



مركز قطر للمال  
Qatar Financial Centre

**REPORT ON THE SOAS-QFC  
PUBLIC LECTURE & WORKSHOP 2019**

# CONVERGENCE OF ISLAMIC & SUSTAINABLE FINANCE

Editor and Co-Chair  
**Dr Jonathan Ercanbrack**  
Chair, Centre for Islamic and Middle  
Eastern Law  
SOAS, University of London

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Report on  
SOAS-QFC public lecture and workshop

13-14 February 2019

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## Introduction

The 13th annual public lecture and workshop on Islamic finance took place under the auspices of the Centre of Islamic and Middle Eastern Law (CIMEL) at SOAS University of London from 13-14 February 2018. The annual events, which SOAS inherited from the LSE and Harvard, are made possible with the generous support of the Qatar Financial Centre Authority. As chair of CIMEL at SOAS I am excited to be able to host this important workshop and public lecture to SOAS, a vibrant centre of academic discussion in the heart of London.

First and foremost, I would like to thank Professor Syed Nazim Ali of the Hamad bin Khalifa University in Doha, Qatar, for his unerring support and guidance in conceptualising and co-organising these events. Furthermore, I would like to thank Professor Frank E. Vogel, Founding Director of the Islamic Legal Studies Program at Harvard Law School, and Principal Investigator of the Study of the Commercial Law of the Kingdom of Saudi Arabia. Professor Vogel Professor Vogel has moderated the workshop since it was initiated in 2006 and his skill in doing so is impressive to say the least. Finally, I would like to thank a co-partner of these events, Professor Dr Mohamad Akram Laldin, and the organisation he directs, ISRA, for his invaluable support of these events.

The public lecture and workshop allow a select group of around 30-35 leading Shari'ah scholars, economists, legal practitioners, bankers and academics to gather together for a day long closed-door discussion on an important contemporary theme within the field of Islamic finance. The workshop and public lecture are unique events with almost no parallel in the Islamic finance industry. The workshop, in particular, is designed to discuss in the most rigorous fashion a contemporary topic, which participants choose by poll. Because the workshop is not open to the general public and adheres to Chatham House rules, which means that the information of the workshop may be reported but the source of the information may not be explicitly or implicitly identified, discussion is critical and without social or industry constraint. The public lecture is given by an esteemed practitioner in the Islamic finance industry. It addresses a particularly important topic which is related to the principal workshop theme.





<b>ISLAMIC FINANCE WORKSHOPS</b>	<b>INSTITUTIONAL HOST</b>
2019 Convergence of Islamic and Sustainable Finance	SOAS, UNIVERSITY OF LONDON
2018 Challenging Shari'ah Compliance of Islamic Finance Products	SOAS, UNIVERSITY OF LONDON
2017 Fin Tech and Islamic Finance	LSE AND HBKU
2016 Islamic Infrastructure and Sustainable Development Goals	LSE AND HBKU
2015 Revisiting Islamic Securitisation and Structured Products	LSE AND HBKU
2014 Use and Abuse of Limited Liability	HARVARD AND LSE
2013 Insolvency and Debt Restructuring in Islamic Finance	HARVARD AND LSE
2012 Islamic Financial Intermediation: Revisiting the Value Proposition	HARVARD AND LSE
2011 Reappraising the Islamic Financial Sector	HARVARD AND LSE
2010 Islamic Financial Ethics and Ethical Governance	HARVARD AND LSE
2009 Risk Management: Islamic Economic and Ethico-legal Perspective on Risk Management	HARVARD AND LSE
2008 Sukuk: Economic and Jurisprudential Perspective	HARVARD AND LSE
2007 Tawarruq: A Methodological Issue in Shari'a-Compliant Finance	HARVARD AND LSE
2006 Select Ethical and Methodological Issues in Shari'a-Compliant Finance	HARVARD

In 2019, participants chose the topic of “Convergence of Islamic and Sustainable Finance”. As in previous years, the workshop is preceded by the submission of written commentaries on the topic. The specific issues addressed in the commentaries are initiated by an opening discussion paper. Commentaries provide an opportunity for participants to exchange thoughtful, conceptually well organised and clear ideas in advance of the workshop. Commentaries also enable participants to narrow down the range of relevant issues in relation to the topic so that the workshop deals only with the most advanced topics for discussion. A detailed programme of events is prepared from the commentaries. Participants are requested to have read in advance all of the circulated commentaries, as they form the basis of workshop discussion.

In previous years, the public lecture has brought together a practitioner and scholar to discuss a topic from their disciplinary perspective. In 2019, the public lecture was given by Mr Rafe Haneef, CEO of CIMB Islamic Bank, and moderated by Sir William Blair, Former Justice of the High Court of England and Wales. The lecture, entitled 'Towards Sustainable Development', addressed

the embedded structures and practical foundations of the global financial system and the ways in which Islamic finance has had to adapt as a sustainable form of finance. A public recording of the lecture is available for downloading on CIMEL's website. A table of previous public lectures follows:

<b>Year</b>	<b>Chair</b>	<b>Industry Professional</b>	<b>Academic/Scholar</b>	<b>Theme</b>
2019	Justice William Blair	Rafe Haneef	Jonathan Ercanbrack	Towards Sustainable Development
2018	Dr Jonathan Ercanbrack	Michael McMillen	Nick Foster	Redefining and Retaining Shariah Compliance in Islamic Finance
2017	Justice Ross Cranston	Volker Nienhaus		Fintech in Islamic Finance: Shari'ah and Regulatory Issues
2016	Justice William Blair	Aamir Rehman	Siraj Sait	Revitalising Islamic and Social Finance: Rising to Current Humanitarian Challenges
2015	Justice William Blair	Jaseem Ahmed		Islamic Finance Standardization: Is it a Mirage?
2014	Prof David R Kershaw	Farmida Bi	Paul Mills	Risk Sharing and Cooperative Finance
2013	Justice William Blair	Azman Mokhtar	Frank E. Vogel	Islamic Finance and Shari'a Compliance: Reality and Expectation
2012	Justice Ross Cranston	Muhktar Hussain	Volker Nienhaus	Global Calls for Economic Justice: The Potential for Islamic Finance
2011	Sir Howard Davies	Iqbal Khan	Haytham Tamimi	Building Bridges Across Financial Communities
2010	Sarah Worthington	Stephen Green	M Umer Chapra	Global Perspectives on Islamic Finance
2009	Sir Howard Davies	Ian Pearson	Esam Ishaq	Islamic Finance in the United Kingdom: Current Initiatives and Challenges
2007	Justice Ross Cranston	Michael Hanlon	Mohammed Elgari	Islamic Finance: Relevance and Growth in the Modern Financial Age

The following reports concern the public lecture as well as the workshop proceedings and commentaries. The workshop reports are drafted according to Chatham House rules. Any citations have been taken from primary and secondary sources of literature and

are used merely for elucidating and expanding upon ideas or facts discussed at the workshop.

Dr Jonathan Ercanbrack  
SOAS University of London



# SOAS-QFC Public Lecture on Convergence of Islamic and Sustainable Finance

13 February 2019

Rafe Haneef<sup>1</sup>

Islamic Banking was founded on higher objectives based on social justice: namely to develop financial intermediation based on risk-sharing for socially responsible economic activities.

From an Islamic worldview money is a sterile asset. Its sole economic purpose is to serve as a medium of exchange. Whilst one can lease a land out on rent, one can't lease out money on interest. From Aristotle to St. Thomas Aquinas the narrative on interest was unequivocal. "Money lending with interest, like sodomy, is against the law of nature."

The pioneering Islamic banks were therefore formed as investment houses. The savers place their funds with the Islamic Bank on a profit-and-loss sharing investment like *mudaraba*. The Islamic Bank will then invest the funds with their individual and corporate customers on a profit-and-loss sharing basis. Risk-sharing ventures result in a fairer distribution of wealth. Investors assume risk and receive a commensurate return. They receive a return when entrepreneurs make a profit. The higher the profit earned, the higher the share for the investors. If there is no profit made, then there is no return on investment. In contrast to interest-based lending, the lender receives a fixed return even if the borrower has suffered a loss.

On the other hand, if savers are risk averse, they can deposit their funds with Islamic Banks, who will hold them on trust. The funds will not be invested or lent out and the depositors will pay a fee to the Islamic banks for safekeeping. In contrast, the conventional banks will pay interest to the depositors for safekeeping their money. In reality the savers are not depositors. They are lenders and the bank is the borrower. One then wonders, why do we still call this a deposit? Will the savers' confidence be impacted if this is not called a deposit? Can we still provide deposit protection, if we don't call it a deposit?

The second objective of Islamic Banking is to only invest the funds in socially responsible economic activities. From an Islamic viewpoint everything on this earth and beyond belongs to God Almighty. And whatever human beings own on this earth is held on trust for God. God gives some an abundance of wealth and to

others a pittance. The wealth is but a test on the rich. If the rich consume the wealth wisely, invest the wealth in socially responsible activities and give charity to the poor, they as God's trustee will pass the test and be rewarded with a place in heaven. But, if the rich spend the wealth wastefully, engage in usurious lending, and ignore the poor, they will fail the test.

Hence, one of the pivotal roles of Islamic Banking is to ensure that man's role as a trustee or steward on this earth is fulfilled. Islamic Banking has developed various tools such as a use of proceeds test, screening methodologies and certification processes to avoid investments in socially harmful sectors like usury, speculative trades, gambling, alcohol, arms, porn, and so on. All these activities are seen as socially harmful and prohibited by God. Today, we see the sustainable and green finance industry adopting similar tools to avoid financing or investments in ESG non-compliant businesses.

The original Islamic banking system was based on a two-window model: a deposit window and an investment window. This bifurcation model is what conventional banking reformers are calling narrow banking and wide banking. This dual-window model was first proposed by a group of economists from the Chicago School of Economics in a memo on banking reform that was presented to President Franklin D. Roosevelt in the wake of the Great Depression in 1934. This reform plan, known as the Chicago Plan was supported by prominent economists like Irving Fisher, Frank H. Knight, Henry C. Simons, and Milton Friedman. They recommended that the deposit-taking business be 100% backed by cash or high quality liquid assets and not be used for any loans or credit offering. The second window would be designed as investment unit trusts where the funds invested by savers will be matched with assets, including loans bearing risks acceptable to the investors. If the assets generate returns, the bank will share them with the investors. There is no guarantee by the bank or any form of deposit protection. This dual-window model is remarkably similar to the original Islamic banking model. These economists only realised the stability of the dual-window model after they witnessed the Great Depression. But, unfortunately, the banking lobby was way too strong. The Chicago Plan was never implemented.

Instead, President Roosevelt approved a watered-down reform plan in the form of the Glass-Steagall Act which separated investment banking from the commercial banking business. He also established the FDIC to protect the depositors up to a certain limit so as to bring confidence back to deposit-taking banks. These reforms lead to a period of financial stability till the 1980s, when the regulators in the developed countries began deregulating the financial industry. From the 1980s, many financial crises keep occurring in different parts of the globe. Reinhart and Rogoff list dozens of financial crises including the following 6 major financial crises since the Great Depression in their book, 'This Time Is Different: Eight Centuries of Financial Folly':

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<sup>1</sup>CEO, CIMB Islamic Bank, LLB (IIUM), LLM (Harvard).

