

Muhammad Shahrul Ifwat Ishak

Article

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ISRA International Journal of Islamic Finance

Provided in Cooperation with:

International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur

Suggested Citation: Muhammad Shahrul Ifwat Ishak (2019) : The principle of maṣlaḥah and its application in Islamic banking operations in Malaysia, ISRA International Journal of Islamic Finance, ISSN 2289-4365, Emerald, Bingley, Vol. 11, Iss. 1, pp. 137-146,
<https://doi.org/10.1108/IJIF-01-2018-0017>

This Version is available at:

<https://hdl.handle.net/10419/236939>

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The principle of *maṣlaḥah* and its application in Islamic banking operations in Malaysia

Muhammad Shahrul Ifwat Ishak

*Faculty of Economics and Management Sciences,
Universiti Sultan Zainal Abidin - Kampus Gong Badak, Kuala Terengganu,
Terengganu, Malaysia*

Islamic
banking
operations in
Malaysia

137

Received 30 January 2018
Revised 14 February 2018
7 June 2018
13 February 2019
Accepted 21 February 2019

Abstract

Purpose – This paper aims to investigate the extent to which *maṣlaḥah* (public interest) is taken into consideration in Islamic banking operations in Malaysia, particularly in *bay' al-'īnah* (sale and buyback), *ta'wīd* (compensation) and *ibrā'* (rebate).

Design/methodology/approach – This study applies deductive and inductive methods to analyze the application of *maṣlaḥah* in Islamic financial transactions. Three issues in Malaysia are selected as a case study, allowing *bay' al-'īnah*, standardizing the rate of *ta'wīd* and stipulating the *ibrā'* clause in financial agreements. As this study is qualitative in nature, all data are analyzed based on the content analysis method.

Findings – Both the *maṣlaḥah* of Islamic banks and their customers were found to be considered by the Central Bank of Malaysia in the implementation of contracts and principles of Islamic banking. The first *maṣlaḥah* represents the viability of Islamic banks, while the second *maṣlaḥah* promotes fairness and transparency between Islamic banks and their customers.

Research limitations/implications – This study only focuses on the contracts and principles of Islamic banking operations in Malaysia with regard to three selected issues.

Practical implications – This paper clarifies the practical application of *maṣlaḥah* in the Islamic banking industry, particularly with regard to implementing its contracts and principles.

Originality/value – This paper analyzes the argument of *maṣlaḥah* on the issues of *bay' al-'īnah*, *ta'wīd* and *ibrā'* in Malaysia, which are considered among scholars to be debatable issues. While many discussions focus on the legal aspect of Shari'ah on those issues, this study emphasizes how the application of *maṣlaḥah* aims to solve the current problems and harmonize between Shari'ah and reality.

Keywords Islamic banking, *Bay' al-'īnah*, *Ibrā'*, *Maṣlaḥah*, *Ta'wīd*

Paper type Research paper

Introduction

Malaysia has one of the largest Islamic banking industries worldwide. With 17 Islamic financial institutions (IFIs) (local and foreign) operating competitively, Islamic banking comprises almost 22 per cent of the total national banking sector of the country. Furthermore, it is argued that Malaysia was the first to establish the Islamic interbank money market, a fully-fledged Islamic stockbroking company, corporate *shukūk* (Islamic



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ISRA International Journal of
Islamic Finance
Vol. 11 No. 1, 2019
pp. 137-146
Emerald Publishing Limited
0128-1976
DOI 10.1108/IJIF-01-2018-0017

bond) and Islamic unit trusts (Shaharuddin, 2012). Malaysia has also contributed the largest part of research in Islamic finance (Ernst and Young, 2016).

In terms of regulations, Malaysia has been identified as the most advanced country in promoting Islamic finance via a comprehensive legal framework (Askari *et al.*, 2009). The recent Islamic Financial Services Act 2013 (IFSA) is a clear example of how seriously the government is promoting Sharī'ah compliance in Islamic financial instruments. In other words, IFSA provides a comprehensive legal framework that is fully consistent with Sharī'ah (Islamic law) in all aspects of regulation and supervision, from licensing to the winding-up of an institution (Yusof, 2017). For the purpose of validating Islamic banking, the Shariah Advisory Council (SAC) of Bank Negara Malaysia (BNM), the central bank, was set up in 1997 (ISRA, 2011).

