

The Incoherence of Claims of Incoherence: Some Remarks on Internal Consistency and Legitimacy in Contemporary Islamic Financial Ethics

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In the following brief remarks, I hope to touch upon several pressing issues in the field of Islamic finance (also known as “shari`a compliant finance” or “*halal* [i.e. permissible] finance”). Specifically, I will make some observations about an ongoing debate about issues of coherence, legitimacy, consistency and applicability in contemporary Islamic financial ethics. In the process, I hope to also have something to say about contacts between Islamic finance and the current financial crisis. It should be noted that my perspective throughout is that of a practicing Islamic financial ethicist, not an finance academic, economist, lawyer or financial engineer.

Islamic finance, as many of you will know, is a field, a movement and a sector.

As a field it is concerned with the academic and professional study of answers to following question: How does one “do” modern finance such that it conforms with Islamic precepts, principles and ethical norms. The field is multi-disciplinary and interdisciplinary: various types of experts contribute to the development of the field—bankers, fund managers, lawyers, economists, financial engineers, auditors, regulators and traditional Islamic ethicists (*fuqaha'*, singular *faqih*). It should be noted that, among the field’s various experts, however, it is the last, the Islamic financial ethicist (also known in the sector as a “*shari`a* scholar”, “*shari`a* expert,” “*shari`a* consultant”, “*shari`a* advisor” or just “scholar”) whose contribution

distinguishes the field of *shari`a*-compliant finance from conventional finance. I will have more to say about this point later, Allah willing.

Islamic finance is a movement in that there is an ever-increasing groundswell of support across the world, across various communities and networks, in support of the development and expansion of the aforementioned endeavor.

Finally, it is a sector in that there are approximately 300 financial institutions that offer services purporting to be *shari`a* compliant. The Islamic finance sector is a niche financial sector composed of investment banks, retail banks, insurance companies, fund managers and other financial entities. The sector is concentrated primarily in the GCC (the Arabian Gulf) and Malaysia, but also has significant presences in areas outside the traditional Muslim world, such as the UK.

I should make some introductory remarks about Islamic finance and its position in the constellation of Islamic intellectual traditions. By “Islamic ethics,” here and throughout, I am referring to the discipline known as *fiqh*, an Arabic term that literally means “deep understanding.” The system of ethics that consists of the ethical values associated with universe of human actions is known in this tradition as the *shari`a* (Islamic sacred ethics/law). Islamic ethics, like other systems of ethics is concerned with right and wrong, what human beings ought and ought not to do. Like other systems of religious ethics—particularly the traditional ethics of its fellow Abrahamic religions, Judaism and Christianity—Islamic meta-ethics relies primarily on scriptural sources. Specifically, Islamic ethicists rely primarily on the two revealed sources: 1) the Qur’an, the Scripture that Muslim recognize as *verbo Dei* (a

communication from God himself to humankind) and 2) the authoritative example of the Prophet Muhammad (upon whom be peace), whom Muslim recognize as the last of the prophets, a line beginning with the father of humanity, Adam, and including individuals known to the Judeo-Christian prophetological traditions, such as Abraham, Moses and Jesus.

But why should an average Muslim (say, a Muslim college student or business school student) care about this field at all? In the Islamic religious sciences, disciplines (and sets of issues within disciplines), are categorized by the ethical values linked to the obligation of studying such disciplines (or sets of issues). That is to say, studying some issues may be obligatory while studying others may be recommended, for example. These categories are further subdivided according to whether these ethical values apply to individuals or collectives. A collective obligation, for example, is one that falls as an obligation on a group, such that if the requisite number of individuals needed to discharge the obligation were to step forward and do so, the obligation would, in fact, be discharged. But, if the obligation were not discharged, the sin of failing to meet an obligation would fall on the entire group. The relevance of such basic concepts to our discussion is clear when we assert the following: some aspects of transactional ethics (*fiqh al-mu`amalat*) are individual obligations while others are communal obligations. In particular, some aspects of Islamic financial ethics (a subset of transactional ethics) should be considered individual obligations for most adult Muslims living in North America because they go to aspects of contemporary life that members of this community are likely to encounter routinely, given the nature of basic contemporary financial transactions, such as over the counter purchases at retail outlets or home or vehicle financing. Other issues, such as the ethics of investing in

exchange traded funds (ETFs) are collective obligations. Some members of the community have to be expert at these questions while the rest do not. It should be noted that some issues can become individually obligatory for certain subsets of the community given the predicaments facing the members of these subsets. So, for some professionals or would be professionals (say, finance concentrators at U Penn and Wharton MBA students who expect to go into finance), issues that would be communal obligations for others become individual obligations for them, based on the principle that an agent (an actor) must know the Divinely determined ethical value of any act before engaging in it.

At this point I should say a few words about the financial crisis. It has been noted by several journalists, analysts and other observers, that the recent financial crisis begs the questions of whether Islamic Finance could saved the global economy from the current crisis and if so, how. While some Muslim commentator have made comments on this topic that can be faulted for a certain lack of sophistication and nuance, or an air of hyperbole, the thrust of there comments are in the main correct: without doubt compliance with basic Islamic ethical principles and norms would have made the current crisis an impossibility.

Shari`a compliant financial institutions *have* been affected, indirectly, by the liquidity crisis associated with the failures and troubled operations of conventional financial institutions, but they have not been affected directly as holders of toxic assets or as counterparties to credit default swaps. Professor Samuel Hayes, the eminent Harvard Business School Professor of Investment Banking emeritus (and co-author of *Islamic Law and Finance: Religion, Risk, and Return* (1997), with Prof Frank Vogel) summed

it up nicely in comments that he made several months ago on the performance of Islamic banks in the crisis: “Given their constraints, they actually don’t hold any conventional debt or conventional mortgages. They don’t have any of these derivatives or outright subprime loans. There’s no doubt that they have weathered this better than the conventional banks.”

