

## CHAPTER 7

# BRINGING ISLAMIC FINANCE HOME THROUGH THE CIRCULAR ECONOMY- SOCIAL FINANCE (CESF) DISCOURSE\*

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### **Abstract**

This paper argues that the current Circular Economy and Social Finance (CESF) discourse allows Islamic economists to re-align Islamic Banking (IB) and Islamic Finance (IF) with its roots, i.e. Islamic economics. Notwithstanding the impressive growth figures of Islamic Banking/Finance over the last three decades, reservations are voiced especially on the role and impact of IF in Muslim communities. This paper begins by critically discussing, albeit briefly, selected tensions that have evolved in Islamic Banking literature over the decades that show the departure of IB from IE. The criticism of IB has moved away from merely focussing on contracts/instruments or the debt/equity debate of the 1980s and early 1990s to a substantive systemic focus on the role of IF in developing the real economy to enhance the welfare of society as a whole. Genuine Islamization of Knowledge approach can be a methodological framework that allows IB/IF to be re-connected to IE and to the epistemological bases of Islam. The paper then briefly presents the basic ideas in the CESF discourse and argues that its central features provide an opportunity to re-align the current direction taken by Islamic Banking/Finance. The goals of IB/IF must help achieve the overall socio-economic goals of society and not merely serve outdated neoclassical economics objectives of maximizing individual shareholder welfare, with no consideration for overall equity considerations in society. The paper then argues that the CESF discourse provides a golden opportunity to re-visit the theory of decision-making in economics. Utilizing selected literature written on interdependent utility functions, it is proposed that economic decision-making in Islamic economics must include a concern for others, including its environmental and human impact, something that is at the base of the CESF agenda. The paper generally adopts selected discourse/content analysis involving literature on the various component parts of the paper.

**Keywords:** Islamic finance, circular economy, social finance, genuine Islamization, re-alignment

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## 1. Introduction

The Islamic Banking/Islamic Finance (IB/IF) journey has made progress over the last 40 years. According to the Islamic Financial Services Board (IFSB), the Islamic Finance Services Industry (IFSI) grew by 6.9% in 2018 and is expected to continue growing at about 5% in 2019-2020, despite the very challenging geopolitical environment and global economic uncertainties (IFSB,2019). A lot of ground has been covered, and yet there is a feeling that IBF can still contribute more to the well-being of society. While it is clear that contemporary IB/IF has contributed to Muslim societies by generally providing an alternative to riba based financing, there is no doubt that lessons can be learned. Improvements can, and should, take place. While much literature has been written and analyses have been done over the last three decades or so (Hassan, 2018), much more can be done to provide a more meaningful role for IB/IF that is able to contribute to the real economy and to the lives of people directly. However, there are ‘tensions’ in contemporary IB/IF, especially seen in the literature of IB, both in theory and practice. There is a need to re-visit the role and contribution of IB/IF within the bigger Islamic economics framework and to move forward by re-aligning the goals of IB/IF to its Islamic economic (IE) foundations that were presented in the late 1960s and 1970s. The ‘IB child’ got separated from its ‘IE parent’ with the advent of commercial IB in the mid- 1980s. Performance of IB has generally been good with regards to the usual financial ratios used to measure bank performance, although there are criticisms that even the performance benchmarks need to reflect a more holistic yardstick that represents Islamic goals and objectives of well-being.

With increased financial crises and environmental/climate change issues, there has been a renewed realization that our current economic paradigm is not sustainable. In Standard and Poor’s Islamic Finance Outlook (2020), one of the ‘accelerators’ identified that could assist the IFSI to further strengthen its performance is that of opportunities in the Environmental, Social and Governance (ESG) framework. The natural link between IF and ESG provides IF the opportunity to make a difference. The circular economy and social finance discourse grants us a valuable opportunity to re-visit the understanding and role of Islamic finance on human well-being as a whole. This will bring about the realization of the visionary ideals put forward by pioneer contemporary Islamic economists in the 1970s, hence bringing Islamic banking and finance ‘home’ to where it belongs.

The paper utilises secondary research methodology, reviewing selected literature in the following sub-areas: current Islamic banking and some existing tensions that have led to the ‘separation’ of IB/IF from IE; the methodological approach of Islamization of Knowledge

that requires critical interaction between turath and Islami and modern knowledge; a brief overview of the financialization process, its downsides and IB/IF; the CESF discourse and how it allows for the re-integration of IB/IF to IE through re-visiting the theory of economic decision-making and interdependent utility functions.

## 2. Current Islamic Banking (IB)

According to the Global Islamic Economy Report 2019/20, Islamic Banking assets stand at approximately USD 1.75 trillion at the end of 2019, which makes up approximately 71% of the total Islamic Finance space. This means that other sub-sectors of finance such as the capital market, takaful and other investment funds are yet to challenge the dominance of banks in the IF space. This is quite different in the conventional scene, where banks face stiff pressures from other sub-areas of finance with the rise of the financialization process. If Islamic banks take appropriate action, the pitfalls of financialization can be avoided. Hence, many of the arguments made for IF can actually still refer to the example of IB. However, IB faces challenges of its own.

