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Fintech and Islamic Finance

Setting the Sharī'ah Parameters

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Introduction

Fintech is a new way of finance by providing innovative products that would improve existing practices and facilitate consumers' experiences in transactions in an efficient and effective way. The application of fintech in Islamic finance is welcome development but such fintech solutions must observe the principles and rules of the Sharī'ah. In principle, Sharī'ah allows any innovation in financial practices provided the practices observe the prohibitions such as interest (*riba*), gambling (*maysir*), uncertainty (*gharar*), harm (*darar*), cheating (*tadlis*), and etc.. Such solutions should also observe the rules in contract under the Sharī'ah, namely the pillars (*rukun*) and conditions (*shurut*). Above all, the Fintech solutions should observe Islamic ethics in transactions, and aim at achieving the objectives of Sharī'ah.

This chapter aims at elaborating the Shariah parameters for Fintech solutions in Islamic finance. To achieve this objective, three major dimensions are taken into consideration, namely fintech and innovation in Islamic finance, Shariah compliance and *maqāṣid al-Shariah* (objectives of Shariah) realization in fintech application.

Sharī'ah and Financial Innovation

Finance is ¹⁸ one of the important aspects in human life that help in fulfilling various needs as well as in enhancing the quality of life. Finance assists economic development by allocating funds within the society from those who have extra funds to those who need the funds to fulfill their needs.

In line with human progress and technological advancement, financial practices have evolved from simple transactions into complicated and sophisticated arrangements. Throughout the history of mankind, financial innovations have attempted to assist human beings in their financial arrangement in an efficient and effective way. Financial innovations involve all aspects from the ¹¹ design, development and implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance (Report of World Economic Forum 2012).

Fintech is a new way in providing financial services. Fintech offers product innovation by structuring financial products that are new or significantly improved and enhanced with respect to their characteristics or intended uses. Hence, Fintech is simply defined as ⁸ the application of technology within the financial industry in a more friendly and efficient manner. Lately, the term Fintech has been popularised in the financial industry and the widespread adoption of Fintech in the industry ⁸ covers a wide range of activities including financing, payments, operation and risk management, data security and monetisation, and customer interface as well as other related areas.

Fintech has been adopted in the Islamic finance industry as a new way in delivering core Islamic finance solutions. ¹ Islamic law holds a principle that the basic rule in

business transactions (*mu'amalah*) is permissibility (*ibahah*), except when there is a clear text which prohibits it. The permissibility principle provides a flexible room for innovation and new practices in business and financial transactions. All innovations, in *mu'amalah* are considered permissible and are generally encouraged. Innovations only become impermissible if there is clear evidence that they are in conflict with the fixed (*thawabit*) rules of Shariah.

Shari'ah is also very rich with the resources and methods that would encourage innovations in financial practices and guide them in proper direction, such as *usul al-fiqh* (the study and critical analysis of the origins, principles and sources of Islamic jurisprudence), *qawa'id al-fiqhiyyah* (the study of legal maxims that are used in Islamic law), '*ilm tarikh tasyri*' (the study of the history of Islamic legislation), *falsafah al-tashri*' (the study of the philosophy of Islamic law and its legislation) and '*ilm maqāṣid al-Shari'ah*' (the study of the meaning and objectives of Shari'ah) that recently gained interest among the scholars to respond the changes and development in human civilisation.

Therefore, Islamic finance should be proactive rather than reactive to financial innovations. In the past four decades, Islamic finance industry has been more reactive by following the advance development of conventional finance practices and simply adopting such market practices with some modification. Though not inherently wrong, the replication approach to replicate the conventional products in a Sharī'ah compliance mould has been extensively done in structuring Shariah compliance products. The approach is called by Saeed (2004: 114) as pragmatic whereby the concern is in innovating Sharī'ah compliant product structure by changing the conventional product structure to follow the criteria and principles of the Sharī'ah.

