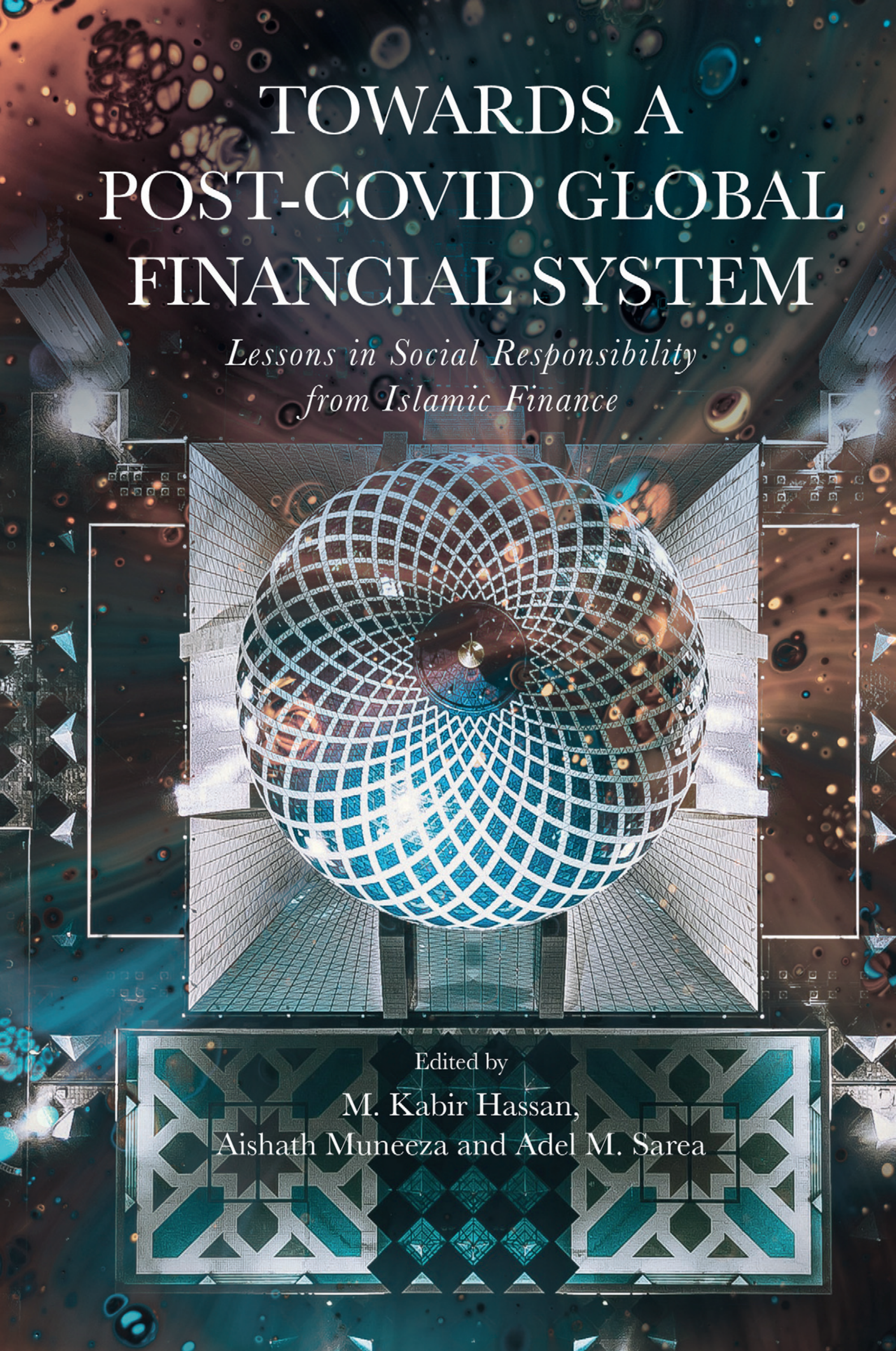

TOWARDS A POST-COVID GLOBAL FINANCIAL SYSTEM

Lessons in Social Responsibility from Islamic Finance

Edited by

M. Kabir Hassan,
Aishath Muneeza and Adel M. Sarea

Towards a Post-Covid Global Financial System

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Towards a Post-Covid Global Financial System: Lessons in Social Responsibility from Islamic Finance

