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FINTECH AND ISLAMIC FINANCE

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INTRODUCTION¹

On February 23, 2017, the London School of Economics and Political Science (LSE) and Hamad Bin Khalifa University (HBKU) organized a workshop on “**FINTECH AND ISLAMIC FINANCE: APPLYING *HIYAL & MAKHARIJ* AND OTHER ISLAMIC PRINCIPLES**”. The workshop theme was selected by the participants who had attended the previous workshop on Islamic Infrastructure Finance and the Sustainable Development Goals on February 12, 2016.

The emphasis of the workshop was not meant to review contemporary Fintech technology, products and processes, but rather focus on the Shariah related challenges Islamic finance must address to ensure their compliance. Therefore, the main purpose of this workshop was to explore whether to use and apply the *Ahkam Fiqhiyya*, and/or, *Hiyal*, *Makharij* or other exception based Islamic principles, to achieve a specific *Masalah* or *Masalih*, within this chosen contemporary area of Islamic finance, i.e., Fintech. More specifically, the objective of the workshop was to examine the proposed theme from the following angles:

1. To understand and to review Fintech as currently practised and applied to Islamic finance, the relevance of achieving Shariah compliance.
2. Shariah Compliance - What are some of the current Shariah issues in Fintech and what needs to be looked into to ensure continued or even improved Shariah compliance and the evolution of Islamic finance.
3. *Fiqh & Ijtihad* – How to apply the best use of Islamic *Fiqhi* tools (*Hiyal & Makharij* and *Dhara‘i*) to Fintech driven products, services and contracts. The question is should we wait for issues to emerge and mature or should we be proactive and be prepared with a suitable and timely response.
4. *Maslahah* Determination – How can we continue to apply *Maqasid al-Shariah* and agree on the ideal *Maslahah* for new technologies, especially those that challenge existing structures and methods? How to determine and deal with disagreements on *Maslahah*?

This document is a summary/report of the event, conveying key themes and discussion points of the workshop. Annotations are therefore not assigned to a specific individual.

OPENING

The workshop began with an opening remark on behalf of the London School of Economics (LSE) and Hamad Bin Khalifa University (HBKU) by Professor Syed Nazim Ali. This was followed by an introduction by Professor Frank E. Vogel who thanked the organizer of the conference for making it happen, and he commented on the event’s unique role in bringing together Shariah scholars, activists, lawyers, economists, practitioners and academicians for candid and rich discussion on critical issues in the industry. After that, the roundtable discussion, over the course of a full day, examined four core themes, namely:

¹**Acknowledgements:** This roundtable was moderated by Frank Vogel and organized by S. Nazim Ali and Hussam El-Khatib. This report is based on the excellent notes of Stephania Prashad. The comments of Frank Vogel and other participants were also instrumental in preparing this report. The usual disclaimer applies. All errors that remain are the author’s own.

- Islamic Fintech - differentiating it from conventional;
- Applying the *Ahkam* or *Hiyal & Makharij* in the context of Islamic Fintech;
- Determination of *Maslahah* in Fintech; and
- Exploring the way forward for Islamic Fintech.

1. Islamic Fintech - Differentiating it from Conventional

The first session began with a presentation of 15 minutes on the overview of Fintech in Islamic finance and the key issues faced. This was presented by Professor Volker Nienhaus. The speaker highlighted that there is an interest in Fintech but the people who run this are usually not experts in finance or Shariah. He added that many Fintech products and procedures seem to be not in full harmony (compliance) with formal requirements of Islamic contract law in general and Shariah nominate contracts in particular. He argued that the fundamental issue is the reliability of information on a fund seeking project in general and on its Shariah qualities in particular. For Instance, a Muslim investor has to be sure that the contracts of “Islamic” P2P equity or financing platform, as well as the use of the funds by the recipient(s), are Shariah compliant. The speaker mentioned that, to ensure the Shariah compliance of contracts and projects, the platform operators would have to play a more active role than operators in the conventional finance industry. The consumer protection regulations for conventional crowdfunding, for instance, will not be sufficient for Islamic schemes where the Shariah compliance of contracts and of the use of funds are essential for the financier/investor. To this extent also Blockchain allows new tools to enhance Sharia Governance and ensure the implementation of the required steps.

