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ORIGINAL PAPER

Ethical and Islamic Banking Compared from a Time-Based Perspective

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Abstract
This conceptual paper explores and compares the ethical dimension of Islamic and so-called ethical banks. The investigation is made in two succeeding steps. First, an individual analysis as regards the respective level of correspondence between ethical principles and business practice. For the latter, a time-based perspective is adopted. Second, a side-by-side comparison of their overall "ethical coherence gap". The results show that this gap is wider in the case of Islamic banks. The final part of the paper draws up three different scenarios for future development of these financial institutions where their ethical coherence is enhanced.

Keywords Ethical coherence · Islamic banking · Ethical banks · Mainstream banking · Time preference · Transaction costs

Introduction

Ethics have always played an important role in the banking industry, namely because of the fiduciary nature of banking activities. The 2007–2008 financial crisis largely contributed to accentuating this trend. People from different countries became increasingly interested in the existence of possible substitutes for conventional banking.

In this regard, Islamic banks were widely perceived as a more ethical alternative. Put simply, the main argument put forward to justify this view is that Islamic banks comply with the *Sharia* (Islamic law) and, unlike conventional banks, they only give financial support to projects considered as *halal* (lawful or permissible).

Accordingly, a considerable bulk of academic research has compared Islamic and conventional banks. Measuring possible differences in terms of financial performance has been the main topic addressed by scholars (Abdul-Majid et al., 2010; Jones et al., 2014; Ramlan & Adnan, 2016; Abdul-Majid et al., 2017; Khan et al., 2017; Miah & Uddin, 2017; Alzoubi, 2018; Ferhi, 2018; Salman & Nawaz, 2018; Iskandar Suppia & Che Arshad, 2019). However, realizing that this approach did not fully capture the idiosyncrasy of Islamic banks, a parallel segment of scholars has focused on ethically oriented aspects. In this respect, traditionalist authors assume that Islamic banks are intrinsically ethical and thus naturally superior to any other type of financial institution. More recently, some critical scholars have argued that, despite being shaped by religious and moral principles, the actual business practice of Islamic banks does not fully correspond with their ultimate goals (Kamla & Alsoufi, 2015; Khan, 2013; Mansour et al., 2015). Consequently, the idea that Islamic banks are naturally embedded with ethics must be nuanced (Asutay, 2012). As we will see, the issue is still open to discussion.

Within the Western tradition, the ethical alternative to the profit-maximizing motive of conventional banks was once embodied by cooperative banks. These financial institutions have nevertheless been the object of significant isomorphic pressures in the last decades. The result is that, despite concerted efforts to remain faithful to their original spirit, cooperative banks increasingly resemble traditional commercial banks (Groeneveld, 2020). In practice, the banks that now best embody Raiffeisen's alternative ideas are the so-called ethical banks (Relano, 2015; Relano & Paulet, 2012). This latter kind of bank, which is relatively unknown, is best illustrated by those members of the FEBEA (European Federation of Ethical and Alternative Banks and Financers) that have a banking license.

While both Islamic and ethical banks have been separately compared with for-profit conventional institutions, there is to date no direct comparison between them. To the best of our knowledge, only the case of Islami Bank

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Bangladesh Limited and Triodos Bank has been scrutinized (Khan & Mohomed, 2017). A more comprehensive analysis of the Islamic and ethical banking families, to which these two institutions respectively belong, has never been carried out. Yet this is precisely the comparison that really makes sense. Ethics is not a primary motive for conventional banks, while it clearly is for the other two. Accordingly, this paper proposes to compare ethical and Islamic banks from an ethically oriented perspective.

In fact, a straightforward comparison of ethical and Islamic banks is not possible. The reason for this is that from the ethical point of view both are placed on different ontological levels. While the principles of ethical banks are socially constructed, the Islamic worldview takes a more holistic approach based on divine command theory. It can thus be argued that the moral standards of ethical banks are unstable and change over time. They cannot be based on fully objective precepts, but rather on inter-subjective societal propositions within a given cultural context. Quite the reverse, Islamic banking derives its ethical principles from religion. They are based on an all-encompassing god distinct from humanity. It then follows that Islamic morality is as eternal and universal as the divine entity itself. It is based on non-human standards, and thus objective. Most importantly, this places Islamic banking within the framework of meta-ethics and makes the comparison with non-Islamic institutions scarcely appropriate.