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emerald
PUBLISHING

United Kingdom – North America – Japan – India – Malaysia – China

Emerald Publishing Limited
Howard House, Wagon Lane, Bingley BD16 1WA, UK

First edition 2022

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN: 978-1-80071-626-1 (Print)
ISBN: 978-1-80071-625-4 (Online)
ISBN: 978-1-80071-627-8 (Epub)

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INVESTOR IN PEOPLE

We dedicate this book to our mothers:
Moshammad Rahima Khatoon
Mariyam Saada
Fatema Shaikh

We have enjoined on man kindness to his parents; in pain did his mother bear him, and in pain did she give him birth.
(Quran, 46:15)

The Prophet Muhammad said, may Allah's peace and blessings be upon him:
Your Heaven lies under the feet of your mother (Ahmad, Nasai).

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Table of Contents

About the Editors *xi*

About the Contributors *xiii*

Foreword *xxi*

Acknowledgement *xxiii*

Introduction *1*
M. Kabir Hassan, Aishath Muneeza and Adel M. Sarea

Part 1 Resilience of Islamic Financial System in the Midst of the Pandemic

Chapter 1 The Impact of the COVID-19 Pandemic on Islamic Finance: The Lessons Learned and the Way Forward *15*
M. Kabir Hassan, Aishath Muneeza and Adel M. Sarea

Chapter 2 OIC Economies during the COVID-19: Implications and Recommendations *37*
M. Kabir Hassan, Saeed Awadh Bin-Nashwan and Aishath Muneeza

Chapter 3 COVID-19 and Islamic Finance: A Practitioners' View and Financial Accounting Investigation *51*
Paolo Biancone, Silvana Secinaro, Davide Calandra and Federico Chmet

Chapter 4 COVID-19 and Resilience of Islamic Home Financing: Enhanced Musharakah Mutanaqisah (EMM) Model as an Example *71*
Alam I. Asadov

Chapter 5 Measuring Good Governance for Islamic Financial Institutions for Achieving Islamic Social Finance Objectives: The Need for Shariah Governance Index *91*
Nor Asila Binti Nazmi, Rusni Hassan and Abdul Rahim Abdul Rahman

Part 2 Pandemic Transformation of Zakat and Waqf Management Practices

Chapter 6 Internationalization of Zakat to Serve Humanity in the Midst of COVID-19: Using International Organizations as Intermediaries of Zakat *105*
Jemilah Mahmood, M. Kabir Hassan and Aishath Muneeza

Chapter 7 Waqf to Support Healthcare Wellbeing Mission: The Proposed Model for Corporate Waqf for Healthcare (CWFH) *129*
Rusni Hassan and Khairul Fikry Jamaluddin

Chapter 8 Modelling Effective Zakat Management for the 'Stans' of Central Asia and Establishing Pandemic Resilience *143*
Ziyaad Mahomed

Chapter 9 A Review on Governance and Best Practices in Waqf Management for Sustainable Development in Selected Malaysian States and Other Countries *161*
Rusni Hassan, Noor Mahinar Abu Bakar and Noor Haini Akmal Abu Bakar

Chapter 10 Role of Zakat in Responding to COVID-19 Pandemic: Lessons Learnt and Way Forward *185*
Randi Swandaru and Magda Ismail Abdel Mohsin

Part 3 Case Studies of Islamic Finance and Pandemic Innovations

Chapter 11 The Need to Digitize Sukuk Issuance Amid COVID-19 Crisis *203*
Sherin Kunhibava, Zakariya Mustapha, Aishath Muneeza, Auwal Adam Sa'ad and Mohammad Ershadul Karim

Chapter 12 The COVID-19 Pandemic: Conceptual Framework for the Global Economic Impacts and Recovery *225*
Md. Jafor Ali, Abul Bashar Bhuiyan, Norhayah Zulkifli and M. Kabir Hassan

Chapter 13 COVID-19 Pandemic and Islamic Social Finance Products in Iran *243*
Majid Pireh