Representing the highest Sharī'ah authority in Islamic finance, the SAC has issued many resolutions, some of which are mandatory for IFIs in Malaysia. These include parameters for Sharī'ah contracts and Islamic financial practices. It is clear that in every resolution, the SAC produces relevant justifications from Sharī'ah sources, as well as the views of scholars, to validate its decisions. Nevertheless, some of them are not in line with other international Islamic bodies, and also are not being practiced by Islamic banks in other Muslim nations, particularly Middle Eastern countries. Such resolutions, for instance, allow *bay' al-īnah* (sale and buyback), standardization of the rate of *ta'wīd* (compensation) and stipulation of the *ibrā'* (rebate) clause in financial agreements. As the issues of Islamic banking are quite complicated and some of them cannot be directly taken from classical works of jurisprudence, *maṣlahah* has become one of the main approaches in dealing with those modern issues. This concept, which reflects the idea of achieving public interest and averting harm, has played a significant role both in establishing rules and in developing products.

While those practices are justified on the basis of *maṣlahah* (public interest), they need greater clarification in terms of which *maṣlahah* is being considered, particularly by regulators. This paper thus aims to investigate the extent to which *maṣlahah* is taken into consideration in Islamic banking operations in Malaysia, particularly in respect of the three selected issues, *bay' al-īnah*, *ta'wīd* and *ibrā'*. It uses content analysis to examine the application of *maṣlahah* in Islamic financial transactions.

The rest of the paper is organized as follows: the next section explains the principle of *maṣlahah* and its significant role in addressing modern issues, including Islamic finance. It then proceeds to examine its application by analyzing three Islamic banking issues in Malaysia, allowing *bay' al-īnah*, standardizing the *ta'wīd* (compensation) rate and stipulating *ibrā'* in financial agreements. It then concludes with a summary of the discussion.

The principle of *maṣlahah* in Islamic finance

Technically speaking, *maṣlahah* can be defined as an attribute of an act that realizes benefits – an act which always or usually benefits the public or individuals (Ibn 'Āshūr, 2001). This term is embodied within the *maqāṣid al-Sharī'ah* (objectives of Islamic law), which is the meaning and wisdom that are emphasized by God in His rules (Al-Yūbī, 1998). In this regard, instead of being restricted to the literal textual meaning, the verses pertaining to a rule in Islamic sources, namely, the Qur'ān and the Sunnah, must be engaged implicitly and understood in the right context to determine particularly what *maṣlahah* is behind the rule (Al-Kaylānī, 2008).

Many texts of the Qur'ān and the Sunnah point to the element of *maṣlahah* as the purpose of Islam. One example is related to the case of mercy: "And we have not sent you, (O

Muhammad), except as a mercy for all creatures" (Qur'ān, 21:107). Another example is about avoiding difficulties: "Allah does not wish to place you in difficulty but, rather, to purify you and complete His favor to you" (Qur'ān, 5:6). At the same time, several rules hold an additional *maṣlaḥah*, such as the rule of *qisāṣ* (proportional retribution): "Fair retribution saves life for you" (Qur'ān, 2:179).

Furthermore, looking at the practices of the rightly guided caliphs, the first four successors of Prophet Muhammad (peace be upon him), it is noted that most of their policies were based on *maṣlaḥah*. These included compiling the Qur'ān as a single book, banning interfaith marriage, declaring divorce which is uttered three times at once to count as three times, selling any lost camel and imposing a fine on craftsmen for the loss or damage to customers' property (Al-Khādīmī, 2010).

While *maṣlaḥah* had been practiced since the time of the Prophet (peace be upon him), his companions and the early generations, its theory was only systematically written about between the fifteenth and eighteenth centuries C.E. (Auda, 2007). Therefore, it is claimed as the last theory in the development of Islamic jurisprudence (Laluddin, 2015). A group of scholars including al-Juwaynī, al-Ghazālī and 'Izz ibn 'Abd al-Salām were among the pioneers in introducing *maṣlaḥah*, its dimensions and its priority (Al-Yūbī, 1998). The next group, comprising Ibn Qayyīm, al-Qarāfī and al-Shāṭibī, developed *maṣlaḥah* as an independent topic in *uṣūl al-fiqh* (the principles of Islamic jurisprudence). Moreover, the discussion has been expanded to cover the parameters of *maṣlaḥah*, dealing with possible clashes between various *maṣāliḥ* (pl. of *maṣlaḥah*), the issue of *hiyal* (legal stratagems) and the application of *maṣlaḥah* in Islamic jurisprudence (Al-Raisūnī, 1995).

