

ARTICLES

ETHICS AND FINANCE: PERSPECTIVES OF THE *SHARĪAH* AND ITS HIGHER OBJECTIVES (*MAQĀṢID*)

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Abstract: This article begins with the ethical foundations of Islam that are relevant to commercial transactions - much of which strikes a common chord of objectives and values with other major traditions. This is followed by an exposition of the ethical substance of Islam in the applied *fiqh* provisions pertaining to contracts, and the relevance also of the higher goals and purposes of the *sharīah* (*maqāṣid al-sharīah*) to the ethical integrity of contracts. This is followed by a discussion of the *sharīah* prohibition and damaging effects of *ribā*. The three remaining sections address the salient characteristics of Islamic commercial law and finance: 1) Islamic finance is characteristically asset-based; 2) it is averse to reliance on debt; and 3) it is also risk-averse. This last segment explains the *sharīah* prohibition of *gharar*, uncertainty and risk-taking in financial transactions. The author concludes with reflections by prominent commentators on the urgency of taking new measures to contain graft and greed and minimise the yawning gap that has developed between ethics and finance. Many have supported the view that the prevailing financial architecture no longer serves the interests even of only the privileged classes but of all strata of society.

Introductory Remarks

The interest-based financial system has nurtured a debt-ridden environment that inflicts anxiety on people with mortgages and business loans lest they are caught in debt-traps and forced failures. This would explain the radical change of attitude in recent decades toward the importance of ethics in business almost everywhere. Leonard Swidler of Temple University thus spoke of the “rise of business ethics and spiritual movement” in many western quarters manifested by the emergence of institutions such as the World Business Academy, the Council for Ethics in

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Economics, the Caux Roundtable, and the Global Dialogue Institute – all based in the United States. Numerous business studies schools and colleges in the West are reported to have included business ethics in their curricula.¹ Robert Holland, a Senior Fellow in Business Ethics at Wharton School, said at a conference presentation in Atlanta that every institution that has instituted business ethics programmes and every CEO he has known of such institutions have reported a marked “improvement in employee morale, better trust within the company, higher quality output [...] and happier customers.”²

Ethics is the foundation of *sharīah*-compliant finance. *Sharīah* laws are richly endowed ethical contents and rules of moral propriety that govern all human relations. But in the sphere of financial transactions, its rules on *ḥalāl* and *ḥarām* are essentially aimed at fair trading, market stability, accountability and the public good. Many of the leading principles of Islamic finance, namely its prohibitions on interest (*ribā*) and excessive uncertainty and risk-taking (*gharar*) in financial transactions, have direct ethical implications. This is also the case with the *sharīah* prohibition of gambling and excessive speculation as well as unethical trades, such as prostitution and pornography, trading in non-*ḥalāl* substances such as alcohol, narcotics, tobacco and weapons, grounded in ethical norms that have in some cases been elevated into binding principles of law. The economic implications of the prohibition of interest (*ribā*) is to prevent unfair exploitation among the transaction parties, and also to ensure that money is a medium of exchange to be sought not in itself but as a unit of value for other commodities. Banking interest is gained by those with surplus money to lend and has therefore the perennial tendency to favour the rich.

Islamic finance relies little on debt but promotes trading and enterprise involving exchange and production of goods and services in the real economy. Islamic financial institutions encourage equity participation and commercial enterprise, and basically confine debt to the needs of those unable to secure financing in any other way. The financier and client come together to share risk and reward in a *sharīah*-compliant transaction. This helps to align the interests of the transaction parties and thus prevent the prospects of undue exploitation among them. It also means that savers, entrepreneurs and financiers share the same prospects with regard to the success or failure of the project. The prohibition of interest in Islamic banking and finance, or indeed of any unwarranted increase that violates the principle of equivalence of counter-values in commercial contracts, makes Islamic finance less vulnerable to the instability and fluctuation that have become the bane of the prevailing financial system. The *sharīah* concepts of *ḥalāl* and *ḥarām* and their ethical postulates are now translated into stock screening methods and exclusion of objectionable contents in trades and finance not only by Bursa Malaysia but by many others including the Dow Jones and FTSE Islamic indices that track and identify *sharīah*-compliant stocks from around the world.

Ethical Foundations

The Qur'ān encourages Muslims to engage themselves in lawful work, trade and transaction by mutual consent but to avoid “wrongful devouring of your properties among yourselves – *akl al-māl bi'l-bāṭil*.”³ This last phrase subsumes virtually all forms of misappropriation, unlawful and unethical procurement of the property of others. There is explicit emphasis in the Qur'ān on trusts (*amānāt*) and their due fulfilment in all spheres of human relations, especially in business transactions and governance.⁴ Business must be conducted with honesty; those who engage in honest trade and faithfully give to people what is due to them are promised God's blessings and spiritual reward.⁵ The *shar'ah* demand for transparency in market transactions, in the description and advertisement of goods and services, leaves no room for concealment of any defects in merchandise. Unfair and exploitative practices, fraud and profiteering, hoarding, unethical manipulations and deceit are strictly forbidden.⁶

The Qur'ān demands clean market transactions and transparency through strict observance of accuracy in weights and measurements, keeping the balance straight, giving the people what is duly theirs, and comprehensive observance of justice.⁷ The concept of *falāḥ* (true success) in Islam is inclusive of material, ethical and spiritual dimensions of success. Worldly success without ethical import and concern for the betterment of others is a violation of the trust of the vicegerency (*khilāfah*) of humankind on the Earth, which is duly fulfilled through faithful promotion of good and rejection of evil (i.e., *al-amr bi'l-ma'rūf wa'l-nahy 'an al-munkar*). *Khilāfah* also requires prudent management of the Earth's resources, care and concern for animals, and protection of the natural environment. Human fraternity (*ukhuwwah*)⁸ and cooperation in beneficial works (*ta'āwun*),⁹ also qur'ānic precepts, further endorse the substance of trust and responsibility that underpin the principle of *khilāfah*.