In general, the practice of Islamic banks is to emulate and replicate the operations of their conventional counterparts or mother companies, albeit with modifications made to contracts used, so that they are 'shari'ah compliant' (read Islamic law compliant). Simplistic as it may seem, this is the present general strategy of development adopted by contemporary IB. Despite the impressive quantitative growth of contemporary IB since its inception, there have always been views that are critical of the *qualitative direction* taken by the IB industry. A recent thesis by Amin (2018) argues that the entire conventional banking system is being replicated by the Islamic banking system. From debates about the purpose of IBs and the types of instruments used (in the 1980s till the mid-1990s), more recent debates have centred on whether operating at a minimum legal standard actually contributes to the genuine improvement of society as a whole. For example, Haniffa and Hudaib (2007) find that ethical values in IBs are considered personal, often under-communicated and likely to be undervalued, while another study finds that issues of CSR are not of major importance in most Islamic banks (Hassan and Syafri Harahap, 2010). Asutay's (2012) critical analysis of IB development leads him to label the sector as a social failure that can only be supplemented by developing non-banking forms of Islamic finance. IDB Prize winner Hassan (2018) in his comprehensive survey of Islamic banking practices from 1983-2016 identifies various challenges in the Islamic banking space as well as alternative practices that include social finance. An earlier paper on 'socially responsible investing' (2013) also made a case for a socio-economic role for Islamic funds.

Put another way, rather than focusing merely on the welfare of shareholders, the debate asks IB to broaden their purview to include all stakeholders. This seems to have had some positive impact on the development of IB. While still dominated by *mainstream commercial* banking practices, the last 10-15 years have seen efforts to establish *other types of Islamic banks*, modelled after what are called social banks that are part of social banking/finance. The last few years have also witnessed increasing discussion on the role of IBF in helping to attain the United Nations' SDGs. Positive steps have also been taken to move away from just focusing on banks to *non-bank alternatives*. In addition, the numerous crises originating usually in the financial sector over the last 20 years have provided a new opportunity to look again at the approach taken. In recent times, the circular economy discourse also provides another platform on which to re-consider the role of IB.

### **3. Selected Tensions in Contemporary Islamic Banking**

Notwithstanding the development and progress made in contemporary IB over the last 40 years, there has also been criticism targeting both the conceptual and practical levels of IB. This section presents some of these tensions. (Haneef, 2009)

#### **3.1. Islamicity, Ideals and Realities: 1980s vs 2010s**

A central nagging tension that has plagued contemporary IB and annoyed its many practitioners since its formation, is the doubt concerning the 'islamicity' or authenticity of Islamic banks. In the 1980s, the discourse seemed to focus primarily on the practice of IB. The main criticism was that the practice tended to replicate conventional products, albeit with shari'ah (read legal) modifications. Critics saw the replications as merely legitimizing or justifying the general framework of the current banking system. However, even within academia, there was, and is, great debate about the direction of IB and the preferences of instruments being used. In the early 1970s, when Islamic economists started writing about Islamic economics, IB was one area specifically addressed. The writings as a whole put forward a very different IB to what IB developed into from the 1980s to the mid-1990s.

Initially, IB was proposed as part of an Islamic economic system that had a more 'developmental' approach and goal; an institution that not only focused on financial profits but also on the socio-economic goals of society. Hence pioneers of Islamic economics put forward equity and participatory modes of financing, such as profit and loss sharing, as the ideal form of IB practice. This would have required significant *structural change* to the institutions rather than just maintaining banks as we know them. However, the practice of Islamic banks and the realities of the replication approach saw preference for debt-based

instruments and modes of financing. Trying to push existing Islamic banks to adopt equity modes of financing and developmental goals of society went against the existing models of conventional commercial banks.

The current discourse on circular economy and social finance (CESF) allows us to re-visit this issue. No more should the goal of the bank be merely to maximise profits or shareholders' wealth. Shareholders constitute one stakeholder of the bank. However, society at large, the next generation as well as nature, are all stakeholders in the economic decision-making process of the bank. Discussions on CSR of banks have also opened up the space of discourse to take another look at the 'dominant IB as a mere *tijari* institution'. Today, the CESF discourse has broken down this paradigm which was put forward in the 1980s and religiously guarded by the IBF leaders and practitioners. Hence, even Malaysia- the leader in the 'old school'- has now put forward its new vision of 'Value Based Intermediation' or VBI that calls for 'looking beyond profit of the bank'. No one wants the 'practitioner-academic tension' that was so prominent in the 1980s and 1990s. The CESF discourse allows for much more interaction and agreement on the more holistic view of IBF in society.

### **3.2. Modifying Instruments or Fundamental Foundational Changes?**

As stated above, one major criticism of IB has been that it is modelled after the interest-based (especially commercial) banking system. Hence, the role and function of banks have primarily been retained while focus has been on creating *sharī'ah* (read legal) compliant instruments. Academic critics see much of what is practiced by Islamic banks as more expensive duplicates of conventional interest-based banking instruments. However, one can even go back earlier to the mid-1980s where critics called the practice of contemporary IB (and Islamic economics) as *patchwork Islamization*, stemming from what they perceived to be the islamization of knowledge agenda. (Haneef, 2009) The argument was that since this agenda takes the modern discipline as the reference point and wants *to seek the relevance of Islam to it*, this can only result in patchwork and bad imitations. (Faruqi, 1982)

This criticism could have some truth to it if one was to take the simplistic and shallow understanding of islamization of knowledge that seems to have prevailed among some proponents of IB and those who have misunderstood what IOK was, especially from those practitioners of IB and those who support the patchwork approach. In addition, the criticism of IB practice should not have been equated with efforts to develop Islamic economics as even Islamic economists were critical of the practice of IBs. In one stroke, the criticised IB practice also unfairly implicated Islamic economics and the genuine agenda of Islamization of Knowledge.

