

CHAPTER 27

Corporate responsibility in Islamic finance

27.1 Introduction

Responsibility in Islamic finance is predicated in large part on its duty of social responsibility, and in this respect, there is much that will overlap with the focus on ethical finance and socially responsible investing (SRI) which represents a growing part of conventional finance. This chapter discusses the core components of corporate social responsibility in Islamic finance, its linkages with individual social responsibility and the various prohibitions and the practicality of compliance with them. Also covered are aspects of governance and responsibility that help the growth of the Islamic finance industry, including that of Shari'a scholars, Islamic financial institutions, regulators, standard setters and governments.

27.2 Social responsibility in Islamic finance

Islamic financial institutions (IFIs) are meant to be socially responsible for two interrelated reasons: their status as a financial institution fulfilling a collective religious obligation and their role as a financial intermediary to lead by example such as implementing a just and equitable distribution of wealth. Islamic social responsibility derives itself from core principles in the holy Qur'an with the three core principles being the viceregency of humanity on earth, divine accountability and the duty on humanity to enjoin good and forbid evil. Viceregency symbolises that humanity is the representative of Allah on earth and Allah has thus bestowed on humanity the care and oversight of Allah's possession. Divine accountability follows logically from the viceregency principle in so far as individuals will be accountable to Allah on the Day of Judgement. Finally, the principle of embracing good and forbidding evil captures the responsibility that is placed on Muslims as trustees and vicegerents. When combined, these principles represent the accountability for

each Muslim to embrace good and justice and to reject all that is evil and unjust.

IFIs exist as a form of collective religious obligation and individuals following the Islamic faith have an implicit social contract with the IFI as part of the broader community or ummah. Accordingly, corporate social responsibility is an extension of the individual social responsibility of every Muslim.

Mandatory forms of social responsibility can be summed up as practices or products that must be avoided to ensure compliance with Islamic religious duties. Failure to do so will mean that the IFI is not complying with fundamental edicts of the Qu'ran. Given the concern of controlling the costs of Islamic finance, this form of social responsibility does not need significant expenditure and is relatively easy for practitioners to comply with. This is because mandatory forms of social responsibility are invariably prescriptions to avoid (for example, riba or interest, alcohol and pork) rather than prescriptions to act. It is also likely that IFIs will need to take action to purify a haram investment via the payment of zakat if avoidance is not possible or proves too costly at inception.

- Screening of investments (no investment in enterprises engaged in impermissible activity - for example, alcohol (serving and production), pork, tobacco, pornography, armaments, etc.)
- Earnings prohibited by Shari'a (riba or interest, immoral);
- Earnings arising from impermissible activities (need for purification);
- Responsible dealings with clients (assistance to debtors);

- Employees (treat justly); and
- Zakat¹.

Recommended forms of social responsibility extend beyond the mandatory requirements and are carried out voluntarily according to whether the IFI has the capacity to perform such activities. The following ten categories are founded on Islamic principles of justice:

- Qard Hasan²;
- Reduction of impact on the environment;
- Screening / negotiating terms with clients and contractors (to ensure they do not engage in prohibited activities, such as usury);
- Industry wise investment quotas – most beneficial to economic development and social equity;
- Social impact-based investment quotas;
- Environmental impact-based investment quotas;
- Customer service excellence; Microfinance;
- Employee welfare (extension) – pay, salary guarantees, equal opportunity, no discrimination;
- Charitable activities; and
- Waqf management (religious endowment).

27.3 The principles of Islamic finance and divergent views

¹ The payment of zakat is a mandatory obligation on the part of all Muslims to purify their wealth, regardless of mental health or youth. The Audit and Accounting Organisation for Islamic Financial Institutions (AAOIFI) has already mandated standards for the accounting treatment of zakat (FAS 9). There is some dispute in Islamic literature as to whether Islamic businesses are obliged to pay this tax, or whether it is only obligatory for individuals.

² Many argue that this is the only type of loan recognised in Islam. It is a gratuitous loan given to needy people for a fixed period without requiring the payment of interest or profit. The recipient is only required to repay the principal. However, some scholars distinguish between simple Qard and Qard Hasan. The implication is that there may be (interest free) loans given for purposes that are not purely altruistic. From this perspective, one could argue that that Qard Hasan is not the only type of loan recognised in Islam.

It is important to note that the Shari'a is not a codified system but rather a set of core principles which are open to interpretation. In some respects, this flexibility is commendable but it also has a downside. This interpretive approach leads to some very divergent opinions and the absence of any doctrine of precedent has led to criticism of an inconsistent approach being taken by scholars. Furthermore, the lack of precedent leads to confusion and can also be seen as running the risk of scholarly arbitrage with some firms actively procuring the view of a scholar whom they regard as being more sympathetic to their product. Some criticism has been levelled at scholarly opinions that seem to be taking too flexible an approach with the use of alternative investments. Whilst a check and a balance can exist via disclosure of the scholar, as we know from conventional finance, disclosure alone is often not enough of a protection for retail investors. It would be beneficial for the growth of the industry if some kind of standardisation and consistency of scholarly opinions could be introduced – perhaps via some kind of agreed database. In countries such as Malaysia where a central scholarly board exists, this helps, but such a system is more beneficial in countries with a predominantly Muslim population. This, therefore, can limit the desirability of such a system.

