Islamic Moral Economy: Foundation of Islamic Finance

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Discussion Questions

• What is Islamic Banking and finance?
• What are the fundamental principles that shape the Islamic financial system?
• What are the main differences between Islamic and conventional finance and banking?
• To what extent leadership’s vision of making Dubai capital of Islamic Economy has succeeded?
• What will be the role of Islamic finance and banking in Dubai as a capital of Islamic Economy?
Islamic finance industry has progressed from humble beginnings
- Concept has been rediscovered to build a USD 3 trillion industry
- Global momentum behind industry: consumer, corporate and government
- Islamic finance has become the proposition of choice in the GCC, and likely to become proposition of choice throughout the Muslim world

In order to understand the essentiality of Islamic finance, the moral economy foundations or the intellectual and operational roots of Islamic finance should be located
Imagination of Islamic Moral Economy

- From late 1960s attempts were made to socially construct an Islamic model of economics and economy;

- In the opinion of the founding fathers, the failure of economic development could be overcome with a moral economy;

- Their objective was therefore to develop a moral economy understanding, which could develop a human-centric development strategy, which is considered to be ‘ideal of Islamic developmentalism’ in economy’

- The Islamic moral economy paradigm aimed at the creation of the Islamic paradigm of economics with its distinct values, norm, rules and institutions with a politically oriented systemic understanding with intra and intergenerational equity;

- Islamic moral economy also aims to shape the behavioural norms of individuals to operationalise the system.
Civilisation and System Understanding

- Civilisations are articulated through their worldviews which includes values, norms, axioms and foundational principles; and aims at construction of a social form with a particular definition of human within that worldview.
- Each civilisation is also articulated through various systems organising the operation of life but also knowledge in the society.
- Islam, in this, represents another civilisation and order, and within this order, economics and other systems related to everyday day life is possible, which are linked through the ethical propositions of Islam.
- Historically, each civilisation has had their social formation in relation of their own social context which is determined by and determined the mode of production of the society;
- As each civilisation defined the ‘forces of production’ and the ‘relation of production’ in a particular manner by responding to the following question in a particular way.
- These are the important questions determining the distinguishing nature of each civilisation; and through such lines that civilisation developed or collapsed.
The rise of modernity as a project introduced a break in the history, as Fukayama states the end of history is determined by modern modes of production and hence social formation in the form of capitalism;

Thus, historically before the current convergence, the civilisations lost their social formation to ideological positioning which became the new force to determine the modes of production and social formation of societies;

Consequently, 20th century witnessed the rise of two main modes of production and social formation: capitalism and communim in various shapes in addition to underdeveloped ‘third world’, which struggled between the two;

By the last quarter of the 20th Century, each and every modes of production/social formation converged towards capitalist form and Western social formation; as the distinctions became invisible in the process for search for economic and financial ‘efficiency’;

From plurality of modes of production and social formation to poverty of systems.
Rationale for Different Economic System

- It is a fact that no human endeavor is value-free, which implies that reality including economic reality is socially constructed.
  - J. S. Mill (1836): assumed premises.
  - J. S. Mill (1836): light by which they think they see it (emphasis added)
  - Schumpeter (1954): Vision;
  - In contemporary times with postmodern understanding the cultural relativist position also provides rationale; initial work of Hofstede on management and its articulation can be given as an example;

- Thus: economics and finance are value-loaded, as at the most abstract level, our values are derived from our worldview.

- Since values are determined by religion, tradition, and culture which is the articulated forms of civilisations.
Defining Islamic Moral Economy

- Part of *din* (religion), Islam;
- Deals with production, consumption and distribution activities of human beings;
- According to Islamic worldview;
- Making economic and financial choices according to Islam;
- Describes, analyses, prescribes;

*Islamic economics, thus, is an “approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam”.*

*Islamic finance is the institutional aspect of Islamic economics, as to finance the economic activity in an Islamic framework, there is a need to have institutions using instruments according to rules and regulations, which are all bound by the Shari’ah.*
Locating Islamic Moral Economics and Finance

LOCATING ECONOMICS AND FINANCE WITHIN ISLAM

ISLAM

AQIDAH
(Faith and Belief)