This mis-guided and narrow approach to IB resulted in prioritizing banking and finance instruments without giving due emphasis to *foundational issues* that would have included developing and applying a consistent philosophy of Islamic economics and finance. This has led to the acceptance of the banking institution as it is, without understanding the history and foundations of modern banking itself and its role within an economic system. Hence, according to these critics, what has been attempted is to mould conventional banks into Islamic shape by purging them of interest and replacing them (or at least trying to) with profit-loss sharing arrangements. From the experience of Islamic banking over the last 40 years or so, we now see that this has actually not happened. Instead of equity instruments like *mudhārahah* and *mushārahah*, Islamic (commercial) banks have actually focused almost exclusively on debt instruments such as *murābahah* and *bay' mu'ajjal* or *bay' bi-thaman 'ajil*. Islamic economists initially argued against such debt instruments being given too much prominence by Islamic banks because of their relatively lower developmental impact. The CESF discourse now allows us the opportunity to take IBF back to its Islamic economics roots.

### **3.3. Debt Based IBF in Theory vs Debt-Based IBF in Practice**

The 1980s and 1990s saw much tension between the ideals of IB initiated by pioneering Islamic economists in the 1970s and the practice thereof. . This continues to be debated today. Unfortunately, *shari'ah* compliance has increasingly come to mean the minimum legal standards that are permissible, rather than aiming to determine preferred options that would have a greater socio-economic impact on society as a whole in relation to developmental goals such as poverty eradication, job creation, entrepreneurial development, greater concern for social impact in society and greater sharing and distribution of benefits (and losses). Economics, a discipline that focuses on dealing with 'making better choices', could/should have played a role in enhancing the contribution of Islamic banks to the well-being of society. Unfortunately, there was in fact a marginalization of Islamic economics from the Islamic banking practice discourse.

Even if we accept the less preferred options of debt-based instruments (like BBA, *tawarruq* and *bay' al-inah*-based contracts in Malaysia) the theory-practice divide is further aggravated when the practice of debt-based IBF does not necessarily follow the requirements of the theory of debt-based IBF. A 2008 High Court judgement in Malaysia (Patail, 2008) gave a verdict that stated explicitly that the "BBA as practised in Malaysia was not a bona-fide sale" and for all practical purposes was more like a loan contract. Of course, this was opposed by the industry. On appeal, the presiding appeal court judgement found that the High Court judge above had erred in his judgement, since *the BBA is a sale contract and not a loan*. A simple reading of

this decision indicates that both judgements seem to be talking about different things: the appeal court was referring to the *theory of BBA*, while the High Court was referring to the *practice of BBA* in Malaysia. Why is there a departure between theory and practice? Why and how were the practices justified by the *sharī'ah* boards? This has brought into question the whole process of *sharī'ah* advisement and the qualifications of members of these boards.

### **3.4. The IBF Advisement Process: Moving from Minimum Standards to Value Based Intermediation**

One controversial and sensitive area regarding the practice of IBF that has come under scrutiny is the role and qualifications of members of the *sharī'ah* advisory boards that govern individual Islamic banks. Central to this questioning of authority in IBF practice is the issue of what qualifications are needed to become *shari'ah* advisors and what the scope of their duties should be. In the case of Malaysia, while there is no explicit requirement for Islamic law/*fiqh* qualifications, the convention is that *sharī'ah* advisors should be trained in Islamic law. While not questioning the sincerity of these scholars, the issue may be more about the qualifications and understanding of these scholars of contemporary banking and finance, and one could add, also of the economic framework that banks function in. While attempts have been made to improve the knowledge of these shari'ah advisors, there is still much to improve in this advisement process.

Besides the 'replication/ duplication' criticism, much deeper soul searching needs to be done by all involved. Is it possible for us to truly develop genuine Islamic alternatives if we are not trained in economics and finance as well as in our heritage? Is it possible to look at instruments from the purely legal reasoning angle dealing with contracts, without also knowing the economic and social implications of those instruments and how development as a whole is served?<sup>1</sup> Can we truly claim that the instruments that are being put forward are genuinely serving public interest if we do not see the bigger picture of the economic and social goals of society? Should we not also give the required attention to ethical (and not just legal) issues in the decisions that we make? Why are we satisfied to just have the 'minimum legal requirement' as the standard that we want to follow?

