual and of the community, and its laws are designed so as to protect these benefits, and facilitate the improvement and perfection of the condition of life on earth. This perfection corresponds to the purposes of the Hereafter. In other words, each of the worldly purposes (preservation of faith, life, posterity, intellect and wealth) is meant to serve the single religious purpose of the hereafter. (Nyazee, 2000)

Kamali (2012) adopts Abu Zahrah’s refinement of Maqasid al-Shari’ah, where he classifies the specific objectives of Shari’ah into three broad areas, namely: Tahdhib al-Fard (educating the individual), Iqamah al-‘Adl (establishing justice) and Jalb al-Maslahah (promoting welfare)

Objectives of Islamic Finance and Banking based on the Maqasid al-Shari’ah framework:

The importance of recognising ‘Maqasid al-Shari’ah - as the goal of Islamic Banking and Finance stems from the objective of Shari’ah of safeguarding wealth as stated by Imam Al Ghazali and Imam Al-Shatibi.

According to Ibn Ashur (1945[2006]), the most important objective of the Shari’ah regarding wealth is to protect the Ummah’s (Global Muslim community) wealth and make it available for their use through controlling its public as well as individual management. Most of its regulations pertain to the protection of the individual’s property as it leads to the protection of the community’s resources in aggregate. This does not mean absolute right of individual ownership but to the person or group most likely to use it wisely in the public and owner’s interest.
“It is the concern of the Shari’ah to see that its management is controlled in a way that would secure its distribution among people as far as possible and to help its growth in itself or in its considerations regardless of whether the direct beneficiaries are private individuals, groups, or sectors, large or small.” (Ibn Ashur 1945[2006])

Ibn Ashur lists several objectives (or values) of Shari’ah for any economic activity namely: circulation of wealth, security, authenticity, equity, dignity of labour and morally filtered consumption.

Siddiqi (2005, 2006) states that the Islamic Economic system has an inherent social orientation and as Islamic Banking and Finance forms an important part of this system, it needs to depict this orientation. The overall goal of the system is to realize the Maqasid al-Shari’ah which should manifest in the economy to enable growth and justice. This implies that other than fulfilling the legal requirements, an Islamic financial system should also cater to the social needs of a society. Accordingly, there is a general agreement that Maqasid should be inherent in the operations and products of Islamic financial institutions.

Lahsasna (2013) distinguishes the Islamic financial system from the conventional financial system by mentioning that it goes beyond focussing primarily on the economic growth and material returns. He states that the Islamic system according to the principles of Maqasid al-Shari’ah places equal emphasis on the ethical, moral, social and religious dimensions to ensure justice, equality and fairness for the good of society as a whole.

As seen in the first section, although Islamic Finance and banking has been expanding rapidly, its focus has shifted from the goals listed by the early proponents of Islamic Finance and Banking. It has been taken for granted that Islamic Banking is only about avoiding riba (Siddiqi, 2005). Abdul Razak (2008) state that even the concept of riba itself has been confined only to interest.

Chapra (1985) outlines the following distinctive features of Islamic banks, among others: abolition of interest, adherence to public interest, catalyst for development, promotion of economic well-being, establishment of social and economic justice, and equitable distribution of income. Also Kamel (1997) opines that unless the impact of the implementation of Islamic Banking is reflected in economic development, creation of value added factor, increased exports, less imports, job creation, rehabilitation of the incapacitated and training of capable elements, the gap between the Islamic and conventional banks would be narrower.

Thus it is clear that the objectives of Islamic Finance and Banking need to be realigned in line with the Maqasid al-Shari’ah as this is undoubtedly the ultimate objective of Islam. The practice of contemporary Islamic Finance and Banking of preference of substance over form for the mere maximization of profitability cannot be the goal. Muslim scholars, practitioners and regulators need to dwell deep into the theoretical framework underlying the objectives of Islamic Economics, finance and banking.

