



## ***Maqasid-al-Shari'ah* vs. Contemporary Islamic Banking and Finance: The Case of Pakistan**

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### **Abstract**

One of the cardinal issues in Islamic banking and finance is how to reconcile the objectives of Islamic moral economy and observed current reality? The skeptics argue that Islamic banking and finance is not contributing towards the universal goals of Islamic economic system and the paradigm contains similar moral hazards like conventional banking system. The study documents the underlying flaws and contradictions of the present-day Islamic banking with regard to *maqasid-al-shari'ah*. Further, the study also recommends reforms in few key areas of Islamic banking to align the goals of Islamic moral economy and contemporary Islamic banking in Pakistan.

**Keywords:** Islamic Banking, *Maqasid-al-shari'ah*, Qur'ān, *Sunnah*, Pakistan, risk

### **Background**

The Islamic economics and financial system could be termed as a socio-economic and financial paradigm that incorporates ethical and moral values like fairness, justice and equity in economic activities.<sup>1</sup> In common terms it can be referred as an economic and financial system that conforms to principles of Islamic *Shari'ah*. Al-Ghazali establishes the objectives of Islamic *Shari'ah* to protect human welfare through five key entitlements; life, religion, reason, progeny and property.<sup>2</sup> Chapra<sup>3</sup> identifies that the underlying objectives of Islamic economic and financial system is to attain positive and stable economic growth rates, full employment and equitable distribution of wealth. Nienhaus<sup>4</sup> terms Islamic economic and financial system as normative economics. Neither Qur'ān nor the *Sunnah* directly present

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<sup>1</sup>Mohammed Obaidullah, *Islamic Financial Services* (Jeddah: Islamic Economics Research Centre, 2005), 8.

<sup>2</sup>Mohammad Nejatullah Siddiqi, *Riba, Bank Interest and the Rationale of its Prohibition* (Jeddah: IDP Islamic Research and Training Institute, 2004), 20.

<sup>3</sup>Muhammad Umer Chapra, *Towards a Just Monetary System* (Leicester: The Islamic Foundation, 1985), 35.

<sup>4</sup>Volker Nienhaus, "Method and Substance of Islamic Economics: Moving Where?" *Journal of King Abdulaziz University: Islamic Economics* 26, no. 1 (2013): 177.



cause-effect economic theories or explain contemporary economic and financial relationships.

From historical viewpoint, Islamic economic system is a recent development rooted in primitive Islamic tradition, where Islamic jurisprudence (*fiqh*) is guiding principle for economic dealings. The sources of Islamic knowledge could be bisected into two major categories, primary and secondary. Primary sources include Qur'ān and *Sunnah*, while the secondary sources comprise of derived knowledge of scholars through *ijtihad* (jurisprudential research efforts), *Qiyas* (analogy) and *Ijma* (consensus) to accommodate present-day issues. The central features of Islamic economic and financial system include prohibition of *riba* (interest based activities), *gharar* (deceptive uncertainty), *maysir* (gambling) and illicit business activities.<sup>5</sup> However, many commercial financial products in existing conventional financial system have *riba* and some sort of *gharar* embedded in them. Thus existing conventional economic and financial system is against Muslim beliefs and Islamic concept of moral economy. Conversely, Islamic financial system presumes norms of *adalah* (social justice), *khilafah* (human agency) in commercial dealings to ensure compliance with the will of Allah.

## 2. Emergence of Islamic Banking and Finance

Post financial crisis of 2008-09, the critique on methodological foundations of “Neoclassical Economics” has significantly spurred.<sup>6</sup> The “Islamization of Knowledge” has emerged as key knowledge discipline around the globe. The substantial rise of Islamic Banking could be traced back to 1960’s in the Middle East. Since, the emergence of Islamic banking industry has augmented exponentially, even though it still represents small share of global financial markets. In last two decades Islamic finance industry grew at double digit growth rates and the assets of Islamic finance industry grew from USD 200 billion in 2003 to USD 1.5 trillion in 2016.<sup>7</sup> Islamic banking outperformed its conventional counterparts over the last decade by capturing more than 15% share in dozen countries in Middle East and Asia. Beck, Demirguc-Kunt and Merrouche<sup>8</sup> shows that Islamic banks have higher asset quality, better capitalization and are less likely to disintermediate in period of financial crisis as compare to their conventional counterparts. Currently, Islamic

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<sup>5</sup>The unethical businesses include alcohol, tobacco and pornography.

