

Fatwa Institution and Product Development for Islamic Finance in Pakistan

Ghazala Ghalib Khan* and Atiq-uz-Zafar**

Abstract

Pakistan, being an Islamic Republic, is constitutionally obliged to eliminate *ribā* (interest) from its economy. Thus, Islamic Finance (IF) industry was introduced as an alternate to conventional *ribā*-based system of financial intermediation. However, efforts towards innovative system of IF are not devoid of criticism. Thus, institutions offering IF, are denounced for excessive reliance on stratagems to legalize *ribā*, misuse of plurality in Islamic legal rules and gross misapplication of the principles of Islamic Law. The pivotal task of determining *sharī'ah* compatibility of products and services is realized through the institution of *fatwa*. Hence, the given scenario of industry stipulates critical appraisal of role and protocols of this very institution for product development (PD). This article argues that for consistency of Islamic financial intermediation with *sharī'ah*, the industry needs to standardize 'product development procedures' with greater focus on regulating its *fatwa* institution.

Keywords: *Fatwa*, Islamic Finance, Product Development, *Sharī'ah*, *Ribā*.

Introduction

Islamic Finance (IF), though a contemporary development in the history of finance, gained popularity due to its proclamation to present *sharī'ah*¹ compliant products and services. The industry was developed to provide an Islamic alternative to conventional *ribā* (interest)-based system of financial intermediation, for which the institution of *fatwa* (religious edict)² plays a vital role. The slogan of *ribā* -free system was exceedingly striking for both, saving surplus as well as, saving deficit sections of Muslim societies. However, this somehow innovative system of IF, across the world and more specifically in Pakistan, is not devoid of criticism by

* PhD Scholar, Lecturer, Islamic Banking & Finance Department, International Islamic University, Islamabad, Pakistan.

** PhD, Assistant Professor, Director General, International Institute of Islamic Economics (IIIE); Head, Islamic Banking & Finance Department, International Islamic University, Islamabad, Pakistan.

¹ Muslim Law (Constitution prescribed by Allah). Muhammad Rawās Qala'jī and Hāmid Sādiq Qanībī, eds., in *Mu'jam Lughat'l-Fuqahā'* [Lexicon of Islamic Juristic Terminology] s.v. "al-sharī'ah" (Beirut: Dār I Nafās, 1988).

² For formal meaning see *infra* text accompanying note 11.

Islamic legal experts, owing to its structural weaknesses,³ excessive reliance on stratagems and patchwork to legalize *ribā*, misuse of Islamic legal plurality and gross misapplication of the theories of Islamic Law.⁴ Although, Usmani has categorically refuted such criticism on factual and logical grounds,⁵ his rebuttals could not bring an end to ongoing concerns of researchers on IF and *sharī'ah* compatibility of products and services. It is worth noting here that the pivotal task of determining *sharī'ah* compatibility of products and services, from the time of their inception to their final provision to customers is achieved through the institution of *fatwa*. Therefore, the current scenario of IF industry in Pakistan necessitates critical appraisal of this vital institution of the industry, as well as its regulatory protocols as maintained by the State Bank of Pakistan (SBP).

The existing established researches regarding *sharī'ah* compatibility of products and services have highlighted some of its significant issues. However, in Pakistani context less has been deliberated upon 'product development' (PD) from its *sharī'ah* perspective; although, the literature is abundantly available in foreign contexts.⁶ The review of literature reveals that development of financial products for IF industry is deemed inevitable, however the researchers have cautioned that it should not be done at the cost of overlooking the objectives of *sharī'ah*. The IF industry needs innovative approaches for PD, nevertheless focused on attainment of objectives of *sharī'ah*; and for proper functioning it is important to establish the specialized departments for product development in Islamic Financial Institutions (IFIs).⁷ Likewise, it is stressed that the development of financial products

³ Muhammad Khaleequzzaman, Muhammad Tahir Mansoori and Abdul Rasheed, "Sharī'ah Legitimacy of Islamic Banking Practices in Pakistan-An Evaluation," *Journal of Islamic Business and Management* 6, no. 1 (2016): 77-96 (89), https://jibm.org/wp-content/uploads/2018/05/7_-Khaleeq-Sahib-Dr_-Tahir-Mansoori-Shar_ah-Legitimacy-of-Islamic-Banking-26-7-16.pdf.

⁴ Rifaqat Dār-al-Ifṭā', ed., *Murawwijah Islāmi Benkāri- Tajziyāti Mutāli'ā, Sharī Jā'iza, Fiqhī Naqd-o-Tabsirah [Contemporary Islamic Banking: An Analytical Study, Islamic Legal Analysis and Islamic Jurisprudential Critique]* (Karachi: Maktabah Bayyināt, 2008), 79; Walīd Hegazy, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets," in *Islamic Finance: Current Legal and Regulatory Issues*, ed. S. Nazim Ali (Cambridge: Harvard Law School, ILSP, Islamic Finance Project, 2005), 143.

⁵ Muhammad Taqi Usmani, *Ghair Sūdī Benkāri [Interest-Free Banking]* (Karachi: Maktabah Ma'arif al-Qura'n, 2009), 55.

⁶ Anam Iqbal, Shahzad Akhtar, and Rab Nawaz Lodhi, "Islamic Financial Product Development in the Pakistan: Shariah Analysis," *European Journal of Accounting Auditing and Finance Research* 2, no. 10 (2014): 112-121 (113), <http://www.eajournals.org/wp-content/uploads/Islamic-Financial-Product-Development-In-The-Pakistan-Shariah-Analysis.pdf>.

⁷ Shaheer Abbas, "Islamic Financial Engineering: A Critical Investigation into Product Development Process in the Islamic Financial Industry" (PhD Diss., Durham University, Durham, 2015), 292, <http://etheses.dur.ac.uk/11358/>.

within *sharī'ah* framework is necessary, however, the use of 'pseudo-*sharī'ah*' products in the pretext of economic needs of society, should be curtailed. Eventually, the adoption of peculiar risk-return patterns of Islamic financial products would be vital for a genuinely *sharī'ah* compliant industry. Moreover, there is a need to develop knowledge base as well as a paradigm shift from 'product centered approach to functional approach of innovating new Islamic banking products.'⁸ This objective is attainable only through duly qualified *muftis*, well equipped with the knowledge of Islamic Finance, who should issue their resolutions in accordance with appropriate methodology of *fatwa*.⁹ These researches establish a valid base for further research on PD in Pakistani IF industry. Moreover, most of the researches have not studied the role and regulatory framework of *fatwa* in this process.

