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Digital transformation of value-based intermediation - a risk-based perspective

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Abstract: Islamic Finance has a strong base from Maqasid al-Shari'ah perspective to really develop a system on social justice & environmental wellbeing to further establish a sustainable value-based economic system. Islamic Banks on this very value-based system can flourish and lead the banking industry. Financial stability is the goal of every organization but adding to it a sustainable ecosystem, modern technological products & services, and proper utilization of the resources broaden the horizon for financial institutions. Luckily, Islamic Finance has these attributes inherited in its principles and legal classical fiqh maxims. We focused on the digital transformation and the risk arising from it while adopting those innovative technology products and services. We will come up with the mechanism to mitigate those risks and evaluate it from Maqasid al-Shari'ah perspective in value-based intermediation. Good attributes in the overall culture of the organization are important and they can be the core value. It must consist of integrity, maintaining high moral standards, fairness & justice, and transparency. All these attributes are already existing in Islamic economics theory. The modern organization to adopt these attributes in digital transformation can lead them to a value-based system that can be trustworthy and sustainable. The Maqasid's guidance can further strengthen this system and make it more reliable and sustainable with the concept of realism which can better contribute to the people, the profitability of the organization, and our planet a healthy place to live.

Keywords: Value-based intermediation; digital transformation; risk mitigation; Maqasid al-Shari'ah

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1. Introduction:

The value-based intermediation is a function with the objective of carrying the projected result of Shariah through practical implication, yielding again with a positive and sustainable impact on Gross domestic products (GDP) of the country, environment and enhancing the overall profitability of the organization which leads to uplifting the society socially & financially and also achieve the shareholder's proposed financial and strategic goals.

We have evaluated what are the Value-based intermediation (VBI) benefits and how it works. We have also elaborated about the digital transformation of Value-based intermediation (VBI) and the associated risk and its mitigation. We will discuss the potential of Islamic financial institutions and the unforeseen risk they are exposed to and recom-

mentation of a strategy to mitigate those specific risks. We will focus on value-based intermediation from Maqasid al Shariah perspectives. We will evaluate the Shariah governance framework and analyze the shortcomings of it and will also highlight the challenges & hurdles in its implementation.

The socio-economic development and uplifting of the standards of the life of the common men living in the society is a major concern. How to fix it to make Islamic Financial institutions more viable and justice-based. Through the litmus paper of Realism, we will analyze the current Islamic banking system and suggest changes.

2. Maqasid al Sharia'h perspective

Maqasid al-Shari'ah is basically a set of regulations derived from Shariah that really identify and promote the typical working of society by achieving the public benefit. This will help protect the society from any harm but not following it will damage the people and further the society as a whole. The motive behind this is to achieve the monetary and social uplifting of society.

So, the Maqasid Al Sharia'h concept and its target is to protect the system from any harm through the following postulates.

- Protection of Faith
- Protection of Health
- Protection of Lineage
- Protection of intellect
- Protection of wealth

The socio-political built financial framework places the prosperity of society at the Centre and accomplishes human advancement through reasonable circulation and foundation of social equity and value as proposed by Maqasid al Shariah or the targets of Shariah (Jan et al.,2018).

The comprehensive perspective on the financial goals for the arrangement of adjusted society makes the Islamic financial substantially more than only an establishment dependent on the standard of intrigue prohibition and adjusting to the lawful prerequisites and details of items and administrations for Shariah consistence(Nouman et al.,2014; Shinkafi et al., 2017; Shinkafi et al.,2017).

The prosperity, equity, and fraternity are the chief objectives of Islam which make prosperity the foundation of Islamic banking. This prosperity incorporates both the spiritual aspects and physical spirit of the human character remembering the felicity for this world and akhirah. This reality calls for the explanation that profit expansion cannot be a definitive objective of the Muslim society, rather it ought to be based on the social, monetary, and justice, which gives equivalent basic liberties to all individuals independent of their religion and beliefs (Al-Omar, & Abdel-Haq,1996). Consequently, the regular business establishments have benefit as a definitive objective; Islamic banks need to incorporate both social commitment and benefit as their objective Ullah et al.,2017).