The replication of conventional financial products and structures is done by adjusting the interpretation of financial principles in Islamic law to accommodate and provide the same types of services and investment mechanisms as the dominant conventional financial system based on the needs of the society. In practice, the approach is done in three general steps, namely the negative screening of prohibited elements in conventional structure, applying Islamic principles/contracts in different types of conventional finance, and adding new features based on Sharī'ah contracts. In the adaptation approach, *hiyal* (legalistic trickery to find justifiable ways of Islamic law application) and *makharij* (finding solutions for application of Islamic law) are necessary within certain Shari'ah parameters and in fact are inevitable to a successful adaptation of conventional finance products (Laldin and Furqani, 2016).

Shariah contracts utilised in Islamic finance should not be restricted to the replication approach to suit the features of conventional finance products. Innovation through Fintech should be explored to emphasis the value proposition of Islamic finance such as how to use technology to ensure minimal risk in *musharakah* and *mudarabah* model of financing or how *istisna'a* and *salam* can be operated and optimised using Fintech. In other words, Fintech should open a new chapter in Islamic financial products and services whereby the industry can witness the application of various Sharī'ah contracts using fintech solutions to facilitate the needs of society.

While we cannot ensure the elimination of *hiyal*, *makharij* and *dhara'i* in dealing with Fintech, it is important to note that the emergence of fintech should trigger innovations among the Islamic finance industry players and promote creativity by providing new perspectives and practices in financial transactions. Sharī'ah scholars and industry players in this regard must work together to produce innovative Sharī'ah compliant

products that fulfil the needs of the society and help in realising the objectives of Shariah (*maqāṣid al-sharī'ah*).¹⁹

Fintech and Sharī'ah Compliance

¹⁰ From the Sharī'ah point of view, the adoption of any supporting services or solutions in Islamic finance is very much encouraged and is within the permissible areas of development in Islam. Sharī'ah compliance in Fintech solutions is similar to the traditional Islamic finance. Fintech solutions should be guided by the broad principles of Sharī'ah by avoiding the prohibited elements in the transactions such as interest (*riba*),¹ gambling (*maysir*), uncertainty (*gharar*), harms (*darar*), cheating (*tadlis*), and etc.

On the question of change in technology as offered in Fintech, it should be noted that the changes in technology shall accommodate the fixed principles of Sharī'ah (which are very few and mainly in the prohibition as in the above). As for the other rules which can change with the change of time and place as well as technology, Sharī'ah can accommodate such rules.⁴ In order to ensure proper Sharī'ah compliance, there should be a synergy between IT and finance experts and Sharī'ah scholars in the product development process.⁹

In addition, as earlier mentioned, transactions carried out using Fintech solutions should also follow the rules of contract (*'aqd*) under the Sharī'ah by observing the pillars (*rukṇ*) and conditions (*shurut*) in the contract. Besides, Fintech solutions should observe Islamic ethics such as transparency, fairness and justice, and avoid cheating, fraud, misrepresentation and other actions that would create mistrust and unhappiness among the users (Kamali, 2012). These values would not only protect customers and the public at large, they will also promote smooth allocation of resources and fair

dealings in transaction that Islamic law aims to achieve. According to Abtani (2007), “Islamic law cannot be separated from its moral, ethical and religious principles; otherwise, its rules will be useless. In other words, the Islamic system cannot be secular. This is because all Islamic rules, including economic and political, are connected with the faith, beliefs and worship of Islam.”

In addition, Fintech solutions should also aim ¹ at achieving the objectives of Shariah (*maqāṣid al-Shariah*), namely to realize the benefits (*maṣlaḥah*) and avoiding the harms or difficulties (*mafsadah* and *mashaqqah*) in the transactions.

