CHAPTER 24

Charities and Islamic finance

24.1 Introduction

When Islamic finance is mentioned, we often think about the prohibition of riba, maysir and more recently, the proliferation of financial instruments such as murabaha, mudaraba and sukuk. Rarely will we see an analysis of actual financial practices of Islamic charities. This article will explain the mechanisms of Muslim charity finance. It will explore the challenges that face Muslim charities operating in Britain. Many of these challenges are shared with Non Muslim charities.

The following issues will be discussed:

- The imperative in Islam to helping those in need.
- The arguments around administration costs and their complications.
- Differences between charity finance and commercial finance.
- How regulators and financial institutions operate in a post September 11th World.
- The changes in the investment guidance for charities and how this may impact future decisions.
- Financial institutions offerings to the sector.

24.2 Islam and charitable giving: An obligation and a right

There is no doubt that Islam has made charity a core component of belief. The word "charity" implies that an individual may have a choice about making the contributions but, for Muslims, Islam makes it clear charity is an obligation.

From the very beginning of the Quranic revelation, Allah (swt) made belief synonymous with caring for the orphan and feeding the poor. Allah (swt) says in Surah Al-Ma'oon: *"Do you see him who denies the faith? It is him who repulses the orphan and does not encourage the feeding of the poor"*. When these verses were revealed in Mecca, Muslims were a minority. Injunctions for helping the poor and needy went beyond the responsibility of Muslims to assist each other. We read in Surah Al-Insaan revealed after the battle of Hunayn in the 8th Year Hijri: *"and they offer food while in need of it to the poor the orphan and the captive. (Saying) We feed you for the sake of Allah. We want no thanks or gratitude from you"*. After the battle of Hunayn, many enemy fighters fell into captivity and the Muslims were encouraged to feed them before they ate themselves.

There are many verses in the Qur'an that point to the importance of helping the needy that extend beyond it being a voluntary act. This all stems from the understanding Muslims share that their lives, health and wealth all belong to Allah and they will be judged according to the manner in which they have discharged their spiritual and worldly responsibilities. In fact, the concept of vicegerency goes beyond responsibility for fellow humans and extends to animals, plants and earth itself.

Such strong injunctions make it conclusive that the traditions of charity are firmly rooted in Islam. Many of the modern concepts of accountability were written in early Islamic works and were tied to charitable giving. There are many examples from pre-modern Islamic history of the extent and diversity of Muslim charitable activity. For our present purposes, a few examples would suffice.

Charitable trusts were set up to care for animals that served as farm labour. Another was set up to replace the pottery broken by servants as they crowded to get milk for their masters. A third was set up to pay fees to actors that spoke within hearing distance of a seriously ill patient commenting on improvements to their health in order to raise their spirits. These and many others were set up around 1000 years ago and highlight an acute sense of societal needs from the marginal to the grand, catering for the unfortunate to the beast. The quite novel purposes for setting up charitable trusts were a means by which funds could be channelled to what would otherwise be ignored in the normalcy of daily activity. It is often forgotten that pre-modern Muslim civil society was renowned for their generosity and infused with a concern for the wider community. Subsequently, the Muslim communities have to ask whether this lofty heritage has continued to the present day.

In modern society, Muslim charities operating from Europe went through different phases. In the first phase, Muslim migrants established a firm link with their home country. It was followed in the second phase by a visceral reaction to disasters in Muslims lands. The third was the increasing media intervention and coverage highlighted clearly by the Bosnia crisis in 1995. We are now living in a period when internet and satellite communication is allowing communities to experience, first-hand, adverse conditions on the opposite side of the world.

24.3 Administration costs

Without charities there will be no organised manner of supporting those in need. However, to function sustainably, administration costs have to be considered and remunerated. Without considering payment of administration costs, charities would not be able to deliver effective services or, worse, cease to operate.

Some organisations that boast low administration costs receive funds and send them as grants to implementing partners on the ground. They argue that tax rebates as part of the gift aid system are adequate to meet their administration costs. However, the channelling of tax funds to pay administrative costs presents a paradox. On the one hand, the donor would want their donation to be fully given to beneficiaries; on the other, a charity has to function and therefore a percentage of the tax funds would need to be used to sustain the organisation. The high percentage of the tax rebate utilised for administration costs can present a moral dichotomy.

The challenge of providing good administration is even greater when we consider that development projects require greater support and expertise than relief projects. When the Prophet (pbuh) saw a man begging, he provided him with monetary assistance but requested him to spend a half on his immediate needs and to buy an axe with the other half in order to earn a living from selling firewood. The lesson being that it is better to help people to become independent than to make them dependant on aid. Additionally, organisations that engage in development work require far greater experience in specialist areas as compared to organisations that engage in relief distribution only.