The speaker then moved to talk about whether Islamic finance is reactive or proactive. He stated that Fintech products and structures are not an alternative to Islamic finance but new phenomena within Islamic finance. Islamic finance, by definition, is proactive but the question could be narrowed down to Islamic banking. Fintech start-ups such as equity crowdfunding or Islamic P2P financing platforms begin to challenge Islamic banks that have to react. He concluded that the determination of *Maslahah* in the Fintech world is a very risky issue. It is not even clear whether and how Fintech innovations such as cryptocurrencies, smart contracts, robo-advisors or matchmaking platforms relate to the public good. As such, the regulatory framework that covers Islamic Fintech should be there in addressing consumer protection and market conduct issues.

After that, the floor was opened for the participants to share their views on the difference between conventional Fintech and Islamic Fintech, and the impact of Fintech on the compliance of the products. Several participants stressed that Fintech is an enabler and it is considered as the application of technology within the financial industry. It refers to the innovative use of technology in the design and delivery of financial services and products. From the Shariah point of view, the adaptation of any supporting services in Islamic finance is much encouraged and is within the permissible areas of development in Islam. Besides, some Participants revealed that there is no real difference in either substance or outcomes between conventional Fintech and Islamic Fintech and they are simply facilitating tools.

One of the participants suggested that we need to understand what the status of Islamic finance industry is in current digital finance era to get to the root of compliance. He added that Bitcoin relies on the blockchain technology, but how does it work and how are these things governed? Where does it stand? What are the challenges faced by Islamic finance industry? What are specific Shariah issues in the light of emerging new technology and contracts? And how will Shariah scholars respond to all these issues?

In response to the above questions, one participant informed that Bitcoin is just an example of cryptocurrency and Fintech goes beyond just cryptocurrencies, as it covers a wide spectrum of application of innovative

technology in financial services. So in lieu of limiting the discussion to cryptocurrencies, other potential applications such as online crowdfunding platforms, smart contracts through the use of blockchain technology, and online dispute resolution platforms for Islamic finance may raise new solutions as well as challenges. By emphasizing on blockchain technology and the significance of smart contracts, Islamic banks may leverage on this for Islamic finance agreements.

Another participant noted that Bitcoin may constitute an effective instrument for the further development of Islamic finance. Islamic finance imposes different requirements compared to conventional financial policies on a monetary instrument concerning its use as a tool for achieving social and economic justice. He added, most eminent Shariah scholars are keeping their minds and hearts open and maintain a close look at developments in the wider cryptocurrency world.

The discussion then moved on to discuss the importance of having Shariah space for people to bring ideas. One participant noted that there is an interest in setting up safe spaces where people can regulate. However, the innovators are not following regulators and the regulators are sitting back and seeing what is happening. Another Shariah scholar stresses that Shariah compliance in Fintech operations and practices should be taken into consideration by the regulator or authority so that Muslims consumers are not sceptical to utilize its services.

In the same discussion, it was noted that, out of the 53 notation platforms and 13 equity platforms available, only 3 equity and 2 loans based are Shariah compliant. The equity-based are mostly in real estate finance in Singapore and US. The rapid growth of the Fintech sector is expected to change the financial landscape in the future and potentially disrupt the traditional models of banks and financial institutions

It was revealed during the discussion that the developments in the Fintech sector can be classified into two spacious categories:

- The first one relates to innovations in operations and infrastructure which includes blockchain, application programming interface ecosystems, payment infrastructure, artificial intelligence, etc. and
- Second, relates to providing different products and services. The trends of recent Fintech products include retail services (e.g., digital, peer-to-peer financing), wealth management (robo-advisory, crowdfunding, social investment), insurance, capital markets and investment banking, small and medium enterprises (e.g. peer-to-peer and next generation financing) and payments (e.g. mobile payments and international remittances).

After all, the participants agreed that Islamic Fintech has no additional distinction or enhancements of any kind over conventional Fintech forms of financing. The participants agreed that there is no real difference and they are simply facilitating tools. Most of them stressed that technology is just a means.

2. Applying the *Ahkam* or *Hiyal* and *Makharij* in the context of Islamic Fintech

The discussion began with an attempt to reach a shared practical definition of “*Hiyal*” and “*Dhara‘i*” in the current context. Key features of these terms were cited as:

Hiyal means legal loopholes or artifices; and

Dhara‘i (plural: *Dharai*) means pretence or instrument or means.