The Qur'ān is emphatic on due fulfilment of promises and contracts. Breach of contracts and promises that cause material loss to their victims incurs legal consequences.¹⁰ The believers are similarly enjoined to continue honouring their contracts even if there be reason to think that the other party is intent on violation. One should, in such circumstances, inform one's counter-party of a formal dissolution of the contract so as to ensure transparency and honest dealing.¹¹ The Prophet Muḥammad has said in a *ḥadīth*: “One who is not trustworthy has no faith.”¹² He is also reported to have said: “The signs of a hypocrite are three: when he speaks he lies, when he promises he breaches, and when trusted he betrays his trust.”¹³ Trade and transactions should also be conducted in a spirit of magnanimity and latitude that inclines towards leniency (*samāḥah*) – as indicated in the *ḥadīth*: “May God bless one who is lenient when he buys, lenient when sells, and lenient when collecting his dues from others.”¹⁴

Leniency is especially advised with debtors who are in difficult conditions; they should be given a respite in which they exercise due diligence in order to meet their obligations.¹⁵ The Prophet went on record to say: “Truly the best of people are those who are best and most courteous in their demand for repayment.”¹⁶ Yet for those who take unfair advantage and procrastinate, their conduct is tantamount to oppression (*zulm*) that falls outside the scope of lenient treatment. Thus, according to a renowned *ḥadīth*, “procrastination by the affluent is oppression.”¹⁷ Another qur’ānic guideline to note is that “wealth should not circulate only among the rich” (59:7). Distributive justice thus becomes an integral part of the qur’ānic conception of justice that demands fair distribution of wealth and opportunities in society.

Yet it must be added that ethical teaching on its own will not ensure transparency and fairness in market transactions. Efficient market operations call for regulatory regimes and constant supervision to ensure accountability and due observance. That said, market regulations without moral commitment are also insufficient to ensure integrity. Umer Chapra thus rightly observed concerning the US subprime crisis that banks in the United States ran into difficulties in an apparently well-regulated system. The banks simply failed to exercise restraint on excessive lending. Hence the call for a systemic reform of the existing financial architecture.¹⁸

Fiqh*, Ethics and *Maqāṣid* (Objectives) of *Sharī‘ah

Muslim jurists have commonly acknowledged that the *fiqh* rules in almost every part take their origins in the Qur’ān and *ḥadīth*. The qur’ānic requirement of accuracy in weights and measurements, for example, is translated into the principle of equivalence of counter-values in exchange contracts that must be carefully observed. That said, the rules of contracts allow for some flexibility through stipulations the contracting parties may agree to insert in their contract. All nominate contracts in *sharī‘ah* (of which there are 25) are thus open to some stipulations, provided they are harmonious with the nature and attributes of the contracts concerned. In principle, all schools of Islamic law agree on contractual stipulations (*quyūd wa shurū‘*) although they tend to differ on the degree of flexibility over them. The basic question that invokes variant responses is that the basic characteristics of nominate contracts have been determined by *sharī‘ah* and the contracting parties do not have the flexibility to alter them completely through their mutual agreement. The Ḥanbalī school of Islamic law tends to allow greater flexibility for contractual stipulations compared to the other leading schools of *fiqh*.¹⁹

The foregoing also poses a question on the role of the *maqāṣid*, or higher objectives, of the *sharī‘ah*, with reference to contracts. The basic position to be stated is that the purpose of a contract is an integral part of the ethics of that contract. Virtually every one of the nominate contracts has certain objectives, or *maqāṣid*, which it must follow and remain clear of manipulations that would

distort its primary purpose or *maqṣad*. Some of these *maqāṣid* are primary and others subsidiary, some general and others more specific. A clear understanding of the *maqāṣid* of contracts is thus a prerequisite of the proper application of those contracts and the extent of flexibility the contracting parties may be able to exercise with regard to contractual stipulations. For any stipulations that amount to a distortion of the *maqṣad* or purpose of a contract are likely to vitiate the contract in question. A fuller analysis of the *maqāṣid* of contracts cannot be attempted here, but what needs to be stressed is that due regard for the primary *maqāṣid* of contracts is not only a legal requirement but an integral part of our discussion on ethical finance. To distort the *sharīah*-ordained *maqṣad* of a contract through questionable stipulations, and worse still, through recourse to legal tricks and stratagems (*hiyal*), becomes problematic, and if allowed unchecked would naturally affect the ethical propriety of the contract in question.

Many of the basic or primary purposes of contracts and transactions are determined by the *sharīah*, which need to be observed without distortion, although the available information in this area is somewhat limited in scope. Readers familiar with the theory of the *maqāṣid al-sharīah* would also know that this whole area of *maqāṣid* suffers from underdevelopment, and adequate information on the *maqāṣid* of specific contracts is scanty and sometimes not available in the existing *fiqh*-literature. A brief discussion may be advanced here on the *maqāṣid*, for example, of *mushārah* and the extent to which the *maqāṣid* relate themselves to the ethics of contractual relations therein.

Mushārah, or partnership, is based on mutual trust among partners and the basic position of the *sharīah* with regard to them is one of equal standing, especially with regard to their participation in management matters, profit and loss. The *fiqh* jurists and *sharīah* advisors of Islamic financial institutions have thus disapproved of inserting stipulations that seek to alter the basic characteristics of *mushārah*, such as preferential treatment of some partners over others. That said, a certain amount of flexibility is available for the contracting parties to insert stipulations they may jointly propose. Some such stipulations are currently employed in *mushārah*, in Malaysia and elsewhere, through the *fiqh* provision of *tanāzul*, or waiver, of some partners in favour of the others by virtue of their mutual agreement. One of the *fiqh* principles of relevance here provides that “contract is the *sharīah* of the contracting parties (*al-ʿaqd sharīʿat al-ʿāqidayn*).” This is of course indicative of the recognition in the *sharīah* of the basic freedom of contract, and a measure of flexibility available in the *sharīah* on contractual stipulations by mutual agreement – provided they do not contravene the basic purpose of a contract nor the general norms of morality and justice.