Consequently, most of the scholarly work dealing with the ethical dimension of Islamic banks is carried out from an endogenous standpoint. This means that rather than comparing Islamic banking ethics against other financial institutions in different cultural contexts, priority is given to inner insights that measure the distance between Sharia-based ideals and the actual banking practice of Islamic banks. Several indexes that will be discussed later on have been proposed. For the time being, what is important to stress is that this approach prevents a comparison of Islamic banks with their Western peers. In the same way that an excessive focus on purely financial variables conceals the real nature of Islamic banks, an emphasis on the religious-based metrics of ethics excludes any possible comparison with Western institutions.

To overcome this difficulty and make the comparison between ethical and Islamic banks possible, we propose a new approach based on a two-step analysis: first an appraisal of the differences between ethical theory and business practice for each type of institution separately; secondly, a direct comparison of their respective level of ethical consistency to establish the nature and extent of their "ethical coherence gap". Both analyses are in fact complementary and address the issue of ethics as coherence, i.e. coherence endowed with an ethical dimension in itself (De George, 1990; DeMarco, 1997; Ess, 2019; Thagard, 2000). Finally, note that a rather atypical time-based perspective will serve as a common unifying thread for approaching the banking practice in different contexts.

We can thus summarize the contribution of this paper to the extant literature as follows: an unprecedented comparison in the domain of business ethics (Islamic banks vs ethical banks); an innovative method of comparison (the "ethical coherence gap" procedure), a singular outlook for apprehending the banking practice (time-based insight).

Bringing these elements together, the paper is structured as follows. After this introduction, section two explores the ultimate source of ethical principles in the banking industry within the Western and Islamic contexts. Section three inspects successively the business practice of ethical and Islamic banks and assesses possible discrepancies with their respective ethical underpinnings. Section four compares ethical and Islamic banks from the point of view of their overall ethical consistency. The last section concludes and proposes several scenarios featuring possible interactions between the above-mentioned financial institutions in the future.

Two Distinct Sources of Banking Business Ethics

As already noted, the ethical principles of Islamic and ethical banks cannot be directly compared. We thus begin by examining each of them separately.

The Western Ethical Divide

In a Western context, it is very difficult to define the concept of ethical banking in precise terms. There is actually no consensus in this regard. Since the 1980s, most authors agree that the ethical character of a company implies an acknowledgement of the existence of certain responsibilities that go beyond the narrow perimeter of the business activity. Delimiting the scope and nature of these extended responsibilities is a cause of division among different scholars.

Without entering into this debate, it is worth noting that today it would be unthinkable to conceive a bank whose goal is exclusively the maximization of profits. A simple look at the annual report of any financial institution taken at random will show that it also claims to care about issues such as the environment, climate change, etc. Conversely, a for-profit company will clearly not devote all of its efforts to causes beyond the heart of its business. Between these two extremes, banks will attempt to make appropriate trade-offs in line with their goals.

Within this context, we suggest defining ethical banks as those institutions for which extra-financial motives are more important than financial ones. In other words, ethical banking is a business attitude where the financial dimension of the company serves certain ethical principles, and not the

other way round. It is not about forsaking profit-making. A bank is not a charity. Ethical banking is rather about optimizing profits. This entails making fewer gains but giving more meaning to the business activity according to pre-established principles. Ethical banks are thus ready to sacrifice part of their profits if this is counterbalanced by further environmental and/or social added value. In short: the trade-off involved is different from that of mainstream banks.

This may still seem rather theoretical, but it actually takes the form of very concrete measures (Paulet & Relano, 2012). One of the most salient is that ethical banks refuse to participate in speculative operations on the financial market. This is particularly noteworthy when considering that this is the main source of income in modern banking. Yet ethical banks prefer to relinquish this practice as a matter of principle. They consider that the rationale underlying the functioning of the financial market exacerbates many of the current problems on our planet. Needless to say, conventional banks, despite their CSR claims, have a completely different discourse in this regard.

Without going into more details as regards other distinctive features of ethical banks, the most important thing to emphasize is that many of these attributes can be measured and thus treated empirically. In this respect, the works of San-Jose et al. (2011), Paulet et al. (2015), and Pedrini et al. (2015) represent a considerable step forward to distinguish between sincere commitment in ethics and greenwashing.

Theoretical Underpinnings of Islamic Finance Ethics

In the Islamic context, the *Sharia* (Islamic law) provides guidance on all aspects of a Muslim's life, including financial activities. It is also the main framework for moral and ethical behavior. Consequently, Islamic banks may be seen as inherently ethical as long as they comply with Sharia rules.