Chapter 14 Islamic Finance Provides Better Solutions in Overcoming the Financial Distress Ascribable to COVID-19: Evidence from Malaysia *261*
Mohd Johan Lee

Chapter 15 Stock Market Volatility Following Uncertainty of COVID-19 Outbreak: News Impact Curve Analysis Approach *271*
Anwar Hasan Abdullah Othman, Razali Haron and Salina Kassim

Index *291*

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Foreword

It is an honor for me to write the foreword to this important book that discusses the post-Covid global finance system with a focus on social responsibility lessons from the Islamic finance industry. The pandemic, which initially began as a health crisis, has not only led to an economic and financial crisis but to a full-blown human crisis. During this unprecedented emergency, our perceptions and conduct regarding socio-economic issues have shifted to attaining socio-economic good through social justice and shared prosperity. Islamic finance is no exception to this. The pandemic has allowed us to rethink and reconsider the direction of Islamic finance as an alternative to the dominant financial system, one that serves humanity with social responsibility. In this regard, I strongly believe that the chapters published in this book have assisted in understanding how Islamic finance ought to be reshaped in the light of the pandemic.

There is no doubt that research and publication play a pivotal role even at a time of unprecedented extremity. In times like this, the focus of research and publications should not only be dedicated to health-related issues; it is equally important to focus on areas of human concern. Therefore, I commend the publisher and the editors of this book for taking the initiative to publish selected quality research papers on pandemic-related Islamic finance subjects. The chapters found in this book shed light on the post-Covid impact on Islamic finance as well as proposing innovative solutions to some of the critical issues faced by it. Therefore, I am confident that this book will play an indispensable role in shaping the post-Covid Islamic financial system.

The economic and social disruptions caused by the pandemic so far have been devastating. The impact it has created on the lives of common people is inconceivable. The social distancing rule is applied today to all human dealings, and the very mode of interactions between humans has been forced to change. Technology adoption and adaption to internet-based human dealings and interactions have become an integral part of our lives. This has resulted in an escalation of the adoption of fintech in commercial transactions. Moreover, the proportion of the world population in poverty has sharply increased. Due to this, social finance is needed more than ever globally, and the importance of collective and social responsibility has been realized.

Today, we have had the opportunity to show the world that Islamic finance is different from conventional finance. The way Islamic financial institutions have dealt with the debt moratoriums without burdening customers who have been subjected to a sudden and sustained loss of income has given hope to the world that Islamic finance is indeed an alternative to the conventional financial system. Likewise, the pandemic also allowed us to experience the social justice Islam provides via Islamic social finance tools and institutions. When the poor and needy required a helping hand, the commercial finance instruments, and products available in the market were utilized to provide them the financial relief they needed. The Islamic notion of social justice through Islamic social finance institutions and instruments whereby the rich and comfortable give back to the society through shared social responsibility became a solution for those who had no means to ask for a helping hand.

The pandemic has taught us several lessons. One of them is that the world is more than ever in need of moral and ethical financing. Islam's emphasis on morality and ethics is reflected in Islamic finance. What is required from the stakeholders of the Islamic finance industry is not only to display the moral and ethical aspects of Islamic finance but to let the world know and appreciate them. This could be achieved by redefining Islamic finance in the light of *maqasid al-Shariah* (objectives of Islamic law) by adopting value-based intermediation in all our dealings. I am pleased to note that the three parts included in this book:

- resilience of the Islamic financial system during the pandemic.
- the pandemic's transformation of *zakat* and *waqf* management practices; and
- case studies of Islamic finance and pandemic innovations

will provide readers, including practitioners, academicians, and students all over the world with comprehensive information on the lessons in social responsibility from Islamic finance while moving towards a post-Covid financial system.

Professor Dr Mohamad Akram Laldin,
Executive Director
The International Shari'ah Research Academy
for Islamic Finance (ISRA),
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Acknowledgement

In the name of God, the most Gracious, and the most Compassionate.

Alhamdulillah! All praise be to Allah (SW) for giving us the strength to complete this book in the midst of the pandemic.

The editors are grateful for all the contributors of this book for their unabated support and valuable contributions.