SHARI’AH
(Practices and Activities)

AKHLAQ
(Moralities and Ethics)

IBADAT
(Human Worshipping to Almighty GOD)

MUAMALAT
(Human-to-Human Activities)

POLITICAL ACTIVITIES

ECONOMIC ACTIVITIES

SOCIAL ACTIVITIES

OTHER ECONOMICS ACTIVITIES

BANKING AND FINANCIAL ACTIVITIES

In this perspective Islam is seen as a system of ethics. The philosophical and conceptual foundations of this system are as follows:
Islamisation of Knowledge

Secular/Western Modernity

Positivist ontology with rational individualistic methodology being the epistemology

Islamization of Knowledge

Revealed knowledge constitutes the ontology and epistemology

Meaning and Institution of Everyday Life in a Religio-Culturally Negotiated Manner

Process: fiqh

Meaning and Institution of Everyday Life

Process
Understanding Moral Economy: Senses of ‘Moral Economy’

- An approach to the study of an object:
- A discipline defined by an object of study
- A particular kind of economy
(i) Moral economy is the application of ethical categories to the study of the economy.


- ‘When economists spoke “qua economist” ...they tried to speak in a value-free “scientific” language with “expletives” deleted.’ (Sen 1980 pp.363-4).

- ‘The fact-value dichotomy ....penetrated neo-classical economics after 1932... [with] the resultant impoverishment of welfare economics’ ability to evaluate what it was supposed to evaluate—economic wellbeing. (Putnam, 2002, p.62)

- Economics needs to rediscover the ethically ‘rich descriptions’ that marked the work of Adam Smith, the early Marx etc. (Sen, Putnam, Walsh, Nussbaum)

(ii) Moral economy is the application of economic categories to the study of ethics - the use of rational choice models, game theory etc. to explain the development of moral norms.
Moral economy is the study of the ethical character of economic life.

- Moral economy is ‘the critical study of the ethical character of economic activities and relationships, and of how this shapes and is shaped by other dimensions of social and political life’.
Senses of Moral Economy (III): A Particular Object

- Moral economy comprises a particular set of relationships, beliefs and norms that constitute a particular kind of economic life.

Consequently,

- Moral Economy’s features are:
  - Embeddedness
  - Reciprocity
  - Collective action: cooperation including labor sharing
  - Community and solidarity
  - Convention and coordination
Consequently,

As can be seen, all these three dimensions of moral economy fits into articulated nature of Islamic economic order; and therefore by definition Islamic proposition is a moral economy in every sphere of economic, financial, social and political dimensions of everyday life.
The rise of independent Muslim states in the post-colonial and post WW II period, and search for an authentic Muslim identity through a constructivist approach resulted in socially constructing an Islamic model of economics and economy;

The failure of economic development was attributed to capitalist economic development strategies, which ignored the importance of human being and its well-being.

Their objective was therefore to develop an economic system understanding, which could develop a human-centric development strategy, which is considered to be ‘ideal of Islamic developmentalism’ in economy’

The Islamic moral economy paradigm aimed at the creation of the Islamic paradigm of economics with its distinct values, norm, rules and institutions with a politically oriented systemic understanding with intra and intergenerational equity;

Islamic moral economy also aims to shape the behavioural norms of individuals to operationalise the system.
The Break in the Convergence: Imagination of Islamic Moral Economy - Definition

- Islamic economics "aims at the study of human (happiness) and participation" (Akram Khan, 1984: 55).

- “Islamic Economics has a different task with conventional economics. Duties in addition to studying the reality of the behavior of economic agents, both domestic producers, domestic consumers, and governments, also must formulate the concept of ideal behavior according to Islamic teachings should be made by economic agents, as well as its effects are possible for the economy” (Chapra, 2000: 127-128).