As a worldview that takes into account both spiritual and material needs, Islam is very concerned with promoting human well-being and social justice (Hasan, 1971). In line with this, Islamic banks are key players in achieving the higher objectives of the Sharia (*maqasid al-Sharia*, hereafter *maqasid*). Although there is no unanimous definition of this concept, most authors agree on endowing it with a welfare dimension (Dusuki & Bouheraoua, 2011; Laldin & Furqani, 2013). Accordingly, Islamic banks' compliance with the Sharia goes far beyond the commercial obligation of serving their clients. In addition, they are supposed to have a moral duty of contributing to fair economic development in society.

Based on the works of the medieval Muslim philosopher Al-Ghazali, modern economist Muhammad Umer Chapra (1992) associates the *maqasid* with three other interrelated principles of the Islamic worldview: *tawhid* (unity of God), *khilafah* (vicegerency), and *adalah* (justice). Very concisely, the first concept highlights that Allah created the entire universe, for which humankind should be grateful and bless God in all actions. The second (*khilafah*) prescribes that humans are only a vice-regent of God on Earth (*Quran*, 2:30). As such, they are responsible for managing God's resources for the benefit of the whole of society. The third (*adalah*) denotes that this trustee mission should always be carried out justly and in a socially responsible manner. Ultimately, what emerges by putting together the three pieces of the puzzle is that the business practice of Islamic banks, aligned with the *maqasid*, should correct existing imbalances and promote social justice and community welfare. Their ethical idiosyncrasy is thus top-down but also bottom-up. Hence the importance of comparing theory with practice in the next section.

Interestingly, the above set-up could also be read through the lens of various corporate governance theories. In terms of the stakeholder approach (Freeman, 2010), the idea of Islamic banks acting as trustees of God's property for the benefit of society stresses the fiduciary nature of their activity and suggests that Allah could ultimately be seen as their primary stakeholder. Additionally, the application of the *maqasid* means that Islamic banks should go beyond the narrow financial interests of shareholders to meet the well-being demand of all stakeholders. This standpoint is nevertheless refuted by those who above all see a private, profit-maximizing motive in Islamic banks (El-Gamal, 2007; Iqbal & Molyneux, 2005). We will examine below, when exploring the banking operations in more detail, whether these allegations can be substantiated.

These and other competing interests can also be analyzed in terms of agency theory (Jensen & Meckling, 1976). In this light, Islamic banking offers a distinctly rich array of interactions (Safieddine, 2009). Some scholars contend that their Sharia-based ethics give Islamic banks a comparative advantage (Zainuldin et al., 2018). In practice, however, the existence of numerous court cases suggests that this purported advantage in terms of agency conflicts should perhaps be nuanced. It is, therefore, time to move from theory to practice and see if a time-based perspective can shed new light on this issue.

Business Practice from a Time-Based Perspective

The Modus Operandi of Islamic Banks

Ideally, Islamic banks should be interest-free, risk-sharing, wealth-redistributing institutions. They should privilege equity-like modes of financing and work exclusively with real assets. In the next pages, we will first explain

why this banking practice fits best with their theoretical underpinnings. Second, we will examine to what extent this ideal Islamic banking practice corresponds to reality. Ultimately, the idea is to insert our specific time-based discussion on Islamic banking into a wider debate about legal form vs economic substance.

It is a well-known fact that Islamic banks are interest-free institutions. There is actually no controversy about the prohibition of *riba* (interest). All scholars agree that the sacred scriptures of Islam explicitly proscribe this practice. However, divergences emerge as regards the precise meaning and scope of the concept (Farooq, 2009), namely between "traditionalist" (Siddiqi, 2004) and "modernist" (Saeed, 1996) scholars. Without entering into this vast debate, it is worth recalling that the prohibition of interest has a strong impact on how the rest of the business activity is organized. Besides, the notion of interest is intrinsically endowed with a significant time dimension. Consequently, it seems appropriate to start the analysis of Islamic banking practice with a few remarks about the notion of interest from a time-based perspective.

In this light, let it be noted that a simple financial transaction such as a loan may possibly be seen as a way to "save" time. A mortgage, for example, allows you to buy a house and enjoy it immediately without having to save for years before being able to make the same transaction in cash. In Western economics, well-known concepts, such as opportunity cost or time preference for money, justify charging interest in exchange for the lender's renunciation of using this money for his/her own utility at the present. In other words, interest is the price of time.