According to Ahmed (2011) two conditions can be identified as requirements of fulfilling Maqasid al-Shari’ah in Islamic financial transactions, the first requirement relates to the legal aspects of transactions and the second relates to the social requirement. The legal aspects would entail upholding property rights, respecting consistency of entitlements with the rights of ownership, linking transaction to real life activity, transfer of property rights in sales, prohibiting debt sale, etc. Kahf (2006) asserts that maqasid at the transactions level are achieved by fulfilling the underlying objectives of exchange envisaged in Islamic law. The second aspect of maqasid relates to the social requirement. Grais and Pellegrini (2006) state that an integrated Islamic financial system based on the principles and goals (maqasid) of the Shari’ah would entail an industry promoting social
Towards a Maqasid Shariah based Islamic Banking

benevolence by undertaking activities that foster societal objectives, such as to encourage equitable distribution of wealth, poverty reduction or eradication, financial inclusion, achievement of socio-economic justice and others.

III. Suggestions on realigning Islamic Banking practices to Maqasid al Shari’ah

In the opinion of the authors, in order for the Islamic Finance industry to achieve its true objectives, it would need to tread along the path of the Maqasid al-Shari’ah. This would entail divergence from the pure capitalist model into a socio-economic philosophy, by establishing:

1. A more equitable distribution of wealth;
2. Social and economic justice; and
3. Capacity building

1. Equitable Distribution:

This refers to the effective and broad circulation of wealth that would lead to an enhanced social paradigm. The concentration of wealth in the hands of a few in society has previously led to disastrous social and political consequences. Krugman (2004) found that free trade and globalisation are not sufficient drivers for equitable distribution as there tend to be more winners at the high end and more losers at the lower end of the income bracket. The primary source of Islamic law states:

“And what Allah restored to His Messenger (PBUH) from the people of the towns - it is for Allah and for the Messenger (PBUH) and for (his) near relatives and orphans and the (stranded) traveller - so that it will not be a perpetual distribution among the rich from among you.” (Qur’an, Chapter 59: Verse 7)

Inequality of income and wealth is increasingly becoming a global problem as it leads the wealthy to obtain power as well more profits at the expense of the poorer section of society through controlling politics to obtain supportive legislation which makes a mockery of democracy. (Stiglitz (2013), Piketty (2013)

Islamic Finance and Banking can contribute to a more equitable distribution of wealth by ensuring the availability of finance to anyone eligible and through more redistributive measures to the lesser fortunate.

1.1 Circulation of wealth through availability of funding

For effective application, it is suggested that any form of funding by an Islamic Bank would require ratification from the Maqasid filters of Daruriyyat (Essentials), Hajiyat (Necessities) and Tahsiniyat (Embellishments). They would need to be applied at each level of product development including conceptualisation and commercialization. Although this may seem to be an arduous task, however considering the level of development of an economy and the availability of funding options, it may not be very difficult to allocate funds to the appropriate sectors. For example, funding for a manufacturing unit should take precedence over consumer finance.

Islamic Finance requires allocating funding to industries and businesses that fulfil the Daruriyyat of the people first, followed by the Hajiyat and further the Tahsiniyat. Financing related to food, housing and infrastructure would take precedence over industries such as luxurious hotels, perfume manufacturing and other opulent goods.
If the funding of products that cater to Tahsiniyat cannot be avoided then the areas associated with Daruriyyat and Hajiyat can be cross-subsidized by charging higher profit rates to the former. For example, a real-estate company that builds low cost housing can be financed at a lower rate than a company which builds luxurious housing.

Islamic Banking should ensure that the funds are channelled mainly towards productive business activities. Corporate and business financing should take precedence over retail financing.

1.1.1 Equity through sector financing:

1.1.1.1 Corporate Financing

Shari’ah is concerned about the development of the economy in the country. Al Ghazali comments that the purpose of the Shari’ah is to benefit mankind. In line with this objective business activity needs to be supported.

a. Development of the Economy & Job Creation: Following the allocations listed above, projects which create employment opportunities and lead to reduction in imports and increase in exports should be financed.

b. Development of SME and Micro Enterprises: The strength of an economy lies in its SMEs, these would not only be the next generation of large companies but also employ a significant number of people and will be a source of innovation. Islamic Banks need to dedicate a portion of their resources to harness such firms.

A nation can only progress when there is inclusive growth in the economy. For this to happen, Islamic Banks need to categorize advances to the poor as a priority sector financing. This can directly be done through microfinance units within the Islamic Banks or through funding microfinance companies. This would not only improve the financial health of the poor but also create a rich culture of entrepreneurship in the society.