The role of *maṣlaḥah* has become more crucial in modern times, particularly in applying Islam in the reality of modern life. With the drastic changes in society, technology, politics and economics, *maṣlaḥah* plays a significant role in reforming Islamic practices (Al-Khādīmī, 2010). This includes dealing with new issues such as banking and finance, politics, medical issues and problems associated with Muslim minorities (Al-Qaraḍāwī, 2006). Not surprisingly, today, many resolutions from Islamic bodies, fatwas and Islamic rules are based on *maṣlaḥah*.

To conclude, the concept of *maṣlaḥah* represents an approach in Islamic jurisprudence that aims to harmonize between revelation and real situations. A balance must be struck between indiscriminate amendments to the practices of Islam in the name of "human well-being" and a mechanically literal application of Islamic texts without any consideration of circumstances and consequences (Malik, 2011). In this regard, it should be understood that rules in Islam should not merely be determined from the theoretical aspect, through Islamic sources or classical works of scholars, but their outcomes also need to be considered as to how far they realize *maṣlaḥah* in concrete situations (Al-Raisūnī, 1995).

The classical issue of price fixing provides a clear example. At first, this action was not preferred by Prophet Muhammad (peace be upon him) because he said:

«إِنَّ اللَّهَ هُوَ الْمُسَعِّرُ، الْقَابِضُ الْبَاسِطُ الرَّازِقُ، إِنِّي لَا أَرْجُو أَنْ أَلْقَى رَبِّي وَلَيْسَ أَحَدٌ يَطْلُبُنِي بِمُظْلَمَةٍ فِي دَمٍ وَلَا مَالٍ»

Indeed, Allah is the determiner of prices, the Constrictor, the Expander, the Provider. I wish to meet my Lord without anybody demanding restitution of me regarding blood or property (Ibn Mājah, 2000).

Analyzing the statement of the Prophet (peace be upon him) gives a clear picture regarding why this action was prohibited during his time. As the price rise was because of limited resources, it would have been unfair to force sellers to reduce the price (Hassan, 2006). Thus, *maṣlaḥah* for the sellers at that time had a greater right of consideration than *maṣlaḥah* of the society. Nevertheless, a few decades later, during the era of the Ṭābi'īn (the

generation after the Companions), some scholars such as al-Layth ibn Sa'd, Rabī'ah and Yahyā ibn Ma'īn argued to allow this action because of *maṣlaḥah* for the society (Al-Dūrī, 2011). As the price rise occurred because of market manipulation at that time, it was more important to consider the *maṣlaḥah* of the society (Ahmad Bashir, 1997).

A case study of Malaysia

Based on the concept of *maṣlaḥah*, a few cases of Islamic banking operations in Malaysia are analyzed hereunder.

Allowing bay' al-'inah

Bay' al-'inah is practiced by selling an item for a deferred payment, then buying it back at a lower price in cash (ISRA, 2009). This practice is also known as *bay' al-ājāl* among Mālikis and Shafī'īs (Mansour, 2007). In modern Islamic banking operations, *bay' al-'inah* is used both as a direct financing method between Islamic banks and their customers, or as a combination with other contracts such as *bay' bithaman ājil* (deferred payment sale), known as BBA, and organized *tawarruq* (monetization) (Mohammad *et al.*, 2013).

Bay' al-'inah has received criticisms from both classical and contemporary Muslim scholars regarding its Sharī'ah status. While the majority of scholars rejected *bay' al-'inah*, claiming it to be a trick to circumvent to the prohibition of *ribā* (interest), some early jurists such as Ibn 'Umar, Abū Yūsuf, the Shafī'īs and Ṣāhīrīs allowed this contract (Lahsasna, 2014). al-Shāfi'ī (2001), for example, rejected the argument of a trick to legalize *ribā*, as he considered *bay' al-'inah* as two separate contracts. In terms of modern discussions, this contract is not favored by many Islamic bodies. The International Islamic Fiqh Academy (IIFA), for example, in its resolution on *muwā'adah* (bilateral promise) in a financial contract, mentioned that an agreement from the contracting parties in order to circumvent the prohibition of *ribā* – for example, *bay' al-'inah* – is not allowed in Sharī'ah (IIFA, 2006). Another organization that takes a similar view is the Accounting and Auditing Organization for IFIs (AAOIFI). In its Sharī'ah standard on *tawarruq*, one of the conditions of its practice is that it must avoid *bay' al-'inah*, which is strictly prohibited (AAOIFI, 2010).

