

### **Ethical Principles of Islamic Financial Institutions**

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The current global economic meltdown is a clear revelation of the shortcomings of the conventional financial set-up and the weakness of self-designed system devoid of spiritual and divine guidance, hence the yearning and desire for a socially just financial system by conscious individuals and corporate bodies. The recent adoption and establishment of Islam based financial institutions in many parts of the world has exposed the system to serious studies by scholars and economists. Also, the adoption and integration of the Sarbanes – Oxley Act of 2002 into the America system of business to introduce ethical principles to the United States corporate environment through the application of many rules, could be seen as a leaf borrowed from Islamic ethical principle. This further strengthens the importance of the ethical principles of Islamic financial institutions. The assertion that Islamic financial system is only distinguished from other economic systems in its emphasis on interest free and other usurious transactions coupled with the fact that many concepts are springing up contending with the Islamic financial system inform the need to study the system within the context of Islamic ethical principles.

In addition to the above, the conventional global financial system needs to adjust its laws to accommodate Islamic financial system and by implication, it cannot be ruled out that the latter too will have to adjust its operations amidst other systems. In the same vein, inter-bank and intra-bank transactions between Islamic financial institutions and conventional banks cannot be avoided both locally and internationally. This implies that a number of intricacies will have to take place between the two divergent systems. This paper is therefore out to articulate the

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ethical principles of financial institutions as enshrined in the Qur'an and the *Sunnah* of the Prophet so that Islamic financial system will not lose focus and to avoid being carried away by the flamboyant and excessive profits and surpluses of the conventional financial institutions. The implementation of the rules and standards laid down by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the principle of ethics of the Islamic system shall equally be considered. Strict adherence to these ethical credentials of Islamic financial institutions would make consumers to find solace in them.

### **Introduction**

The search for efficiency and equity in the distribution of resources becomes a serious concern for economists all over the world, as many theories have been propounded to ensure this. Of such system adopted is the capitalist economic system where all factors of production are privately owned and controlled, and individual or group has absolute right to engage in any type of business he or they desire. The shortcomings of this economic system are however shown by Marx who postulated that capitalism was based on exploitation of the working class by the owners of capital whose profits come from the difference between the wages of labour and the value of the product (Shittu, 1979). The system also poses the problem of equity in goods distribution and as well exposes women who are supposed to be the first teachers at home to all sorts of businesses which do not befit their feminism; while children, orphans, widows, handicapped and aged people with little or no bargaining power are suffering the consequences. Also, as democratic as the system is, it fails to realise the unity of life by over-emphasising man's material values at the cost of his spiritual aspirations. Worship of money and lust for material acquisitions thus leads to all sorts of corruption, looting, and exploitation at all means.

Socialism and communism were out to correct both the exploitative nature of capitalism, resource misallocation and the inequitable distribution characteristic of modern mixed economies. The economy is centrally organised that the state takes grasp of everything by owning and managing all factors of production while all citizens of the country are regarded as employees of the state. In socialist and communist countries, equalization of the opportunities of education, culture, medical care and other social amenities are emphasised, while an equitable

distribution of income among various social classes is maintained. As good as the system is, it creates a wide gap between man's material desires and his spiritual aspiration. Though, it restores equilibrium in the distribution of income and wealth, it succeeds in destroying the most fundamental equilibrium in the distribution of political and economic power. Not this alone, the concentration of power in the hands of the state or the ruling elites seems to have violated the principle of free-will, as it reduces man to a mere cog in a gigantic social machine. Apart from this, it goes against human nature, as men are not equally endowed and so can not be equally remunerated or compensated, hence, socialism or communism can not totally do without resorting to capitalism. Conversely, it is difficult to get a state which is purely capitalistic to the extent that governmental non-interference in the machinery of business and the market is at zero level.

The wobbling of mankind within multifarious economic theories and practices is a welcome development as long as these exercises are operated within the limits of divine guidance sent through the prophets. The theories became faulty and ineffective when their protagonists decided to leave aside the divine guidance and so opted for their own personal whims and caprices. The current global economic meltdown is a demonstration of the consequence of an economic system which does not allow divine ethical practices in the affairs of its operation. It therefore becomes imperative to emphasise a set of ethical values that will sanitise any economic theory put in place by human beings.

### **The Imperatives for Islamic Ethical Values in Financial System**

It is natural to have a set of ethical regulations in the society so that people don't unjustifiably tramp on other people's rights. Islam does not however wait till such ugly situation occurs before it puts in place these ethical values. The emergence of the welfare economics in the 1930s was an indication of the significance of ethical values which economists considered as an ingredient of societal well-being. However, Mobolaji (2010:15) considers the self-interest models of the conventional economics as a major barrier hampering the welfare economics, the negative impact which consequently led to the new call for ethically-based studies. He equally quoted Sen (1987) to have argued that "the distancing of economics from ethics has impoverished welfare economics and also weakened the basis of a good descriptive and

predictive economics.” In the same vein, Hassan (2009) is of the opinion that the global financial crisis is a crisis of failed morality, manifest in forms of greed, exploitation and corruption.

