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2008 Financial Crisis and Islamic Finance: An Unrealized Opportunity

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Abstract The Islamic finance industry is relatively new and vibrant. It is becoming a mainstream industry in the MENA (Middle East and North Africa). The industry is based on a number of Sharia'a maxims and in particular the prohibition of Riba. Islamic law scholars' emphasis on the ethical dimension of this industry and how it can be seen as a solution to existing capitalism. The current financial crisis presented this industry with an unprecedented test and an opportunity to influence and merge into main stream finance. This paper presents an evaluation of Islamic finance industry in the current financial crisis and whether the governance and ethical foundation of Islamic finance institutions distinguished itself from conventional finance. Thus, this paper begins with an overview of Islamic finance, then it discusses the governance framework structure of Islamic finance institutions and the role of its organs. In addition, this paper will compare between the ethical framework of the Islamic finance institutions and the conventional institutions. Finally, this paper will discover the ethical failure of the current global financial system and its relation with the current financial crisis.

Keywords Islamic finance · Business ethics · Financial crisis · Sharia'a board · Governance

1 Introduction

The Islamic finance industry is relatively new and vibrant. It is becoming a mainstream industry in the MENA (Middle East and North Africa) region and is estimated to have a value of one trillion U.S dollars with an annual growth of 10–15 % [1]. The industry is based upon the principles of Islamic law, Sharia'a, and

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is considered to be a faith based industry. The growth of this industry invited the participation of major international financial institutions, such as HSBC, Citi Group and Standard Chartered Bank. In addition, major international financial centers, such as London, are aiming to establish themselves as the Centre of Islamic Finance [2].

The industry is based on a number of Sharia'a maxims and in particular the prohibition of Riba. Islamic law scholars' emphasis on the ethical dimension of this industry and how it can be seen as a solution to existing capitalism. The current financial crisis presented this industry with an unprecedented test and an opportunity to influence and merge into main stream finance. This paper presents an evaluation of Islamic finance industry in the current financial crisis and whether the governance and ethical foundation of Islamic finance institutions distinguished itself from conventional finance [3].

The paper starts with an overview of Islamic finance industry and its development. It then evaluates the governance structure of Islamic finance institutions with emphasis on the unique characteristics of these institutions. The role of Sharia'a supervisory boards is then investigated and their role in enhancing the governance and enforcing the ethical framework of Islamic finance institutions. The paper then will reach its major theme by assessing the ethical framework of Islamic finance that differentiates it from conventional finance and whether the current financial crisis exposed the ethical claims of Islamic finance institutions. This paper will argue that the ethical framework is far from applicable in practice in Islamic finance institutions and that in order for this industry to fulfil Sharia'a objectives the role of Sharia'a supervisory board has to be redefined. The focus of the practice of these institutions must shift towards a new model that is based on the ethical foundation presented by Sharia'a instead of the current trend that revolves around offering conventional finance products that are restructured in a way to ensure that they are Sharia'a compliant.

2 Islamic Finance Definition

According to Warde, "this widely used phrase 'Islamic finance' is by no means a crystal clear concept. Definitions tend to vary considerably starting from simple definitions such as interest-free banking to very broad definitions such as 'financial operations conducted by Muslims" [4, p. 5]. Warde defines Islamic finance by saying that "Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from conventional institutions, which have no such pre-occupations" [4, p. 5].

Two major elements underline this industry. The first is the risk-sharing philosophy, as the lender needs to share the risk with the client (borrower). The preferred theoretical model in this industry is the profit-loss sharing scheme. It can be noticed that the model of profit-loss sharing is favored by IFI's when dealing with depositors but it is not as common when the IFI is engaging in lending activities where the *Murabaha* and *Ijara* are favorites due to their risk profile. The second element is the promotion of social and economic development; this is

usually achieved via *Zakat* (almsgiving). This is a more challenging assumption as the practice do not reflect this.

Islamic finance can be seen as a sort of "private club industry" in that its participants are for the most part limited to practitioners of the Islamic faith. The Western perception about Islamic finance is misguided in many cases. Especially in the United States, Islamic finance is often associated, by unsophisticated members of the general public, and with the financing of terrorism [5].

The prohibition of usury, *inter alia,* is the jurisprudential foundation of the industry. The prohibition of *riba*, interest, is not unique to Islamic law; it can be seen in all other major religions [6, p. 5]. The development of the notion of usury in the West is akin to its development under Islamic law and is still present in Western legal systems, e.g. Usury laws can be found in almost all states and in some cases in the heart of the constitution of these states with aim of eliminating predatory lending and legalizing commercial lending [7, p. 2].[1] This include countries such as Germany and France and these laws prohibits excessive interest rate restrictions [8]. However, in England and under the influence of Jeremy Bentham Usury laws were abolished in 1854. The ethical foundation of usury prohibition can be equated with preserving justice and is seen as a practice that is equivalent to predatory lending in today's finance terms [7, p. 1].

