

## **Defining Ethics in Islamic Finance: Looking Beyond Legality**

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### **1. Introduction**

The pioneers of Islamic economics asserted that an economy based on Islamic values and principles would produce a moral economic system serving the needs of not only Muslims but humanity at large. The economy would strive to fulfill the goals of Shari'ah (maqasid al-Shari'ah) and result in achieving a just and vibrant economy. The financial sector was expected to entail risk-sharing features and serve all sections of the population thereby bringing about equity, stability and growth. The manifestation of Islamic economics, however, ended up as sub-economies in the financial sector. While the growth of Islamic financial industry in its short history has been impressive, there is a general feeling that Islamic finance has failed to fulfill the social and ethical goals of Shari'ah.

Although the criticisms labeled against the industry need to be verified empirically, there is a need to come up with a clear understanding of what is considered ethical in Islamic finance. Addressing this issue would require examining the nature and responsibilities of a firm. Carroll (1979) and Schwartz and Carroll (2003) identify the responsibilities of a firm as economic, legal, ethical and philanthropic/discretionary. The economic responsibility is obvious given that firms supply goods and services to earn profit. Firms have to comply with all the laws and regulations of a country in the pursuit of profit. Other than the economic and legal responsibilities, the society also expects firms to follow certain ethical norms. Finally, it may be desirable for firms to be philanthropic, though this is left to their choice and discretion.

Being a part of the moral economy and following the Shari'ah principles, the nature of responsibilities for Islamic firms in general and Islamic banks in particular changes. Islamic banks have to conform not only to the national laws and statutes, but also to the Islamic law of contracts at the transactions level. Furthermore, being ethical is required of an Islamic firm, not just expected. As ethics is considered a key for Islamic banking practice, there is a need to define its scope from an Islamic perspective. Note that ethics is difficult to define even for conventional businesses.<sup>2</sup> For Islamic banks it becomes even more difficult as it will include the ethical standards that apply to conventional banks and some additional requirements.

As Islamic banks comply with the values and principles of Islam, there are additional factors that influence ethics. Specifically, two other norms of morals and laws will also affect ethics of Islamic banks. Whereas there is some discussion on the relationship between Islamic law on ethics, there is no research (to the best of my knowledge) linking ethics of Islamic banking practice to moral issues. This paper attempts to fill this gap by providing a framework of ethics for of Islamic finance by linking it to morality. I argue that to arrive at an appropriate

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<sup>2</sup> The concepts of morals and ethics are vague even in conventional literature. Vesilind (1988) is of the view that even ethicists cannot agree on the definition of ethics. Lewis (1985) and Carroll (1979) points out the difficulty in defining ethics from the perspective of businesses.

Islamic stance on the ethics for Islamic banking there is a need to go beyond the legalistic arguments and examine the moral principles derived from Islamic teachings.

To have the discussion in some perspective, the paper examines the ethical issues arising from debt, a key instrument used by the banking sector. Whereas the ideal model of Islamic banking envisaged a two-tier *mudarabah* model, Islamic finance turned out to be one that is dominated by debt-based instruments. Although debt will be an integral part of an Islamic financial system, its magnitude and impact on individuals and society may have certain moral implications. However, the moral consequences of debt have been ignored in the Islamic finance practice and discourse. This is apparent from the indifference shown by some practitioners, Shari'ah scholars and Islamic economists towards larger share of debt in the economy, both at the individual and national levels. The lack of concern towards increasing debt levels stems mainly from adopting a legalistic approach that asserts that as long as debt is created by Shari'ah compliant means, its level is not considered a problem. I argue that this legalistic approach can lead to unethical practice as it ignores the broader issues related to moral teachings of Islam.

The paper is organized as follows. To have a clear understanding of different norms, the next section provides definitions of morals, ethics and laws. Section 3 discusses the three norms from an Islamic perspective. After providing a classification of acts as legal and moral, the section reviews the relationship of ethics with law and morality. In Section 4, the implication of moral teachings of Islam on ethics of Islamic banking practice is discussed in relation to financing debt. The last section concludes the paper by providing some suggestions of improving ethical practices of Islamic banks.

