

## Islamic Finance: Revisiting the Value Proposition

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### Abstract

The pioneers of Islamic economics envisioned that an economy based on Islamic values and principles would strive to fulfill the goals of Shari'ah (maqasid al-Shari'ah) and fulfill the aim of Islamic law of promoting welfare or benefit (maslahah) of mankind and prevent harm (mafsadah). The practice of the Islamic finance, however, has been to become a 'prohibition-driven industry' focussing primarily on avoiding the prohibitions of riba and gharar. Ignoring the foundational values and focussing only on legal compliance makes the industry devoid of its essence and spirit. If the industry fails to promote the foundational values, it will fail to claim its uniqueness as being a positive ethical and social force in the economy.

**Keywords:** Maqasid al Shariah, Legal Compliance, Ethical and Social Value.

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## Islamic Finance: Revisiting the Value Proposition

The pioneers of Islamic economics envisioned that an economy based on Islamic values and principles would strive to fulfill the goals of Shari'ah (maqasid al-Shari'ah) and result in achieving a just and vibrant economy. As the overall aim of Islamic law is to promote welfare or benefit (maslahah) of mankind and prevent harm (mafsadah), they argued that realization of the maqasid would produce a moral economy with a financial system that would serve the needs of not only Muslims but humanity at large. The implication of this vision was that other than fulfilling the legal requirements, an Islamic financial system would be ethical and cater to the social needs of a society. Based on this worldview, the value proposition for the Islamic financial system was that it would entail risk-sharing features and serve all sections of the population thereby bringing about equity, stability and growth.

The manifestation of Islamic economics, however, ended up as sub-economies in the financial sector. Starting with a handful of Islamic banks in the 1970s, the industry has grown rapidly and become a global phenomenon now. The practice of Islamic finance, however, turned out to be predominantly a prohibition-driven industry, whereby the goal was to exclude *riba* and *gharar* from financial transactions. As a result, even with the impressive growth of the Islamic financial industry during its short history, there is a general feeling that Islamic finance has

failed to fulfill the social and ethical goals of Shari'ah. The contention is that the industry is not playing the anticipated positive role in the economy. Two examples on how the industry has failed to implement the positive value propositions illustrates gap in the practice of the industry.

### **Promoting Maslahah: Social Responsibility and Sustainable Development**

The United Nations launched a bold initiative of Sustainable Development Goals (SDGs) in 2015 to eradicate poverty by 2030 by promoting development in a sustainable and balanced manner. SDGs are ambitious and the challenge of achieving them will be daunting for many Muslim countries where poverty is pervasive with estimates of people living under \$2 a day being 700 million (World Bank 2014: 38). Given the huge needs of funds to achieve the SDGs, the Islamic financial sector can play an important role in mobilizing resources that in acceptable from cultural and religious perspectives in Muslim countries. The ethical and social worldview of Islamic finance can help promote equitable distribution of income and can play an important role in contributing positively to the sustainable development.

Carroll (1979) and Schwartz and Carroll (2003) identify the responsibilities of a firm as *economic*, *legal*, *ethical* and *phil-anthropic/social*. The economic responsibility is obvious given that firms supply goods and services to earn profit. Firms have to

comply with all the laws and regulations of a country in the pursuit of profit. Other than the economic and legal responsibilities, the society also expects firms to follow certain ethical norms. Finally, it may be desirable for firms to be philanthropic, though this is left to their choice and discretion.

Being a part of the moral economy and following the Shari'ah principles, the nature of responsibilities for Islamic firms including Islamic financial institutions is expected to be different. While pursuing the economic goals, Islamic firms have to conform not only to the national laws and statutes, but also to the Islamic law of contracts at the transactions level. In addition, being ethical is required of an Islamic firm, not just expected. Furthermore, it is highly commendable that the Islamic financial sector performs the social role by serving all sections of the society, including the poor. While there is no data available of the clientele served by the Islamic finance industry, there is a general belief that Islamic finance mostly serves the high net-worth clients and the financial needs of the relatively poor and micro and small entrepreneurs are not met.

A second contemporary issue relates to social responsibility and wider ethical and social concerns. These would include, among others, questions related to environment, human rights, labour rights, etc. To uphold the ethical and social values and produce a positive impact on the economy and society,

these issues cannot be ignored by the industry. This is apparent in Islamic mutual funds which use negative screening to weed out sin companies and those not fulfilling certain financial ratios. Unlike many conventional ethical funds, Islamic funds have yet to add positive screening and invest in companies that actively contribute to social and ethical practices.

To play a proactive positive role, there is a need to address the novel and contemporary ethical and social matters at two levels. First, the legal (fiqhi) opinions on these concepts need to be clearly specified. Second, these dimensions need to be incorporated in the practices of Islamic financial industry to create a positive and healthy impact on the economy and society.