The classic ethical rationale for the prohibition of r*iba* in Islamic writings include "(i) the protection of the disadvantaged from exploitation by the wealthy and knowledgeable; (ii) the corrupting effect on the lender making money from money, rather than from honest toil; [and] (iii) the Islamic contention that money is solely [a] means of exchange, not a commodity" [9, p. 8]. Similar critique to usury can be traced back to the writings of Franciscan and Dominican preachers in the thirteenth century and the scholastic debate in that era revolved around the prevention of exploitation of the poor [7, p. 4]. The ethical framework governing the prohibition of *usury* leads some writers to equated with predatory lending and as a result it is important to distinguish it from legitimate compensation in lending. This perspective can be traced to the scholastic debate in the thirteenth century that relates to the exploitation of the poor and the legitimate interest of the lender.

The concept of interest which is pivotal to the Islamic finance has been subject to a number of *fatwas* that have been considered to be controversial and have led others to question the reasons behind issuing such *fatwas*, the prime suspect being the role of political pressure in the process. There have also been a number of famous genuine *fatwas* that have seemingly served only to confuse things further as to the true meaning of *riba*. For example, the reformer mufti, religious clerk, Muhammed Abdu, in 1904, issued a *fatwa* that considered the Egyptian Saving Fund, a form of governmental treasury bills, to be *sharia'a* compliant, because the purpose was the good of the economy and the people [7, p. 56]. In fact, the grand mufti of Egypt, Shaikh Mohammed al-Tentawi, launched an attack in the early nineties of the twentieth century against Islamic banks accusing them of hypocrisy.

[1] This evolution in the meaning of usury can also be traced to the definition of the word in the Oxford Shorter Dictionary on Historical Principles where the "old meaning of the word usury was defined as "the fact or practice of lending money at interest" but also observes 'in later use, the practice of charging excessive or illegal rates of interest for money on loan."

Conversely, the Fiqh (jurisprudence) Academy of the Islamic Conference issued a decision that considered all interest bearing instruments to be *rabawi* instruments, i.e. instruments that are based on *riba* [7, p. 57]. This issue was also present at the end of Ottoman empire and an inclination to accept a ceiling for interest rates was reflected in the *farman* that was issued in 1887 as article one stipulated that the maximum interest rate that is applicable civil and commercial debts should not exceed 9 % [10, p. 28].

3 Islamic Finance Development

The modern history of Islamic finance can be traced to the 1970s and was associated with the oil-boom at that time. Nonetheless, some attempts to establish an Islamic bank started during the 1940s in the Indian subcontinent and in Malaysia (e.g., Muslim Pilgrims Savings Corporation), but these experiments either failed or had a minimal impact and cannot be considered full fledged financial institutions [11, p. 18].

Dr. Ahmed Al-Najjar made the first real attempt to establish an Islamic bank in 1967. He was supported by West German banks and the Egyptian government. This initiative did not refer to Islam or *shariah,* and the bank was influenced by the cooperative saving schemes in West Germany. The bank did not charge, nor did it pay, interest. The profits were generated by direct participation in trade and partnership in various industries. This successful experience ended in a very ambiguous situation; some said it faced financial difficulties, while others linked the closure of the bank to political reasons (the emergence of Islamic fundamentalism) [4, p. 73]. On the other hand, the Dubai Islamic Bank, established in 1975, can be considered the first non-governmental *shariah* compliant bank. Afterward, a number of Islamic banks were established in 1977, e.g., KFH, Faisal Islamic Bank of Egypt, and others. These developments took place through the efforts of a number of major pioneers, such as Prince Mohammed Al-Faisal Al-Saud and Shaikh Saleh Kamel [4, p. 74].

The main target operations of these institutions were profit-loss sharing schemes, although these proved to be difficult and more complicated than envisaged, and the depositors feared the high risk associated with such undertakings. Thus, banks started to focus upon creating products that simply synthesized those used by conventional banks. One might argue that the fact that the majority of the people who worked in these banks came from conventional banks influenced the operation and development of Islamic institutions. This shift towards debt structures versus equity, profit-loss sharing, investment is becoming now the trend especially in the liability side of the balance sheets of IFI’s which undermines to an extent the classical Islamic finance definition.

4 The Unique Characteristics of Islamic Finance Institutions

Islamic finance banking industry is distinguished from the conventional banking sector in terms of its governing laws and operating dynamics. For a start, IFI’s are usually serving two masters, the local governing law and the Sharia’a. The story

does not end here in terms of distinguishing features but it extends to the way these institutions conduct business. In particular, the involvement and the relationship between Islamic banks and its stakeholders introduce an additional set of governance challenges that conventional banks usually do not encounter.

