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## ISLAMIC BANKS VS. NON ISLAMIC ETHICAL DIMENSIONS

Dr. Kassim Dakhllallah\* & Dr. Hela Miniaoui\*\*

*Preliminary Version*

### Abstract

Islamic banks have become an international phenomenon as one of the world's fastest-growing financial sectors. It was estimated that since 2007 the growth rate of Islamic finance products has reached 30%. In addition, Islamic financial institutions are becoming substantial players in the global banking and financial market and therefore a proper definition is essential to understand why they are different; how they started; and how they entered the international banking market. Islamic banks can be used to meet the challenges of this competitive environment, considering that they offer new resources and products, yet new ideologies, and it sets a new discourse. The paper introduces the main sources of Islamic finance principles that are the foundation for Islamic banking practices. The formation and the different structure of an Islamic financial institution and the challenge to corporate governance are of great importance to the conduct of Islamic banking. The need for regulation in the context of Islamic banking and the main risks associated with the different financial products will be rigorously discussed.

**Keywords:** Islamic Banks, Ethics, Adverse Selection, Moral Hazard

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## INTRODUCTION

Islamic banking and finance is one of the fastest growing segments of global financial industry. Currently, there are over 300 Islamic financial institutions (IFI) which are mainly concentrated in the Middle East and Southeast Asia, and gaining popularity in Europe and the United States as well. They provide Islamic products for an estimated 1.82 billion Muslims in 2009 (26.72% of the world's population). Even if the sizes of IFI are relatively small compared to international standards, it has to be noted that the prospects for growth and expansion in non-Muslim countries are strong. IFI have experienced a steady growth during the last decade thanks to strong economic development in their host countries. The top 500 Islamic banks enjoyed an increase in their assets by 28.6% in 2009 (\$822 billion) from US\$639 billion in 2008 and the value of *Shari'a*-compliant bonds was \$100bn in 2009. The share of issuance of *Sukuk* notes represents about 10% of the global Islamic finance industry. In addition, it is broadly known that Islamic Banks (IBs), the main part of the Islamic Financial System (IFS), performs better, during the crisis, than Conventional Banks (CBs). One key difference is that the formers don't allow investing in and financing the kind of instruments that have adversely affected their conventional competitors and triggered the global financial crisis. These instruments include mainly derivatives and toxic assets.

In this paper, we will explore the logic of Islamic Finance from the pillars of *Shari'a*. We will investigate the ethical dimension that dominates the relationship among bankers, depositors and investors. We will compare the nature of that relationship to that of the nature of the dominant players in western banks. In fact, when we compare IBs to non Islamic, we are not comparing one financial institution to another as many analysts like to put it. We are rather comparing two different natures. It is the nature of the west alongside the nature of the east. Ethical vs. unethical are key differences. Greed, exploitation and abuses are the dominant factors in most financial transactions that take place under the conventional banking system. So long commissions are received and interests are paid and the collaterals are in place, banks will lend. Reckless investors, on the other hand, knowing the borrowed money is not theirs will borrow to the max. Depositors who care most about the high interest they receive, will keep on depositing regardless of the behaviour of the bankers. Thus, a good recipe for a crisis. They all contribute to it and they all suffer from it. While under Islamic finance, we notice that greed, exploitation, abuses are at minimum. Reasons are attributed to the religious nature of the depositors, the bankers, and the investors, and because of the direct involvement of all the parties in the transaction. No one has any direct or indirect interest in exploiting one another, and if they do, they all fail. In addition, IBs do not finance risky investments, or intangible assets, and they equate the interest of the society to that of the investor. Furthermore, the formation and the different structure of an IFI and the challenge to corporate governance are of great importance to the conduct of Islamic banking. The need for regulation in the context of Islamic banking and the main risks associated with the different financial products will be discussed. Concepts related to corporate governance (Asymmetric information, Moral hazard, and Adverse selection) will be analyzed as well. The paper is organized as follows. Section 1 presents the background of Islamic banking. Section 2 discusses the relationship between depositors, intermediaries and investors. Section 3 describes and analyses performance of IBs and CBs and the last section concludes the paper.