## **2. Morals, Ethics and Laws**

Norms in any society can be distinguished as morals, ethics and laws. To avoid confusion about these concepts and to determine how they are related to each other, there is a need to clarify what they mean. Hazard (1994-1995: 451) defines morals as 'notions of right and wrong that guide each of us individually and subjectively in our daily existence'. Erhard et. al. (2009: 35-36) view morality as a societal issue and defines it as 'the generally accepted standards of what is desirable and undesirable; of right and wrong conduct, and what is considered by that society as good behavior and what is considered bad behavior of a person, group, or entity'. They place morality in the realm of 'social virtue domain'. Morals are embedded in cultures and determined by a variety of factors such as upbringing, education, religion and environment. Morals tend to have emotional orientation whereby its validity is taken as given (Ray 1996).

Hazard (1994-1995: 453) defines ethics as 'norms shared by a group on a basis of mutual and usually reciprocal recognition'. Erhard et.al. (2009: 36) provide a more elaborate definition of ethics as 'the agreed on standards of what is desirable and undesirable; of right and wrong conduct; of what is considered by that group as good and bad behavior of a person, subgroup, or entity that is a member of the group, and may include defined bases for discipline, including exclusion'. They identify ethics to be in the realm of 'group virtue domain'. One way in which ethics can be understood is to examine the ends or consequences of actions or activities. Thus, an act will be ethical 'when it promotes good of society or more specifically, when the action is intended to produce the greatest net benefit (or lowest net cost) to society when compared to all of the other alternatives' (Schwartz and Carroll 2003: 512).

Laws are 'norms formally promulgated by a political authority that are enforceable and more or less regularly enforced through a legal process based on adjudication (Hazard 1994-1995: 448) Erhard et.al. (2009: 37) put law in the realm of 'governmental virtue domain' and

defines it as ‘the system of laws and regulations of right and wrong behavior that are enforceable by the state through the exercise of its policing powers and judicial process, with the threat and use of penalties, including its monopoly on the right to use physical violence’. In general, law entails a body of rules which can be formed through statutes, decrees and edicts, decisions of judges or jurists, etc. While ethics entails standards that members of a group are encouraged to follow and realize, law sets clear rules and standards that are enforced by higher body (such as government) by using punishment and sanctions (Ray 1996: 50).

The norms of a society residing at different levels as morals, ethics and laws have unique features and are interrelated. Whereas morals relate to individuals and are subjective, ethics is more rational and can change in the context of a group. Ethics is considered as an aggregate concept whose components are morality (Ray 1996). Unlike law, ethics and morals cannot be adjudicated or enforced by an authority. In the Western legal scholarship there is a debate among the legal theorists on the role morality plays in laws. While the positivist theorists (such as Hart) view law as amoral, interpretive theorists (such as Dworkin) link laws to morality (Donato 1988). Hazard (1994-1995) takes the interpretive view and maintains that ethics and morals shared by individuals and community can influence laws. With concerted efforts, it is possible for individuals in a community to convert a moral norm into a law. Although the three norms are expected to be complimentary, yet they can potentially contradict each other. For instance, enacted laws can turn out to be either unethical or immoral. Examples of such laws included ones that legalize slavery and discrimination.

As mentioned, the relevant norms affecting financial institutions are laws and ethics that govern their operations and activities. While laws apply equally to all firms, ethical norms in the organizational setting are more specific to tasks and situations which members in a firm face (Sinclair 1993). Davies (2001: 282) indentifies some of the ethical norms for financial institutions as conduct operations with integrity and due skill, care and diligence, organize the affairs responsibly and effectively with adequate risk management systems, observe proper standards of market conduct, ensure that conflict of interest does not exist, pay attention to the interests of its customers and treat them fairly, etc.

### **3. Ethics, Morality and Legality from an Islamic Perspective**

The essence of Islamic worldview is *tawheed* which means oneness and sovereignty of God (Allah). Though *tawheed* means unity of God and creation, it has implications related to all aspects of life including economics and finance. The concept of *tawheed* also implies that God is the only source of value and norms. Thus, all discussions on law and morality ensue from this concept (Kamali 2008, p. 17). Islam, being a complete code of life provides rules and norms for economic activities and transactions. Islamic economics and finance will reflect the Islamic worldview and, as such, is driven by Islamic laws and morals related to economic transactions.

