



HARVARD LAW SCHOOL
Islamic Legal Studies Program

and

LSE

LONDON SCHOOL OF ECONOMICS

Workshop on
*Ethics and
Governance*

Islamic Economic and
Ethico-Legal Perspectives

Thursday, February 25, 2010

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

HARVARD LAW SCHOOL
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February 25, 2010

Dear Participant:

On behalf of Harvard Law School's Islamic Legal Studies Program (ILSP) and the London School of Economics (LSE), I would like to welcome you to this seminal workshop on Ethics & Governance.

This workshop is the continuation of efforts for the past four years in which LSE and ILSP have brought together scholars, economists and practitioners to discuss the most pressing contemporary issues facing Islamic Finance. These gatherings serve as a forum for all participants to express their points of view. For the 2010 workshop, we have a carefully planned agenda for a topic that was chosen by last year's participants, Ethics & Governance.

During the past two decades, we have seen unethical corporate procedures translate into economic crises. In the midst of our current global economic crisis we face questions like the following: How do we ensure that corporations maintain a balance between profitability and sustainability? Do we need an Islamic finance code of ethics? How would we regulate such standards?

Already, we have commenced the conversation by distributing a paper among participants and sharing your valuable comments and concerns. This way, our time here is spent even more productively, helping attain our goal of engendering an advanced and insightful dialogue. We thank you for your valuable participation and hope to see you at future events, such as the Ninth Harvard University Forum on Islamic Finance on "*Building Bridges Across Financial Communities*."

I would also like to thank the visionary leadership of the LSE for partnering with ILSP in this event and hopefully others in the future. Furthermore, I am grateful to the sponsors of Harvard Law School's Islamic Finance Project (IFP): Abu Dhabi Islamic Bank, HSBC Amanah, Kuwait Finance House as well as our new sponsor Islamic Research Training Institute of the Islamic Development Bank.

We hope this workshop will fulfill its goal with your help and welcome any suggestions for the future.

Sincerely,

S Nazim Ali
Director, Islamic Finance Project

OVERVIEW

For the fourth straight year, Harvard Law School and the London School of Economics join hands to convene a day-long workshop in which leading Islamic ethico-legal scholars (*Shari'a* scholars), Islamic economists and Islamic finance professionals address a pressing and major topic in the field of Islamic finance. Following up on our February 2009 workshop on risk management, this year's workshop addresses "ethics and governance".

The relationship between ethics and corporate governance has been a reoccurring topic in the media, with every new headline-grabbing corporate scandal and institutional collapse over the last two decades only underscoring its relevance. From the overreaching of the so-called "Asian crisis" of the late nineties to the more blatant corporate frauds of Enron and WorldCom, the question of how to turn simple corporate governance into *good* (or ethical) corporate governance has remained largely unanswered, and therefore, unimplemented. In unprecedented fashion, the recent global financial crisis has forced many regulators, professionals and observers to acknowledge that the moral hazards of profitable "business-as-usual" have far outstripped the capacity and scope of most corporate governance regimes. As corporate governance frameworks are being shaped and re-shaped in response to lessons learned from the global financial crisis, financial professionals and stakeholders alike must seriously consider the balance between profitability and sustainability, or, otherwise put, between efficiency and equity, that drives any discussion of corporate governance.

Given the nature of the field of Islamic finance and banking, practitioners of Islamic finance have long been aware that in business efficiency and equity cannot be pursued to the exclusion of moral considerations. In theory, concepts of ethical governance are central to *fiqh al-mu'amalat*. The aims (*maqāsid*), principles (*qawā'id*) and values (*ahkām*) of Islamic ethics and law as applied to any business enterprise have always "mapped cleanly" to the concepts of accountability, transparency, fairness and social responsibility. The *shari'a* board—as advisor, monitor and auditor when it comes to the *shari'a* compliance of products and business processes—is regarded by many observers as the entity through which the application of these lofty theories is to be achieved. Yet, with *shari'a* boards operating with varying levels of structural independence from the businesses that they review and with varying mandates for the extent of their review, important questions arise regarding the ability of *shari'a* boards to influence the broader ethical governance of businesses in the Islamic finance sector.

As thought-leaders in the conventional financial sector attempt to repair damaged neo-liberal models by re-examining the relationship between ethics and governance and, in some cases, by considering the adoption of concepts and practices from the *shari'a*-compliant finance sector, scrutiny will most certainly fall upon the role and responsibilities of the *shari'a* board. Furthermore, as these same *shari'a*-compliant institutions come under increasing pressures associated with product innovation and "standardization", we are clearly at a watershed moment in the ongoing discussion of the continued evolution of ethical governance and the role of regulators, management and *shari'a* boards therein. The strengths recognized, dangers acknowledged and reforms recommended at this time will go far to ensure that ethical governance theory is applied in the Islamic finance sector and beyond.