<sup>6</sup>Asad Zaman, “Crisis in Islamic Economics: Diagnosis and Prescriptions,” in *Islamic Economics: Theory, Policy and Social Justice*, eds. Hatem A. El-Karanshawy et al. (Doha: Qatar Foundation, 2015), 1.

<sup>7</sup>The statistics are drawn from Islamic financial services industry stability report of Islamic Financial Standard Board, Malaysia.

<sup>8</sup>Thorsten Beck, Asli Demirgüç-Kunt, and Ouarda Merrouche. “Islamic vs. Conventional Banking: Business Model, Efficiency and Stability,” *Journal of Banking and Finance* 37, no. 2 (2013): 424.



banking and finance industry is operating in 90 countries around the globe, yet the assets of Islamic finance industry are concentrated in Muslim majority countries. The portfolio of Islamic finance industry includes banking, securities (*sukuk*) and equity markets, investment funds, leasing (*ijarah*), insurance (*takaful*) and microfinance. The assets of banking and *sukuk* account for more than 90% of the total assets of Islamic finance industry.<sup>9</sup>

### 3. Current Practice of Islamic Banking and Finance and *Maqasid-al-Shari'ah*

The emergence of Islamic finance as a developing niche in global financial system in last two decades could be denominated as intellectual attempt to conform to the notion of Islamic moral economy. The contemporary enactment seeks to provide Islamic financial alternatives to conventional financial system, so Muslims can participate in present-day financial system without violating *Shari'ah* Law. Whilst, the existing Islamic banking and financial system proclaims to be *Shari'ah* compliant, there is growing body of literature that asserts the complete exercise is against the essence of Islamic moral economy. Most of the prevailing criticism recognizes that the contemporary practices of Islamic banking and finance is not contributing towards the universal goals (reduction of poverty and income inequality) of Islamic economic system. Further, the prevailing Islamic financial system also contains similar moral hazards like the conventional financial system and it is barely promoting development and welfare in Muslim countries and communities.

Nejatullah Siddiqi writes that, “The goals are God-given while the rules are man-made.”<sup>10</sup> The paradox of something conforming to the rules, yet failing to accomplish the goals is not something new in Islamic legal background. The scrupulous review of the ancient Islamic literature unveils Imam Abu Hanifa’s idea of ‘*Istihsān*’ (embracing the better option) and Imam Malik’s concept of ‘*Maslahah*’ (good cause) which manifests that it requires more than following a set of guidelines to attain the gains from Islamic economic system. The extant evidence shows that following *fiqh* rules does not necessarily ensure development of effective economic alternatives to the conventional capitalistic system.

Monzer Kahf in, “Islamic Economics, what went wrong” writes, “It seems to me that the present generation of Islamic economists is exhausted and already consumed in the activities of Islamic banking and finance that the best it can do is to

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<sup>9</sup>The statistics are drawn from Islamic financial services industry stability report of Islamic Financial Standard Board, Malaysia.

<sup>10</sup>Muhammad Nejatullah Siddiqi, “Islamic Economics: Where From, Where to?” *Journal of King Abdulaziz University: Islamic Economics* 27, no. 2 (2014): 64.



hand over the torch to a second generation that may carry deeper theoretical analysis and fill the gaps left by our generation.”<sup>11</sup>

Although, *Maqasid-al-shari'ah* aspires to promote values of ‘*Tawheed*’ (oneness of Allah), human brotherhood, equality, cooperation and sharing of Allah bestowed resources, with rapid development of Islamic banking and finance industry, the primary reliance is shifted towards ‘*fatawa*’ to gain the trust of the customers. Whereas, the contemporary practice of *fiqh* lacks creativity and depth that distinguished it in primitive Islamic period. Despite the recent zealous efforts to restore *fiqh* to its original essence, the present-day Islamic banking and finance system fails to significantly contribute towards development of just, equitable and efficient economic system.