The editors also express their deepest appreciation to the following institutions:

- University of New Orleans, USA
- INCEIF (International Centre for Education in Islamic Finance), Malaysia
- Ahlia University, Bahrain

Last, but not least, the editors also acknowledge the guidance and assistance provided by the publisher.

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Introduction

M. Kabir Hassan, Aishath Muneeza and Adel M. Sarea

COVID-19 is an unprecedented health crisis which has led to a human and economic crisis. The pandemic has not forced to create a 'new normal' only to people inhabited in a specific geographical location; but it has created the 'new normal' for the whole world and all spheres that are linked with humankind including the economy and the financial systems. The time that will end this pandemic crisis is unknown and it is impossible to know with certainty as at the moment neither a specific cure nor a vaccine has been invented and the process is ongoing. The World Health Organization (WHO) has already said that 'this virus may never go away' (Aljazeera, 2020). As such, currently even the financial systems including Islamic financial system is searching for the 'new normal' that would shape the future of it.

With COVID-19, the most critical challenge facing the financial systems in the world is to provide financial products and services in a socially distant manner where physical participation of parties are avoided due to fear of putting one's health and life at the risk caused by the pandemic. The pandemic came as a surprise and no country in the world got the opportunity to prepare for the consequences of it nor was aware of its adverse impact on the whole world including the economies. The financial systems operated in countries where physical involvement of human was required to the most of the activities though depending on the jurisdiction, some adopted technology to provide different financial products and services. Even the regulatory laws and requirements including consumer protection laws applied in the financial system were enacted contemplating the physical involvement of human. There are some exceptions to those online products and services offered where exclusive laws and requirements including consumer protection laws were enacted in contemplation of the specific situations that involved technology based involvements such as crowdfunding platforms. As a result, no buffer time was provided to the financial systems to 'switch' their operation fully from offline to online to offer products and services in a socially distant manner. Due to this, administrative glitches including delays or halt in financial activities have been faced.

The negative impact of COVID-19 on economies is yet to fully comprehend as the damage is still ongoing. The damage it created is beyond anyone's imagination. The financial system plays a vital role in assisting government and private sector to

Towards a Post-Covid Global Financial System, 1–12

doi:10.1108/978-1-80071-625-420211022

mitigate the damage it has caused politically, socially and economically to the individuals due to liquidity issues it has created as all major economic activities has come to a halt. COVID-19 has caused irrecoverable adverse impact on individuals, companies and the governments. The domino effect that it made has created more demand for alternative financial products and services and it warrants financial system to operate effectively and fast to provide remedy to uplift their situations of which the root cause is due to lack of money to fulfil their needs.

When COVID-19 spread in the world, people started to fear their lives. The way this virus spread required humans to be careful in dealing with other humans physically to the extent that isolation of one's self was the only precautionary step that was recommended to take. For the sake of protection of human lives, the countries adopted 'lock down' approach which eventually brought all economic activities to a complete halt including airports, shops, restaurants, malls, schools, universities and offices and increased panic buying and hoarding of food stuffs. When the business activities came to a halt, there was no way to generate money and they were faced with loss. Some of the businesses did not build up a reserve or did not have any savings to even pay a month's salary to their staff resulting in no choice, but to terminate their employees from employment. Those who were self-employed were forced to quit their business activities resulting in loss of income they received. As a result, private sector who contributes a substantially to the gross domestic product (GDP) of countries did not have a choice, but to rely on the mercy of the government to save them from the economic downturn they faced. Furthermore, the individuals who lost their income due to loss of job or being unable to engage in the business had to be saved by the government too. When individuals had no money, they were unable to pay rent for their shelter or utility bills or financing facilities or loans and had not food to eat affecting the peace and harmony of the countries creating political, social, economic and psychological crisis. Therefore, the governments had to rescue the businesses as well as individuals who were/are affected by COVID-19 by providing them with relief or stimulus packages or via financial institutions providing moratoriums to those who are unable to pay for the financing facilities or loans taken from the financial institutions. However, the challenge the governments face is again the financial challenge as they even have limited resources and rely on fiscal tools like tax to earn revenue. When there are no tax payers, the revenue of the government reduces and as a result they are forced to borrow. But, the money available in the domestic markets for them to borrow again may not be enough and alternative financing options is explored by the governments to cover the fiscal deficits. Multilateral financial institutions who were also not ready for such a high demand from sovereigns are trying to provide rescue mechanisms for the governments. Furthermore, COVID-19 as emphasized on the importance of re-distribution of wealth and as such, social financing mechanisms such as charity-meaning giving from those who have to those who need has emerged as a trend.