### 1. BACKGROUND ON ISLAMIC BANKING

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *Shari'a*, known as *Fiqh al-Muamalat* (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss (PLS) and the prohibition of *Riba* (usury). Many studies have discussed in depth about the rationale behind the prohibition of interest (see, for example, Chapra (2000)) and the importance of PLS in Islamic banking (see, for example, Dar and Presley (2000)). Indeed, all commercial transactions and contracts must be free from elements of *Riba* (*interest*), *Gharar* (uncertainty), *Maisir* (gambling) and non-*Halal* (prohibited activities). Principal Islamic financing modes used in Islamic banking are presented as follows:

### 1.1 Profit Sharing modes:

- *Mudāraba: Trustee Finance Contract*, *Mudāraba* is an arrangement or agreement between the bank, or a capital provider, and an entrepreneur, whereby the entrepreneur can mobilize the funds of the former for its business activity. Three conditions need to be met :
  - a. The bank should not reduce credit risk by requesting collateral to this purpose: it bears entirely and exclusively the financial risk. Collateral may be requested to help reduce moral hazard, e.g. to prevent entrepreneur from running away
  - b. The rate of profit has to be determined strictly as an agreed percentage (between the Bank and the entrepreneur).
  - c. The entrepreneur has the absolute freedom to manage the business.
- *Mushāraka: Equity Participation Contract*, *Mushāraka* means partnership. It involves you placing your capital with another person and both sharing the risk and reward. The difference between Musharaka arrangements and normal banking is that you can set any kind of profit sharing ratio, but losses must be proportionate to the amount invested. *Mushāraka* means partnership. It involves you placing your capital with another person and both sharing the risk and reward. The difference between Musharaka arrangements and normal banking is that you can set any kind of profit sharing ratio, but losses must be proportionate to the amount invested.
- *Muzaar'ah*: Traditional counterpart of the *Mudāraba* contract in farming. The harvest is shared between the bank and the entrepreneur. The bank may provide funds or land.
- *Musaqat*: Traditional counterpart of the Musharaka contract in orchard keeping. The harvest is shared among the partners based on their respective contributions.
- *Musaka: Islamic Bonds* is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

**1.2 Non Profit and Loss Sharing Modes:** They are used in cases where PLS modes cannot be implemented, for example for cases of small scale borrowers or for consumption loans.

- *Qard al Hassan: Good (Benevolent beneficence) Loan*, these are zero-return loans that the Quran exhorts Muslims to make to "those who need them." Banks are allowed to charge the borrowers a service fee to cover the administrative expenses of handling the loan, provided that the fee is not related to the amount or maturity of the loan.

This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor.
- *Bay as-salām* ou *Bay as-salaf Istisna' Bai Salam*, means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver, or currencies. Barring this, Bai Salam covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship. The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date. This mode only applies to products whose quality and quantity can be fully specified at the time the contract is made. Usually, it applies to agricultural or manufactured products.
- *Ijāra* ou *ijāra wa iktinā: Leasing Lease Purchase*, is a contract under which an Islamic bank provides equipment, building, or other assets to the client against an agreed rental together with a unilateral

undertaking by the bank that at the end of the lease period, the ownership in the asset would be transferred to the lessee pursuant to a sale or gift contract. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease. Banks add a certain percentage to the purchase price and/or additional costs associated with these transactions as a profit margin, and the purchased assets serves as a guarantee.

- *Murābaha: Cost Plus*, this concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement.

IBs are very similar to their conventional competitors in terms of the legal formation procedures. Generally, banks are mainly structured as companies or corporations, two terms that are used to describe organizations that are associated with the aim of carrying out business for gain. (Davies, 2003, p.3) The formation process of Islamic banking companies is similar to that of CBs, except that the shareholders of IBs will demand that their banking company refrain from many transactions, such as those relating to trading in alcohol and tobacco production. In the case of Islamic banking companies, however, the basis of the institution requires the presence of a special board: the Sharia Supervisory Board (SSB). This body has been defined as 'the main vehicle to evaluate, approve contract documents and supervise all operations of the bank in conformity with its objectives and ultimately with principles of Islamic law'. (Al-Tamimi, 1995) Accordingly, the board consists of scholars in Islamic law, who have, a background in economics and finance. The role of this board is totally different from the role of the board of directors, although the two boards, in one way or another, collaborate to run the company. Members of the SSB ensure that the transactions carried out by the institution comply with the principles of Islamic finance.

## 2. RELATIONSHIP BETWEEN DEPOSITORS, INVESTORS AND BANKERS

As has been noted, Islamic economic theory is highly driven by certain ethical issues. Most of the prohibitions stated in the main textual sources have a moral dimension, such as the prohibition of interest. The other injunctions offered by Islamic economic theory also rely on the ethical commitment of individuals: voluntary charitable giving, for example, is not imposed by any of the textual sources of the Islamic law; rather, it is based on the individual's own commitment to certain moral aims and objectives. Further, the key principles of Islamic economic theory (justice, equality and fairness) are based on certain values such as consideration of the needs of other individuals, not taking advantage of those who are in difficulty, and selflessness. It must be noted that the individuals' commitment to the ethical aspect of Islamic economic theory is based on its religious genesis. The individuals' beliefs in the rewards granted and punishments meted out in this world and the next, and in the pleasure or displeasure of God, have a key role in maintaining the individuals' commitment to these principles. All the involved parties in any financial transactions under the umbrella of the Islamic finance have no interest in exploiting one another. Cooperation is a key to the success because if the transaction fails, they all fail. Yet, it is still important to maintain and guarantee discipline and for that the SSB was created. Furthermore, Islamic intermediation is asset-based and centers on risk sharing. This eliminates and reduces the probability of defaults by bond issuers.