- “The downturn of 1981-1982 – Commodity prices plunged. U.S. interest rates reached the highest levels since the Depression. This crisis hit most emerging markets.
- The debt crisis of the 1980s – Widespread sovereign defaults, hyperinflation and currency devaluations primarily hurt developing African and Latin American nations.
- The Japanese crisis of 1991-1992 – Real estate and stock market bubbles burst in Japan and the Nordic nations, also affecting other European economies. Japanese real estate prices still hadn’t returned to pre-bubble levels nearly two decades later.
- The “tequila crisis” of 1994-1995 – The Mexican currency collapse ensnared emerging economies in Latin America, Europe and Africa.
- The Asian contagion of 1997-1998 – This crisis began in Southeast Asia and spread to Russia, the Ukraine, Colombia and Brazil.
- The global contraction of 2008 – The bursting of the U.S. subprime real estate bubble triggered stock market crashes, currency collapses and banking crises.”

Faced with the destruction caused by the 2008 global financial crisis, we again saw the banking reformers discussing the stability of the dual-window banking model. Leading economists like Lord Adair Turner, Sir Mervin King, John Kay and others have all advocated for some form of dual-window banking model to replace the existing banking model to create a more stable financial system. Again, the conventional banking lobby was way too strong. The old broken financial system has been patched up again and is now up and running, spreading even more debt in the economy.

Given these circumstances, the dual-window Islamic banking model faced strong headwinds. In the real world, interest-based debt intermediation is the key to the capitalist economy. Banks were able to use customer deposits to give out loans. Since deposits are seen as risk-free, banks pay very low returns to the depositors. Under the fractional reserve banking system, banks only keep 3 to 10% of the deposit as reserves and lend out the rest. And the loan may end up as a new deposit in the same or another bank, allowing the banking system to give out another loan. With a £100 deposit and 10% reserve, the fractional reserve banking system can create a loan size of £900. This multiplier effect allows the banks to price their loans very competitively. This cannot be matched by the Islamic profit-and-loss sharing arrangement which is not guaranteed and hence more expensive.

The capitalists have also lobbied the governments to ensure that debt financing receives favourable tax treatment. In almost all economies in the world today, interest payments are deductible as expenses, whilst profits or dividends under risk-sharing ventures are fully taxable. Historically, interest payments were also taxable. During the 19th century railway boom in America, the US government introduced tax deductions for interest

payment made by the railway companies given their importance to the American economy. But, over time this tax deduction was extended to all companies. Today the size of the tax deduction for interest payments in countries around the world ranges from 3 to 5% of their respective GDP. If a company takes £100,000 loan and pays £5,000 interest, it gets a £2,000 tax benefit if the corporate tax rate is 40%. The net interest payment for the company is £3,000. If the company receives £100,000 equity and wants to pay £5,000 dividend, it has to earn around £8,000 in profit since it has to pay 40% tax. So, the true cost of the dividend is £8,000. This makes debt financing more attractive than profit-and-loss sharing. The tax arbitrage attracts the corporates to maximize their debt financing so that they could minimize their tax obligations. According to the Economist, a big American firm typically pays an after-tax interest rate of 3% on debt, while the cost of equity is 8% or more. About half of that gap is explained by tax breaks.

In some countries, when the shareholders receive dividends, they have to pay income tax on the dividends received. In the UK, you have to pay tax if you receive more than £2,000. So, if you receive £5,000 dividend your tax obligation will be £2000, if your tax band is 40%. The total tax paid on a £5,000 dividend is £5,000 (£3,000 by the corporate and £2,000 by the shareholder).

On the households front, the current economic conditions seems to encourage consumers to spend more than they earn though piling up more debt. According to ONS in 2018, the British households, for the first time in 30 years, collectively spent more than they earned. The household debt-to-GDP ratio increased to 125% in 2017. When the Bank of England increased interest rates from 50bp to 75bp, the households faced even more pressure to keep afloat, putting the wider economy at risk.

The capitalist economy has resulted in a long period of stagnant wages for the working class. Since the 1970s real wages in most countries have hardly grown. The shift to new technology that requires less labour and the fear of unemployment has stifled the working class from demanding higher wages. To supplement the gap between their rising cost and stagnant income, the households ended up taking on more debt. Debt became a way of life. In lieu of a pay rise, they resorted to more debt. The banks were ever more willing to provide more credit to the households to the extent that the size of mortgage debt grew to £24b and credit card debt ballooned to £17b in June 2018.

If one day all the capitalists shift to automation, robotics and AI and lay off workers and only hire a small group of top managers, just imagine who will end up buying their goods and services. The robots certainly won’t be able to fill that gap. The economy needs people who are employed and earning fair wages so they can consume the goods and services produced by the capitalists. Similarly, if household debt financing is moderated or controlled, the capitalists will also not be able to sell

their goods and services to the working class without increasing their wages. Policy makers must ensure that the growth of debt financing is controlled so that capitalist will be driven to increase wages for their workers so that they could buy their goods and services.

Finally, the conventional banking system stifles risk-taking appetite by providing deposit insurance. Hence, savers choose to store money in safe deposits rather than investing in profit and loss sharing instruments. In reality, the FDIC that insures deposits in the US has very little funds. In 2018, the FDIC had a fund size of \$72.6 billion, which constitutes a reserve ratio of 1.11% out of total deposits in the banking system. This means that the FDIC fund can recover less than 2% of total deposits during bank failures. This means that the FDIC becomes almost irrelevant during financial crises. The three-largest U.S. banks ranked by total deposits hold over \$1.2 trillion worth of deposits.

Similarly, in the UK the government provides deposit insurance (via the Financial Services Compensation Scheme) to most bank accounts up to a limit of £85,000. In theory the FSCS is funded by levies on banks whose customers are covered by the guarantee, but in practice the major contributors to the cost of the scheme have been taxpayers. Due to the failure of certain banks in 2008-09, just £171 million of the £19.86 billion (less than 1%) was funded through levies, while the rest was provided by government. (source: <http://www.narrowbanking.org>). Yet, the perception that deposit insurance will protect the deposits entices savers to opt for deposits rather than profit and loss sharing investments.

In addition to the deposit subsidy, economists have also estimated exactly how much the Lender of Last resort subsidy lowers big banks' borrowing costs. An IMF study by Kenichi Ueda and Beatrice Weder di Mauro, estimated the subsidy that big banks receive by borrowing funds at a lower rate than other borrowers at about 0.8 percentage points. The discount applies to all their liabilities, including bonds and customer deposits. According to Bloomberg, if we multiply that

by the total liabilities of the 10 largest U.S. banks by assets, this amounts to a taxpayer subsidy of \$83 billion a year. To put the figure in perspective, it's tantamount to the government giving the banks about 3 cents of every tax dollar collected.

Given the monumental challenges posed by the hard-wired debt-based banking system, Islamic banks' efforts to develop a risk-sharing financial model came to a dead end. Muslims who wanted Islamic financing could not resist the various subsidies inherent in debt financing and preferred Islamically structured debt financing. Muslims operating in a capitalist system also faced the realities of maximising profit for their shareholders by maximising debt financing. Muslim consumers facing the harsh realities of stagnant wages also depended on easy credit to make ends meet. There were hardly any takers for risk-sharing solutions in the banking space.

To survive in the skewed banking space, Islamic banking went through a phenomenon similar to character displacement. This term is used in ecology when two similar species compete for the exact same resources in the same geography. Without differentiation, the dominant species will exclude the other from competition. The less dominant species will either go extinct or undergo evolutionary changes to find a niche, like shrinking their beaks over a period of time to feed on smaller seeds and increase their chances of survival. In a similar fashion, in order to survive, Islamic banks had to change their character and evolve into debt intermediation institutions similar to conventional banks to better compete for the same resources. In ecological terms, Islamic banks enlarged their beaks over time so that they could feed on the same resources sought by the conventional banks.

Instead of mobilising funds as investments, the Islamic banks had to take deposits which were guaranteed by deposit insurance. Instead of charging a fee for holding the deposit, they ended up making discretionary 'gift' payments. Instead of investing in ventures, Islamic banks offered credit financing through instalment sales, finance leases, fee-based transactions which mirrored



the risk and reward profile of the conventional banking system. These “hybrid” solutions, which comply with the Islamic legal requirements whilst mirroring the conventional profile, allowed Islamic banks to remain relevant and to grow rapidly.

But, over time these hybrid solutions seem to threaten the value proposition of Islamic banking. If Islamic banks offer the same risk and reward profile, why can't we simply stick to the conventional banking system? This has forced the Islamic banking industry to seek a new narrative. Whilst the risk-sharing objective faces severe challenges, the second objective of financing socially responsible activities was gathering huge momentum globally. Like the Muslims, other religious groups, such as Quakers and Methodists, also required their investments to be made according to their socially responsible investing guidelines.

In April 2006, the then UN Secretary-General, Kofi Annan, launched the Principles for Responsible Investment. The PRI requires asset owners and investment managers, who are signatories (around 1,800 as of 2018), to ensure that their assets and investments comply with environmental, social and governance factors. These ensure sustainable outcomes to people, the planet and profit in line with the 17 Sustainable Development Goals.

The ESG requirements are perfectly in harmony with Islamic values-based investments which focuses on minimising harm and maximising benefit to society (which includes the environment). Avoiding investments in companies that pollute the environment, harm the ecosystem, employ child labour or forced labour, fail to provide diversity and equal opportunity, and so on are in line with the higher objectives of Shari'ah. Although in the past, Islamic banks have been focused on a more narrow scope of prohibition around sin sectors like alcohol, tobacco, gambling, etc., they are beginning to widen their scope to include the ESG considerations as well. The UNEP-FI and the RFI Foundation (a think tank based in the UK) are taking the efforts to get Islamic banks to embrace ESG considerations and SDGs. Bank Negara Malaysia has already started this process

by launching the Value-based Intermediation (VBI) to promote the Islamic banking industry to adopt these universal values in their banking practices.

It is perhaps easier to get the Islamic banking industry to embrace these universal principles, then getting the ESG-compliant investors to go beyond ESG considerations. The terms 'socially responsible investment' and 'Islamic investment' are broader than the term ESG. An ESG compliant investor will not invest in an alcohol, tobacco or gambling company that, say, employs child labour. But, a socially responsible investor and Islamic investor will not invest in an alcohol, tobacco or gambling company, even if they don't have child labour issues.

But why is investing in a tobacco, alcohol and gambling company considered in compliance with ESG considerations when they conflict with SDG 3 which focuses on Good Health and Well-Being. In many countries alcoholism and addiction to gambling are causing severe social issues that often force children to work. So, what is the moral justification for investing in an alcohol, tobacco or gambling company that causes more social harm than good? Thankfully, there are ongoing efforts in the UN to include gambling under prevention of addictive behaviour under SDG 3. Hopefully, the ESG-compliant investors will widen their screening methodology to exclude these sin sectors.

In the next 5 years, the Islamic banking industry will likely shift towards enhancing their screenings to include ESG and SDG considerations and at the same time ESG investors will likely broaden their scope to exclude the sin sectors from their investment portfolio.

The convergence between Islamic and sustainable finance will continue until the world decides to end the current form of banking and migrate to the dual-window banking model based on risk-sharing. At that juncture, there will probably be no need for Islamic banking. The dual-banking model with the built-in ESG and SDG considerations would be in line with Islamic principles.