The basic purposes of *mushārah* may be said to facilitate beneficial cooperation among people through the pooling of resources and skills, and trading

and investment that earn profit for the partners and benefit society. The Qur'an and *ḥadīth* are explicitly supportive of lawful work and cooperation among people in the pursuit, trade and transactions among people, and unhindered flow of transactions in the market place.²⁰ The more specific objective of *mushārah* may be said to institute trust and its due observance among the partners through a series of more detailed regulations elaborated in the *fiqh* blueprint on this contract. The *fiqh* classification of contracts designates *mushārah* as one of the *'uqūd al-amānāt* (fiduciary contracts). There must as such be full transparency among the partners and the element of trust must remain the governing principle of their business relations.

Now if one were to expatiate in the insertion of clauses and stipulations in *mushārah*, such as by assigning more than one voting right to the preferential share-holding partners, giving them priority rights to profits/dividends, and priority also to claim their capital in the event of liquidation of partnership – even if these were to be through mutual agreement of the parties, or through *tanāzul* -- they are bound to erode the substance of equality and trust among the partners.²¹ For stipulations of this kind clearly place some of the partners in a different, superior or inferior, position over the others.

The *fiqh* discourse on *mushārah* provides helpful details that can ascertain the limitations of contractual stipulations in *mushārah*. Thus it is made known, for instance, that profit is a comforting prospect, but suffering loss is distressing. Hence the *fiqh* flexibility that the partners in a *mushārah* may agree on a different apportionment of profits compared to their share in the capital but that the losses absorbed must always be proportionate to their share of the investment. To contravene this by way of differential stipulations is likely to damage the integrity of the trust (*amānah*) of partnership that necessitates transparency and equality among the partners. In odd or special cases, this may or may not present a problem, but as a general rule of *mushārah*, if one were to stretch the limits of differentiation, it is likely to compromise the objectives of *mushārah* and its basic characteristics.

To give an example of the *maqāsid* of a non-commercial contract, the *shar'ah* identifies procreation of the human species as the primary (*aṣlī*) *maqṣad* or purpose of the marriage contract. Other purposes, such as friendship and companionship, as well as sexual enjoyment, are among the subsidiary (*tab'ī*) objectives of this contract. The spouses are allowed to insert certain stipulations in their contract provided they are harmonious with the purposes of marriage. But a marriage contract cannot take stipulations totally outside its *shar'ah*-determined *maqāsid*. A *shar'ah*-compliant marriage thus precludes same-sex union in matrimony simply because it fails to obtain the purpose of procreation. It would also go against the purpose of marriage to insert a condition that the spouses (unless elderly or invalid) will not have a child, or that they will not cohabit with one another.²²

The substance of our discussion concerning the observance of the *maqāṣid*/objectives of contracts can be extended to almost every contract, which we do not propose to elaborate here. Our main point is that an ethically integrated approach to *sharīah*-transactions and contracts must be duly informed by their primary and secondary purposes and be reflected also in the kind of flexibility that the contracting parties can exercise through their mutual agreement.

As already noted, equity participation and risk sharing are the preferred modes of transaction in Islamic finance. The profit and loss sharing (PLS) arrangement is meaningful when the financier shares in the risk aspect of the transaction and avoids the temptation of shifting the entire burden of losses to the entrepreneur and client. Both the financier and entrepreneur are to equitably share the profit as well as the risks that may anticipate loss. One of the general principles of Islamic finance-cum-legal maxim of *fiqh* to note here is that “risk justifies gain – *al-kharaj bi 'l-daman*.”²³ One who seeks to have gain, in other words, must also be prepared to take its related risk.

Another important principle of Islamic finance, which is also a general objective, or *maqṣad ʿāmm*, of the *sharīah* as a whole, is social justice. This is realised through a variety of *sharīah* provisions on *zakāt*, *iḥsān* (benevolence), *tabarruʿ* and charity (*ṣadaqah*), as well as the giving of benevolent loans (*qarḍ ḥasan*), within and beyond the sphere of contracts. The *fiqh* regulations on contracts, their essential requirements (*arkān*), conditions (*shurūṭ*), procedural requirements, objectives and prohibitions, are on the whole guided by considerations of accuracy and equivalence of counter-values in exchange contracts, just as they also seek to realise an equitable regime of contracts or contractual justice that translates in turn into social justice.

An example of how uneven distribution of risk in financing can have adverse consequences for social justice is the US subprime (mortgage) crisis of 2008, which was a result largely of excessive lending. Banks and mortgage originators passed the entire risk of default to the ultimate purchaser of the loan security through repeated instances of securitisation. They had little incentive to undertake risk or to ascertain careful underwriting. The loan volume to them had priority over loan quality, and the amount of lending to subprime borrowers increased. A number of banks and other financial institutions either failed or had to be bailed out at the taxpayers’ expense not only in the US but also in the UK, Europe and other countries.²⁴

Enhancing the scale and size of PLS in Islamic finance, which both Umer Chapra and Abbas Mirakhor have recommended for conventional finance, is likely to prove beneficial. This is because sharing risk and reward between financiers and clients helps to induce the financial institutions to assess the risks more carefully and then also to monitor more effectively the use of funds by the borrowers. This double assessment of risk by both the financier and the entrepreneur should help

inject greater discipline into the financial system, and go a long way to reducing excessive lending.²⁵

Two areas of public finance that effectively incorporate PLS are the stock markets and foreign direct investments (FDIs). PLS constitute the basic purpose of stock market transactions generally, not only in the Islamic but also in conventional finance. Mirakhor has thus highlighted the role of stock markets as well as FDIs as effective tools of risk distribution. The former are effective in diversifying the investor base while distributing risk across the whole spectrum of investors, which increases the resilience of the economy to shocks. Capital inflows through FDI similarly exert a great stabilising influence on the economy, in contrast to debt and extensive recourse to credit-based finance, which add to the risk of recurrent financial crises.²⁶

Prohibition of *Ribā* (Interest)

The *sharīah* prohibits *ribā* and the qur'ānic prohibition of *ribā* is worded in characteristically very broad and unqualified terms that “God permitted sale and prohibited usury” – *aḥall Allāh al-bayʿ wa ḥarrām al-ribā* – 2:275) which subsume all kinds of sales as well as all kinds of *ribā*.²⁷ Since the Qur'ān permits all sales, permissibility (*ibāḥah*) becomes a basic norm that extends to all of them, unless there be exceptions or qualifications of some kind. The Prophet has made certain exceptions to the basic norm of permissibility when he declared some varieties of sale that were common among the Arabs of his time as impermissible for various reasons- hence they became the exceptions.²⁸ Muslim jurists have also added certain others to the list on such grounds as *gharar* or *ribā*, but beyond that the basic element of mutual consent validates all sales and no specification or itemisation of the permissible varieties of sale is therefore necessary.

