MAQĀṢID AL-SHARĪʿAH AND ISLAMIC FINANCIAL PRODUCTS: A FRAMEWORK FOR ASSESSMENT

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I. INTRODUCTION

The overall aim of Islamic law is to promote welfare or benefit (*maṣlaḥah*) of mankind and prevent harm (*mafsadah*). According to al-Shāṭibī, *maṣlaḥah* is achieved by promoting the necessities/essentials (*ḍarūriyāt*), the complementary requirements (*ḥājiyyāt*) and the beautifications or embellishments (*taḥsīniyyāt*) (Hallaq, 2004). Essentials entail the basic elements of a good life, and protecting them constitutes the goals of the Sharīʿah (*maqāṣid al-Sharīʿah*). Al-Ghazālī identifies the *maqāṣid* as safeguarding the faith, self, intellect, posterity, and wealth (Chapra, 2008). Thus, the objective of Islamic commercial law would be to protect and enhance one or several of the *maqāṣid*. This is confirmed by Hallaq (2004), who maintains that contractual and commercial transactions are sanctified and encouraged in Islam as these preserve, enhance and support property and progeny.

Islamic finance is considered to be a part of an Islamic economic system which has an inherent social orientation. The overall goal of this system is to realise the *maqāṣid al-Sharīʿah* which should manifest in the economy as enabling growth and justice (Siddiqi, 2004). 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 *maqāṣid* should be inherent in the operations and products of Islamic financial institutions (Siddiqi, 2006). Dusuki and Abdullah (2007) study the implication

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of *maqāṣid* on the operations of firms and study the implications of the *maṣlaḥah* pyramid (of essentials, complementarities and embellishments) on corporate social responsibility. There is, however, no specific research that studies the ways in which *maqāṣid* can be implemented at the level of financial products. In this note, a characterisation of *maqāṣid* related to products is provided.

Contemporary practice of Islamic finance has been criticised for not fulfilling the *maqāṣid*. The debate surrounding the practice of Islamic finance has led to the distinction between Sharīʿah-compliant and Sharīʿah-based Islamic products. However, there are no clear definitions as to what these terms entail. Whereas some scholars assert that Sharīʿah-compliant and Sharīʿah-based products are the same, there is a need to distinguish between different nuances of Islamic finance in terms of legal and social Sharīʿah requirements. In this research note (note), an objective way of classifying categories of Islamic financial products is suggested. In particular, the legal and social Sharīʿah requirements implied in the *maqāṣid* are used to classify Islamic financial products as Sharīʿah-based, Sharīʿah-compliant and pseudo-Islamic. The note also identifies the role of different stakeholders in choosing the types of products.

II. *MAQĀṢID* AND SHARĪʿAH REQUIREMENTS

Two conditions can be identified as requirements of fulfilling *maqāṣid al-Sharīʿah* in Islamic financial transactions. The first Sharīʿah requirement relates to the legal aspects of transactions. Kahf (2006) asserts that *maqāṣid* at the transactions level are achieved by fulfilling the underlying objectives of exchange envisaged in Islamic law. These include 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. Furthermore, as legal maxims (*al-qawāʿid al-fiqhiyyah*) reflect the spirit of Islamic law, these can be linked to the overall goals or *maqāṣid* (Kamali, 2006). Thus, abidance with the relevant legal maxims to develop rulings related to financial products can be associated with achieving the *maqāṣid* at the transaction level. The second aspect of *maqāṣid* relates to the social requirement. Islamic finance being a component of Islamic economy would realise *maqāṣid al-Sharīʿah*. As pointed out by Grais and Pellegrini (2006), an integrated Islamic financial system based on the principles and goals (*maqāṣid*) of the Sharīʿah would entail an industry promoting social benevolence by undertaking activities that foster societal objectives. The legal and social Sharīʿah requirements related to products emanating from *maqāṣid* are outlined below.

A. Legal Requirements

Fulfilling the legal requirements entails satisfying the contractual stipulations and compliance of all necessary documents, processes and operations with the principles of Islamic law. As pointed out, fulfilling the legal requirement of *maqāṣid* would also mean fulfilling the objectives of exchange and complying with the relevant legal maxims. The legal maxim 'in contracts, attention is given to the objects and meaning, and not to the words and form' (Majallah, 2001, Article 3) provides the guiding principle of using contracts in devising financial products. Accordingly, contracts used by Islamic banks should fulfill the form and substance of the Sharīʿah. One implication of the form and substance in Islamic contractual arrangements relates to the outcome of the transaction. Products that combine different legal Islamic contracts and produce illegal outcomes in substance or violate the legal maxims will be contrary to the spirit of Sharīʿah principles. Many Islamic banking products are controversial as these use several contracts which may be separately legal, but when taken together produce outcomes that are in substance similar to prohibited transactions. As such, some Sharīʿah scholars/bodies object to products that focus on the form and ignore the substance. For example, Delorenzo (2007) views the total return swap unacceptable even though the form is Sharīʿah-compatible. Similarly, the Islamic Fiqh Academy has ruled that organised *tawwaruq* as practiced by the Islamic financial industry is not permissible as it contains elements of *ribā*.[1]

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1 The ruling was issued by the International Council of the Fiqh Academy in its 19th session which was held in Sharjah, United Arab Emirates during 26 – 30 April, 2009.