The fact that human nature might not guarantee a set of ethical values which favours a group of people and difficult for another to adhere to, makes the Creator Himself to give a clue as per what should be the content of the ethical values for mankind. This, in our view has being the major focus and guideline for Muslims to formulate ethical regulations which are acceptable to the world. The level of acceptability of the Islamic financial ethical value could be appreciated in the level of compliance with the AAOIFI and its intrinsic ethics by its members. Its inimitability is further confirmed in the non-intrinsic nature of the ethics of Sarbanes-Oxley in American corporate culture and it's being considered as superfluous to achieving the Act's regulatory objectives (Walsh, 2007: 770). Contemporary steps at introducing ethical principles to the United States corporate environment through the adoption and integration of the Sarbanes – Oxley Act of 2002 into the America system of business are indications of the imperatives for having a set of ethical values guiding the operation of financial transactions. This however became necessary in the US consequent upon major corporate and accounting scandals which cost investors billions of dollars especially as they affected Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. Meanwhile, Walsh (2007) has discussed extensively the similarities and disparities in the AAOIFI and the Sarbanes-Oxley's Standard. He however observed that:

Despite the structural similarities and comparable goals, compliance with Sarbanes-Oxley is resisted whereas AAOIFI standards are voluntarily embraced. Even after the collapse of Arthur Anderson, Enron, and WorldCom and the revelation of corruption, the response to Sarbanes-Oxley is to avoid compliance because it is too costly. Rather than comply, companies are opting to not be listed on the United States stock exchanges. Publicly-traded small capitalization companies and foreign companies, which are listed on the United States stock exchanges, are considering delisting, and other companies not currently listed are deterred from listing. The United States public offerings dropped by 300% in 2003, the year following the implementation of Sarbanes-Oxley (Walsh, 2007: 773-774.)

The above submission of Walsh was based on the public criticism of the provision of the regulations even at the floor of the U.S House of Representatives where Congressman Ron Paul and others stated that the regulations were “damaging American capital markets by providing an incentive for small US firms and foreign firms to deregister from US stock exchanges.” Wikipedia (visited on 4<sup>th</sup> April, 2010) further gives an editorial statement on the Sarbanes-Oxley that it had not only failed to achieve its objectives of preventing frauds but also to have managed to kill the creation of new public companies in the U.S, cripple the venture capital business, and as well damage entrepreneurship.

The sum total of our argument is that the ethics inherent in Islamic finance go beyond enforcement of rules as intended by the American corporate law. Rather, it is indistinguishable from the Islamic system, as against the American corporate structure where the principle of ethics is distinct from her system. In other words, there is a dichotomy between the implementation of the rules and the ethics themselves. Apart from this, while Islam appreciates *ijtihad* aimed at improving the well-being of the society, it understands that depending solely on human whims and caprices might fail to achieve such objectives just like the Sarbanes-Oxley’s. It therefore becomes imperative that Islamic ethical values as entrenched in the Qur’an and practised by the Prophet and his companions should not be thrown into dustbin; it needs rather to be energised and promoted for the purpose of salvaging the contemporary economic system.

The global acceptance of Islamic banking and finance is enormous and the level of its acceptance differs. For instance, while all the financial institutions in the Islamic Republic of Iran and Sudan are being operated in compliance with the principles of Islam; Pakistan is in the process of joining them to transform its financial system to become fully Islamic. In Malaysia, Indonesia, Bangladesh, Jordan and Egypt, Islamic banking system is being operated alongside conventional banking through “the opening of Islamic “windows” in conventional institutions, or establishment of separate banks, or branches and subsidiaries, that specialize in Islamic financial products” (Sundararajan & Lucarrico, 2002).

In Nigeria, some Nigerian commercial banks are trying to lure Muslim customers into patronizing them by coming up with certain Islamically

branded products. The Hajj Target Savings are operated by the Unity Bank, FinBank, UBA and Bank PHB while the Hajj Target and Loan are being promoted by FinBank alone. As for the first, any interested intending hajj pilgrim will operate this savings account depositing a fixed sum of money or deposits in convenient piecemeal. He will later have the total deposit in pursuit of the purpose when the hajj operation is approaching. The second product being promoted by FinBank allows for 60% loan of the total hajj fare to an intending pilgrim having deposited about 40% of the required funds with it. Such loan would however be repaid with interest as will be agreed upon.

Apart from the above, some banks purportedly appear to be floating some Islamic banking related products. Such include Platinum Habib Bank Plc (Bank PHB); United Bank for Africa Plc (UBA), Afribank Nigeria Plc and First Inland Bank Plc (Finbank) which is about to join them. The modus operandi of the interest-free windows of these banks has been discussed by Abubakar and Luqman (2010:12-16). However, as prompt as these windows are, their shortcomings lie in the operational environment where no significant discrimination is made in the banks' general investment ventures, not minding the compliance of those ventures with the principles of Shari'ah (Adebayo, 2010: 4). It needs to be noted that the banks were able to put in place the Islamic products consequent upon the amendment in the Banks and Other Financial Institutions Act (BOFIA) No. 25 especially in section 9 (2) sub section (1) which gives the necessary legal framework for the establishment of profit and loss sharing banks in Nigeria.