This research has taken up the study of *fatwa* institution for the sake of PD of IF industry of Pakistan. In order to explore this area a few questions need attention. First, what are the requisite protocols of *fatwa* as determined by Islamic legal theory that may be adopted by IF? What is the role and methodology of *fatwa* in 'product development' mechanism? How legal system of Pakistan has regulated the *fatwa* procedures? What are the pitfalls of such regulations that hinder in attaining the objectives of financial intermediation that must be premised on principles of Islamic Law?

The study aims to achieve certain specific objectives, such as, to study the practices and regulatory measures for PD, in order to identify the weaknesses of *fatwa* institution in IF industry of Pakistan and to find out ways to streamline system of financial intermediation with principles of Islamic Law. Thus, the article appraises, first, the principles of *fatwa* and its methodology for novel issues like those faced by IF industry, in the light of Islamic jurisprudence; secondly the role of *fatwa* institution in IF industry, specifically its impact on PD; and finally, an analysis of the present regulatory measures for this vital institution of IF.

Fatwa Protocols in Islamic Legal Theory

In Islamic Legal tradition, the novel issues /hard cases of Muslim societies have always been resolved through the institution of *fatwa*.¹⁰ Thus,

⁸ Habib Ahmed, *Product Development in Islamic Banks*, Edinburgh Guides to Islamic Finance, ed. Rodney Wilson (Edinburgh: Edinburgh University Press, 2011), 225.

⁹ Ahcene Lahsasna, "Fatwa and Its Shariah Methodology in Islamic Finance," *Journal of Fatwa Management and Research* 2, no. 1 (2011): 133-79, <http://jfatwa.usim.edu.my/index.php/jfatwa/article/view/121/101>.

¹⁰ Ronald Dworkin, "Hard Cases," *Harvard Law Review* 88, no. 6 (1975): 1057, 1057-1109, <http://dx.doi.org/10.2307/1340249>. These are technically termed as *nawāzil* (pl.) in Islamic legal tradition. (Qala'jī and Qanībī, s.v. Al-Nāzilāh.). In English

unaddressed questions of law require legal opinions of jurisconsult (*mufti*) in the light of Islamic legal principles. Seeking *fatwa* is a formal way to get 'response'¹¹ to any question. Whereas technically it implies an edict or a formal response of a *mufti*, to any legal question, pertaining to various domains of Islamic law (rituals, financial, personal or criminal law). In legal jargon it is defined as, 'a formal and legal opinion/ruling, expounded by a Muslim jurist in response to the query of a questioner/client.'¹² Islamic legal theory has dealt with this institution in thorough details, thus defining its status, ethics and the requisite qualifications of eligible persons (*muftis*).¹³

Fatwa is deemed to have taken the status and sanctity of legislation, thus binding on the questioner. However, the authority to legislate belongs to Almighty Allah alone, or on His behalf the Prophet (SAW). However, Muslim jurists extend this delegated authority further to *mufti*, provided he is duly qualified. Al-Shātbi describes them as men of authority (*ūlu al-amr*), thus their verdicts have a binding authority just like rest of *sharī'ah* dictates coming through the word of Allah (SWT) and His Apostle (SAW) as being ordained in Qur'ān.¹⁴

The mandate to issue a *fatwa* is given only to qualified persons, who could derive the law through rules of interpretation of Islamic legal texts, that is, Qur'ān and Sunnah. Further, Islamic legal theory describes the qualifications of *mufti* in extensive details, thus requiring him to be a Muslim jurist (*mujtahid*), qualified enough to interpret and apply Islamic Law to hard cases, through his independent legal reasoning (*ijtihād*).¹⁵ A *mujtahid* must have thorough knowledge, interpretative skills and a legal theory of Islamic law to find solutions in hard cases. Accordingly, his expertise must comprise:¹⁶

Jurisprudence they are termed as 'hard cases', meaning such novel cases in which the solution is not clearly dictated by the statutes or precedents. The phrase was used by Ronald Dworkin to illuminate his assertion that there is a right answer to each case.

¹¹ Literal meaning of *fatwa*.

¹² *Qala'jī and Qanībī*, s.v. "Fatwa."

¹³ Hāmid Muhammad ibn Muhammad Al-Ghazalī, *Al-Mustsfā min 'Ilm Al-Usūl [The Fundamentals of the Discipline of Islamic Legal Theory]*, vol. 2 (Boulaq: Al-Maktabah al-Amīriyyāh, 1925), 350–53; Abu Ishāq Al-Shātbi, *Al-Muwāfaqāt Fi Usūl 'l Sharī'ah [The Harmonization of the Principles of Islamic Law]* (Beirut: Dār 'l Kutub Al-Ilmiyyah, 2004), 867–68.

¹⁴ Al-Shātbi, *Al-Muwāfaqāt fi Usūl 'l Sharī'ah [The Harmonization of the Principles of Islamic Law]*, 867–68; and Qur'ān 4:59. 'O you who believe! Obey Allah and obey the Messenger (Muhammad SAW), and those of you (Muslims) who are in authority...'

¹⁵ Kamāl al-Dīn Ibn-al-Hamām, *Fath al-Qadīr [Unfolding Law of the Almighty]*, vol. 7 (Beirut: Dār al-Kutub al-Ilmiyyah, 2003), 238.

¹⁶ Al-Ghazalī, *Al-Mustsfā min 'Ilm Al-Usūl [The Fundamentals of the Discipline of Islamic Legal Theory]*, 350–53.

1. Qur'ānic knowledge of verses (nearly 500), relating to Islamic Law (*ahkām*) without there being a requisite of their memorization by heart. Moreover, he must be well aware of abrogating and abrogated verses, rules for interpretation of the text (*nass*), as well as the historical context of those verses;
2. Knowledge of law-making Sunnah,¹⁷ as well as proficiency in *hadith* sciences;¹⁸
3. Thorough information of Juristic Consensus (*Ijmā'*) and the points of disagreements around legal rulings;
4. Proficiency in Arabic language and linguistics;
5. Adeptness in Islamic legal theory. Thus, he must have juristic skills and approach to analyze the question in hand and the ability to find legal solutions from Islamic legal sources;
6. Adeptness in the theory of objectives of *sharī'ah*, and an aptitude to indoctrinate them in his legal reasoning (*ijtihād*) while interpreting or applying Islamic Law in hard cases;
7. Sufficient knowledge of issue at hand along with the impact of auxiliary circumstances on it;
8. The qualities of a competent, trustworthy Muslim, who not only utterly avoids major sins but also abandons persistence of minor sins.

