



Islamic Finance: The Ethical Ideals vs the Controversial Practice

Abderrafi EL MAATAOUI

CSAA-AAOIFI, Chartered Public Auditor, ISCAE Doctoral School
Email : finaliancesarl@gmail.com

Abstract:

Ethics resonate well with the Islamic finance moral goals. But, the tremendous commercial and financial success of Islamic finance over the last three decades raises some questions about the practice adherence to the original moral goals of finance in Islam. The goal of this paper is to highlight the significant criticism addressed by prominent specialists to the excessive use of debt based products and non-participatory financing contracts such as Murabaha and Ijarah. The negligible part of participatory financing contracts such as Musharaka and Mudaraba is also pointed out by jurists and practitioners. Also, some key issues are involved in Islamic banks controls by the Shari'a Supervision Board, and in corporate governance related to investment accounts holders.

Key words: Ethics, Islamic finance, Islamic banks, Murabaha, Shari'a Supervision Board.

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Introduction

Over the last three decades, the international Islamic finance sector grew at a rapid and unprecedented speed from nearly \$ 50 billion in assets in the early 1990s to \$ 2293 billion in 2016 ¹ across the banking sector, Islamic capital markets, and Islamic insurance (Takaful).

The ideal of Islamic finance is to improve, both on an individual and collegial side, the human condition on Earth, to establish social equality, and to prevent injustice in trade and finance. This is the origin of the prohibition of interest and its replacement by a fair system of sharing of profits and risks between lenders and borrowers.

This paper is an attempt to shed some light on how the practice of Islamic banks responds to this goal, in a business context marked by a strong competitive pressure. In a first section we recall the basic pillars of Islamic finance. In a second section we highlight some major criticism areas against the Islamic finance and the banking industry model as practiced in reality and that may jeopardize its credibility.

1- Pillars of Islamic Finance

Islamic finance falls within the framework of the Islamic commercial jurisprudence (fiqh al_mouamalat). The basic general rule of this branch is the original permission or lawfulness. This rule states that everything is lawful until an opposite argument proves its prohibition.. It is forbidden only what has been prohibited by an authentic and explicit position of the Shari'a. In this field, the scope of the prohibitions is very narrow (interest and usury, speculation, uncertainty,...), whereas the scope of Shari'a-compliant possibilities is huge.

According to the mainstream view, the Islamic finance model construction is based on five key pillars:

- i. The prohibition of Riba : Conventional finance makes a difference between between the acceptable interest, and the usury which is the excessive rate of interest beyond which it is prohibited to lend money. On the opposite, Islamic finance does not make this distinction, as both lending money at predetermined interest at any rate and usury at excessive rate, are considered commonly as Riba and prohibited.
- ii. The asset backing: This commonly accepted rule states that all contracts must be backed by a productive project of goods or services, or by the transfer of goods. The lawful profit is realized from a real production of wealth. In other terms, all financing by Islamic banks must be backed by a real and tangible asset.

¹ Dubai Islamic bank, « GLOBAL ISLAMIC FINANCE REPORT 2017 »,P 36



- iii. The prohibition of excessive uncertainty in contracts (Gharar): the term “Gharar” defines a transaction in which there is an unacceptable level of uncertainty about the object of the contract. Gharar is the case of a contract in which one or more essential items are not disclosed, unclear, or uncertain, such as price, nature, delivery, delay,... Accordingly, the sale of risk is not Shari’a-compliant (conventional insurance, conventional derivatives created by the Mortgage backed security industry : CDOs, CMBSs, CDSs ,)

As a consequence, the prohibition of speculation or gambling (Mayssir): "purely speculative" activities that have no productive or economic wealth-creating purpose are also prohibited.

- iv. The ban on investing in illicit activities such as the alcohol and tobacco branch, the pornographic industry, gambling, the traditional banking sector based on interest and usury, ...
- v. The sharing of profits and losses: in Islamic finance, the fundamental relationship between the financiers and the entrepreneurs is based on a partnership and involves a fair sharing of risks and profits.

2- The Major critics against the Islamic finance banking practice

Despite the great commercial success of Islamic banks over the last decades, this growing faith-based finance is facing vital challenges. After more than 40 years of existence, significant critics have raised about the practice conformity with the original moral aspirations and claims of Islamic economy based on social equity, risk and profit sharing, and fair redistribution of wealth.

The major fundamental critics addressed to the common practice of Islamic banks are highlighted as follows:

2-1 The Murabaha and Ijarah “syndrome”

Murabaha (known as Mark up or Cost plus financing), and Ijarah ((known as leasing or hiring) financing modes are widely used by Islamic banks in different countries of the world. According to a joint World Bank-IDB report², Murabaha is defined as “a contract between a financier and a client through which the financier purchases assets required by the client and

² World Bank, Islamic Development Bank, Islamic Research and Training Institute, (2015),” Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)”



then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in installments. ”.

