Islamic Principles to Construct Islamic Social Finance Instruments

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Presentation Outline

• Social Finance: Islamic Values and Principles

• Islamic Social Finance: Framework & Products

• Islamic Social Finance: The Way Forward
Locating Economics/Finance in Islam

Aspects of teachings in Islam

- Belief and Ethics
  - *Aqidah*—faith and belief
  - *Akhlaq*—ethics and moralities
    - Ethics related to economic/financial activities

- Practices and Laws
  - *Ibadat*—Rules of relationship between human and The Creator (rituals & worshiping)
  - *Muamalat*—Laws related to human dealings with the created, including other humans (Political, social, economic, etc.)
    - Laws governing economic/financial activities
Classification of Acts

• Classification of acts (*al ahkam al khamsa*)
  – Obligatory (*wajib*)
  – Recommended (*mandub*)
  – Permissible (*mubah*)
  – Reprehensible (*makruh*)
  – Forbidden (*haram*)

• Obligatory and forbidden have legal force, other acts have moral underpinnings
Law and Ethics in Islamic Law

- Law and ethics from the same source—Shari’ah (Quran and Sunnah)
- Legality of contracts
  - Valid (Shari’ah compliant) and Invalid
- A contract can be legally valid, but unethical
- Principles of ethics can be understood from
  - Values and principles provided in the legal maxims (quwaid al fiqh)
  - Overall objectives of Shariah (maqasid al Shariah)
Contract: Legality & Ethics

Intention: To do the permissible, increase benefits, avoid prohibitions & harm

Contracts have to be legally valid (Shariah compliant)

Impact/Outcome: Any contract that lead to illicit or harmful outcome is void/reprehensible

- Focussing on the legality of contracts only is not enough to make judgments on ethics
- Example—sale of grapes to winemaker or weapons to robbers
  - Malikis and Hanbalis—invalid
  - Shafi‘is & Hanafis—reprehensible
- Harmful consequences or transactions affecting welfare adversely will make contracts unethical
Legal Maxims as Source of Ethics

• Legal maxims (*quwaid al fiqh*)—General principles of Shariah
  o Based on Quran and Sunnah
  o Manifests the essence of Shariah
  o Used as guidance in framing new laws

• Some maxims have legal and others ethical connotations
  o Legal: ‘What is prohibited to take is also prohibited to give’
  o Ethical: ‘Judgment is to be based on knowledge and understanding’
Maxims Related to Contracts

• Maxims related to Contracts:
  – ‘Matters are determined according to intentions’
  – ‘The fundamental requirement in every contract is justice’
  – ‘In contracts attention is given to the objects and meaning, and not to words and form’
  – ‘Harm must be eliminated’
Objectives of Shariah

• Overall Objective of Shari’ah—introduces ethical/social elements
  • Fundamental maxim: Shariah’s goal ‘promotion of welfare (maslahah) and prevention of harm (mafsadah)’

• Shatibi—maslahah is achieved by promoting
  • Essentials (daruriyyat)
    • Elements necessary for proper functioning of an individual’s life and society and their absence would lead to chaos and disruption of social order
  • Complementary requirements (hajiyyat):
    • Elements that facilitate life and their absence leads to hardship but not breakdown of the social order
  • Beautifications or embellishments (tahsiniyyat)
    • Elements that enhance and refine the customs, culture and conduct of people and society
Essential Goals (maqasid al Shariah)

- Essential Goals (maqasid al Shariah): ‘Protection of religion, life, reason, progeny, and property serves to increase welfare’ for all

- Values & Principles guiding some of the goals:
  - Messenger of Allah [SAW] said: 'Seek refuge with Allah from poverty, want, humiliation and wronging others or being wronged.' (Sunan an-Nasa’i 5461)
  - The Messenger of Allah [SAW] used to say: O Allah, I seek refuge with You from Kufr and poverty." A man said: "Are they equal?" He said: "Yes." (Sunan an-Nasa’i 5485)
Social Values & Orientations

• Values & Principles guiding some of goals beyond self
  – “...If you leave your heirs rich that is better than leaving them destitute and begging from people.” (Sunan Ibn Majah, Vol. 3, Book 22, Hadith 2708, Sahih)
  – "The best of people are those that bring most benefit to the rest of mankind." [Daraqutni, Hasan]
  – Allah's Messenger (ﷺ) said, "There is none amongst the Muslims who plants a tree or sows seeds, and then a bird, or a person or an animal eats from it, but is regarded as a charitable gift for him." (Sahih al Bukhari Vol 3, Book 39, Hadith 513)
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SDGs Themes and Financing Gaps