Based on this qualification criteria, Islamic legal theory, gives such mandate to various persons according to the level of their qualification and skills.¹⁹ Thus, more preferably *muftis* are required to be qualified as absolute jurists (*mujtahid mutlaq*), having their own rules of interpretation of text, thus bound to derive the law through them while prohibited to follow the opinion of other jurists.²⁰ The next level is that of followers of interpretive methodology of absolute jurists (*mujtahid fi al-madhab*), in case they are less qualified and unable to have their own legal theory of interpretation.²¹ Moreover, this mandate is also allowed to less skilled jurisconsults, that is, the followers (*muqallid*), who lack the juristic skills to derive the laws, however they are able to memorize and

¹⁷ The Prophet Mohammad (SAW)'s sayings, actions and tacit approvals to others' actions are known as Sunnah.

¹⁸ Narrative relating to deeds, utterances and tacit approvals of the Prophet (SAW). (Qala'jī and Qanībī, s.v. al-hadīth.) The study about authenticity of reported *Sunnah* is termed as *Hadīth* Sciences.

¹⁹ Wael B. Hallaq, "Ifṭa' and Ijtihād in Sunni Legal Theory: A Developmental Account," in *Islamic Legal Interpretation: Muftis and Their Fatwas*, eds. Muhammad Khalid Masud, Brinkley Messick and David S. Powers (Cambridge: Harvard University Press, 1996), 33-43 (37).

²⁰ Mohammad Amīn Al-Hanafī Amīr Bādshāh, *Taysīr Al-Tahrīr [Commentary of the al-Tahrīr]*, vol. 4 (Beirut: Dār al- Fikr, 1996), 248.

²¹ Al-Imām Ali bin Muhammad Al-Āmidī, *Al-Ihkām Fi Usūl al-Ahkām [The Refinement of the Theoretical Principles of Islamic Law]*, vol. 4 (Beirut: Ai-Maktab al-Islami, 1984), 236.

transmit the opinion of the school they follow.²² It is due to the fact that these schools of law actually provide distinctive norms of interpretation and in the words of Nyazee, '[t]he body of rules adopted by each school amounts to the theory of interpretation or theory of law of that school.'²³ The mere haphazard pick and choose of opinions (*talfiq*) of various schools of law, and that too by a non-qualified jurist is not permissible according to the theories of Islamic Jurisprudence.²⁴ It is worthwhile mentioning here that in addition to above-stated qualification criteria, jurists have also mentioned prospect of specialized *ijtihād* through experts (*'ālims*) with proficiency in issuing *fatwa* in one or more specific subjects of Islamic law only.²⁵ Thus, another criterion may be added here, that the *mufti* of various specified branches of Islamic Law should additionally be well versed in that specific discipline too; such as, a *mufti* in IF must be qualified in Finance and Economics as well and so on.

Role and Methodology of *Fatwa* Institution in Product Development for Islamic Finance

Present day IF is basically transformed through the Law of Islamic Commercial Transactions, realized by means of *fatwa* institution. Contemporary scholars of Islamic finance spotlight the contribution of *fatwa* to IF industry in various ways. Among others, it resolves ambiguous issues in banking and finance sector by issuing Islamic rulings; second, it formulates new standards or develops the new products whenever required by the industry; thirdly, it decides what is lawful and what is unlawful in financial transactions vogue in banking and finance industry; fourth, it ensures that the requirements of Islamic law are fulfilled when new products are created, before they are marketed.²⁶ However, in addition to such contributions, its role in 'product development' mechanism of Islamic banking products is of vital importance.

Undeniably, the notion of product development through *fatwa* as its major contributor is quite challenging, complicated and controversial

²² Hallaq, "Ifta' and Ijtihād in Sunni Legal Theory: A Developmental Account," 37.

²³ Imran Ahsan Khan Nyazee, *Nyazee on the Secrets of Usūl Al-Fiqh [Principles of Islamic Jurisprudence] Following a Madhhab [School of Thought] and Rules for Issuing Fatwās*, Course Module VI (Islamabad: Advanced Legal Studies Institute, 2014), 18.

²⁴ Ghazala Ghalib Khan, "Application of Talfiq in Modern Islamic Commercial Contracts," *Policy Perspectives* 10, no. 2 (2013): 133-159 (154), <https://www.jstor.org/stable/42909314>.

²⁵ Al-Ghazalī, *Al-Mustsfā min 'Ilm Al-Usūl (The Fundamentals of the Discipline of Islamic Legal Theory)*:253.

²⁶ Mohamad Akram Laldin, Mohamed Fairouz Abdul Khir, and Nusaibah Mohd Parid, "Fatwas in Islamic Banking: A Comparative Study Between Malaysia And Gulf Cooperation Council (GCC) Countries" (paper, International Shari'ah Research Academy for Islamic Finance, Kuala Lumpur, 2012), 2.

area of IF. Many contemporaries criticized the products of IF industry on the ground that, they are mere replica of their conventional counterparts due to over reliance upon the use of pseudo-Islamic and replica conventional banking products.²⁷ However, Shaheer Abbas refutes these claims as his research outcomes 'demonstrate that the main source of ideas for new products is other Islamic financial institutions'²⁸ rather than conventional products. Thus, adaptation rather than innovation is the strategy of Islamic Banking Institutions (IBIs). Regarding IF industry in Pakistan, the legitimacy of many of the contemporary Islamic financial products in Pakistan is criticized on various grounds. For instance, the underlying contracts of such products are denounced by some of the IF experts because according to them these products merely seem to be legal in their form, however, in essence they are far from dictates of *sharī'ah*. As a result, one might find the components of contract as in accordance with *sharī'ah*, however if seen as a whole, the contract would be found inconsistent with *sharī'ah* dictates. Moreover, there are several banking practices, which are disapproved by scholars for overlooking the higher objectives of *sharī'ah*. For instance, running *mushārakah* (partnership), commodity *murābahah* (sale with disclosed profit margin), and liquidity management product of SBP, that is, *bai' al-mu'ajjal* (credit-sale) or GoP *ijārah sukūk* (lease-based Islamic bonds) effected through open market operation (OMO).²⁹ This is encouraging that IF experts from within the industry highlight the weaknesses of the system, thus urging it to review and revise its strategies and processes.