There is no doubting the fact that the operation of those banks gives the impression that they are operating Islamic windows which might be mistakenly taken as proper Islamic banking system. The provision of the Central Bank for establishing profit and loss sharing banks might also be taken to mean that the Bank has given room for operation of real Islamic banking system in Nigeria; yet it needs to be stressed that it only allows a part of the features of Islamic financial service delivery. In view of these multifarious conception and approaches to Islamic finance and banking, we strongly feel that the ethical values of the Islamic system need to be vehemently reiterated so that Muslims don't derail themselves from the actual focus of Islam. It is observed that scholars, jurists and economists of high repute have outlined compliance with the following conditions for any conventional bank to set up Islamic banks, windows or funds:

- i. Complete segregation of funds;
- ii. Shari'ah Supervisory Board;
- iii. Managerial Commitment;
- iv. Safeguarding Muslim Investors' funds; and
- v. Compliance with AAOIFI standards (Yaquby, 2000: 133).

The interaction between Islamic financial institutions and the conventional financial institutions also call for reiteration of Islamic ethical values. In the first instance, the contact of the Muslims with foreign civilizations and cultures had to a very large extent impacted both the Muslims and the civilizations. In the same vein, there is every tendency that the rapport between the conventional financial institutions and Islamic financial institutions would affect the two institutions of divergent worldviews. A clue to this is the feeling that conventional banks have the opportunity of adopting Islamic practice if considered profitable, whereas Islamic banks are restrictive as they could not just adopt any conventional practice without considering its acceptability to Islam. This therefore gives the conventional banks upper hand over Islamic banks, hence the temptation to see the Shari'ah as obstacle to the performance of Islamic financial institutions and searching for means of technically violating some of the Shari'ah regulations. Meanwhile, a clear understanding of the fact that economic consideration should not be over-emphasised over and above moral consideration will make the Islamic financial institutions to understand that they have social responsibilities to offer rather than emphasising profitability of the institutions. Profitability is not therefore the criterion or the prime element in evaluating the performance of Islamic financial institutions. A thorough and serious emphasis on Islamic ethical values will help in no small measure at understanding this.

In the final analysis, economics is a social science discipline which accommodates dynamism and improvement and as well allows diverse views of different thought, hence, the serious researches into various aspects of Islamic economic and financial system with a view to finding Islamic solutions to contending contemporary issues. Such an attempt had been made by some who attempted to demarcate between usury and interest and so legalise interest and condemn usury (*riba*). Apart from this, there are developments in financial markets which demand *qiyas*

and *ijtihad* from the perspective of Islam. What should guide Muslims' contribution on these developments is their consciousness of Islamic ethical principles which would save them from wobbling amidst numerous theories and practices. Strict adherence to these ethical principles might also convince conventional financial institutions not only to borrow a leaf from Islamic financial institutions, but also to transform into full-fledged Islamic financial institutions.

### **The Ethical Principles Guiding Islamic Financial Institutions**

Ethics, according to Beekun (2001:2), is a set of moral principles that distinguish what is right from what is wrong. A number of ethical systems had been adopted in the secular society all of which are not free from one shortcoming or the other. Such include:

- i. Relativism which is made on the basis of self-interest and needs.
- ii. Utilitarianism which is outcome-oriented and upholds that an action becomes ethical if it results in the greatest benefit for the largest number of people.
- iii. Universalism which focuses on the intention of the decision or action.
- iv. Rights, which emphasises liberty and considers an action ethical when it is based on individual rights and ensuring freedom of choice.
- v. Distributive justice which sees justice as major determinant of ethics and as well emphasises equitable distribution of wealth and benefits and burdens.
- vi. Eternal law which implies the ethical values as contained and taught by revealed scriptures.

Ethics, from Islamic point of view, are far above these ethical systems. Though, it shares from them, it incorporates all aspects emphasised by each and synthesises them in such a way that it takes care of their shortcomings. Delving further into this might result to another thesis; hence we consider the ethical values guiding Islamic financial institutions.



### ***Principle of Vicegerency***

In the words of Al-Faruqi (1998:85):

Islam wants humans to pursue what is of nature to eat and drink, to have lodging and comfort, to make of the world a garden, to enjoy sex, friendship and all the good things of life, to develop the sciences and to learn, to usufruct nature, to associate and build socio-political structures- in short, to do all these things, but to do them righteously, without lying and cheating, without steal and exploiting, without injustice to self, to neighbor, to nature, to history, Islam calls man the *khalifah*, precisely because to do all these things well is to fulfil the will of God.