27.4 Prohibitions

Of course, the main principles of Islamic finance are found in various prohibitions and these include the taking of interest, or *riba*, with Islamic banking being intolerant of the notion of a risk-free reward for return. The other haram, or banned, principles cover uncertainty of contract (*gharar*); gambling (*qimar*) and games involving speculation (*maysir*), as well as unethical investments and unfairness or unjust gain at the expense of the other party. It is appropriate to discuss the issue of certainty which then feeds neatly into the concept of gambling and speculation. This is significant given the pace of product innovation and the often divergent views held amongst different Islamic scholars. A contract lacking in certainty poses problems for conventional contracts of insurance which presupposes payment of compensation for an event that may happen but which people rather hope will never happen. This will be contrary to the Shari'a as the trigger event for payout is not guaranteed and indeed the actual amount of compensation payable bears no predictable relationship with the amount paid by way of premium. However, insurance is of course a good thing and is actually a legal requirement in some cases and so the Shari'a compliant solution is to use *takaful* which means mutual or joint guarantee. In order to eliminate the element of uncertainty in the *takaful* contract, the concept of *tabarru* ("to donate, contribute, or give away") is incorporated. A participant agrees to relinquish (as *tabarru*) a certain proportion of his *takaful* instalments (or contributions) that he agrees or undertakes to pay, should any of his fellow participants suffer a defined loss. This agreement enables him to fulfil his obligation of mutual help and joint guarantee. *Takaful* is different from conventional insurance as it uses the concepts of solidarity and co-operation with both parties mutually agreeing to share both losses by making periodic donations with the right to share in any surplus profits.

Contracts entered for purely speculative purposes will be void. However, it is important to make clear that this ban does not exclude general commercial speculation where there is a risk of incurring losses as well as earning profits – the test is one of making a gain via chance rather than the use of productive effort. This prohibition on speculation can lead to complications where firms are using financial derivatives – especially where there may be no physical delivery. Lack of physical delivery will be banned – however, there are certain Islamic products which have characteristics not dissimilar to conventional derivatives: for example, *salam*, *istisna'a* and *arbutun* but each of these products anticipates physical delivery. In terms of certain strategies used by hedge funds, such as the long / short strategy, it is likely that this subject will continue to exercise the minds of both alternative asset managers and Shari'a scholars for some time to come.

27.5 Overlap between Islamic finance, ethical finance and SRI

The ban on unethical investments is actually very similar to many investment restrictions imposed on conven-

tional financial products either at a fund level or indeed demanded at an investor level, with the notable exception of riba. For example, the Shari'a prohibits a number of activities including gambling, armaments, alcohol, tobacco and pornography. However, depending on which Shari'a scholar you speak with, you will get differing views – for example, some might argue that either an airline or a hotel which happens to serve alcohol would still be acceptable as an investment using the approach of proportionality – after all what is the real purpose of those entities – they are to allow people to stay there or to fly from one destination to another. Others might argue a more purist interpretation and that is fine, but if the approach is so conservative so as to limit the investment universe then investors need to be aware that this could have an adverse effect on their investment returns.

27.6 Responsibility of scholars

Scholarly opinion is vital for ensuring that Islamic products and services are acceptable and comply with Islamic principles and scholars perform this role adequately but the industry suffers from the lack of experienced scholars. An added difficulty is that too few scholars are in some cases sitting on too many Shari'a Supervisory Boards bringing into question issues such as corporate governance and conflicts of interest. Comparisons with the expectations on a Non-Executive Director in conventional finance raise significant questions of how conflicts of interest can be managed effectively and indeed issues such as confidentiality when handling too many competing firms. Whilst helpful guidance on Shari'a Governance has been issued by both AAOIFI and the Islamic Financial Services Board (IFSB), neither is enforceable – unlike persons in controlled functions within a regulated environment or subject to Directors' duties under various Companies Acts, nothing equivalent currently exists within any of the Islamic standards-setters.

27.7 Responsibility of standard-setters

The global financial crisis has provided an opportunity for Islamic finance, in that the obvious failures in the conventional financial system have at least created a willingness to listen to alternatives. There may still be considerable scepticism, but at least Islamic finance has an opportunity to showcase its potential. There is also an opportunity for the institutions of Islamic finance (the IFSB, AAOIFI, Islamic Development Bank and so on) to take an active role in promoting this niche model. However, given the current weakened state of the financial markets, even those that had previously taken an interest in Islamic finance have backed away. That gives the Islamic finance world time to get its house in order. But if it does not do so, it will allow more powerful conventional regulatory bodies to regulate – and perhaps not in the way it would choose.

Even though both AAOIFI and the IFSB have now generated a series of standards, they are not fully accepted or even applied often. Many countries with substantial

ambitions in Islamic finance have scarcely made a start in transposing those standards into their national regulatory regimes. In some respects, this is not surprising. The same could have been said a few years ago about the standards of the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). What changed the situation, and considerably raised the status of those bodies, was the FSAP programme, which started assessing jurisdictions against some of those standards. It was a clear case of "what gets measured gets done."