The PD process in IF differs from the process involved in conventional finance (CF), as it necessitates '...to follow the additional parameters of conformity with *sharī'ah* tenets. It requires common efforts of the *sharī'ah* scholars and the bankers.'³⁰ Gainor defines the term 'product development', for the purposes of his paper as 'the internal process that a financial organization adapts in order to create a financial product or service for delivery to its customer.'³¹ In CF industry strategic directions, growth strategy, future business directions and market conditions drive the process of PD. Thus, the legal and regulatory environment, growth potentials in markets and the orientation of banks towards innovation determines their PD schemes.³² However, the

²⁷ Ahmed, *Product Development in Islamic Banks*, 192.

²⁸ Abbas, "Islamic Financial Engineering: A Critical Investigation into Product Development Process in the Islamic Financial Industry," iii.

²⁹ Khaleeqzaman, Mansoori, and Rasheed, "Sharī'ah Legitimacy of Islamic Banking Practices in Pakistan-An Evaluation," 89.

³⁰ Muhammad Ayub, *Understanding Islamic Finance* (Hoboken: Wiley, 2007), 357.

³¹ Thomas R. Gainor, "A Practical Approach to Product Development," in *Islamic Finance: The Task Ahead: Proceedings of the Fourth Harvard University Forum on Islamic Finance* (Cambridge: Center for Middle Eastern Studies, Harvard University, 2000), 235-41 (237).

³² Ahmed, *Product Development in Islamic Banks*, 97.

motivating factors in an IF industry are not perceived as merely growth-oriented rather they are driven by a need to develop a potential industry based on Islamic legal norms and objectives.³³

Keeping in view the significance of various essential processes, many authors have highlighted the dynamics of PD in diverse manners. Gainor identifies seven essential areas— *sharī'ah*, governing law, tax structure, accounting standard, technical system, finance and marketing—to be involved and well scrutinized in the process of product development. Thus, ideally an Islamic product development team should essentially include *sharī'ah* scholars, asset managers, legal advisors, custodians of administrative services, customers and project coordinators, directors and distributors. However, the most important role is observed to be that of the *sharī'ah* scholars. Therefore, these scholars, instead of just approving or disapproving the final product at the end, should be involved from the very beginning.³⁴ Products' development must focus on *sharī'ah* aspects besides their economic sustainability. The figure below represents the essential role of agents that are bound to observe the *sharī'ah* compliance of any product and processes. Thus, before validating or approving any such product or process, they must be aware of all the other given aspects affecting it. Moreover, it also necessitates the expertise of *sharī'ah* board members in the given areas.

³³ Yasmin Hanani Mohd Safian, "Shariah Scholars and Fatwa Making Process in Islamic Finance," *Journal of Fatwa Management and Research* 10, no. 1 (2017): 120-135 (122).

³⁴ Gainor, "A Practical Approach to Product Development," 239; and Iqbal, Akhtar, and Lodhi, "Islamic Financial Product Development in the Pakistan: Shari'ah Analysis," 119.

Figure: Product Development Factors for Islamic Finance



As the figure represents, a central character is assumed by the body which determine the compatibility of products as per *sharī'ah* norms, for which purpose the institution of *fatwa* is required. As regards the methodology of *fatwa* for PD, it is debated in contemporary scholarship on IF. The review of literature divulges various trends of the modern Muslim jurists to analyze it. The group of IF experts tends to develop the products by way of 'adaptation through *ijtihād*', for which various doctrines may be employed, such as, 'general permissibility',³⁵ 'maximizing human welfare'³⁶ and 'dire need or necessity.'³⁷³⁸ They are inclined to verify the product compliance through the 'principle of permissibility' and they view it as major governing rule in developing the law of IF.³⁹ The prohibitions regarding transactions are clearly found in the texts of *sharī'ah*.⁴⁰ Thus, newly designed transactions should pass the

³⁵ Based on Islamic Legal Maxim, that is, the basic presumption about things is that of permissibility. Meaning thereby every kind of transactions would be deemed to be permissible unless prohibited by the express texts of *sharī'ah*.

³⁶ It is another general principle of Islamic legal theory that laws should seek the welfare of human beings while repelling every possible harm.

³⁷ The doctrine of necessity allows even prohibited acts in case of dire need.

³⁸ Munawwar Iqbal, *A Guide to Islamic Finance* (London: Risk Books, 2007), 53.

³⁹ *Ibid.*, 19; and Ayub, *Understanding Islamic Finance*, 114.

⁴⁰ Qur'ān 2:275; Qur'ān 5:90; and Qur'ān 83:1-6. See Mohammad bin Ismail al-Bukhari, "34 -The Book of Sales, (61) Chapter Al-Gharar (the Sale of What Is Not Present) and Habal-Il-Habla (i-e., the Sale of What Is in the Womb of an Animal)," in *The Translation of the Meaning of Sahih Al-Bukhari*, trans. Muhammad Muhsin Khan,

prohibition test as prescribed in expressed texts of *sharī'ah*. Observing the pragmatism of this approach as compared to the other one, Munawwar Iqbal deliberates:

The approach usually taken to fit a contract into the mould of one of the classical modes is not very fruitful...any contract should be examined to see whether it involves any prohibition. If not, it should be allowed, whether or not it fits a particular classical cast. This will require a radical change in the attitudes of Islamic jurists, who try to examine whether a contract is *mudārabah* [semi partnership] and hence fulfills the conditions of a classical *mudārabah* contract or *ijārah* [leasing] and hence complies with *ijārah* conditions and so forth. Most modern contracts are hybrid and involve departures from classical conditions. Those conditions were set by jurists to suit the conditions of their time. They can be changed in view of the changed circumstances. What is important [is] to ensure that any contract does not violate any conditions established in the basic sources of Islamic law. Within these limits, variations on classical contracts should be acceptable.⁴¹

In this age of financial engineering, this viewpoint urges the development and creation of innovative Islamic financial products to fulfill the requirements of the industry without compromising prerequisites of *sharī'ah*. Thus, a teamwork including certified muftis of IF to approve/disapprove the newly designed products, in the light of Islamic Law of Transactions, would suffice the challenges of *sharī'ah* compatibility for the industry to find solutions.