The eloquent submission of the Qur'an on the purpose of human creation as Allah's vicegerent on earth has many implications. In the first instance, it implies that man should not only worship and serve Him, but must as well obey Him and fulfil His commandments. His freedom to do according to his wish is therefore curtailed by the fact that he has to subject his wish to that of Allah. It also implies that Allah is the owner of everything on earth and beyond. He, Allah is however magnanimous to have entrusted man with all wealth on earth with a view to exploiting it according to the will of Allah. Man's claim of ownership of a particular wealth therefore is only metaphoric, as whatever he claims he owns does not actually belong to him. He is therefore restricted in the way he acquires, invest and utilize this wealth. As such, he has the obligation of acquiring his wealth through legitimate means. This legitimacy implies that he does not embark on a business that is not in line with the wish of Allah. As vicegerent of Allah, he is guided by the Islamic code of conduct, Shari'ah, by not engaging in exchange of goods and services which are not approved by Allah. Also, he should not also engage in business that would harm him or others. This explains why transaction in alcohol, pork, obscene material or narcotic is strictly forbidden in Islam. Also, as Allah's vicegerent, he needs to invest and utilize what he owns in a satisfactory manner and without violating the stipulated laws of Allah. Of that rules is that he should not allow excess production to influence him negatively and as well avoid *israf*. In essence, he should avoid over-exploitation of resources and so equitably and efficiently utilize what is entrusted to him by Allah. In the other way round, he should not hoard what he is endowed with, as there are co- human beings

who are not as equally endowed as he is. This should be distributed to the less privileged ones in the society.

The institution of zakat is meant to ensure equitable distribution of wealth among mankind and to check the concentration of wealth in the hand of few individuals. The Islamic principle of zakat implies that resources are not only God's gift to mankind, but also an *amanah* (trust) which must be discharged equitably. While zakat discourages hoarding, it encourages investment which consequently allows the circulation of wealth, as the owner of the wealth would like to avoid an accelerated reduction on the wealth through zakat payment. In addition to this, the institution of zakat takes care the interest of the rich who invests his resources; as such resources will not be zakatable for the period the entire amount of investment is subsisting.

### ***Principle of Brotherhood and Universalism***

The concept of *ummah* seems to be comprehensive and elaborate in the Qur'an. After narrating the history of many prophets, Allah concluded by referring to them as one *ummah* and Himself their Lord whom they should worship, and that the divergences among them are man-made (Qur'an 21: 47-94). Therefore, race, country and language should not be cogs in the wheel of this brotherhood. The sense of brotherhood could however be hampered through unjust dealings, oppression, lie, and other means of misappropriation of one another's property. The principle of brotherhood culminates into that of universalism where a universal law is allowed to guide and bind them together. It is apposite quoting Al-Faruqi's (1998: 78) submission on the principle of universalism. He writes:

The totalism of the divine will leaves no human being outside of its relevance, just as it leaves no point outside of its relevance, just as it leaves no point outside of space-time. The whole world is the object, and the whole of humankind is the object and subject of moral striving. The universalism of Islam is absolute and without exception just as God is Lord and Master of all without exception

By implication, the Islamic ethical principles spare no nation, tribe or clan; it is universal. Juxtaposing the Qur'anic and Biblical condemnation of usury for example would confirm the universality of Islamic ethical values on it.

O you who believe! Fear God, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from God and his Apostle: But if you turn back, you shall have your principal (sum); Deal not unjustly, and you shall not be dealt with unjustly (Qur'an 2: 278-279).

O believers, devour not usury, doubling its rate many times. Have fear of Allah, and you shall prosper. Guard yourselves against the fire prepared for unbelievers (Qur'an3: 130-131).

You shall not charge your interest to your brother, interest on money or food or anything that is lent out at interest.

To a foreigner, you may charge interest, but to your brother, you shall not charge interest, that the Lord your God may bless you in all to which you set your hand which you are entering to possess (Deuteronomy 23: 19-20).

Our awareness of some other biblical verses which clearly prohibit usury and interest shows that the practice is inimical to divine justice generally. However, the above quoted verses demarcate Islamic total prohibition of the act as against the biblical injunction which allows it to be charged on foreigners. Such injunction has however resulted to neck-breaking interest charged by developed countries on developing countries that are ought to be assisted. The prohibition of usury is total in Islam, as those who facilitate and witness to it will have their own share of its sin. An *hadith* says:

Allah has cursed the one who takes interest, the one who pays it, the one who writes the contract, and the one who witnesses the contract (Reported by Ahmad, Abu Daud, Ibn Majah and al-Tirmidhi).

It needs to be noted that Islam does not allow an iota of interest to be charged above the capital. The side effects of interest have been acknowledged by some countries; hence, many have drastically reduced the interest rate of their respective countries. The table below shows the previous and current interest rate of some countries.