Bank Negara Malaysia or the Central Bank of Malaysia has put forward its Value Based Intermediation (VBI) agenda. Basically, VBI argues that finance - in this case Islamic banking/finance - must look beyond the individual profit motive. While welcome, VBI needs much more discussion and debate to ensure that it is a transparent, all-inclusive discourse and

1 In this issue, M.N. Siddiqi (2007) pointed out the importance of understanding the 'macro-*fiqh*' dimensions of IBF on the economy and society as a whole as opposed to the 'micro-*fiqh*' qualifications of most legal scholars.

not to be monopolised by the same players who were championing the ‘old school’ of thought. Hence, while the instruments may be *fiqh* or legally compliant, they may not meet the requirement of being *sharī’ah* compliant in the true sense, since the *shari’ah* is much broader than law and consists of guidance (including laws, values, norms, principles etc.). By overly focusing on the legal requirements of banking financing contracts, IB/IF has failed to give sufficient attention to the bigger goals of socio-economic development of the ummah. The VBI initiative must be given attention by Islamic economists to avoid the pitfalls that have occurred due to the process of financialization over the last few decades.

#### **4. Financialization: Has IBF made a difference?**

In terms of a definition, financialization refers to ‘the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international levels’ (Epstein, 2001, p.1). Its principal impacts are three, (1) to elevate the significance of the financial sector relative to the real sector. For example, in 1973, the ratio of financial transactions to global trade was 2:1, in 2004 it was 90:1<sup>2</sup>; (2) transfer income from the real sector to the financial sector, shown by the increase in the share of return to owners of money capital vis a vis workers or labor<sup>3</sup>; and (3) a general increase in income inequality and wage stagnation. Intra-country studies have shown there is a growing inequality between the rich and poor in all countries, if not in income, certainly in wealth inequality.<sup>4</sup>

Additionally, there are reasons to believe that financialization may render the economy prone to risk of debt-deflation and prolonged recession. Financialization is “a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production (Kripner, 2005, p. 2). Financialization also entails the internalization of finance at the level of corporate groups, where transnational corporations control the operation of financial markets. Many corporations even create independent financial companies and carry out credit operations. *Simply put, the financial sector no longer serves the real economy, but rather permeates and dominates it* .

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2 For the figures quoted in this paragraph, please see Thomson and Dutta (2015), *A Primer on Financialization*. P. 6-14.

3 As an example, the average trading in foreign exchange for WTO countries in April 2013 was USD 53.9 trillion whereas average total trade in goods and services for WTO countries in 2012 was USD 58.9 billion, meaning that what is traded in foreign exchange in less than a week is more than the total trade in goods and services for one year!

4 Thomson and Dutta (2015) quote an UNCTAD study that shows that USD 800 billion of capital flows have actually moved from developing to developed countries in 2008, thus showing the domination of the rich over the poor.



If we are all in agreement with the above, what has been the performance of leading IBF countries vis-à-vis these features of financialization? Has the introduction and development of IBF made a difference to the issues of inequality, dominance of the financial sector, the rise of debt and environmental degradation? The short answer seems to be that countries that have introduced IF do not seem to have been spared from these, but this is more an intuitive statement. Much more serious research is needed.

The financial sector has gained stature and importance over the sectors of trade and manufacturing. Many Muslim countries are rushing to become 'Islamic finance' hubs. Huge numbers of people are seeking employment in the Islamic banking/ finance industry rather than becoming entrepreneurs or working in manufacturing. Inequalities have increased in many Muslim countries. Despite the claim that Islamic banking is more stable, since financial transactions always have an underlying real asset, the pressure to 'replicate' and to allow increasingly more assets to be considered 'real' is a genuine challenge to our Islamic banks, especially to the members of the *shari'ah* committee. Rather than always limiting views to the legal/ fiqh dimension, Islamic banks and Islamic banking regulatory authorities particularly, must adopt an approach that promotes and upholds Islamic banks as having an economic and social role in society as a whole, and not merely in narrowly defined shareholder interests.

While IBF has been acknowledged in various studies to have been safer and more stable during the 2008 financial crisis, it is too early to celebrate. Islamic banks have been involved in various activities that seem to be features of financialization, but in a very cautious way. That is the best way to proceed. In tandem, studies need to be conducted to determine the degree to which Islamic banks and Islamic finance have both contributed to raising inequalities. Or have they contributed to reducing it, or at least slowing down its pace? It is also very important to conduct social impact studies of IB in various communities. Issues of basic needs as well as general well-being of society cannot be left to the government or the voluntary sector. IBs must play their role in providing for society, not just for those with money. However, we need to change the present trend and direction of development. The CESF discourse allows us the opportunity to do so. Hence, it is important to critically evaluate modern economics and finance and to be able to integrate Islamic values and ethics to develop a new paradigm of socio-economic development

### **5. Genuine Islamization of Knowledge: The Role of CESF**

Islamic scholars would agree if we said that the *shari'ah* is a complete code of guidance for human beings. In the case of economics, banking and finance, we are talking about a social science that tries to understand, analyse and describe human interaction and choices

made in areas of allocation of resources, distribution, exchange and finance (among others). Though the category of finance involves the creation of financial instruments, it should not only be limited to this. Hence, what we need is not only ‘instrument development and legal guidance’, but guidance that also covers ethical choices and choosing ‘better’ alternatives.

This realization has to be incorporated into the Islamic economics and finance education curriculum, so that these values are inculcated and reflected in the academic research of future graduates who are a product of such an education system. It should also be institutionalised in our current Islamic financial system. The CESF discourse that is now gaining prominence in global circles is a discourse that calls for a fundamental change in the way economic and financial decision-making is done. The entire philosophy and approach to decision-making adopts a radically different path.