Religion's protection from the concept of the Maqasid Al Sharia'h is when Riba is avoided and there is a clear injunction in Sharia'h derived from primary sources. So there is no tolerance for Riba in any capacity. In Quran in Surah e Baqarah Ayah 275, it is said that "Those people who consume Riba/Usury will not stand except as stand one whom the evil touch has driven to Madness. That is because they say: "Trade is like Riba," but Allah has permitted trade and forbidden usury (riba)"

Nafs get protected when trade is based on religious obligations and no Riba & burden of loss on one party while doing business together. The best example of financial product that, somehow, faces Maqasid al-Shari'ah in Islamic capital marketplace could be seen in equity-based sukuk. The Important singularity of equity-based sukuk, from Shari'ah point of view, lies in their two essential conceptions:

1. The capital cannot be warranted

2. The periodic returns are also Interdependent on real profits made and can be irregular (Dusuk, 2009).

Mal gets automatically protected when our very first footstep towards earning that is investment is done by halal Means. Thus, all the Maqasid are interrelated and connected with each other. The importance of the Maqasid al-Shari'ah in the Islamic account begins from the point of view of wealth in Islamic law. This relates to the targets of the Islamic law in financing and business exchanges and to the general objectives of Shari'ah in wealth. (Lahsasna, 2009). Islamic capital market like customary is a remarkable factor of the general Islamic financial scheme. It plays an indispensable role in the allotment of funds, from savers to borrowers in daily human activity.

Moreover, the Islamic capital market fundamentally furnishes a tremendous section of liquidity to a large number of non-liquid assets. This is accomplished by supplying a broad spectrum of goods assorted from Shari'ah-compliant securities to bond-like placement known as Sukuk (Vejsagic & Smolo, 2011).

3. Value-based intermediation in Islamic Banks

As we know that financial products and services are the main focus of all the banks but it has to be broadened to no financial activities such as the wellbeing of the society, more disclosure and awareness to customers, sustainable environment, and profit & growth enhancement. This will lead to higher transparency and further this transparency will motivate the stakeholders for some good decisions with wider benefits.

The VBI was proposed by the Malaysian central bank. It was rightly devised because the Malaysian Islamic Banking industry is well regulated with proper infrastructure and future vision. Islamic Banks are already offering Shari'ah-compliant products and services but it's time to broaden the horizon by focusing on non-financial aspects along with financial aspects. IBI's mission shouldn't be restricted to Shari'ah compliance of a few products only, Shariah compliance is the base of Islamic Banking but Shariah in totality will be seen in VBI implementation. Shariah in totality will cover all aspects whether financial or non-financial.

It is important in VBI implementation to have a clear vision of the IBI and the proper mechanism of performance review. IBI's will be responsible to formulate a business-driven strategy with no contradiction to Shariah and also meet the social needs of the society. The core values and objectives will be followed strictly to achieve the goal and be ready for leading the industry. It is possible only if IBI's has a strong governance structure. The regulatory framework can help the IBI's up to some extent but with the help of best governance practically can take them to the driving seat. A smooth drive for IBI's is possible with better infrastructure and good governance with strong command, control, and clarity from top to bottom.

It is important to go ahead and take the Islamic Finance industry to the next level with sustainable development and growth with a clear strategic plan. The future strategy should be different than what it is now or what it has been so far. The future strategy should be more focused on financial as well as non-financial aspects. We should keep the people's social and economic benefits and think about the planet we are living in, besides profitability. Profitability should not be the only concern of the banks but there must be some value-added propositions.

As modern technology is taking place of the traditional process and products. In the digital transformation, many challenges will come and risks will arise. There is a Shariah non-compliance risk and cyber security risk, the major among others associated with digital transactions. In the innovative technology-based transaction, It is necessary that subject matter should exist physically, which must be Halal as per Sharia'h. Possession of the subject matter either physical or constructive is a must condition and proper transfer of the owner too. The digital transaction's process flow should be the same as in the contemporary existing Islamic Banking but in the case of digital transactions, further vigilance is required to eradicate the element of Gharar/Uncertainty. Their Sharia'h process flow for

the digital transaction should be fully approved by the Shariah advisor and Shariah Board. The socio-political built financial framework places the prosperity of society at the Centre and accomplishes human advancement through reasonable circulation and foundation of social equity and value as proposed by Maqasid al-Shariah or the targets of Shariah (Jan et al., 2018).