As in traditional Islamic finance, Fintech practices should also be supervised to ensure the operations are Sharī‘ah compliant. Nevertheless, the existing Shariah Governance Framework did not recognise the existence of Fintech and how to supervise its Shariah compliance. Moving forward, the issue of Sharī‘ah compliance in Fintech operations and practices should be taken into consideration by the regulators or supervisory authorities so that Muslim consumers do not remain sceptical about such innovations. This will also help to boost the confidence of potential investors in embracing such technologically-enabled financial intermediation.

¹⁴ A proper Shariah governance framework also would ensure the operation of Fintech is ⁴ in total compliance with Sharī‘ah, minimise Sharī‘ah non-compliance risk in firms who utilise Fintech and minimise related disputes (Laldin, 2017).

In certain situations where there are shared services between the Islamic and conventional financial institutions, Fintech should be developed to enforce the purpose of the transactions as envisaged by ⁴ the Sharī‘ah. For example, in the structuring of a Fintech-enabled transaction related to *ijarah* (lease contract), the system should be able to define the ownership of the underlying assets of *ijarah* whereas the lessor owns the

asset and the lessee owns the usufruct of the asset. Similarly in a *murabahah* transaction, all the parties involved, transfer of ownership and price, and the sequence of the transactions must be captured so as to avoid any inconsistencies with the requirements of Sharī'ah.

There are several services which can be similar between the conventional and Islamic entities of a financial institution. For example, in facilitating the transfer of cash between parties using internet banking, if A wanted to make a payment for purchasing certain commodity from B using e-transfer or online mode ¹⁷ there is no difference between Islamic and conventional as both can use the same system and method of transfer as the end result is the amount that A wanted to pay to B will be debited from his account and credited into B's account to complete the transaction. As mentioned earlier, the general rule of Sharī'ah regarding transactions shall be observed and the technology can facilitate such mode of payment.

It should be noted that, the 'Sharī'ah compliance' ⁶ title carries the expectation of a financial system and practices that are ⁴ truly based on all the tenets of the Sharī'ah, namely, faith (*aqīdah*), Islamic legal principles (*ahkām shar'iyah*) and ethics (*akhlāq*), and that ⁶ serve the noble goals prescribed by Islam (*maqāṣid al-Shariah*) (Furqani, 2013).

Fintech and *Maqasid al-Sharī'ah* Realisation

Fintech ² for players in the financial sector will result in shorter transaction chain, reduced operational cost, enhanced resilience of operational processes, ability to access new customer segments to increase revenue and improved capital efficiency. Fintech enhances consumer value proposition as Fintech ² innovations promise to reduce the

transaction cost, increase the available choices, improve the transaction speed and empower the customers by moving control over conducting a financial transaction from the financial institution to the customers. Fintech innovations and high penetration of mobile technology promise to enhance financial inclusiveness by bringing in a large segment of society. All these benefits can be considered as *maṣlaḥah* to the customer and other stakeholders in the whole practice of financial operations.

Sharī'ah itself aims at establishing *maṣlaḥah* that would contribute to the wellbeing of mankind, and *maqāṣid al-Sharī'ah* are basically ¹³ related to human interest by providing for a good order of life and wellbeing (*maṣlaḥah*). Fintech, in this regards, is viewed as innovation in financial practice that would facilitate transactions in a convenient way and hence would contribute to the overall wellbeing (*maṣlaḥah*) of the society. In this regards, Allah (SWT) said:

“Allah intends every facility for you; He does not want to put you to difficulties.” (Qur'an 2:185).

In other word, fintech is welcomed so long brings real benefit to human being and remove hardship in financial transactions. The Islamic legal maxim (*qawa'id al-fiqhiyyah*) in this regards says “hardship begets facility”. Likewise, Shari'ah also promotes fintech so long it is developed with noble intention of facilitating transactions and not for cheating, manipulating or others. This is based on the Islamic legal maxim which says “matters are determined according to their intentions”.