Nevertheless, the SAC of BNM has developed a different approach by allowing *bay' al-'inah* for Islamic banks in Malaysia. In its first meeting, dated 8 July 1997, the SAC resolved that the issuance of Negotiable Islamic Debt Certificates based on the *bay' al-'inah* concept is permissible. This decision was justified with the general verse permitting sale in the Qur'ān, as well as the view of early scholars who allowed this contract, including Abū Yūsuf and al-Shafī'ī (BNM, 2010). Subsequently, special resolutions on the permissibility of *bay' al-'inah* as an instrument in the Islamic interbank money market and for offering Islamic credit cards were issued by the SAC (BNM, 2010).

Even though the central bank did not clearly mention the justification of *maṣlaḥah*, some researchers claimed that *bay' al-'inah* is allowed in Malaysia since this contract promoted Islamic banking, particularly during the first period of this industry (Tita and Saim, 2012). Moreover, as this contract is used in the structuring of Islamic credit cards, which today are crucial for daily business dealings and commercial transactions, it is considered as *maṣlaḥah* for the people (Shaharuddin, 2012). As for the *maṣlaḥah* of Islamic banks, as there are many restrictions in terms of alternatives, this contract is important to provide liquidity for Islamic banks (Md. Hashim *et al.*, 2015). In fact, liquidity represents a *ḍarūrah* (necessity) for a banking institution to compensate for expected and unexpected balance sheet fluctuations, and to provide funds for growth (Iqbal and Mirakhor, 2007). In other words, it represents a bank's ability to accommodate the redemption of deposits and other liabilities,

as well as to cover the demand for loan and investment funding (Van Greuning and Iqbal, 2008).

Nevertheless, considering the controversy surrounding *bay' al-'inah*, the central bank has discouraged Islamic banks from using this instrument in their financing products (BNM, 2007). Moreover, the central bank has attempted to strengthen the application of *bay' al-'inah* and enhance its operational processes and documentation to comply with the theoretical features of *bay' al-'inah* that are mentioned by scholars who favor it. This can be seen when, in 2009, the central bank tightened the parameters of *bay' al-'inah*, stating that it must consist of two clear and separate contracts without stipulated condition in the sale contract to repurchase the asset. In addition, both contracts should be concluded at different times (BNM, 2010). This approach, it is argued, has successfully encouraged Islamic banks to replace this contract in their products (Amer Hamzah and Vizcaino, 2014). Another approach to minimize the influence of *bay' al-'inah* has been to introduce Bursa Suq al-Sila' (BSAS). This special exchange was introduced by Bursa Malaysia for practicing *tawarruq* because it can avoid the element of *bay' al-'inah* as the sale to the commodity supplier is carried out on a random basis (Dusuki, 2010).

Through this issue, it is learnt that the application of *maṣlaḥah* must be carried out realistically in order to successfully achieve it without causing any adverse result. While it is undeniable that *bay' al-'inah* is a controversial contract in terms of its status, it also provides *maṣlaḥah*. Therefore, it is important to engage with this issue gradually, considering its impact on the Islamic banking industry. Moreover, it is important to note that the technical issues in Islamic banking should not be exaggerated. In other words, strengthening the application of *bay' al-'inah* to avoid the element of a trick to practice *ribā* seems to be a more practical solution than banning it totally.

Standardizing the ta'wiḍ rate

Ta'wiḍ is one of the measures imposed by Islamic banks on defaulting customers. In general, according to the Qur'ān (3:130), charging borrowers due to late payment qualifies as *ribā* (Ibn Kathīr, 2008). However, in the case of current Islamic banking operations, if this penalty is totally abolished, it may affect the banking practice altogether. In other words, any delay by customers will directly affect Islamic banks as the financier in terms of incurring additional expenditure such as the costs of issuing notices and letters, as well as legal fees (BNM, 2010). Moreover, the context of the verse is argued to be slightly different from the context of practicing late payment charges. Islamic banking institutions act as financial intermediaries between two sides, taking capital from one side, and offering financing to the other side (Briscoe and Fuller, 2007). When customers default or make late payments on their financings, it impacts the liabilities side of the bank as well (i.e. affecting deposit customers).