Hilah and *Dhara‘i* are among the two common terms often discussed with relevance to *Sadd-al- Dhara‘i* in the *Usul al-Fiqh* discourses. Both are similar in the sense that these act as determinants of legal rulings, whether or not an act is permissible or otherwise.

One of the participants conferred that many jurists have rejected all *Hiyal* with an invalid means, however, Ibn *Qaiyyim al-Jauziyyah* argued for accepting all *Hiyal* which uphold justice and establish the *Maqasid al-Shariah*. Likewise, the *Dhara'i* also play vital roles in accomplishing the *Maqasid*. The relationship between the two is so interconnected that the *Maqasid* would not be fulfilled without the means. Therefore, the impacts of the *Dhara'i* on the *Maqasid al-Shariah* in general, and on the *Maqasid al-Muamalat*, in particular, is immense. In other words, Islamic jurists have accepted the use of many *Hiyal* depending on their compliance with the *Shariah* and fulfilling their objectives (*Maqasid al-Shariah*), establishing justice, or preventing injustices.

The discussion then moved on to discuss the applications of *Hiyal*, *Makharij* and *Dhara'i* to Islamic Fintech. Most of the participants were of the view that Fintech is an innovative service, which is no doubt expected to contribute to the expansion and growth of the Islamic Finance Institutions (IFIs). Such an innovative tool, however, could be considered as a *Dhara'i* (means) leading to a service or benefit (*Maslahah*), and not necessarily a *Hilah* or *Makhrāj* (artifices), since the application of Fintech is not intended to divert any legal rulings (*Aḥkam*) of a transaction. Rather it is used as a smart tool in facilitating the regular financial services of the IFIs.

According to a Shariah scholar, *Hiyal*, *Makharij* and *Dhara'i* are necessary and in fact are inevitable. Shariah contracts should not be restricted to the replication approach to suit the feature of conventional finance products. Innovation through Fintech shall be explored to emphasise the value proposition of Islamic finance such as how to use technology to manage risk in *Musharakah* and *Mudarabah* model of financing or how *Istisna* and *Salam* can be operated using Fintech.

Another participant stated that Bitcoins are digital currencies, which could be easily created (or minted) by solving cryptographic equations; however, these are extremely volatile, with high chances of speculation, and there is lack of control due to decentralization of its creation. There is also a risk of hacking and criminal misuse of technology. The intrinsic value of the Bitcoins may also be questionable, as it needs to be backed by tangible assets under Shariah parlance. He raised several questions about what would be the *Nisab* for *Zakah* to be obligatory upon the owner of the Bitcoins, or if the *Zakah* itself could be paid with the Bitcoins?

In response to the above questions, one participant mentioned that Bitcoin is still in its infancy phase, thus it requires further development to provide any concrete Shariah answer. However, the Shariah scholars should endeavour to determine the Shariah perspectives of Fintech and its relevant services, and guide the IFIs towards incorporating the digital technologies. Fintech is a global trend, and a reactive approach towards it could render IFIs to lag behind their global competitors. Thus, the roles of the Shariah scholars along with IFIs are vital for a proactive approach towards Fintech and its related services.

After that, the discussion went back towards how to make the best use of Islamic *Fiqh* tools (*Hiyal* and *Makharij* and *Dhara'i*) to new Fintech driven products, services and contracts. Participants agreed that we cannot ensure the elimination of *Hiyal*, *Makharij* and *Dhara'i* in dealing with Fintech, it is important to note that the evolution of Fintech should trigger Islamic finance industry players for innovations and creativity by supplying new perspective and practice in financial transactions. Shariah scholars and industry players in this regard must work together to produce innovative Shariah compliant products that fulfil the needs of society and realize the *Maqasid al-Shariah*.

3. Fintech – Determination of *Maslahah* in Fintech

The discussion on this began with a recap of the importance of Fintech to Islamic finance and how it can contribute positively to the development of the Islamic financial products and services offering. Among the questions that have been raised during the discussion were about how to determine *Maslahah* for new technologies and how to deal with disagreements on *Maslahah*?

Participants spoke briefly about introducing Fintech in the financial sectors will result in shorter transaction chain, reduced operational cost, the enhanced resilience of operational processes, ability to access new customer segments to increase revenue and improved capital efficiency. Besides, Fintech innovations and high penetration of mobile technology promise to enhance financial inclusiveness by bringing in a larger segment of society. All these benefits can be considered as *Maslahah* to the customer and whole practice of financial operations.