- The individual objective function is summed by *falahl* through the *ihsan* or beneficence process.
Islamic Moral Economy: A Value Oriented Proposition

- Islamic moral economy, in modern sense, developed since 1970s aiming at development issues; and therefore in the essence of this constructivist world view there was a response to the failures of capitalist and socialist economic development projects in the Muslim world;

- The founding fathers aimed at creating an Islamic response to this failures by constructing a human-centred development model based on the ontology and epistemology of Islam;

- Islamic financing expected to provide an alternative solution as a financing tool and method;

- Ethicality in this value proposition in the original sense is not only prohibition of *riba* (interest) but relating to larger social and economic development issues;

- A financing proposition shaped by the rules (fiqh) but also moral values of Islam;
Islamic Moral Economy: A Value Oriented Proposition - Foundational Axioms (I)

- Islamic moral economy aims at creating a moral based economy, with the following axioms:

- Vertical ethicality - the Oneness of God (tawhid), God’s prophets as the source of Divine Guidance (risalah), (life-after death, that is the continuity of life beyond death and a system of accountability based on Divine Law (akhirah); and hence vertical equality; The vertical ethicality or the equality of individuals in their relations to the creator, God, and having equal opportunities for the bounties on earth created by God; namely tawhid;

- Horizontal ethicality/equality - Social justice and beneficence (adalah and ihsan), which constitutes the horizontal equality between individuals within the tawhidi framework
Islamic Moral Economy: A Value Oriented Proposition - Foundational Axioms (II)

- Purification plus growth in harmony (*tazkiyah*); As a direct result of the vertical and horizontal ethical axioms, Islamic Moral Economy assumes growth in individual, social, economic and biological environment to take place in harmony with the stakeholders within the spiritual framework of *tazkiyah*

- *Rububiyah* (perfecting things towards perfection) - Islamic Moral Economy, as consequence of the above axioms, assumes in a functional sense enabled individual, society and natural environment so that each of these can reach its perfection within *tawhidi* framework, as God has chosen perfection as a path by definition for everyone and everything. This refers to *rububiyah* as the functional axiom;
• **Fard**: In fulfilling *rububiyah* in all aspects of individual, society, economy and environment *tazkiyah* process aims to overcome the conflict between individuals and society. Therefore, IME assumes that in order to overcome the perceived conflict between individual and society, voluntary action is not perceived to be enough; and hence certain socially oriented financial and economic obligations are made mandatory, or *fard*, so that moral economy objectives should be achieved
In operationalizing such expectations as expressed within the axioms of Islamic Moral Economy, as part of *tawhidi* framework, individual is perceived to be vicegerent of God on earth, namely *khalifah*, to fulfill the expected duties in their social, economic, financial and other behaviours to make their decision through a moral filter. In other words, since the individuals are considered to be the representative of God on earth, they are expected to fulfill such roles and responsibilities.
All these axioms, as the foundational framework of IME, are the articulation and operationalisational aspect of *maqasid al-Shari’ah* or the ‘objectives of *Shari’ah*’ process, which is defined as realizing ‘human well-being’. In other words, the entire objective of IME and also its operational aspect of *Shari’ah* is to serve ‘human well-being’ which is the main and essentialised aim of all efforts within the *tawhidi* framework.
Implications of the Foundational Assumptions of Islamic Moral Economy

• Human beings can only claim partial credit for what he/she produces... The needy and society have a right too; *zakah*, etc.;

• Responsible use of rightful earnings by keeping the moral purposes of human beings in view;

• Individuals must not prevent others in society and nature from meeting their basic biological needs;

• All people should have equal opportunities to benefit from environmental and public resources.

• Wealth creation and effort is necessary and good. However, the immoral, prohibited modes (*riba* prohibition as well as some economic activity harmful to individuals), oppressive exploitation of human beings and creation of ecological imbalance or environmental disruption.
The Operational and Institutional Features of Islamic Moral Economy

- Social change is essential and has to take place for the progress of the societies;

- Self-interest is a natural motivating force in all human life, which must be linked to the overall concept of good and justice;

- Private property and private enterprise are essential but property in its all forms is a trust (amanah), and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives - the *Maqaasid al-Shari’ah* (the objective of the Islamic way).

- Cooperation and competition defines the framework for economic activity.