# Workshop Report on Responsible Investment, Value-based Intermediation and the Future of Islamic Finance

**Josh Baker\***

## Introduction

Business ethics is as old as the concept of ethics.<sup>1</sup> Indeed, in classical Islamic law ethical exhortations such as the prohibition of *riba* were given the force of law and a legal superstructure was created around them over centuries of judicial reasoning.<sup>2</sup> In the Western world the link between religious ethics and business ethics is not as explicit, but it is still claimed by some that the Protestant reformation and the change it effected in the field of business ethics laid the foundations for the global capitalist system of today.<sup>3</sup> Even the notion of ethical lending is an old concept, with historical records showing that a 16th century Italian bank practiced what could be described as an early form of corporate social responsibility (CSR) in engaging in local social activities and providing treasury functions for local social institutions.<sup>4</sup>

In his survey of CSR debates in the 20th century Harwell Wells notes that CSR is an “unchanging solution to an ever-new problem”<sup>5</sup> and the biggest problem that we currently face as a planet is surely that of global warming caused by climate change. In that sense, the Bank Negara Malaysia strategy paper on ‘Value-based Intermediation’ (VBI)<sup>6</sup> served as a useful case study for workshop discussants. While sustainable finance and Islamic finance both present a different face to conventional finance, the Bank Negara Malaysia paper is one of the first examples of dialogue between the two types of finance. Why is that and should this change move forwards? Answering this question leads to others. For example, what will the process of such dialogue look like? How will this affect Islamic finance’s current and potential customer base? And will convergence with sustainable finance cause Islamic finance to lose a piece of itself?

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<sup>1</sup> David Vogel, ‘The Ethical Roots of Business Ethics’ (1991) 1(1) *Journal of Business Ethics* 101, 101

<sup>2</sup> Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press 1964) 113

<sup>3</sup> David Vogel (n 2), 102-104

<sup>4</sup> Olaf Weber, ‘Sustainable Banking – History and Current Developments’ (10 October 2010) <<http://ssrn.com/abstract=2159947>> accessed 15 August 2019, 5; Riccardo Milano, ‘Social Banking: a Brief History’ in Olaf Weber and Sven Remer (eds), *Social Banks and the Future of Sustainable Finance* (Routledge 2011) 20

<sup>5</sup> C A Harwell Wells, ‘Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century’ (2002) 51 *University of Kansas Law Review* 77, 81

<sup>6</sup> Bank Negara Malaysia, ‘Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance’ (Bank Negara Malaysia Paper BNM/RH/DP 034-2, 12 March 2018) <<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=612&bb=file>> accessed 1 August 2019

## Bank Negara Malaysia's Concept of VBI

*An intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests<sup>7</sup>*

It is worth briefly considering what the Bank means by various sections of the above definition. Firstly, “the intended outcomes of the Shari’ah” per the strategy paper correspond to the preservation of wealth, faith, lives, posterity and intellect.<sup>8</sup> Of those five factors, Islamic financial institutions have a specific duty regarding the preservation of wealth – namely to go beyond mere preservation and ensure that wealth is generated, accumulated, and distributed in a fair and just manner by, for example, ensuring as part of their intermediation function that money is not hoarded but rather channelled towards productive sectors of the economy.<sup>9</sup>

Secondly, by ending the definition, “consistent with the shareholders' sustainable returns and long-term interests” the Bank notes that the motivation for VBI is not simply the sustainability of the planet or the preservation of Al-Ghazali's five factors. Additionally, the sustainability of the Islamic finance industry in Malaysia is a factor. This is made explicit later in the strategy paper when the decline in the Islamic finance industry's growth rate in Malaysia from 24.2% in 2011 to 8.2% in 2016 is mentioned.<sup>10</sup> Bank Negara Malaysia appears to be suggesting that Islamic finance needs to be supplemented with VBI in order to grow further and ensure its survival.

Thus, VBI's definition begins with the goal of delivering the intended outcomes of the Shari’ah and ends with the goal of generating sustainable returns for shareholders to ensure the long-term growth of the Islamic finance industry. The middle of the definition states what financial institutions must do to achieve both goals – “practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment” – and much of the rest of the strategy paper is dedicated to explaining how such behaviour will be encouraged in a system based on VBI.

According to the VBI strategy paper, the Islamic finance industry is driven only by a narrow focus on the bottom line, and the role of other stakeholders is minimal.<sup>11</sup> While there is good conduct, that reflects the regulatory environment and is not evidence of any higher goals.<sup>12</sup> VBI aims to change this, by shifting the focus to a “triple bottom line” approach taken from the Global Alliance for Banking on Values (GABV).<sup>13</sup> The VBI scorecard – which will initially be used as a tool of self-assessment by banks before being made public at a future date – was the result of a collaboration between Bank Negara Malaysia and GABV and will grade Islamic financial institutions on a scale ranging from “emerging” to “established” based on not only their financial performance but also their conduct and focus on the real economy.<sup>14</sup>

Meanwhile, customers and other stakeholders will be encouraged to take a more active governance role in a VBI-based system. This will be done through enhanced mandatory disclosure requirements. VBI's mandatory minimum level of disclosure is one of ‘Corporate Val-

ue-Intent’, which requires banks to declare their intent/commitment and disclose their implementation strategy alongside any key performance indicators against which they can be measured. Banks will use these key performance indicators to measure their success in meeting their goals as they report back to the public.<sup>15</sup> By mandating this transparency, alongside other measures such as impact-focused disclosures of customers and projects, Bank Negara Malaysia's VBI proposal hopes to create a more inclusive governance structure in which other stakeholders are more informed and hence more able to influence the future of the Islamic finance industry.<sup>16</sup>

Thus, VBI represents a vision for the future of Islamic finance in Malaysia. A system where sustainable banks combine with active stakeholders to reduce negative externalities and better align the banking industry with Malaysia's national goals.<sup>17</sup> Yet some questions must be answered. Firstly, given that the scorecard and triple bottom line approach is taken from the GABV, what makes VBI Islamic? Secondly, and more broadly, what differentiates VBI from CSR, from sustainable responsible impact investing (SRI), or from any of the other acronyms pertaining to ethical business practices? Bank Negara Malaysia pre-empted those questions in their strategy paper, stating that VBI is not a reinvention of the wheel because it focuses on both “ensuring application of [...] established concepts is in line with Shariah”<sup>18</sup> and emphasising other areas of the Shariah which are not yet optimally propagated such as entrepreneurship and community empowerment.<sup>19</sup> It is this foundation in the underlying principles of the Shariah that differentiates VBI from SRI and others. To Bank Negara Malaysia, VBI may serve as a competitive advantage for Islamic financial institutions, which further differentiates it from CSR – which the Bank sees as a cost-centre to financial institutions and not as a means of directly contributing to profits.<sup>20</sup>

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<sup>7</sup> Ibid. 6

<sup>8</sup> Ibid. 12. These outcomes correspond to Al-Ghazali's five maqasid al-Shariah, and he is referenced in the strategy paper.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid. 9

<sup>11</sup> Ibid. 10

<sup>12</sup> Ibid.

<sup>13</sup> Ibid. See also GABV, ‘Principles’ (GABV) <<http://www.gabv.org/about-us/our-principles>> accessed 1 August 2019

<sup>14</sup> Ibid. 30-31; see also: Bank Negara Malaysia, ‘Value-based Intermediation Scorecard (Consultative Document)’ (Bank Negara Malaysia Paper BNM/RH/DP 034-5, 3 October 2018) <[http://www.bnm.gov.my/documents/2018/Value-based%20Intermediation%20Scorecard%20\(Consultative%20Document\).pdf](http://www.bnm.gov.my/documents/2018/Value-based%20Intermediation%20Scorecard%20(Consultative%20Document).pdf)> accessed 1 August 2019

<sup>15</sup> Bank Negara Malaysia (n 7), 28; see also: Bank Negara Malaysia, ‘Implementation Guide for Value-based Intermediation (Consultative Document)’ (Bank Negara Malaysia Paper BNM/RH/DP 034-4, 3 October 2018) <<http://www.bnm.gov.my/documents/2018/Implementation%20Guide%20for%20Value-based%20Intermediation.pdf>> accessed 1 August 2019

<sup>16</sup> Bank Negara Malaysia (n 7), 28

<sup>17</sup> Ibid. 17

<sup>18</sup> Ibid. 14

<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

## VBI, the Shariah, and the Purpose of Islamic Finance

To the workshop discussants, there was an immediate dichotomy between the obligations that are placed on Islamic financial institutions in some areas when compared to others. Increased transparency, best conduct policies, and a focus on innovation of products for previously underserved sectors are ambitious goals for VBI and could remake the industry. Similarly, due to the Islamic principle of stewardship of the environment, it was felt by discussants that it should be easy to marry environmental concerns with the products that Islamic financial institutions currently offer. Moreover, due to the Islamic finance industry's reliance on the real estate sphere<sup>21</sup> it is suggested that a greater focus on the provision of affordable housing – as suggested in the VBI strategy paper<sup>22</sup> – would be an ideal first step for Islamic financial institutions into a VBI system.

The triple bottom line approach and the obligation of increased transparency which would be placed on banks operating in a VBI system can be contrasted with the conspicuous absence of any profit and loss sharing obligations, or any provisions related to *riba* and *gharar*. To some attendees, this represented a deviation from the goals of Islamic finance – perhaps even a 'Christianisation' of it.

The history of Islamic finance is well-known, beginning as a response to the (often forced) adoption of Western civil codes in the Middle East, which Al-Sadr called a "long, bitter history of exploitation and struggle".<sup>23</sup> The first Islamic banks were created in order to advocate a third way between capitalism and communism, where the pious Homo Islamicus could use his investment decisions to strike back at the secular system and create an alternative paradigm where partnerships based on profit and loss sharing were to replace the traditional conventional intermediation relationship.<sup>24</sup> Of course, various factors including the rise of neoliberalism, the concurrent increase in the importance of technology, and the distaste that consumers raised in the conventional system exhibited towards the possibility of losses, combined to cause a shift in Islamic finance away from the creation of a new paradigm.<sup>25</sup> Instead, Islamic financial institutions have adapted their business towards the use of classical Islamic structures to approximate their conventional equivalents.<sup>26</sup> Carving out an Islamic niche while being competitive within the hostile world of conventional finance is seen as an intermediate step on the way to a truly Islamic system by many.

This attempt by Islamic economics and Islamic finance to create an alternative system may be contrasted with the approach of sustainable finance. Sustainable finance began in the 1960s and 1970s alongside Islamic finance<sup>27</sup> but was not a challenge to conventional finance. Instead, sustainable finance, ethical investing, and other such movements were an attempt to harness the power of conventional finance to effect change in the world, as can be seen in the campaign of divestment from South Africa beginning in the 1960s that some have credited with helping to end the system of apartheid.<sup>28</sup>

This refusal to mention the traditional Islamic financial profit and loss sharing model as an aspirational goal for the industry, while couching the VBI proposal in

the language of 'sustainability' that was created in an environment hostile to Islamic finance, was seen by some attendees as representing an unacceptable compromise. In contrast, other attendees saw the VBI strategy paper as simply recognising the current reality of the Islamic finance industry. To them, any attempt to make the current system safer and more sustainable was laudable, while true profit and loss sharing must wait until the systemic constraints operating on the Islamic finance industry are lifted.