Traditional Islamic theory has a very different approach to this question. Money is not considered as a commodity. It has no intrinsic value. Paying interest for a service thus makes no sense. Likewise, proponents of this theory consider that it is incongruous to make someone pay an extra charge associated with the mere passage of time. Indeed, in compliance with the *Quran* (31:34), traditional Muslims believe that God alone is the owner of time. Only He knows the future with certainty. We humans cannot guarantee the outcome of our activities over time. Yet this is precisely what loan interest seeks to determine. Bankers thus like the idea of playing God, but their financial forecasts cannot predict the future with absolute certainty. Even the best econometric tests work with margins of error. The contrast is thus striking. On the one hand, human knowledge is rational. It operates in time and space. It is fallible. On the other, true knowledge, according to Islam, emanates from God and is revealed in the Holy Scriptures. It is infinite and timeless. Therefore, bankers should stop receiving a reward for selling something that ultimately belongs to Allah. This is why, from a time-based perspective, *riba* is *haram*.

More interesting still is to look at the issue under discussion when applied to the achievement of the *maqasid* goals related to welfare and justice. In its traditionalist version, the underlying rationale could be summarized as follows: interest-based transactions are biased because the lender (banker) is certain of obtaining, *ex-ante* and without risk, a positive return; the borrower (entrepreneur), on the contrary, cannot know in advance the result of his or her investment (Ahmad & Hassan, 2007). Some authors even assume that the former is necessarily rich while the latter is inherently poor, thus resulting in unfair transference of wealth and exploitation (*zulm*), not only at the level of individuals, but also for society at large (Borhan, 2009; Lewison, 1999; Presley & Sessions, 1994; Siddiqi, 2004).

This "exploitation argument" has not gone unnoticed by critical Islamic scholars. Indeed, the idea of wealthy lenders acting against poor borrowers is something of a stereotype (Farooq, 2012). Expressed in the above terms, one could easily flip the argument by considering rich entrepreneurs asking for loans with plans for highly profitable projects. In so doing, they would be "exploiting" the lender in the opposite way. Likewise, from a macroeconomic point of view, it does not make sense to look at debt as strictly synonymous with poverty (Farooq, 2009; Saeed, 1996). This does not mean that predatory conditions on loans, credit cards or national debt-burden do not exist. Nor can the influence of excessive debt in triggering financial crisis be denied (Minsky, 2015). However, the benefit of interest-based debt in the economy has also been highlighted by a long tradition of scholars (Giovannini et al., 2013), from Schumpeter's (1961) pioneering remarks on the sources of development to more recent works, such as those of Allen and Gale (2001) and Beck et al. (2020).

Still in relation with the issue of redistributive justice, but now looking at it the other way round, modern critical scholars have also raised the problem of dealing with inflation in the context of a free-interest economy. Since this would erode the real value of money, several authors have proposed that some kind of indexation with inflation is needed in order to ensure that justice is restored in favor of the moneylender (Khan, 2020). This would be tantamount to shifting the concept of *riba* from the framework of nominal to real interest rates. The problem is that such a move would re-open the door to the endless debate on whether or not to distinguish between different types of *riba*. We will thus not go into this matter in more detail.

To get out of this imbroglio, Islamic economists advocate financing systems based on profit-and-loss sharing (PLS). This is certainly a more ethical mode of financing because it is closer to the welfare spirit of the *maqasid*. The basic idea underlying this type of financial instruments is that, instead of gaining a fixed rate of return, like on conventional loans, the bank, along with the principal, collects a pre-agreed

percentage of the profits (or losses) that the enterprise that requested the funding eventually obtains. PLS thus constitutes a more participatory method of financing the economy. From a time perspective, it is worth noting that instead of an *ex-ante* fixed rate of interest, PLS involves an *ex-post* share of uncertain profits. Only the profit-lost sharing ratio between the two major actors, the capital provider and the entrepreneur, is stipulated in advance.

The purported benefits of this mode of financing would be multiple. PLS enhances social redistributive justice (Raza et al., 2011) and allows a more efficient allocation of capital (Khan, 1986). On a microeconomic level, PLS seems better suited to financing small businesses, while from a macro-perspective, PLS appears to promote better risk management and improve global financial stability (Kammer et al., 2015). More importantly for the purpose of this paper, PLS would finance projects in the longer term, thus contributing to higher inclusive growth (Mills & Presley, 1999).