International Monetary Fund (IMF) has in their official website compiled the effect of COVID-19 on countries with the key policy responses implemented by the respective countries (IMF, 2020). One thing common to all countries is that the pandemic has disrupted the trade and transportation sector creating loss of income due to unemployment and have spiked up the price for food and essential goods due to inflated demand. IMF has grouped key responses of the countries into fiscal measures, monetary and macro-financial measures and exchange rate and balance of payment measures. The fiscal response includes allocating funds for emergency pandemic response (e.g. Afghanistan) or as stimulus packages (e.g. Australia); with the support of the World Bank and other humanitarian agencies, social relief packages are given to needy (e.g. Afghanistan); ease in tax compliance is granted (e.g. Afghanistan); support packages for businesses is granted by the governments consisting budget spending, tax deferrals and sovereign guarantees are given (e.g. Albania); supplementary finance laws have been prepared to include measures to mitigate the economic effect of the pandemic (e.g. Algeria), due to oil price shock, many governments have been impacted and as a result government spending is cut down so that spending on wages, health and education will not be affected (e.g. Algeria); provide subsidized short term (2–3 years) loans to provide emergence support to businesses and SMEs (e.g. Armenia); provide direct subsidies to SMEs and micro-enterprises to help maintain their employees (e.g. Armenia); and provide lump-sum transfers to the vulnerable including individuals who were unemployed after the COVID-19 outbreak, families with or expecting children, micro-businesses, general population who needed help with utility bills, and temporary part-time employment (e.g. Armenia) (IMF, 2020). The monetary and macro-financial measures include central banks reducing the policy rate (e.g. Armenia, Australia); lowering the reserve requirement for commercial bank's deposits (e.g. Aruba) or providing temporary relief for the capital requirement of banks (e.g. Australia); the central bank buys back the government bonds and conducts repo operations daily (e.g. Australia); and central banks have requested the financial institutions to defer loan repayments for small businesses/anyone affected by COVID-19 for six months (e.g. Australia (for small businesses), Malaysia (for all affected)) (IMF, 2020). The exchange rate and balance of payment measures for some countries like Armenia, the exchange rate has been allowed to adjust flexibly and has appreciated to pre-pandemic level against the US$, while no balance of payment or capital control measures have been adopted while in countries like Aruba, the central bank has announced it would not grant any new foreign exchange licenses related to outgoing capital transactions, and that it stands ready to take further measures to preserve the peg (IMF, 2020). In some other countries like Australia, the exchange rate has been allowed to adjust flexibly to absorb economic shocks (IMF, 2020).

Islamic finance is an alternative financial system to the classical conventional finance system. The main difference between the two types is that in Islamic financial system, giving a loan with a view of making profit is prohibited as it triggers *riba* which is prohibited in Islam, the law applicable to the system. Islamic finance transactions are structured using Islamic commercial contracts based on sale, lease or partnership where an underlying asset or a real economic activity is used as a means to generate profit. However, the typical contract used in conventional financial system is loan, where money is used as a commodity to general more money; making profit. Simple interest and compound interest are the mechanisms used to make money out of money. Due to colonization, when conventional financial systems became widespread in Muslim countries, those who were learned in those societies did not want to utilize the system. Therefore, Islamic financial system emerged as a proxy to the conventional financial system and irrespective of the faith convictions, it has gained popularity in the world.