The position is different with regard to the *sharīah*-prohibition of *ribā*. Prohibitions cannot be generalised and must be clearly identified and explained, as the Qur'ān clearly declares that “God has explained to you in detail what is forbidden to you.” (6:119). The prohibited varieties of *ribā* have thus been expounded by the *Sunnah* of the Prophet, but the information so provided is not all-inclusive, due partly to what the second Caliph of Islam ‘Umar b. al-Khaṭṭāb has been quoted to have said: that the prohibition of *ribā* came at the final stages of the qur'ānic revelation, and the Prophet did not live long enough to provide fuller explanation on *ribā*.

Ribā (lit. ‘increase’) denotes a predetermined return on capital or loan that accrues to the creditor. Two main varieties of *ribā* have been distinguished in the ḥadīth and juristic doctrine. Credit-based (*ribā al-nasī'ah*, or *ribā al-duyūn*) is analogous to bank interest, and incremental *ribā* (*ribā al-faḍl*, or *ribā al-buyūʿ*) involves increase in one of the counter-values in sale or other exchange transactions.²⁹ To receive,

for example, two kilos of wheat for one kilo in a barter exchange (even of a different quality), either at transaction time or in the future, would be *ribā al-faḍl*. The principal *ḥadīth* on this type of *ribā* confines it to six items, namely gold and silver (which were the two units of value at that time), as well as wheat, barley, dates and salt, which were basic foodstuffs. Sale of these items was to be in equal measures and spot, without any deferment on either side. It seems that the *ḥadīth* clubbed the six items together due to the fact that all of these were the most frequently traded and exchanged in barter sales at that time. The economic implication is that money is a medium of exchange to be sought not in itself but as a unit of value for other commodities.

The institutional support that Islamic law provides for its interest-free financial system across the board includes, inter alia, the sanctity of contract, regulation of property rights and trusts (*al-amānat*), rules of behaviour for market participants and government functionaries, and rules governing allocation and distribution of resources. “There can be little doubt that with such a strongly rule-based framework in which faithfulness to contract and strong prohibition against taking interest, lying, cheating, and fraudulent activities are stipulated, the financial system of Islam would be efficient, transparent, and informationally trouble-free.”³⁰

Credit interest is the price paid for the use of money; it is not the yield of capital. And herein lies the difference between interest and profit. Interest arises from a loan of money whereas profit accrues from the investment of capital. Money-lending without investment is forbidden by the *sharīah* as it involves exploitation and violates the spirit of social justice. For it involves no genuine sacrifice by the financier and leads to imbalances in wealth and income distribution in society. Whereas the orthodox doctrine related interest closely to profit as if the two progressed or declined together, John Maynard Keynes portrayed them as antagonists. “Interest upon money is simply an added cost upon capital goods and therefore a deduction from profit and a burden upon enterprise.” Socialist theory assailed interest even more vehemently than Keynes, but socialist theory also assailed profit, whereas Keynes salutes profit as the engine that drives the car of progress.³¹ Without the institution of interest, unspent income would find its way to investment in exchange for a reward contingent on the outcome of the real sector investment. The debt-based financial capitalism is thus prone to encouraging unemployment. Abbas Mirakhor’s analysis of the Keynesian General Theory leads him to the conclusion that the end-result of rentier-based finance is unemployment, poverty and deprivation; that the chief evil of the modern financial capitalism is its strong tendency to generate arbitrary and inequitable distribution of income and wealth.³²

Hyman Minsky also observed that a financial system dominated by fixed interest-based debt contracts is inherently unstable. He saw capitalism as a dynamic system, which is burdened, however, by a number of internal dialectical processes that made instability, unfair distribution, and unemployment structural problems of the

system. Minsky concludes that the financial system of money capitalism is eventually unsustainable.³³

Muhammad Rawas Qalaji has noted that one who places his money in a bank to earn predetermined interest without having a say in the manner the interest is earned is naturally not involved in any enterprise or investment activity nor can one expect to gain any skill. When a large number of people simply place their money in interest-bearing accounts, it is likely to have negative consequences for the health of society as it suppresses the spirit of individual enterprise and development of skill on the part of the individual.³⁴ A person who takes interest without taking any investment risk also falls foul of the *shar'ah*-principle already mentioned that "risk justifies gain."³⁵

Taqi Usmani and Umer Chapra both maintain that exclusion of interest from financial activities does not necessarily mean that the financier cannot earn a profit. If financing is meant for a commercial purpose, it can be based on partnership or on *commenda* (*musharakah* and *muḍarabah*). In the event these do not offer relevant options, trading contracts like *murabahah*, *ijarah*, *salam* and *istiṣnā'* can be employed.³⁶

Asset-backed Financing

One of the salient characteristics of Islamic finance is that it is generally asset-backed and based on assets in the real economy. Whereas conventional finance deals in money and monetary articles, Islamic finance does not recognise money as an object of trade, but only as a medium of exchange. In Islamic finance, profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged one for another. The profit that accrues from dealing in liquid assets, money or the articles representing it is interest, which is prohibited. Islamic finance nearly always uses liquid assets which create profits and inventories.

The ideal instruments of financing in the *shar'ah* are *musharakah* and *muḍarabah*, as already mentioned. When the financier contributes money on the basis of these two instruments, it is bound to be converted into assets that have intrinsic utility. Profits are consequently generated through the sale of real assets.

Financing on the basis of *salam* (forward sale) and *istiṣnā'* (manufacturing contract) also creates real assets. The financier in the case of *salam* receives real goods and can make a profit by selling them in the market. In the case of *istiṣnā'*, financing is effected through manufacturing some real assets, as a reward for which the financier earns profit.