In addition to the above debate on the 'Christianisation' of Islamic finance through grafting sustainability principles onto it, there were also those discussants who believed that the VBI's strategy paper and its focus on the *maqasid al-Shariah* were a welcome response to the Islamic finance industry's slow uptake of sustainability principles. Due to the 'legalistic' way in which Islamic finance's initial principles were derived from classical rules pertaining to commercial transactions,<sup>29</sup> and the relative youth of the industry when compared to conventional finance, it is perhaps understandable that the relationship between modern Islamic finance and sustainability needs to be reconceptualised. VBI is a step on that road, but who can take the initiative further? That will be discussed later in this report. First, the relationship between VBI and the industry on a practical level will be discussed.

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<sup>21</sup> According to the Islamic Financial Services Board (IFSB)'s 2018 Industry Stability Report, almost 71% of the Islamic finance industry consists of household financing and construction. (IFSB, 'Islamic Financial Services Board Industry Stability Report 2018' (IFSB 2018) 22

<sup>22</sup> Bank Negara Malaysia (n 7), 16

<sup>23</sup> Muhammad Al-Sadr, 'The Psychological Role of Islam in Economic Development' in Donohue, J and Esposito, J (eds) *Islam in Transition: Muslim Perspectives* (Oxford University Press 2007) 252

<sup>24</sup> Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism* (Cambridge University Press 2006) 111; Haider A Hamoudi 'Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance' (2007) 40 *Cornell International Law Journal* 89, 116-117

<sup>25</sup> Haider A Hamoudi (n 24), 116-117; Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press 2000) 78-80

<sup>26</sup> Haider A Hamoudi (n 24), 118-119

<sup>27</sup> Weber (n 4), 2; Schroders, 'A short history of responsible investing' (Schroders, 28 November 2016) <<https://www.schroders.com/en/insights/global-investor-study/a-short-history-of-responsible-investing-300-0001/>> accessed 13 August 2019

<sup>28</sup> Schroders (n 28)

<sup>29</sup> Walid S Hegazy, 'Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism' (2007) 7(2) *Chicago Journal of International Law* 581, 589-595

## Practical Considerations Relating to VBI VBI and Governance Systems

Several objections to Bank Negara Malaysia's VBI scorecard were voiced by workshop attendees. Firstly, there were concerns that the imposition of such a scorecard could lead to a similar phenomenon to 'greenwashing' where a product or service is claimed to be more sustainable than it really is. For example, the reliance on self-reported scorecard results may lead to discrepancies between reported and actual behaviour, as can be seen in Volkswagen being a market leader on the Dow Jones Sustainability Index while simultaneously programming their cars to skirt around emissions laws.<sup>30</sup> It was felt by attendees that scorecards based on self-reporting were likely to incentivise such behaviour.

Additionally, scorecards were thought by some attendees to be superfluous as investors were said to look to indexes when making decisions about where to invest. The fact that there are so few common stocks between the FTSE Shariah Index and the FTSE4GOOD Index was cited as a cause for concern, as was the fact that no Islamic financial institution is currently a member of the European Federation of Ethical and Alternative Banks. Islamic financial institutions would gain increased consumer and investor faith in their sustainability if they were to try to join such indexes and organisations. According to discussants, consumer faith in Islamic finance would be better served by the creation of an international lobbying body than the use of scorecards. Said lobbying body could publicise the ethical base of the industry and its benefits over conventional finance in certain areas,<sup>31</sup> which would lead to increased custom. It was felt by attendees that the way to reach out to ethical consumers, particularly non-Muslims, was through such a body as opposed to a scorecard system.

In terms of the governance structures of individual Islamic financial institutions, attendees felt that the VBI process should be separate from the Shariah audit process already carried out by Shariah Supervisory Boards (SSBs). It should be the responsibility of management to ensure that products classed as Shariah-compliant are used in a sustainable manner, and VBI concerns should not prompt an SSB to disallow a transaction that otherwise formally complies with the Shariah. Instead, a two-tier system was foreseen, with the first stage being the Shariah-compliance of the individual transaction, followed by a second stage in which VBI is assessed. All products will be Shariah-compliant, but some will receive a higher classification due to their relationship with the Maqasid al-Shariah. This could work similarly to a 'halal and wholesome' classification for food.

Given that VBI is grounded in the Maqasid al-Shariah, should SSBs lead the internal assessment process? Workshop attendees thought not. This was felt in part because VBI assessment necessarily includes the assessment of different sources of data than Shariah scholars are used to, ranging from environmental impact assessments to labour and human rights reports. It is simply unrealistic to expect scholars to synthesise such varied sources from fields in which they may lack expertise. Of course, it could be argued that Shariah scholars could carry out such a function alongside experts in each field. While that would involve reconceptualising the role of the Shariah scholar – seeing them act almost as ethical

consultants – being a Shariah scholar on an SSB is a relatively new job, which scholars have often acquitted themselves well at. There is no theoretical reason why scholars could not further adapt to suit their new roles as VBI auditors.

However, there are some practical considerations. Given the shortage of Shariah scholars it is common to see scholars who are members of multiple SSBs, which raises the issue of conflicts of interest. Further specialisation of the SSB's role would exacerbate this issue. Also, Shariah scholars already face situations in which board members or management withhold information about certain transactions from them when seeking their approval. Any extension of their powers of oversight would simply increase their chance of being deceived about the features of a transaction.

So, what is the solution to this problem of governance? In Malaysia, ultimate oversight of the VBI initiative lies with Bank Negara Malaysia, and in Shariah matters the decision of the Shariah Advisory Committee is binding.<sup>32</sup> Thus, Malaysia has the ideal infrastructure in place to support the VBI initiative through a combination of external audits and self-assessment, whether such self-assessment is carried out by SSBs or another element of the financial institution. In countries such as the United Kingdom, which are unlikely to develop a centralised Shariah infrastructure, the implementation of VBI or other sustainability principles will necessarily require the creation of new governance structures. One option discussed by attendees involves having a mixed panel of Shariah scholars and practitioners assessing VBI compliance. Scholars would be able to give insight on whether the Maqasid al-Shariah were complied with in a given case, while having practitioners on the panel should minimise the risk that the scholars are misled by the institution. Without any industry guidelines for the composition of such boards, it is certain that a multitude of different structures will be created, some more effective than others.

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<sup>30</sup> Jennifer Thompson "'Greenwashing is rampant', warns chief of global accounting body' (Financial Times, 2 April 2019) <<https://www.ft.com/content/fbc6e4f7-bd89-3971-af89-7c007cb57e8c>> accessed 10 August 2019

<sup>31</sup> To provide just one example that was discussed at the workshop, an Islamic mortgage using a Murabaha structure may be settled early without penalty, unlike its conventional equivalent.

<sup>32</sup> Bank Negara Malaysia (n 7), 8; Central Bank of Malaysia Act 2009

## New and Sustainable Islamic Finance Products

While Bank Negara Malaysia's strategy paper does not explicitly state that new products are required in order to realise a VBI system, workshop attendees discussed multiple ways in which Islamic financial products could be used to meet the Sustainable Development Goals (SDGs). For example, Indonesia's March 2018 issuance of a \$1.25 billion green sukuk<sup>33</sup> shows that there is an appetite among investors, both in the Islamic world and outside it, for sukuk offerings which seek to combat climate change. Indonesia's sukuk was the first sovereign green sukuk,<sup>34</sup> and all its proceeds went to financing or refinancing green projects aimed at mitigating climate change, in sectors ranging from green tourism to renewable energy.<sup>35</sup> Indeed, the issuance has already been used to fund a solar power plant and a sustainable railway line.<sup>36</sup>

As well as providing regular sukuk with sustainable goals, Islamic financial institutions can look to offer so-called 'humanitarian impact bonds', the first of which was offered by the International Committee of the Red Cross (ICRC) in 2017.<sup>37</sup> The funds raised by the issuance of the bond were used by the ICRC to build three rehabilitation centres (in Mali, Nigeria and Democratic Republic of Congo) and run them over a 5-year period.<sup>38</sup> Several ICRC donors including the UK government and 'La Caixa' Foundation agreed to be "outcome funders" and to pay returns to initial investors based on the efficiency of the new rehabilitation centres.<sup>39</sup> If efficiency is adjudged by an independent auditor to be above a set benchmark then initial investors will make a profit, but if efficiency falls below that benchmark initial investors will make a loss.<sup>40</sup> There are numerous ways in which such a bond could be replicated using Islamic financial methods. One method suggested at the workshop involves the charity in question committing certain assets to a musharaka for the purposes of generating a return for investors. Since the workshop there have been further developments in this area of Islamic finance. In May 2019 the International Federation of Red Cross and Red Crescent National Societies (IFRC) and the Islamic Development Bank (IsDB) signed a memorandum of understanding aiming to reduce cholera deaths by 90% in the most affected OIC countries over the next ten years.<sup>41</sup> This ambitious programme will be funded in part by the "WASH Impact sukuk".<sup>42</sup>

This sukuk is backed by upfront donor commitments and a partial guarantee offered by the Islamic Solidarity Fund for Development. Social investors invest in the sukuk and receive returns from outcome investors if the WASH programme is found to have met certain key performance indicators (such as the proportion of men, women and children in the target population having access to and using safely managed drinking water and sanitation services).<sup>43</sup> It is exciting to see an Islamic financial structure being used to fund such a project, as well as in keeping with the workshop's theme of sustainability and Islamic finance. Given the large amount of Muslim philanthropy that happens each year,<sup>44</sup> and the appetite of social investors for such products, it is predicted that such products will become ever more common and important to the Islamic finance industry moving forwards.

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<sup>33</sup> Ministry of Finance of the Republic of Indonesia, 'Indonesia's Green Bond & Green Sukuk Initiative' <<https://www.ndcs.undp.org/content/dam/LECB/docs/pubs-reports/undp-ndcsp-green-sukuk-share.pdf>> accessed 8 August 2019, 5

<sup>34</sup> Ibid.

<sup>35</sup> Ibid. 20-23

<sup>36</sup> Ibid. 30

<sup>37</sup> ICRC, 'The world's first "Humanitarian Impact Bond" launched to transform financing of aid in conflict-hit countries' (ICRC, 6 September 2017) <<https://www.icrc.org/en/document/worlds-first-humanitarian-impact-bond-launched-transform-financing-aid-conflict-hit>> accessed 8 August 2019

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> IFRC, 'One WASH Sukuk – Concept Note' (IFRC, May 2019) <<http://media.ifrc.org/innovation/wp-content/uploads/sites/9/2019/07/One-Wash-Concept-note-May2019.pdf>> accessed 8 August 2019, 2

<sup>42</sup> Ibid. 5-6

<sup>43</sup> Ibid. 5-6, 8

<sup>44</sup> The amount of Zakat collected in a given year just through formal methods is estimated to be "at the very least, in the tens of billions of dollars" according to a 2015 report. Chloe Stirk, 'An Act of Faith – Humanitarian financing and Zakat' (Development Initiatives, March 2015) <[http://devinit.org/wp-content/uploads/2015/03/ONLINE-Zakat\\_report\\_V9a.pdf](http://devinit.org/wp-content/uploads/2015/03/ONLINE-Zakat_report_V9a.pdf)> accessed 18 August 2019, 3



## The Future of VBI and the Future of Islamic Finance

Workshop discussants agreed that VBI in the form proposed by Bank Negara Malaysia was likely to remain specific to Malaysia. As discussed above, this is because Malaysia possesses a Shariah infrastructure centred around Bank Negara Malaysia and its Shariah Advisory Committee. In countries without such an infrastructure, such as the United Kingdom which treats Islamic financial institutions the same as their conventional counterparts, VBI's implementation would not be mandated or enforced by the national regulator. Even in other countries where a dual system is operational, such as the Gulf states, discussants thought that VBI would not be transplanted from Malaysia in the near future. It was suggested that institutional investors in Malaysia were a major influence on the development of the VBI strategy paper, just as institutional investors had a key role in the emergence of sustainable and ethical finance in the 1970s in the United Kingdom and United States.<sup>45</sup> As the Gulf states have comparatively fewer institutional investors, it was thought that the move towards the implementation of VBI in their systems would be slower, if it were to happen at all.