Islamic finance has gained its momentum in the world due to the fair and just principles it has adopted in implementing the system which is derived from Islamic law or Shariah. One of the principles it promotes is risk sharing. Risk sharing ensures that there is no over exploitation of one party in a commercial transaction at the expense of the other. From the inception of Islamic finance, one of the criticisms it has faced is on this aspect. Islamic finance has been criticized stating that it has not shown 'enough' distinctiveness from its conventional counterpart when it comes to displaying its risk sharing nature. It has been contended that Islamic finance merely replicates conventional financial products resulting in mimicking of conventional financial products, and it is just a mere change of name making 'apple to apple' comparison between the two. Other principles adopted in Islamic finance such as elimination of riba, avoiding excessive uncertainty (*gharar fahishah*), avoidance of gambling (*maysir*) and removing oppression are also observed in all Islamic financial transactions. Furthermore, to ensure that strict compliance with Shariah is observed practically by Islamic financial institutions beyond all reasonable doubt, a Shariah governance mechanism is formulated and adopted where the minimum requirement observed is to have a Shariah scholar who is knowledgeable in Shariah to approve and oversee the operations. For Shariah governance mechanisms, single and dual Shariah governance mechanisms are practiced in the world. In single Shariah governance system, there will be in-house Shariah committees which is also known as Shariah supervisory boards to ensure Shariah is followed in all operations while in dual Shariah governance system there will be in-house Shariah committees or Shariah supervisory board within the financial institutions and they will be supervised by an apex Shariah advisory council which is an external body set up by the regulatory authorities or any other external relevant part given the jurisdiction to do so by the law of the country. Shariah compliance officers is also a job created in the Islamic financial institutions to ensure Shariah is followed. Today, there are also check and balance mechanisms put in place to ensure Shariah is observed such as conducting Shariah review or Shariah audit of the operations periodically. There are countries in the world, like Malaysia and Pakistan who has adopted strict Shariah governance mechanisms as part of law.

There are three components of Islamic finance. They are Islamic banking, takaful and Islamic capital market. However, apart from these general components of Islamic finance, Islamic social finance has also emerged which was previously considered as an informal sector of Islamic finance. The main reason why it was considered as an informal sector was because, the mechanisms/tools/institutions used in Islamic social finance was considered as part of Muslim personal law. However, due to United Nation's Sustainable Development Goals (SDGs), there is a paradigm shift in revitalizing Islamic social finance as part of main stream financial system. With industry 4.0, Islamic finance has been used with financial technology (FinTech) and it has become relevant in achieving environmental, social and governance (ESG) goals. In 2018, it was reported that

Islamic finance industry is worth US$2.19 trillion (Islamic Financial Services Board, 2019).

The impact of COVID-19 on Islamic finance industry need to be studied. One important reason why this study is important is because it is believed that COVID-19 will prove the practical differences between Islamic and conventional financial system. The advantage Islamic financial system provides in terms of risk sharing by using underlying assets and real economic activities to make profit and the disadvantage of conventional financial system in terms of risk transferring and using money as a commodity to make profit will be understood by studying the impact of COVID-19 on financial systems.

Islamic banking differs from conventional banking. As to ease the financial burden on customers of Islamic banks that has been faced due to loss of income due to COVID-19, if a moratorium for a period is granted to the customers of an Islamic bank, the implication of such a moratorium would be huge on the Islamic bank than a conventional bank. This is due to the nature of Islamic banking and due to the Shariah restrictions imposed on the contracts used to structure the products.

For takaful, due to COVID-19, it is predicted that the demand for claims would increase. As a result, the surplus in the risk fund of the contributors will go down. Furthermore, the liquidity of the takaful institutions might be affected and as a result, there will be less money to be invested. This could slow down the growth of Islamic capital market as there would be less funds available for investments. Furthermore, re-takaful companies also would be affected. Not only this, but there could be glitches in the payment of takaful contributions and this could end the takaful policies. As such, the Central Banks of some of the countries such as Malaysia has provided some consideration to takaful contributors. In Malaysia, it has been announced that the family takaful operators will allow COVID-19 affected policyholders and takaful participants the option to defer the regular contribution payments due under family takaful certificates for three months without affecting the policy coverage (The Sun Daily, 2020). In Malaysia, these impacts in takaful industry is viewed as 'severe but temporary' that could be recoverable gradually at the end of the year (Asia Insurance Review, 2020). This could be the case of takaful industry in other countries as well.

