Islamic Finance Project

Harvard Law School
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Workshop on Islamic Financial Ethics and Governance : A short Report

The Islamic Finance Project (IFP), under the auspices of the Islamic Legal Studies Program (ILSP), and the London School of Economics and Political Science (LSE), jointly hosted their fourth annual daylong workshop on the 25th of February 2010 at the LSE campus in London. Leading Islamic ethico-legal scholars (more commonly known as Shari'a scholars), Islamic economists, and Islamic finance professionals came together to address a pressing topic in the field of Islamic finance: ethics and governance. Before this conversation commenced, participants were requested to submit their comments and concerns on this topic to the organizers and over 100 pages of comments were received. To advance the discussions on the day and to ensure that everyone was well-versed on the subject matter, these comments were compiled and distributed to all participants prior to the workshop. As intended, the workshop dialogue focused on these valuable contributions and insights.

Last year's workshop focused on risk management, a timely topic in light of the global financial crisis, and it highlighted the shortcomings of risk management practices. This year's workshop focused on ethics and governance from Islamic economic and ethico-legal perspectives. As thought-leaders in the conventional finance sector are re-examining the relationship between ethics and governance in an attempt to repair damaged neo-liberal models, many have been considering the adoption of concepts and practices from the Shari'a-compliant financial sector. Furthermore, as institutions offering Shari'a-compliant financial products come under increasing pressures associated with product innovation and standardization, this is a watershed moment in which to examine the ongoing direction of ethical governance in modern Islamic finance and the role regulators, management, and Shari'a boards play therein.

With this backdrop, the overall objectives of this year's workshop were to (1) review the aims (maqasid) and ethical principles (qawa'id) that are central to any discussion of enhanced ethical governance in the Islamic financial services sector; (2) discuss specific practices in the Islamic finance sector in which the opportunity for expanded ethical consideration is particularly noteworthy; (3) discover the best practices associated with enhanced ethical governance in the Islamic finance sector and determine who should be responsible for establishing and applying such standards; and (4) evaluate the possible impact of religious and moral teachings on behavior and determine if better ethical behavior can be secured through moral education.

Sir Howard Davies, Director of the LSE, provided the opening remarks, commenting on the need for such timely discussions on ethics and governance in both the conventional and the Islamic finance sectors. Any discussion on ethics, even in Islamic finance, cannot but be framed by the global impact of the current financial crisis. This has been a financial crisis of considerable proportions. Though the exact impact on the Islamic finance industry is still unclear, most recognize that it too has been significantly affected. Issues of excessive debt, lack of liquidity, regulatory uncertainty, lack of proper risk management, and speculative transactions have all been raised as causes of this crisis. Understanding the ethical causes is one part, remedying those ethical lapses is another. He concluded by reminding the participants that the questions in regard to how institutions are made accountable and how boards think about the external influences on themselves are the same themes that are currently in discussion in the conventional field as well. Thanking Sir Howard and Dr. Nazim Ali for their efforts, Dr. Frank E. Vogel, moderator of the workshop then introduced the structure for the day.

In this year's workshop, participants analyzed three fictitious case-study scenarios in Islamic finance. Each scenario was devised to raise various contentious issues about ethics and governance in Islamic finance, while helping to inspire and focus the group's discussion about the topic at hand. In analyzing the three scenarios, participants were encouraged to comment on the impact at a systemic, institutional, and personal level. Participants also engaged in discussion on what Islamic ethical boundaries, if any, were crossed; what Islamic standards should subsequently be prescribed; and who should be responsible for prescribing those standards in the industry and how should they be enforced at all three levels. Using a simple medical analogy, Dr. Vogel summarized: 1) Is there a malady? 2) Diagnose this malady; and, 3) How should it be treated and who should treat it?

In the first scenario the group dealt with the bursting of a hypothetical regional economic bubble created by several over-leveraged and speculative real estate projects financed by a variety of Shari'a-compliant facilities and Sukuk from Islamic banks. This scenario in many ways paralleled the evolution of today's global financial crisis and, in particular, specific instances of failure by companies and Islamic financial institutions in the Gulf. The primary challenge for participants was of regulating markets and institutions without sacrificing efficiency.

The initial moral reaction to this scenario was that since speculation is forbidden, speculative projects should be impermissible. This was followed by a very lively debate on the definition of speculation, demonstrating the difficulty of identifying the threshold beyond which legitimate risk becomes impressible.

The group also debated the permissibility of debt-based modes of finance. While some argued for a check on debt-based modes of finance, others said that debt is sanctioned by the Qu'ran. And as long as contracts fulfill all the conditions of a contract, jurists cannot question the validity of such contracts on the basis of assumed intentions. However, there was some consensus around preventive measures to avoid excessive debt. One of the participants quoted Shaykh Justice Taqi Usmani in saying that when deals are done one must consider if value was created. As such 'value creation' could be one of the yardsticks to consider when evaluating the permissibility of a contract.

The group came to the conclusion that in the proposed scenario, the Islamic banks followed in the footsteps of the conventional banks and as a result were faced with similar risks. Participants also discussed that this situation was compounded by the fact that the regulatory system was not geared to deal with the nascent sector of Islamic finance. There was no clear consensus as to how to avoid this scenario. There was disagreement over whether Shari'a scholars and the board should be more active: some felt that it wasn't part of their job, others that it should be included. But, the general feeling among many participants was that the government and regulatory agencies need to step up their interaction with the Islamic financial industry to avoid such situations in the future.

The second scenario addressed Islamic ethical standards at the level of the individual Islamic finance institutions. In this hypothetical situation, participants together assumed the role of the board of directors of an Islamic bank who had been presented with demands from institutional investors that the bank immediately transform to become "strictly ethical." The shareholder's demands included changing the bank's internal structure, dealings, product lines, and marketing practices. Since the shareholders insisted on these demands, despite the risk of losing profitability, the group had to work to balance profitability with ethical considerations.