Ijarah is defined by the same report as “a contract through which one party "lessor" leases an asset to be used by a client "lessee" for a period of time and in return for an agreed rental fee. Another form of *Ijara*—*Ijara wa Iqtina*—is a lease to own, with an additional unilateral undertaking by only one of the parties to buy or sell the asset at the end of the lease period.”

Murabaha and Ijarah provide short and medium financing for real estate, buildings, motor vehicles, computers, machinery and equipment,...

Murabaha and Ijarah are not ranged among the participatory Islamic financing modes related to profit-and-loss-sharing (PLS). In fact, These non-PLS techniques have many advantages for Islamic banks as they ensure less risk, a guaranteed profitability, a better short-time liquidity, and more flexibility in terms of asset and liability management..

Murabaha and Ijarah financing modes offer a significant level of similarity with conventional banking products (respectively overdraft and short term loans facilities, the facility of leasing).

Despite the fact that Murabaha and Ijarah products are commonly considered as Shari’a compliant, they are not considered Shari’as PLS based transactions by many prominent Islamic jurists and practitioners.

The criticism raised by the excessive use of these two non-participatory financing contracts has been underlined by many international empirical studies. An international study conducted by Salman S.A in 2011 over 30 banks from 9 countries of the MENA region reveals that :”Murabaha financing is the dominant mode used by Islamic banks in all countries of MENA region. In some countries Murabaha constitutes more than 90 percent of financing, in others it is just below 50 percent. On the average, for overall MENA region, the proportion of Murabaha in total financing is 75 percent”. The author summarizes this finding in the following figure:

**Figure 1: Composition of Financing Modes in Islamic Banking Sectors, 2008**

Source : SALMAN SYED ALI, ISLAMIC DEVELOPMENT BANK – ISLAMIC RESEARCH AND TRAINING INSTITUTE , FEBRUARY 2011

Accordingly, the easy and risk averse way for Islamic banks is to finance clients with Murabaha and Ijarah products. In a comparative study between Islamic and Conventional Banking, Hanif, M. (2011) considers that “Murabaha has successfully replaced the overdraft and short term loans facility under conventional banking”.

On another hand, Musharaka (project partnership) and Mudaraba (trust funding) products are not sufficiently developed in the common practice of Islamic banks, as they are considered complex and risky. Nevertheless, the two financing modes are preferred under the value scale of Islam, as they are real PLS financing modes. Musharaka financing is particularly interesting for companies in need of capital for further expansion. Musharaka can also provide financing for companies to structure equity, as a working capital facility, or as a joint investment in many activities (industry, real Estate, rural finance,...).

Dar and Presley (2000) give seven different explanations for the PLS lack in Islamic banks financing:



- “PLS contracts are inherently vulnerable to agency problems as entrepreneurs have disincentives to put in effort and have incentives to report less profit as compared to the self-financing owner-manage.
- PLS contracts require well-defined property rights to function efficiently. As in most Muslim countries property rights are not properly defined or protected,
- PLS contracts are deemed to be less attractive or to fail if used.
- Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive.
- The restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; the transacting parties share financial resources without participatory decision-making (Choudhury, 1998).
- Unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing.
- Secondary markets for trading in Islamic financial instruments, particularly Mudaraba and Musharaka, are non-existent. Consequently, they have so far failed to effectively mobilize financial resources.”

Hajjy,A & Ballet,J (2014) find that” By making short-term instruments the core of the banking activity, Islamic banks are gradually losing their singularity and are getting closer to the logic of conventional banks”.

The same authors conclude also that: ”the observation of the contemporary reality of Islamic banks reveals a number of points which confirm the dichotomy between what should be, that is, the initial concept and what actually exists, that is to say the objective reality of these institutions”.

Despite, many other authors rise opposite ideas and stand as defenders of the current practices of the Islamic banks. Their major defense line is based on the doctrine of necessity.



Accordingly, Usman H. and Malik. (2014) point out that:”The argument is that the prevailing economic environment and the nascent stage of the Islamic finance field necessitate the relaxation of the rules of Islamic finance. Once Islamic finance has grown sufficiently in size, it can be geared toward genuine risk–reward sharing between contracting parties, rather than merely mimicking interest based products (Haneef 2009)”.

In addition, Usman H. and Malik. (2014) consider that “Defenders have also suggested that Islamic financial practices should be judged by their intention. They argue that their intentions are good even if the methods are imperfect”.



2-2 Shari'a governance issues related to SBB

Another key issue that may jeopardize the sustainability of the Islamic banking model is related to the incomplete regulation of the external control performed by Shari'a Supervision Boards (SBB).