Islamic money market and Islamic capital market also will have a negative impact due to COVID-19. Due to change in monetary policy, minimum reserve requirements could be lower down resulting in more money to be circulated in the economy. This is a measure used to provide more financing facilities to public. Islamic capital market consists of equity market and debt market. The equity market could become stagnant as the dividend paid will be lower and secondary market activities could be slow as well. In the debt market, the existing sukuks yet to mature might be defaulted if the sukuk is structured using debt based contract where the payment to the sukuk need to be paid from the cash flow of the company and since it is a fixed return instrument. However, if the sukuk is structured using equity based contracts, then lapse of a payment or making a payment less than what could be expected without occurring a default as this is a variable return instrument where risk is shared. In the equity contracts, except in case of negligence, loss will be shared between the partners. As for the new sukuk issuances, it can be contemplated that there could be a slow-down in the sukuk issuances by the corporations; but the sovereign sukuk issuances may increase to cover the fiscal deficits or stimulus (RAM, 2020). Furthermore, technology-based sukuk may emerge as a proxy to the traditional or classical sukuks and the role of technology could be used in regulating them as well.

Due to COVID-19, the demand for Islamic social finance products/institutions have increased. For instance, there is need to increase the distribution of zakat which means that the collection of zakat needs to be increased as well. Internet based platforms fused with technology has been innovated to facilitate this. Likewise, similar trends have been seen in *sadaqat* (charity) and waqf (endowment) as well. Innovative ways are being introduced to spread Islamic social finance and reach the needy in this unprecedented situation faced by whole humankind.

It is essential to understand that the impact of COVID-19 on Islamic finance industry is not uniform in all sectors or components of Islamic finance and across all countries. Therefore, a case study approach would be useful to comprehend the impact of the pandemic to specific products and to specific countries. It is anticipated that the current trend shows towards a virtual economy and as such, rules and regulations required for the operation of financial system and to protect consumers need to be enacted not only for the domestic financial markets; but for the cross-border transactions as well. Therefore, case studies on the effect and opportunities of COVID-2019 would assist to learn from one another to save whole world from the deadlock situation.

The lessons COVID-19 has taught the world is also worth looking at. Portfolio diversification is a risk mitigation tool used in business transactions which is always spoken about; but failed to implement at government level. Some economies have been heavily reliant on one or two sectors to receive revenue. Oil and tourism are two sectors that is affected heavily and as a result some countries lost an exponential amount of their income forcing them to reduce their spending and find immediate alternatives. It has been reported that air traffic industry has faced substantial losses which is estimated at US3 billion causing a huge adverse impact on tourism sector where the World Travel & Tourism Council (WTTC) estimates that 50 million jobs in the sector are at risk, including some 30 million in Asia (Herald Malaysia Online, 2020). In this regard, Saudi Arabia good be one good example where the country relies on oil trade and tourism to generate income. Due to sudden fall in the oil prices and total suspension of ‘umrah visitors and probably the Hajj visitors which is estimated to create a US billion per year (Herald Malaysia Online, 2020), the country lost and is losing a lot of revenue forcing the country to find alternative ways to obtain revenue. As a result, the country has increased its value added tax (VAT) from 5% to 15% from July 2020 and cost of living allowance given will be abolished from June 2020 (The Malaysian Reserve, 2020). COVID-19 has taught many countries in the world to diversify their portfolios, so that failure in earnings received in one or two sectors will not make the country to forgo its revenue.

Due to the pandemic, there are important proactive roles and initiatives the organs of Islamic financial institutions need to take to realign the business continuity and operations to the 'new normal' situation. In this regard, it is recommended that the Board of Directors as the apex organ of the Islamic financial institutions from corporate governance perspective need to review their business continuity and operational risk management frameworks to evaluate the actual and possible implications that may be a threat to the growth of the institution by stress testing and other mechanisms to understand the resilience of institution to the situation faced. There is need to formulate and adopt reasonable and required risk management measures accordingly.