The prohibition of *riba* in Islam forced the Islamic finance institutions (IFIs) to look for a way to emulate conventional borrowing from the public via deposits[2] to engage in financial intermediation. This led to the adoption of mainly two finance structures that are considered to be Sharia'a compliant. The first is the Mudaraba structure[3] and the second is the Wakala.[4]

These two products are based upon the concept of profit and loss sharing and incorporate this unique characteristic of the "deposit" taking products that introduce an additional risk that depositors face in comparison to conventional depositors. In other words, the conventional depositor is guaranteed, at least contractually, that the financial institution will return the deposit either on demand or on a pre-agreed date, whereas the IFI depositor faces an additional legal risk due to the fact that the IFI is not legally obliged to return the deposit unless there is a breach of contract, fraud or negligence by the financial institution. In theory, this means that the IFI can be solvent and, at the same time, fail to return a deposit due if the underlying investment was not successful. This additional risk imposes an additional challenge for the conceptual corporate governance framework for IFIs.

In addition to the uniqueness of the nature of the deposits, IFIs usually engage in direct investments, i.e. IFIs are usually involved as a principal in many direct investments. In many cases, these IFIs, acting as financial intermediates, offer facilities, which means that there is an inherent conflict of interest, since the IFI in such a situation is the borrower and the lender.[5] It should be noted, however, that the borrower will not always be a fully owned subsidiary of the IFI.

The fact that IFIs are obliged by their constitutional documents to engage in Sharia'a compliant investments means only that any revenue that is generated from a non-Sharia'a compliant investment must be paid to charity, as the shareholders of these institutions demand that they receive only profits that are generated from Sharia'a compliant activities. To ensure that the IFI activities are Sharia'a compliant, everything is expected to be reviewed by the Shari'a Supervisory Board (SSB) pre completion and post completion of any transaction or contractual relationship the IFI was party to in the annual Sharia'a audit.

[2] Deposits usually are in the form of a loan from the client to the financial institutions. In some legal systems, such as in the United Kingdom, it is a regulatory requirement that all deposits have to be capital certain, i.e. the financial institutions are legally obliged to return the deposited amounts.

[3] In a Mudaraba Rab Al-Mal (capital owner/depositor) provides the entire capital needed to finance a project while the entrepreneur (the IFI) offers his labour and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by Rab Al-Mal (Depositor). The liability of the entrepreneur (the IFI) is limited only to his time and effort.

[4] In a Wakala the IFI acts as an agent and the depositor is considered to the be the principle. It is very similar to the relationship between asset management clients and the managers in that industry.

[5] I use the word borrower to illustrate the relationship, since, in Islamic finance, the word borrower is not acceptable, as clients never borrow funds directly (it always has to be via a Sharia'a compliant product, e.g. Ijara or a Murabaha).

Finally, IFIs usually end up owning assets, sometimes for a very short period as in the case of Murabaha,[6] or for the term of the facility as in Ijara (leasing) based structures. Ownership of any asset immediately introduces ownership risks, such as environmental liability, third-party claims, total destruction risks, and the absence of any appropriate insurance to cover these risks.

5 Governance Challenges for IFIs

In addition to the characteristics mentioned above, IFIs are prone to the same corporate governance challenges that are usually encountered by conventional financial institutions, such as the agency problem [12, p. 50; 13, pp. 57–74). However, not all Islamic economists and scholars share this view; as some argue that IFIs are immune from scandals and, due to their nature, enjoy a more efficient corporate governance structure [14]. The rationale behind these views is the theoretical framework of IFIs, which is based upon profit-loss sharing dogma. Hence, it is argued, IFIs are real partners of the depositors and, therefore, are forced by the nature of this "partnership" to have a more efficient corporate governance structure, i.e. their interests are aligned. Obviously, this is not realistic and, in fact, corporate governance challenges are greater than those that conventional financial institutions face because of the unique characteristics of IFIs which is discussed in more detail throughout this paper.

The focus of Islamic scholars in terms of Islamic corporate governance in practice has revolved so far around the transactional aspect and mainly through reviewing IFI's transactions compliance with core fundamentals of Islamic commercial law, i.e. the avoidance of *Riba and Gharar* [15, p. 4]. This emphasis has led to a negligence of the context and general framework of corporate governance in the industry. As a result the Sharia'a perspective on IFI's corporate governance was accordingly neglected.

Nonetheless, some institutional initiatives such as the IFSB and AAOIFI on corporate governance in IFI's is a step towards the emergence of a distinguished Islamic corporate governance framework. The main element that is missing in this discussion is the ethical dimension in the operations of IFI's.

6 Dilemma of Investment Account Holders

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) stipulates that:

[6] "A Murabaha is a sale on profit. Technically a contract of sale in which the seller declares his cost and benefit. This has been adopted as a mode of financing by a number of Islamic banks. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance." See www.islamic-banking.com visited on 5 January 2008.

> One of the basic characteristics that distinguish Islamic banks from conventional banks is that the contractual relationship of Islamic banks with investment account holders does not specify that holders of these accounts [sic] are entitled to a predetermined return in the form of a percentage of their investment as this is strictly prohibited by Sharia'a. Rather, the contractual relationship is based on the mudaraba contract which stipulates that profit realized from investing the mudaraba fund is shared between investment account holders- as rab al-mal- and the Islamic bank as mudarib [16, p. 4].