<b>Central Bank</b>	<b>Previous Interest Rate</b>	<b>Current Interest Rate</b>
Bank of Canada	0.50%	0.25%
Bank of Japan	0.3%	0.1%
United States	1.0%	0.25%
United Kingdom	1.0%	0.5%
Egypt	8.50%	8.25%
South Africa	7.0%	6.5%
Australia	4.00%	4.25%
China	5.58%	5.31%
Hong Kong SAR	1.5%	0.5%
Switzerland	0.5%	0.25%
Sweden	0.5%	0.25%
Slovakia	2.25%	1.75%
Poland	3.75%	3.50%
Iceland	9.5%	9.0%
Hungary	5.75%	5.50%
European Monetary Union	1.25%	1.00%
Czech Republic	1.25%	1.00%
Taiwan	1.50%	1.25%
Korea	3.00%	2%

Source: <http://www.fxstreet.com/fundamental/interest-rates-table/> visited on 13<sup>th</sup> April 2010

That Islam tolerates zero level of interest rate deserves special commendations from world economists. In his Tafsir, Imam Razi (cited by Al-Qaradawi, 1989) discusses the wisdom of the Qur'anic prohibition of interest. These include:

- i. it amounts to appropriation of another person's property without giving him anything in exchange;
- ii. it prevents people from working to earn money, as it reduces the value of work. The rich will have no interest in investing his money on a business or risking his money in trade or industry. This therefore paralyses commerce, trade and industry;
- iii. it discourages benevolent acts which is prime to brotherhood. It also weakens the feeling of goodwill and friendliness toward the lender by the borrower.

- iv. It allows exploitation of the poor by the rich and this makes the lender wealthier and the borrower poorer.

To replace usury, Islam puts in place the principle of profit and loss sharing which fosters the spirit of unity, cooperation and brotherhood among those concerned. Warde (2000: 200) considers profit-loss sharing as the cornerstone of Islamic finance. Some reasons are advanced to substantiate this assertion. These include:

- i. *Mudarabah* and *Musharakah* as strategies of profit-and-loss sharing, have their roots in the Islamic tradition;
- ii. Profit-and-loss sharing is just and equitable;
- iii. it is conducive to a dynamic economy in which the benefits of growth are shared by the community at large;
- iv. it is compatible with the changing financial environment as well as the norms and principles of the global economy.

The germane nature of *tawhid* (unity) is stressed further by Khan (1996: 396) when he writes:

The theme of unity is fundamental in Islam and runs through the Qur'an. *Tawhid*, in a broader sense, means divinity and also incorporates the concept of brotherhood of the *ummah*. Brotherhood implies a relationship of mutual care and universal welfare in which all Muslims are treated as one *ummah*, community, or nation, as well as the collective responsibility of ensuring the well-being (*falah*) of each individual. It obligates humanity to maintain *amanah* (trust) among the *ummah* and to refrain from *fasad* (mischief, animosity, and corruption) (Qur'an 2: 205), especially since all resources are in abundance, are for the welfare of all and not for just a few, and have to be utilized equitably for the well-being of all (Qur'an 2: 29).

Apart from enjoining sense of brotherhood, Islam further condemns acts that could jeopardise the brotherhood. Such include fraud, cheating, lie and falsehood among others. Islam therefore enjoins observing due measure and weight. On this, the Qur'an enjoins the establishment of weight with justice and avoidance of short in the balance (Qur'an 55: 9). A total condemnation of dealing in fraud is given in the following Qur'anic passage:

Woe to those that deal in fraud,  
 Those who, when they have to receive by measure  
 From men, exact full measure;  
 But when they have to give by measure  
 Or weight to men, give less than due.  
 Do they not think that they will be raised up?  
 On a Mighty Day  
 A Day when (all) mankind will stand  
 Before the Lord of the Worlds (Qur'an 83: 1-6).

Islam also frowns at an act of cheating by showing one kind of goods and then delivering another kind inferior, or rather by adulteration of food or goods. There was a time the Prophet was passing by a grain merchant who displayed dried grain at the upper layer whereas the wet one was beneath. The Prophet thrust his hand into the heap of grain and found that it was wet. Upon request, she confessed it was deliberately done. The Prophet therefore concluded saying: "Why did you not put the wet on top so that people could see it? He who deceives us is not of us."

### ***Principle of Partnership***

The sense of brotherhood is further promoted by Allah's directive to cooperate with one another in righteousness and piety and not on sinful acts and enmity (Qur'an 5: 2). Response to this divine call implies offering of loan with no iota of interest, establishment of partnership and agency, promoting Islamic cooperative societies, with a view to helping the needy and the poor, and assisting those in problem and debt. With this, many people had come together to organise themselves into cooperative societies for the purpose of pooling resources together to assist members. Apart from this, some Islamic financial instruments are put in place for the purpose of pooling both material and human resources together. Such include the following:

#### *i. Mudarabah*

*Mudarabah* is defined by Kahf (1978: 71) as Islamic mechanism for introducing monetary assets into production as a result of a joint action

between the owner of the assets and the entrepreneur. It is a form of partnership where the *rabb al-mal* or *sahib al-mal* (investor) entrusts money to the *mudarib* (managing trustee) for him to use the money for a specified period after which the profits are shared according to an agreed proportion. The opportunity offered by *mudarabah* allows the entrepreneur who has no financial backing to have access to money with which he can start a business and earn a livelihood. Meanwhile, Ariff (1993: 11) sees some shortcomings in the traditional *mudarabah* system which to him does not make it a true representative of Islamic spirit. He says emphatically:

Like profits, the institution of *mudarabah* can be exploitative. Much would depend on how it is practised. In particular, one may question the fairness of the arrangement whereby all losses were the result of wrong decision and bad management by the entrepreneur. In the same vein, one may wonder how just it is that the entrepreneur gets nothing for his efforts if no profits are made for reasons beyond his control. To put it quite mildly, there are deficiencies in the traditional *mudarabah* system. Search for alternative arrangement which conform to the Islamic ethical values in both is that which entitles the entrepreneur to wages for services rendered and allows both profits and losses to be shared by the entrepreneur and the owner of capital.

The observation of Ariff on the institution of *mudarabah* might be given serious consideration if he had informed where to source for wages for services of entrepreneur who could not make profits due to certain circumstances beyond his control. Also, that the loss incurred out of misconduct, negligence or violation of the agreement agreed upon by the *mudarib*, would be bore by him (the *mudarib*) settles the case of fairness in *mudarabah*.

## ii. *Musharakah*

Ismail (2010: 60) sees *musharakah* as a “contract of partnership between two or more parties in which all the partners contribute capital, participate in the management, share the profit in proportion to their capital or as per pre-agreed ratio and bear the losses (if any) in proportion to their capital ratio.” It connotes the conjunction of two or more persons to carry on a business to share the profits by joint investment. The essence of this is to strengthen the partners in their

commercial activities and to allow pooling the material and human resources together for the purpose of sharing the profit and loss (if any) among themselves.

*Shirakah* can take different forms. It can take the form of joint purchase of equipment for the purpose of sharing the proceeds therein. This is called *Shirakat al-Mulk* which can be optional or compulsory. It is optional when the people mutually agree to purchase equipment jointly. A compulsory joint ownership occurs when a person dies leaving his property. All the heirs of the deceased inherit this property which comes into their joint ownership automatically consequent upon the death of the person. *Shirakah* can also be in form of 'aqd. This is a form of partnership effected by a mutual contract either in form of investing of capital into a commercial enterprise by all the partners (*Shiraka al-Amwal*) or where all partners agree to render some services to their customers and whatever profit accrued from such services are distributed among them according to an agreed ratio (*Shirkat al-A'mal*, or *Shirkat al-abdan*). It can also be a form of partners purchasing a commodity on a deferred price and such is sold at spot and the profit therein is shared between them at an agreed ratio (*Shirkat al-Wujuh*).

### iii. *Ijarah*

*Ijarah* is defined as "a contract between two parties, the lessor and lessee where the lessee enjoys or reaps a specific service or benefit against a specified consideration or rent from the asset owned by the lessor" (Ismail, 2010: 62). The acceptability of this type of contract depends on certain conditions which include:

- a. the lawfulness of the object and purpose of the contract;
- b. the termination of the leasing contract with the failure of asset to give the service for which it was rented;
- c. the ownership of the asset by the lessor throughout the lease period so that it can be maintained by him in case of harm or loss caused by factors beyond the control of the lessee;
- d. the specification of the period and the service that the asset is supposed to provide and for which it is being rented should be clearly stated and known to the parties involved.



Ismail (2010: 65) further classifies *ijarah* into *al-ijarah Thumma al-Ba'i*, *al-ijarah Muntahiya bil-Tamlík*, and *al-ijarah wal-Iqtina*. While *al-ijarah thumma al-Ba'i* involves leasing and then selling the leased asset at the end of the lease period, *al-ijarah muntahiya bil-Tamlík* has to do with leasing agreement with option to own leased asset at the end of the lease tenure. *Ijarah wal-Iqtina* is a form of hire purchase by means of lease agreement with option to acquire leased asset at the end of lease period.

iv. *Murabahah*

This is a kind of contract between a buyer and a seller where the seller purchases commodities and resells them at a fixed mark-up profit above the original cost of the commodities. This method is mostly used by Islamic banks. The bank purchases a particular commodity and then resells it to the customer at an agreed price plus a fixed mark-up and allows the customer to pay on a deferred specified time. The money expended to procure the commodity on behalf of the customer and the time spent by the bank explains the risk involved in the contract and this demarcates the rate of profit from usury.

v. *Bay' Salam*

This is a type of contract which involves advanced payment for the goods to be delivered at a later date. This contract encourages a bank to enter into agreement with a farmer for the advance purchase of agricultural produce and payment is made prior the delivery of such commodity. This type of contract is made on commodities which quality and quantity could be accurately specified. Commodities which quality, size or weight are difficult to specify do not fall under this category. For instance, it would be ambiguous to pay for the fruit on a particular tree or wheat of a particular field as it could not be accurately quantified or weighed. As such, resorting to this type of contract involves a good understanding of the nature, quantity and quality of the commodity to be transacted by the parties involved.