The underlying principle guiding *Shari’ah* is that ‘God orders the good because it secures the welfare of the community and forbids evil because it is evil and because it is against the public good’ (Abdel-Wahab 1962-63: 122). As *Shari’ah* entails all the teachings of Islam, it is understood to include both Islamic morals and laws. The implication is that Islamic law and morality are expected to contribute positively to the welfare and public good (*maslahah*). For the purposes of this paper, however, we use three domains of norms discussed above: morals related to individuals (and society), ethics belonging to groups including organizations, and laws governed and implemented by entities with legal and regulatory authority.

The distinction between laws and morals can be made by examining the section of Islamic jurisprudence known as *hukm taklifi*. Accordingly, any human act will fall under one of the following five types: obligatory (*wajib* or *fard*), recommended (*mandub*), reprehensible (*makruh*), permissible (*mubah*) and forbidden (*haram*) (Reinhart 1983: 195). Kamali (2008: 47) contends that while the first and last types of activities (*wajib* and *haram*) have legal force, the remaining three activities fall in the domain of morals that cannot be adjudicated in courts. When *Shari'ah* proscribes usury or gambling, these become legal obligations. However, Islamic teachings encouraging people not to cause injury to women and elderly or animals reflect 'the moral underpinnings of *Shari'ah*' (Kamali 2008: 49).

The moral teachings in Islamic will take the form of encouraging the recommended and avoiding the reprehensible. The morals related to the recommended and the reprehensible are derived by from *Shari'ah*. While there are some clear indications about morality in the texts, others are implied and are extracted indirectly. Example of a clear recommendation is found in the Prophetic sayings "Feed the hungry, relieve the distressed and visit the sick" (Khan and Hasan undated: 100). An example of an indirect implied norm can be observed in the saying of the Prophet (PBUH) "Oh God, I seek your refuge in You from niggardliness" (Khan and Hasan undated: 84). The implication of the above *hadith* is that niggardliness is a morally reprehensible act and as such should be avoided. Similar conclusions can be drawn from the verses of the Quran. Uddin (2003) derives some norms for business related practices from different verses of the Quran. For example, he concludes that Quran (17:36) can mean "honesty and truthfulness; investigation and verification before action; right and ethical conduct; true witness". Quran (11:85) can be interpreted as 'no deception in measure and weight, mischief and corruption is avoided'.

Note that while the legal issues were adjudicated by independent courts in Islamic societies, the institution of *hisbah* (in charge of promotion of good and prevention of evil) historically functioned to support moral values (Kamali 2008). This not only shows the difference of the legal and moral aspects in the light of *Shari'ah*, but is also indicative of the importance that Islamic societies place on morality in general. Given the above framework, the roles of law and morality on ethics at the organizational level are discussed next.

### ***Islamic Law and Ethics***

The basic principle for commercial transactions is 'permissibility' which signifies that all acts/contracts are permissible unless there is a clear injunction of prohibition (Kamali 2000: 66).<sup>3</sup> The two broad categories of prohibitions related to economic transactions recognized in *Shari'ah* are *riba* and *gharar*. At the contract level, these prohibitions are intended to bring about fairness and good measure and, as such, these get more consideration over complete freedom of contracts (Saleh 1992: 146). The legal maxim 'in contracts, attention is given to the objects and meaning, and not to the words and form' (Majallah 2001, Article 3) provides the guiding principle of devising contracts in financial transactions. While the form is the contractual construct of the transaction, the substance relates to the outcome. For example, the outcome of a sale contract is the transfer of ownership of an asset in exchange of price. Fulfilling the form, but not the substance will not be harmonious with the spirit of Islamic law.