*a. Genuine Integration of Knowledge: Islamization and Relevantization Applied to Economics and Finance*

The Integration of Knowledge agenda consists of two components. On the one hand, we have modern knowledge and disciplines that are a product of the western civilization and experience. On the other hand we have our Islamic turath or legacy/heritage. Both these components need to be critically evaluated and then consciously ‘integrated’ using a methodology that is able to handle them both. The critical evaluation of modern disciplines undergoes ‘dewesternization’ followed by ‘infusion’ of Islamic elements; the critical evaluation of our legacy/heritage requires ‘filtration’ of time-space concerns, as well as cultural elements, and also making the heritage ‘relevant’ to our current environment. The goal is to develop contemporary bodies of scientific knowledge or disciplines that represent both our revelation and universe as twin epistemological sources of knowledge.

In discussing methodology of integration, we have to develop this as well since the current bodies of knowledge we have are not able to represent the genuine integration needed. On the one hand, modern knowledge and disciplines are a product of mere reason and observation; on the other hand, our heritage/legacy is overly ‘text’ oriented. In addition, when discussing social sciences, the use of empirical methods in our heritage, while acknowledged, is quite lacking. More often than not, when we talk of the methodology that needs to be adopted, the discipline of *uṣūl al-fiqh* (understood as more legal reasoning) is referred to. This must be distinguished from *uṣūl al-iqtiṣād*, the latter including a much broader area of the foundations and methodology of Islamic economics. The latter will also be open to including the CESF discourse into its methodological approach.

Rather than only being limited to the legal dimension of the heritage and its methodology, *uṣūl al-iqtisād* would be based on the Islamic worldview and would benefit from inputs covering *uṣūl al-‘ilm* (sources or foundations of knowledge), *fiqh* and *uṣūl al-fiqh*, *uṣūl al-dīn*, history, analytical techniques as well as empirical techniques that would enable holistic decisions to be made; decisions that will enable the ‘more preferred choices to prevail, and decisions that will take into consideration a wider end-result that represents public interest and civilizational goals of Islam and its *shari‘ah*.<sup>5</sup>

Hence the knowledge of the heritage required to develop contemporary Islamic economics banking and finance must be more than just the narrowly ‘mis-defined’ *shari‘ah* (legal) sciences. One of the greatest maladies to befall Muslims is this *corruption* of original, rich meanings of terms and concepts in the Islamic worldview to narrow meanings.<sup>6</sup> As far as modern economics and banking/ finance education are concerned, meaningful Integration/ islamization cannot occur without some level of critical understanding of the functioning of the modern economy, its system and constituent elements.

The use of the word ‘critical’ indicates that the modern system has to be evaluated. This involves understanding where it is coming from and also the ability to evaluate it *from an Islamic framework or perspective*. Knowledge in this category would include areas such as economic history (both of thought and practice), statistics (including today’s econometrics), theory (both macroeconomics and microeconomics) and economic sociology (which may include other social sciences). One must also be prepared to include elements of sociology, logic, psychology and philosophy in their connection to economics<sup>7</sup>.

In the context of developing Islamic economics, it would be necessary for us to ‘master’ these areas of knowledge by understanding their origin, development and current state, but always with reference to the Islamic perspective. In terms of economics, banking and finance, this would mean understanding contemporary advances in these areas *critically*. The author disagrees with the proposition that a blanket rejection of modern knowledge is required. The teachings of the Qur’an, as well as the example of the Prophet (pbuh) and of Muslim civilization deny such blanket rejection.

Meaningful and genuine Islamization implies that the Islamic economist or the Islamizer of contemporary economics, banking and finance must know what is acceptable, what needs

5 On the discussion of *usul al-iqtisad* see Haneef and Furqani (2007).

6 For detail arguments on the ‘loss of adab’ and the corruption of knowledge theses, see the works of Professor Syed Muhammad Naquib Al-Attas, especially his *Prolegomena to the Metaphysics of Islam* (1995), International Institute of Islamic Thought and Civilization (ISTAC), Kuala Lumpur.

7 See Joseph Schumpeter (1994), *History of Economic Analysis*, Routledge, London.

modification (what is to be done and how to do it), what is to be rejected (what and why) and how to be able to relate these to contemporary realities as well. On the other hand, the Islamizer must also have some understanding of the Islamic heritage and how to relevantise it. This is certainly a tall order and one that does not seem possible if we continue to move in the present way contemporary Islamic banking products are being developed. While bankers are not necessarily familiar with the rich Islamic heritage, the *sharī'ah* (Islamic law) scholars are not necessarily familiar with the running of the economics and finance sectors and the macro-impact of the latter on the former.

If people are questioning present day products, it is not necessarily only for their legal validity but also for their economic, social and ethical implications. The CESF discourse provides this more holistic approach and paradigm to develop IF. However, make no mistake, the CESF discourse also needs to be critically evaluated.