***Principle of Dignity of labour***

As a sign of ummatic unity and brotherhood, Islam enjoins that the honour and dignity of mankind be safeguarded and so prohibits begging. This was properly demonstrated by the Prophet when a poor man came

to him to beg for alms. The Prophet (PBUH) asked him if there was any asset he possessed. He replied that he had one sheet of cloth and one bowl. The Prophet (PBUH) asked the gathering of *Sahabah* if they would like to buy these things. Some *Sahabah* bought the two things. The Prophet (PBUH) gave that money to the man and asked him to buy an axe, cut trees, and sell the wood in the market. The Prophet (PBUH) thus taught him and others that Islam wants them to protect their own self-respect and that can only come through working to earn, not by begging. At another instance, he said:

That one of you should take his rope and then come with a load of wood upon his back and sell it is better than to beg of men whether they give him or reject him (Quadri, 1995: 36).

On another occasion, he was reported to have said

No one eats a better food than one who eats from his own sweat. Indeed, a prophet of Allah, Dawud (peace be on him) used to eat from his sweat (Quadri, 1995: 44).

The above Prophetic traditions imply the fact that man has to work and the fruit of that work serves as his means of livelihood. In essence, productive work needs to be compensated appropriately. The implication is that interest as a reward for saving money is tantamount to sleeping in expectation of food. The fact that man should work before earning is stressed by some scholars to the extent that they consider rent for agricultural land without any contribution of the landlord to the tilling of the land as unearned income which is forbidden. Except in cases of inheritance, grants and payment of *zakat* to those who deserve it, no reward should be legitimized unless it is genuinely earned.

### ***Principle of Optimism and Pessimism***

The expectation of gain in any transaction without consideration for probable loss is against the spirit of Islam, as the world is not expected to be perceived so. As one is optimistic, he should equally be pessimistic. In other words, those who hope for gain out of any transaction must also be ready for a comparable loss. This principle of Islamic transaction is deduced from the general concept of justice in Islam. Any contract dealing therefore, that stipulates an assured gain without possibility of loss is illegal and void. Even if in such a contract the principal is

guaranteed in case of loss, the contract is null and void. The wrong perception of likening usury to trading is borne out of the feeling that any financial transaction should automatically attract profit. While expatiating on this, Mawdudi (undated: 1981) has this to say:

They (interest takers) based their vice on wrong theory and did not see the fundamental difference between profit and interest. They argued like this: “when profit on capital is lawful in trade, why should then interest on money invested in loans be unlawful?” And the Arab money-lenders were not alone in arguing like this; the bankers and money lenders of today also put forward similar arguments for charging interest. They argue that a person who lends a sum of money to another, could himself make profit from it and that the debtor actually does invest it in a profitable business. Why should not the creditor then get a portion of that profit for his productive credit? However, what they forget is that there is no business in the whole world where there is fixed and guaranteed profit without any risk. In trade, commerce, industry, agriculture etc, one has to spend both labour and capital and at the same time, one has to face risks, without any guarantee of a fixed profit.

### **Institutional set-up for Ensuring Ethical Values in Islamic Financial Institutions**

#### ***(i) Islamic Development Bank (IDB)***

Consequent upon the Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul-Qa'da 1393AH (December 1973), the Islamic Development Bank came into existence. The inaugural meeting of the Board of Governors was held in Rajab 1395AH (July 1975) while the bank was formally opened on 15 Shawwal 1395AH (20 October 1975). The aim of the bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah. The Bank with its headquarters in Jeddah has up to 52 countries as its members with the prerequisite of being a member of the Organization of the Islamic Conference and be ready to accept the terms and conditions as may be decided upon by the Board of Governors.

The following are the functions of the Bank:

- provision of financial and other forms of economic and social assistance to member countries;
- participation in equity capital and grants loans for productive projects and enterprises;
- establishment and operation of special funds for specific purposes;
- Assisting Muslim communities in non-member countries;
- Accepting deposits and raising funds in any other manner;
- Assisting in the promotion of foreign trade, especially in capital goods among member countries;
- Provision of technical assistance to member countries;
- Undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the Shari'ah;
- Provision of training facilities for personnel engaged in development activities.

For effective accomplishment of some of the above functions, especially those related to training, the Board of Executive Directors of IDB inaugurated the Islamic Research and Training Institute (IRTI) in 1401AH (1981CE). In 1403AH (1983CE), the Institute became operational with the aim of undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to Shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries. This Institute has organised series of international workshops, conferences and seminars both at local and international levels. Its publications have become household materials for scholars, economists and practitioners.