The problem is that, despite its potential advantages, Islamic banking practice has never relied on the PLS paradigm. Empirical evidence in various countries unambiguously shows that, contrary to the ideal equity-based funding system set out above, the Islamic banking industry is primarily based on debt-like instruments (Aggarwal & Yousef, 2000; Asutay, 2012; Khan, 2010; Khan & Bhatti, 2008; Minhat & Dzolkarnaini, 2016; Siddique & Iqbal, 2016; Uppal & Mangla, 2014). Thus, rather than using PLS instruments such as *Musharakah* (joint venture equity financing) and *Mudarabah* (trust financing), Islamic banking practice is dominated by debt-like contracts such as *Murabahah* (mark-up financing), *Salam* (purchase with deferred delivery) and quasi-debt instruments like *Ijarah* (lease). So much so that many now refer to this phenomenon by the name of "*murabahah* syndrome" (Yousef, 2004). Most importantly, this gap between ideal and real ways of financing entails a series of ethical issues that we analyze next.

Ethical Implications: Revisiting the Form-Substance Debate

We have seen so far that Islamic finance is basically characterized by the injunction of charging interest and by the parallel incentive to use PLS modes of financing. The former criterion is indeed respected in practice, at least in formal terms, but the latter is not. It should be noted that it would be virtually impossible for an economy to function exclusively according to PLS mechanisms. This is because, on the one hand, not all of the financial needs of an individual are long term; and on the other, not all entrepreneurial projects that need working capital are intended for profit. Therefore, the fact that Islamic banks get involved in a number of debt-like transactions is not surprising. The problem is the overwhelming success of this method of financing, even in full-fledged Islamic economies (Miah & Suzuki, 2020). To some critical observers this may appear as a renunciation of the original purpose of Islamic finance (Khan, 2013).

As regards the formal prohibition of interest, this is also a major source of inconsistency at the level of ethical coherence. Let us start with an example to set the record straight. It concerns contracts called *bai salam* (prepayment with deferred delivery). From a time-based perspective, in this type of transaction the future price of the commodity sold is generally different from its spot price, even if no transformation has occurred in the meanwhile. The only change is the passage of time. Accordingly, it would be tempting to see here a recognition of positive time preference. Yet some scholars contend that the price variance does not reflect the time value, but rather a change in the forces of supply and demand at different points in time (Ahmad & Hassan, 2006; Khan, 1991). Accordingly, this can be perfectly acceptable from an Islamic perspective, since changes are not directly related to time, but rather to modifications in the market conditions. Interestingly, the increased price of the sale usually corresponds to the equivalent in interest-based calculations. Therefore, in terms of time valuation, there is no real difference between interest on loans and deferred sales. Likewise, the rental installments in a "diminishing *musharaka*" *(Musharaka al-Mutanaqisa)* are usually benchmarked to conventional interest rates. So once again, we come across the equivocal dichotomy between something that is legally admissible but far more controversial in its intrinsic economic substance.

The same applies as regards risk. In most *murabaha* contracts, the bank buys the good on behalf of the client only if there is a legally binding and *ex ante* certainty that the latter will in turn purchase that asset as soon as possible. Quite often, the bank owns the asset for just a few hours, if not minutes. This is namely the case in the monetization process associated with *tawarruq* contracts (tripartite sale). Therefore, contrary to what is widely proclaimed in the principles of Islamic finance, there is no real risk-sharing. Ultimately, this means once again that there is Sharia-compliance in the form, but not in the content.

If we look at this whole process from the perspective of the transaction costs theory (Coase, 1937; Williamson, 1979), the situation is even worse. Not only do debt-like instruments look similar to conventional financing tools in all regards, but they are also less efficient. Indeed, the process of making a transaction Sharia-compliant usually involves additional steps, circumventing diversions, and needless paperwork to reach the same outcome in substance. Only the path taken changes. Most often, it also involves more time.

From a more strictly ethical point of view, shifting from Sharia-based to Sharia-compliant entails resorting to ruses (*hiyal*) or "fatwa shopping" to avoid facing the real nature

of certain products (Abedifar, 2019; Azmat et al., 2014; Khan, 2013). Pragmatism prevails over intrinsic coherence. It is worth noting, however, that the *Quran* (7:163) warns against the use of such stratagems. It is thus not surprising that several empirical studies show a discrepancy between what the banks communicate and what they actually do (Belal et al., 2015; Haniffa & Hudaib, 2007; Rahman et al., 2014). Many products marketed as Sharia-based turn out to be simply Sharia-compliant, thus creating an "expectations gap" (Hayat & Malik, 2014). This means that Islamic banks attract Muslim clients with religious sensibility by promising them financial services in line with their spiritual convictions, but in practice they only meet these expectations to a certain extent (in form, not in substance).

The fierce competitive context in which most Islamic banks evolve has been pointed out as a possible explanation for this ethical and "identity drift" (Hidayah et al., 2020). The idea is that Islamic banks are obliged to abide with rules that are not their own. Hence the variance between the purity of ideals and the reality of practice. The problem with these types of argument is that they suggest that there is no possible alternative, in substance, to mainstream banking. To see if this is really so, let us come back to the ethical banking proposals.