OBJECTIVES

- I. Review the aims (*maqāsid*) and ethical principles (*qawā'id*) that are central to any discussion of enhanced ethical governance in the Islamic financial services sector.
- II. Discuss specific practices in the Islamic finance sector and other comparable financial sectors, (e.g. SRI) in which the opportunity for expanded ethical consideration is particularly noteworthy.
- III. Discover the best practices associated with enhanced ethical governance in the Islamic finance sector and determine who should be responsible for establishing and applying such standards.
- IV. Possible impact of religious and moral teachings on behaviour; can better ethical behaviour be secured through moral education?

Workshop Agenda

8:30 a.m.	Reception and Coffee
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9:00 a.m. Opening Remarks by LSE Director, Sir Howard Davies

9:10 a.m. Introduction by Workshop Moderator, Frank E. Vogel

PART 1: ETHICAL SCENARIOS

In this year's workshop, participants will be provided with three fictitious scenarios in Islamic finance. These fictitious scenarios have been devised to raise various issues about ethics and governance in Islamic finance, while helping to inspire and focus our discussion.

The three scenarios address three levels of consideration:

- I. **SYSTEMIC/MACRO** (i.e., at the level of surrounding social, political and economic systems);
- II. **INSTITUTIONAL** (i.e., at the level of individual Islamic finance institutions); and
- III. **PERSONAL** (i.e., at the level of individual consumers).

For each scenario, we hope participants will respond to the following three questions. Each discussion period will take up these three questions in turn:

1. **What, if any, Islamic ethical boundaries have been crossed?**
2. **What, if any, Islamic standards (rules, principles, values, or guidelines) would you prescribe and why?**
3. **Who should be responsible for prescribing those standards in the industry and how will they be enforced?**

Participants may wish to bring up issues relevant to ethics and governance in Islamic finance going beyond those literally raised by the scenario or the questions. Please try to bring these issues up during the session to which they are most relevant: i.e., according to the levels systemic, institutional, and individual.

PLEASE NOTE: THE SCENARIOS ARE SUBJECT TO CHANGE PRIOR TO THE WORKSHOP.

Scenario 1: Islamic Ethical Standards on a Systemic Level

Company X issues a number of *sukuk* and takes out several lines of *shari'a*-compliant debt to fund its global real estate projects. The success of its first several projects creates jobs and increases prosperity within the region. Due to this success, Company X issues more *sukuk* and incurs greater debt to fund even larger, more ambitious real estate projects, capturing even greater profits.

Several other companies decide to emulate Company X's practices, rushing in to build several speculative projects and many Islamic banks help fund their expansion plans. All of these factors contribute to a high inflationary environment and increase stock market volatility in the region.

Eventually, the regional economic bubble bursts and Company X, as well as several other similar companies, default on their debt, leaving huge piles of non-performing assets on the balance sheets of the Islamic banks. These defaults lead to a severe recession, high unemployment and massive governmental interventions to save the overly exposed Islamic banks, which are 'too big to fail'. All of this tarnishes the reputation of not only Company X but the entire Islamic finance industry.

9:20 a.m. Participants' Views – Open Floor Discussion

Participants are again encouraged to state what they consider to be relevant issues at the systemic/macro level as to Islamic ethics, as well as to refine, debate and answer the above three questions.

11:00 a.m. Tea/Coffee Break

11:15 a.m. Summary – Frank E. Vogel to provide a summary of all the points of views for Scenario 1

Scenario 2: Islamic Ethical Standards on an Institutional Level

Several well-known institutional shareholders send a letter to the board of directors of Islamic Bank X calling for an immediate transformation of the bank to become 'strictly ethical', with respect to everything from its internal structure, dealings, product lines and marketing practices. They demand that the board of directors

start at once making the following changes to the bank's business. They request that these changes be the main focus of the upcoming shareholders' meeting of Islamic Bank X.

They call for the Bank to:

1. Develop more profit-and-loss products and proportionately increase their use;
2. Have a large *qard hasan* portfolio;
3. Foreswear *tawarruq*;
4. Stop selling products that wrap non-*shari`a* compliant returns into apparent *shari`a* compliant structures;
5. Develop and price products without reference to conventional ones;
6. Declare AAOIFI and other industry standards generally too lenient and develop their own stricter standards;
7. Do business locally and regionally as much as possible;
8. Require transparency as a major objective in all transactions and contracts;
9. Publish the current decisions of its *shari`a* board, with reasoning;
10. Require new customers to watch instructional videos;
11. Offer workshops on managing debt (for consumers) and on adopting Islamic business practices (for businesses);
12. Hold a series of public seminars where the *shari`a* board and management explain one after another of the bank's products and strategies;
13. Ensure that some of its products serve the poor and the un-bankable;
14. Offer greater levels of *zakat* and charitable giving;
15. Require that all of the bank's practices and investments be strictly socially responsible (environmentally friendly and sustainable, not linked to human rights abuses, discrimination, or abusive labour practices); and
16. Augment the *shari`a* board's authority and capacities to enhance and audit ethical standards throughout the Bank.