1.1.1.2 Retail and Consumer Financing:

Although an important and a profitable part of an Islamic Bank’s portfolio, consumer funding should be limited to purposes such as housing, healthcare and vehicle financing rather than personal advances and credit cards which may induce people to spend beyond their means.

Also Islamic Banks could finance affordable housing developments at a cross subsidized rate, setting off the differential in loss from a higher financing cost charged to high end housing projects. Similarly small car financing can be cross subsidized with financing rates applied to luxury cars.

1.1.2 Equity through Instruments

Profit and Loss sharing ensures equitable allocation of productive resources and thus is one of the key principles of Islamic Finance. The use of equity-based financing instruments can promote distributive justice by reducing the concentration of wealth and income disparities. Although debt-based financing products (with underlying contracts such as murabaha, salam and istisna) and lease-based products (with the underlying as the ijarah contract) may be necessary considering the development of Islamic Finance in the country, an Islamic Bank should move towards profit and loss sharing products like musharakah and mudarabah. This would be more in line with the Maqasid al-Shari’ah. These instruments will encourage risk sharing and lead to a number of positive outcomes.
like the reduction in debt in the economy, increasing entrepreneurship and wider distribution of wealth, to name a few.

1.2 Circulation of wealth through redistributive measures: The Shari’ah has instituted Zakat as the third ‘pillar’ of Islam. Some Islamic Banks make zakat payments on behalf of their depositors and shareholders. However besides Zakat, Islamic Banks can use the institutions of Qard Hasan (profit-free / benevolent loans) and waqf (endowments) effectively for the redistribution of wealth to sections of society which do not have the means to support themselves. This money can be channelled for religious, educational and healthcare purposes.

Islamic Banks can use part of their profit share to be donated towards a Qard Hasan fund which can be used to advance financing based on benevolent loans. Depositors and Investors can also be encouraged to part with a portion of their profit share towards contribution to the Qard Hasan fund. Similarly, entities financed should be encouraged to part with some portion of the profits generated from the ventures financed by the Islamic banks towards such a fund.

Islamic banks can use part of their profit share to be given away as a waqf endowment each year, where this money can be utilised to buy shares of the Islamic Bank. The dividend proceeds from these shares can thereafter be utilised for any purpose deemed useful for the Ummah. (Hameed, 2013)

2. Establishing Justice

One of the key areas in Maqasid al-Shari’ah is the establishment of justice. For Islamic Banks, the authors have broken down the concept into fairness in returns to the various stakeholders.

2.1. Fairness to Depositors: The depositors i.e. the investment account holders should be given a fair return on their deposits, which is commensurate to the risk taken by them. The depositors should be given a higher profit share rather than the equity shareholders as they are taking on more risk and do not have any capital gains entitlement.

2.2. Fairness to Investors: the investors or the shareholders are entitled to a fair return on their investment in the Islamic Bank. This should be in line with returns that investors can make taking a similar amount of risk for the funds invested, for example, returns offered by similar banks or other Islamic financial institutions.

2.3. Fairness to Employees: The employees of the Islamic Banks need to be fairly compensated for the efforts they contribute. This can be gauged by the salary levels in comparison with other such banks. In addition, other benefits such as allowances can be further incorporated. The working conditions of the employees, overtime, leave and other human resource issues should be dealt with more equitably.

Islamic Banks also need to address the issue of awarding large bonuses to senior bank executives while employees reel under pressure to meet the business targets imposed upon them by their management, without being compensated justly. Islamic Banks need to work on a relative parity structure which reduces the gap in the money made by the various tiers of employees.

2.4. Fairness to the Community: Community and the environment are factors which generally tend to get neglected by institutions. In line with the Maqasids, Earth has been accepted by man as amaanah (Qur’an, Chapter 33: Verse 72), thus an Islamic Bank needs to be fair to the environment on the basis of the resources it uses and paying back for these. This can be gauged by measuring the consumption of energy and other resources. In terms of giving back the community and the
environment, contributions to CSR initiatives should be considered. Islamic Banks also need to incorporate financing norms to finance companies and clauses which protect the environment rather than destroy it. They should also encourage investments in bio-diversity projects, eco-friendly power plants and environmental-friendly investments. They should avoid financing ventures such as shale gas or oil exploration which harm the environment and the Earth; which we need to hold in amanah.