#### 4. *Shari'ah*. Based vs. *Shari'ah*. Compliant Islamic Banking and Finance

In a world of increasing inequality Islamic economic initiative seeks to operationalize the moral values into economic and financial transactions. To build an economic and financial system with compassion, freedom and enterprise requires innovation and credibility. Moreover, the changing business needs necessitate creative thinking which may vary our understanding of the Primary sources of *Shari'ah* and our perception of *maslahah*. Nevertheless, the recent *fiqh* based strategy of Islamic banking and finance to repulse conventional financial system may not be necessarily very successful.

In common terms, *shari'ah* compliance entails that all the financial transactions must conform to Islamic law and rules. The *fiqh* rules and regulations are derived from the Qur’ān, *Sunnah* and secondary sources based on *ijtihad*, *qiyas* and *Ijma*. The contemporary examples of *shari'ah* compliant financial products include *sukuk*, *takaful* and *shari'ah* compliant stocks and mutual funds. Conversely, *shari'ah* based financial products and services (*mudaraba*, *musharka*, *ijarah* and *murabahah* etc.) originate from the time period of Prophet Muhammad (SAW). Although, the *shari'ah* compliant products should conform to the goals of Islamic moral economy, but on the other side of the coin wrong and inaccurate understanding of *fiqh* rules can lead to outcomes that disregard *maqasid-al-shari'ah*.

In modern Islamic banking and finance model each contract is approved and certified by board of *shari'ah* scholars, yet apart from few perplex speculative products (default swaps), every conventional financial product is available in Islamic financial markets. These peculiar details corroborate the perception that the business model of Islamic financial institutions may not be significantly different from

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<sup>11</sup>Monzer Kahf, “Islamic Economics, What Went Wrong,” Islamic Development Bank Roundtable on Islamic Economics: Current State of Knowledge and Development of the Discipline, Jeddah May (2004): 26.



conventional financial institutions.<sup>12</sup> The foundational difference between Islamic banking model and conventional banking is the concept of risk sharing (Joint venture Islamic Finance). Whilst, the concept of Islamic moral economy presents joint ventures as the ideal Islamic alternative to the conventional debt base financing<sup>13</sup> but the prevailing practices of Islamic banks exhibit proliferation of debt styled contracts.<sup>14</sup> Extant empirical research<sup>15</sup> has documented and criticized the contemporary practices<sup>16</sup> and recommended change.<sup>17</sup> Azmat et al.<sup>18</sup> showed that Islamic *shari'ah* compliant replica contracts crowd out original Islamic joint venture *musharaka* contracts. The primary reliance of Islamic banking and finance on these *shari'ah* compliant replicas contributes very little to the goals and objectives of Islamic moral economy. The existing state of affairs is well summed up by Muhammad Nejatullah Siddiqi, a leading figure in Islamic economics. He writes, "Those who proposed debt-creating models later on failed to see that debt-finance would lead them straight into the capitalist financial markets."<sup>19</sup>

The fundamental notion of Islamic moral economy is justice, which is attained through risk sharing. Kamali (2002)<sup>20</sup> asserts that justice is the core value of *shari'ah* and the success of any *shari'ah* application is strictly dependent upon its ability to achieve social justice. Over the centuries, scholars have highlighted the non-permissible economic transactions, which include *riba* (interest), *gharar* (excessive uncertainty), *maysir* (gambling) and *haram* (forbidden by Islamic law). The ultimate mechanism to attain compliance with above mentioned principles is to have financial system dominated by *Shari'ah* based financial products and services. As *shari'ah* based financial instruments epitomize the general guidelines of Islamic law, thus they ensure that no exploitation exists in the financial transactions.

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<sup>12</sup>Thorsten Beck, Asli Demirgüç-Kunt, and Ouarda Merrouche, "Islamic vs. Conventional Banking: Business Model, Efficiency and Stability," *Journal of Banking and Finance* 37, no. 2 (2013): 424.

<sup>13</sup>Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (The Hague: Kluwer Law International, 2002), 40.

<sup>14</sup>Muhammad Ayub, *Understanding Islamic Finance* (London: Wiley, 2007), 4.

<sup>15</sup>Beng Soon Chong and Ming-Hua Liu, "Islamic Banking: Interest-free or Interest-based?" *Pacific-Basin Finance Journal* 17, no. 1 (2009): 125.

<sup>16</sup>Mohsin S. Khan, "Islamic Interest-free Banking: A Theoretical Analysis," *Staff Papers IMF* 33, no. 1 (1986): 2.