In order to become more 'ethical', the shareholders demand that these changes be implemented even if this sacrifices some profit. But they claim that the new bank will be sooner or later be more popular and profitable than the old one. They threaten to sell their shares and go public with their position if not listened to.

The board of directors, of which you are a member, holds a meeting. What happens?

11:25 a.m. Participants' Views – Open Floor Discussion

Participants are again encouraged to state what they consider to be relevant issues at the institutional level as to Islamic ethics, as well as to refine, debate and answer the above three questions.

12:45 p.m.

Lunch

1:30 p.m. **Summary** - Frank Vogel to provide a summary of all the points of views for Scenario 2

Scenario 3: Islamic Ethical Standards on a Personal Level

Relationship Manager (RM) works for the well-known Islamic Bank Z. RM is under pressure to find and retain customers as Bank Z faces competition from other banks, both conventional and Islamic, with cheaper product offerings.

Bank Z has run an aggressive advertising campaign, even calling account holders encouraging them to take on more debt.

In response Customer C, who has a savings account at Z, goes to see RM. Aged 57 years, C is an average, hardworking Muslim who loves to spend and provide well for himself and his large family. RM shows C product offerings that would allow him to buy a second car, purchase a house, raise funds for his children's education, spend more on their weddings and/or take an overseas holiday. C would like a credit card. He seems agreeable to monthly garnishment of his wages. He shows interest in buying Islamically-screened stocks on the local market.

RM doesn't explain how the various transactions work. C did ask about the *shari`a* board and who was on it.

Several days after this meeting, Customer C's neighbour tells C that Islamic financial institutions are different from conventional banks only in name. Upon investigating, C learns that if there is a difference, it is small, or at least formal and technical. When there is a real difference, people say, the Islamic product becomes more expensive and less convenient. Shari`a boards and scholars differ, some more restrictive than others.

Upon hearing all of this, Customer X feels very confused. He goes to see RM. What does C say, and what does RM say?

1:40 p.m. **Participants' Views – Open Floor Discussion**

Participants are again encouraged to state what they consider to be relevant issues at the personal consumer level as to Islamic ethics, as well as to refine, debate and answer the above three questions.

3:00 p.m. **Tea/Coffee Break**

3:15 p.m. **Summary** - Frank Vogel to provide a summary of all the points of views for Scenario 3

Part 2: Recommendations for Advancing the Cause of Ethics in Finance

3:25 p.m. **General Open Floor Discussion**

Participants to discuss—and, where possible, reach consensus on—general recommendations and issues for further research by way of advancing the cause of ethics in Islamic finance, and/or in relation to other issues to be defined by the moderator.

Part 3: For the Future

4:30 p.m. **Conclusions and Recommendations**

- **Draft Summary and Action Plan** – Participants to assist Frank Vogel in framing any conclusions from the workshop, suggesting solutions and remedies and any action to be taken on them, and identifying areas for further research or discussion. These points will be included in a draft summary of the workshop to be prepared after the workshop and distributed to all parties
- **Next Workshop** – Participants propose topics for the next workshop, for later vote

5:30 p.m. **End of Workshop**

ADDITIONAL QUESTIONS & POINTS FOR CONSIDERATION

*Extrapolated from Participants' Comments
by Husam El-Khatib*

I. Islamic Finance and Ethics

A - Why is there a need for increased ethical standards and governance in Islamic finance?

- Has ethics been downplayed (or perceived to be downplayed) in modern Muslim Thought; if so, why? Is there too much of a focus on '*haram* and '*halal*' versus a focus on the moral actual outcomes of the legal permissibility?
- Is it true that there is a perception of a moral & ethical deficiency and 'social failure' of Islamic Finance as a whole?
- The business design of Islamic banks, modeled / based on conventional banks, is purely product-centric. Do you agree?
- Among other arguments in favor of a code, is one needed in order to counter the view that Islamic finance is simply mimicking conventional banking and its moral & ethical problems?
- Islamic Finance is "more than simply removing elements of *Riba* in contracts and ensuring that financial activities in contractual norms are derived from the *shari'a*". Do you agree?
- But how can IF institutions remain competitive by adopting greater standards and ethical restrictions than the majority conventional banking? What will be the codes be : Simply what the *shari'a* defines as *fiqh al-muamalat* and/or include contemporary, man-made ethical corporate rules?
- Is increased Islamic ethics a burden or an asset to an institution and its management?
- *Akhlaq* versus Ethics. Is ethics much more encompassing and why?
- Law and Morality - Does all law have to be moral?
- The difference between intentions and deeds?
- Should there be an empirical rather than a purely textual assessment of ethical requirements?