This brings us to an important question. How do we define administration costs? Is the cost of paying for a water specialist, a teacher, social worker, doctor or a project manager, administration or project cost? Whatever definition an organisation uses, the calculations that reflect the different costs attributed to projects should be clear to donors. Experience has shown that organisations that do not prepare proper beneficiary lists, store goods properly, handle distribution in an organised fashion can waste much of the relief supplies they have. Development programmes could do more harm than good if the impact on the surrounding community, the environment, or even the beneficiaries themselves, is not examined carefully.

Some aid agencies see donations received as a burden that they need to discharge speedily without adequate long term consideration for the context and conditions of the socio-economic situation on the ground. After every disaster, we see the efforts of well wishers translated into tents pitched next to highways threatening the lives of the inhabitants. Furthermore, the wrong type of supplies is sent which then end up being destroyed creating great wastage of needed resources.

Fundraising is an important part of the work carried out by aid organisations. Without proper accountability, agencies could lose the opportunity to collect additional funds. The minute an organisation receives a donation they are responsible for safeguarding this donation for the purpose for which it is received. Recent research into the sector indicates that average contribution by organisations on raising funds has gone up 10% – 11%. This may be regarded as very reasonable in the mainstream charity sector but in the Islamic charity sector it would be considered too high.

The process for helping people in-need starts with the people in need themselves. Raising awareness of their plight then raising funds to cover the identified needs. Some organisations spend large sums campaigning for better rights for people in need either by arguing against government policy or simply by highlighting their plight or by just encouraging solidarity from others. They argue that their approach is far more effective in helping people in need as it changes the dynamics of the situation that created the poverty trap in the first place. How is that classified? They are classified as advocacy costs, being part of programmes. Muslim-led charities are not known as leaders in this area. More will be expected in the future from Muslim charities to reflect the addition to the global humanitarian movement that Islam brings.

24.4 Regulation

Charities operating from Britain have a well established regulatory framework guiding their operations. Charities operating on Islamic principles often find that secular regulations comply with their religious edicts and institutions. There are many similarities between a waqf and an English Trust, and research has been undertaken, which suggests that the Trust borrowed concepts from the waqf.

The British charity apparatus has developed far more impressively than the Islamic system. Institutions of regulation have been set up to oversee the healthy functioning of this sector. In the UK, the Charities Commission, an independent body that reports directly to Parliament through an appointed board of commissioners, was set up to regulate the sector. The Commission ensures that charities are effective and incur the public's confidence and trust. One of the most fundamental aspects of regulating a charity is ensuring that the organisation has a good accounting system and they followa tried, tested and accepted set of guidelines. The Statement of Recommended Practice (SORP) fulfils such objectives and helps charities prepare accounts accordingly.

There is a difference between the accounting practice on charities and commercial organisations. The best way to describe the difference would be to say that commercial accounting has a profit and loss account while charity accounting has an income and expenditure report that could be made up of many profit and loss accounts. Charity accounting has to be prepared to reflect the income and expenditure from each charitable fund, created for a specific project. Each fund will have direct costs and a proportion from indirect costs that will get allocated using some reasonable method. Accounts will have to consider the number of staff, staff pay, floor space, time etc. Each type of fund has an income and expenditure report. Fund accounting is what ensures that funds are kept for the purpose for which they were received.

Many disasters take place in parts of the world that suffer from conflict or poor governance. Those in power may regard organisations arriving with large sums of money as a potential source of destabilisation. This makes the responsibility for charities to maintain transparency very important.

The approach to registration and regulation of charities varies greatly. In fact the definition of charities is so broad that many countries have multiple registers with different government departments. Some charities could be registered with local authorities while others are registered on a national register. Some charities are registered with specialist departments like education, health or social welfare. This leads to different state arms offering competing guidelines to charities.

Charities operating across borders will have many regulators to contend with. Some will afford international charities that arrive on their shores a different status and other jurisdictions will make no distinction. Unfortunately, Islamic charities are often regarded with additional suspicion after September 11th.

With additional responsibilities taken up by governments after September 11th the tax authorities represented the best source of information on charities as tax concessions required submission of annual returns by qualifying organisations. However, not all organisations qualified for tax concessions and there are countries that have a limited tax system.

In certain cases, records of the governance structures and financial dealings of Non-Profit Organisations were not submitted to any regulators let alone maintained on a register. Financial investigation units and compliance units in banks became the most influential players in fighting terror financing. The restrictions imposed on charities gave reassurance to the governments that all is well. The reality is that many of these countries have not developed an effective regulatory regime for the charity sector. In fact, there are many arguments that support the view that terror regulations have been used as an excuse for restricting the space open for civil society generally and, in particular, charities.