As the ¹⁵ Sharī'ah is designed on the basis, and for the purpose, of *maṣlaḥah*, ³ *maqāṣid al-Sharī'ah* constitute the various dimensions of human needs, and their fulfilment will create balanced satisfaction in human life at the level of both the individual and the society and help realise overall human wellbeing. Therefore, *maqāṣid* would

encompass the micro and macro dimensions of individual and societal life. With reference to Islamic finance in particular, *maqāṣid al-Sharī'ah* refer to the overall goals and meaning that the Sharī'ah aims to achieve from its principles and rulings related to financial activities and transactions (Laldin, 2008: 77).

However, at the same time we have to ensure that commitment to Sharī'ah is upheld such as no *riba* (interest), *gharar* (uncertainty), *maysir* (gambling), and *darar* (harm). Such Fintech transactions must be transparent, with no hidden costs and irresponsible finance devoid of cheating and fraud, etc. These controls allow for the execution of an ethical transaction to really ensure that the goal of realising *maṣlaḥah* (benefits) and avoiding harms (*mafsadah*) is realised. Therefore, there should be in place a regulatory framework to address consumer protection and market conduct issues as well as the technological impact on the orderly functioning of financial markets that promotes *maṣlaḥah* to general public as desired by Sharī'ah. A Fintech firm that operates within the framework must also commit to observe reasonable standards of service, transparency to customers, appropriate funding and reporting and disclosure requirements.

Likewise, Fintech in Islamic finance is also expected to broaden and deepen the financial market by reaching out to the marginalised segment of the society. Financial exclusion can be solved if the financial institutions consider the poor and the weak in society as potential partners to grow and develop together. In a debt-based system, this segment of society will always be marginalised due to the reason of high risk of default as they have no collateral and weak ability to settle the debt. Fintech application in Islamic finance is expected to bring a new hope to this segment of society to nurture, empower and grow together.

Furthermore, risk-sharing financing instruments⁵ for small and medium enterprises (SMEs) and micro-insurance⁵ can be offered to solve the problem of the availability of credit, mobilisation of savings, insurance and risk management of the marginalised segments of society. Islamic finance should be concerned with this sector, not only because the private sector or conventional finance⁵ may not be willing to provide financing to some areas because of the high cost associated with credit assessment, credit monitoring and because of the lack of acceptable collateral, but because it is an approach of eradicating poverty, to build a healthy and vibrant economy and as a means to circulate wealth smoothly among a number of different groups in the society as emphasised in the concept of *maqāṣid al-Sharī'ah*. The Qur'an also in this regard said "...so that wealth is not circulated among the rich in the society only" (Qur'an, 59: 7). Fintech application in this regards is expected to provide the much-desired solution by seamlessly connecting the surplus sector in the society with the deficit sector; and hence, assistance, cooperation, and mutual help and empowerment could be given for mutual profit and prosperity as desired by the Sharī'ah.

Conclusion

Fintech as a new innovation in financial services is a welcome development in Islamic finance. The emergence of Fintech should be used by Islamic finance industry players as a new means for innovation by developing products and services that will benefit the society and promote economic development. The expectation is not merely in offering financial products that are Sharī'ah compliant by using conventional structures, but also in the ability to offer financial products that are distinct coming up from Islamic teachings, worldview and principles.

In the application of Fintech in Islamic finance the following Sharī'ah parameters need to be observed, namely (1) financial and technological innovations are welcomed since under the Sharī'ah, the basic principle is permissibility (*ibahah*) and Islam encourages innovation in financial services to facilitate mankind's activities in transactions; (2) Fintech application should observe the prohibitions such as interest (*riba*), gambling (*maysir*), uncertainty (*gharar*), harm (*darar*), cheating (*tadlis*), and etc.; (3) Fintech application should observe the rules in contract, namely the pillars (*ruk'n*) and conditions (*shurut*); (4) Fintech application should observe Islamic ethics in transactions; and (5) Fintech application should aim at realising benefits (*maslahah*) and avoiding harms (*mafsadah*) in the society.

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