That does not mean that there will not be an industry-wide push towards sustainability principles following the Malaysian example, however it is not known how quickly such a push will occur. Islamic financial institutions and regulators in other jurisdictions will likely look to see how well Bank Negara Malaysia's proposals do in practice before committing to such principles themselves. Although data compiled by the GABV suggests that value-based banks tend to make better and more stable returns than "Global Systemically Important Banks"<sup>46</sup> it should be noted that such banks are much smaller in scale than the Islamic financial institutions that are pledging to put VBI into practice in Malaysia.<sup>47</sup> If the data from Malaysia's VBI policy shows that a shift towards sustainable values anchored in the maqasid al-Shariah benefits a bank's bottom line, then we should expect other banks around the world to adopt VBI type policies.

If there is to be a worldwide industry shift towards VBI, who will lead the way by setting and enforcing standards? It is clear from the example of the United Kingdom that not all national regulators would be willing or able to step into this vacuum. Instead, attendee consensus seemed to suggest that a collective responsibility approach is best. On an institutional level, such an approach would encompass the management and SSB of each Islamic finance institution, plus any novel governance organs created to deal with VBI matters. They would all bear part of the responsibility for ensuring that their practices and conduct upheld VBI principles. Where possible, such an institutional approach would be supported by national regulators. However, where that is not possible, there could be a role for AAOIFI in setting industry standards for matters such as transparency and disclosure. Enhanced disclosure would hopefully create a base of well-informed consumers who are able to hold their banks to the principles which they claim to uphold. The industry lobbying body postulated above could also serve an advocacy and education role, helping to expose both Muslim and non-Muslim potential consumers to the benefits of a VBI system.

Workshop attendees then discussed the potential future of the Islamic finance industry. There was some concern that current students of Islamic finance were learning about the industry as it is, as opposed to how it should be, and that that could lead to further financialisation and imitation of conventional finance. Instead, attendees agreed that the long-term focus of Islamic finance should be on the implementation of true profit and loss sharing contractual models. Thus, any calls for further convergence with the sustainable finance movement should be tempered. Yet to avoid joining such a movement would be to forgo the ability to wield any influence over it. Discussants thought that sustainable finance could learn something from Islamic finance, particularly with regard to the prohibition of riba. Similarly, profit and loss sharing contractual structures such as the mudaraba can be set up which avoid the implicit power structures that are inherent to debt-based lending contracts. Perhaps



such structures could be utilised in sustainable finance projects, such as the funding of small businesses, if the problem of information asymmetry that is endemic to profit and loss sharing contracts can be solved.<sup>48</sup> Islamic finance does not have to simply accept sustainable finance's principles; instead, Islamic finance can influence sustainable finance both in principle and operationally moving forwards – although this is dependent on Islamic financial institutions joining associations such as the European Federation of Ethical and Alternative Banks mentioned above.

Finally, the impact on customers of pivoting towards VBI was discussed. In all markets in which Islamic financial institutions operate, their customers know to expect a product that is competitive with conventional finance but avoids the appearance of *riba* or excessive speculation. It is key to note that such a product must be competitive with conventional finance alternatives. Research carried out in the United Kingdom in 2008 suggests that only 4% of Muslims will choose Islamic financial products in every case, with 21% only choosing them if they are competitive with conventional alternatives.<sup>49</sup> While this survey was carried out in a Western nation, the relatively low market share of Islamic banks in dual systems across the Islamic world also bears out the fact that in general Muslims will only choose Islamic finance if it is competitively priced.<sup>50</sup> Surely any move towards VBI will increase costs, thereby making products less competitive and driving Muslim consumers towards conventional finance? Discussants agreed that this was a possibility. Studies have shown that while 30% of people claim to be ethical purchasers, only around 3% of purchases reflect these ethics;<sup>51</sup> financial institutions thinking of moving towards a VBI model should bear this in mind. Ethical banks reached new customers because of the recent global financial crisis, which shook trust in the conventional system,<sup>52</sup> which proves that Islamic finance could find a market among disaffected non-Muslims if it markets itself as an ethical alternative. Yet, if such a strategy risks alienating current Muslim consumers, it should be followed with caution.

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<sup>45</sup> Schroders (n 28)

<sup>46</sup> Bank Negara Malaysia (n 7), 17

<sup>47</sup> According to data on the GABV website (<<http://www.gabv.org/the-movement/bankingonvalues-campaign-digital-assets>>), GABV consists of 55 banks with \$197.6 billion in assets. The 'Community of Practitioners' which helped Bank Negara Malaysia in the drafting of their VBI strategy paper consists of only 5 banks, all of which have more assets than the average GABV bank.

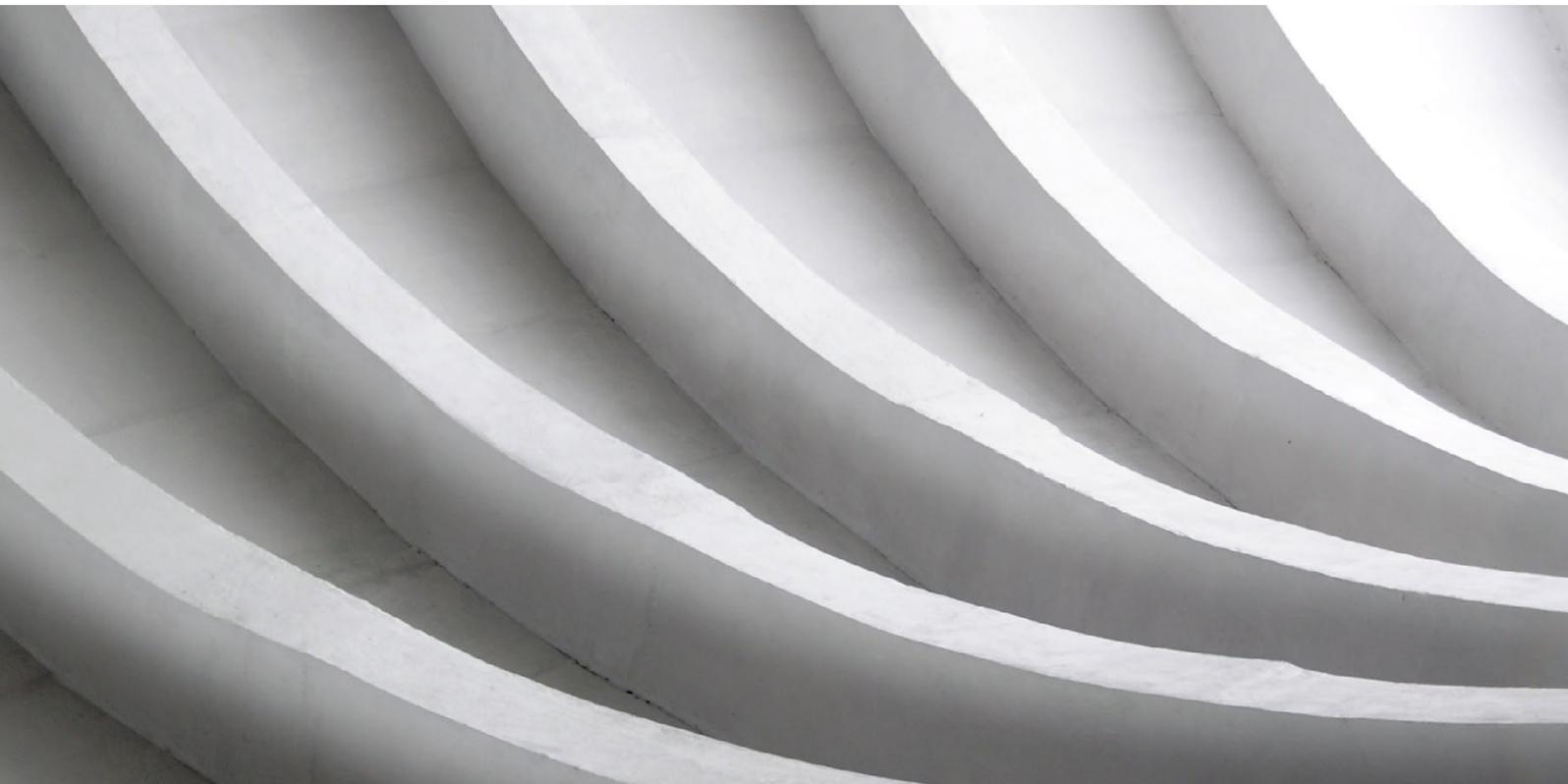
<sup>48</sup> See, for example, Mervyn K Lewis, Latifa M Algaoud, *Islamic Banking* (Edward Elgar 2001) 69-71 for an explanation of why the problem of information asymmetry exists in this context.

<sup>49</sup> J G Ercanbrack *The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition* (PhD Thesis, School of Oriental and African Studies 2011) 253

<sup>50</sup> According to the 2018 IFSB Stability Report in only 11 countries do Islamic financial institutions have a greater than 15% share of all banking assets. That list of 11 countries includes those that make Islamic finance mandatory, such as Iran (IFSB (n 21), 10)

<sup>51</sup> Jeffery Bray, Nick Johns, David Kilburn, 'An Exploratory Study into the Factors Impeding Ethical Consumption' (2011) 98(4) *Journal of Business Ethics* 597, 597

<sup>52</sup> See, for example, Fernando E. Callejas-Albiñana, Isabel Martínez-Rodríguez, Ana I. Callejas-Albiñana, Irene M. de Vidades-Carrasco, 'Assessing the Growth of Ethical Banking: Some Evidence from Spanish Customers' (2017) 8 *Frontiers in Psychology* 782, for evidence on the choices of Spanish banking customers after the financial crisis.



## Concluding Remarks

In conclusion, Bank Negara Malaysia's VBI strategy may remain Malaysia-specific for now, but to workshop attendees it served as a useful case study for examining several issues at the forefront of the Islamic finance industry. On the question of whether the future of Islamic finance requires a convergence with sustainable finance principles, attendees were somewhat split. Some saw the conceptual gap between Islamic finance's attempt to create a new paradigm and sustainable finance's attempt to utilise that paradigm – albeit for noble purposes – as a conceptual gap that is simply too wide to bridge without Islamic finance losing sight of its goal of profit and loss sharing. Others were more concerned with future industry growth. To them, it is noteworthy that young Muslims in both the West and the Islamic world see the Shariah more as a set of guiding principles as opposed to ironclad rules.<sup>53</sup> While a shift towards ethical finance may risk pricing out some current customers, it could help to attract custom from these young Muslims, while appealing to disaffected non-Muslim consumers in the event of another financial crisis.

