**Islamic Finance and Social Welfare**

**An Introduction to the Issues and Practices**

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We live in a time of distrust, destruction and disparities of all kinds galore. Economies are operating at levels never seen in human history, yet markets are volatile and wealth distribution highly skewed. Financial markets have made many billionaires, yet a vast majority — especially in the developing world — are still excluded from the fruits of this unprecedented economic development. In response, international organizations such as the United Nations have initiated Sustainable Development Goals (SDGs), succeeding the Millennium Development Goals (MDGs) to achieve a minimum level of standards of life for all.

Many individuals have also responded to the challenges faced by humanity by creating charities out of their life savings. Governments in various countries have come forward to mandate their corporate sector to spend a certain percentage of their profits on socially responsible activities. Big institutional investors are turning to more ESG investments than ever before. Retail investors are also making sure that they invest their savings in businesses which do not just cater to profits but are also concerned with people and planet.

Islam, since its inception, has shown great care for the poor, orphans, widows and other destitute individuals. Many financial tools such as *zakat*, *sadaqah*, *qard hasan*, *fitra*, *waqf* and *takaful* have been used by people to support and care for each other. In fact, the Quran is very explicit in its declaration that the poor have a right to your wealth. Since the reward for giving is only expected from God, the Almighty, there is a tradition not to reveal such contributions. Scholars, however, are clear that there is no harm in disclosing them if the aim is to encourage and inspire others. Nobel Laureate Jean Tirole said that if donations are made publicly, it will encourage others to donate.

After a considerable gap, when Islamic finance emerged in the mid-seventies, scholars envisioned an economic society that would be as egalitarian as the early Islamic period. However, this was not achieved, despite several decades of Islamic finance practices in most of the Islamic world. People asked, if Islamic finance is Islamic, why do most of the poor still live in Muslim countries? Why are the major contracts of Islamic finance still not commonly practiced? Why is the true risk and reward-based economic system still a dream? Leaders and scholars in the Islamic finance industry are not oblivious to these expectations, but the challenges are not easy to overcome. When money becomes a source of only worldly consumption and the reward for the hereafter is not measurable, then it is difficult to convince people to work for others.

Islamic financial institutions should start to incorporate social welfare as part of their mandate. In an event held recently at Oxford University by World Humanitarian Summit[[1]](#footnote-1): Roundtable on Islamic Social Finance, thought leaders gathered to discuss various ways to construct a link between Islamic finance and humanitarian aid organizations. At this summit, it was recommended that Islamic social finance should work hand in hand with the conventional charity models of the Global Humanitarian Council and other similar organizations. The issue is of forming templates and avenues developed on common interaction using the available predominantly active global Muslim and non-Muslim bodies. Major charities, both Islamic and non-Islamic organizations, can work together.

There are areas which complement and some which diverge as far as humanitarian action and social welfare are concerned. Caring for the underprivileged, in particular, is part and parcel of Islam. One cannot differentiate between charity based on religion or nationality, etc. It is something culturally adopted. Also, during the time of Muslim dynasties, especially during the Ottoman period, there was an economic system where *zakat* and other charitable actions were managed by the government. In the current landscape, so far there have been no concerted efforts to create synergies between such institutions.

A recent study[[2]](#footnote-2) highlights for stakeholders in Islamic banking the need to move towards responding to the socioeconomic needs of Muslim communities. Contemporary Islamic finance is seen by many as operating in “push” mode, with players selling their version of products in the market, rather than working in a “pull” mode, where society’s requirements drive industry evolution. Different models, including microfinance, crowdfunding, blended finance, mutual funds and *takaful* etc. are reviewed in this light, identifying business models more suited to social needs.

In the face of large-scale poverty in some regions, the role of Islamic social finance assumes great significance. Given that the primary objective of Islamic social finance — *zakat*, *awqaf*, cooperative and not-for-profit microfinance — is to meet the needs of the poor and to make a dent on their ever-rising levels of poverty, it is important to estimate scientifically to what extent Islamic social funds may meet the resource requirements for poverty alleviation. We proceed first by calculating the resource gap for poverty reduction and then measure the potential Islamic social funds that could be tapped to meet this gap.

The global impact of Islamic social finance can be tremendous simply because it is able to penetrate all levels of economic structures. Combined with the powerful tool of *zakat*, *awqaf*, cooperative and not-for-profit microfinance, crowdfunding can be implemented as an instrument of social welfare and community development. Crowdfunding based on the principles of *Shari‘ah* and humanity has the potential to penetrate segments at all levels of economic activity, provided it is administered and supported by all classes of people and by both the sectors of Islamic finance.