In fact, concepts of asymmetric information, moral hazard, and adverse selection went a long way in explaining a large number of capital market phenomena as well as behaviour of capital market participants. The main concepts related to asymmetric information are explained below.

### 2.1 Adverse selection

Adverse selection, anti-selection, or negative selection is a term used in economics, insurance, statistics, and risk management. It refers to a market process in which "bad" results occur when buyers and sellers have asymmetric information (i.e. access to different information): the "bad" products or customers are more likely to be selected. Adverse selection problems arise before the contract is signed because the bank has less information on the project

than the client (borrower) or the entrepreneur (information concerning the characteristics of a venture). According to Mishkin (2003) adverse selection is an asymmetric information problem that transpires before the transaction occurs, when parties who are the most likely to produce an undesirable (*adverse*) outcome for a financial contract are most likely to try to enter the contract and thus be *selected*.

Financial transactions do expose IBs to principal-agent problem when the bank enters into the contract as *rab al-mal* (principal) and the user of funds is the agent.

According to Ali (2007), the bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform. Obviously, adverse selection can be avoided by careful screening of finance seekers. When a bank provides equity and debt finance simultaneously, it will have more access to information than in a situation when only debt finance is provided. It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking. In summary, banking theory indicates that IBs should operate as universal banks, and when they do, they would be exposed to lower levels of moral hazard and adverse selection. Adverse selection is one of asymmetric information problems arise in a situation where one party has extra information that others don't. It creates the other party to have a failure judgment in making a decision. In the case of *Shari'a* banks, adverse selection is a situation where bad debtors have more information about their business proposal future condition. Although in the beginning of business proposal they already have loss calculation on the business, they still propose the business to *Shari'a* banks, because the risk will be shared between the banks and the debtors.

For Morris and Shin (2010), some participants in financial markets have either private information or better expertise in evaluating new financial instruments and markets. This gives rise to adverse selection. In Akerlof (1970) and the classical adverse selection models that followed, there is market unravelling with equally informed traders on both sides of the market. We are concerned with situations where, on both sides of the market, some traders are informed and some are not informed. This then translates into a coordination problem among uninformed traders. This coordination problem among uninformed traders plays an explicit or implicit role in a wide variety of finance models. For Al-Jarhi (2003), the bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform. Obviously, adverse selection can be avoided by careful screening of finance applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. We can therefore conclude that screening would be more effective and adverse selection less probable with universal banking. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns. "By allowing entrepreneurs to choose between interest and PLS, CBs create an adverse selection problem for the IBs: entrepreneurs with below-average profit expectations prefer PLS in order to minimize their losses in the likely event of failure, while those with above-average expectations prefer interest in order to maximize their gains in the likely event of success. The upshot is that the Islamic banks receive a disproportionately large share of the bad risks". (Kuran, 2004, p.12)

## 2.2 Moral Hazard

Abdul Rahman (2007) distinguished between *ex ante* and *ex post* moral hazard problems. *ex ante* moral hazard problems arise from the fact that financial institution cannot effectively monitor borrowers and therefore cannot write a credible contract that enforces prudent behavior. *ex post* moral hazard problems arise as it is assumed that the financial institution cannot observe such returns and thus borrowers have incentives to pretend that their returns are low or default on their debt obligations. Akerlof and Romer (1993) further elaborate on the moral hazard, arguing that banks may use fraudulent lending practices (such as insider lending) to "loot" banks. In this case, bank managers extract value out of the banks even if this leads to insolvency. The moral hazard phenomenon, noted in the text, is by no means specific to Islamic banking; it exists in all situations, quite common in a capitalist system, where decentralized decision-making is the rule, and where there are incentives for economic agents (the agency), whose activities cannot be perfectly monitored because of high information cost by the provider of capital (the principal)

(Akerlof, 1970). But the point is that such information costs will become too high in a profit-only system to insure against risk (as the premium will be too high). Ways and means must, therefore, be found to minimize such costs. Adverse selection problems arise before the contract is signed because the bank has less information on the project than the entrepreneur (information concerning the characteristics of a venture). The moral hazard problem occurs at post-investment stage because of the 'hidden' action motivated by self-interest of the entrepreneurs which is unknown to the bankers (information concerning the true characteristics of an individual entrepreneur are concealed from the bankers).