### **Preventing Mafsada: Excessive Debt**

One of the features envisioned by the founders of Islamic finance was that it would entail risk-sharing modes of financing that will contribute to the stability of the financial system. While it is not expected that an Islamic financial sector will be wholly equity-based, it was expected that it will have a healthy balance between debt and equity to produce a stable and equitable system. However, the practice of the Islamic financial industry has been pre-dominantly debt based. The current global financial crisis has brought forth the problems arising from excessive debt, both at the micro and macro levels.

Evidence shows that excessive debt

is harmful to both households and economies as a whole. Analyzing the problems related to the financial crisis, Taleb and Spitzagel (2009) identifies too much debt as the 'real evil'. Another study revealed that higher debt levels were associated with lower levels of growth (Economist 2010a). There are studies that show addictive nature of debt and the negative effects of excessive debt on household welfare. Economist likened debt to alcohol and nicotine stating 'a debt boom tends to induce euphoria' (Economist 2010a). In a study, Campbell and Hercowitz (2009) find the higher growth in the level of debt reduces the welfare of households.

Furthermore, there are some moral underpinnings for Muslims related to debt. As implied is various sayings of the Prophet (pbuh), it is preferable not to be indebted (see the ahadith on debt in the Appendix). In one hadith, the Prophet seeks refuge from sins and debt, thereby implying the negative attributes of both. In another hadith, the Prophet refuses to lead the funeral prayer of someone who died indebted and did not have the means to repay it. The incident shows that even though the deceased was a Muslim, the consequence of not repaying the debt was a serious enough factor that led him not to lead his funeral prayer. The implications that one can draw from these sayings of the Prophet are the following: people should take on debt only if it necessary, the debt should of amounts that is within a person's capacity to repay,

and once indebted people should strive to repay it back.

Data shows that Muslim countries are not immune to the culture of debt and the financial sector, including Islamic, is contributing to this problem. Consumer debt in the GCC peaked in 2008 at \$151 billion and then fell to \$139 billion in August 2010 in the aftermath of the crisis. The growth rate of the level of outstanding debt was 80 per cent between 2002 and 2010 (White 2010). A survey shows that 52 per cent of the youth are indebted in Saudi Arabia, of which two-thirds is due to credit cards (White 2010). A study on UAE revealed that 85 percent of UAE residents are in debt, many having difficulty in paying their dues (Walter 2010). A report by Lafferty Group in 2010 indicates that there were 199.4 credit cards for every 100 people in the UAE, which is one of the highest in the world. After the crisis, the amount of bounced checks increased to 25 percent in UAE (Sambidge 2010).

However, an unfortunate aspect of the debt-equity debate in Islamic finance is that instead of seeking ways to increase the share of equity based modes in the economy, some proponents of the industry are rationalising the use of debt and arguing against equity. This approach results from narrowly focussing on the legality of contracts and ignoring the negative economic and moral implications of excessive debt on individuals and society as discussed above.

### **The Way Forward and Conclusion**

Realization of the foundational values needs to be address at two levels. First, it is important to recognise that the responsibility of attaining the broader goals of Shari'ah does not lie on Islamic banks only, but on the financial sector as a whole. Ideally, the sector would have a variety of organizations and markets that would provide diverse services fulfilling the social and ethical objectives. For example, there is a need for appropriate microfinance and microtakaful institutions to meet the financial needs of the poor and expansion of venture capital and private equity type firms and efficient stock markets to increase the share of equity based financing. Second, at the individual financial institution or organizational level there is a need to balance the economic,

legal, ethical and social elements identified above.

In conclusion, being a part of Islamic moral economy the value proposition of the Islamic financial industry was the promotion of welfare and prevention of harm. However, the practice of the Islamic financial industry appears to be focussed primarily on avoiding the legal prohibitions. Ignoring the foundational values and focussing only on legal compliance will strip the industry of its essence and spirit. If the industry fails to promote the foundational values, it will continue to being identified as a 'prohibition-driven industry' and fail to claim its uniqueness as being a positive ethical and social force in the economy.

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## Appendix: Hadith Related to Debt

1. Narrated 'Aisha: Allah's Apostle used to invoke Allah in the prayer saying, "O Allah, I seek refuge with you from all sins, and from being in debt." Someone said, O Allah's Apostle! (I see you) very often you seek refuge with Allah from being in debt. He replied, "If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises." (Bukhari, Volume 3, Book 41, Number 582).

2. Narrated Salama bin Al-Akwa: Once, while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, "Is he in debt?" The people replied in the negative. He said, "Has he left any wealth?" They said, "No." So, he led his funeral prayer. Another dead man was brought and the people said, "O Allah's Apostle! Lead his funeral prayer." The Prophet said, "Is he in debt?" They said, "Yes." He said, "Has he left any wealth?" They said, "Three Dinars." So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), Please lead his funeral prayer." He said, "Has he left any wealth?" They said, "No." He asked, "Is he in debt?" They said, ("Yes! He has to pay) three Dinars', He (refused to pray and) said, "Then pray for your (dead) companion." Abu Qatada said, "O Allah's Apostle! Lead his funeral prayer, and I will pay his debt." So, he led the prayer. (Bukhari, Book 37, Hadith 488)