Reinhart (1983: 186) maintains that Islamic law is not just a law, but inheres ethics as both constitute 'a call to righteous action in conformity with the guidance of Revelation'. Thus, while the ethics related to contracts will include virtues such as honesty, trust, transparency, etc, they also will incorporate fulfilling the legal obligations and stipulations. As a result,

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<sup>3</sup>Also see Fatwa No. 1 of the First Albaraka Seminar 1981 (Dallah Albaraka 1994:75-76).

ethics can be evaluated by examining whether the legal conditions and stipulations of a contract are fulfilled or not (Arabi 1997). For a transaction to be ethical, the overall goals of *Shari'ah* (*maqasid*) should also be fulfilled at the contract level. Other than avoiding *riba* and *gharar*, Kahf (2006) indicates that fulfilling *maqasid* at the transaction level would involve satisfying the objectives, principles and values underscored in the Islamic laws of transactions. This would include, among others, linking returns to risks and bearing the risks of ownership by the owner of the asset. An important related principle includes fulfilling the conditions of a sale which is realized by transferring the asset to new owner. Similarly, conditions of trust and guarantee relationships in terms of liability of loss has to be implemented. Given the divine nature of these conditions, a contract would be considered unethical if some of these stipulations are fulfilled.

Another aspect related to ethics at the contract level relates to intention (*niyah*) and outcomes. While *niyah* is an integral component in worshiping rituals (*ibadat*), in economic affairs (*muamalat*) there is difference in opinions about its status among different schools of thought. Note that all schools agree that illegitimate motive will make a contract illegal even when the all the legal components of a contract is fulfilled. The disagreements arise in relation to the status of intentions when they are not explicit in contracts (Arabi 1997: 215). Thus, an intention of coming up with an illicit act using a valid contract would not only be void, but also immoral. The legality of a transaction will not only depend on the validity of a contract but also on the end use of the contract which can be deduced ex-ante by the *niyah* and ex-post by examining the outcome or consequences.

### ***Islamic Morals and Ethics***

All Islamic banks will be expected to be ethical in ways similar to their conventional counterparts. As mentioned above, these ethics include among others conducting operations with integrity and with due skill, care and diligence, avoid conflict of interest, etc (Davies 2001). As ethics relates to the notions of what is right and wrong in the organizational context, for Islamic banks it will also be influenced by the Islamic notions of legality and morality. As such, Islamic banks will have additional ethical dimensions arising from their adherence to the laws and morals of *Shari'ah*. Although Islamic scholarship has discussed issues related to the application of laws to ethical practice, the relationship between morality and ethics has not been addressed.

If the ethical and legal norms are presumed to coexist in a transaction, some may argue, as some *Shari'ah* scholars do, that as long as the requirements and stipulations of the contract are fulfilled, the contract will be both legal and ethical. However, this argument may lack credence as the outcome of the transactions can lead to adverse effects on morality and societal welfare. One way to link morals to ethics is to examine the impact of activities of firms on the society. As pointed out by Schwartz and Carroll (2003: 512), a business activity will be ethical if it promotes good in the society. We use the same logic to determine the ethicality of transactions and activities of Islamic banks. Specifically, activity of an Islamic bank would be ethical when it enhances welfare (*maslahah*) and morality of individuals in the society. On the contrary, any banking practice that produces adverse effects on either welfare or Islamic morals would be considered unethical. A specific example showing the moral implications of debt and its relation with ethics is discussed next.

## **4. Morality and Ethics: The Case of Debt**

In an Islamic economy, debt can be either created by interest-free loans or sale-based debt-instruments. Debt can be create transactions involving *murabahah* (cost-plus or mark-up sale), *bai-muajjal* (price-deferred sale), *istisna/salaam* (object deferred sale or pre-paid sale)

and *ijarah* (leasing).<sup>4</sup> Islamic banks do bulk of their financing by using the fixed-income debt based products. While debt is permissible in Islam, some moral issues related to its size and magnitude can arise. To study the ethicality of extensive use of debt, the morals and welfare implications related to indebtedness are discussed below.