<sup>17</sup>Saad Azmat, Michael Skully, and Kym Brown. "Can Islamic Banking ever Become Islamic?" *Pacific-Basin Finance Journal* 34 (2015): 254.

<sup>18</sup>Saad Azmat, Muhammad Naiman Jalil, Michael Skully, and Kym Brown, "Investor's Choice of *Shari'ah* Compliant 'Replicas' and Original Islamic Instruments," *Journal of Economic Behavior and Organization* 132 (2016): 5.

<sup>19</sup>Muhammad Nejatullah Siddiqi, "Islamic Economics: Where From, Where to?" *Journal of King Abdulaziz University: Islamic Economics* 27, no. 2 (2014): 66.

<sup>20</sup>Mohammad Hashim Kamali. *Freedom, Equality and Justice in Islam* (Cambridge, UK: Islamic Text Society, 2002).



Recently, the financial crisis of 2008-09 has also drawn significant attention of academics and policy makers towards the wider applications of financial system that can assist in restoring social justice and fair wealth distribution. Globally, the recent emphasize on Islamic banking and finance is primarily drawn by the fact that Islamic financial institutions market themselves on social and ethical grounds. However, the universal success of Islamic banking and finance is not attainable without offering viable products and services for the larger audience. Hence, the conundrum encountered by Islamic banks around the world is to offer products and services that *shari'ah* compliant and competitive at the same time.

Given, the emphasize on social justice, one would expect that overwhelming focus of Islamic financial institutions would be on *shari'ah* based products. Unfortunately, this is not the case and the predominant reliance of Islamic financial industry is on debt-based Islamic financing modes. Conversely, the true essence of Islamic moral economy lies in risk sharing financial system with dominance of participatory forms of financing. At its most basic, this can lead to higher economic growth, stability and allocative efficiency.

## 5. Development of Islamic Banking in Pakistan

### 5.1. Emergence of Islamic Banking Industry

Initially, Islamic banking in Pakistan could not thrive up to the expectations due to political instability, regional conflicts, foreign dominance and absence of conclusive Islamic financial paradigm. The Islamization of financial sector in Pakistan started in 1980, but the efforts to transform the financial sector on Islamic paradigm over 22 years were all in vain. After emergence of Islamic banking industry in 2001 State Bank of Pakistan (SBP) re-launched Islamic banking in Pakistan. After the revival of Islamic Banking in 2002, Islamic banking has evolved and emerged as a key player in the financial sector. The industry has exponentially increased its size in terms of assets, deposits, financing, investment, branches and customers. The total assets of Islamic banks have increased from PKR 13 billion in 2003 to PKR 1745 billion in June 2016. Meanwhile, total deposits have increased from PKR 8 billion (0.4% of total banking industry) to PKR 1461 billion (12.9% of the total banking industry). For the same period, financing and investment activities of Islamic banks has grown from PKR 10 billion to PKR 1337 billion and the total number of branches has increased from 17 to 2146.<sup>21</sup>

### 5.2. Risk Sharing

The most unique attribute that differentiates Islamic banking from conventional banking is Profit-and-loss sharing (PLS) paradigm which is rooted in

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<sup>21</sup>The statistics are drawn from different versions of State Bank of Pakistan's *Quarterly Islamic Banking Bulletins*.



Islamic concepts of *mudaraba* (profit-sharing) and *musharaka* (joint venture). Khan and Mirakhor<sup>22</sup> and Iqbal<sup>23</sup> advocate that Islamic banks can better absorb exogenous shocks as compare to the conventional banks because financial losses are partially shared by the depositors. Further, PLS paradigm permits Islamic banks to make long term financing decision based on higher risk-return profile, which also reinforces economic growth.<sup>24</sup> Moreover, the paradigm also requires the Islamic banks to show greater market discipline.

The true potential of Islamic banking as a chief contributor to economic growth is strictly dependent on the use of PLS paradigm on asset side. At the end of 2016 the financing mix of Islamic banking in Pakistan reveals that 50% of the financing is based on *mudaraba* and *musharaka* contracts. To achieve the true fruits of Islamic banking the proportion of *shari'ah* based modes of financing on asset side needs to considerably increase. However, the liability side of Meezan bank (largest Islamic bank in Pakistan) shows that 70% of the deposits are based on *mudaraba*. Moreover, these *mudaraba* deposits which are structured according to PLS paradigm are very similar to conventional deposits. These facts imply that the adoption of PLS paradigm needs to be accelerated in Islamic banking sector of Pakistan.