## **6. The Circular Economy and Social Finance Discourse: Opportunity for A New Decision Making Model**

### **6.1. Circular Economy**

A circular economy is an alternative to a traditional linear economy (make, use, dispose) in which we keep resources in use for as long as possible, extract the maximum value from them whilst in use, then recover and regenerate products and materials at the end of each service life<sup>8</sup>. It is **a manifestation of economic models that highlight business opportunities where cycles, rather than linear processes, dominate. It is restorative and regenerative by design and aims to keep products, components, and materials at their highest utility and value at all times.**<sup>9</sup> The World Economic Forum provides the following definition

*“A circular economy is an industrial system that is restorative or regenerative by intention and design. It replaces the end-of-life concept with restoration, shifts towards the use of renewable energy, eliminates the use of toxic chemicals, which impair reuse and return to the biosphere, and aims for the elimination of waste through the superior design of materials, products, systems, and business models.”<sup>10</sup>*

The circular economy is presented as a system of resources utilization based on 3 Rs where reduction, reuse and recycling of elements prevails: minimize production to a bare minimum, and when it is necessary to use the product, go for the reuse of the elements that

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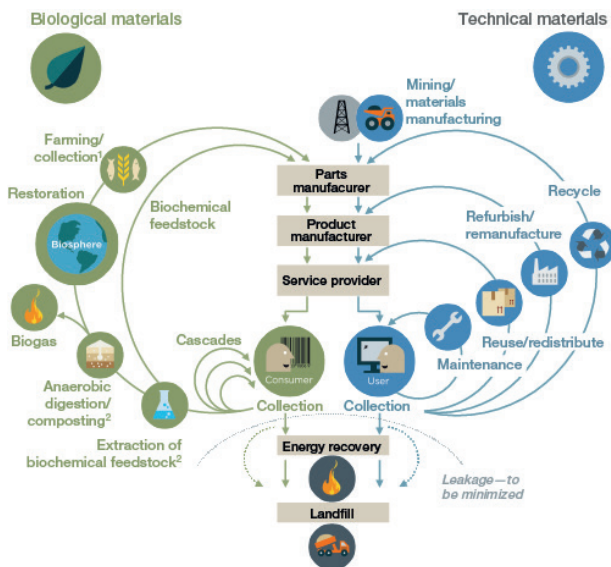
8 <http://www.wrap.org.uk/about-us/about/wrap-and-circular-economy>

9 <https://sustainabilityguide.eu/sustainability/circular-economy/>

10 <https://youmatter.world/en/definition/definitions-circular-economy-meaning-definition-benefits-barriers/>

cannot return to the environment. That is, the circular economy promotes the use of as many biodegradable materials as possible in the manufacture of products -biological nutrients- so they can get back to nature without causing environmental damage at the end of their useful life. When it is not possible to use eco-friendly materials instead of technical nutrients such as electronics, hardware, and batteries, the aim is to facilitate a simple uncoupling to give them a new life by reintroducing them into the production cycle and compose a new piece. When this is not possible, they will be recycled in a respectful way into the environment.<sup>11</sup> One immediate comment on the 3Rs of the circular economy could be the need for 4Rs where the first R is 'refuse' (rather than reduce), in other words a rejection of consumerism.

Unlike other economic models where the economic aspect prevails over the social or environmental, a circular economy is a substantial improvement common to both businesses and consumers. Companies that have implemented this system are proving that reusing resources is much more cost effective than creating them from scratch. As a result, production prices are reduced, so that the sale price is also lowered, thereby benefiting the consumer, not only economically, but also in social and environmental aspects. While there is still a debate concerning the sustainability of CE, Sillanpaa and Ncibi (2019) have argued that it is attainable if the right models are used and subsequent policies implemented by all stakeholders at the local, national and global level.



**Figure 1.** The circular economy in a diagram<sup>12</sup>

11 <https://www.activesustainability.com/sustainable-development/what-is-circular-economy/>

12 <http://reports.weforum.org/toward-the-circular-economy-accelerating-the-scale-up-across-global-supply-chains/from-linear-to-circular-accelerating-a-proven-concept/>

More research into the circular economy and how Islam views it is required. It is still a relatively new area of research among Islamic economists.<sup>13</sup> However, what is clear is that the circular economy discourse asks that economic decision making must go beyond the limited goal of individual gains/interest. Concern for society and nature will have to be incorporated. The issue of sustainability that has gained prominence in the last 5 years or so due to the UNs Sustainable Development Goals agenda is central in Islamic economics since the nature of Allah as Rabb (lord) means that not only is He the Creator and Provider, but He is the Sustainer as well. ‘Concern for others’ is also very central in the concept of social economics and social finance literature which has been around for a few decades now but has not really captured the attention of many Islamic economists and almost none from among scholars of Islamic banking and finance. However, this has changed in the last five years or so.

## 6.2. Social Finance

What is social finance? In the finance paradigm, social finance is seen as ‘investment decisions that not only give a financial return, but also have positive social and/or environmental impact’<sup>14</sup>. Hence social finance still makes a financial return (could be less than return under pure business criteria), but also does greater good to others in the process. It can include schemes and programmes that make economic resources (including funds/financing) available to those segments of society who otherwise may not have access to these resources. It could also involve a social/environmental goal that requires funding due to lack of public funds per se. It seeks to balance between material profits and social good. This is where social finance can serve the circular economy paradigm. It works by taking the individual, society and the environment into account when making decisions. Put in another way, it requires a ‘multi-objective profit function’ that also incorporates ‘interdependent utility functions’. Pioneer Islamic economists in the 1970s put this idea forward but this seems to have faded away from the discourse.