Clearly, this structure adds an additional ingredient to the agency problem, as the management of IFIs now acts simultaneously as agents for the shareholders and the depositors. This additional risk is one of the fundamental corporate governance challenges in the Islamic finance industry. Hence, governing bodies, such as AAOIFI and the Islamic Financial Services Board (IFSB), have issued a number of standards and recommendations to tackle this point. In 2005, the IFSB issued Guiding Principles to address corporate governance challenges confronting IFIs [17]. The guideline stipulated the best practices to ensure that IFI corporate governance structures are efficient and address its special characteristics. In the case of investment account holders, the guideline recommended that the account holders be given the right to monitor the performance of the deposit taker and that one of the main duties of the corporate governance committees in the IFI shall be to look after the interest and protect the rights of the investment account holders [17, p. 7]. Imposing a disclosure requirement on IFI's to disclose the mechanism of how the profits are divided between the IFI's shareholders and the depositors is a long waited reform that will reveal and assess the way that IFI's stakeholders are treated.

The characteristics of this industry are unique and cannot, therefore, be found in conventional financial institutions.[7] This means that the regulation and the risk management of this industry must be addressed differently [18, p. 1]. In addition, the majority of these institutions operate in emerging markets, which imposes greater levels of risks, especially in terms of corporate governance, as the concept of corporate governance itself is new. The Guiding Principles of the IFSB compare the relationship between IFIs and investment account holders to those that can be found in collective investment schemes. In addition, the IFSB recommends that IFIs fully disclose all information that is material to the investment account holders [17, p. 8]. IFIs are recommended by the likes of AAOIFI and IFSB to establish a Profit Equalization Reserve (PER) and an Investment Risk Reserve (IRR) to cushion any losses in the investments. The former is recommended to act as a profit smoother when it comes to distributing profits for investment account holders, and the practice is that any distribution from the PER should be disclosed to the account holders [17, p. 8]. It should be noted also that the PER is built by deducting a portion of the realized profit via account holders' funds. Disclosing any distribution from the PER to the investment account holders is essential, since otherwise account holders will be deceived, as they would assume that the distributed profits are the result of actual realized profit by the IFI, which is not true. IFSB also recommends

[7] These characteristics will be discussed in more detail below.

that any utilization of the PER must be appropriate and that the corporate governance committee must be authorized to review such utilization [17, p. 2.2]. Finally, the same recommendations apply to the IRR.

It should be noted that a great number of IFIs do not follow these recommendations due to the lack of enforceability, as the two main bodies, AAOIFI and IFSB, enjoy a very limited recognition by regulators worldwide.[8]

In addition to these recommendations, investment account holders should be represented on the boards of directors, as they represent a major stakeholder in IFIs. The German model of stakeholders is the most appropriate model for IFIs, and the way that the employees are represented in the supervisory board can be replicated, and the same privileges should be given to the investment account holders.

7 Fiduciary Duty Challenge

Fiduciary duty as a concept aims at defining and enforcing the duty that management owes to the company in the United Kingdom and, in some exceptional cases, to the shareholders [19, p. 263]. The tricky question is whether investment account holders can be considered part of the company. In the classic common law jurisprudence, directors' fiduciary duty consists of two main duties. The first is the duty of care, and the second is the duty of loyalty [20].

Directors of IFIs are in a constant conflict of interest position due to the nature of the IFIs' activities. In accordance with the conventional concept of fiduciary duty, they owe a fiduciary duty to the company, and the classic concept of fiduciary duty does not capture the interest of investment account holders. Obviously, this is not an issue for conventional banks depositors, as they are deemed to be creditors and are offered the needed legal protection contractually. The lack of legal protection raises the importance of corporate governance practices that offer a minimum protection for the investment account holders.

8 Governance of Sharia'a Supervisory Boards

The SSB as a body is associated with IFIs due to the nature of their business, i.e. adherence to Sharia'a. Hence, a Sharia'a expert is required to offer advice and supervision. This existence of this body raises a number of fundamental questions, such as who appoints such a body. What are the required qualifications? What is the nature of the work performed by this body, and what are the governance challenges such a body imposes?

The answer to all of these questions would require a separate body. Accordingly, general answers to these questions will be offered in this section. The shareholders usually appoint SSBs in the same way that external auditors are appointed [21]. The

[8] These countries include Indonesia, Lebanon, Malaysia, Pakistan, Saudi Arabia, Bahrain, Sudan, Qatar, Syria, South Africa and UAE. See AAOIFI presentation on the Middle East Financial Services Summit, May 2008 Kingdom of Bahrain.

SSB is an independent body that reports to the board of directors and the shareholders directly. The main reason for the existence of this body is that the constitutional documents of IFIs usually state explicitly that the activities of the IFI shall be in accordance with Sharia'a principles and that the SSB shall be responsible for ensuring that the management meets this requirement. AAOIFI offers the following definition of an SSB: "A Shari'a supervisory board is an independent body of specialised jurists in fiqh almua'malat (Islamic commercial jurisprudence). However, the Shari'a supervisory board may include a member other than those specialised in fiqh almua'malat, but who should be an expert in the field of Islamic financial institutions and have knowledge of fiqh almua'malat The Shari'a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution to ensure that the institution is in compliance with Islamic Shari'a Rules and Principles. The fatwas and rulings of the Shari'a supervisory board are binding upon the Islamic financial institution" [21, p. 4].