Alternative Banking Experiences in the West

The idea of working without interest rates is not exclusive to Islamic banks. It already existed in antiquity and early Christianity (and Judaism to a certain extent). The advent of the Protestant Reformation, nascent capitalism and mercantilism, and perhaps more importantly, the increasing transaction costs that a free-interest system imposed on the growing international trade, led to a generalized change of attitude in Judeo-Christian countries (Mews & Abraham, 2007; Munro, 2011). Today, interest-free banking institutions are an exception to the rule in the Western tradition, but they still exist.

An outstanding example is the JAK Members Bank, an ethical-driven financial institution based in Sweden. Their system has some fundamental similarities with Islamic finance, but also important differences, both as regards the justification of interest-free banking and at the level of its actual implementation. Focusing first on the former aspect, it should be noted that JAK Bank's refusal to work with interest has nothing to do with religion. The bank was founded in response to the Great Depression of the 1930s, namely the shortage of money and the high real interest rates that prevailed in that period. Since then, their refusal to work with interest has always had an important macroeconomic dimension (Anielski, 2004). On the one hand, they stress the fact that interest favors investment in prosperous areas, which usually host projects yielding higher returns. This results in increasing territorial inequalities, which somehow recalls the welfare and justice dimension of the *maqasid* in Islamic banks. On the other hand, they note that the compounding effect of interest endorsed by the current financial system generates exponential perpetual growth. This is not only economically unsustainable, but also ethically unacceptable.

From a microeconomic perspective, JAK Bank's anti-interest rationale echoes the "exploitation argument" put forward by Islamic banks. Both agree that charging interest entails an indirect transfer of money from the poor to the rich, as the former pay out much more interest on what they borrow than they earn from their savings. Conversely, the balance is far more favorable for the wealthy, especially for the most opulent among them (Kennedy, 1995).

Beyond certain similarities, Western ethical banks and Islamic financial institutions differ on two important points. The first is ethical banks' concern for the environment. Interest rates play a major role in this regard, namely because of the prominence given to high-yield, short-term projects that use finite natural resources at the expense of long-term, lower-yield projects involving alternative energy sources. In the case of Islamic banks there is no comparable environmental sensibility (Foltz et al., 2003), despite their alleged adoption of the *khilafah* (viceregency) principle. The second major difference is the focus of ethical banks on the local dimension. JAK lenders and borrowers, for example, are actually the same and live in the same region. This has important implications at the level of the bank's involvement with the surrounding community and in counteracting information asymmetries. Islamic banks, which theoretically share these concerns, have never launched a similar strategy. Their concept of community has a much broader meaning.

Shifting now to the practical mechanics of their interest-free savings-and-loans system, it is important to note that, unlike conventional and Islamic financial institutions, JAK bank does not create money. This means that borrowing activities always need to be balanced with savings. JAK bank ensures this through a system of "saving points". In terms of time reasoning, this means that for a typical basic loan, the borrower is normally obliged to save *ex-ante* for a certain time before being able to apply for a loan. Although more flexible arrangements are now possible (with compulsory post-savings), the fact remains that all loans are supported by other members' savings and liquid assets. Unlike conventional and Islamic banking, all transactions at JAK are fully backed by the bank's own reserves.

It is obvious that using such a set-up requires more time and involves higher transaction costs, but this is the price that all members of the bank are ready to pay for a system which is more in line with their values. All other ethical banks would agree on this inference and the underlying philosophy behind it. Despite certain variations in the way they implement it, it has already been shown that ethical banks form a homogeneous bloc with a business model distinct

from that of conventional banks (Paulet et al., 2015). It could be added that ethical banks are also different from Islamic banks, not only in practice but also from an ethical point of view. This latter aspect is developed in the coming section.

Assessing the "Ethical Coherence Gap"

Having examined separately the distance between ethical principles and business practice for each of the two types of bank considered (Islamic and ethical), it is now time to confront them globally, side by side, in terms of their ethical coherence. In this regard, it has already been noted that a primary ethical divide contemplates the existence of two ideal types of banking strategy: on the one hand, those financial institutions that seek to *maximize* their profits (conventional banks); on the other, those that *optimize* their profits to obtain the utmost extra-financial benefits (ethical and Islamic banks). Each follows its own internal logic, yet both strategies are a priori fully coherent. Inconsistencies may possibly emerge only when acts (practices) do not correspond to words (principles). This is typically the case of commercial banks with greenwashing practices.