One participant asserted that Fintech in the Islamic finance space can contribute positively to the evolution of Islamic financial products and services offering. Through the elimination of intermediaries, operating costs are lowered whilst the potential returns are higher. Crowdfunding and Peer-to-Peer financing provides the platform for alternative techniques such as *Musharakah* and *Mudarabah*-based financing, which have struggled to settle in the space occupied by traditional Islamic institutions, as well as their conventional counterparts.

According to an academician, the impact of technology on Islamic finance is considered as a real opportunity to enhance research and education in Islamic Finance. More multidisciplinary research could be created and encouraged such as IT, finance and Shariah. The industry should support conferences and workshops in these new multidisciplinary of fields. Universities also are encouraged to reflect these technological changes and developments in its textbooks, classes and students.

In contrast, one participant had a different view on the determination of *Maslahah* in Fintech. He raised several questions about how do we consider the *Maslahah* in robo-advisors for portfolio management? More importantly, what is the value of Shariah robo-advisors or robo-advisors for Shariah-compliant products? This might pose a significant legal, operational, reputational and Shariah risks to Islamic finance transactions. He added, can investors trust robots to render better investment advice in Shariah-compliant transactions? Can we replace Shariah Officers in financial institutions with robots? This would have some implications for consumer protection laws and agencies. Therefore, *Maslahah* determination of Fintech should consider the imperativeness of legal and regulatory framework to avoid market abuse which is currently being experienced in some cryptocurrency applications.

A Shariah scholar remarked that Shariah aims at establishing *Maslahah* that would contribute to the wellbeing and welfare of the people in this life and the life hereafter. As such, the practice of transactions in Fintech application should follow the rule of contract used in the transaction by observing the pillars and conditions of the contract. In addition, Fintech application should also aim at achieving the objective of Shariah (*Maqasid al-Shariah*), namely to realize the benefits (*Maslahah*) and avoiding the harms or difficulties (*Mafsadah* and *Mashaqqah*).

After that, it was concluded that Fintech is impermissible only if there is clear evidence that it is in conflict with Shariah principles, such as presence of prohibited elements in a transaction – *riba*, *maysir*, *gharar*, etc. The transaction must also be transparent with no hidden costs, irresponsible or unethical financing. On the issue of the regulatory framework, participants suggest that a firm that operates within the framework must commit to observing reasonable standards of service, transparency to customers and appropriate funding and reporting requirements. A proper Shariah governance framework would also ensure that the operations of Fintech are in compliance with the Shariah to minimize Shariah non-compliance risk to firms who utilize Fintech, thus reducing dispute and conflict. To an increasing degree such governance can be embedded part of the FinTech solution, akin to RegTech.

CONCLUSION - EXPLORING THE WAY FORWARD FOR ISLAMIC FINTECH

In concluding remarks, participants were asked to comment on what needs to be done to contribute positively to the evolution of the Islamic finance. Most of the participants expressed the view that Fintech enables innovative and flexible organizational structures and business models to enhance financial inclusion. It has the flexibility to adopt business models that can provide various financial services in a more efficient way. Besides, Islamic finance has an opportunity to use this new trend to reorient itself by introducing innovative business models that will help fulfil its broader goals of *Maqasid al-Shariah* and reflect its values and principles.

In addition, participants noted that the deployment of Fintech applications for Islamic financial services and products should not only be properly regulated under the laws of different jurisdictions but the emphasis should also be placed on Shariah governance. Regardless of the numerous advantages inherent in Fintech applications, its significant regulatory challenges remain a major concern in the global Islamic finance industry. Therefore, proper Shariah governance framework would ensure that the operations of Fintech are in compliance with the principles and precepts of Shariah. Further, developing Shariah standards that is related to Fintech by international standards-setting bodies such as AAOIFI and IFSB.

In addition to the preceding discussion, questions uncovered by this workshop and proposed for future discussion included:

- Further study of peer-to-peer banking model that Fintech companies can facilitate and how could that benefit the development of the Islamic Banking and Finance industry;
- Address the concerns attached to the Fintech sector, particularly the concerns of regulators and consumer groups;
- Assessing current Islamic social finance projects (WAQAF/ZAKAT);
- Regulations of Islamic social finance products.

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