Muslim-led charities became vulnerable to accusations of terrorism links and vast resources were invested in defending organisation reputation. New definitions of terrorism, lists of proscribed individuals and entities, and court cases throughout the world fostered increased legal scrutiny, red tape and litigation. Resources (especially by leading Muslim charities) were diverted from the beneficiaries to defending their name and reputation as well as to meet new standards. Charities working in conflict zones were put at risk by expecting them to start asking people for extensive personal information. How can a charity work in developing countries, failed states or conflict zones where a regulator does not exist? How can a charity go into an area hit by a disaster and start working to save lives immediately if they have not been registered in that country previously? How will they open bank accounts and move funds around quickly?

Currently, the reality of work in international aid at this moment in time is that organisations have to conduct more due diligence than ever before. They must now screen names of organisations, individuals and suppliers at a substantial cost and, despite this, they are more vulnerable than ever before to accusations of funding terror. Charities need to apply proportionality to the work they do (as do regulators and financial institutions). It is not possible to monitor and assess every individual beneficiary or donor though asking for details on organisations they partner and carrying out background checks on large benefactors is possible. Charities have regularly collected information about a partner's capacity and track record in implementing projects. This is an effective way for identifying dubious organisations that are often overlooked. Screening is not the only effective tool. Charities especially Muslim charities have a duty to implement the highest standards in this area. The cost incurred in ensuring greater transparency and protecting the charity is necessary to protect the sector's reputation against constant attacks.

24.5 Financial institutions

Over the past few years financial institutions started to offer more Shari'a compliant solutions. Charities can never be expected to dispose of all funds immediately on collecting them. Programmes will take years to complete and charities will need a few months' reserves to cover core expenses. This makes the potential for investing a portion of funds inevitable.

The Charity Commission published its latest guidance on investing charity funds in October 2011. The guidance expanded the purpose from investments for increasing profits to investments entered into to further organisational objectives. Charities were sometimes caught out under the old guidance when they extolled the virtues of making an investment beyond making profits.

It seems only reasonable to expect charities to use investments as a means to achieve their stated objectives. Muslim charities may have engaged in Islamic micro finance projects for many years with the aim of empowering the poor and achieving sustainable development. They however had to reflect on the amounts they spent on these projects as programme expenditure not as investments.

The new guidance opens the doors to charities to establish programmes that may have a dual purpose of investing funds and achieving the charity's objectives. Muslim charities in Britain can take advantage of this change in rules in order to create Islamic investment products that address their needs and yet fulfil their religious duties.

Financial institutions have not developed many solutions that address Muslim charity needs specifically. Many of the leading institutions in the investment market would be willing to consider developing an investment fund if adequate funds materialised. It is reasonable to assume that the minimum an investment fund manager would consider in managing would be £5million. This is not an amount that a single charity could afford to put forward on their own. Better co-ordination between Muslim charities could open the door for smaller organisations and individuals to join the fund.

If charities were to venture into broader investment strategies they will need to consider both the risks and the "Halal" conditions. Muslim charities may adopt a differing stance on the interpretation of what is Halal. Indeed some have argued that taking higher interest from government secured bonds and the like is acceptable as charities spend the returns on good causes and no personal benefit exists. However, Muslim charities have a responsibility to lead the way in following Islamic principles.

The financial solutions on offer to the Muslim charity sector are increasing. Leading financial institutions will be keen to develop solutions when they are presented with adequate funds. The potential for growth in this market are immense and these investment funds could be made available for the public at large once they are developed. Like all new projects it will come at a higher cost. Muslim charities need to coordinate their efforts to agree definitions of Halal investments and to approach institutions collectively.

In recent years, some Muslim charities faced problems with financial institutions. After September 11th 2001, financial institutions were expected to play a policing role on all financial transactions with the warning of heavy penalties if they failed to do so. To make matters more complicated, financial institutions had to defend themselves against legal actions brought by the victims of terrorism. Not only were they expected to have identified proscribed persons and organisations, they were also expected to have foreseen potential problem customers.

All financial institutions involved in a financial transaction have equal responsibility for carrying out checks without relying on checks already carried out by other institutions (reputable or not). This leads banks to adopt a zero tolerance approach. The risks made banks turn down business because related risk assessments made the business not worth the trouble. This only led to people carrying out charitable activities privately. The expectation that correspondent banks would carry out screening to the same extent as remitter or recipient banks has resulted in greater reliance on screening lists rather than first-hand knowledge of parties to a transaction. This in turn resulted in them holding up transactions based on name similarities. In the end, harm is done to the beneficiaries and charities. Muslim charities have especially suffered greatly in the last decade from restrictions on financial transactions.

24.6 Conclusion

Charities are a necessary vehicle for the delivery of help to those that need it. Muslim charities are especially obligated by principles of Islam. Charities need greater professionalism and transparency to protect the sector against accusations of wasting resources or worse. Realistic policies for the recovery of administration costs are needed. Muslim charities need to pool their efforts together to make the financial sector willing to offer better investment options. This could be of benefit to the wider community. The charity sector also needs to lobby effectively to ensure rules introduced to counter terror do not restrict charity work.