The statistics also unveil that Islamic banks in Pakistan are showing greater market discipline as compared to their conventional counterpart. At the end of 2016 the Non-Performing Loans (NPLs) ratio of Islamic banking stands at 4.1 as compare to 10.1 of the total banking industry. Additionally, the NPL to total financing ratio of Islamic banks is 0.6 as compare to 1.7 of the total banking industry.<sup>25</sup>

### 5.3. Entrepreneurship and SME Financing

Numerous studies have highlighted the pivotal role of entrepreneurship and small businesses in delivering innovation which drives sustainable economic growth. The significance of entrepreneurship and SME sector for economic growth is more evident in case of emerging economies, as small businesses represent major share of employment in emerging markets. A strand of literature has shown that cost of capital and access to finance are the major growth impediments for small businesses. The problem of high-cost financing is more pronounced in emerging economies because of weak institutional framework and adverse business environment. Earlier evidence shows that income inequality is more evident in economies where financing is intermediated than in a market where entrepreneurs rely on self-financing.

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<sup>22</sup>Mohsin S. Khan and Abbas Mirakhor, "Monetary Management in an Islamic Economy," *Journal of King Abdulaziz University: Islamic Economics* 6 (1994): 7.

<sup>23</sup>Zamir Iqbal, "Islamic Financial Systems," *Finance and Development* 34, no. 2 (1997): 43.

<sup>24</sup>Paul S. Mills and John R. Presley, *Islamic Finance: Theory and Practice* (London: Macmillan, 1999).

<sup>25</sup>The statistics are drawn from different versions of State Bank of Pakistan's Quarterly Islamic Banking Bulletins.



In a developing country like Pakistan, small businesses and self-employment is the mainstay of the economy. In emerging markets small businesses primarily rely on informal financing from family or friends to get around their financing needs. Over the period, commercial banks in Pakistan have failed to satisfy financing needs of small business ventures. In this regard the initiatives of Islamic banking and finance also have been sluggish. SME sector in Pakistan represents 90% of the business in the economy and also contributes 40% to domestic GDP. Anecdotal argument also asserts that small businesses are more inclined towards Islamic banking and finance due to pronounced religious sensitivity. However, there is been little realization among Islamic financial institution to serve the financing needs of this segment of the population. At the end of 2016, the financing mix of Islamic banking reveals that only 3.4% of the total Islamic financing is offered to the SME sector.<sup>26</sup> Whereas, the true essence of Islamic *shari'ah* based contracts lies in supporting investment and entrepreneurial ventures.

#### 5.4. Reduction in Poverty and Income Inequality

The paramount goal of Islamic moral economy is to use Allah-given resources to support prosperous life. The hallmark of *maqasid-al-shari'ah* is to promote justice, equality and balanced distribution of wealth, while keeping check on corruption, oppression and poverty to ensure sustainable economic growth. However, the skeptics refer that Islamic banking and finance is also moving wealth upwards like the conventional paradigm. Hence, the contemporary practices result in concentration of wealth in few hands. Theoretically, the asset base nature of Islamic finance should serve as shield to mis-utilization of financing and restrict indebtedness.

The Islamic microfinance institutions have a massive role in providing financial services to the masses, particularly to the poor. The substantial emergence of conventional microfinance industry in Pakistan can be traced back to three decades. However, the extant evidence shows that it has failed to deliver to the needs of the population. The situation of Islamic micro-finance institutions is not very different from their conventional counterparts. Around 80% of the Islamic micro financing is concentrated in three industries, including trade, services and manufacturing. On the other hand, 67% of the population lives in rural areas and around 70% of the population segment is attached with agriculture and livestock.<sup>27</sup> The sector wise breakup of the Islamic micro-financing unveils that only 2% of financing extended to these two sectors. Additionally, the cost of Islamic micro-financing is also too high for the majority of the poor population.

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<sup>26</sup>The statistics are drawn from different versions of State Bank of Pakistan's Quarterly Islamic Banking Bulletins.