3 Capacity Building:

Education has been given great importance in Islam and forms a key area of Maqasid al Shari’ah. For an Islamic Banking business, capacity building can serve as a catalyst for successful enterprise. The following are some areas in which education can be promoted:

3.1. Employee education and training expenses: A trained and educated workforce is probably the most important asset in a service industry like Islamic Banking. Their skills need to be constantly updated and enhanced.

3.2. Islamic Banking awareness: For the industry to grow sustainably, society’s awareness of the values and functionality of Islamic Finance is essential. Islamic banks can gain exposure through sponsoring seminars, conferences and workshops.

3.3 Funding: Islamic banks need to focus keenly towards funding for education, to individuals and to institutions. Provisions should be made for grants and scholarships for promising minds either internally or externally in order to promote education.

IV. Methodology of Performance Measurement:

Performance as a concept enables a firm to determine whether it has achieved its objectives. Performance yardsticks form the measurement criteria. According to Richard et al. (2009)

“Organizational performance encompasses three specific areas of firm outcomes: (a) financial performance (profits, return on assets, return on investment, etc.); (b) product market performance (sales, market share, etc.); and (c) shareholder return (total shareholder return, economic value added, etc.)”

This definition is restricted to the financial benefit to the shareholders. It does not encompass how the performance could be interpreted and measured from the perspective of its stakeholders.

Kaplan and Norton (1998) developed the approach of Balanced Scorecard using three non-financial dimensions for the assessment of performance in order to measure it in a non-financial manner. The three additional dimensions are customer perception, internal business processes, and learning & growth. Although the approach adds non-financial dimensions for the interpretation of performance, the ultimate objective is materialistic i.e. how the other dimensions can add to profits in the long run.

Over the years, ethical yardsticks have been developed to go beyond the financial measures. However, their importance remains tertiary. Although these ethical yardsticks are closest, the Maqasid al-Shari’ah perspective would go much further than the realm of ethics.
Numerous studies have tried to explore the performance of conventional banks and their end objectives. However, there are only a few studies that have ventured in studying the performance of Islamic Banks on the basis of Maqasid al-Shari‘ah, save Dusuki (2005) on corporate social responsibility (CSR), Hameed et al. (2006) proposing the ‘Islamicity Disclosure Index’, Mohamed et al. (2008) and Shaukat and Hameed (2010).

The failure to address Maqasid al-Shari‘ah as the underlying assumptions in the objectives of Islamic banks has encouraged the use of conventional financial yardsticks to measure the performance of Islamic banks. The problem with using of conventional norms to interpret the performance of Islamic banks has weak explanatory power since conventional banks and Islamic banks are very different in nature. Using conventional benchmarks would highlight only one dimension (financial) and would lead to a further widening of the ideological gap between where an Islamic Bank ought to be with respect to its wider objectives and where it currently stands. This study attempts to identify the ideal objectives of Islamic banking from the theory of Maqasid al-Shari‘ah. Considering the lack of emphasis on concepts such as justice and equity, the authors use Uma Sekaran’s method (2000, p.176-195) to operationally define these objectives of Islamic Banking into measurable elements.

**Sekaran’s Operationalization Method**

Sekaran’s method breaks down abstract notions or concepts (C) into observable characteristic behaviours termed dimensions (D). The dimensions are then further broken down into measurable behaviours referred to as elements (E). She cites the example of thirst as a concept. The behaviour of thirsty people is to drink a lot of fluid (Dimension). The degree of thirst can be measured by the number of glasses drunk by each thirsty individual (Element).