Financial lease (*ijarah*) and cost plus profit sales (*murabahah*) are not primarily designed to be modes of financing. But in order to meet some needs they have been employed as financing tools, subject to certain conditions, especially in situations where *musharakah*, *muḍarabah*, *salam* and *istiṣnā'* are not workable. These uses of leasing and *murabahah*, however, have come under criticism in that their net result is often the same as that of interest-based borrowing. This criticism is not without merit

as there is a groundswell of opinion among *sharīah*-advisors that these are not ideal modes of financing and should only be used in cases of need with full observance of the conditions attached to them. Notwithstanding the validity of this critique, leasing and *murābahah* instruments are also fully asset-backed and thus distinguishable from interest-based financing.³⁷

Minimal Reliance on Debt

Islamic financing does not allow the creation of debt through direct lending and borrowing. It rather facilitates the creation of debt through the sale or lease of real assets through sale and lease-based modes of financing (*murābahah*, *ijārah*, *salam*, *istiṣnāʿ*, and *ṣukūk*). The purpose is to enable an individual or firm to buy the real goods and services needed in line with the ability to make payment later. This position is further endorsed by a number of *fiqh* provisions that help prevent excessive expansion of debt. Some of these provisions are:

- The asset which is being sold or leased must be real, and not fictitious or notional;
- the seller must own and possess the goods being sold or leased;
- the transaction must be a genuine trade transaction with full intention of giving and taking delivery; and
- the debt cannot be sold and thus the risk associated with it cannot be transferred to someone else. It must be borne by the creditor himself.³⁸

The first condition will help eliminate most of the speculative transactions that involve excessive uncertainty (*gharar*), and risk-taking akin to gambling (*maysir*). The second condition will help ensure that the seller (or lessee) also shares a part of the risk to be able to partake in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he/she bears the risk. Exceptions to this rule are made in cases of *salam* and *istiṣnāʿ*, where the goods are not already available in the market, nor owned as such, and need to be produced before delivery. *Salam* and *istiṣnāʿ* have, however, been exceptionally validated due to the public need and *maṣlaḥah*. The Islamic modes of finance can thus expand only in step with the rise of the real economy and thereby help excessive credit expansion.

The third and fourth conditions, that the transaction must be a genuine trade transaction and that the creditor cannot transfer the risk to someone else by selling the debt, will help eliminate speculative transactions, and also prevent debt arising far above the size of the real economy. These conditions also help release a greater volume of financial resources for the real sector and thus expand employment and self-employment opportunities through the production of goods and services.

As will be noted from the foregoing, the *sharāh* permits debt-based transactions, which are, however, limited to situations where only one of the two countervalues in an exchange contract consists of a debt. For example, in *bay' bi-thaman 'ājil*, or deferred sale, only the price, but not the sale object, consists of a debt. Since the sale takes place over a real asset, such as a building or a plant, the debt in question is asset-based and proportionate to the price of the sold item.

This is also the case in the forward sale of *salam*, in which only the sale object, but not the price, consists of a debt. All the contractual details of the debt in *salam* must be specified in writing to ensure commitment, proportionality and equivalence in the exchange of values.

Sharāh-law does not approve of a financing scheme in which both the countervalues consist of debt. The sale of debts (*bay' al-dayn*) which consist of debts on both sides of the transaction is thus prohibited owing to excessive uncertainty (*gharar*) that jeopardises market stability and puts into doubt due fulfillment of contractual obligations. A difference of opinion has thus arisen concerning the validity of *istiṣnā'*, or manufacturing contract, whereby an order is placed for manufacture of goods, be it a house, ship or handicraft. Nothing changes hands at the time of contract and both sides of the bargain consist of debts payable in the future – which is why Muslim jurists have considered *istiṣnā'* as basically *ultra vires*. Yet *istiṣnā'* has been exceptionally validated by consensus (*ijmā'*) because of the people's need for it.³⁹

Moreover, in conventional financing, loans may be advanced for any profitable purpose. A gambling casino can borrow money from a bank to develop its gambling business, and so can a pornographic magazine or a company that produces prurient films. This would not be allowed in IFI as these cannot remain indifferent to the nature of activity for which the facility is required. Neither *murābahah* nor financial leasing can be employed for immoral and socially harmful purposes.

There is also a difference between a conventional loan and *murābahah*. In an interest-bearing loan, the amount to be repaid by the borrower keeps on increasing, whereas in *murābahah* the selling price, once agreed, remains fixed and the financier cannot increase it even if the client does not pay on time. In leasing too, financing is offered through providing an asset having usufruct, and the financier bears the risk of the leased property. Islamic financing transactions are thus backed by assets, and financing in them is matched with corresponding goods and services. This is unlike interest-based financing wherein the supply of money through the loans advanced by the financial institutions does not normally match the real goods and services produced in the economy.⁴⁰ In his monographic work on *murābahah*, Yūsuf al-Qaradāwī too has come out in defence of *murābahah* and refutes the critique that *murābahah* is used as a mere disguise for *ribā*.⁴¹

The hard reality prevails, however, that conventional financing makes debt a preferable option because of tax and other incentives attached to it. Easy availability

of credit at present enables individuals and institutions to have high debt profiles even beyond their means. Excessive lending and layers of debt-financing through repeat securitisation of mortgages in the US subprime crisis is a case at point. With every percentage rise in the house prices, the owners increased their borrowing on the strength of that increase and lenders were more than willing to oblige. The result was that the financial sector dominated the real sector, as layer upon layer of securitisation thinned the relation between the two to the point where an inverted pyramid of debt was supported by a very narrow base in the real sector. This prompted many observers to assert the need for a new architecture that favours equity financing and reduces over-reliance on debt.⁴² Yet in response it is also noted that a decisive shift is not likely, simply because the market will not easily adapt to equity structures when debt is cheaper. Only when debt is made more expensive by taking away tax and other incentives, can a larger space be created for equity-based financing away from the presently prevailing over-reliance of the financial system on debt.⁴³