A central role has to be performed by the SBB to ensure that Islamic banks activities comply with Shari'a, in terms of fatwa's (religious rulings) and review. The common model is that each Islamic bank has an external Shari'a supervisory board, with at least three members who are experts in Islamic commercial law. These members are appointed by the Annual Shareholders meeting.

Shari'a governance standards have been developed by two main standard setters : AAOIFI in Barhein, and IFSB in Malaysia. These standards and guidelines cover important areas such as : appointment, competence, independence, confidentiality, and supervision consistency.

Despite this existing Shari'a governance framework, Hasan (2012) considers that the disclosure of Shari'a governance is "still at a very minimal and weak level". One key issue raised is related to Conflict of interest. The Standard setters have not sufficiently addressed this issue. For instance, Shari'a scholars still have the possibility to undertake both advisory and audit roles for the same Islamic Bank. Grais and Pelligrini (2006) consider that: "The SSB members' dual relationship with the financial institution, as providers of remunerated services and as assessors of the nature of operations, could create a conflict of interest".

Dual competence of Shari'a supervision board's members is also a big issue. Grais and Pelligrini (2006) consider that: "In performing their function, *Shariah* scholars are expected to be familiar with Islamic law and to have financial expertise. In practice, very few scholars are well-versed in both disciplines".

Another example of crucial issues is the fact that Shari'a scholars – outside Malaysia - may be members of as Shari'a supervisory boards as they want, without any limitation or conflict interest special prior review. Unal (2011) points out in his report "The Small World of Islamic Finance: Shari'a Scholars - A Network Analytic Perspective, Version 6.0", that the top 20 international Shari'a scholars hold 14 to 85 positions in Islamic financial institutions.

This research shows that the two top Shari'a scholars hold each one 85 positions as members of Shari'a supervisory boards. This reports pointed out the high level of Hierarchy scores showing to what extend scholars` links are dependent on one influential scholar. The author concludes that "The current concentration among the senior scholars hardly allows for thorough mentorship and apprenticeship programs as supported by regulators as the same senior people are sharing the board, not being able to pass on their collective wisdom efficiently to the next generation of Shari'a scholars



Besides, Shari'a scholars can be represented simultaneously in Shari'a supervisory boards, and in standards setting bodies.

A recent study was conducted by Haridan et al. (2018), and aimed to assess the quality of governance and assurance provided by Shariah boards (SB). The researchers highlight major concerns relating to :

- « (1) the general level of competency of individual SB members;
- (2) lack of technical banking and finance knowledge;
- (3) SB members generally fulfilling a ceremonial role rather than undertaking vigilant monitoring».

To enhance the SB member's performance and competence, these authors suggest that « Islamic banks establish a clear line of separation in the responsibility of SBs by delegating the religious compliance role to an external auditor competent to undertake religious auditing whilst the SBs are to focus on their advisory role.»

Another study conducted by Hussain et al. (2016) found that several concerns, relating to the appointment and cessation of the Shariah Committee Member of the Islamic Banks, exist in the existing legislations which should be addressed by relevant authorities.



2-3 Corporate governance issues related to investment depositors

As Islamic banks do not allow interest-bearing deposits, Islamic banks raise funds through participatory investments accounts. These profit-sharing investment accounts have a great part in Islamic banks financing resources. The issue in terms of corporate governance is the fact that the holders of investments accounts are not represented by separate legal entities and, do not have any voting rights in Islamic banks.

Their legitimate right to a true, rapid, and symmetrical information disclosure is not legally protected compared to shareholders and managers. For example, they do not have any possibility to appoint or to resign the board of directors, the Shari'a supervisory board, or the auditors.

Also, Investments accounts holders have no legal means to assess the correct use of their funds and the correct calculation and distribution of their investment profit parts. Especially, they cannot control the "profit equalization reserve" and "investment risk reserve" made by Islamic banks in diminution of the distributable profits.

On the basis of an international empirical study, over 90 Islamic banks during the period 2006-2014, Farag et al. (2017) conclude that "Mudaraba contracts may create another type of agency conflict between IAHs and Islamic banks' management."



Conclusion

After nearly 40 years of existence, the promising industry of Islamic banking is still facing vital challenges that may compromise its reliability. Due attention should be given to the controversial side of the Islamic banks practice. Both Jurists and practitioners have to be creative and develop a specific innovative financial engineering highlighting the profit and risk sharing principle and based on Musharaka and Mudaraba modes of financing.

Besides, the Shari'a governance legal and regulatory framework has to be deeply strengthened to satisfy the basic needs of independence and competence of Shari'a scholars. Finally, the financial interests and rights of investments accounts holders, as real stakeholders, should be legally protected against any inappropriate behavior or misconduct of Islamic banks management, especially in terms of investments policy and profit sharing calculation and distribution.

These necessary corrective measures will impact positively the soundness and the robustness of the Islamic finance model. They will also lead to the respect of the original and authentic moral and ethical goals of Islam.

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