### ***Morals Related to Debt***

While Islam does not prohibit debt, several sayings of the Prophet (PBUH) discourage Muslims to engage in excessive indebtedness. The following sayings (*hadith*) provide the moral implications related to debt:

Narrated 'Aisha: Allah's Apostle used to invoke Allah in the prayer saying, "O Allah, I seek refuge with you from all sins, and from being in debt." Someone said, O Allah's Apostle! (I see you) very often you seek refuge with Allah from being in debt. He replied, "If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises." (Bukhari, Volume 3, Book 41, Number 582)

Narrated Salama bin Al-Akwa: Once, while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, "Is he in debt?" The people replied in the negative. He said, "Has he left any wealth?" They said, "No." So, he led his funeral prayer. Another dead man was brought and the people said, "O Allah's Apostle! Lead his funeral prayer." The Prophet said, "Is he in debt?" They said, "Yes." He said, "Has he left any wealth?" They said, "Three Dinars." So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), Please lead his funeral prayer." He said, "Has he left any wealth?" They said, "No." He asked, "Is he in debt?" They said, ("Yes! He has to pay) three Dinars', He (refused to pray and) said, "Then pray for your (dead) companion." Abu Qatada said, "O Allah's Apostle! Lead his funeral prayer, and I will pay his debt." So, he led the prayer. (Bukahri, Book 37, Hadith 488)

The above two sayings of the Prophet clearly indicate that a Muslim should try to stay away from debt. In the first hadith, the Prophet is seeking refuge from sins and debt, thereby implying the negative attributes of both. In the second hadith, the Prophet refused to lead the funeral prayer of someone who died indebted and did not have the means to repay it. The incident shows even though the deceased was a Muslim, the consequence of not repaying the debt was a serious enough factor that led him not to lead his funeral prayer. The implications that one can draw from these sayings of the Prophet are the following: people should take on debt only if it necessary, the debt should of amounts that is within a person's capacity to repay, and once indebted people should strive to repay it back.

### ***Welfare Implications of Debt on Individuals and Society***

The recent financial crisis exposed the damaging features of excessive debt in the economy. It revealed that too much debt was one of the key causes of the predicament and harmed many indebted individuals and economies at large. The aftermath of the crisis led to a renewed scrutiny on the harmful consequences of debt. The weekly Economist published a special report on debt in its 24 June 2010 issue in which it examined various aspects of indebtedness. The morals related to debt changed from being something negative in the past to acceptable in the present. Over the past century taking on debt became fashionable and was promoted in the society, both at the individual and national levels.

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<sup>4</sup>For a discussion on these modes of financing see Ayub (2007) and Usmani (1999).

The result of the change in attitude results in the increase in levels of debt for individuals, corporations and nations. This is reflected in rise in the amount of household debt from about GBP 14,000 per head to GBP 24,000 per head between 2001 and 2010 in UK and from USD 27,000 to USD 44,000 in the US during the same period (Economist 2010b). The corresponding figures for public debt were GBP 5,000 and GBP 18,000 and USD 16,000 and USD 34,000 for UK and US respectively. For ten industrialized countries, the average total debt (private and public) increased from 200% of GDP to 300% between 1995 and 2008, with Iceland having a debt 1200% of its GDP (Economist 2010a).

High levels of debt have various detrimental effects on both individuals and national economies. A study revealed that higher debt levels were associated with lower levels of growth (Economist 2010a). In a study, Campbell and Hercowitz (2009) find the higher growth in the level of debt reduces the welfare of households. Economist likened debt to alcohol and nicotine stating ‘a debt boom tends to induce euphoria’ (Economist 2010a). Analyzing the problems related to the crisis, Taleb and Spitzagel (2009) identifies too much debt as the ‘real evil’.

Data shows that Muslim countries are not immune to the culture of debt. Consumer debt in the GCC peaked in 2008 at \$151 billion and then fell to \$139 billion in August 2010 in the aftermath of the crisis. The growth rate of the level of outstanding debt was 80 per cent between 2002 and 2010 (White 2010). A survey shows that 52 per cent of the youth are indebted in Saudi Arabia, of which two-thirds is due to credit cards (White 2010). A study on UAE revealed that 85 percent of UAE residents are in debt, many having difficulty in paying their dues (Walter 2010). Another survey reveals that over 25 percent of UAE residents have a debt of Dh 250,000 each and 40 percent have personal loans between Dh 100,000 and Dh 200,000. Interestingly, 20 percent did not have any idea of the amount of debt they owed (Emirates 24/7 2011). A report by Lafferty Group in 2010 indicates that there were 199.4 credit cards for every 100 people in the UAE, which is one of the highest in the world. After the crisis, the amount of bounced checks increased to 25 percent in UAE (Sambidge 2010).