Using ruses or legal stratagems (*ḥīlah*) to produce outcomes that are unlawful in substance or that distort the legal principles would be contrary to *maqāṣid al-Sharīʿah* (Habil, 2007). Note, however, that the maxim 'hardship causes the giving of facility' (Majallah 2001, Article 17) leads to the maxim of necessity (*ḍarūrah*) stating 'necessities make forbidden things canonically harmless' (Majallah 2001, Article 21). The implication is that during hardships concession (*rukhṣah*) can be used to dilute the force of established law as an exception. Thus, the use of ruses may be permissible only when Sharīʿah-compliant solutions are not available in the feasible set.[2] However, it must be noted that exceptions made due to a certain hardship become void once the difficulty ceases to exist. This is deduced from the maxim 'a thing permitted on account of an excuse becomes unlawful on the cessation of the excuse' (Majallah, 2001, Article 23). Thus, necessities are assessed according to their intensities and permitted accordingly. Once the excuse ceases to exist, the concession related to the necessity becomes unlawful (Laldin, 2006, p.144).

B. Social Requirements

Whereas the social aspects of financial institutions can be assessed by examining their involvement in socially responsible activities, from a product perspective the social role can be determined by the market segments and the needs served. An objective way of identifying and assessing the social goals based on these two product features is provided next.

a. *Market Segment*: The market segment served by an Islamic bank will determine its social orientation. The segments can be classified according to customer type and class. Customer types can be generally distinguished as the household and the business sectors. Three categories of classes can be identified in each sector. In the household sector, the market segments can be classified according to income levels. Accordingly, the affluent,

2 Ahmed (2011) distinguishes between potential product space and feasible product set. While the former includes all possible alternative modes that can be used for a particular product, the latter represents the modes that Islamic banks can use under the institutional and organisational constraints.

middle-income group and the poor can be identified. For the business sector, Islamic banking products will first screen out the prohibited industries such as casinos, breweries, etc. Market segments in the business sector can be grouped according to size as large, medium and small/micro enterprises. Fulfilling the social goals of Sharīʿah would entail serving the financial needs of all market segments in general and the small/micro enterprises and the poor/middle-class groups in particular.

b. *Needs/Purpose*: Closely linked to the market segment, a product has to suit the financial needs of the target population. The hierarchy of financial needs indicates the purpose served of different products. There are different ways in which financial needs can be categorised. Maslow (1954) distinguishes between lower-level and higher-level needs, with people seeking to fulfill the higher needs only after the former is satisfied.[3] Harrison (1994) and Kamakura et al. (1991) provide a five-level hierarchy of financial needs: foundation products, emergency cash reserves, risk management, growth to offset inflation, and risk and tax protection. Similarly, Xiao and Anderson (1997) identify three levels of needs: survival, security and growth. As income increases, the demand for security and growth-related needs increases.

As pointed out, the hierarchy of needs from an Islamic perspective can be discussed in terms of different levels of *maṣlaḥah*. Welfare can be enhanced by promoting the necessities (*ḍarūriyāt*), the complementary requirements (*ḥājiyyāt*) and the beautifications or embellishments (*taḥsīniyyāt*). The classical categorization of needs can be transformed into three types of financial products and services in line with the classification provided by Xiao and Anderson (1997). First, the necessities would be the *survival* products that satisfy basic needs. The products included in this category would be various types of deposits (checking and savings), mortgage and financing required for essential activities/items, etc. Second, *security* or complementary products would satisfy additional needs beyond

3 Maslow's hierarchy of human needs is further classified into physiological, safety and security, love and belonging, esteem and self-actualisation (Olesan 2004).

the necessity level. These products would satisfy cash reserve and risk management needs and include insurance, pension plans, endowments and time deposits. Finally, *growth* or higher level needs will be satisfied with ameliorable products that can offset inflation and protect against risk and taxes. The products under this category would include investment in stocks, mutual funds, tax-protected bonds, financing speculative real-estate purchases, foreign travel for leisure, conspicuous consumption, etc. Note that the market segment being served will also determine the kind of needs being fulfilled. For example, whereas financing a car for a poor family can be used as a taxi and income-generating source and fall under the survival or essential category, financing a second or third car for an affluent individual would be categorised as a growth or luxury item.