One thing that attendees agreed upon, however, was the importance of dialogue between Islamic and sustainable finance. Both industries share several goals, including the admonishment of excess and concern for the just distribution of resources. Indeed, perhaps through dialogue Islamic finance could influence sustainable finance's concept of Riba. Similarly, perhaps financial technology will soon offer Islamic financial institutions the ability to mitigate the problems that have always been associated with profit and loss sharing contracts in practice? Clearly, Islamic finance must not remain sequestered from the world of sustainable finance but should seek to utilise its unique contractual structures to effect change in the sustainability movement and change in the world. That is why developments such as green sukuk offerings and the humanitarian impact sukuk soon to be offered by IFRC and IsDB are so exciting. They show that the Islamic finance industry does not simply have to join the sustainable finance movement; instead, Islamic finance has the tools and structures to lead it into new territory.

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<sup>53</sup> Masooda Bano, 'Introduction' in Masooda Bano (ed), *Modern Islamic Authority and Social Change Vol 1: Evolving Debates in the Muslim-Majority Countries* (Edinburgh University Press 2018) 25; Masooda Bano, 'Introduction' in Masooda Bano (ed), *Modern Islamic Authority and Social Change Vol 2: Evolving Debates in the West* (Edinburgh University Press 2018) 1-2, 18-19. Draft versions of both above chapters are available at <<https://www.csia-oxford.org/>>





# Summary of Commentaries

Mudassar A. Baig<sup>1</sup>

This brief compilation includes selective editing, from the notes and commentaries shared by the participants of the workshop on “Responsible Investment, Value-based Intermediation and the Future of Islamic Finance”, which was held at SOAS - University of London on 14th Feb 2019. A list of contributors is placed at the end of this report.<sup>2</sup>

## A Gradual Shift in Global Investor Consciousness

The adverse impact of the human activities on the environment leading to global warming and possible other impending ecological disasters is well researched and documented now. There is also a strong trend to suggest that the focus of global investors has been drifting away from a paradigm of pure profit towards one which takes the welfare of a broader definition of stakeholders into consideration. The significance of the environment, social and governance (ESG) factors in major corporate, national and international strategies and goal settings cannot be overstated. The investors are becoming more and more conscientious and demand that their values and aspirations be reflected in their investments too.

The Western capitalist model was predicated on the concept of humankind only wanting to maximise wealth and preference satisfaction such that self-interest, competition and profit motive became the pillars of capitalist philosophy. This view is now being challenged in part because of the massive damage that this approach has done to the planet. If we look at the anthropology of conventional capitalism (where the mythical power of Smith’s ‘invisible hand’ leads antagonist interests to efficiency in the market) and the ethical re-consideration of its pillars, the concept of sustainability enters the economic debate only in the last decades with the emergence of the ‘moral economy’ movement in Western literature. This is later embodied in various terminologies such as social finance; impact finance; humanitarian finance; social responsible investments; PRIs; ESG investment principles and others discussed below and in the 2030 UN Agenda through the famous 17 SDGs.

The 2008 global financial crisis that began with the US subprime debacle brought the concern over the collapse of ethics in financing to the forefront of the G20 summit 2009 agenda in London when Gordon Brown and Kevin Rudd – then prime ministers of the United Kingdom and Australia, respectively – called for the observance of moral values in financial markets. European momentum for socially responsible and eth-

ical business practices has been gathering steam ever since its inception in the 1970s. The recently issued humanitarian impact bond (HIB) for the International Committee of the Red Cross (the ICRC) demonstrates the use of innovative structures to enable investors to finance socially useful projects.

The ubiquity of concepts such as, “responsible investment”, “values” or “ethical investment”, “values-based Intermediation”, “Environmental, Social and Corporate Governance (ESG)”, “Ethical Finance”, “Impact Investing” or Sustainable Development Goals (SDGs) is a standing testimonial to the emerging trend discussed above. These concepts reflect a broader discussion about the role of ethics in investment and economic activities. The ideas seem to be sharing a common intended objective, which is to deliver sustainable economic, social and environmental development. This is also the objective of the Sustainable Development Goals adopted by the United Nations in 2015. The aim of the Global Alliance for Banking on Values (GABV), which was one of the ethical reactions to the 2008 financial crisis or the newly introduced Value-Based Intermediation (VBI) scheme, advocated by the Central Bank of Malaysia. However, the SDGs are much broader in terms of scope and acceptance as they are backed by the United Nations and its member countries while the GABV initiative is championed by several banks from around the world focused on introducing ethics in the banking sector in particular. Value-Based Intermediation, on the other hand, has its demarcation as being based on Shariah principles. However, all these initiatives have a common denominator, which is the need for more ethical values in finance, economics and other human activities.

Ethical finance can be understood as a response by consumers to the negative outputs of a global economy that can have a devastating impact on local communities, the climate, and ecosystems. Innovations in ethical finance may also reflect a concern about the limitations of capitalism to provide solutions to issues of social justice, such as the widening gap between rich and poor. Awareness of the cost of climate change, environmental damage, and child labour violations – to name a few – have galvanised support for not-for-profit organisations and spurred consumers to re-examine the activities that their finances support.

Transformation in economic circumstances also means a shift in the landscape for sustainable investment. Questions about corporate governance, previously seen as the preserve of the specialist, have moved centre-stage as questions are asked about how the market’s best and brightest bankers could preside over risk-taking that ultimately resulted in the most significant episode of wealth destruction since the Great Depression. At the same time, there are risks that companies fighting for survival will see sustainability management as an unaffordable luxury. However, various stakeholders in ethical finance present a compelling case that proper control of environmental, social and governance risks will make them more resilient to the ups and downs of the global economy.

## Alignment with Principles of Islamic Finance

The overall goal of Shariah can be briefly said to be the promotion of welfare (maslahah) and prevention of harm (mafsadah). This fundamental principle of the Islamic economic system carries with it a value proposition that is well suited to affect equitable and sustainable economic development. With its comprehensive scope encompassing all aspects of human life and that of its surroundings, Shariah principles seem to provide an ideal compass for steering the investments according to the social and environmental ethics of value-driven investors. The fact is that these objectives are also the heart of the Shariah and its goals.

When talking about the essential objectives or maqasid al-Shari'a, the most common reference point are the five objectives put forward by Abu Hamid Al-Ghazali. Ghazali asserted that the overall aim of the Shariah was to promote the well-being of the people, and this includes safeguarding their faith, their lives, their intellect, their posterity and their wealth. There are also those who do not believe that these five objectives encompass the limits of the maqasid al-Shari'a. Additionally, there is the concept that humans are Allah's vice-regents. Therefore, they (and the institutions in which they work) must act with justice, and this can also be seen as an exhortation that resources should be available to everyone.

The Islamic concept of corporate social responsibility considers the relationship of individuals and organisations with all its stakeholders and society in general. It is viewed as a "social contract" in which all individuals or organisations are entrusted by, and accountable to, community and God for their actions and behaviour.

The concept of Khalifah in Muslim political and economic governance has relevance for the management of the environment. It implies stewardship of resources with the responsibility to the Almighty for how these are treated. Abuse of the ecosystem damages the creation of the Almighty, with such irresponsibility being regarded as sacrilegious.

So, it is against this background that one can see there is the potential for considerable overlap between the aims of the SDGs and an Islamic economic model that also takes into account the maqasid al-Shari'a and the concept of vice-regency. The most succinct way to describe the approach of Islam towards ethics is by referring to the famous hadith of the Prophet (peace and blessings be upon him) - "I was sent just to uphold and complement noble ethical values."

Apart from sharing similar historical developmental background, ethical and Islamic finance movements share many characteristics. Both share a fundamental philosophy of social justice, responsible utilisation of resources, and equitable distribution of income. They

also detest the harmful and noxious result of corporate economic growth under greed-led capitalism. Translated into active policy decisions, a negative screening list for investment illustrates a common philosophy between ethical and Islamic finance:

- Tobacco
- Alcohol
- Gambling
- Porn and violent media
- Armament
- Nuclear and biological
- Exploitation of children and animals
- Ecological /Carbon footprint

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<sup>2</sup>See appendix 1.

## Lack of Initiative in the Islamic Finance Industry

The founders of Islamic finance wanted to create a halal system, one which complied with Islamic law but were unsure of what that entailed in practice. Complying with Islamic law in other areas was comparatively simple. The prohibition on the consumption of pork and wine is simple. Setting up a Shariah-compliant financial system is far more complicated. One of the problems facing the founders was the determination of the aim of the system. They could have tried to build an industry which aimed to fulfil, directly and immediately, general ethical goals. What they did, however, was to take what has been called a 'legalistic' approach, one in which the aim was to observe certain specific, law-like parts of the Shariah, such as the prohibition of riba and gharar.

Whereas Islamic finance should have been at the vanguard of campaigning for these values, it has only been a passive spectator in the global investment arena, limiting itself to the narrow scope of strict legal compliance with the explicit requirements related to riba and gharar. Islamic finance, despite its claims to promote social justice and welfare, has consistently played 'catch-up' in these areas, only giving them its attention when others have taken the lead. The practice of Islamic finance turned out to be predominantly a prohibition-driven industry using, for instance, only negative screening criteria to decide the Shariah validity of any investment. This is demonstrated by the fact the many of the constituents of the FTSE Shariah All Share Index are not part of the FTSE4Good index.

For most of its history, Islamic finance has not been significant enough to merit the attention of those pressure groups and regulatory authorities which have led to the introduction of ethical best practices in conventional finance. As mentioned above, Islamic finance has played 'catch-up', but it must also be said that the traditional sector did not take the initiative. The measures were imposed upon conventional finance as a result of societal movements. Consumer protection, for example, can be traced to the growth of consumerism after World War II and the activities of people such as Ralph Nader. It took decades of sustained pressure by many people to affect change. Another example, mentioned above, is that of the World Bank. Environmental and social issues associated with such financing, first considered in the 1970s were addressed mainly as a result of sustained criticism directed at the World Bank throughout the 1980s and 1990s.

It may well be that, given its greater importance, Islamic finance will also be put under pressure to comply and incorporate the ethical aspirations discussed earlier. The Bank Negara Malaysia initiative seems to be an indication of this trend.

There are criticisms about the manner of implementation of Shariah principles that it tends to work in a very atomistic fashion, lacking appropriate tools for taking a holistic view of adverse developments in the market. The 'moral economy' of Islam itself represents a vibrant branch of this ethico-anthropological discourse in relation to the nature of the market, which is usually sustained by a developmentalist aim. While this is a topic which is often (if not always) mentioned in many introductory chapters to the subject, it is easily forgotten in its practical applications where the core parameter becomes that of Shariah compliance as certified by Shariah scholars.