The second question that relates to the required qualifications for SSB members is hard to answer due to the fact that there is no formal "qualification" process or criteria that can be adopted and applied to assess whether an SSB member has the minimum requirement. As can be noticed from the SSB definition that is offered under the AAOIFI Governance Standard No 1, an SSB member should be a specialized jurist in Islamic commercial jurisprudence. This is a very broad and loose requirement and must be complemented by more specific requirements that should be incorporated in the Institution of Directors mentioned previously. Although such specific requirements are very hard to ascertain due to the nature of the requirements, usually there are minimum requirements, such as the completion of a degree in Islamic studies and a minimum number of years of experience in the field of Sharia'a advisory. This difficulty led to the emergence of a number of models when it comes to Sharia'a compliance in general. The first is the Malaysian model, which opted for establishing a central Sharia'a supervisory board that is part of the Bank Negara Malaysia (the central bank). This board has the ultimate authority to decide whether a transaction is Sharia'a compliant (See Sect. 16B, Central Bank of Malaysia, 1958). In addition, each IFI will have its own SSB, and the relationship between the IFIs, SSBs, and Bank Negara Sharia'a committee is complimentary. In Malaysia, members of the central Sharia'a supervisory board are not allowed to serve as members of any IFI SSB. Moreover, to address any conflict of interest in the Sharia'a advisory industry, Sharia'a advisors in IFIs are not allowed to serve on more than one SSB in the same industry [22]. These restrictions were introduced to avoid any potential conflict of interest. However, it should be noted that this practice is not very popular, as in the majority of jurisdictions such restrictions do not exist.[9]

The other model is what we call the GCC[10] Model, in which there are minimal governing rules that apply to SSBs. For instance, there are no minimum requirements for the qualifications and experience of SSB members, nor is there

[9] For example, Kuwait, UAE, Bahrain, UK, Qatar and Kingdom of Saudi Arabia.

[10] Gulf Cooperation Council which consist of Kuwait, Bahrain, Saudi Arabia, UAE, Qatar and Oman.

a minimum membership restriction. In other words, the conflict of interest dilemma is not addressed at all, and it is very common to see Sharia'a advisors serving as members of more than fifteen IFIs. However, absence governing regulation to Sharia'a scholars has been substituted by best practices among scholars in terms of adhering to confidentiality and other potential risks. This is why it is very rare to see that clients, IFI's, complain that this lack of formal regulation is undermining their operations.

In fact the increase of demand to SSBs services led to the introduction of Sharia'a Consultancy firms and the function of Sharia'a supervision became a widely used service that is not directly related to individuals but to firms. This development continues as there is an effort to initiate the establishment of a Sharia'a Supervisors Society in Kuwait which represents a self-regulation mechanism to this industry.

The failure to adhere to Sharia'a principles will have a detrimental impact upon IFIs and investment account holders. For the former, the reputational risk that will arise as a result of the failure to comply with Sharia'a principles will most likely lead to a bank-run, as the main reason for depositing with an IFI is the adherence to Sharia'a. As a result, any breach of such expectation will result in a run on deposits. In addition, the remedy for such failure is to pay the returns that were generated from non-Sharia'a compliant activities to charities. In other words, profits generated from non-Sharia'a compliant investments will not be paid to the investment account holders; rather, it will be paid to charity. This process is called purification. For these potential risks, AAOIFI recommends that IFIs establish internal Sharia'a compliance units to complement the SSBs and to ensure the smooth implementation of the SSB rulings [21]. The practice of purification can also be traced back to Medieval Europe when usury was considered a heinous crime that involved the exploitation of the poor and merchants that were suspected of engaging in such practice used to engage in philanthropic activities in order to clear their conscience [7, p. 5].

One of the additional SSB duties is the calculation of Zakat,[11] which is usually done on a yearly basis. This religious obligation can be seen as the social responsibility side of IFIs and is usually implemented in one of two ways. The first way is for the SSB to calculate the amount of Zakat that must be paid by the shareholders, and then the IFI pays the gross dividends to each shareholder so that he or she may use those funds to pay the Zakat. The alternative is for the shareholders to require that management pay the Zakat on their behalf.

SSB role in enforcing the ethical dimension of IFI's is something that needs to be re-evaluate it in the current practices. This dimension is relatively neglected as SSB's focus have been primarily on the compliance of IFI's with the applicable economic Sharia'a principles. Ensuring that IFI's enforce ethical values that reflects Sharia'a maxims such as.

Finally, one of the additional SSB duties is to conduct an annual Sharia'a audit. The purpose of this audit is to verify whether the instructions and rulings that were issued by the SSB in the relevant year have been implemented and followed by the IFI management (ex-post verification) [23, p. 17]. Since the result of this audit is

[11] Zakat is a religious tax to be deducted from wealth to be paid to the needy.

usually published in the annual report of the IFI, management takes this audit seriously, as any negative results will have a serious reputational risk and possibly lead to shareholder upheaval [24].