The view that a financial system dominated by credit and debt-based contracts is prone to instability and eventual collapse has been around since the nineteenth century. But its most respected intellectual pedigree dates back to the Great Depression years of 1930s when the view found forceful expression in the writings of eminent economists such as Henry Simons in the United States and Keynes in the United Kingdom. The recognition that the fractional reserve banking in which credit multiplier and leverage ratio mechanisms were operative was the source of credit instability led American economists (especially the Chicago Group) to propose reform of the US-banking system, to require banks to maintain reserves equal to 100 per cent of their deposit. While the proposal was not enacted into law, it remained influential and resurfaced time and again; the proposed reform was aimed at imposing discipline and limitations on credit creation within the system.⁴⁴

Whereas many American economists saw fractional reserve banking as a source of financial instability, Maynard Keynes saw the role of interest and the rentiers who demanded it as the greater evil. In his renowned book, *The General Theory* (1936), Keynes called for steps toward the “euthanasia of rentier”. The issue of interest as rent on money occupied no less than three chapters (12, 17, and 23), that is, a good part of Keynes’s *General Theory*.⁴⁵

Commenting on the role of debt in Islamic finance, Umer Chapra observed that the *sharī‘ah*-limitations on debt-financing do not necessarily mean that debt financing is ruled out altogether, nor even that it should be ruled out. This is because the financial needs of individuals, firms and governments cannot all be made amenable to equity-based contracts and profit-and-loss sharing arrangements. Debt is therefore indispensable, but should not be promoted for inessential consumption and unproductive speculation. Chapra cautioned, however, that if the debt is not

used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises.⁴⁶

Risk-Taking (*Gharar*)

Islamic finance is averse to excessive risk-taking that causes instability in market transactions and threatens due fulfilment of contractual obligations. *Gharar* refers to elements of uncertainty in contracts that expose one or both of the contracting parties to risk. The Ḥanafī jurist al-Sarakhsī (d. 1090) defined *gharar* as something with unknown consequences.⁴⁷ An example of the prohibited *gharar* would be a sale and purchase contract which does not specify the price. *Gharar* can also be caused by doubt or ignorance of one or both of the parties over the existence, quality, deliverability, or other material attributes of the subject matter of contract. The question whether risk-taking in transactions amounts to *gharar* often depends on its scale and magnitude. An exorbitant *gharar* (*gharar fāḥish*) may render a transaction null and void or constitute a ground for indemnity and compensation. *Gharar* cannot be totally eliminated, as one would be hard-pressed indeed to preclude all uncertainty from even ordinary business transactions. Muslim jurists have consequently agreed that a slight *gharar* (*gharar yasīr*) is generally tolerated in exchange contracts (*‘uqūd mu‘āwadhāt*), and so is *gharar*, even when exorbitant, if preventing it would inflict hardship on the society at large.⁴⁸

The prohibition of *gharar* in the *shar‘ah* is founded on considerations of fairness and justice as *gharar* in a transaction may cause injustice and loss of property to one or both of the parties. The presence of exorbitant *gharar* in a contract is also likely to undermine the integrity of contractual consent. This is because a person’s consent to a transaction might be based on false information concerning a material aspect of the subject matter of contract and therefore the consent given is not genuine. One of the basic objectives, or *maqāṣid*, of the prohibition of *gharar* in the *shar‘ah* is also to prevent future disputes among the contracting parties. A *gharar*-laden contract concluded in ignorance of material information by one or both of the parties to contract can naturally provoke a dispute when the missing information becomes known.⁴⁹

Conclusion and Recommendations

In one of her landmark speeches on India, Sonia Gandhi, President of the Congress Party of India, observed, “Our economy may increasingly be dynamic...but our moral universe seems to be shrinking,” adding also that “graft and greed are on the rise [...] prosperity may have increased, but so has social conflict.”⁵⁰ A Shanghai business personality, Ji Qi, also commented at an interview that the economic success of China has brought with it a “crisis of meaning,” adding further that “it is impossible to feel calm and quiet in a society that only chases profit; there

is too much attention to money and not enough to values.”⁵¹ If the sentiments of young achievers in these countries are any guide, the next chapter in the Indian and Chinese stories will be “about anchoring and purpose, about the quiet life within.”⁵²

The western notion of ethical investment, which also takes its origin in religious and moral precepts, has much in common with Islamic finance. The 2008 global financial crisis that began with the US subprime debacle brought the concern over the collapse of ethics in financing to the forefront of the G20 summit 2009 agenda in London when Gordon Brown and Kevin Rudd – then prime ministers of the United Kingdom and Australia, respectively – called for observance of moral values in financial markets.⁵³

The aftermaths of that crisis were still being debated two years later. In his May 2011 speech at the Oxford Centre for Islamic Studies, Malaysia’s current Prime Minister, Najib Tun Razak, called for virtues of moderation to curb extremism and greed and drew attention to the positive role Islamic finance can play to achieve them: “in place of excess, Islamic finance offers moderation and transparency. In place of greed, Islamic finance offers fairness.”⁵⁴

Yet the way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with its *sharīah*-requirements. It has not been able to come out totally of the straitjacket of conventional finance. The use of equity and PLS modes has been insignificant, while that of the debt-creating sale and lease-based modes of financing have been predominant. Even in their use of debt-creating modes, Islamic financial institutions do not fulfil all the conditions laid down by the *sharīah*. They try to use different stratagems (*hiyal*) to transfer the entire risk to the purchasers (debtors) or the lessees. One of the reasons explaining why this is happening – in addition to the general reluctance of banks to share risk – is the absence of institutions to minimise risk. Institutions to minimise risk associated with anonymity, moral hazard, principal/agent conflict of interest and late settlement of financial obligations have not yet been established.⁵⁵ These are needed to enable Islamic financial institutions to obtain reliable information about their clients and to ensure that the financing they extend to their clients is efficiently employed, and that the profit declared by them reflects the true picture of the business.