Realizing the *maṣlaḥah* behind this issue, many bodies allow the implementation of a late payment charge, but with different approaches. The IIFA, for example, has allowed Islamic banks to impose a penalty clause in a financial contract if any party causes harm to another, and the *ta'wiḍ* is imposed based on actual loss (IIFA, 2000). Nevertheless, AAOIFI in its Shari'ah standards mentioned that *ta'wiḍ* should not be imposed, whether by mentioning this condition at the beginning of the contract or through court judgements. However, AAOIFI agrees that debtors should bear all expenses incurred by creditors resulting from the debt settlement process. It also allows the mention in the contract that if there is a delay in payment, debtors must donate a certain amount of money to charitable bodies, known as *gharamah* (penalty) (AAOIFI, 2010).

In the case of Malaysia, the SAC in its 4th meeting introduced a late payment charge for Islamic banks based on the concept of *ta'wiḍ*. This charge must, however, fulfill three conditions: its amount cannot exceed the actual loss suffered by the Islamic bank, the compensation shall be determined by the central bank and the default or delay of payment must be applied only to customers who have not paid despite having the ability to do so (BNM, 2007). Later, *gharāmah* was introduced as another option for Islamic banks, as well as a combination of *ta'wiḍ* and *gharāmah*. The main difference between *ta'wiḍ* and *gharāmah* is that the former can be recognized as income while the latter must be channeled to charity. In addition, the rate of *ta'wiḍ* must be imposed at one percent per annum, while *gharāmah* can exceed 8 per cent per annum (BNM, 2015).

In regard to *ta'wiḍ*, its actual loss can be formulated from the costs in the claiming process of debt such as lawyers' fees, auction fees, storage fees and assessment fees, as well as communication costs (Md. Hashim *et al.*, 2011). However, the different approach imposed by BNM in this case is to standardize the rate of *ta'wiḍ* at one percent per annum (BNM, 2010). This could go against the original concept of *ta'wiḍ*, which aims to cover the actual loss incurred due to the delay of payment. Moreover, one percent is similar to the late payment penalty imposed by many conventional banks in Malaysia, and this may cause the public to view both systems as having no appreciable difference.

Nevertheless, BNM's standardization of the *ta'wiḍ* rate realizes greater *maṣlahah*. First, if Islamic banks were allowed to charge the actual loss based on their own judgement, it might lead to issues of transparency and exploitation of customers. Second, charging more than one percent and recognizing it as income would create a negative perception towards Islamic banks because it would be higher than the amount charged by their conventional counterparts. Third, *ta'wiḍ* is easier to apply without additional cost and effort in comparison with *gharāmah*, which needs to be channeled to charitable organizations (Laldin, 2017). Finally, it is important to standardize the actual loss which usually is based on the cost of funds. Using an appropriate rate can avoid a disruption of the banking operation, including depositors' withdrawals, banks' earnings, and financing activities. All of them could affect both the reputation and image of the IFI (Md. Hashim *et al.*, 2011).

To conclude the issue, it seems that *maṣlahah* of standardizing the rate of *ta'wiḍ* should be taken into consideration because it affects the viability of the Islamic banking industry. At the same time, it is important for Islamic banks to be careful in implementing *ta'wiḍ* since late payment charges in Islam must be different from the practice of *ribā*. In this regard, even though the central bank has allowed *ta'wiḍ* to be recognized as a bank's income, it would be better for Islamic banks to take a precaution in this matter. This includes recognizing only the actual loss and channeling the remaining money to charitable organizations.

Stipulating ibrā' in financial agreements

Technically speaking, *ibrā'* is an action by lenders to withdraw their right to collect the debt from their borrowers (Mohamad and Trakic, 2013). Based on the majority of literature written by classical scholars, *ibrā'* is considered a benevolent practice that is given at the sole discretion of the creditor without any consideration or counter-value (Abdul Khir, 2013). In modern Islamic banking, *ibrā'* plays a significant role when Islamic banks implement floating rate pricing on their products. This results in two different prices: the maximum selling price, known as the ceiling rate, and the price calculated against the specific rate, known as the effective rate (Lahsasna, 2014). For example, in BBA financing, the selling price could be based on a profit rate of 10 per cent, but Islamic banks only require a 6 per

cent effective rate based on the current financing because customers enjoy an *ibrā'* of 4 per cent (BNM, 2019).