The 10th International Conference on Islamic Economics and Finance, held in March 2015 in Doha, Qatar, brought together a substantial body of literature on various aspects of its central theme, institutional aspects of economic, monetary and financial reforms. A total of over 720 papers were submitted. After a double-blind peer review, 132 papers were selected for presentation. Of these, 87 papers were selected for publication in four different volumes.

This particular volume covers the theme of Islamic finance and social welfare. 15 papers in this volume (authored by 18 researchers) are divided into four major sections. Section I is on socioeconomic inclusion in Muslim societies. Section II deals with Islamic banking, development and socially responsible finance, section III with product development, and the final section IV provides several case studies which deal with a variety of aspects of social welfare, ranging from microfinance to *waqf* to *Shari‘ah* objectives.

**Socioeconomic Inclusion in Muslim Societies**

In this section, five papers deal with socioeconomic issues in Muslim societies. The section starts with Ayub and Ahmad demonstrating that Islamic insurance depends more on mutual help than the mere concept of donation. *Takaful* as a sense of mutual aid and shared responsibility which works for the welfare of the community is not felt while functioning as a corporation model. It is shown how the different historical systems of *al-nahd, al-`aqilah*, and *al-qasāmah*, etc. had the idea of mutual contribution for risk mitigation. Some issues have been raised in the paper that need to be questioned. They relate to the current system of *takaful*, which appears to be akin to the commercial insurance system. The objectives of *takaful* and the *maqasid al-Shariah* are not being considered in the present day *takaful* structure. The chapter — while discussing an analytical approach and also *fiqhi* characterizations — proposes a different model in *takaful* business. It is suggested that the structure of *takaful* companies should be based on a mutual and cooperative model (*musharaka al-ta`awuniyyah*).

Mahmood discusses a new method for reducing the default risk of borrowers. The situation of Islamic banks is no different from conventional ones when it comes to default risk, as they are also not immune to it. The *Biniog Sathi* model provides a new opportunity for employing *zakat*, which can also be used as a tool for supporting those borrowers who can help fuel the engine of growth for the entire economy. The default risk is never entirely mitigated, yet the author claims the proposed model is more competitive in comparison with contemporary models, as it is assumed to reduce risk significantly.

While assessing a fundamental cause of poverty in different societies, Hossain deals with food security in much detail and tries to connect this with the z*akat* system, as both are concerned with either household or individual welfare. In the context of the poor and needy of a rural locality, Hossain attempts to design a model which uses a *zakat* management system to improve food security. Similar to the concept of *baitul maal*, the author suggests the creation of a food bank, with consideration being given to the customary staple foods of the rural locality. Food security relates to the production, accessibility, availability and affordability of nutritious food. To promote local production and limit the common practice of interest-based borrowing among farmers, which usually turns out to be a burden rather than supporting the food supply and demand chain, the paper suggests that the Islamic financial instrument of *salam* can be utilized to provide advance payments to meet the necessities of the locality. A *salam* contract can be beneficial for agricultural producers, since it can provide working capital during production time so that farmers can manage their expenses, and they can be given incentives for increased production. As part of *zakat* management, the paper further suggests a way to distribute food as *zakat*, giving timely access to eligible recipients.

In his paper, Mohseni-Cheraghlou claims that only half of the world’s adult population have an account at a formal financial institution. Enhancing financial inclusion has now become a mandate of most regulatory and supervisory bodies. Access to a variety of financial services has a positive impact on economic development and can reduce poverty and inequality. Global Findex data reveals that individuals in the MENA region gave “religious factors” as one of the main reasons for not having an account. Although other reasons are also given for financial exclusion, religious reasons are the third highest in ranking for this issue in the MENA region specifically. The paper suggests that the percentage of unbanked adults on religious grounds is positively correlated with being situated in the MENA region and negatively correlated with the density of *Shari‘ah* compliant financial assets in an economy. The research basically examines the potential role of Islamic finance in increasing financial inclusion, thus hinting at a means of reducing poverty and boosting shared prosperity in the MENA region and OIC countries. The paper claims that an enhanced presence and access to *Shari‘ah* compliant Islamic financial products in countries with considerable Muslim populations can reduce voluntary financial exclusion for religious reasons. Addressing another reason for financial exclusion, the paper suggests that in addition to increasing availability of *Shari’ah* compliant financial institutions in these countries, financial inclusion policies must also pay close attention to increasing trust in these institutions. The development of transparent and generally recognized standardization and accreditation processes can play a significant role in increasing trust in the compliancy of Islamic financial institutions with *Shari’ah* guidelines.