Regulation is naturally important, yet there is growing recognition that law and contract alone are not enough to make up for information asymmetry and trustworthiness. “We need ethics,” as Anas Zarqa rightly stressed, simply because excessive supervision and “elaborate specifications of details and enforcement costs will take a big bite out of the potential benefits of the transaction. Thus contract and law cannot by themselves protect the interest of those who lack information.”⁵⁶ The ethical purpose of Islam in human relations and in business transactions is to ensure justice and fair dealing, which help to bring about harmony, equilibrium and social progress. This is all the more desirable in the age of globalisation that brings

countries and communities in constant interaction where hardly anyone is totally immune from economic and financial instability and turmoil.⁵⁷

All legal traditions, including the *sharīah*, recognise certain lines of distinction between law and ethics, and it would be unrealistic to expect governments and regulatory bodies to change that. Ethical advice can best be practiced through persuasive measures and incentives. It should be possible, however, to integrate the ethical purpose with regulatory requirements by looking more closely into the *maqāṣid* guidelines, which are naturally informed by ethical precepts and purposes. This aspect of integration between the *sharīah* rules and their purposes in Islamic banking and finance manifests a characteristic feature of the *sharīah* and has been the main theme of this article.

- Integrating the *maqāṣid al-sharīah* in the operative rules of Islamic banking and finance will help bridge the gap between the substance and form of *mu‘āmalāt* and also enhance the measurability aspects of performance. Accountability into the system can also be meaningfully enhanced when purposes of contracts and transactions are identified with greater clarity. Hence the regulatory authorities should enhance not only the knowledge of *maqāṣid* but also take measures to integrate them into industry regulations and contract specifications.
- A self-critical and evaluative approach to IBF should open fresh avenues to enhancing ethical and social justice dimensions of the industry. This is a much neglected aspect of Islamic banking and finance whose drive for profit maximisation makes it indistinguishable from its conventional *ribā*-based financing. Islamic banking and finance should pay closer attention to micro-finance and ways and means of eradication of poverty through it.
- Ethical concerns and credibility factors demand that Islamic banking and finance should develop greater vigilance in order to reduce the hitherto rampant tendency toward imitation and match-making of the conventional banking modalities and products.
- The risk-sharing component of *sharīah*-based transactions and finance manifests the ethical core of Islamic finance. But risk-sharing has yet to find a meaningful place in Islamic banking and finance operations. This may take time but it will not happen of its own accord. Proactive measures are therefore necessary to enhance the share of participatory contracts and financing in Islamic banking and finance operations.
- Islamic financial institutions should liaise more closely with financial institutions in the West and elsewhere that encourage ethical investment schemes and products. Ways and means should be found to facilitate greater cooperation, which would hopefully also contribute to the health of world economy.

- Greater vigilance is called for against arbitrary and unwarranted insertions of stipulations in, and technical manipulations of, *sharīah*-contracts that erode the ethical substance and authenticity of these contracts. Aberrations should be identified and suitable amendments and or substitutes should then be found and encouraged. This could be made a part of the *sharīah*-research component of the *Sharīah* Governance framework the Central Bank of Malaysia introduced in July 2011.
- The system rewards debt in both the conventional and Islamic finance. There is clearly too much reliance on debt, and greater vigilance is called for to identify risk-laden debt and lending operations in the system and reduce it to tolerable levels. On a side note, the Government and Central Bank of Malaysia have, much to their credit, already set in place policy guidelines to curb easy availability of credit for motor vehicles, credit cards and property financing, which have been the main movers of debt and bulging volumes of non-performing loans, even of mass default. The Central Bank has been on the right track to “preempt the risk of financial calamity by standing firm in its lending policy rather than resolving the problem when it is too late.”⁵⁸ Debt-reduction measures serve the larger *sharīah*-purpose of preservation of property (*hifẓ al-māl*), just as they also enhance clarity and accuracy (*wuḍūh*) in the identification of consumer need and ability to repay. Both of these are well-organised *maqāṣid*.

In sum, due to many permutations and close matching of conventional products, Islamic banking and finance stand at a crossroads over loss of credibility and public confidence among Muslims. Taking well-considered measures and policy initiatives to enhance the ethical dimensions of their operations and products will go a long way to curb that negative trend from becoming unmanageable.

Notes

1. Nik Mustapha Nik Hassan, “Business Social Responsibility from the Islamic Perspective,” in: idem and Sheikh Mohd Saifuddeen Shaikh Mohd Salleh (eds.), *Corporate Governance from the Islamic Perspective*, Kuala Lumpur: Institute of Islamic Understanding Malaysia, 2002), 38.
2. Quoted in *ibid.*, 39.
3. Qur’ān, 4:29.
4. *Ibid.*, 4:58.
5. Cf., *ibid.*, 29:127.
6. *Ibid.*, 83:1-6.
7. *Ibid.*, 17:35, 4:135, and 57:125.
8. *Ibid.*, 49:10 and 49:13.
9. *Ibid.*, 5:2.
10. *Ibid.*, 5:1; 4:58; 23:8 and *passim*.
11. *Ibid.*, 8:58. See also Mushtaq Ahmad, *Business Ethics in Islam* (Islamabad: International Institute