- The market mechanism is a fundamental pillar of the Islamic moral economy, but the consequences of market system has to be moderated;

- The prohibition of certain sources of income is a particularly distinctive plank of the Islamic economic system.
The methodological postulates of Islamic moral economy, on the other hand, can be summarised as follows:

• Sociotropic individual, not only individualism but social concern is a prerequisite;

• Behavioural postulates: socially concerned God-conscious individuals who (a) in seeking their interests concern with the social good, (b) conducting economic activity in a rational way in accordance with the Islamic constraints regarding social environment and hereafter; and (c) in trying to maximise his/her utility seek to maximise social welfare as well by taking into account the hereafter as well.

• Market exchange is the main feature of economic operation of the Islamic system; however, this system is filtered through an Islamic process to produce a socially concerned environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided not to curb incentives in the economy.
Mechanisms/Institutions/ and Instruments of the Islamic Moral Economy System

- Islamic moral economy and financial activities are shaped by these kinds of measures:
  - Positive measures (*zakah; hisbah*)
  - Voluntary measures (*sadaqah, waqf*)
  - Prohibitive (*riba’*)
Islamic Economic and Financial Institutions and Instruments

(i) Elimination of *riba* (interest);
(ii) Islamic financial system;
(iii) *Zakah* and *Zakah* fund for development;
(iv) *Takaful* (insurance);
(v) *Awqaf* system;
(vi) Islamic commercial law and application;
(vii) *Hisbah* (market supervision);
(viii) Social welfare institutions and charities.
Ibn Khaldun’s (15th century)’s framework provides a summary of the interdisciplinary dynamic model for Islamic socio-economic system:

• “The strength of the sovereign (al-mulk) does not become consumed except by implementation of the Shari’ah;

• The Shari’ah cannot be implemented except by a sovereign (al-mulk);

• The sovereign cannot gain strength except through the people (al-rijal);

• The people cannot be sustained except by wealth (al-mal);

• Wealth cannot be acquired except through development (al-‘imarah);

• Development cannot be attained except through justice (al-‘adl);

• Justice is the criterion (al-mizan) by which God will evaluate mankind; and

• The sovereign is charged with the responsibility of actualising justice”.  

Summarising the Aspirations of Islamic Moral Economy
• Islamic economic and financial system, on the one hand, aims to guarantee individual liberty, freedom of choice, private property and enterprise, the profit motive and possibilities of unlimited effort and reward.

• On the other hand, it seeks to provide effective moral filters at different levels of life and activity and established institutions in the voluntary sector, as well as through state apparatus to ensure economic development and social justice in the society.

• Islam does not prescribe a particular economic system but provides the core elements and principals, which form the basic philosophy of a system or an economy.

• Islam provides primarily normative principles for economics and finance. However, it is not devoid of positive economic statements or hypotheses. Several areas of economics are truly positive and cannot be different in an Islamic or in any other framework.
Islamic Moral Economy: A Value Oriented Proposition

- As the foundational axioms demonstrate, as a system, Islamic moral economy refers to economic and sustainable development, social justice and social investing oriented principles;

- They aim to respond to economic development failures by offering a dynamic and micro solution to the problem;

- The aim is to develop functioning individuals in terms of doings and beings through creating the right and just environment and opportunity spaces for such development to take place;

- Islamic financing in this paradigm thus was imposed the role of generating the necessary funding for economic development by abiding the norms of the social and moral economy.
Islamic Finance Principles Reinforce the Ethos of Islam

- Islamic moral economy has an explicit value framework
  - Based on justice, equity, human dignity, freedom of enterprise and moderation

  - Based on developing and harnessing economic resources to satisfy spiritual, material and social needs of all members of the community

  - Based on a moral obligation to serve poor and destitute from share of wealth

Islamic finance is based on socially responsible investing
Islamic Finance is More than Financial Contracts