The social aspects of financing are summarised in Table 1. The table shows how the needs and market segments interact to produce a matrix that can identify the range of activities that can be considered social. Across needs, providing products that fulfill survival needs (A1, B1 and C1 in Table 1) would rank higher socially than serving the security needs (A2, B2 and C2 in Table 1), which in turn will rank higher that satisfying growth needs (A3, B3 and C3 in Table 1). Similarly, the social role of an Islamic bank can be enhanced if the poor and micro-enterprises market segments can also be served along with middle-class and affluent clients. Note, however, that assessing the social role in light of the needs/segments matrix will be relative and can differ for different societies. For example, whereas fulfilling the survival and security financial needs of the poor and micro and small enterprises (A1 and A2 in Figure 1) may be considered fulfilling the social goals in some countries, in others the needs of the middle-class income group and the medium-size businesses (B1 and B2 in Figure 1) can also be included in the social realm.

Table 1: Social Requirements and Needs/ Segments Matrix

Segments *Needs*	Poor/ Micro/ Small	Middle-class/ Medium	Affluent/ Large
Survival (Necessities)	A1	B1	C1
Security (Complementary)	A2	B2	C2
Growth (Luxuries)	A3	B3	C3

Source: Author's own

III. SHARĪʿAH REQUIREMENTS AND PRODUCT CATEGORIES

Based on the legal and social Sharīʿah requirements discussed above, different categories of Islamic financial products can be identified. As discussed, the legal requirement can be deliberated in terms of form and substance and the social aspects of the product can be recognised in the role played by the bank in the market segment served and purpose/needs met. Accordingly, the following three types of products can be identified:

1. **Pseudo-Islamic Product**: A pseudo-Islamic product conforms to the legal form only but does not fulfill the substance of the Sharīʿah or serve the social needs. This will be the case when ruses (*ḥīlah*) are used to develop products that fulfill the legal form of the contracts, but in substance represent an illegal transaction. Note that in certain cases when no Sharīʿah-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 and/or alternatives are available, the lawful ruling due to necessity becomes void. Using *ḥīlah* when there are no dire needs or other alternative Sharīʿah-compliant modes can be used would result in pseudo-Islamic products. Thus, using a *tawarruq*-based product when other Sharīʿah-compliant alternatives are not available may be legitimate. However, using *tawwaruq* when Sharīʿah-compliant alternatives are available would make it a pseudo-Islamic product.

   A key question arising in situations in which the maxim of necessity is invoked is to ascertain what constitutes dire needs. One objective way to resolve the issue may be to examine the alternatives in Table 1 to decide what would constitute dire needs. For example, a narrow view may consider survival needs across all market segments as dire needs. A more liberal interpretation can also include the security needs identified in Table 1 as dire needs. Note that once Sharīʿah-compliant alternatives are added to a feasible product set or a dire need ceases to exist, the maxim of necessity will not apply. In such cases, use of ruses to come up with pseudo-Islamic alternatives will not fulfill the legal Sharīʿah requirements.

2. **Sharīʿah-compliant Products**: Sharīʿah-compliant products would satisfy the form and substance of Islamic law, but fail to pay attention to the social goals. Specifically, a Sharīʿah-compliant product will not meet the survival and security financial needs of the poor and small/micro enterprises adequately. For example, while providing mutual funds to the affluent only by setting very high minimum investment requirements would be Sharīʿah-compliant, it does not meet the 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 fulfills the legitimate needs of all market segments. Specifically, a Sharīʿah-based 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/micro entrepreneurs. Thus, a Sharīʿah-based product is a Sharīʿah-compliant one realising the social goals. For example, a home financing product that targets all segments of the population, including the poor, would be Sharīʿah-based.

The features of different categories of products are summarised in Table 2.

Table 2: Sharīʿah Requirements and Product Categories

Product Types	Legal		Social	
	Form	Substance	Market segment	Needs
Pseudo-Islamic	✓	?	?	?
Sharīʿah-compliant	✓	✓	?	?
Sharīʿah-based	✓	✓	✓	✓

Source: Author's own

IV. SHARĪʿAH REQUIREMENTS: CHOICES AND DECISIONS

The specific products developed from a feasible product set will depend on many factors. The internal dynamics of decision making related to social and legal requirements can be best understood by examining different domains of control and decision making regarding Sharīʿah requirements. As product development is a complex process involving various actors and departments of a bank, frictions can arise in determining what mode of financing to use. Tensions can appear if there are trade-offs between economics factors and Sharīʿah requirements. The ways in which the legal and social Sharīʿah requirements may be determined in an Islamic bank are discussed below.