It will be a win-win situation if all stakeholders are given a proper role to contribute. The focus should be realigned to eliminate the negative impact of Islamic Banking on society in general. As we already accentuated that negative impact should be eliminated, and it shouldn't have any impact on profitability and non-financial aspects including environment:

"Intended outcomes of Shariah focus on the enhancement of the well-being of the people through preservation of wealth, faith, lives, posterity and intellect. In the context of Islamic financial business, preservation of wealth goes beyond its literal meaning since it includes encouragement to generate, accumulate and distribute the wealth in a just and fair manner" by Bank Negara Malaysia.

The intended outcomes of Shariah should be based on just dealings, dealing with zero gharar and no exploitation and speculation and zero externalities. So the transaction should be based on realism. "The asset is non-existing at the time of finance provision in certain types of sales, they remain valid and permissible as they still conform to the Maqasid of dealing with real-life needs and surrounded with conditions that line them up within the principle of realism as it is evident in the condition of deserving return only after possession in parallel Salam and parallel Istisna' which make them truly represent actual genuine transactions. The key to legitimate Islamic financial engineering would then not be to superficially fulfill the form of a contract but to meet the requirements of the Shari'ah in form and substance and observe the Maqasid behind its rulings" (Kahf & Amiirah, 2016).

The basic theory of realism is to adopt the set of policies with the spirit of the Shariah which is free from all prohibited things, modern financial technological products should also be free from the aspects discussed and must not be harmful to the IFI's, common people and our environment. "The use of FinTech in a particular Islamic finance product should not be such as to create harm, deception/ cheating, hidden costs, nor should it inculcate any Riba, gambling, Gharar, or other prohibited elements such as those that make the sale invalid" (Irum et al., 2020).

Islam always supports positive economic activity and economic development. Islam also gives assurance to business and economic enhancement through decent work, expressing the difference between right and wrong, Halal and Haram (disallowed). That's the reason why Riba, Maysir, fraud, bribe, theft, etc. are strictly prohibited in Islam because it is not only harmful to individuals but these bad tactics are disturbing society socially and economically.

Protection of wealth is one among the Maqasid of Shariah, in a broader sense the protection or preservation of wealth is with proper possession and transfer of the ownership, avoiding misinterpretation and misuse of the rights of others, and recognition of the ownership of the wealth or property/asset. Another aspect is equitable distribution of income rather than equal distribution. A proper mechanism should be in place for equitable distribution of income. The needs of the people in the society should be known. Equal distribution is giving equal to everyone in the society and equitable distribution is giving people according to their needs. Accumulation of wealth and its use in Shariah legitimate progressive sector of the economy with proper pre-feasibility work and also discourage the unreal activities and transaction which is against the real spirit of the Shariah.

4. Propose Structure:

IBI's to establish the Assembly of the practitioners (AOP) and it should work together with the VBI members who will be team members of the concern IBI. These members will

be from the Risk management department, Information technology department, cyber security department, Finance & strategy department, and Shariah advisor of the bank. The main objective of the group will be to come up with the knowledge product guide and process of implementation as per international standards. They will devise the core value proposition (CVP) and VBI Financial strategy (VBI-FS). The success and achievement of goals will be evaluated through a special purpose VBI-Key performance indicator (VBI-KPI). VBI-Knowledge management (KM) system will be formulated for awareness and training purposes.