This ignited discussion in a very delicate area. Islamic banks historically have been run by dedicated Muslims who very strictly adhered to a code of ethics. The success of Islamic banks induced a short supply of adequately trained human resources. Correspondingly, Islamic banking was adopted by international banks to appeal to their respective client base. As a result, the self-imposed code of ethics, which it is argued had worked well initially, was not adequate. For Islamic finance to continue to succeed, Shari'a standards had to be institutionalized.

Participants recognized the contribution of industry bodies such as the Accounting and Auditing Organization for Islamic Finance (AAOIFI), but participants felt that more should be done. The real challenge, however, will be to strike a balance between prescribing ethical rules and growth.

The participants discussed the possible solutions that included developing a new, independent ethical rating agency or making Shari'a boards independent from banks. Participants agreed that if such steps must be taken, it must be in partnership with the central banks and the regulators.

The third scenario presented to the workshop's participants focused on Islamic ethical standards at the personal and consumer level. In the proposed scenario, the Islamic bank presents its customer with a variety of product offerings which have the effect of making the customer more indebted. At the same time, the consumer receives mixed signals from both the bank and his neighbors about whether or not Islamic banks are really different from conventional banks.

The participants as a group assumed the position of both the customer and the bank's relationship manager in order to debate the ethical issues of offering debt-based products to customers and justifying the higher cost for Islamic products.

The participants acknowledged that as Islamic finance has grown in tandem with conventional finance, it has become difficult to distinguish between Islamic and conventional products on the basis of economic outcome. As a result, customers are often very confused about which products are Shari'a-compliant and which are not. However, they are still committed to buying compliant products. Additionally, there is a problem with the rise of the debt culture. Participants discussed how this concept has taken root in a large number of communities worldwide, and many felt that this needs to be discouraged. Furthermore, some felt that it needs to be communicated to the banks that selling products to lure people into more debt is arguably against the Qu'ran because of the prohibition on squandering resources. Financial instruments are supposed to add value to the life of a customer and not trap him into debt.

The group concluded that education and training were essential for both bank employees and customers. Employees must understand the products that they are selling in order to explain them to their customers, so that the customer in turn can make informed decisions about these products and not rush headlong into debt.

In further discussion, the participants agreed that while banks must implement this raining for employees and customers to educate them about debt and products, Shari'a boards must also be more proactive. The boards must insist that only approved products are used by Islamic banks. However, some participants mentioned that people who earn their living from Islamic banking are not the most suitable to decide on what is ethical due to the obvious conflict of interest. This brought the discussion back to the need for an independent body, such as national Shari'a boards, for the oversight of ethical standards.

During the second part of the workshop, a list of action points, including a code of ethics, was presented to the group of participants for discussion. It was hoped that the participants could reach a consensus on recommendations for future development in the industry and recommend issues for further research. From this discussion emerged an Islamic Code of Ethics where the participants recommended adopting pillars of transparency, authenticity, corporate governance, and social responsibility.

- Transparency: Islamic financial institutions should become more transparent to their customers. These institutions need to clearly and explicitly explain profit rates to customers. Additionally, they should make decisions of Shari'a boards publicly available along with the underlying structure and reasoning of those decisions.
- Authenticity: Islamic financial institutions need to focus on authenticity. At a minimum, this means universally applying AAOIFI Shari'a standards. Preferably, this would entail self-certification on up holding the letter and spirit of Islamic finance and by striving to avoid fueling consumerism. This could consist of mandatory reporting on the efforts to reduce the dependence on tawarruq transactions and other debt-based products. Subsequently, debt-based retail products should only be used for a customer's needs, as opposed to a customer's wants (i.e., prohibition of tawarruq for holidays overseas or extravagant, dream weddings, etc.).
- Corporate Governance: Under corporate governance, a Shari'ah audit should be part of the internal audit procedures along with a mandatory comprehensive external audit. Shari'a boards should also be given a say in the compensation packages of senior management to create an incentive for them to take the recommendations of the Shari'a board more seriously.
- Social Responsibility: With regard to social responsibility, Islamic financial institutions must become powerful forces of change in their business and social communities. Internally, each institution should create its foundation for qard hasan and micro finance based on equity, possibly using proceeds from zakat and impure income. Furthermore, 5% of yearly financing targets should be committed to sustainable projects and the institution should have consideration for environmental issues as well. Consideration for the environment should be imbedded in the philosophy of Islamic financial institutions.

In addition to the code of ethics, the discussion of the participants produced several recommendations for the industry's consideration. Additional recommendations included the creation of Shari'a standards in marketing and standard terms of reference ("TOR") for Shari'a Supervisory Boards (SSBs). Shari'a standards for marketing would entail adopting regulations for marketing campaigns, and ensuring Shari'a approval to avoid fueling consumerism. Under the TOR for SSBs, SSBs would be entirely independent of management. Additionally, the TOR should include annual Shari'a certification of the bank's activities, an extensive Shari'a audit report to be submitted to the central bank in addition to an internal audit. To facilitate this, the SSB would nominate two directors: one for the internal audit committee and one for the HR committee. Additionally, management would report to the SSB on their efforts to reduce consumer dependence on tawarruq and other debt-based products.

The closing discussion of the day focused on the next steps necessary to implement the ideas developed at the workshop and future workshop topics. It was decided that the existing committee would refine and then redistribute the code of ethics and once 60% of the people have provided their consent, these recommendations would be shared with AAOIFI, IFSB and other regulatory bodies. To further the movement for standardization, it was also agreed that, as a first step, all Islamic financial institutions should adopt AAOIFI standards.