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## Making People Behave Properly in Islamic Finance: Some General Thoughts

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**ABSTRACT**

The aim of this paper is to consider two issues:

Is ethical governance the right concept for making people behave properly in Islamic Finance?

How do you make people behave properly?

This paper is limited to looking at some case studies, asking some questions and suggesting some thoughts. The emphasis is on legal and related aspects.

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## I. IS ETHICAL GOVERNANCE THE RIGHT CONCEPT FOR MAKING PEOPLE BEHAVE PROPERLY IN ISLAMIC FINANCE?

Is ethical governance the right concept for ensuring proper conduct in Islamic Finance?

Consider the concept of **governance**. The word has numerous meanings. Let us take it in a very wide sense, covering external and internal normative regimes.

The *external* aspect comprises rules formulated and enforced outside an organisation, what one might call 'regulation'. Types of such rules include law and law's normative offshoots such as self-regulation and the 'comply or explain' basis of the United Kingdom's Combined Code on Corporate Governance.

The *internal* aspect comprises rules which are externally designed, but are internal in the sense that they relate to the structure and practices of an organisation. This might be called 'governance' in a narrower sense. The purpose of internal regimes is to ensure that the organisation is properly managed and, in particular, to ensure that each group of actors concerned with the organisation (stakeholders) acts in accordance with the principle underlying that type of organisation, neither abusing its power nor being abused by another group. The most discussed type is Anglo-Saxon corporate governance.

**Ethics** is the 'science of morals' (Shorter OED). It is clearly distinguished from law.

Both governance and ethics are Western concepts based on Western values. Western thought in these areas is, however, dominant. In particular, governance (in the narrower sense just sketched), although relatively new, has become extremely fashionable, generating its own 'industry'. Indeed, its popularity can produce absurd results, evidence a publisher's flyer advertising books on 'Corporate Governance and Company Law'. This dominance and popularity are such that the culture-specific nature of the two concepts is easily missed. There are lessons to be learnt from the literature on legal diffusion in this regard. Possible evidence of hegemony can be found in, for example, the Malaysian Code of Corporate Governance 2007, which is entirely Western in origin and does not mention Islam or the sharia at all. The Code of Corporate Governance for Bangladesh 2004 is similar to the Malaysian code. Pakistan's Code of Corporate Governance 2002 is solidly based on the Anglo-Saxon model but contains an intriguing section in which the English law concept of fiduciary duties is discussed, and justified in terms of the sharia.

And ethics is not *akhlaq*.

There is therefore a risk inherent in the use of these terms that conceptual hegemony be unconsciously granted to the conventional system. In order to avoid that risk, we need explicit articulation of that cultural specificity; a consideration of whether ethical governance is useful in the quest to attain the aim of Islamic Finance, ie compliance with the sharia in financial dealings; and, if the answer is in the affirmative, a consideration of whether it should be adapted and, if so, how.

Addressing the first question, whether ethical governance is needed in Islamic Finance, one can argue that the sharia encompasses ethics (in the sense of *akhlaq*), so all that is necessary is a set of mechanisms to ensure compliance with the sharia. (For the sake of simplicity, the form/function debate is ignored here.)

On the other hand, the sharia and Western governance do have many principles in common such as the aim of ensuring fairness, transparency and accountability, and the usage does have the marketing advantage of giving the impression that IFIs are covered by protections similar to those existing in conventional finance.

If the latter argument is accepted, then the concepts do need adaptation. For example, Anglo-Saxon corporate governance gives pre-eminence to one stakeholder group, shareholders. Such pre-eminence is against the (ethical) principles of justice and equality in Islam. We also see the need for adaptation in the structural differences between IFIs and conventional institutions resulting from compliance with the sharia, for example the existence of the group of double *mudaraba* investment depositors which has quite different characteristics from those of conventional bank account holders. Such adaptation has already been seen in, say, the IFSB's broadening of the scope of governance to include all relevant groups in IFIs.

How is this adaptation to be effected?

Governance as an explicitly articulated idea is new even in Western legal thought, but at least Western law had corporations, whereas the sharia had none. So we cannot follow the usual method of adapting mechanisms from the classical sharia. The challenges here are demonstrated in the disparate state of the literature on Islamic governance. We see references to a range of principles including *tawhid*, *khilafa*, 'adl, equality and balance of treatment, social welfare, *zakat*, *maslaha*, cooperation, accountability, *taklif*, honesty in trade. Choudhury and Hoque have proposed adaptation of the ideas of *shura* and *hisba*. Their suggestion is intriguing but it also serves as a demonstration of the challenges. In other words, the approach has been, and in the absence of specific mechanisms must be, one of recourse to the general principles of the *maqasid* and the *qawa'id*. Possibilities in this regard are dealt with by colleagues and will not be repeated here, except to mention that the normative regimes of the legal systems which govern IFIs on the municipal level will also need to be taken into account.