B - Islamic Ethico-legal debates

- Short-term-ism versus long-term-ism in society – where are the ethical boundaries?
- Should we not adopt a holistic approach to ethics and ethical governance in Islamic finance?
- Is Islamic Ethics at odds with the concept of what is 'ethical' to shareholders, being the primary focus of most institutions and banks?
- What is the *shari'a* standard of care applicable in debt transactions? Is the standard applicable similar to caveat emptor (buyer's beware)? Or should it be *caveat emptor* (seller's beware) or both?

- Should the Islamic bankers also be required from an Islamic ethico-legal perspective to provide the right advice to the customers instead of deploying clever marketing tactics and fine prints to lure customers into debt?
- Islamic banks slashing their profit rates during Ramadan in response to conventional banks doing the same to incentivize customers to borrow beyond their means.
- Shareholder preference? - How to deal with with a clash between interests of various stakeholders, especially Islamic.
- How much transparency should there be in Islamic finance?
- Whether consumers should educate themselves on the bank's doings?
- How much should consumers be expected to pay for Islamicity, or are they right in expecting that Islamic finance will be fairer, more efficient and cheaper -- as well as *halal* and socially responsible?
- How about something that balances doing social good with profits for shareholders?
- What are the reasons why *mudaraba* is not built up and *tawarruq* is favored?
- Are there more cumbersome credit cards that don't use *tawarruq*?
- Should *tawarruq* be explained in detail to the customer?
- Should there be an industry website with pros and cons among scholars opinions listed for each product?
- Should *shari'a* boards publish their opinions about products, with dissents?
- When does the excuse of "*darura*" stop being valid? What are its limits?
- Should banks standardize products now -- for the sake of the success of the business -- or try to become more Islamic?

2. Format - What is the best format for increasing ethical standards in Islamic finance ?

- Principle based versus rule based – Which is better?
- Do we need a written code of ethics and why?
- Written law versus taught law - Should the focus be merely on legal rules and standards to define the *maqasid al-shari'a* and translate the *fiqh*? Or rather, should it be on promoting an ethical and reasonable mindset instead (i.e., a community of *ihsan*)? or both?
- Is a code of ethics sufficient in of itself? Or should there also be a focus on devising/enhancing organizational ethics? - A written code has deficiencies, like imposing simplistic rules on complex situations, adding to the legislative and regulatory burden, added costs of interpretation and legal harmonization, more bureaucracy, and expensive enforcement mechanisms.
- Should the focus really be on ethics that is taught and instilled into the public versus that which is written like a code of ethics?
- Proscribing ethical rules versus having 'restrictions and barriers and incentives to guide people into good behavior' - Which is better in a society where pressures to gain, perform and be rule based have taken over ethical common sense leading to lots of misconduct as seen today?
- Education – How much of an effective role is it in enforcing/promoting ethics?

3. Responsibility for Enforcement of Islamic Ethics?

- How can you enforce ethics? - It is easy to be preach but difficult to enforce.
- Should each institution be left to its own to devise & enforce its own code of ethics?
- Governance in the past was enforced through the concept and formalised via the institution of *al-hisbah*. Should ethics be enforced and implemented through the same 'institution' today?
- What about the corporate focus on shareholders' well being? Is that not the real impediment to implementing increased ethical standards and enforcement procedures? Should there be an alignment of shareholder expectations?
- How do you increase regulation but without making IF institutions less competitive than their conventional peers?
- *Shari'a* Supervisory Boards be responsible? Oversee moral & *shari'a* issues in transactions. But problem of overstepping their scope of authority in company law.
- What about self-regulation? Not good for creator of new products to self-regulate.
- Institutional regulators? - Ethics through new standards. They can help uniformly raise the bar of ethics standards for all to avoid moral hazards. They can also give authority to SSBs to implement ethical as well as *shari'a* compliance.
- National *Shari'a* Authority ? - to oversee the broader aspects of *shari'a* related issues of the Islamic sector.
- Other independent judicial body - a body independent from the technical standard setters of AAOIFI and IFS.
- What social responsibilities do individuals have to monitor and enforce their own levels of ethics?
- Who should decide and be responsible for personal ethics, other than the individual themselves?

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