A. Legal Requirements: Who Decides?

A product development process involves various departments of the bank providing input at different stages of the development cycle. The Sharīʿah department and Sharīʿah Supervisory Board (SSB) play a vital role in ensuring the fulfillment of legal requirements. The SSB has direct responsibility to ascertain that the product complies with the principles and values of the Sharīʿah before it is launched in the market. The choice of the appropriate mode will depend on institutional and organisational constraints under which financial institutions operate and the availability of alternatives in the feasible product set.

The objectives of banks, including Islamic ones, are to come up with products that are efficient and can generate high expected returns. Efficiency of products would imply lower risks and costs in terms of development and delivery. In some cases, however, the calculus of economic factors may conflict with the principles of the Sharīʿah. In these situations, the bank has to decide on the priorities between expected return/profit and risks on the one hand and Sharīʿah principles on the other. Too much emphasis given to economic factors can lead to choosing inferior modes of financing. This can happen if the SSB is lax and allows pseudo-Islamic alternatives even when the feasible set contains Sharīʿah-compliant products.

While the SSB has an important role in minimising the use of pseudo-Islamic products, the tension between the Sharīʿah requirements and economic interests can also be reduced significantly if there are clear directives from the top management about the Sharīʿah-related issues vis-à-vis the profitability. Ideally, in Islamic banks the norm should be that in situations where trade-off between

Sharīʿah principles and economic factors arise, the former should prevail. However, too much emphasis given to profitability and economic factors by the top management will create incentives to dilute the legal Sharīʿah requirements.

B. Social Requirements: Who Decides?

As pointed out, a bank's social performance can be established by identifying the market segments and needs that its products serve. As market/product decisions are made at the strategic levels, social responsibility of the bank and its implications at the product levels will be established at the highest levels of organisational decision making. The banks have to decide at the level of overall mission and vision whether the products will be Sharīʿah-based or Sharīʿah-compliant. As producing Sharīʿah-based products can be costlier and riskier, economic considerations may incline banks to move towards Sharīʿah-compliant or pseudo-Islamic products. The board of directors (BOD), along with the top management, determines the overall strategy of the bank, which will include market/product dimensions. Once the BOD determines the social orientation of the organisation by identifying the market/product targets in the overall strategic goals, the senior management devises the product development strategy and plans for implementation. The feasible set for each product type determines the options available to Islamic banks to realise these plans.

A related decision that the BOD has to make is to identify the preferences in the Sharīʿah goals-profitability domain. As Sharīʿah-based products may be developed and offered at some cost, there may be some trade-off between economic and Sharīʿah goals in certain cases. If profitability is the only concern, the banks may sacrifice certain social Sharīʿah requirements. For example, providing finance to the poor is socially desirable but may not make economic sense in terms of profitability. While the bank may opt out of financing this market segment by considering the economics of financing, the Sharīʿah-based approach would be to develop appropriate products that minimise the associated risks and provide the bank with a satisfactory rate of return. The BOD has to clearly demonstrate preference for Sharīʿah-based products by accepting this approach and providing the resources to develop them.

IV. CONCLUSION

This note provides a framework of assessing the implementation of the overall goals of Islamic law (*maqāṣid*) at the level of products. The *maqāṣid* imply two sets of Sharīʿah requirements, one legal and the other social. While the former is identified by fulfillment of form and substance of Islamic law at the contract level, the latter is recognised by the market segments and purpose/needs served by a product. Given these shades of Sharīʿah requirements, three types of Islamic financial products are identified. A Sharīʿah-based product is one that fulfills both the legal and social requirements. A Sharīʿah-compliant product would be one fulfilling the legal requirements, but not the social requirements. Finally, a pseudo-Islamic product is one that fulfills the form but not the substance of Islamic law.

There is a belief that the SSB should be responsible for implementing *maqāṣid* in Islamic banks.[4] This note, however, shows that there are two dimensions of *maqāṣid* relating to products. The role of the SSBs is to ensure that the *maqāṣid* is achieved at the contract level by fulfilling the form and substance of Islamic law. Among others, this would require approving Sharīʿah-compliant products and avoiding pseudo-Islamic products. Control of broader social character of banking operations in terms of product and market features lies in the hands of the BOD and senior management, not SSB. In other words, while it is the BOD who determine whether products are Sharīʿah-based or Sharīʿah-compliant, it is the responsibility of the SSB to ensure that products are not pseudo-Islamic.

4 For example, Siddiqi (2006) asserts that the SSBs should oversee the fulfillment of the overall objectives of Islamic law or *maqāṣid*.

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