## II. HOW DO YOU MAKE PEOPLE BEHAVE PROPERLY?

Whatever the process is called, however it is formulated and whatever the contents of its norms, some way of ensuring compliance with the sharia by IFIs needs to be in force. What is the best way of achieving this aim? More generally, how does one make people behave properly? This question has occupied the minds of many thinkers over millennia.

One solution is to make good people who will behave properly because that is the way they are made. In this model, the child has good principles instilled into her from birth by her family, those principles are reinforced by education. Adults adhere to the principles because of their upbringing, deviations are dealt with by peer pressure and

other informal mechanisms. Formal rules do exist, but they are fairly simple. They operate as a back-up to social mechanisms, indicating by their weight and seriousness the importance attached by society to correct behaviour, and they deal with extreme cases or those in which social mechanisms have proved inadequate.

Another solution is to rely on formal rules. But rules have well known deficiencies. They are crude, imposing a simple world view on a complex world. Attempts to make them more sophisticated leads to complexity and less knowledge and understanding among those subject to them, more cost to society in terms of legislative processes, specialist lawyers, legal education etc. They are subject to different interpretations. They need expensive enforcement mechanisms.

An example of the former model can be seen in the Victorian United Kingdom, briefly mentioned in the last workshop. It seems that it was the loose morals of the 18<sup>th</sup> century which led to a general desire for change. Profound transformations were effected. Thomas Arnold, headmaster of Rugby School 1826-1841, was very influential in the creation of the ideal of the gentleman. Similar notions motivated the British Idealist philosopher and alumnus of Rugby School TH Green, and the Northcote-Trevelyan Report 1854 built upon his work, resulting in extensive reform including open recruitment and the end of patronage. Queen Victoria set an example of dedication in public life. Debt was regarded as morally questionable at best, banks were supposed to lend only to those who could afford to repay.

The success of the Victorian reform movement must not be exaggerated. The official imposition of a certain moral view of the world created what some people felt was a moral straitjacket. In any event the reality departed considerably from the ideal even within the parameters of the system, let alone those elements taken for granted and which we now find unacceptable such as male domination, oppression in family life, societally embedded racism, jingoistic imperialism and a rigid class structure based on privilege. Eventually much of that moral view was rejected. But it is nonetheless true that, whereas public life in the 18<sup>th</sup> century rivalled those of many of today's most corrupt regimes, by the end of the Victorian era British systems had become models to follow in their ethical standards. So the 'restrictions and barriers and incentives to guide people into good behaviour' they set up were effective to a significant degree (quotation from the transcript of the last workshop, a comment on this author's interjection).

An example of the former model can be seen in the regulatory regime instituted in the United Kingdom financial sector upon Big Bang in 1986. The pre-1986 City of London still ran on the Victorian model. It was based on the 'Old Boy Network', a small, close-knit group from the British ruling classes, still dominated by the idea of Thomas Arnold's gentleman whose (spoken) word was his bond - *dictum meum pactum*, the motto of the Stock Exchange. Formal regulation was nugatory. The protection provided by the Prevention of Fraud (Investments) Act 1958 was laughable; the Bank of England exercised oversight with a 'tea and biscuits' approach; regulation in the stock market consisted of listing rules and the Companies Act. Such regulation as did exist was structural, separating functions, keeping Stock Exchange firms British and small and requiring unlimited liability, as befitted a gentleman. More was not considered necessary because the Old Boys were seen as controlled by their upbringing and by social mechanisms, mainly the principles

instilled by a public school education and, if necessary, an informal reminder of those principles by your peers or, in extreme cases, exclusion.

This was a comfortable, 'gentlemanly' world of relationships, confidentiality (or secrecy, depending on one's point of view) and relatively modest financial gain. There was hardly any competition and measures of performance were practically unknown. Commission rates in the Stock Exchange were fixed. In reputable banks, the balance between credit control and lending departments was in favour of the latter. Client bases in City professional firms were stable and fees not negotiable. Solicitor's firms operated what was in effect a cartel, in which competition on fees was not possible (by tacit agreement, if a potential client asked for a competitive fee quotation, he would be told by all City firms that fees were not negotiable, and that there would be calculated in accordance with Law Society guidelines). Hours were 9 to 5, pressure to perform was modest.