<table>
<thead>
<tr>
<th>Tenet-bound</th>
<th>Principles-based</th>
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<tbody>
<tr>
<td><strong>Fundamental tenants are derived from <em>Shari’ah</em></strong></td>
<td><strong>Concept is grounded in ethics and values</strong></td>
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<tr>
<td>– Absence of interest-based transactions</td>
<td>– Principles akin to ethical investing</td>
</tr>
<tr>
<td>– Avoidance of economic activity involving speculation</td>
<td>– Emphasis on risk-sharing and partnership contracts</td>
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<td>– Prohibition on production of goods and services which contradict the values of Islam</td>
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<tr>
<th>Embedded Financing- Real economy-linked</th>
<th>Social and Development Objectives</th>
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<tr>
<td><strong>Islamic finance offers an alternative paradigm</strong></td>
<td><strong>Islamic banking is community banking</strong></td>
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<tr>
<td>– Asset-backed transactions with investments in real, durable assets</td>
<td>– Serving communities, not markets</td>
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<tr>
<td>– Stability from linking financial services to the productive, real economy</td>
<td>– Aims to enable and function individuals</td>
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<tr>
<td>– Credit and debt products are not encouraged</td>
<td>– Open to all-faith clients</td>
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<tr>
<td>– Restrains consumer indebtedness</td>
<td>– Instruments of poverty-reduction are inherent part of Islamic finance (zakat &amp; qard hasan)</td>
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A holistic approach to financing a society; in essence a value and moral proposition and more than financial contracts
Islamic Finance Aims and Positive Impact

1. Engagement of an **under-served and previously un-banked market**
   - Providing an ethical banking solution to local communities to deepen the banking market

2. Promoting the **investment mind-set rather than the banking mind-set**
   - Investing in real assets rather than promoting speculation and leverage

3. Making meaningful **real economy impact**
   - Investing in asset-backed instruments and real economy ventures

4. Attracting **foreign investment and cross-border partnerships from Islamic financial institutions**
   - Attractive source of cross-market ventures and cross-border lines

A growing industry promising benefits
Islamic Finance is the Outcome of IME in Banking

Banking and Finance Needs

Shariah sources
- Quran
- Sunnah
- Ijma’ (jurist consensus)
- Qiyas (analogy)
- Maqasid al-shariah (objectives of Islamic Law)

Islamic Banking and Finance Solutions

- Prohibition on:
  - Interest
  - Speculation
  - Gambling

- Prohibition of certain investments:
  - Sectors (e.g.: alcohol, armaments, financial services, gambling, pork, pornography, tobacco)
  - Instruments (e.g. no forward transactions, limited option use, no derivatives, short-selling)

- Fiqh al-Muamalaat contracts
  - Musharaka - Partnership
  - Mudaraba - Partnership
  - Murabaha - Purchase-resale
  - Ijara - Lease
  - Istisna’ - Manufacturing contract
  - Salam - Forward sale

- Asset-backed transactions with investments in real, durable assets
- Credit and debt products are not encouraged
- Financing solutions aim capacity building and empowerment of individuals and society;
- Social, human and economic

Moral Screening Process
- Moral process through endogenising substance related issues and also through consequentialistic approach;
- Definition of policy objectives
- Developing risk and profit-loss sharing economy through embedded financing for the development of economy and social capital
Islamic Finance aims at Alternative Banking Paradigm to Create Ethical Profits

- Accountability to God
- Corporate Governance
- Corporate Social Responsibility
- "More-than-profit" mentality

Ethical profits (rather than "profits-at-any-costs")

Business Ethics

Shari'a
"Code of Ethics"

Banking with morals
Conceptually, Islamic Banking is Rooted in Developmental Aims of Islamic Moral Economy

- **IBF can fulfill the moral economy objectives by following strategies:**
  - Direct investments: Banks independently employ funds in profitable projects
  - Participation investments: Banks as capital partner with share in projects in PLS arrangement
  - Equity-based structures: Private equity, venture capital, project and trade finance
  - Ethical underpinning: Investments inherently follow International Equator Principles*
  - Financing the ‘unbankable’ individuals to create social capital for development through microfinancing; and other financial instruments, such as zakah funds, *qard al-hassan;*
  - Contributing economic, social and human development by returning the right of society to society and by engaging with projects to increase the social return.