<sup>27</sup>The statistics are drawn from different versions of Economic Survey of Pakistan.





## 5.5. Rural and Agricultural Financing

The importance of agriculture sector to accelerate employment and economic growth in Pakistan is unmatched. The financing needs of the rural population are largely being ignored by financial sector as well the Islamic banking and finance sector in Pakistan. The client wise breakup of Islamic financing depicts that only 0.7% of the total financing is extended towards the agricultural sector.<sup>28</sup> Though, the large unbanked rural population can serve as the locomotive of growth for the Islamic banking and finance industry. Financial intermediation through Islamic banks should not be only source of Islamic financing for the large agricultural sector as the role of microfinance Islamic institutions and government support initiatives is also very crucial.

Currently, Islamic banking industry is 15% of the total financial sector. However, to sustain phenomenal progression of the past, Islamic banking industry has to reach the door step of masses residing in rural and underdeveloped areas of the country. The region wise breakup of Islamic banking branches shows that around 78% of the Islamic banking branches are concentrated in two large provinces (Punjab and Sindh).<sup>29</sup> The large segment of population in rural areas of small provinces is largely ignored and unaware of developments in Islamic banking. To serve the *maqasid-al-shari'ah* Islamic banking sector in Pakistan needs to rapidly improve regional distribution of Islamic financing.

## 6. Conclusion

The Islamic banking industry has rapidly grown in Pakistan and it is set to be among the top players in global Islamic financial markets. However, in this study we discussed the underlying flaws and contradictions of the present-day Islamic banking with regard to *maqasid-al-shari'ah*. Our study also identified few functional areas to align the goals of Islamic moral economy and Islamic banking sector in Pakistan.

Unfortunately, despite the century long efforts, the contemporary Islamic banking paradigm does not significantly contribute towards the development of Muslim countries and communities. The prevailing situation in Pakistan is not different from Gulf and South East Asia, as the economy retains gross inequities and low level of productivity. The progression of the industry is strictly dependent upon, how it responds to the behavioral and technological challenges ahead. To formulate workable agendas, we have to closely model how PLS paradigm will flourish in an economy with weak institutional and legal framework. The monetary role of the regulator (SBP) is very critical to ensure that transformation of financial sector into Islamic banking and finance paradigm is smooth and in line with the *maqasid-al-*

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<sup>28</sup>The statistics are drawn from different versions of State Bank of Pakistan's Quarterly Islamic Banking Bulletins.

<sup>29</sup>Ibid.



*shari'ah*. The transformation process should not be executed in hasty manner as legislations seeking political points and acclaim can lead to exorbitant confusion.

### 6.1. Recommendations and Way Forward

The previous section identified key reform areas for Islamic banking and finance industry in Pakistan. In this section, we conclude our study with few more applied recommendations that can assist in more fruitful application of Islamic banking and finance in Pakistan. In our humble opinion, given recommendations will corroborate in aligning the goals of Islamic moral economy with contemporary Islamic banking and finance in Pakistan.

- Foremost, State Bank of Pakistan (SBP) in collaboration with eminent scholars should establish a dedicated forum to formulate exhaustive master plan for smooth development of Islamic banking industry in Pakistan. The focus of the research and development plan should be to embed core values of Islamic moral economy into existing banking practices in Pakistan.
- It is also recommended that the regulator, industry and academics should aggressively undertake initiatives to ensure availability of skilled human capital to lead the innovation in the industry.
- Consumer education particularly in rural areas is also a vital issue for rapid growth and development of Islamic banking in Pakistan.
- We also recommend perpetual tracking by the regulator to ensure convergence between objectives of Islamic moral economy and present-day Islamic banking. SBP should continuously monitor the impact of Islamic banking in promoting social justice and fair distribution of wealth.
- The true potential of Islamic banking resides in supporting entrepreneurial ventures for disruptive development of the economy. The policy makers should ensure that Islamic banks in Pakistan promote participatory form of Islamic finance contracts to ignite the true spirit of Islamic moral economy.
- In order to achieve the universal goals of Islamic moral economy, scholars, bankers and regulator should focus on formulating innovative universally acceptable Islamic financial products and services to promulgate the existence of Islamic finance as a suitable alternative of conventional finance.

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