The Thatcher government dismantled this world and replaced it with one based on the ideology of competition, markets and public choice. Structural regulation was removed, the Stock Exchange was opened up to corporations, including foreign institutions, banks were allowed to buy stockbroking houses. Big players came in. Social control of behaviour was replaced by enormous amounts of complex formal regulation. For instance, you could combine functions and create conflicts of interests so long as you obeyed the rules about such conflicts and put systems in place (Chinese Walls) to deal with them. Competition became the norm, performance measures were introduced everywhere possible, fixed commissions were abolished in the Stock Exchange, law firms bid against each other for work. Relationships were replaced by transactions, remuneration and profits went up, and were publicised. Pressure on individuals and institutions to perform increased, as did working hours. Risk aversion was replaced by profit preference. A herd effect appeared, paradoxically caused by the competition, profit and measurement motivated culture. Institutions and individuals found it almost impossible to stay out of high risk high profit areas and the balance between risk-controlling and profit-seeking departments shifted in favour of the latter.

The underlying changes were all in line with thatcherite ideology. The idea that Margaret Thatcher intended to encourage greed is historical revisionism, but she did believe in competition and free markets and had little time for the privileged classes and their outlook on life.

This ideology also contributed to real, if not scientifically assessable, changes in ethical standards and expectations in society as a whole. Contrast the attitudes of City professionals in 1986 and those in 2010. For many in the former group, money and ambition were significant but were not major motivating factors in entering the City. Family and social expectations and connections and security of employment were just as important. Those entering in recent years have grown up in a different atmosphere. Without falling into the trap of demonising those working in the financial services industry, it is nonetheless true that financial gain is now a major societal aim (and it is now socially acceptable to admit it), ambition is instilled from an early age, and once in the City, pressure to perform is intense. In society at large debt has become normal. It is encouraged by the banks and even by the government as a means of funding higher education. There is also the phenomenon of over-juridification, when the

existence of an apparently complete set of rules encourages the attitude that a normative regime replaces ethics. If it is legal, it is allowed.

It is arguable that it is the combination of opportunities afforded by the removal of structural barriers, pressure to perform, societal expectations and the replacement of social norms by rules which has led to many of the problems encountered in recent years. Take the Chinese Wall; it is no more than words unless kept solid in the mind of an ethical person. This can be seen in a share issue in an institution which has corporate finance and broking departments. The corporate financiers pressure the brokers to place the shares, regardless of their worth. The brokers want their commission. The incentive to sell clients poor quality shares is considerable, the possibility of being caught minimal. Or take the Arthur Andersen/Enron affair. It was the conflict of interest between the management consultancy and the auditing arms and the primacy given to financial considerations over professional ethics which led to the misconduct. Another example is the conduct of institutions buying securities related to 'sub-prime' borrowing, as clear an instance as one could identify of the abandonment of the fundamental banking principle of only lending to borrowers with the long-term capacity to repay and the reversal of the balance of powers between risk-avoidance and profit-seeking departments in those institutions.

In all these instances, it is difficult to see how external or internal governance could have prevented the behaviour in question.

In a related field, and one close to home for our purposes, the Thatcher era also saw the rise of the idea of corporate governance. But the effectiveness of this system is unproven. In particular, corporate governance has signally failed in its aim of controlling managerial remuneration, when this was the major objective in the initial stages of United Kingdom corporate governance.

These examples by themselves do not, of course, provide definitive proof of anything. But they do indicate that social controls can be useful and that formal rules do not necessarily provide a complete answer. However, we should remember that the old system was not perfect. It seems to have failed signally in the scandals which emerged in Lloyds in the early 1980s. And the system only worked by relying on the ethos of a close-knit group formed by one country's social and educational system.

It is the belief that formal rules are the answer which has led to the widespread popular demand for externally imposed rules. Whether they should become the norm is open to doubt. The Enron and WorldCom affairs occurred in a heavily regulated environment. The arguments in circulation against such regulation when the Financial Services Act was being conceived, such as the difficulty of regulators understanding complex products and allowing enough flexibility for development, remain valid despite the disappearance of the self-regulatory bodies set up under the Financial Services Act 1986. Such rules certainly do have a role to play, but considerable thought needs to be given to their application and to other societal elements which influence behaviour. One example of effective application may be found in listing rules. Norms concerning the track record of companies wishing to list and concerning the disclosure of adequate information once listed seem to show their worth in the history of stock markets, which always start with a lack of effective regulation, go through a period in which fraudsters exploit the situation by deceiving the public, a



collapse ensues, the scandals come to light and regulation is imposed, bringing relative stability. Or take the conservative policies of the Canadian regulatory authorities, which seem to have played a significant part in the relative insulation of that country from the credit crisis; in this instance, the formulation and enforcement of that policy may well have been easier given the general conservatism of the Canadian banking community. Another example of behavioural regulation which may have a profound effect is on the level of basic principles. Take France, where irresponsible lending (*soutien abusif du crédit*) and withdrawal of credit without sufficient reason (*rupture abusive du crédit*) are forbidden. These rules go to the heart of a lending culture, reflecting and sustaining a quite different climate.