It is contemplated that the economic side effects of this pandemic could lead to a default crisis as the majority of the customers of the financial institutions whose liquidity position has been affected adversely might not be in a position to pay back the financial commitments it has either to pay pack a financing facility or to contribute to a takaful policy. Furthermore, due to this dilemma, it is also anticipated that mismanagement in communication with the fund providers to Islamic financial institutions could lead to a situation whereby lack of funds available in the institution may jeopardize their operations affecting the cash flow moving towards insolvency. As such, it is important to manage a possible default crisis of customers of Islamic financial institutions due to the liquidity deficit crisis that the pandemic has caused to individuals and businesses who are the customers and stakeholders of the financial institutions. Also to manage credit crunch situation that is possible if the depositors simultaneously demands for the withdrawals of the deposits kept in the financial institutions, it is important to establish an effective communication system with the stakeholders where not only the messages of the financial institutions are passed to the stakeholders; but it shall be an effective two way communication system where easily without physical presence, the stakeholders shall be able to reach the financial institutions and clarify their concerns. It is recommended in this regard to establish a special department within the financial institutions to deal with the COVID-19 affected customers/stakeholders. This proposed special department established within the financial institutions must be able to offer required financial counselling in debt management and if possible, even divert the customers/stakeholder who need immediate financial assistance to Islamic social financial institutions like zakat. To facilitate in this regard, if the financial institutions are not an amil or zakat collector and a manager who can disburse zakat to its recipients, then it is recommended for such institutions to affiliate with zakat institutions within the jurisdictions to save its customers/stakeholders from the financial crisis. This pandemic has proved that Islamic commercial financial institutions need to merge the principles of Islamic social financial institutions as well. As such, they require strategies to merge Islamic commercial finance with Islamic social finance needs to be formulated by the Board of Directors and shall be implemented accordingly.

It is also recommended for the Shariah apex organ of the Islamic financial institutions to play proactive role in adjusting with the 'new normal' situation created by COVID-19 and the required Shariah opinions considering the nature of the circumstance faced by the customers/stakeholders of the institution need to be issued in a timely manner. This is the right time to show the true difference between the conventional and Islamic finance to the world and the ability to show this difference lies in the hands of the Shariah scholars who sits in the Shariah organ of the financial institutions. The first challenge faced to the Shariah scholars in this regard in the issue of moratorium and whether any ‘profit’ over the agreed amount in the Islamic finance contracts made with the customers could be charged to consider time value of money. In dual Shariah governance jurisdictions where there is an apex Shariah organ with the regulatory authority or established by law to oversee the individual Shariah Supervisory Boards or Shariah Advisory Committees established within the financial institutions, this case is easier as a uniform view on this matter can be established and Shariah harmonization can be achieved in this regard. However, in those jurisdictions with single Shariah governance structure, the issue of harmonization of views in this regard seems to be challenging and the respective Islamic financial institutions in this regard need to take a proactive role in obtaining the view of Shariah scholars and harmonizing the view within the community. Furthermore, communicating these Shariah views given by the competent Shariah organs to the stakeholders in a timely manner is important. When publishing such announcements, as a Shariah corporate responsibility, the difference between the practices of Islamic financial institutions and conventional financial institutions need to be highlighted and explained in detail to create awareness and use this pandemic situation to show the practical difference between the two kinds of financial systems which some believe is one and the same or a mere change of name without any practical difference. Shariah governance procedural manuals of Shariah organs need to be enhanced with the situation whereby remote meetings need to be allowed when required and Shariah compliance functions such as Shariah review and Shariah audit shall be continued without any failure. This is because in any situation faced, Shariah compliance shall not be compromised and the processes and controls established for this purpose shall have a continuity plan. Since Shariah governance is the backbone of Islamic finance, Shariah risk elimination shall be given paramount consideration in this pandemic.

As stated above, communication and disclosure of relevant information by the Islamic financial institutions is mandatory. As such it is recommended for the Islamic financial institutions to identify the stakeholders who are affected such as depositors and investment account holders in case of Islamic banking whose deposits if made via equity based contract like *Mudharabah*, except in case of negligence all loss shall be borne by the capital provider (depositor); takaful contributors who need to know the special considerations that could be given due to pandemic; sukuk holders whose sukuk is going to mature soon or who is to receive profit payment who are affected due to cash flow situation of the sukuk issuer/obligor on what is the options available and to show that Islamic financial institutions are responsible towards the stakeholders. It is important to establish a channel to have regular communications with the stakeholders in a remote and easy manner. Transparent and time disclosure of all relevant material information to stakeholders will boost the confidence the stakeholders of Islamic finance towards the Islamic financial institutions and irrespective of the jurisdiction or in