**Historically driving connectivity with the real economy**
Islamic Finance aims at...

Islamic banking and finance aims at:

- Business but also community banking;
- Responsible Finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; ethical investment, and CSR Initiatives;
- Alternative Paradigm in terms of stability from linking financial services to the productive, real economy; and also it provides moral compass for capitalism;
- Fulfils Aspirations in the sense it widens ownership base of society, and offers ‘success with authenticity’.
Commercialisation Has Required Replicating Conventional Banking Product

Development of Industry

- **1950s**
  - Development of theoretical framework
  - Muslim-majority nation independence

- **60s**
  - Egypt and Malaysia pioneering institutions
  - Establishment of the OIC

- **70s**
  - Islamic Development Bank and DIB
  - One country-one bank setup

- **80s**
  - Advancement of Islamic products
  - Full “Islamization” of Iran, Pakistan and Sudan

- **90s**
  - Entry of global institutions e.g. HSBC Amanah

- **00s**
  - Tipping point reached in some markets
  - Development of industry-building institutions

Evolving Richness in Products

- **Structured products**
  - Debt
  - Private equity
  - Project finance
  - Equity

- **Insurance**

- **Syndications**

Industry has near like-for-like parity with conventional offering
Shari’a-based Financing Adheres to the Inherent Principles of the Islamic Tenets

Islamic finance has developed by remaining competitive with market demands...

- Competitive pricing
- Familiar risk/return profile
- “Buy-now-pay-later” mentality
- Conducive to debt finance

...however the spirit of Shari’ah principles has lagged from its ideals

- Profit-loss share financing
- Asset price risk sharing
- “Save-now-buy-later” culture
- Discouragement of debt

What is needed is a mindset shift
A Shari’ a-based Mindset is Critical for Product Innovation

**Shariah-based solutions**
- Income-sharing products
- Shift from debt-based product offering

**Examples**
- Venture capital and private equity vehicles and instruments to enable “real economy” play
- Hedging instruments for risk management using risk pooling concepts of Takaful
- Savings scheme using infrastructure projects as sources of investment return
- Substitute commodity-based financing products with specific asset-backed/linked products
- Debt-based products to be marketed responsibly and provided conservatively

**Significant scope to improve the quality of product proposition**
Conclusion

- Commercialisation and market pressures has shaped industry’s development to date
  - Competitive forces have ensured replication of conventional offering
  - Global regulators initially dismissive, now “no obstacles, no favours”
  - Global debt-friendly monetary system has hampered development of equity based propositions

- Islamic finance should embrace an evolving role
  - Industry should perform role of asset managers with socio-economic banking
  - Shariah-based vision is next stage of industry development: from replication to innovation
  - Islamic financial institutions have an important role to play in the Islamic world’s development

We must preserve what is distinctive about Islamic finance
Conclusion: The Industry Has a Key Role to Play in the Path Towards Economic Development

**Invigorate human capital**
- Promote education and build academic “centres of excellence”
- Facilitate training and skill broadening institutions
- Deepen access to finance
- Build social and physical capital base

**Build wealth distribution channels**
- Uplift SME sector contribution to GDP
- Provide efficient zakat distribution system
- Grow economy’s “wealth manager” base
- Integrate and develop waqf models and institutes with the objective of developing Islamic moral economy system

**Promote OIC trade bloc and connectivity**
- Instigate and enhance mutual cooperation
- Build efficient governments
- Grow “OIC-national” companies

Building a sustainable socio-economic development model with human development objective through aiming at falah with the ihsani social capital

Islamic banking is one tool to enable economic development
Islamic Finance and Socio-Economic Development

- Since economic development is a larger concept, Islamic Finance with its current structure has not been able to affect nor has it aimed at affecting the economic development in a systematic manner;

- This does not mean that Islamic finance does not have impact on economic growth; on the contrary due to financial development and pooling of funds it does contribute economic growth. However, economic development is beyond the growth of the economy.

- ‘Islam’ in IBF refers to particular value system beyond conventional banking understanding; and that is the banking aiming to fulfill the maqasid as identified through the values and norms of Islam; and therefore is in contradiction with ‘financialisation’.
For socially and environmentally responsible value oriented just economic and financing system, which can enable individuals to function and which can aim at well-beings of individuals…

Utopias should exist so that realities can be constructed and engineered…

Thank you…