Economic

- UNCTAD—Developing countries investment gap in achieving SDGs US$ 2.5 trillion/per year
- The gap has to be filled from different sources in a holistic and optimal manner: Public, private and nonprofit sector
ISLAMIC FINANCE

• Social and ethical ethos, asset-linked and risk-sharing features of Islamic finance—conducive for promoting SDGs
• Islamic social finance—focus on financial inclusion and social impact
Social Finance Sectors and Instruments

• Financial institutions
  – Different Islamic financial products provided to all

• Capital markets
  – Social Impact funds, Social impact sukuk

• Nonprofits
  – Zakat, Waqf, Qard hassan
# Product Structure Features

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Examples</th>
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</thead>
<tbody>
<tr>
<td>Market Segment</td>
<td>Consumers—Affluent, Middle-class, Poor Producers—Micro &amp; Small, Medium, Large</td>
</tr>
<tr>
<td>Purpose/Need</td>
<td><strong>Survival/Essential</strong> (<em>dururiyyat</em>)—demand/savings deposits, emergency cash, working capital financing, etc.</td>
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<td></td>
<td><strong>Security/Complementary</strong> (<em>hajjiyat</em>)—cash reserve and risk management needs, etc.</td>
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<tr>
<td></td>
<td><strong>Growth/Embellishments</strong> (<em>tahsiniyyat</em>)—risk and tax protection, hedge funds, etc.</td>
</tr>
<tr>
<td>Mode</td>
<td><em>Murabahah, ijarah, salam, istisna, mudarabah</em>, etc.</td>
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## Financial Needs, Market Segments and Social Finance

<table>
<thead>
<tr>
<th>Needs</th>
<th>Segments</th>
<th>Poor/Micro &amp; Small</th>
<th>Middle Class/Medium</th>
<th>Affluent/Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Survival (necessities)</td>
<td>A1</td>
<td>B1</td>
<td>C1</td>
<td></td>
</tr>
<tr>
<td>Growth (luxuries)</td>
<td>A3</td>
<td>B3</td>
<td>C3</td>
<td></td>
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</tbody>
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- Fulfilling Social Outcomes—products satisfying A1, A2, B1, B2
- Not fulfilling Social Outcomes—products satisfying A3, B3, C1, C2, C3
Social Finance: Analytical Framework

Pathways to Social Impact

Financial Institutions
- Commercial
- Nonprofit

Products
- Survival
- Security
- Growth

Market Segments
- Poor & Middle Class/MSMEs
- Affluent/LEs

Outcome/Impact
- Economic
- Social

Commercial
Blended
Nonprofits

Survival

Social

Security

Social + Economic

Poor & Middle Class/MSMEs
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Islamic Social Finance—Way forward

• The focus of Islamic finance is on *Shari‘ah* compliance—prohibition driven industry
• This approach cannot contribute to economic, social and environmental goals (SDGs)
• Moving forward, implementing Islamic social finance would require changes at different levels
  – Epistemological (Conceptual/Methodological)
  – Innovations to implement Islamic social finance
Islamic Finance and Social Value Creation: Epistemological/Conceptual Issues

• Need to expand the notion of Shari’ah compliance from negative screening to include broader maqasid perspective
  – Pay attention to both means and ends
  – Maqasid is about ends/outcomes—maslahah and mafsadah

• Need to include positive screening by examining social goals and environmental impact

• Shariah perspective—AAOIFI disclosure standards has not yet contributed standards to SDGs

• Incorporating social values in Islamic financial practice would require linking these to maqasid and the Shariah sources
Approaches to Innovation

• Current Practice: ‘Reverse engineering’—an Islamic replication of a conventional product is engineered
  – Contractual stipulations (mode) are fulfilled in a legalistic manner

• Way forward: ‘Innovative engineering’—come up with Shari’ah based products
  – Start with the market segment and needs and then come up with new products satisfying the need and the form/spirit of Islamic law

• Innovations in both products and organizational formats (including fintechs)
Islamic Social Finance Innovation: Akhuwat

- Interest free loans to groups (social collateral) and individuals with guarantee
  - Groups being phased out
- Individuals must have two guarantors
- Branches associated with mosques/church
- Loans (qard hassan) advanced in mosques
- Dec 2016: Branches—569; Amount disbursed—Rs. 33.854 billion; Recovery rate—99.93%
- Jan 2019: Branches—811; Amount disbursed—Rs. 78.482 billion; Total benefitting families—3.188 million; Recovery rate—99.95%
- Akhuwat’s model challenges deeply entrenched assumptions about economic behavior and microfinance models
Questions??

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