Part of the problem of high indebtedness is the easy access of credit and the willingness of banks to provide facilities with relatively lax standards. Some specific cases in the UAE indicate banks were permissive with lack of proper scrutiny of clients before providing credit. Walter (2010) reports that a person with a salary of Dh 15,000 ran up debts of Dh 250,000 and people with salaries of as low as Dh 6000 managed to get eight credit cards. While it is difficult to ascertain the extent to which the debt was fueled by Islamic banks, given the significant share of the Islamic banking sector in the country it is safe to conclude it has played an important role in the buildup in indebtedness.<sup>5</sup>

### ***Ethics of Debt for Islamic Finance***

The above discussion indicates that there may not be any ethical issues arising in using debt from a legal perspective as appropriate *Shari’ah* compliant instruments can be used to create it. However, the morals derived from the Prophetic traditions indicate the Muslims should strive to keep the levels of debt to a minimum. If the objective on Islamic banks is to expand business by financing goods and services that results in higher indebtedness among individuals, then they contribute to the immorality of being highly indebted as perceived from an Islamic perspective. Consequently, if the banking practices affect moral values negatively, the practice of Islamic banks would be considered unethical.

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<sup>5</sup> The share of deposits and loans provided by Islamic banks in UAE stood at 18.7 percent and 16.4 percent of the total banking system in 2010 (CPI Financial 2011).

Beyond the moral proposition from a religious point of view, limiting the level of debt also can be rationalized from the perspective of welfare (*maslahah*) implications at the individual and societal levels. As discussed above, higher levels of debt can affect the welfare of individuals in the economy adversely. The evidence of the adverse impact of debt on individuals and national economies indicates that the levels of debt must be kept reasonable and manageable. If Islamic banks ignore the harmful effects of debt on individuals and help fuel its increase to levels that start to affect welfare of the people negatively, then these activities could be considered immoral from an Islamic perspective. The implication is that if Islamic banks focus narrowly on the legal technicalities and ignore the impact debt on the moral teachings and *maslahah*, they fail to operate ethically.

## 5. Conclusion and the Way Forward

The paper discussed the role of laws and morals in defining ethical practices of Islamic banks. While Islamic law and ethics appears to be closely linked, cases may arise when the practice of Islamic banks can produce unethical results even when the contracts are legitimate. To judge if banking practices are ethical or not, it is important to examine the consequence of transactions on morality and welfare. Situations can arise when the transactions may not have legal/ethical issues at the contract level, but can be unethical as it has adverse impact on welfare or morality. The paper examined the morality of excessive and concluded that the practice of Islamic banks could be unethical if they fuel the increase in indebtedness of individuals beyond certain levels.

The ethicality of Islamic banking practice arising from the effects on moral values cannot be grasped by focusing at the legal aspects of contracts only. A question then arises whether morality and ethical norms can be realized by Islamic banks that are engaged in expanding their businesses in competitive markets. While there are certain aspects of ethical self-regulation at the organizational level that can be useful, it has limitations. Davies (2001: 281) points out that self-regulation may not be appropriate for ‘raising standards in the market as a whole, or dealing with a problem where there was a need for the whole industry to change’. Furthermore, when the conduct of banks has implications that go beyond its realm and affects other members of the society, regulatory oversight may be necessary to govern these activities.

If Islamic banks narrowly focus on legality of transactions that can lead unethical outcomes, there is a need to have a mechanism to ensure that the Islamic banking practices are ethical by not contradicting the moral teachings of Islam. Kamali (2008) asserts that if public interest (*maslahah*) necessitates it, a lawful government is authorized to change the reprehensible into forbidden and the recommended into obligatory. In the past, Islamic societies had institutions that oversaw the morals issues related to economic affairs. Kamali (2008) maintains that while the courts dealt with the legal issues, the market controller (*muhtasib*) was authorized to intervene and stop immoral practices. During contemporary times, this role can be taken up by the regulators whereby ensuring ethics at the organizational level is moved to the public domain. The paper suggests that there is an additional role of regulators overseeing Islamic financial industry—it is to promote morality-enhancing ethical behavior in Islamic banking practices.

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