Using the method, the three (3) broad objectives of IB, namely Circulation of wealth, Establishing Justice and Capacity Building are operationally defined. Each of these objectives or concepts (C) are
then translated into broad characteristics or dimensions (D) and finally into measurable behaviours or elements (E) as shown in the table below:

<table>
<thead>
<tr>
<th>Concepts (Objectives)</th>
<th>Dimensions</th>
<th>Elements</th>
<th>Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Circulation of wealth</strong></td>
<td>Equitable allocation</td>
<td>Investment in Real Sectors</td>
<td>Investment Deposit / Total Deposit</td>
</tr>
<tr>
<td></td>
<td>Redistribution</td>
<td>Personal Income</td>
<td>Zakah / Net Income</td>
</tr>
<tr>
<td></td>
<td>Income Distribution gap</td>
<td>Non - Performing Assets</td>
<td>Total Financing / NPAs</td>
</tr>
<tr>
<td></td>
<td>Profit and Loss sharing</td>
<td>Risk sharing products</td>
<td>Financing with P&amp;L Instruments / Total Financing</td>
</tr>
<tr>
<td><strong>2. Establishing Justice</strong></td>
<td>Fair Dealings with Depositors</td>
<td>Affordability and competence</td>
<td>No of Accounts / Total Expense</td>
</tr>
<tr>
<td></td>
<td>Fair Dealings with Investors</td>
<td>Fair returns to Investors</td>
<td>Net Profit / Total Equity</td>
</tr>
<tr>
<td></td>
<td>Fair Dealings with Employees</td>
<td>Fair compensation to Employees</td>
<td>Salaries / Total Expense</td>
</tr>
<tr>
<td></td>
<td>Fair Dealings with community &amp; environment</td>
<td>Fair compensation to community &amp; environment</td>
<td>CSR Expenses / Total Expenses</td>
</tr>
<tr>
<td><strong>3. Capacity Building</strong></td>
<td>Enhancement of employee skills</td>
<td>Training</td>
<td>Training Expense / Total Expense</td>
</tr>
<tr>
<td></td>
<td>Islamic Banking Awareness</td>
<td>Research &amp; Seminars</td>
<td>Publicity Expense / Total Expense</td>
</tr>
<tr>
<td></td>
<td>Advancement in Knowledge</td>
<td>Education and Educational Inst. Financing</td>
<td>Educational Grants / Total Financing</td>
</tr>
</tbody>
</table>

From the table above, the first four ratios that follow are attributed to the first objective of the Circulation of wealth.

1. Investment Deposit / Total Deposit
2. Zakat / Net Income
3. Total Financing / NPAs (Non-Performing Assets), and
4. Financing with P&L Instruments / Total Financing

A higher ratio of Investment Deposit to Total Deposit indicates that the bank is investing a higher portion of the deposits it receives in the real economy. These include manufacturing, construction, agriculture, mining etc. which have implications to the betterment of a wider portion of the population and leads to a nation’s capital formation.

A high ratio of Total Financing to NPAs would indicate a lower level of Non-Performing Assets, whilst a lower ratio would indicate that clients are unable to pay back their obligations, consequently widening the income gap.
High Zakat to Net Income would mean that the bank is acting as conduit for movement of wealth to the poor and the needy and helping bridge the inequality gap.

The fourth ratio of Financing with P&L Instruments to Total Financing would indicate the portion of Profit and Loss sharing instruments the bank is using in its financing activities. Profit and Loss sharing or risk sharing contracts can play an important role in the circulation of wealth.

The ratios below are associated with the second objective of Establishing Justice.

1. Accounts /Expense
2. Net Profit / Total Equity
3. Salaries / Total Expense
4. CSR Expenses / Total Expense

A higher Accounts to Expense ratio would mean that the bank is managing the per-account cost well and is a sign of higher affordability and competence.

A high Net Profit to Total Equity or high Return on Equity is associated with value and wealth generation for the equity holders.

From the point of view of the employees, a larger Salaries to Total Expense ratio would entail a greater degree of fairness.

Likewise, a higher CSR Expenses to Total Expense ratio would mean that the bank contributes well towards the betterment of the society and the community it is a part of.

The last objective of Capacity Building can be ascertained by

1. Training Expense / Total Expense,
2. Publicity Expense / Total Expense, and

A larger apportionment towards the above would be indicative of the Islamic bank being serious in its efforts of increasing education levels. A high Training Expense to Total Expense ratio would mean that the bank is investing in the knowledge and skill enhancement of its workforce.

Similarly a higher Publicity Expense to Total Expense would be indicative of the bank holding research seminars, education events and creating awareness about itself and Islamic Finance.

A higher Educational Grants to Total Financing ratio would entail a high exposure of the bank in the advancement of knowledge in the society through student financing or financing to educational institutions.