In recent years, there has been interest in talking about Islamic social finance (ISF). While welcome, the effort has been limited to discussing zakat, waqf and Islamic microfinance. While these three institutions are important areas of ISF, it is still a very narrow approach to the social finance discourse mentioned above. It is very important that

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13 Yuossef Aboul-Naja had a brief mention of this in Islamic Finance News, September 2015 titled ‘Circular Economy and Islamic Finance: An Ijarah Way forward. However, more academic writings and research have been made in the last 5 years, culminating in a dedicated Conference held at the Hamad bin Khalifa University in February 2020.

14 The four broad areas covered under this include socially responsible investing/finance, environment finance, development finance (including microfinance) and impact investing. See Tim Rourke, *From ESG to SRI*, Knowledge Leadership, CIBC Mellon a Canadian Company that specializes in social finance.

ISF discourse be widened to include all areas of finance - including Islamic banking - since what is crucial is to see a new model of decision-making develop. Hence, ISF should also argue for all banking, capital markets (for example sukuk), as well as all other investment funds to have a 'social impact'. Hence, we firmly place the value of thinking of others and of the environment into the centre of all our decision making. The circular economy paradigm is an ideal project to combine with social finance discourse since the central idea is about a new decision-making model.

Many may not be aware, but this is not new to Islamic economics. In the late 1970s and early 1980s, pioneers of Islamic economics asked this question: 'Is the goal of the firm only to maximize its financial profit'? While the answer was a firm 'no' (no pun intended), the details of how you would do this and show this theoretically, did not get sufficient attention. Faced with the available calculus tools of analysis used in standard economics, it was counter-argued that we should continue to use the 'maximization' hypothesis but change the function/goal that was to be maximised. This argument may have been a good 'solution' to the debate, but unfortunately, not enough theoretical work followed to build on these ideas. Hence, the standard maximization rule was 'purified' without detailing out the components that had to be included in the profit/objective function and the constraints or limitations that represented Islamic considerations.

With less interest in 'theoretical' model building, the matter was generally left to rest. As time went on, the standard view was that Islamic economics utilised a modified maximization rule. Unfortunately, these 'modified' elements were not put in place and gradually in most discussions, including those of Islamic banking and finance, they were forgotten. In the world of Islamic banking, the maximization rule was taken as 'given', namely, the goal of the Islamic bank is to maximise profit or to maximise shareholder income/wealth. This was to be done following shari'ah (read as fiqh or law) requirements. It is always re-iterated by proponents of current IBF industry that IBs are 'tijari' entities and not welfare organizations. Without the capital of the shareholders, there would be no business, hence we should be fair to the shareholders.

While this was the discourse 30 years ago, things have changed drastically. From CSR discussions in the later part of the 1990s this question of the 'role of corporate entities,' and especially banks, has come under scrutiny. With the advent of social business discussions, and more recently the circular economy discourse, the idea of greedy, self-interested maximisers has come under scrutiny again.

## 7. CESF Discourse and a New Model of Decision-Making

As mentioned above, when we talk of Islamic social finance, interestingly enough, one does not see the discussion of social finance as given in the west. Rather than discussing modifications to the business sector (as found in the conventional discourse of social finance) as well as the potential to bring the ‘theory of the firm’ back in focus, in Islamic discourse circles, to some extent, discourse seems to have been rather limited to our three institutions that ‘represent Islamic social finance’: zakat, waqf and microfinance/micro investment.<sup>15</sup> Hence, financing was made available to society as a whole and not just to the already well-to-do. In addition to these three institutions separately, some works have even tried to combine zakat and waqf with Islamic microfinance in order to be able to serve the ummah even better. However, the division of the Islamic economy into the tijari sector (private), siyasi sector (public) and ijtimai sector (social/voluntary) has led to less discussion about the hybrid model as in the west. As mentioned earlier, until very recently, many ‘Islamic bank experts’ still insisted that the role of IBF was to maximize returns for their shareholders. It is as if the three sectors cannot be integrated. If we widen the discussion of Islamic social finance to include ‘overall decision-making’ of all forms (banks included), we then have a new model of the firm.

The 3Ps (people, planet and profits) model is what the circular economy paradigm brings to Islamic economics and finance. Stemming from the Islamic worldview and Islamic economic philosophy discussions about the nature of resources, the nature and role of man as ‘abd and khalifah, together with the ethical principles that this brings in economics and finance, plus the call for socio-economic justice and equity, naturally makes the circular economy and social finance discourse relevant. Khan (2019) is one of the few scholars who have tried to merge and integrate circular economy and social finance by positing a ‘venture waqf’ model that tries to move away from a ‘waste oriented linear model to a zero-waste circular model’; where the compassionate nature of waqf institutions temper the business and profit motive to produce ‘responsible’ business decisions, hence having a transformative role. Ismail (2019) presents his ‘ecosystematic’ approach that combines innovation and technology to promote a more responsible finance system for human development.

Despite these few recent efforts, one could actually connect finance with economics in a more effective way by looking at the literature written in the last few decades, in particular,

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15 As for microfinance, Muhammad Yunus and Grameen Bank did something that many others could not. He managed to develop a system whereby the unbankable poor were the targets of microfinance schemes where group dynamics made collection and repayment an almost 100% success. There have also been criticisms, but as a whole, breaking the existing paradigm of ‘collateral’ and credit worthiness has been achieved.



if one was to search for references on interdependent utility functions. It would be surprising to many Islamic economists that much theoretical work has been written. The idea is very simple: my utility depends not only on my consumption, but also on the consumption of others<sup>16</sup>. Drakopoulos (2012) carries out a historical study.