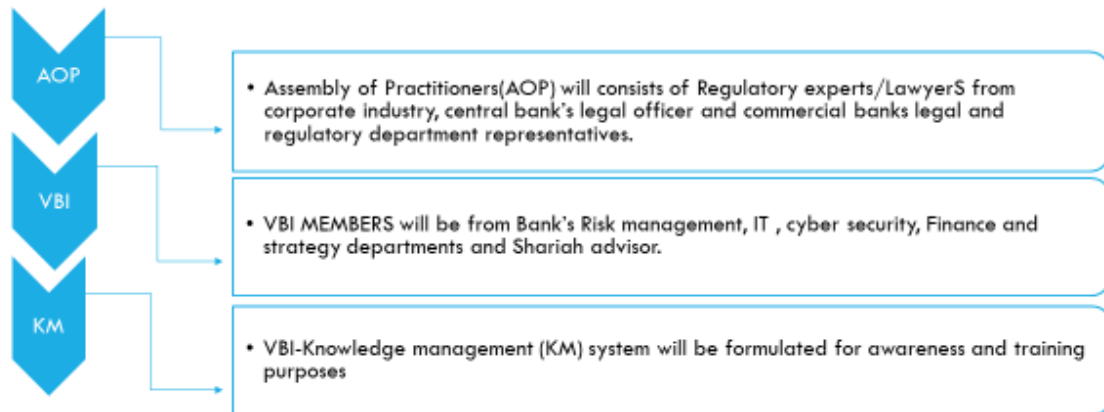


Figure 1: the sequence and activities of the concern representatives

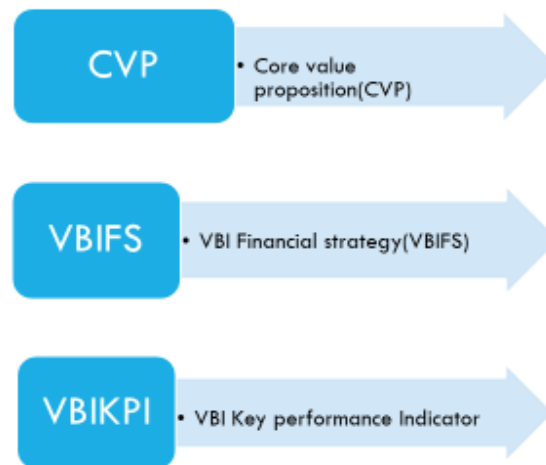


Figure 2: The output of the above activities

5. IBI's and a way forward

The governor of Bank Negara Malaysia said that “the rapid changes and dynamism of the industry require Islamic finance to strive even harder now. True to its name, Islamic finance needs to continuously carve its own branding and distinctiveness to provide wholesome value propositions. On this premise, the next frontier and the major milestone would be positioning Islamic finance to become a more prominent and leading agent of positive change for the financial system and operates within a network economy that is built upon shared values of integrity, inclusivity, and sustainability. Greater attention will

be devoted to value creation and value-based businesses that reflect the true essence of Islamic finance.”

It is stated in the implementation guide for VBI by Bank Negara Malaysia in 2018 “Implementation of VBI may, to a certain extent, transform existing banking practices, business modality, and risk profile. Such transformation usually requires major capacity building, which may adversely affect operational efficiency and competitiveness of industry players”. It is one of the biggest challenges to IBI’s.

Proper segmentation of the society is required to offer products and services to people after a need base analysis. This segmentation can be on the basis of geographic and demographic bifurcation. From one area to another area in the country, the demands and needs of the people are changing. It depends on the education level, production, employment/business, climate, and also geographic connectivity of the area. Connectivity can either be through expressways and canals as the route for trade and its easy access to main markets in commercial cities.

For the innovative products which can be modern technology products and services, we need a proper regulatory framework from regulators for Islamic Banking. We should have in-house experts for both cyber-attack detection and stopping and also experts to develop modern technology applications without involving any third party. These modern technology experts in-house will protect banks from any external cyber breach of their system. No third party means Banks will not share its system through the interface and will not give any weak space for cyber attackers to enter the bank’s system. Cyber risk is “Unlike other risks, cyber risk poses a uniquely different set of exposures as it is intertwined with the medium and the message in the increasingly global interconnected, distributed, and, networked world of digital communications powered by universal use and reuse of enabling global monocultures of ICTs and standard computing network protocols.”(Malhotra,2015).

6. Risk in digital transformation

There are several risks in digital transformation but the prominent is implementation risk and governance risk. As per Deloitte’s report on managing risk in digital transformation, implementation is “Risk-based architecture for the digital enablers, w.r.t. technology, operations, vendors, compliance, security and resiliency, right digital technologies for different business processes and Culture of ‘digital mindset’ and a secure usage of the digital components” and they further added about governance risk that “Effective governance around the Digital transformations to ensure cross-functional synergies and eliminate risks arising due to interdependent processes, Risk management framework that can be used by the organization for managing risks that may arise in any future digital initiatives”. A proper risk governance risk framework and strong risk-based architecture are necessary to mitigate the risk in digital transformation.