Performance Measurement:

The above objectives and their representative measurement ratios can be incorporated into a performance measurement system to gauge the performance of Islamic Banks.

In this paper the authors use the weighting, aggregating and ranking processes called the Simple Additive Weighting Method (SAW) – (Hwang and Yoon, 1981). SAW is a Multiple Attribute Decision
Making (MADM) method, which has also been used by Mustafa (2008). The working of the method is as follows:

Each of the three objectives, Circulation of wealth, Establishing Justice and Capacity Building are assigned weights in relation to each other and similarly all elements under each of the above objectives are assigned weights in relation to other elements under the same objective. As per Mustafa (2008) the process of assigning weights can be done by Shari’ah experts. The total score for each bank can be obtained by multiplying the scale rating for each objective by the measurement ratio obtained for each corresponding element and, adding the total score for the products.

Thus in calculation, the evaluation of the individual Islamic Banking objectives can be computed as below, where the Performance Indicator for Objective 1 is denoted by PI (O1).

$$\text{PI(O1)} = W^1_1 \times E^1_1 \times R^1_1 + W^1_2 \times E^2_1 \times R^2_1 + W^1_3 \times E^3_1 \times R^3_1 + W^1_4 \times E^4_1 \times R^4_1$$

or

$$\text{PI(O1)} = W^1_1 (E^1_1 \times R^1_1 + E^2_1 \times R^2_1 + E^3_1 \times R^3_1 + E^4_1 \times R^4_1)$$

Where,

- **O1** - Denotes the first Shari’ah Objective – ‘Circulation of Wealth’
- **W^1_1** - is the weight assigned to the first Shari’ah Objective – ‘Circulation of Wealth’
- **E^1_1** - Denotes the weight assigned to the first element – ‘Investment in Real Sectors’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **E^2_1** - Denotes the weight assigned to the second element – ‘Personal Income’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **E^3_1** - Denotes the weight assigned to the third element – ‘Non-Performing Assets’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **E^4_1** - Denotes the weight assigned to the fourth element ‘Risk Sharing Products’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **R^1_1** - Denotes the evaluations for the performance ratio ‘Investment Deposit / Total Deposit’ corresponding to the first element – ‘Investment in Real Sectors’ of the first Shari’ah Objective ‘Circulation of Wealth’
- **R^2_1** - Denotes the evaluation for the performance ratio ‘Zakah / Net Income’ corresponding to the second element – ‘Personal Income’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **R^3_1** - Denotes the evaluation for the performance ratio ‘Total Financing /NPAs’ corresponding to the third element – ‘Non-Performing Assets’ of the first Shari’ah Objective - ‘Circulation of Wealth’
- **R^4_1** - Denotes the evaluation for the performance ratio ‘Financing with P&L Instruments / Total Financing’ corresponding to the fourth element ‘Risk Sharing Products’ of the first Shari’ah Objective - ‘Circulation of Wealth’

Similarly the Performance Indicators for the second Shari’ah Objective – ‘Establishing Justice’ PI (O2) and the third Shari’ah Objective – ‘Capacity Building’ PI (O3) can be computed. Post the calculation
of PI (O1), PI (O2) and PI (O3), a consolidated figure which is the sum of the three would constitute the total overall performance indicator for the three Shari’ah objectives for Islamic banks:

\[ MI = PI (O1) + PI (O2) + PI (O3) \]

A similar exercise can be undertaken to find the Maqasid al Shari’ah score for other competing Islamic banks in order to create a Maqasid Index.

**Challenges / Issues in Performance Measurement:**

A few earlier studies which tried to work on performance measures based on Maqasid al Shari’ah had a few setbacks due to the deficiency in disclosures on the part of the Islamic Banks. The current study has limited itself only to the Malaysian banks and discovers that a number of parameters required to calculate the above measures are not available in the bank annual reports, also the disclosure of this information is inconsistent and non-standardised. An example of this is identified where most of the Malaysian banks do not fail to highlight, even glorify, the Corporate Social Responsibility initiatives undertaken by them, but fail to mention the amount of funds actually spent.

The absence of any such effort stems from the lack of emphasis to the concept of Maqasid Al Shari’ah not only by the banks themselves and the accounting standard setting body but more importantly, from the corridors of the regulators.