The second approach undertakes a validity test of jurisprudential methodologies employed for the development of products in IF.⁴² Thus, the criticism is not merely because the newly framed products are deviant from early *fiqh*-nominated contracts, rather due to misapplication of deriving rules for them. Nyazee's treatise upon one of the most

vol. 3 (Riyadh: Darussalam, 1997), 203. Such prohibitions are expressly ordained through the texts of Qur'ān and Sunnah. Some major prohibitions include transactions involving interest; gambling as well as consuming the intoxicants or administering their business; short measuring; speculative/uncertain/vague financial deals.

⁴¹ Iqbal, *A Guide to Islamic Finance*, 52.

⁴² Dār-al-Iftā', *Murawwijah Islāmi Benkāri- Tajziyāti Mutālī'ā, Sharī Jā'iza, Fiqhī Naqd-o-Tabsirah [Contemporary Islamic Banking: An Analytical Study, Islamic Legal Analysis, Islamic Jurisprudential Critique]*, 79.; Hegazy, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets," 143.

practiced Islamic Banking product, that is, *murābahah lil āmir bi al shirā'* (Sale with disclosed profit margin to the purchase orderer) exposes 'how the rules of *fiqh* are being twisted and violated for legalizing the charging and paying of interest.'⁴³ Likewise, various modes of financing and participation are sometimes blamed for use of erroneous structural methodologies on the basis of amalgamation (*talfīq*) of legal rules of various schools of thought; and the use of stratagems (*hiyal*) to legalize *ribā*.⁴⁴ This approach actually emphasizes the need for creativity and innovation with respect to development of the industry in accordance with the Islamic theory of Jurisprudence.

These approaches differ in theory and practice. The former approach emerges through hands-on demands of the industry. However, such a *fatwa* institution could only be approved, in terms of Islamic legal theory, if absolute *mujtahid* level *muftis* are involved in this process. In other words, only a thoroughly qualified person would have the ability to analyze the features of any given product in the light of Islamic legal doctrines. The other approach provides some practical solution instead, whereby higher level *muftis* may also be involved in the process, provided they adhere to interpretative methodology of any specific Islamic legal theory.

The above-mentioned theoretical debate leads to a very crucial question, whether PD processes involve the methodology of *fatwa* in accordance with the theories of Islamic Law or not? For this purpose, it would be quite fruitful to compare the *fatwa* norms for IF with those of jurisprudential norms that are set by early Muslim jurists. A summary of juristic norms has already been discussed in first section of this research.

Various studies have revealed that although IF industry as well as consumer demand have shown remarkable growth since the development of the industry, yet expertise towards *sharī'ah* compliance of IFIs are quite inadequate. Consequently, there is poor understanding of some fundamental issues of subject topic leading to inefficient efforts towards its standardization.⁴⁵ However, it does not mean that the industry is operating blindly without any standards. The remarkable initiatives of International bodies—such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)⁴⁶ and

⁴³ Imran Ahsan Khan Nyazee, *Murabahah and the Credit Sale* (Rawalpindi: Federal Law House, 2009), 46.

⁴⁴ Hegazy, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets," 143.

⁴⁵ Karim Ginena and Azhar Hamid, *Foundations of Shari'ah Governance of Islamic Banks* (Hoboken: Wiley, 2015), xvii.

⁴⁶ AAOIFI was established as an international, independent, non-profit, non-government, corporate organization, with an objective to undertake the worthy task

International Financial Services Board (IFSB)⁴⁷ in this regard are undeniable. The former organization has developed standards for alternative Islamic Banking products. The later body is engaged in framing standards for regulation and supervision of IFIs.⁴⁸ The standards and guiding principles issued by IFSB augment the international prudential regulations for banking supervision. To strengthen *sharī'ah* compliance, it provides guidelines over development of governance framework for its member countries.⁴⁹ Pakistan being a member of IFSB has successfully launched its *Sharī'ah* Governance Framework (SGF), in 2015 (updated in 2018). This development has assisted in furthering the cause of developing a *sharī'ah* compliant industry.

AAOIFI itself has considerably relied upon the institution of *fatwa*, for determining the *sharī'ah* compatibility of its standards.⁵⁰ Thus, an overview of various standards reveals that it has adopted various *fatāwa* issued by *Sharī'ah* Supervisory Boards of different IFIs, such as, Kuwait Finance House or Qatar Islamic Bank. AAOIFI has also postulated rules for the institution of *fatwa*, in order to regulate the IFIs through aboveboard juristic methods. Standard No. 29 methodically deals with the *fatwa* ethics and methodology that may be applied to any institutional framework. Thus, in its clause 2/1, the term *fatwa* has been defined as 'a *sharī'ah* opinion presented to a person who seeks it with regard to an incidence that has already occurred (the *fatwa* incidence) or is expected to occur. It does not refer to answering queries pertaining to hypothetical incidences.'⁵¹ The statement of the Standard specifies an adaptable approach for issuance of *fatwa*, in comparison to deriving and following rules of any particular Islamic legal school. Thus, its clause 6/4 postulates that, financial institutions should not insist for *fatāwa* of specific legal school except in jurisdictions where the legal or judicial systems follow a particular school and there is an apprehension that given issue may be litigated in future.⁵²

of developing and structuring *Sharī'ah* Standards pertaining to banking operations, accounting, auditing, good governance and ethics, for Islamic banking industry.

⁴⁷ IFSB is a Malaysian international organization involved in setting standards for regulation and supervision of IFIs.

⁴⁸ IFSB, "Articles of Agreement" (Kuala Lumpur: Islamic Financial Services Board, 2018).

⁴⁹ IFSB, "Guiding Principles on *Sharī'ah* Governance Systems for Institutions Offering Islamic Financial Services," standard 10 (Kuala Lumpur: Islamic Financial Services Board, 2009), <https://www.ifsb.org/published.php>.