El-Komi and Croson present microfinance as a powerful tool for socioeconomic inclusion and for social welfare development. Due to the presence of interest in traditional microfinance contracts, a significant proportion of the poor – being practicing Muslims – stay away from participating and taking advantage of such a tool. This paper describes and experimentally tests Islamic compliant microfinance products in the context of moral hazard. Two Islamic compliant microfinance contracts are compared with an interest-based loan for experimental purposes. The results show that the Islamic compliant contracts (profit sharing and joint venture) demonstrate significantly higher compliance rates than the traditional contract (interest-based). These types of loans in the microfinance context hold great promise for both Muslims and non-Muslims. The paper aims to combine microfinance and Islamic finance in order to develop financial products that are consistent with Islamic law, to reduce the impoverishment of the poor.

**Islamic Banking, Development and Socially Responsible Finance**

In section II, there are five papers. The first one, by Rizwan Malik, raises important points about the existing practice of *Shari‘ah* compliant screening methodologies. Although these methodologies screen out activities that are incompatible with *Shari’ah* guidelines, they do not screen for social responsibility. However, it should be known that *Shari‘ah* is not just about avoiding incompliant business practices, but it is a holistic approach for the betterment of the universe. Malik proposes improvements to existing *Shari‘ah* screening methodologies by incorporating socially responsible principles. These screening methodologies were needed at the time of inception and were introduced as *maslahah* for the betterment of society to offer an alternative platform for *Shari‘ah* sensitive investors. But a thorough study shows that the screening methodologies have failed to include ethical precepts commonly adopted by the socially responsible investment industry. There is a need to realign the concept of Islamic banking with *Shari‘ah* compliancy and social responsibility. This paradigm shift will make Islamic investments both *Shari‘ah* compliant and socially responsible, and hence attractive to socially responsible investors. The research examines the compatibility of the United Nations Global Compact with Islamic principles, analyses the performance of Socially Responsible Investments portfolios with portfolios that are both socially responsible and *Shari‘ah* compliant, using risk-adjusted return tools, and then examines the performance of seven Islamic and socially responsible indices. It was found that the Islamic principles not only comply with and endorse the principles of the UN Global Compact, but they go a step further in making the Compact enforceable and accountable. The Islamic economic and finance system is actually a socioeconomic finance system that requires the incorporation of ethics and morality into economic activities. Taking the *maqasid al-Shar’iah* into account will assist the Islamic fund management industry to move away from mere religious-based screening to objective-based screening. There is a need to develop existing screening methodologies to account for more social issues promoted by *Shari‘ah* and to support institutions that are striving to give back to society.

Mertzanis, in his paper, explores the extent of access to finance by companies residing in a sample of Islamic countries, using micro survey data. Access to finance is believed to be one of the most binding constraints on any firm’s growth. Since Islamic countries vary due to different socioeconomic systems and values, the data sample is split between a measure of more developed and less developed ones. However, the quantitative analysis is bound by the limitations of existing methods concerning binary variables. Hence, following it using probit methodology, the results show that firms in Islamic countries with higher levels of economic development, financial intermediation, efficient legal systems and government operations and enforcement, as well as human development, perform well and show effective results and thus report lower financing constraints, compared to countries with lower levels of economic development.

Al Amine deals with issues of Islamic finance and its adherence to the core objectives of *Shari‘ah* (*maqāṣid*). Two primary issues have intensified this debate during the last few years: firstly, the excessive employment of debt-based instruments by Islamic financial institutions, and secondly, some structural shortcomings in the *sukuk* market, despite its reverberating success in the industry. One can add to these some concerns about the marginal role of Islamic financial institutions in fulfilling their social responsibilities, specifically poverty reduction. The debate is sometimes explained in terms of differences between *Shari’ah* scholar approaches, i.e. by the juristic approach or the economists’ approach which draws much attention to the social needs of society. It is a clash between Islamic finance and Islamic economics, or one could say, a debate between analogical reasoning and empiricism. It is the absence of true sale in most *sukuk* which creates real doubts regarding the transfer of *sukuk* assets from the balance sheet of the originator to that of the issuer. The paper prompts the reader to ask an important question: is Islamic finance a financial system where debt-based products and profit and loss sharing instruments cohabit harmoniously, or is it a profit and loss sharing industry where debt-based instruments are used only when necessary? The paper argues that it would be constructive if efforts were directed towards the innovation of new products and the designing of institutional settings where other non-monetary financial intermediaries would be best placed to use profit and loss sharing modes of finance. It would be much more productive to present practical alternatives to the use of debt-based instruments, rather than labeling the Islamic finance industry as a mere copy of the conventional finance industry or a failure, due to the marginal use of profit and loss sharing instruments. Expecting Islamic finance to eradicate poverty is unfair and might be based on a misunderstanding of *maqasid al-Shari’ah*.