*The notion of interdependent preferences has a long history in economic thought. In its general form, it can be found in the works of authors such as Hume, Rae, Genovesi, Smith, Marx, and Mill, among others. In the twentieth century, the idea became more widespread mainly through the works of Veblen and Duesenberry.....However, such preferences were never part of the corpus of orthodox theory. For instance, although Pareto and Marshall were aware of their existence, they did not advocate their incorporation into orthodox economic theory.*

Despite this long history of recognition, this powerful idea has not been able to become mainstream. The ideological bases of mainstream neoclassical economics dominated and led to the current ‘individual maximization of satisfaction’ models. Bergstrom (1999) put forward a highly mathematical presentation of ‘benevolent utility functions’ but these alternative theories of decision making of economic agents did not gain traction in conventional economics. However, if the CESF discourse is to re-align Islamic banking/finance to Islamic economics, this interdependent utility function literature needs to be seriously re-visited and developed by economists with analyses made from Islamic perspectives.

There have been some attempts to develop more sophisticated utility models in Islamic economics. For example, Zaman (2005) presented his alternative to consumer behaviour that tried to separate the demand function into two so that the consumption pattern for the poor will be acknowledged clearly. Chowdhury and Tageldin gave their own critique to this article. While one can find some work in this area, the reality of the matter is that these writings are just insufficient and in no comparison to the levels written by alternative economics in the west. Much more attention is needed to attract our young scholars to do research in these areas and to build theoretical models that reflect the Islamic perspectives on individual decision-making. The CESF discourse affords a golden opportunity to revive interest in this.

However, while the CESF nexus provides the necessary intellectual motivation to re-energise the Islamic economics and finance discourse, one must also be critical of the CESF discourse. A thorough evaluation of CE and SF from Islamic perspectives is also needed, just as we would call for the critical evaluation of our turath and modern knowledge in the IoK agenda.

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16 <https://www.oxfordreference.com/view/10.1093/oi/authority.20110803100006606>

## 8. The Way Forward and Conclusion

Besides the overall need to situate IBF within the Islamic economic framework, other positive developments have taken place over the last 10 to 15 years. The CESF discourse allows a re-look at the economic and financial decision-making process of the agent, be it the consumer or producer. The rise of social and community banking has given alternative banking models other than the Anglo-Saxon commercial model. In addition, there must also be emphasis given to non-banking financial institutions such as development financial institutions (DFIs) and other community-based alternatives. One could argue that companies such as Malaysia's e-hailing GRAB transport service and Air BNB's accommodation service are all examples of a democratization of asset ownership that could actually bypass established institutions such as banks.

As far as microfinance is concerned, a new area of Islamic social finance has developed rather extensively over the last 10 years. Zakat and awqaf are also part of this Islamic social finance where commercial interests are balanced with societal interests. However, everyone must be vigilant to not 'over commercialise' the institutions of zakat and waqf. Already there are writings by more commercially minded entities that are calling for a greater role of Islamic banking in zakat and waqf management. Caution needs to be taken so that the noble aims of zakat and awqaf are not corrupted by crass material intentions.

The Islamic economic system is quite unique in that it is a three-sector system: private, public and voluntary or not for profit sectors. Each plays its own complementary role to achieve well-being for all. The private sector, in this case, commercial Islamic banks have to work together with other institutions to achieve the wider goals of society. This can only be effectively done if IB re-aligns with its Islamic economic roots. With some of the developments of the post-2008 crisis, the environment has become more conducive to receiving alternative approaches to develop contemporary IB. The circular economy paradigm also allows us to seriously question the narrow approach taken in developing IBF of the last 40 years. Alternative banks, non-banking alternatives, as well as more holistic solutions that call for structural reforms, including those in distribution and redistribution, are now being discussed even in mainstream conferences.

Islamic economics and finance should take the opportunity to participate in this movement for reform. After all, the Islamic concepts of *tajdid*, *islah* and *ijtihad* are all central to achieving the well-being of the ummah. Islamic economics, banking and finance must genuinely solve problems of the ummah and not just provide legally compliant instruments

that do not necessarily establish justice and wellbeing for all, and something that is central to the objectives of the *shari'ah*. In addition, just providing longer repayment periods to allow people to afford an already overpriced house, does not genuinely solve the problem of the need for provision of the basic human right of shelter, which is a crucial goal of the objectives of the *shari'ah*. Solutions must be sought in a framework where finance is unified with economics and the socio-economic goals of society. Islamic banks and banking authorities must take the lead.

There is an oft-repeated saying in the Malay language, which happens to be one of my favourites- '*Kalau sesat, balik ke pangkal jalan*' (if you are lost, return to the beginning of the journey). In Islamic banking, there is much soul-searching required, and the way forward is to re-visit its Islamic economic foundations. Perhaps the current discourse on circular economy and social finance will provide the incentive and impetus to re-connect IB to its roots. It is the responsibility of all to assist in bringing Islamic banking and finance home.

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