9 Ethical Framework of Trade in Islam

The claims by some that Sharia'a rules are inherently hampers trade conflicts with the basic tenants of Islam as according to Lieber, "Islam is perhaps the one great religion which affords the merchant a highly honoured place in society" [9, p. 3]. Furthermore, according to Rodinson,

> There are religions whose sacred text discourage economic activity in general, counseling their followers to rely on God to provide them with their daily bread, or more particularly, looking askance at any striving for profit. This is certainly not the case with [the] Koran, which looks with favour upon commercial activity, confining itself to condemning fraudulent practices…[I]t is reported that the Prophet said,"…merchants are the messengers of this world and God's faithful trustees on earth."

It can be inferred from these statements that Islam is not against trade or wealth; in fact, it is the other way around, as it encourages and promotes trade. This fact is reflected in the Prophet Muhammed (PBUH) hadith"The truthful and trusty merchant is associated with the prophets, the upright, and the martyrs"(*Jami' at-Tirmidhi, Vol. 2, Book 12, Hadith 1209).*

Islam sets the rules and principles that govern all aspects of human life, which include economic, social, political, moral, and all other aspects of human activities [6, p. 1]. The ethical aspects of markets has long been part of classical Islamic jurisprudence, scholars such as Abu Hamid Al-Ghazali states explicitly that markets should function freely and without withholding information, what is known today as asymmetry of information. Hording and deception is also stated clearly in Al-Ghazali writings [25, p. 30].

The ethical framework that governs trade in general in Islam is truly a distinctive feature that can present current practices with a more humane approach to trade. Looking at one of the latest codification attempts during the Ottoman Empire reflects this unique characteristic. The *majalla alahkam al adaliyyah* stipulates in Article 17 that:

> Difficulty begets facility; that is to say, difficulty is the cause of facility and in time of hardship consideration must be shown. Very many subjects of Islamic jurisprudence, such as loans, transfer of debts and interdiction are derived from this principle, and the latitude and indulgence shown by Islamic jurists in their rulings are all based upon this rule.

This ethical principle which was part of the legal system has become something of the past in terms of its applicability in the real-world by neither Sharia'a compliant institutions or conventional ones. The tenants of Islam also emphasis on tolerance when it comes to trading and conducting business as the Prophet (PBUH)

stated that "The mercy of Allah be on him who is tolerant when he sells, tolerant when he buys and (even) when he makes a claim (of debt or any other obligation)."(*Bukhari vol. 2, p. 730*). This *Hadith* sets a general governing framework for conducting business in Islam it emphasis on tolerance as a virtue that would lead to prosperity. Furthermore, the status of employees as stakeholders in the operation of any business are well protected under Islam as the *hadith* "I will be the antagonist of three set of people on the Day of Resurrection, (one of them being) he who, when he employs a person and the employee has accomplished his duty, refuses to give him (the employee) his wage." One can notice that business ethics in *Sharia'a* deals with the internal operations of businesses and with the way that businesses conduct their affairs with each other. Honesty and transparency also can be found in the Sharia'a maxim of *Gharar* as the term *gharar* is not directly mentioned in Quoran, but a number of etymologically related words are mentioned, such as delusion and deception. *Gharar* is also a concept that is controversial among various Islamic schools of thought. Some schools do accept *gharar* under the umbrella of haja, i.e. necessity. The meaning of *gharar* includes deception, delusion, and hazard or risk, and, within the financial industry, it can be defined as uncertainty, risk, or speculation [4, p. 59]. In addition, *gharar* is greater than uncertainty, as it includes all undue risks, and it can be linked or associated with maysir (gambling).

According to Maxime Rodison, "any gain that may result from chance, from undetermined causes, is here prohibited. Thus, it would be wrong to get a workman to skin an animal by promising to give him half the skin as reward…. It is impossible to know for certain whether the skin may not be damaged and lose its value in the course of work." [4, p. 59] Further, the Prophet (PBUH) "forbade the sale of…an object chosen or determined by throwing of pebble and the sale of gharar" [4, p. 60]. The Messenger also admonished against buying fish in the sea, since it is gharar. According to Frank Vogel, "A possible interpretation of the gharar hadiths is that they bar only risks affecting the existence of the object as to which the parties transact, rather than just its price. In the hadiths, such risks arise either: (i) because of the parties' lack of knowledge (jahl, ignorance) about that object; (ii) because the object does not now exist; or (iii) because the object evades the parties' control. Therefore, scholars might use one of these three characteristics to identify transactions infected by the type of risk condemned as *gharar*" [4, p. 60]. Nonetheless, one should not infer that Islam prohibits risk quite the opposite; Islamic law associates links to risk.