In the case of Islamic banks, inconsistencies arise when they pursue two contradictory goals at once. While they do not hide their ambition of achieving a similar performance to that of mainstream banking, they simultaneously claim to be highly ethical. This is just not possible. At least in the short term, ethics involve additional costs that curtail profit-maximization. An appropriate trade-off is therefore needed. Otherwise, as the proverb says, Islamic banks run after two hares at the risk of catching neither.

Previous time-based examples and numerous court cases illustrate that there is indeed a significant discrepancy between the legal form and the economic substance in many of the financial transactions of Islamic banks. Their normative endeavor is appropriate for describing the world as it should be, according to their worldview, but it is rather ill-suited to apprehending reality as it actually is.

An increasing bulk of specialized literature has tried to measure the distance between one and the other. The idea is to compare the potential divergence between the ethical dimension of Islamic banks stemming from religious ideals, and the way that it is implemented in their business practice. Since in this sense Islamic financial institutions are expected to fulfill *maqasid* requirements, their ethical dimension is evaluated by seeing how far they are from attaining the ultimate objectives of this theoretical benchmark. To this end, the multifaceted concept of *maqasid* is first broken down into a number of measurable components, which are used as a proxy of the ethical dimension. On this basis, a *maqasid* index can then be created.

Since the pioneering works of Hameed et al. (2004) and Mohammed et al. (2008), various forms of this type of index have been proposed (Antonio et al., 2014; Mohammed & Shahwan, 2013; Amir-ud-Din, 2014; Mili, 2014; Asutay and Harningtyas, 2015; Mohammed et al., 2015; Bedoui & Mansour, 2015; Ngalim et al., 2015; Hasan & Ali, 2018). More recently, efforts have concentrated on developing a more unified assessment model (Hudaefi & Noordin, 2019; Syafa'atur Rahman and Haron, 2019; Alhammadi et al., 2020; Mergaliyev et al., 2019). For the purpose of this paper, it is worth highlighting that all of these works confirm that there is a considerable distance between moral ideals and banking practice.

These shortcomings of Islamic banks in achieving the developmental and social objectives of the *maqasid* can be seen, through the lens of corporate governance theories, as a failure to meet stakeholders' interests. In fact, the profit orientation of Islamic banks increasingly mimics the business model of conventional banks to the detriment of their expected social responsibilities (Salma Sairally, 2013). It is thus not surprising that preliminary empirical evidence shows that Islamic banks have no significant impact in the communities they serve (Aksak & Asutay, 2015). This illustrates once again that there is no clear trade-off between ethics and financial return in the strategy of Islamic banks. We can thus conclude from a threefold perspective (the *maqasid* index, stakeholder theory, and transactions costs theory) that there is a significant "ethical coherence gap" in the case of Islamic banks.

The contrast with ethical banks in Western countries is noteworthy. Their distinct ethical coherence dimension can first be appraised through the prism of transaction cost theory. Indeed, ethical banks are ready to work with higher transaction costs if this is offset by supplementary added value in social and/or environmental terms. This means for instance that on behalf of a project which is well aligned with their values, ethical banks accept to work with higher monitoring costs or lower collateral.

That profit-maximizing institutions do not want to bear this kind of additional costs is quite understandable. What is more difficult to grasp is the ambiguous attitude of Islamic banks in this regard. Actions such as the allocation of *zakat* funds seem to go in the same direction as ethical banks, but they remain rather peripheral to the heart of their business. They are in fact more reminiscent of the charity endeavors of traditional firms, where such actions are conceived as personal undertakings rather than corporate responsibility. The sincere commitment of a firm to society always entails an adjustment of its business model accordingly. Islamic banks seem to refuse this important step, at least in its economic substance.

In addition to accepting higher transaction costs, ethical banks reinforce the correspondence between ethical

principles and actual practice by various other means. For example, rather than relying on a single bottom line analysis (screening mostly based on financial criteria), ethical banks apply a triple bottom line. This means that consideration of social and environmental standards comes first and prevails over financial performance. It is therefore not surprising that, in line with their objectives, ethical banks end up specializing in sectors such as ecological housing and organic farming.

Transparency is also an important feature to consolidate their ethical coherence. On the inside, an active transparency policy facilitates the participation and democratic requirements deriving from these banks' cooperative status. On the outside, transparency allows direct contact between borrowers and savers to jointly decide the best use of the banks' funds. Unlike the commercial confidentiality of conventional and Islamic banks, decision-making in ethical banks involves less intermediation. Paradoxically, this often entails further transaction costs, but it is the price they are willing to pay for a banking practice in line with community expectations.