The authors are of the view that a standard Maqasid al Shari’ah based disclosure format should be adopted, which would include the following:

1. **Financing Details:** The portfolio matrix of the banks financing, which can be depicted on the basis of type of Shari’ah contract (Tawarruq, Ijarah etc.), type of customer (Individual, SME etc.) and Sector (agriculture, housing, manufacturing etc.)

2. **SME and Priority Sector Lending:** Disclosures of policies and amounts spent towards micro, small and medium sized enterprises.

3. **Banks dealings with Clients:** Disclosures like provisions related to late payment, insolvency, credit restructuring etc.

4. **Prohibited Earnings:** Disclosures on the banks policy and amount of earnings and the spending of amounts from sources prohibited by Shari’ah

5. **Employee Welfare:** Disclosures on the amounts utilised towards salaries, bonuses and other perks of employees.

6. **Corporate Social Responsibility Initiatives:** Disclosures with respect to the amounts spent and the areas of fund use. These may include amounts used towards charity to help the poor, old, disabled, victims of natural disasters and any needy individual or groups. CSR initiatives may also relate to education, environment protection, healthcare and other such socially responsible ventures.

7. **Zakat:** Disclosure to the amount of Zakat and the calculations related to the same.
8. **Qard Hasan**: In case the bank operates a Qard Hasan fund, proper disclosure of the receipts and disbursements of the fund, along with the parties and purposes of the use.

9. **Charitable Funds and Waqf Management**: In case banks operate charitable funds and waqfs, there needs to be complete disclosures on the activities and the management of the funds.

This paper serves as a preliminary exercise and hopefully acts as a catalyst to further research that Shari’ah Scholars and all connected stakeholders of Islamic Banks can build on, in order to establish a more robust Maqasid al Shari’ah framework.

This framework would consist of necessary disclosures and minimum accepted practices to be followed by the Islamic Banks to ensure the industry moves towards a Maqasid-driven approach to do business. However, we are under no illusion as to the capitalist leaning that most Islamic Banks attribute to global competitiveness. Hence, a framework of this nature must be scientific in its underpinnings with measurements that are easily quantifiable, in order to extend its purpose beyond moral binding.

A business case would need to be built around Maqasid Al Shari’ah to demonstrate that adherence to Maqasid Al Shari’ah-based code is not only helpful as a welfare objective for the society as a whole, but can also be helpful commercially in terms of goodwill, brand equity, employee satisfaction and customer retention.

An approach which has worked for companies that are seen to be socially responsible is one where they are categorised as an asset class by themselves. Niche investors prefer investments in socially responsible companies, enhancing the overall value of the approach. This in itself is attractive as a motivating factor for Islamic Banks to become more involved.

A Maqasid Index can be created whereby Islamic banks can be scored on various Maqasid parameters consistently, as the ones suggested by the authors. Such an exercise could raise awareness amongst fund managers as to ‘Maqasid Compliance’, creating further choice for investors and an additional unique selling point for Islamic Banking stocks.

Another approach to get Islamic Banks to take the adherence to the Maqasid al Shari’ah with seriously would be to get the implementation enforced from domestic regulators. Regulators such as the Bank Negara Malaysia and the Securities Commission, in the interests of the stakeholders can make sure that all the Islamic Banks align their practices, disclose necessary information and adhere to the necessary requirements.

**V. Shari’ah Audit and its role in incorporation of Maqasid al Shari’ah into the Banks Operations:**

According to BNM Shari’ah Governance Framework - “Shari’ah audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for Shari’ah compliance."

Unlike conventional statutory financial audit, which requires auditors to express a true and fair view that the financial statements have been prepared according to relevant auditing standards, the Shari’ah audit covers a wider scope i.e. the compliance of the company’s operations and the management to the Shari’ah precepts.
However as seen from the above definition of BNM the industry’s focus of Shari’ah audit seems to be on legal compliance and there is no mention of the Maqasid al Shari’ah. Although legal compliance is necessary for Maqasid al Shari’ah to be achieved, the more important aspect lies in the moral responsibility.

Perhaps a better definition is given by Hameed (2009), which defines Shari’ah auditing “as the systematic process of obtaining sufficient and appropriate evidence in order to express an opinion as to the subject matter (processes, personnel, financial and non-financial performance, financial position, systems, marketing, products, transactions, contracts, etc.) corresponds to the criteria (the Shari’ah rules and principles) which is broadly accepted by the Islamic community and reporting to the stakeholders thereon.”