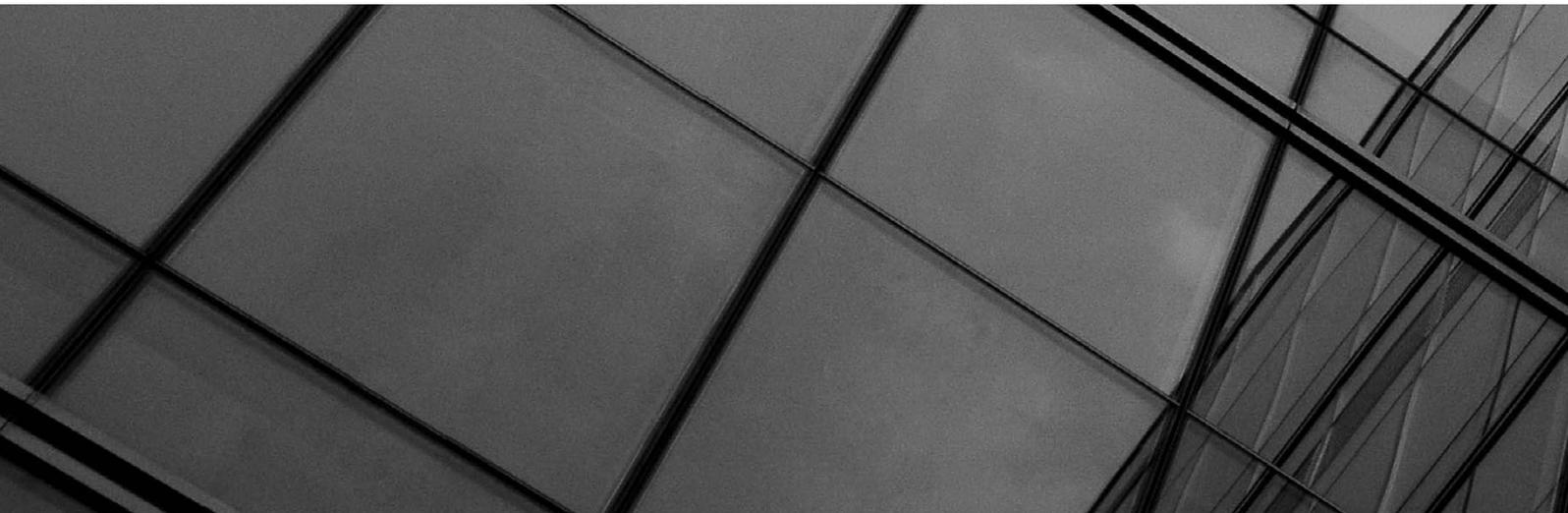
The reality seems to be quite far from what the potential appears to be.

## United Nations Sustainable Development Goals

The UN Millennium Declaration was the precursor to the SDGs and spoke of six fundamental values in terms of international relations, namely: freedom, equality, solidarity, tolerance, respect for nature and shared understanding. The Declaration adopted these shared values and created various objectives, which included development and poverty reduction. While there was success in reducing poverty, it was recognised that a broader set of principles was needed which would apply to all countries, and this led to the SDGs.

The SDGs are 17 goals with 169 targets set by the UN General Assembly in 2015 with the intent of transforming the world towards sustainable development by 2030. The goals cover social and economic issues including poverty, hunger, health, education, gender equality, climate change, clean water, energy, urbanisation and social justice.

To define the possible alignment of Islamic financial institutions objectives with the SDG goals and targets, it is necessary to analyse the SDG goals in light of maqasid al-Shariah and compare SDG objectives and that of Islamic economics. Moreover, the maqa-



sid al-Shariah discussion should not be limited to the objectives but should also include the means and priorities and what the competitive advantages of Islamic financial institutions are in achieving the SDGs. Such an analysis is essential when it is recognised that the Sustainable Development Goals (SDGs) are open to multifaceted interpretations, and the same is true for their ethical implications. Thus, while SDG values are widely accepted as universal, the moral structure of the SDGs is complex, with differing interpretations and ideas. The United Nations and all other major stakeholders who are actively driving the 2030 Agenda forward recognise the need to localise the SDGs for greater implementation, thereby increasing the role of local institutions and faith-based organisations to find models that work best for their communities and societies towards achieving the Global Goals.

The United Nations Environment Programme – Finance Initiative very recently launched a first draft of the UN Principles of Responsible Banking that was spearheaded by 28 banks around the world seeking to align banking practices, products, services and operations with the SDGs. For the very first time, an initiative like this includes the requirement to set goals and meet targets regularly. In other words, it is seeking to redefine a bank's role in the economy it operates within. This provides an opportunity to explore common interests between what the principles aim to achieve and the maqasid al-Shari'a. This is especially the case in the area of transforming culture in banking so that it is more aligned with sustainable, fair and transparent practices that consider all those impacted by everyday decisions.

### Malaysian Central Bank's 2018 Strategy Papers on Value-based Intermediation

In July 2017, BNM issued a strategic paper on Value-Based Intermediation (VBI) which articulated strategies to strengthen the roles and impact of Islamic banks towards a sustainable financial ecosystem. The VBI initiative is a collaboration with the founding members of VBI Community of Practitioners (CoP) comprising Bank Islam Malaysia Berhad, Bank Muamalat Malaysia, Agrobank, CIMB Islamic Bank Berhad and HSBC Amanah Malaysia Berhad. In the strategy papers, the bank suggested that Islamic finance has deviated from the goals of Islamic Economics, the maqasid al-Shariah. It defined VBI as an intermediation function that aims to deliver the intended outcomes of Shariah through

practices, conduct and offerings that generate positive and sustainable impact on the economy, community and environment, consistent with the shareholder's sustainable returns and long-term interests. Sustainability is depicted as the 'positive and sustainable impact' generated by (good) 'practices, conduct and offerings' through which the intermediation function delivers the 'objectives of Shariah'. Concurrently, the 'good' intermediation function provides maqasid to the extent to which 'good' practices generate sustainability. Hence, implicitly, sustainability becomes one of the 'intended outcomes' of Shariah.

There are three key components which are crucial for realising the above-stated goal:

- Offerings and market segments: introducing innovative products that create a more significant impact on existing sectors and focusing on high impact segments such as new growth areas and underserved segments.
- Practice: the adoption of VBI will further strengthen the current banking offerings and practices by introducing innovative products and techniques such as offtake agreement or supply-chain finance, which enable industry players to mitigate the risks arising from serving high-impact areas.
- Enhance collaboration: VBI will enhance cooperation with strategic partners, encourage the creation of new business opportunities, and contribute to more sustainable returns for Islamic banking Institutions (IBIs) in the long term.

BNM has suggested the adoption of a more holistic approach while assessing the impact of business activities. This encompasses stakeholders who go beyond the traditional definition limited to shareholders as well as a focus on fulfilling longer-term obligations to the society and the planet and not merely short-term shareholder profits. It aims to achieve the intended objectives of Shariah or maqasid which focuses on the enhancement of the well-being of the people through the preservation of wealth, faith, lives, posterity and intellect. Preservation of wealth in this proposal goes beyond its literal meaning since it includes encouragement to generate, accumulate and distribute the wealth in a just and fair manner. It argues that such an approach will enable the creation of a superior and more sustainable financial system.



## Key Factors of Value-based Intermediation

VBI has four underpinning themes: entrepreneurial mind-set, proper self-governance, community empowerment, and best conduct. Entrepreneurial mindset facilitates entrepreneurial activities through holistic offerings by IBIs. Proper self-governance ensures meaningful participation of all stakeholders in the governance framework. Empowering community is achieved through funding and implementation of practical solutions for issues faced by communities. Finally, best conduct improves IBIs' offerings, processes and treatment of their stakeholders. By incorporating these principles in the business of IBIs, there will be more significant socio-economic development, and this will ultimately create value for stakeholders.

A typical question that may arise at this stage is how to measure the critical components of VBI? The strategy paper recognises some possible indicators which can be used to measure each of the four factors. The following table summarises the measurement indicators of VBI factors.

### VBI Factors and the corresponding possible Indicators<sup>3</sup>

#### **Entrepreneurial mind-set**

- Percentage of financing disbursed to identified sector/new growth areas
- Number of innovative products launched for business sector/SMEs
- Number of initiatives to support the business sector/SMEs
- Number of first-time banking customers (financial inclusion)
- IBIs' contribution to improved efficiency and productivity level of business entity (customers)

#### **Community empowerment**

- Number of innovative products and services introduced for the community
- Number of community-based projects driven by IBIs
  - Number of individuals who have benefitted from community-based projects
  - Social impact indicators e.g. enhanced the standard of living

#### **Good self-governance**

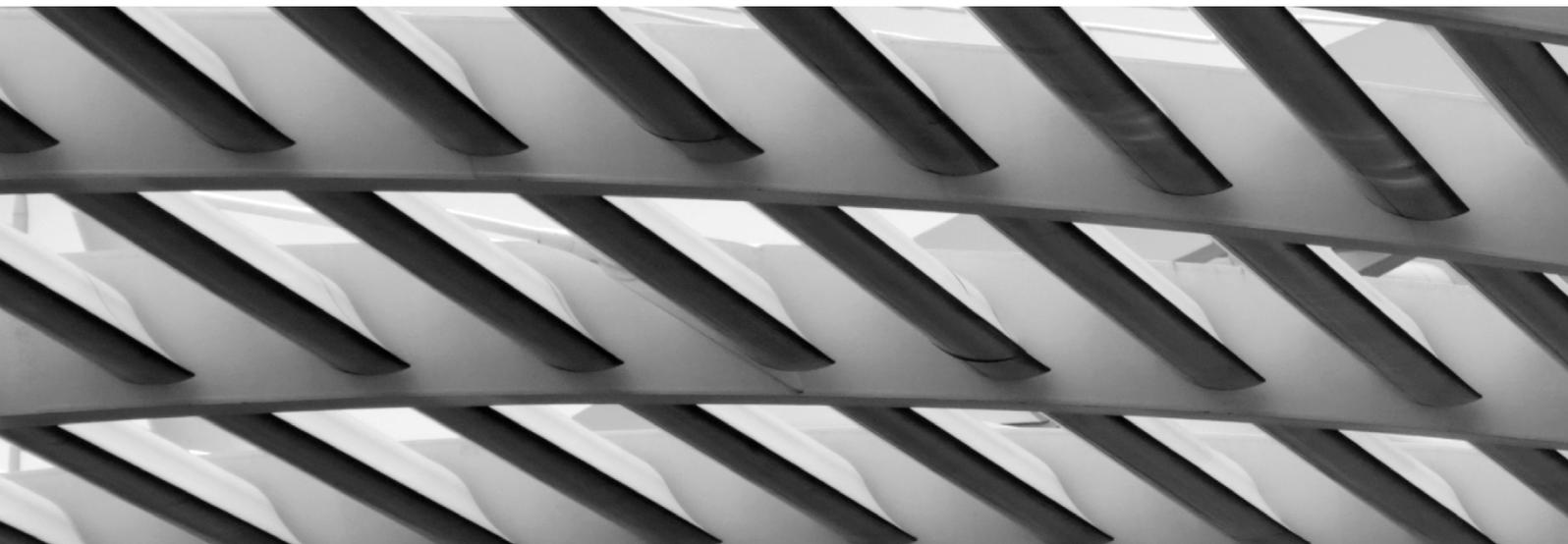
- Robustness of engagement/ consultation with other stakeholders, e.g. materiality assessment framework
- The trend of internal fraud cases
- Compliance to relevant global standards, e.g. ESG and Integrated Reporting

#### **Best conduct**

- Number of customers' and employees' complaints
- Customer and employee satisfaction index
- Enhanced level of transparency
- Staff turnover rate
- Quality of after-sales service
- Number of affected customers who have benefited from the implementation of proactive policies in dealing with customers with genuine financial difficulties, e.g. affected by a natural disaster
- Amount of cost-savings resulting from improved staff competencies

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<sup>3</sup> Bank Negara Malaysia, 'Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance' (Bank Negara Malaysia Paper BNM/RH/DP 034-2, 12 March 2018) <<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=612&bb=file>> accessed 1 August 2019



## Implementation of Value-Based Intermediation in the Industry

The Bank Negara Malaysia (BNM) has effected a quantum leap in embedding Shariah-compliance in the management toolkit and pushing it to all Islamic financial institutions – this can and will be a model for the Islamic world. The Bank has proposed a two-pronged approach in facilitating VBI adoption by industry players:

- Creating an enabling environment through regulatory guidance
- Enhancing the quality of transparency to trigger intended stakeholder activism

The biggest challenge with the previous step is to manoeuvre the varied and complex regulatory environments under which the various Islamic financial institutions operate. The jurisdictions vary from a solely Muslim-majority jurisdiction, through the ‘parallel’ financial systems seen in Malaysia, Bahrain and others, to secular ones such as the English legal system, which makes some special allowances for Islamic finance while ostensibly treating institutions as their conventional counterparts. In recent years, Islamic finance has even made some progress in jurisdictions where the legal systems appear to be hostile to its core principles, such as in the United States.