⁵⁰ AAOIFI, *Sharī'ah Standards for Islamic Financial Institutions* (Manama: Accounting and Auditing Organization for Islamic Financial Institutions, 2015), 222.

⁵¹ AAOIFI, "*Sharī'ah* Standard No. (29): On Stipulations and Ethics of *Fatwa* in the Institutional Framework," in *Sharī'ah Standards for Islamic Financial Institutions* (Manama: Accounting and Auditing Organization for Islamic Financial Institutions, 2015), 734-752 (738).

⁵² *Ibid.*, 740.

It seems quite logical that while formulating rules for an international body like AAOIFI, the adherence to a particular school of thought should not be mandated. However, it is quite essential to standardize the *fatwa* institution at national level, in a way to make it mandatory that the methodology of *fatwa* must adhere to the principles and theories of any particular school of thought. Here it is significant to mention a practical problem arising due to non-adherence to any particular school of law. In majority cases, it is most likely hard to find an absolute *mujtahid*. Hence, the *Sharī'ah* Board members would be non-*mujtahids* and as per Islamic legal theory they are bound to transmit the views of *mujtahids* they follow. A non-*mujtahid* jurisconsult is required to apply any particular theory of interpretation, for developing new products and services for IF, otherwise inconsistent and *sharī'ah* incompatible products would result. Thus, for the sake of consistency in deriving and interpreting the law through its sources, a coherent theory of interpretation needs to be adopted. Otherwise, there would be probabilities of mishandling the novel issues of IF.

The Standard postulates Qur'ān, Sunnah, *Ijma'* and *Qiyās* to be the main sources of any fatwa. Special reference is also made to a few juristic tools, like *istihsān* (juristic preference) and *maslaha mursalah* (public interest) to be considered, for issuance of *fatwa*. In case of unavailability of explicit rulings from Qur'ān and Sunnah, fatwa is required to be inferred from general principles of *sharī'ah*. Thus, in such cases fatwa may only be issued after thorough research and analysis of the rulings of various legal schools of thought, regarding such issue. Moreover, it also recommends that in such cases collective fatwa may be sought for, as provided by various *fiqh* academies.⁵³ It is also emphasized that while seeking fatwa the most preferred opinion of each school of thought should be adopted. Moreover, in case where fatwa provides two equally permissible solutions, preference should be given to the easiest one and every such solution is required to be avoided which may lead to a blight (8/3). The Standard categorically prohibits frequent adoption of concessions in every stated case. However, in exceptional cases the *fiqh* concessions may be adopted, after their rationalization in any stated issue (8/4). *Talfīq* is categorized as misuse of *fiqh* concessions. Therefore, whenever adoption of such concessions leads to legalizing a unanimously prohibited act, or results in two varied *fatawa* for two similar cases, it will be treated as a case of prohibited *talfīq*. The given Standard provides quite an elaborative methodology to be employed for deriving fatwa, however, while stating the requisite qualifications for the persons authorized to issue fatwa, Clause 5/1 postulates:

⁵³ Ibid., 741.

A board member shall be well versed in *Fiqh* (Islamic Jurisprudence), well informed of the contributions of diligent *Fiqh* scholars, and has the ability to use the *Shari'ah*-accepted methods of deriving reasonable rulings on emerging issues. He shall also be known for his discernment, cautiousness and knowledge about the circumstances and traditions of people, and should always remain alert against the different means of human misbehavior. Competence in *Fiqh* is usually manifested by the vast reputation of the scholar or his distinguishable contributions especially in the area of financial transactions performed by institutions.⁵⁴

The bare reading of this clause finds many ambiguities, for instance, without a requisite condition of his ample knowledge of *Qur'ān*, *Sunnah*, *Ijmā'*, Juristic differences and the rest as discussed in previous section, the only qualification required here is his ability to derive the law from diverse *fiqh* resources. Moreover, the given test to measure the competence of a *mufti*, that is, 'his vast reputation' or 'his distinguishable contributions' for IF, are quite alarming. However, the given standard provides a base for regulating *fatwa* institution in any jurisdiction and IF industry in Pakistan is required to adopt and implement it *mutatis mutandis*, incorporating the detailed requirements of *mufti* qualifications.

Mechanisms to Regulate Product Development in Pakistan

The regulatory measures relating the PD in IFIs of Pakistan have gradually developed into their present form, whereby IF industry is required to maintain exclusive departments of PD in organizational setups.⁵⁵ This gradual development is a sequel of regulatory efforts for Islamizing the banking sector in Pakistan. The state level efforts to Islamize banking sector may be phased into three periods, during which the focus also remained on how banking products and services may be offered in a *ribā*-free mode.

First phase started in 1977-78 when Council of Islamic Ideology (CII) was assigned the task to prepare a working draft for the *ribā*-free economy; for which time frame of three years was fixed. Consequently, CII assigned this task to a panel of economists and bankers, who proposed various measures for a phased elimination of interest from domestic transactions. Eventually *Zakat* (mandatory alms) and *Usher*

⁵⁴ Ibid., 739.

⁵⁵ Islamic Banking Department, SBP, "Sharī'ah Governance Framework for Islamic Banking Institutions -Updated till June 2018," (Karachi: State Bank of Pakistan, 2018), <http://www.sbp.org.pk/ibd/2018/C1-Annex-A.pdf>.

(mandatory alms on land's produce) Ordinance was promulgated in 1981. In the same year, the first effort towards *ribā*-free products was made, whereby all nationalized commercial banks were directed to introduce interest-free counters in the form of Profit-Loss Sharing or PLS accounts parallel to interest-bearing accounts. However, it did not prove successful, thus in 1985, parallel *ribā*-free modes of financing were introduced by SBP. These modes were classified into three broad categories including, financing by way of lending, trading and investment. Within these broad categories 12 modes or products were defined, however, the main loophole left in this process was that adoption of these modes of financing was non-mandatory and the clients had the option either to avail interest-based or interest-free financing. CII opposed the idea of parallel Islamic Banking as its outcome was also not prospective enough to eliminate the *ribā* from economy.⁵⁶ These proposals and consequential governmental legislative measures proved just a charade to eliminate *ribā* from economy. Federal Shariat Court (FSC) in its famous historic judgement of 1991 declared this Islamization process as unIslamic due to its gross dependence on technique involving 'mark-up' with or without 'buy-back arrangement'.⁵⁷ The judgment required radical changes in that system in order to bring it in conformity with Islamic teachings. Thus, the major issues that led to the failure of that system were the non-mandatory status of Islamic modes/products of finance and their incompatibility with *sharī'ah* dictates.