Goud presents a template for a *musharaka*-based Islamic microfinance product to provide affordable access to off-grid renewable energy, targeting people living in poverty who currently rely on expensive and dirty sources of energy. Aiming at achieving social welfare in its true meaning, the author proposes community-owned renewable power generation financed by the *musharaka* model that can provide employment as well as access to electricity. Poverty alleviation and greater environmental protection can be simultaneously achieved by using this model. It also proposes a rotating savings and credit association model for the financing of smaller renewable energy technologies. The paper describes potential non-monetary benefits that renewable energy products can provide for the needy sectors of society financed by Islamic microfinance. Microfinancial institutions (MFI) need to limit their exposure to large payments due upon maturity of *sukuk,* hence an Islamic MFI should find ways to tap capital markets so that much of the underlying risk is passed from the products onto the investors.

Asutay discusses the topic of the Islamic financial industry and social welfare in the context of their visionary objectives. His paper mainly follows a discursive method in developing its argument within the framework of political economy in different regions where Islamic banking industries exist, to ensure that this debate benefits from a deconstructive process as part of the discourse analysis. He argues that the Islamic moral economy was conceived with the objective of producing human-centric economic development, aiming for capacity development and individual and social empowerment. In this vision of a developmentalist project, Islamic banks and financial institutions are expected to contribute to this process. The notion of industry formation must be taken into consideration, as the formation system of the Islamic finance industry may have consequences for economic development and social welfare. The author notes that the development of the Islamic banking and finance industry followed a direction which diverged from its vision and the spirit of the Islamic moral economy, leading to Islamic capitalism, by converging on the working mechanism of the conventional finance and banking system. Thus, the causality between economic development and the rise in the asset accumulation of Islamic banks does not indicate any direct correlation. The paper analyses several types of formations of the Islamic finance industry, such as the Gulf model, the Malaysian model, the Indonesian model, the peripheral economy model and the newly emerged Turkish model, which is more like a corporatist model of state-oriented and dominated Islamic financial development. The paper aims to identify these models within the Islamic banking and finance industry and to locate their developmentalist and welfare outcomes, to determine the deadweight loss in industry formation, enabling some conclusions to be drawn for countries aiming to develop their Islamic finance industries. The paper argues that the Malaysian model results in considerable welfare costs and that there are some positive welfare consequences associated with the Indonesian model. It further goes on to argue that the Gulf Cooperative Council model does not have any particular effect on societal welfare and its developmentalist impact is insignificant. The developmentalist needs of the Muslim world have not decreased; on the contrary, both capitalist desires and poverty continue to remain an issue in many Muslim countries, including some of the oil-rich Arab countries. The paper concludes that there must be consistency between aims and tools in order to ensure an optimum outcome.

**Product Development**

This section contains two important papers that deal with product development. Alamad’s paper emphasizes that a clearly defined structure for product development in Islamic finance is well overdue in the industry. The author proposes to fill the gap and presents a well-designed framework, which also incorporates the *maqasid al-Shari‘ah* and business and regulatory requirements, based on a questionnaire. It is likely that the Islamic banking industry could lose its identity if proper product development is not put in place, as it is already being seen as a replica of the conventional banking system. The proposed framework could include all stakeholders, from financial institutions to consumers, employees and shareholders, legal and regulatory elements and society as a whole. The author first discusses financial innovation, then follows it with financial product development, both in the conventional and Islamic financial systems. One can see how Islamic banking would be fairer, more transparent and more ethical if the structure was set up. The paper discusses some issues, including redemption mechanisms for exiting customers, which should be considered for ethical reasons and would be in line with *Shari‘ah* objectives.

Zulkhibri’s paper critically analyses the relevance of directly targeted poverty reduction programs in Muslim countries using conditional cash transfers (CCTs). CCTs are one of the effective tools used by governments, development institutions and non-profit organizations with an aim to decrease chronic or shock-induced poverty, reduce economic vulnerability and provide social protection, while at the same time promoting human capital development. The findings of research into the CCTs’ experience in a sample of Muslim countries, namely Bangaldesh, Pakistan, Indonesia and Turkey, while comparing CCTs in the different dimensions of policy rationale, design characteristics, impact assessments and lessons from project application, suggest that CCTs programs have been positive and that the costs are relatively affordable if implemented with appropriate program design. The CCTs concept works via a redistribution approach to eradicate poverty. The paper however points out that none of the CCTs programs in Muslim countries explore and integrate the potential of Islamic instruments to provide additional resources through *zakat*, *sadaqah*, *awqaf* and *qard* *hasan*. The paper concludes by listing a few critical factors that will assist Muslim countries to successfully implement CCTs programs and reap their benefits.