Introducing a worldwide VBI initiative for Islamic banks will face other practical impediments. Other than in Malaysia, regulators generally are neither willing nor able to provide guidance or standards in this area. Perhaps a body like AAOIFI can help achieve buy-in from Islamic financial institutions (IFIs).

Critics argue that the ethical leadership in the Islamic finance industry has been weak, driven primarily by short-term metrics, pure financial KPIs and perverse compensation incentives. As the Bank Negara paper states, “VBI is a long journey that requires a significant transformation of mindset among key stakeholders. Strong and visionary leadership is central to this paradigm shift[...]”. In light of these arguments, it may well be that the change may come from the bottom-up – grassroots non-bank financial intermediaries, often tech-based, created to solve specific problems and often run by young people not held back by the fetters of the incumbent banking establishment.

## Strides Made in VBI Implementation

A few strides have been made by a handful of Islamic banks towards the implementation of the VBI initiative. A good example is Maybank Islamic, which recently launched a Rent to Own (RTO) product called HouzKEY. HouzKEY is an alternative method of home financing by way of a ‘lease agreement’ based on the Islamic concept of Ijarah (lease) that includes an option to purchase (via cash or mortgage). HouzKEY is a response to the high demand for an affordable house, and it will assist Malaysians who have difficulties to own homes. It is expected that other IBIs will follow the example of Maybank Islamic, and it will further open the gate of innovation in Islamic finance.<sup>4</sup>

Another critical initiative worth noting is Sadaqa House by Bank Islam, which launched in January 2018 as part of its agenda for social finance initiatives. Sadaqa House is a donation platform operated by Bank Islam. It allows the public to donate cash through several channels such as internet banking, mobile banking or through the bank’s digital crowdfunding platform. The fund collected will be then channelled towards helping needy beneficiaries in two main sectors; namely, education and healthcare. This is considered as one of the efforts to create more sustainable economic development, community and environment. Likewise, in August 2018, CIMB Group announced its official membership in the United Nations’ (UN) Environment Program Finance Initiative Principles for Responsible Banking (UNEP-FI), making it the only banking group in ASEAN to be a founding member, together with 26 other leading banks from five continents and 19 countries. CIMB’s UNEP-FI membership complements Bank Negara’s Value-Based Intermediation strategy for the Islamic banking industry and will undoubtedly assist in achieving the objective of VBI.

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<sup>4</sup> Muhammad. M, Zada. N (2018). Value Based Intermediation: It Scopes and Implementations in Malaysia. Paper presented in the 13th International Shariah Scholars Forum at Intercontinental hotel, Kuala Lumpur.



## Impact of Fintech Innovations on Islamic Banking and Finance

In recent years, there is a widely held opinion that we are undergoing a paradigm shift in the reality of the financial ecosystem as a consequence of the digital revolution or the so-called fourth industrial revolution (Schwab, 2016). This revolution is characterised by bringing about radical changes at an unprecedented speed due to the convergence of technological advances in the area of artificial intelligence, big data, cloud computing and the Internet of Things (IoT).

Several factors explain the growth experienced by FinTech companies since the outbreak of the global financial crisis. From the supply side, the reputation of some traditional financial institutions has been damaged due to their share of responsibility in the origins of the crisis which has reduced society's trust in them. This situation has led to consumers preferring FinTech companies, which also usually provide a far superior user experience. Furthermore, the pressures stemming from low-interest rates and increasing regulatory burdens have decreased the financial margins of traditional banks, implying a more cautious and stricter lending policy. As a result, those who are unable to get their financial needs met by their usual bank are forced to resort to alternative financing options such as those offered by FinTech.

From the demand side, we are witnessing a change in the consumption patterns of a whole generation of consumers, driven mainly by the mass adoption of smartphones. The central role played by smartphones in the life of the "Millennials" (i.e. those born after 1980 and the first generation to come of age in the new millennium) is particularly significant. The habits of this generation promote the use of the mobile channel to interact with their bank, forcing all financial institutions to adapt their range of services to the demands of the new digital era.

In short, the digital revolution as a disruptive force in the financial industry has meant the beginning of a process of banking disintermediation that has led to the establishment of a new paradigm by FinTech companies. Significantly, not only has this new FinTech paradigm started to emerge in the Islamic finance industry too, but a foreseeable impact can also be evaluated in terms of the promotion of a social-oriented model of financing able to address the use of new technologies towards community development.

The evaluation of social costs and benefits of (the use of) technologies is quite complicated and requires multi-disciplinary competencies. However, there is sufficient reason to believe that Fintech is going to transform the banking and finance industry completely. The current and potential future end-users, who share the vision of risk-sharing and ethical finance, may look for alternatives, not just for the financial product and service offerings of conventional banks but also that of Islamic banks. There is an ample number of cheap/fast/more convenient FinTech payment services, for

instance, with seemingly no Shariah issues involved ("neutral technologies"). The real estate business of Islamic banks, which is currently dominated by home financing, may be challenged by new forms of (debt-based but interest-free) group lending and crowdfunding schemes. Shariah compliant pilot projects are in the pipeline or have recently come to market. Interestingly, Shariah compliance was often not the primary purpose but a kind of by-product of these initiatives.

Investment advice for retail customers – if provided at all by Islamic banks – could be replaced by robo-advisors or by specialised portfolio managers. These market players may find it more attractive to tap directly into the retail investors' pool than as white label service providers for challenged Islamic banks.

Regarding corporate finance, all (incomplete and not always reliable) data indicate that Islamic banks (as their conventional peers) are not particularly active in the vital medium to long term financing of the SME sector. The little that they provide may be taken over by crowdfunding platforms which have already replaced banks as the most crucial source of SME funding (next only to retained profits) in many Western countries.

The "intrusion" of large e-commerce companies (such as Amazon, Alibaba) should concern banks in general but alarm Islamic banks in particular because large parts of their financing business are vulnerable to their attack. E-commerce companies may try to expand their sales by giving customers deferred payment options by merely offering a cash price and a mark-up for deferred payment on their platforms. This option is not only more convenient for buyers but can also quite easily be based on a fully Shariah compliant murabahah contract. There is no need for the complicated and costly "murabahah-isation" of de facto loans by Islamic banks once these user-friendly and straightforward options become prevalent.

The paradigm shift experienced in the conventional financial ecosystem is beginning to become observable in the Islamic finance industry too. Islamic banks and financial institutions must adapt to a new reality in which they are no longer solely responsible for providing financial services in compliance with the Shariah. The digital revolution has enabled the launching of a significant number and variety of FinTech initiatives based on Islamic principles that have recently emerged in the market to have a significant social impact in local communities, as well as at a global stage.

In particular, relevant Islamic FinTech experiences can already be found in the fields of crowdfunding platforms; charitable initiatives (zakat and waqf); Islamic wealth management; and blockchain technology applications (namely: smart contracts, identity authentication and cryptocurrencies). At the same time, both private and public market actors are currently investing in Islamic FinTech to reinforce the Islamic finance ecosystem.

## Way Forward

The Shariah rules used in Islamic finance were never intended to be a complete, final code for financial transactions and the macro effect of such transactions on society, the economy and the environment. They were designed for commercial (not financial) operations which took place in a radically different context from that of present-day Islamic finance in terms of matters such as the overall social, political, economic and environmental environment, the financial system and the legal system. All law has to change to accommodate the changing needs of society and, as is well recognised, Islamic law is no exception. 'Change' in this context does not just cover changes to existing rules; it also includes the formulation of new rules and entire areas of law.

It is argued that the Shariah boards are often denied privileged information about a bank's operations or transactions, or may lack the technical skillset and the practitioner view of the market to help them reach meaningful conclusions on some aspects of VBI (e.g. environmental, corporate culture, social impact). The creation of "governance boards" within IFIs, comprising of both Shari'a scholars and practitioners might help to implement VBI.

Value-based financing in contemporary times needs to push the incumbent Islamic finance ecosystem underpinned by prohibitions and restrictions to go well beyond and create a decisive and positive impact on the society by addressing broader ethical and social concerns.

Professor M Hashim Kamali advocated following four distinctive methodological approaches towards integrating ethics into Islamic Financing activities:

- Integrating the maqasid al-Shariah in the operative rules of Islamic banking and finance will help to bridge the gap between the substance and form of financial transactions (mu'āmalāt) and also enhance the measurability aspects of performance. The supervision and regulatory authorities should improve not only the knowledge of maqasid but also take measures to integrate them into industry regulations and contract specifications.
- Ethical concerns and credibility factors demand that Islamic banking and finance should develop greater vigilance to reduce the hitherto rampant tendency at imitation and match-making of conventional banking modalities and products.
- The risk-sharing component of Shariah-based transactions and finance comprises the ethical core of Islamic finance. But risk-sharing has yet to find an essential place in Islamic banking and finance operations.
- Islamic financial institutions should liaise more closely with financial institutions in the West and elsewhere that encourage ethical investment schemes and products. Ways and means should be found to facilitate greater cooperation, which would hopefully also contribute to the health of the world economy.

Realising the broader goals of Shariah is not the exclusive responsibility of the Islamic banks but one which also needs to be shouldered by the rest of the financial sector. Appropriate microfinance and micro takaful institutions, for instance, need to take the initiative to address the issues of poverty alleviation and financial inclusion while the secondary markets including the stock market, the venture capital and private equity industries should shoulder the burden concerning the capital raising activities of businesses.

Islamic banks have been slow to attract and persuade non-Muslim customers (Malaysia being an exception). Emphasising holistic/universal ethical standards or de-emphasising the Islamic/Shariah aspect (without removing the need for Shariah compliance) can help to close that culture gap and grow Islamic finance.

Increasing interest in what is often labelled as 'ethical finance', offers the Islamic finance sector an exciting opportunity to adopt and drive developments in this space. The fundamental Shariah principles that underpin the Islamic finance space imply that cross faith finance and opportunities offered by the SDGs, naturally align with the Islamic finance sector's DNA. The focus here would be more on the substance of a transaction (i.e. does it meet the maqasid al-Shariah) rather than just the form of a transaction.

If Islamic Finance wants to lead VBI Intermediation which aims to deliver intended outcomes of Shariah through activities that generate positive and sustainable impact to society consistent with sustainable financial returns, we should be cognizant of the need to take into account the factors we have described. Moreover, convergence towards existing ethical banking models should be prioritised such as towards that of the GABV. This will remove the possibility of isolation in an irrelevant alternative system or a financial model asynchronous with the industry trends.

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The above report is based on the written commentaries of the following workshop participants:

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