- of Islamic Thought and International Institute of Islamic Economics, 1995), 82 ff.
12. *Ṣaḥīḥ al-Bukhārī* (Cairo: Dār al-Ḥadīth, 2004), 17, *ḥadīth* no. 33.
 13. Aḥmad b. Muḥammad Ibn Ḥanbal, *al-Musnad* (Cairo: Dār al-Ḥadīth, 1995), 10:438, *ḥadīth* no. 12,324.
 14. Ibn Ḥajar al-ʿAsqalānī, *Jawāhir Ṣaḥīḥ al-Bukhārī*, ed. ʿIzz al-Dīn al-Sīrwan (Beirut: Dār Iḥyāʾ al-ʿUlūm, 1407AH/1987), *ḥadīth* no. 275.
 15. Qurʾān, 2:280.
 16. Abū Dawūd, *Sunan Abī Dawūd*, “kitāb al-buyūʿ,” “bāb fī ḥsun al-qaḍāʾ,” *ḥadīth* no. 3,346.
 17. Muslim, *Mukhtaṣar Ṣaḥīḥ Muslim*, 255, *ḥadīth* no. 962.
 18. Umer Chapra, “The Global Financial Crisis: Can Islamic Finance Help Minimise the Severity and Frequency of such a Crisis in the Future?” *Islam and Civilisational Renewal* 1, no.2 (December 2009), 236.
 19. See for details Mohammad Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (Cambridge: Islamic Texts Society, 2000), 74ff.
 20. Cf., Qurʾān, 2:275; 2: 282; 4:29.
 21. Cf., Muḥammad Rawās Qalajī, *al-Muʿāmalāt al-māliyyah al-muʿāsirah fī dawʾ al-fiqh wa ʾl-sharʿah* (Beirut: Dar al-Nafāʾis li ʾl-Nashr wa ʾl-Tawzīʾ, 2002), 62.
 22. See for general information on Islamic matrimonial law, Mohammad Hashim Kamali, “Islamic Personal Law,” in: *The Encyclopedia of Religion* (New York: Macmillan, 2005, 2nd ed.).
 23. This is also a *ḥadīth* – cum legal maxim; see Muḥammad ʿUthmān Shābir, *al-Qawāʾid al-kulliyah wa ʾl-ḍawābiḥ al-fiqhiyyah fī ʾl-sharʿah al-islāmiyyah* (Amman: Dār al-Nafāʾis, 1426AH/2006), 311. A second legal maxim of similar purport discussed in the same work is that “liability for loss justifies gain – *al-ghurm bi ʾl-ghumm* – *ibid.*, 316.
 24. Cf., Chapra, “The Global Financial Crisis,” 233.
 25. *Ibid.*, 235. See also Abbas Mirakhor, “Toward a Meeting Point between Islamic Finance and Globalisation,” *Islam and Civilisational Renewal* 1, no. 2 (December 2009), 246ff.
 26. *Ibid.*, 251.
 27. For details of the various varieties and classifications of *bayʿ* see Yūsuf al-Qaraḍāwī, *Bayʿ al-murābahah li ʾl-ʾamir bi ʾl-shirāʾ kamā tajrīh al-maṣārif al-islāmiyyah* (Cairo: Maktabah Wahbah, 1415AH/1995), 16.
 28. This includes the *mulāmasah* (touch) and *munābadhah* (throw) sales which resembled gambling. Thus, if one touched an item it was deemed sold, or if one threw it, or set it aside, it was also deemed sold.
 29. See for details Securities Commission Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council* (Kuala Lumpur: Lexis Nexis, 2007, 2nd ed.), 98.
 30. Abbas Mirakhor and Nouredine Krichene, “Recent Crisis: Lessons for Islamic Finance” (Kuala Lumpur: Islamic Financial Services Board, 2009), (available online at http://www.ifsb.org/docs/OTHER_IFSB_Lecture02_Dr%20Abbas%20Mirakhor.pdf (accessed on 17 May 2012), 35.
 31. *Ibid.*, 26.
 32. *Ibid.*, 30.
 33. Hyman P. Minsky, “Global Consequences of Financial Deregulation,” Working Paper no. 96 (September 1986), Washington University, St Louis MO, Department of Economics, available online at http://digitalcommons.bard.edu/cgi/viewcontent.cgi?filename=0&article=1377&context=hm_archive&type=additional (accessed on 17 May 2012).
 34. Qalajī, *al-Muʿāmalāt*, 44.
 35. *Ibid.*, 46.
 36. Muhammad Taqī Usmani, *An Introduction to Islamic Finance* (Karachi: Idāratul Maʿārif, 2000), 10; Chapra, “The Global Financial Crisis,” 236.

37. Cf., Usmani, *An Introduction*, 19-20.
38. Cf., Chapra, "The Global Financial Crisis," 237.
39. See for details on *istiṣnāʿ* Mohammad Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (Cambridge: Islamic Texts Society, 2000), 25-26.
40. Cf., Usmani, *An Introduction*, 22.
41. al-Qarāḏāwī, *Bayʿ*, esp. 27f.
42. Cf., Mirakhor and Krichene, "Recent Crisis," 21.
43. Mohammed Imad Ali, "Ṣukūk: Perception, Innovation and Challenge," forthcoming in a book soon to be published by IAIS Malaysia.
44. Cf., Mohsin Khan and Abbas Mirakhor, "The Financial System and Monetary Policy in an Islamic Economy," *Journal of King Abdulaziz University (Islamic Economics)* 1 (1989), available online at http://islamiccenter.kau.edu.sa/arabic/Magallah/Pdf/1/01-MohsinAbbas_10.pdf (accessed on 17 May 2012); see also Shoji Kobayakawa and Hisachi Namkamura, "A Theoretical Analysis of Narrow Banking Proposals," *IMES Discussion Article Series* 99-E-19 (Bank of Japan, 1999).
45. John Menyard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harbinger Books, 1936).
46. Chapra, "The Global Financial Crisis," 229.
47. Shams al-Dīn al-Sarakhsī, *al-Mabṣūṭ* (Beirut: Dār al-Maʿrifah, 1989), 12:194.
48. See for details on *gharar* Kamali, *Islamic Commercial Law*, 84-99; see also Securities Commission Malaysia, *Resolutions*, 103.
49. See for details Securities Commission Malaysia, *Islamic Commercial Law (Fiqh al-Muʿāmalāt)* (Kuala Lumpur: Lexis Nexis, 2009), 58.
50. Quoted by Anand Giridharadas, "Soul Searching in India, China," *New Straits Times* (Kuala Lumpur), 28 November 2010, 21.
51. *Ibid.*
52. *Ibid.*
53. See for details Roziana Hamsawi, "If only They Had Followed Islamic Principles," *New Straits Times* (Kuala Lumpur), 13 April 2009.
54. Mohd Najib Tun Razak, "All Moderates Will Reap the Prize of Peace," *New Straits Times* (Kuala Lumpur), 17 May 2011, 20.
55. Cf., Chapra, "The Global Financial Crisis," 238.
56. Quoted in Nik Mustapha Nik Hassan, "Business Social Responsibility," 40.
57. *Ibid.*, 41.
58. Article by 'R.C.W.' (anonymous), "Bank Negara's Stand Apt," *New Straits Times* (Kuala Lumpur), 14 May 2012, 19.