Bodies with a serious interest in Islamic finance have a responsibility to find a way, individually or collectively, to engage with the Financial Stability Board (FSB), and specifically to be recognised as global standards-setters. This will not be easy. If this means an acceptance that there are many overlaps with, for example, accounting standards to those of the International Financial Reporting Standards (IFRS), then so be it – engagement with the International Accounting Standards Board (IASB) will at the same time acknowledge where there really are differences and provide an international platform of recognition for Islamic finance. When the FSB itself is grappling with difficult issues, the temptation will be to ignore what can easily be seen as a small niche market. But the luxury of delay should be avoided. If Islamic finance is not part of the global standard setting process, it will always be trying to live in a world created by others, with even less freedom of manoeuvre that it has now. Its ability to offer something distinctly different will have been lost.

27.8 Responsibility of governments

The impediments which certain tax regimes can pose to Islamic finance is predicated on the convoluted nature of Islamic contracts, which trigger additional stamp duty events given their structures. It is not that governments intend to prejudice Islamic finance but exemptions need to be made to prevent these additional tax charges. A benign and non-prejudicial tax regime is a core aspect of adopting a practical approach to Islamic financial services regulation. The application of tax regimes should be on par with conventional financial products. Islamic capital market products (and general Islamic products) should not be disadvantaged as a result of the legal mechanisms that are required to give full effect to a transaction. Changes have already been seen in a number of countries such as the UK which has brought Islamic products in line with the tax treatment for conventional products.

27.9 Standardised legal contracts

In respect of the legal implications of Islamic finance, it is important to have a sound legal structure which provides clarity of obligations and certainty in dealings. A specific issue in respect to Islamic finance, which has become exacerbated by the international nature of sukuk offerings, is the need to standardise legal documentation. In an industry which depends

on innovation and expeditious delivery of new products to the market, delays caused by ensuring Shari'a consistency and approvals continues to be an impediment to the industry. The industry needs a more practical approach to such issues. The International Islamic Financial Market (IIFM), in conjunction with International Swaps and Derivatives Association (ISDA), has made good progress in its introduction of the standardised commodity murabaha contract and the tahawwut hedging agreement but it is important that standardised contracts are used. To this end, law firms should play a greater role in drafting tailored contracts, specific to Islamic finance. However, many still find the temptation to use their own bespoke versions (and charge accordingly) too tempting.

27.10 Responsibility of regulators

From a regulatory point of view, the starting point is to accept that the basic precepts of conventional financial markets regulation apply with equal force to Islamic financial markets. The principles that underpin conventional markets regulation are primarily designed to ensure that financial firms are able to deliver upon their promises. These may take the form of promises to indemnify policy holders against loss; or to repay investors or depositors upon particular terms agreed at the time of contract formation. Of course, regulation also extends beyond the assurance of promises, most obviously in the securities sector where integrity of the secondary market is a key policy objective. But, principally, financial services regulation has developed to mitigate against the instability caused to a financial system when financial firms fail to honour their promises.

This should be the common starting point for all forms of financial services regulation, be they conventional or Islamic. Although the particular terms of promise may differ, reflecting the special structural features of Islamic products, the underlying character of those promises and the consequences of their failure, are the same as conventional. Accordingly, when considering how regulators might best adopt a responsible approach to Islamic financial services regulation, we should start with the conventional market. If we identify the core issues in that market, we can then deal with any supplemental issues arising in the Islamic finance context.

27.11 Responsibility of IFIs

IFIs must continue to innovate but do so in a manner where real added value is identified and ensure that costs are no less competitive than products offered in the conventional sector. Cost and service benefits are core elements of Treating Customers Fairly initiatives in many countries. A good example, of excessive costs impacts firms engaged in Islamic windows – many argue that the need to have a Shari'a Governance framework, however important, merely replicates what they already have via their Corporate Governance framework – perhaps the time has come

for some form of compromise, especially where the conventional organisation with its Islamic window is already an active player in ethical and socially responsible investing.

27.12 Conclusion

Individual social responsibility is intertwined with corporate social responsibility. But in many respects this is the easy part of the debate over responsibility in Islamic finance. As Islamic finance grows, its Shari'a governance models will in any event come under strain. Firms cannot continue to rely on a relatively small number of ever more stretched top scholars, even if those scholars are supported by more junior team members. One option is an increase in the number of scholars. But that will increase the risk of inconsistent rulings and fatwa shopping unless some measure of consistency is applied via a doctrine of precedent or otherwise. The alternative is to reduce the reliance on scholars, at least at a firm level. To some extent, this may begin to happen naturally, as the industry begins to evolve standard products and modes of operation. But more is likely to be needed, whether through some authoritative international body or through a change to the structure of the advisory profession. The responsibility to sustain the growth of this important industry rests on a number of factors such as standardisation and precedent of fatwas. Governments have largely done their bit, as have regulators – now is the time for the Islamic standard-setters to engage with conventional standard-setters and to receive the support they deserve as well as for scholars to become accountable themselves – to do otherwise would be irresponsible indeed.