***(ii) Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)***

This body was set up in 1990 for the purpose of standardizing the governance of every Islamic business product and service. The mandate of AAOIFI is succinctly itemised by Christine Walsh (2007) as including:

- i. develop the accounting, auditing and banking practices thought relating to the activities of Islamic financial institutions;
- ii. disseminate the accounting and auditing thought relating to the activities of Islamic financial institutions and its application through training, seminars, publication of periodical newsletters, preparation of research and other means;
- iii. prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonize the accounting practices by these institutions in the preparation of their financial statements, as well as to harmonize the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions;
- iv. review and amend the accounting and auditing standards for Islamic financial institutions to cope with developments in the accounting and auditing thought and practices; and
- v. approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the accounting and auditing standards, as well as the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions that are published by AAOIFI.

To effectively carry out the above obligations, the AAOIFI establishes a Standard Board comprising renowned Shari'ah scholars, university professors, certified accountants and users of the financial statements of Islamic institutions. Ever since its establishment, the body has issued codes of ethics and Shari'ah standards, as well as about seventy standards on accounting, auditing and governance. According to Karuvelil (2000: 157), the body is working tirelessly to enhance transparency of financial statements. This it does through constant publication of accounting, auditing and governance standards for Islamic financial institutions. It also conducts researches and consultancies to meet the challenges of new developments in Islamic financial industry. The body has released guidelines on the following issues among others:

- a. capital adequacy and issues of profitability, risk management and liquidity;

- b. a code of ethics for the accountants and auditors of Islamic financial institutions;
- c. audit test by an external auditor for compliance with Shari'ah rules and principles;
- d. the disclosure of bases for determining and allocating surpluses of deficits in Islamic insurance companies;
- e. investment funds;
- f. dealing in currencies; and
- g. Debit cards, Charge cards and Credit cards (Shu'aibu, 2003: 133).

On ethical standards, the AAOIFI has published the Code of Ethics for Accountants and Auditors of IFIs, as well as the Code of Ethics for Employees of IFIs.

**(iii) *Islamic Financial Services Board (IFSB)***

The Islamic Financial Services Board is an international standard setting organization established in Kuala Lumpur, Malaysia in 2002 for the purpose of promoting and enhancing the soundness and stability of the Islamic financial services industry. The organization has equally assisted in promoting prudence and transparency in Islamic financial services industry by introducing new, or adapting existing international standard consistent with Shari'ah principles. It has 191 members comprising 50 regulatory and supervisory authorities, six international inter-governmental organizations like the International Monetary Fund, World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank and the Islamic Corporation for the Development of Private Sector, Saudi Arabia; and 135 market players, professional firms and industry associations operating in 40 jurisdictions.

As part of her activities, the Board has conducted researches and coordinated initiatives on Islamic finance industry related issues. It has also organised conferences, workshops, trainings, seminars for regulators and industry stakeholders. So far, it has issued twelve Standards, Guiding Principles and Technical Rules covering such aspects of Islamic finance as Risk management, Capital Adequacy, Development of Islamic Money Markets, and Conduct of Business for Islamic Financial Services among others.

(iv) *International Islamic Financial Market (IIFM)*

The International Islamic Financial Market (IIFM) is a non-profit global market standard setting body of the Islamic Financial Services Industry (IFSI). It was established by the collective efforts of the Central banks of Bahrain, Indonesia, Sudan, Labuan Offshore Financial Services Authority (Malaysia), Islamic Development Bank, and Ministry of Finance Brunei Darussalam. In 2006 and 2008, the State Bank of Pakistan and Dubai International Financial Centre (UAE) were given permanent membership of the body respectively.

The body was established with the aim of unifying the Islamic Capital and Money Market segment of the Islamic Financial Services Industry; and with the primary focus of ensuring standardization of products, documents and related processes. To achieve these, the body has initiated what it calls IIFM Master Agreements for Treasury Placement (MATP), while her IIFM/ISDA Tahawwat (Hedging) Master Agreement has reached an advanced stage. As contained in the website of the organization, the following are the benefits of the body to the Islamic Financial Services Industry:

- standard setting body with regulatory heritage;
- addressing the standardization needs of the industry;
- providing universal platform to market participants through “Global Working Groups” for the development of Islamic Capital and Money Market;
- Shari’ah harmonization in documentation, products and processes; and
- Shari’ah Advisory Panel consisting of renowned scholars, hence ensuring wider Shari’ah acceptance.

### **Conclusion**

The discussion so far has reiterated the imperativeness of strict adherence to ethical credentials of Islam by the Islamic financial institutions so as to maintain the tempo of patronage of the institutions and the solace the consumers find in them. Undoubtedly, the ethical principles of Islamic financial institutions can not be compromised in view of their divine origin. As it is dangerous to employ a weaver of mats in a silk factory thinking that he is a weaver, so also it is catastrophic to solely rely on conventional laws and principles to guide mankind on their financial activities. While trying to expand the scope of the institutions and gaining a good position in the markets, the Islamic principles and regulatory system should not be handled with levity. The Ummah is accredited as the best community ever raised for mankind by virtue of enjoining virtues and eschewing vices. This should be rigorously exploited to avoid falling victim of what befell the conventional financial institutions. In short, for Islamic financial institutions to be viable alternative to the current economic system, the ethical values guiding them should be upheld.



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