The *second phase* may be counted from the promulgation of the Enforcement of Shari'ah Act of 1991, which was another crucial effort for Islamization of economy. Its Standard 8 directed the State to ensure construction of its economic system in accordance with Islamic principles.⁵⁸ The Federal Government was directed, under the said law to appoint a Commission of bankers, economists, *ulema* and elected representatives to analyze the interest based fiscal laws and recommend changes for Islamization of economy for the well-being of people as enunciated in Article 38 of the Constitution of Pakistan, 1973. Unfortunately, the Act could not bring any radical change, neither recommendations of the Commission of 1991; another report of reconstituted Committee of 1997, could not be materialized due to political upheavals in the country. The Judiciary also contributed in this struggle first in 1991 through FSC Judgement and later in 1999 through judgement of Shariat Appellate Bench, and banking interest in all its

⁵⁶ Aurangzeb Mehmood, "Islamisation of Economy: Past, Present and Future," *Islamic Studies* 41, no. 4 (2002): 675-704 (684), <http://irigs.iiu.edu.pk:64447/gsd/collect/islamics/index/assoc/HASHf2dc/66330663.dir/v41i45.pdf>.

⁵⁷ Dr. M. Aslam Khaki v. Syed Muhammad Hashim and 2 others., [2000] PLD SC 225, Shariat Appellate Jurisdiction (Pak.).

⁵⁸ Enforcement of Shari'ah Act of 1991 4, sec. 8, (1991).

forms was declared as *ribā* thus prohibited and the State was urged to bring alternative Islamic banking modes and products.⁵⁹ In fact, the efforts to accommodate Islamic banking system within the same conventional framework could not prove successful, hence requiring some bolder initiatives. The need was felt towards shift of approach from merely offering *ribā*-free products to promotion of parallel banking system instead.

The *third phase* starts from the year 2001, when the government took that bold initiative to promote a parallel system of banking devised in accordance with *sharī'ah* norms. Consequently, Meezan Bank Limited (MBL) was granted the license to commence its operations from March 2002, as the first-ever Islamic bank of the country. The legislative efforts to promote Islamic Banking however are still lagging behind and it is quite unfortunate that no single regulatory legislation is found in this regard. Nonetheless, it is commendable that the Islamic Banking Department (IBD) of SBP is regulating such practices through its Circular/Notifications and providing various guidelines and instructions to this industry.

To further the said initiative, SBP first issued 'Policies for Promotion of Islamic Banking' vide its BPD Circular No. 1 of 2003. These policies elucidated SBP's 'three-pronged strategy' to promote Islamic Banking across the country. Thus, it provided criteria for the development of, 1) Full-fledged Islamic banks; 2) Islamic Banking Subsidiaries; and 3) Stand-alone Islamic Banking Branches. These criteria provided broad procedures for incorporation of Islamic Banks, through Banking Policy Department of SBP, as Public Limited Companies. Moreover, *sharī'ah* compatibility of all financial transactions was declared a pre-requisite for establishment of scheduled Islamic Commercial Banks. It also required a disclosure of their proficiency to ensure compliance of their banking business with *sharī'ah*.⁶⁰ Remaining sections of the said criteria detailed out corporate requirements for such banks. Likewise, requisites were stated for setting up subsidiaries and stand-alone branches of Islamic Banks. These criteria were revised and modified in 2004, in order to launch a uniform policy relating to minimum *sharī'ah* regulatory standards for Islamic Banks, their Subsidiaries and Branches. However, there was no such criteria provided to elucidate PD framework or its requisites.

⁵⁹ Mehmood, "Islamisation of Economy: Past, Present and Future," 689.

⁶⁰ "Detailed Criteria for Setting up of Scheduled Islamic Commercial Bank Based on Principles of Sharia in the Private Sector," Annexure-I to BPD Circular No. 1 (Karachi: State Bank of Pakistan, 2003), http://www.sbp.org.pk/bpd/2003/annexC1_I.pdf.

It was in 2008 when IBD, issued its detailed 'instructions' and 'guidelines' for *sharī'ah* compliance in IBIs, through one of its circulars.⁶¹ The said Instructions elucidated thirteen modes of financing, and the IBIs were directed to design their products accordingly. However, they still had the freedom to develop new products after prior approval of their *Sharī'ah* Advisors. It also required IBIs to submit the salient features of products offered by them, along with their *Sharī'ah* Advisor's certification, at least thirty days before the proposed launch of new products and/or services. It in turn necessitated that every Islamic Bank would maintain a specific department for product development, at least to meet such regulatory directions of SBP. However, no such mandatory requirement could be devised until the year 2018, when the updated SGF provided for the establishment of such departments in their organizational structures.⁶²

It is worthy to mention here that IBD made multiple efforts to harmonize and standardize the products and services of IBIs, as per the available internationally recognized *Sharī'ah* Standards. Thus, it issued its policy to gradually adopt various standards of AAOIFI.⁶³ So far, twelve Standards have been adopted through various circulars of IBD, issued from time to time. These adopted Standards operated in addition to and without replacing the existing regulatory policies and procedures offered by SBP and IBD. Majority of these standards relate to various financing and investment products and their procedures, as offered and practiced by IBIs.⁶⁴ Thus, the adoption of these Standards facilitated IBIs to standardize their products accordingly.

Another milestone was achieved in 2015, when a comprehensive SGF was formulated with an objective to strengthen the *sharī'ah*

⁶¹ Islamic Banking Department, SBP, "Instructions for Shariah Compliance in Islamic Banking Institutions," Annexure 1 of IBD Circular No. 2 (Karachi: State Bank of Pakistan, 2008), <http://www.sbp.org.pk/ibd/2008/Annex-c2-1.pdf>.

⁶² Islamic Banking Department, SBP, "Sharī'ah Governance Framework for Islamic Banking Institutions -Updated till June 2018.

⁶³ Islamic Banking Department, SBP, "Adoption of Shariah Standards Issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)," IBD Circular No. 1 (Karachi: State Bank of Pakistan, 2010), <http://www.sbp.org.pk/ibd/2010/C1.htm>.