“Digital transformation is not really a pure technological revolution. Indeed, it is the driving force of the third industrial revolution which concerns the development of new information and communication technologies, where the increased usage of digital devices and digital platforms are transforming the way customers do banking, changing market expectations, and transforming the model of financial intermediation as well” (Omarini,2017).and they further added “Digitization of products, services, and business processes allow disruptive players to deliver the same value a traditional competitor provides—and even augment it—without having to reproduce the conventional value chain. In fact, that is the objective of digital disruption: to provide superior value to the end customer—either a consumer or another business—while avoiding the capital investments, regulatory requirements, and other impediments of encumbered incumbents with a new and different business model”.

7. Associated Risks

The trend of the market is adopting innovative technology-based products and services in order to grab more business and be easily accessible. But innovative digital products are not free of hazard and risk.

There can be many risks associated with digital transformation but some of them are given below;

- Legal and Regulatory Risk
- Software System adaptability and interface with the third party
- Customer's education on technological products and services
- Human capital scarcity for developing technological services in the financial sector
- Data management risk
- Third-party risk in Fintech transaction
- Cyber security risk
- Shari'ah non-compliance risk
- Ownership and possession risk in a digital sales transaction

The technological products and services are more rapidly coming than anticipated by Islamic Financial institutions. Deloitte added in Managing risk in digital transformation that "We have considered 10 risk areas– Strategic, Technology, Operations, Third Party, Regulatory, Forensics, Cyber, Resilience, Data Leakage, and Privacy–as the risk landscape in any digital ecosystem. Based on the applicable risk areas for the digital initiatives, different control measures need to be designed as per leading standards and industry practices. The critical aspect in defining the controls is to take into consideration the nature and level of digitization in the operations, as most of these areas are at a nascent stage and tightly coupled with systems or manual processes, so there might be constraints to implementing the controls".

8. Challenges to IBI's

Now the challenge is that how value-based intermediation can change the prevailing Islamic Banking modus operandi? Islamic Bank should come up with innovative products and adopt modern technology products and services to facilitate their people in a better way. In this digital transformation of the Islamic Banks, some risks will arise mainly, cyber security risk and Shariah non-compliance risk.

No proper ownership and constructive or physical possession of the subject matter while transacting it digitally, the specific risk is arising known as Non-Shariah compliance risk. In a Fintech-based model transaction, it can arise because sometimes the transaction span is only a few seconds. It would be vulnerable if IBI's had no proper command and control over the technology product from designing.

Cyber security experts are in scarcity in the market. If no in-house team of experts then IBI's will be exposed to this very risk and will have no protection. These experts in IBI's are the first line of defense against any external intervention of cyber-attack.

The customer is price-centric and consider while taking any financial decision. IBI's products can be expensive due to the value-added propositions. This may discourage the customer from a financial relationship with IBI's.

IBI's top leadership's concepts must be clear and the mission statement of the organization should be agreed upon by all top management executives. More clarity will lead to more success in the implementation and governance of the VBI. Confusion among the management can be a real challenge. VBI Implementation may change the existing policies and procedures. With no proper understanding and training of the VBI will affect the effectiveness and efficiency of the staff. IBI's would not be competitive enough in the market.

9. Recommendation and conclusion:

A proper modern technology risk-based architecture and governance should be in place in IBI's to curb the risk arising in digital transformation. Proper training should be given to staff to understand the VBI and changes it causes to the policy and operational procedure of the concerned IBI's. Uniformity in the vision and mission statement after the agreement and understanding of the IBI's executives is a must.

Price consideration by the IBI's in product development along with value-based proposition to meet the customers' needs. VBI management by the IBI's top executive to oversee the activities and recommendation of AOP and proper monitoring of the implementation. IBI's should focus on the strategy and core values formulation to achieve the objectives of the VBI with proper performance evaluation. Shariah Advisor/Residence Shariah board members should be given a key role in VBI and KM in order to have knowledge products as per the Maqasid al Shariah guidelines and training to staff. IBI's should have a proper cyber security department in-house consisting of cyber security experts to detect any cyber-attack.

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