It may also be the case that well-conceived rules can play a part in lifting ethical standards, but the Victorian reforms seem to indicate that they have this effect when they constitute the legal manifestation of a social consensus among a significant portion of the population. This is unsurprising, indeed it is basic jurisprudence: good rules are, inter alia, owned by those subject to them in the sense that they reflect, to a reasonable degree, generally held beliefs and are made by authorities enjoying general confidence. Rules may well then lend their normative weight and the prestige of a legal obligation to such beliefs. In other words, they can back up social norms.

The case studies also seem to show that structural regulation deserves serious consideration. If you remove the possibility of transgression, people will transgress a lot less. The abolition of barriers between functions in Big Bang and the consequent creation of conflicts of interests demonstrates its effectiveness and what happens when it is removed. Or take an example of physical structure. In the centre of the town of Aix-en-Provence in France many streets are very narrow. Up to the early 1980s the police spent much time, effort and money on enforcing regulations which forbade drivers to park on the pavements. The authorities then thought of a much cheaper and more effective measure. They installed bollards, so it was physically impossible for a car to go on the pavement.

On the technical level, structural regulation works well because it deals not with qualitative, multivalent ('fuzzy') matters such as an assessment of the way in which behaviour is effected, the reasons for it, the desirability of the behaviour vis-à-vis clients and so on, but with the simple, bivalent issue of whether a transaction may take place or not. This is the sort of issue for which rules are suited and such regulation is simple and easy to understand and enforce. It is arguable therefore that structural regulation should play a significant role in a rule-based system.

What are the implications for Islamic Finance?

There is a case for saying that formal rules have their place and can be effective for certain tasks, but they must be used sparingly and advisedly. The danger of over-juridification is particularly relevant in Islamic Finance. There is a natural tendency to rely on formal manifestations such as considered, carefully drafted text and bodies giving authoritative rulings, to the exclusion of general principles, but as seen above this can lead to an ouster of ethics by rules.

It is well worth reconsidering structural regulation. As a guiding principle, 'lead us not into temptation' is effective and cheap.

The third possibility is inducing and keeping a high standard of financial ethics in society. This is far more difficult to achieve, of course, but the Victorian example shows that one should not lose hope and by careful study we may be able to benefit from their mistakes as well as their successes. A similar desire to that of the Victorian reformers drives Islamic Finance, with many of those involved actively promoting the values of Islam. There are of course numerous Islamic educational projects on hand. Is one of them, or a group of them, equivalent in future influence to Rugby School in Victorian United Kingdom?

We can also learn from the thatcherite experience, particularly in terms of unexpected consequences. It can be argued that systemic changes made on an ideological basis can modify personal ethics. But, as noted above, the Thatcher government did not intend to produce a society in which money was such a major societal motivation, nor did they wish to tilt the balance in financial institutions between caution and profit so far that the pressure to act unethically or irresponsibly could not be resisted by sufficient individuals and institutions. What they wanted was, inter alia, more competition, more transparency and a better service to customers. Margaret Thatcher herself may well have, like other reformers, unconsciously assumed that the high moral values of her own background were natural, inevitable and did not have to be instilled, and those natural value would be sufficient protection against temptation and pressure in the new environment. It seems, therefore, that when considering change one needs to examine carefully the present situation, its positive aspects and their foundation before instituting 'reforms' which may remove those foundations.

One might conclude that it is not possible to legislate morality, but it is possible to create an environment which encourages or discourages it.

There is at the same time a significant element which might push Islamic Finance away from its ethical base, and that is conventional finance. The obligation to work alongside and within the conventional system inevitably limits and to some extent determines what is achievable in the Islamic system. As we know, it is this phenomenon which is at the base of one of the main criticisms of the system, that conventional finance has already had this effect: we return to the form/function debate.

An additional risk is of a phenomenon similar to the change in motivation of those entering the City. As Islamic Finance becomes ever more successful, it may attract people who are less interested in the ethical than the financial rewards.

Finally in this regard, millions of pounds are spent every year on governance (in the broad sense of the word, including regulation) but, to this author's knowledge, hardly anything is spent on research into its efficacy. A very effective use of some of that money would be to fund such research. Perhaps Islamic governance would be a good place to start.

## SOME MATERIAL RELEVANT TO ISLAMIC GOVERNANCE

### *Document Issued by Standardising Bodies*

Accounting and Auditing Organization for Islamic Financial Institutions (2008) *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*  
Islamic Financial Services Board (2006) 'Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)'  
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