These humane elements of trade and finance in Islam is the true distinction between Islamic finance and conventional finance. The biggest challenge of these ethical rulings is how to translate them from simply being theoretical to incorporating them as part of the practices of Islamic finance industry. This presents a major challenge that the industry unfortunately is not paying attention to. In other words, there is a missing link between what scholars keep on emphasizing and what is been practiced translating these principles to policies and practices.

10 Ethical Dimension of the Current Financial Crisis

The current financial crisis is a true result of irresponsibility and ethical failure of the current global financial system. Tainted with unethical subprime lending that pushed a global economic collapse with US banks suffering loan losses in the region of $2.5 trillion with 8 million Americans losing their homes.

The usual economic and business reasons behind the crisis are truly symptoms as seen by many and the real cause of this crisis is a total collapse of ethical behavior in the financial sector with predatory lending being the name of the game [26, p. 1]. Organizational ethics was a total failure in the current crisis as incentives structure in these organizations was perverse and lacked any incentives to behave ethically [27, p. 5]. Official reports in the US have concluded that there had been "systemic breakdown in accountability and ethics" [28, p. 5].

The behavior of rating agencies can be seen as the igniting factor behind the current crisis as the competition and race to the bottom between Moody's and Standard & Poors led to a total collapse of their ethical framework for the mere sake of satisfying their customers. These two agencies control around 80 % of the market and the irony is that despite the fact that they are operating a business model that is based on conflict of interest hold neither of them liable for any ill advise by simply classifying their work as mere opinions that are protected by the first amendment rights [29, p. 7]. Both agencies have dropped their binomial models that have it been applied it would have not resulted in all the ratings of subprime securitized assets and other products that are main driver behind the crisis.

In addition to the practices of rating agencies banks started to widen its subprime lending practices that presents the best example of total ethical failure that led to the current crisis. Subprime mortgages were offered with no or low documentation meaning that literally anyone can apply and the banks would lend them regardless of their creditworthy. Other practices included what was known as teaser rate mortgages where interest rates were misguiding the customer by hiding the fact that after a period time applicable interest would spike. These practices aimed at luring potential clients by misguiding them that the they can afford these mortgages.

11 Ethical Supremacy of Islamic Finance

Islamic finance advocates frame their industry as being socially responsible and ethical as it is based on the principles of Sharia [30, p. 80]. This theoretical framework can be found in the work of scholars, however, the reality may differ. In particular, the trend of Islamic finance institutions in emulating conventional finance has been criticized and seen as a failure of introducing genuinely distinct product that is ethically superior.

In contrast to conventional financial institutions whom primarily concentrate on the financial returns of transactions, Islamic Finance must pay attribute to ethical, social economic [30, p. 76]. The theoretical foundation of Islamic finance emphasis on the importance of making a return and the preservation of the morality [31, p. 35].

This ethical foundation must be reflected in the way that Islamic finance institutions are conducting their business which is something is yet to be settled in reality. Should Islamic finance institutions be based on shareholders' primacy which revolves around the profit maximization proposition or should it be based on stakeholders' primacy. It has been suggested that the notion of the Islamic Finance system according to the sharia principles tend to protect the interests of shareholders and stakeholder at the same time [32, pp. 43–63].

It has been said that the prominent Islamic scholar Ibn Rushd agreed with the Aristotelian opinion that "Happiness not only includes the acquisition of measurable things (wealth, assets, etc.) but also, the full range of human life and action, involving moral virtue and practical wisdom [31, p. 39; 33]. Bearing in mind that the Sharia provisions does not prevent the maximization of personal wealth but it poses obligations at the same time to taken into consideration the prosperity of the public as well. It has been alleged that the existed Islamic finance transactions are not fully compatible with the ultimate objectives of sharia [31, p. 51].

It has been suggested by Dean the there are eight ethical principles the practitioners in the financial sectors must adopt: "1. Due care and concern for others in professional activities; 2. Respect, where appropriate confidentiality; 3. Fidelity to special responsibilities; 4. Avoidance of conflict of interest; 5. Willing compliance with the law; 6. Acting in good faith during negotiations; 7. Respect for human well-being; 8. Respect for liberty and constitutional rights of others". All these ethical principles can be found in the realm of Sharia'a scholars workings [31, p. 51; 34, pp. 285–290] but it is rarely reflected in the operation of Islamic finance institutions.

The current financial crisis has threatened the ethical foundation of conventional finance as it has been admitted that the financial crisis was attributed to the failure in morality, greed, exploitation and corruption [35, p. 66].

Looking at the practices of Islamic finance institutions similar flaws can be found. This does not mean that theoretical and ethical foundation of Islamic finance are flaw in fact in 2009 the Vatican stated that "*The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service*,". This reality imposes serious challenges on Islamic finance industry to distinguish itself from conventional finance not in terms of prohibition of interest as it has been the ultimate focus since the inception of modern Islamic finance industry but rather the true distinction should be based on the ethical foundation of Islamic finance.

This overlap between theology and finance can be traced all the way to the 15th century as Antoninus the Archbishop of Florence was particularly focused on his preaching on the ethics that governs the relationship between the borrower and the lender [7, p. 5].