### 3. PERFORMANCE OF IBs Vs. CBs

The financial liberalization and deregulation have created new challenges and new realities for IBs; the globalization effect has also put these institutions in cutthroat competition with traditional financial institutions in well developed financial markets. On the other hand, the recent global crisis has renewed the focus on the relationship between both Islamic and conventional banks and financial stability. As Islamic banking has become a phenomenon, economists have started to study the benefit of financial transactions that are free of interest. The idea of prohibiting interest now has a new, economic dimension, as a result of which, religion is no longer the only reason for eliminating interest from business transactions. In theory, many economic advantages to interest-free banks have been suggested. In 1995, the International Association of Islamic Banks (IAIB) described three profound advantages, as follows:

- a. The involvement of the bank in business will improve the efficiency of capital allocation. The bank will be more concerned about the productivity of a project in which it shares losses and profits. A better allocation of the available funds can be achieved. (Agrawal and Youssef, 2000) In contrast, in the case of interest-based banks, the banks earn a fixed rate of interest; there is therefore no incentive to give priority to those ventures that have the highest profit potential. (Venardos, 2005)
- b. The socio-economic aspect of Islamic banking can help to create more job opportunities, because the feasibility and productivity of a project are the only criteria on which an Islamic bank will base its financing decision. Consequently, many small productive projects can take place in the market, creating many new job opportunities. (Agrawal and Youssef, 2000) In contrast, the interest-based system is 'security-oriented' rather than 'growth-oriented'. This attitude deprives many potential entrepreneurs of the opportunity to get the required funding, because they lack sufficient security to satisfy the banks' criteria of creditworthiness. (Venardos, 2005)
- c. In the profit-sharing system, the supply of money is not allowed to overstep the supply of goods and services. In any case in which the enterprise suffers losses, any capital that is to be repaid to the bank will be diminished by the amount of the loss. This eventually curbs inflationary pressure within the economy. (Agrawal and Youssef, 2000)

Moreover, some economists have been more specific in discussing the economic benefits of the Islamic banking system. Their argument relates particularly to developing economies: theoretically, the level of moral hazard within any economy will be reduced where immoral and unethical conduct is eliminated by Islamic banking principles; further, the absence of the limitations normally imposed by the debt leads to an improvement in profits, which eventually encourages an increased level of investment. All of these conditions, in theory, are therefore ideal for the growth of a developing economy. (Ghannadian and Goswami, 2004) Additionally, some economists have argued that the financial services market constantly needs new products. The products that have historically fuelled the development of the market have now become 'commodities', which means that they have become increasingly low profit, if not unprofitable. The industry therefore needs to reinvent itself in order to continue to prosper in the which, in one way or another, offers a new set of different financial products. In practice, having a zero rate of interest in a

banking system is not an impossible ideal. Some of the biggest economies at a global level have kept their interest at a near-zero or zero rate for a few years. Due to certain economic circumstances, the Central Bank of Japan, for example, decided to maintain a 'zero or near zero interest rate policy'. (Stevens, 2001) The zero-rate call has lasted for almost five years and the economists' expectation is that the interest rates will remain under 1 per cent for a very long time. (Kaletsky, 2006) This shows that interest is not always a positive component in the economy and that eliminating interest from banking transactions could become, at some point, a way out of many economic problems. In the last few months, the Bank of England has implemented certain cuts in the interest rate in order to cope with the pressure of the current financial crisis. Finally, it has been argued that the prohibition of interest would substantially prevent individuals from becoming over-indebted. It has been suggested that those who control individuals' access to credit (that is, the regulators and the banks) do not place individuals' interests at the top of their priorities list. On the one hand, regulators are mainly concerned with the well-being of the whole economic system rather than that of individuals. They may therefore allow certain transactions that can be hazardous to individuals, but beneficial to the economic system as a whole. On the other hand, bankers are mainly concerned with their own interests rather than with those of their clients or the whole economic system. Thus they would make a large amount of credit available to individuals to borrow if there were a prospect of high profits in the long term, which can be reflected in their balances and remuneration. (El-Gamal, 2001) The current banking crisis is a good example of the consequences of bankers' careless lending policies.

## CONCLUSION

Prohibition of *Riba* is central to Islamic financial ethics and law. All transactions and contracts must be free from elements of *Riba*. Moreover, Islamic banking is not based on creditor-debtor relationship, but on the principles of PSL between the bank and its customer under different financing arrangements and other trading and leasing contracts. Whilst, non-Islamic banks rely primarily on the interest rate instrument, Islamic banks use a variety of contracts and instruments that have been developed in compliance with *Shari'a* laws. Moreover, in Islamic finance, the nexus between financial assets and real assets is crucial. Indeed, they connect bank resources in financing real assets rather than investing in derivatives.

In this paper, we introduced the foundation for Islamic banking practices and we discussed the governance concepts important in the conduct of Islamic banking. The main differences between Islamic and non Islamic banks were identified as well.

According to the literature, Islamic banks outperform non-Islamic banks especially during the last financial crisis. The question left is what role should Islamic banks play in order to contribute to the financial stability?

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