All in all, ethical banks seem more coherent. They do not try to compete openly with conventional banks on all fronts, but rather specialize in the ethical niche market. To do so consistently, they have developed a distinct business model. Islamic banks would also be coherent if they were fully Sharia-based and achieved the *maqasid* goals. The problem is that this entails higher transaction costs and reduced profits that they are not willing to assume. They prefer to curtail the former and augment the latter by means of a Sharia-compliant policy. This allows them to appear as intrinsically ethical without giving up being as performant as conventional banks. Yet this is like squaring a circle. In fact, Islamic banks are not as ethical as ethical banks, at least in the sense of the "ethical coherence gap"; and they are not necessarily more efficient than mainstream banking either. In contrast, they are less coherent. Since ethics is also about coherence, this is an ethical failure in itself.

Conclusion

The goal of comparing Islamic and ethical banks was not to see which is more ethical. As mentioned above, at this level they are not comparable. The idea was rather to first analyze separately their respective coherence between theoretical principles and business practice. Once this was done, we could evaluate and compare their respective external consistency in terms of what we have called the "ethical coherence gap". In this regard, the results show that this gap is actually wider in Islamic banks than in ethical banks.

Translated into a more time-related perspective, this simply means that, in line with their principles, ethical banks emphasize long-term commitment and small-scale projects at local level. Although these activities tend to yield lower returns, the banks are ready to pursue them provided that the hampered short-term maximization of financial profits is counterbalanced by higher long-term social/environmental benefits. A similar picture could possibly be drawn in the case of Islamic finance if, as prescribed by their religious-based rules, it were mostly based on equity-like modes of financing. We know, however, that in substance this is not actually the case. Hence the gap between *de jure* ethics and de facto practice.

Against this backdrop, the challenge is how to enhance the ethical coherence of Islamic banks. This is difficult to determine with certainty, but there are at least three possible scenarios. The first would consist in leaving the existing state of affairs as it is. Most likely, this would broaden the coherence gap and the ongoing denaturalization of Islamic banks to the point that their business practice would become virtually indistinguishable from that of conventional banks. It would also involve these banks competing as peers with conventional banks in the same arena; but since in fact they are not on an equal footing, further denaturalization would still be needed. Identity drift will thus continue. Eventually, the most pious Muslims would no longer want to be customers of Islamic banks. Conversely, it is not certain that less religious people would simultaneously leave conventional banks to make a move in the opposite direction. Overall, the fate endured by cooperative banks in their struggle against isomorphic forces from mainstream banking can give an idea of the prospective outcomes in this scenario.

The second possible strategy would be to emphasize the alternative nature of Islamic banks. Priority would then be given to innovative financial engineering to issue groundbreaking products fully embedded in Islamic law. By developing original devices that are completely different from mainstream finance, Islamic banks would reaffirm a distinct Islamic identity. This would in turn attract dedicated Muslims by offering them financial services more in line with their religious convictions. Building upon this momentum, Islamic banking could potentially become the backbone of a new set of rules and standards shaping economic life in Islamic countries. Alternatively, this very same scheme could initially be deployed on a smaller scale in non-banking institutions (Asutay, 2012). The important thing to retain is that, in this scenario, Islamic and conventional banks would not be direct competitors, but complementary institutions. As with ethical banks, Islamic banking would be one option among others within a niche market strategy. The ethical coherence gap would definitely shrink and the *maqasid* performance would certainly improve.

Somewhere in between, a third scenario would consist in creating a gradation of financial compliance with the Sharia. Islamic banks would then be in a position to propose

different elements of progressive differentiation. In practice, the Islamic International Rating Agency (IIRA) already provides non-binary Sharia compliance ratings for entities and products. It would suffice to standardize and generalize further this procedure at an international level. More simply, setting up an assessment scale for financial products, going from minimum Sharia-compliant to maximum Sharia-based, with one or two additional intermediate steps, would not be very difficult if there were a real willingness to do so. The ethical coherence gap would still persist; it would be greater than in the previous scenario but would be much smaller compared with the current situation. Symptomatically, the expectations gap, at least, would disappear.

Declarations

Conflict of interest The Authors declare that they have no conflict of interest.

Research Involving Human Participants and/or Animals This article does not contain any studies with human participants or animals performed by any of the Authors.

Informed Consent Informed consent is not applicable. The Author declares that his research has no individual participants. The empirical data were collected from publically available annual reports and websites of banks.

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