Shafii, Salleh and Shahwan (2010) point out that the current Shari’ah Audit framework is not effectively structured nor is it effectively tested at industry level. They argue that a more robust framework will help Islamic banks avoid Shari’ah Non-Compliance altogether. External Shari’ah Audit is expected for future implementation in the Malaysian context as it has not been a requirement previously. (The State Bank of Pakistan recently introduced External Shari’ah Audit in its 2014 Shari’ah Governance Framework). This allows for a restructuring of the Shari’ah Audit process as it seems to be at its infancy. Inclusion of a Maqasid set of criteria as proposed in this paper will prepare Islamic Banks for a more holistic compliance beneficial to all stakeholders rather than legal compliance which can be argued as the minimal requirements for compliance.

The scope of examination should include Maqasid testing that will move banks towards more balanced institutions as encouraged through the Shari’ah; institutions that benefit all stakeholders whilst contributing to socio-economic empowerment and development of society. This is particularly relevant for Islamic Banks as users of these financial reports include Zakat agencies and public organisations that extend beyond the standard group of stakeholders for conventional banks.

The Shari’ah Audit Program, Maali, Casson and Napier (2006) emphasised the need for a social component to Shari’ah Audit for Islamic Banks in order to determine their contribution to social development. Their results indicated that Islamic banks lack sufficient social disclosure, with those paying Zakat providing marginally better disclosure than those that did not. They found that Islamic Banks do not disclose activities that may attract criticism even though transparency and honesty is a requirement in the Shari’ah. Islamic banks therefore tend to avoid social issues that are in line with the Maqasid in order to construct a positive corporate image, even at the expense of true and fair disclosure. By incorporating Maqasid criteria within the Shari’ah Audit framework, a further step towards complete Shari’ah compliance will be established, achieving the goal of the preservation of society and its empowerment.

VI. Conclusion

The theoretical underpinnings of Islamic banking are established by the most sacred texts in Islamic law. These texts convey the true spirit of business, i.e. the commitment from individuals and organisations to achieve justice, brotherhood and social welfare that enable a society to achieve success and happiness in both this world and the next. Islamic Finance was structured to create an evolution in finance practice that would create a more ethical value system in conformance with the objectives of the Shari’ah or the Maqasid al Shari’ah.

The use of conventional criteria for performance measurement at Islamic Banks only focuses on the financially related aspects of practice. A more robust index is required that successfully employs Maqasid al Shari’ah, specifically measuring performance with their contribution to the circulation of
wealth, their promotion of socio-economic justice and their focus on capacity-building and education.

Sekaran’s approach can be used to incorporate these objectives and by using ratio analysis for each of the elements a more detailed Maqasid-oriented analysis can be performed. These ratios can be assigned weights in terms of their relevance to the key objectives, thereby determining a legitimate method of comparison between Islamic Banks.

Application of such analysis is not without its challenges. Necessary disclosure is required before conducting the analysis. Whilst it has been found that the information can be extracted from Islamic bank financial reporting in Malaysia, it is wrought with difficulty. The IFRS approach to financial reporting seems to intensify this problem as this method of disclosure does not effectively reflect Islamic banking operations. AAOIFI on the other hand, not free of weakness, tends to treat Maqasid requirements more effectively.

Therefore, from a policy perspective, regulators are urged to require Islamic banks to disclose required information that will allow for Maqasid measurement. Information such as funds utilised for corporate social responsibility including a Qard fund, beyond compulsory Zakat requirements as well as amounts and types of capacity-building provided, a profile matrix of financing providing in terms of product type and sector will all create a measure that can be benchmarked for contributions to social empowerment and economic development.

An effective Shari’ah Audit program that incorporates the Maqasid testing requirements will provide an external, independent measurement that stakeholders can utilise with confidence and that banks can apply for improvement and enhancements to a better and more productive society. Isn’t that what Islamic banking is all about?
VII. References:


Hameed S. (2009), Accounting and Auditing of Islamic Financial Institutions, Kuala Lumpur: International Centre for Education in Islamic Finance.