A question arises here whether financial development and product development actually reduce poverty. It seems that there cannot be a simple yes or no answer. the answer will depend on other socioeconomic factors already present in a given country. If there is a high degree of initial inequality, then financial development might be considered detrimental to the poor. One might also presume that the quality of financial institutions matters for the poor, but this also depends on the country’s economy. Further studies should be conducted to investigate whether financial development correlates with poverty eradication. Perhaps different socioeconomic and geopolitical contexts will generate different results.

**Case Studies**

The last section of this book is dedicated to a few case studies from Indonesia. Indonesia is the most populated Muslim country and a large percentage of its population lives in poverty. It is therefore a suitable arena for research into eradicating poverty in Muslim societies. Religion plays a role in shaping economic behavior in Islamic communities, and hence an effective way of achieving economic development will be to put Islamic finance to work.

In her paper, Musari discusses the viability of *sukuk* for the Association of Farmer Groups (Gapoktan) to finance cocoa farmers. She takes the discussion further, suggesting that this *sukuk* could be constructed through a linkage program between Islamic banks and Islamic microfinance institutions by a modification to the scheme employed by Gapoktan Guyub Santoso. Very little has been done by Islamic banks for the poor segments of the community, and hence this proposed linkage program could be valuable, along with the help of authorities and policymakers. One cannot overlook the problems of lack and excess of liquidity. It is proposed that a regulatory framework for a proper development of Islamic microfinance will provide an alternative source of basic financial services for the poor. The paper also answers the challenge of moving from debt into equity financing modes.

Yumna and Clarke tackle *zakat*, which has characteristics that can be used in various productive and innovative ways for the benefit of the poor. A few approaches are proposed in this paper to integrate *zakat* and microfinance for poverty alleviation. The authors devise a plan whereby *qard hasan* could be joined with commercial microfinance to improve the financial situation of the poor. They argue that *qard hasan* is for social assistance and is a safety net rather than being a tool for poverty alleviation, unless integrated with another Islamic feature like profit and loss sharing or another cooperative mechanism. The paper presents a study of welfare indicators for 153 clients of *zakat*-based MFIs and 82 non-clients. The authors call for a new model of Islamic charity based on microfinance.

The last paper in this section, by Yaumidin, focuses on the engagement of the poor in productive economic activities and motivating them to set up new enterprises so that they can escape the poverty trap. The paper specifically examines empirical evidence of the impact of Islamic microfinance on Muslim women and their empowerment in the West Java region of Indonesia. Although philanthropic collections like *zakat*, *infaq* and *sadaqah* are regarded as social safety nets among Muslims, yet it is noted that most *zakat* beneficiaries belong to vulnerable segments of society who are economically weak and remain so for a longer period of time, if not forever. Today, *zakat* management has transformed into a microfinance enterprise while also utilizing finance raised from *infaq* and *sadaqah*, and it is increasingly used as a tool to alleviate poverty in Indonesian urban areas. The government institution in Indonesia (BAZNAS) strictly avoids using *zakat* funds for microcredit financing, instead using *infaq* and *sadaqah* as microcredit funds. The paper attempts to evaluate the impact of an Islamic microfinance institution operating in the urban area of Bandung City, Indonesia, as an indicator of women’s empowerment. Much in accordance with the general perception, it finds that microfinance has not had a great impact in improving the preference of Muslim women for empowerment in Bandung. The author concludes that the women’s involvement in microfinance will improve their position within the household through a few external factors, like access to independent income, control over savings and credit use, and their ability to bring productive assets to the household economy.

Islamic finance began its journey in the early 1960s with the promise of better financial intermediation, more equitable distribution of wealth in society and a more stable financial system, with an appropriate balance of risk and reward. During the early years, Islamic banks and financial institutions focused entirely on their commercial viability and making inroads into the mainstream financial landscape. They have been mostly successful, but an impression also gained currency that Islamic finance has distanced itself from its ideals. However, in the last few years we have seen increased activities aimed at achieving Islamic finance goals (*maqasid al-Shari‘ah*). This book is an attempt to highlight Islamic financial activities from this social angle.

1. World Humanitarian Summit on Islamic Society Finance, Oxford University (March 2015). [↑](#footnote-ref-1)
2. Nazim, Ali S. (2017) ‘Moving Towards Community Driven Islamic Finance’, *Journal of Islamic Business and Management*. [↑](#footnote-ref-2)