⁶⁴ In the first phase four Standards i-e. 3, 8, 9 and 13 were adopted, which were related to 'Procrastinating Debtor', 'Sale with Disclosed Profit Margin', 'Leasing' and Semi Partnership, respectively. (Ibid.) Next the Standard 12 on Partnership and Modern Corporations, was adopted (IBD Circular No. 01 of 2013). Further, Standard No. 17 on 'Islamic Investment Bonds' was adopted. (IBD Circular No. 03 of 2013). Finally, five new Standards i-e, 2, 5, 14, 18, 24 and 38 are recently adopted, which relate to "Debit Card, Charge Card and Credit Card", "Guarantees", "Documentary Credit", "Possession", "Syndicated Financing" and "Online Financial Dealings" respectively. (IBD Circular No. 01 of 2019).

compliance environment of IBIs.⁶⁵ Thus, it explicitly defined '... the roles and responsibilities of various organs of IBIs including the Board of Directors (BOD), Executive Management (EM), *Sharī'ah* Board (SB), *Sharī'ah* Compliance Department (SCD), internal auditors and external auditors towards *Sharī'ah* compliance.'⁶⁶ The SB members were given the crucial responsibility to supervise all stuff involving *sharī'ah*, including review and approval of PD processes. The resolutions declared by them were made binding on their respective IBIs. It also required them to thoroughly deliberate upon the matters presented before them, and their *fatwa* must record the reasons for approval/disapproval of products.⁶⁷ However, still there was no clear mention of who should develop the product before presenting it for approval. Eventually, it was further revised and updated in 2018, and a new clause about PD added, which makes it mandatory for every IBI to establish research departments, with qualified and trained staff, for the development of innovative products for them.⁶⁸ However, without making it mandatory, it is required that IBIs would be encouraged to engage at least two individuals, who would be qualified enough to meet the qualification criteria of *Sharī'ah* Scholar Members as given under Fit and Proper Criteria (FAPC).⁶⁹ Contrarily the appointment of *Sharī'ah* scholars for the purpose of PD seems vital in order to develop the financial products in a *sharī'ah* compatible manner.

The Framework prescribes well in detail the constitution and procedure for the appointment of SB members and FAPC details out the requisite qualifications for them. The given criterion seems to be based on assumption that the required educational qualification meets the qualification of a *mufti* as prescribed by principles of Islamic jurisprudence. The Clause (1) of FAPC provides requisite educational qualification:

Shahadat ul Aalmia Degree (Dars e Nizami) from any recognized Board of Madaris with minimum 70% marks and Bachelor's Degree with a minimum of 2nd Class and sufficient understanding of banking and finance.

⁶⁵ Islamic Banking Department, SBP, "Shariah Governance Framework for Islamic Banking Institutions," (Karachi: State Bank of Pakistan, 2015), <http://www.sbp.org.pk/ibd/2015/C1-Annex.pdf>.

⁶⁶ Islamic Banking Department, SBP, "Sharī'ah Governance Framework for Islamic Banking Institutions -Updated till June 2018."

⁶⁷ Islamic Banking Department, SBP, "Shariah Governance Framework for Islamic Banking Institutions," sec. 3.

⁶⁸ Islamic Banking Department, SBP, "Sharī'ah Governance Framework for Islamic Banking Institutions -Updated till June 2018, sec. 6.

⁶⁹ Islamic Banking Department, SBP, "Sharī'ah Governance Framework for Islamic Banking Institutions -Updated till June 2018, Annexure-A (clause 1).

OR

Post Graduate Degree in Islamic Jurisprudence/ Usooluddin, L.L.M. (Shariah), etc. with a minimum GPA of 3.0 or equivalent from any recognized University with exposure to banking and finance.⁷⁰

However, these requisite qualifications are not proper indicators of *mufti* qualification, unless one is assured that these degree programs incorporate a thorough syllabus comprising the requisite base of knowledge and skills for a qualified *mufti*, as discussed in the first segment of this paper. Moreover, eligible members under this criterion may be categorized *muftis* of different levels, as per their juristic ability to issue *fatwa*, such as *mujtahid mutlaq* (absolute jurist),⁷¹ *mujtahid fi al-madhab* (jurist of a school of legal thought),⁷² *muqallid* (follower of a school of legal thought),⁷³ or *‘alims* (expert in specific branch of Islamic Law)⁷⁴. Thus, their qualification and expertise would determine their mandate to issue *fatwa*. Accordingly, there is a need to revise FAPC to incorporate the standards drawn from principles of Islamic jurisprudence, in order to introduce financial intermediation process through skilled class of experts in the field of PD and *shari‘ah* compliance. Finally, the process of PD should be categorized as an *ijtihad* process, thus requiring qualified *mufti* to innovate new products.

Conclusion

The struggles for Islamic financial intermediation seem to be far from reality unless the flaws in the process of product development mechanism are highlighted, rectified and regulated in compatibility with Islamic legal norms. The academic criticism over the *shari‘ah* compatibility of the IF products, leads to an assumption that the *fatwa* institution is not up to the mark, thus requires improvement. A rich legal and jurisprudential heritage provides detailed theories for regulating the *fatwa* institution and the stakeholders should take initiative to benefit from such principles.

The IF sector in Pakistan has made a positive move towards achieving the milestone of genuinely *shari‘ah* compatible industry, by introducing mandatory requirements for establishment of PD departments in IBIs. However, *fatwa* institution requires standardization,

⁷⁰ Ibid.

⁷¹ See *Supra* note 18.

⁷² See *Supra* note 19.

⁷³ See *Supra* note 20.

⁷⁴ See *Supra* note 23.

which has a strong impact not only on PD, but also *Sharī'ah* Compliance department of IBIs.

Finally, this study concludes and recommends that the process of PD should be categorized as an *ijtihādi* process, thus requiring qualified *mufti*, well equipped with the knowledge of IF, to innovate new financial products. Standard 29 of AAOIFI provides a good base for standardizing the methodology of *fatwa* institution, which may be adopted in Pakistan with necessary modifications in the light of Islamic legal theory. Moreover, it is recommended that FAPC be revised to incorporate the qualification standards drawn from Islamic legal theory, in order to introduce PD process through skilled experts.