12 Islamic Finance and the Financial Crisis

The 2008 financial crisis has been described as the great recession due to its severity and impact. In particular, the crisis hit the banking and financial systems and as a result it presented a unique natural experiment to examine the resilience of Islamic

banking. The crisis has also been seen as an opportunity for Islamic finance to raise and influence the modern banking and financial systems as the crisis led everyone to start questioning the current structure of financial systems. According to Lord Turner "what has occurred is a shock to a set of intellectual assumptions about the way that markets work, about their self-equilibrating character" the same has been stressed by various authoritative figures. This has left the door open for new ideas and Islamic finance had an unprecedented opportunity to merge and influence mainstream finance.

In order to have such impact Islamic finance industry must showcase its resilience and the minimal impact that the current crisis had on its institutions. The bulk of writings that emerged as a result of the current financial crisis aimed at showing how economically resilient the Islamic finance industry to what has happened [36], rather than emphasizing on the ethical supremacy and how its been translated on the ground by praising ethical practices that are lacking with the conventional institutions. The role of SSB's should evolve to capture and emphasis this dimension in the operations of IFI's. The governing ethical framework between customers and IFI's should be distinct from the one that is practiced and followed by conventional banks. The move toward a shared value approach as a new model of conducting business should be the aim of the industry and in particular Sharia'a scholars involved in the industry. Since its modern inception, Islamic finance industry has aimed at overcoming the prohibition of *riba* by engineering new products that mirrors economically what is been offered by conventional banks. The next phase of intellectual and practical evolution of this pivotal industry is to re-examine the ethical foundation governing its current practices and present a set of new ethical maxims that can move the industry from being a Muslim based industry to an ethical and global industry.

13 Conclusion

The paper aimed at shedding the light on the importance of focusing on the ethical framework and practice of IFI's as a true differentiator from conventional finance and its philosophical and ethical foundation especially after the current financial crisis. This crisis presented a unique opportunity for Islamic finance and Sharia'a to participate and push the global agenda towards more ethical financing, however, the reality suggests otherwise.

This reality combined with the fact that the governance structure of Islamic finance institutes raised a number of new challenges and risks that were never considered to be a concern for lawmakers and regulators can be seen as a recipe of disaster. The theoretical foundation of IFIs raises serious issues of governance such as conflict of interest and fiduciary duties dilemma as has been highlighted in this paper. The only two organizations that have introduced practical solutions internationally are AAOIFI and IFSB. The fact that both organizations lack the needed enforceability undermines their efforts. The failure to address these deficiencies in the corporate governance structures of IFIs is a serious threat to the industry as a whole. We must remember that this is an infant industry and is still

fragile. Any serious reputational risk can have a detrimental impact upon and lead to the collapse of this new and vibrant industry. Regulators who aim to develop this industry, such as the Financial Services Authority, should consider the recommendations and the standards issued by these two organizations and acknowledge the unique characteristics of this industry.

The current phase of governance practices in IFI's on both the practical and theoretical sphere has been merely focusing on what I call the formalistic school of thought. That is, an approach that aims at integrating best practices of corporate governance in the conventional world along with some unique technical aspects of IFI's that have been discussed in this paper. However, one would expect that the practices in the industry should evolve to what is known as the *Maqasid* (objectives of Sharia'a) school[12] [37, p. 279]. In this stage one would envisage that the involvement and relationship between IFI's and its stakeholders would develop from the protection of the interests of these various stakeholders to a cooperative model that would aim at achieving social justice as the underlying foundation of the prohibition of usury in Islamic law. For example, the way that IFI's deal with its debtors should be different from that of conventional banking especially by applying the Quranic verse "And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [from your right as] charity, then it is better for you, if you only knew". Failure to evolve to this level and abandon of the current formalistic foundation of the industry will confirm the thesis that Islamic finance industry is a mere replica of conventional finance. The seeds of such positive development can be traced to the seminal paper by Muft Uthmani in relation to the Sukuk that was later reflected to one of AAOIFI Sharia'a standards in 2008 where he emphasized on the importance of maqasid over formalistic approach in the Sukuk industry [38].

The role of SSB needs to evolve from its current rule that focuses primarily on the compatibility of the products offered by IFI's with Sharia'a to become the ethical guardian of IFI's practices. This move will help in institutionalizing the ethical framework that should be governing IFI's. The current financial crisis has illustrated that one of the main drivers that could affect the operation of any economy is the failure of ethical foundations. The existence of SSB's positions IFI's in a better position in comparison to their conventional counterparts institutionally and reforming SSB's functions with more emphasis on the ethical implications of IFI's practices can truly reflect a superior ethical position of IFI's.

Finally, the fact that Islamic finance industry is the only major industry that focuses on interest and usury while all other socially responsible investments are specializing on other areas such as environment positions Islamic finance uniquely. In specific Islamic finance scholars and institutions should move to the next level by pushing the ethical lending agenda further by advocating, preaching and reflecting these ethics on their practices and the financial industry in general.

[12] The maqasid approach can be traced to the writings of Choudhury and Hoque quoted in.

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