What made such practice of *ibrā'* in Malaysia unique was when the central bank issued a special regulation that Islamic banks must incorporate a clause of *ibrā'* and its calculation in their financing agreements. At the SAC's 101st meeting on 20 May 2010, this approach was introduced to further safeguard public interest and to ensure that customer protection is carried out consistently (BNM, 2013). Nevertheless, this resolution of the SAC appears contrary to the resolution of the IIFA, which says that *ḍa' wa ta'jil* (reducing the amount for speeding up payment), is allowed as far as it is not agreed upon in advance (IIFA, 1992). In fact, the practice of *ibrā'* in Islamic banking today is similar to the discussion of *ḍa' wa ta'jil* among classical scholars (Dusuki *et al.*, 2010).

While this decision seems to be against the original concept of *ibrā'* which should be at a bank's discretion, it protects the *maṣlahah* of customers, particularly in the case of early settlement, when a customer is liable to pay the entire selling price even though no deferment has been given to them to settle their debt (Abdul Khir, 2016). In this regard, to achieve the more important *maṣlahah*, in some cases, the specific *maṣlahah* needs to be compromised. In this case, the *maṣlahah* of transparency and fairness between contracting parties must be seen as a priority instead of the original *maṣlahah* of *ibrā'*, which is to show benevolence. Also, this decision is argued to bring *maṣlahah* for the image of Islamic banks because, prior to this, many disputes between them and their customers were because of the unclear and unfair application of *ibrā'* (Dusuki *et al.*, 2010).

Nevertheless, it is also unfair to blame the original concept of *ibrā'* when it is adopted only to justify the practice of floating rate, as well as to avoid the high price of Islamic banking products. Although Islamic banks have been established for more than half a century, their products are significantly influenced by interest rates. In addition, the predominant contracts being applied are debt-generating, which is a common factor they share with conventional contracts. Therefore, for the sake of long-term consequences, Islamic banking players must strengthen their effort to establish a better concept of financing for Islamic banks. For example, equity-based products such as *musharakah* (partnership) contracts where *ibrā'* is not implemented in their practice.

Conclusion

This paper has attempted to investigate several Islamic banking contracts and principles in Malaysia from the perspective of *maṣlahah*. While Malaysia is leading the Islamic banking industry in many aspects, BNM, through the SAC, has developed several resolutions which differ from those of some international bodies. Moreover, these resolutions are not being practised in some Muslim majority countries. These include allowing *bay' al-'inah*, standardizing the rate of *ta'wid* and stipulating the *ibrā'* clause in financial agreements.

From the above discussion, it is found that BNM has attempted to consider the *maṣlahah* of both Islamic banks and their customers in its regulations. In the case of *bay' al-'inah*, this contract helps to facilitate the bank's liquidity as well as helping to fulfill people's needs. As for *ta'wid*, standardizing its rate makes this penalty easier to impose, and also this approach can protect customers from exploitation. Meanwhile, requiring Islamic banks to stipulate an *ibrā'* clause in their financial agreements not only protects customers in the case of early settlement, but it has also improved the image of Islamic banks because the previous practice of *ibrā'* was claimed to be unfair. Thus, it can be concluded that the implementation of *maṣlahah* aims to sustain the viability of Islamic banks and ensure fairness and transparency between Islamic banks and their customers.

Nevertheless, it is important for Islamic banking players to consider their current practices. In this regard, *bay' al-'inah* should be replaced with another less controversial contract. As for *ta'widq*, it would be better for Islamic banks to recognize only the real cost from their one percent per annum charge and to channel the remaining money to charitable organizations. Meanwhile, in the case of *ibra'*, Islamic banks can avoid this practice by offering equity-based products such as *musharakah* instead of debt-based products that, it is argued, are not in line with the spirit of Islam.

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About the author

Muhammad Shahrul Ifwat Ishak, PhD, is a lecturer at Faculty of Economics and Management Sciences, Universiti Sultan Zainal Abidin (UnisZA), Malaysia. He obtained his PhD from the University of Aberdeen. His research interests focus on the application of *maqāṣid al-Sharī'ah* (objectives of Islamic law) in Islamic banking. Muhammad Shahrul Ifwat Ishak can be contacted at: shahrulifwat@gmail.com