In the midst of the crisis, in the wake of expert observations about the fragility of the prevailing financial models that allowed the practices that led to the crisis and in the midst of wide spread popular anger at financial institutions and their managers (consider the recent AIG compensation fiasco!) it seems appropriate and interesting for us, as observers of Islamic finance, to consider the following questions: How should we respond as a society to the current financial crisis? What changes need to be made to our financial system in order to mitigate the harm resulting from the crisis? What are the principles that should govern our reform of the dominant financial system so that such crises are less likely to occur again?

I will summarize the sort of changes to the current financial regime that an Islamic ethicist might support (I have discussed these in greater detail elsewhere): Islamic ethicists would support deep structural changes to the prevailing financial system characterized by 1) the elimination of interest-based debt financing mechanisms in favor of asset-based financing mechanisms and 2) the elimination of risk-shifting risk management tools and techniques in favor risk sharing, tangible asset-based mechanisms. While this evolutionary path may seem radical and strange to some, it is, in fact, not. Rather, such changes, to a large extent, are consistent with what several economists and finance academics have already been calling for.

As I mentioned earlier, in this talk, I want to address claims of incoherence in the application of traditional fiqh to contemporary finance. First some meta-ethical background: Although normative Islamic ethics is characterized by the deontological tendency that a comparative ethicist would expect in a system of religious ethics (i.e. things are right or wrong because God has made them so), most traditional Muslim ethicists also recognize what a comparative ethicist might call a consequentialist (or teleological) bias to Islamic ethics as well (i.e. actions are right or wrong because God has made them so, **as evinced by the aims or consequences associated with these actions**). The *apparent* tension between these two principles is a matter that has been worked out by theologians and ethicists over the centuries. In the Islamic intellectual tradition, one of the ways in which this apparent tension has been addressed is through the elaboration and application of ethico-legal maxims (qawa'id). In Islamic ethics, maxims are both pithy expressions that capture principles that apply to broad areas, if not all, of the law, as well as the principles themselves. It should be noted that maxims make it easier for us to discuss Islamic ethics in a comparative ethical context.

Back to those claims of incoherence: Critics claim that complying with the ethical norms that have been developed by our ethicists—what some of the critics call “contract-based jurisprudence”—no longer satisfies the *raison d'être* of Islamic financial law (which the critics claim, correctly, is welfare regulation). These norms—the entire edifice of Islamic financial ethics, that is—are therefore ill-suited to our times and should be dropped, the critics continue. (By “ethical norms” here I am referring to the definitions of the nominate contracts, the rules that govern which

transactions are permissible and which are impermissible; the rules that establish what the integrals and conditions of validity of the permissible transactions are and are not, etc.) A new system of ethics and jurisprudence, the critics continue, should be created that is appropriate to the modern financial reality, a reality in which innovations in financial engineering and low transaction costs (think money whizzing over the wires) allow financial engineers to create synthetic contracts that circumvent the prohibitions found in the standard texts. It is only by destroying and then recreating the entirety of Islamic financial jurisprudence, the argument goes, that we can stop those dastardly financial engineers from accomplishing what the pre-modern jurists wanted to prevent with the norms that they captured in their texts!

Our response will only be sketched out here. (I expect the substance of it will be elaborated on during the Q&A period.) In short: This argument does not stand up under scrutiny. Firstly, the contract-based approach to financial ethics and law is an approach that prevails in many if not most of the world's enduring ethico-legal systems—consider Justinian law, English law, Napoleonic law, etc. Is the problem, then, to be found in having the concept of the contract at the heart of our system of financial ethico-legal analysis? If so, is English law and American law similarly flawed? The answer would appear to be “no,” based on the critics' own comments about these two legal systems. So, if the problem is not to be found in the centrality of the concept of the contract in Islamic financial ethics, is there something peculiar to the Islamic tradition that makes *its* “contract-based” jurisprudence especially moribund and out of step with the times? The critics might argue at this point that the problem with Islamic financial ethics lies in the norms that define what the basic (nominate) contracts are and that describe the integrals (i.e. components) and

conditions of validity for each. The problem with this argument is that the nominate contracts are so basic as to resemble other basic typologies of contract (sale, lease, gift, partnership, etc). The simplicity of this typology would seem to weaken any claim that the typology itself is the fatal flaw. If the problem is not the typology, we must turn then to the integrals and conditions of each nominate transaction. The integrals are minimal and are often merely *descriptive* (e.g. a contract requires contractual parties, a contractual form [offer/acceptance], etc) and as such appear, in other ethical and legal systems. Those conditions that are not merely descriptive are traced to indicant texts (*adilla*) that indicate the impermissibility of certain prohibited transactions. It should be noted that such prohibited transactions are few in number. (it should also be noted that wrangling with the pre-modern ethicists about these indicants means contesting with them on a hermeneutical playing field on which they are the recognized masters). In any case, importantly, it is recognized in the *fiqh* that the *application* of the conditions in this last category (and all of the other concepts, for that matter) is subject to **elaboration and extension** in consideration of ethico-legal principles and in consideration of the aims of the law, in the face of changing circumstances (as the critics themselves recognize). The point here is that, even if it is accepted that, in some cases at least, the norms found in the manuals do not fit some of the circumstances found in contemporary finance, **the mechanisms for dealing with such changes are part of the tradition itself**. Therefore, in order to argue for the wholesale tossing out of Islamic finance ethics with the proverbial bathwater it does not suffice for one to merely show that implementation of a superficial reading of the norms found in the beginner-level and intermediate-level texts does not safeguard the aims of the law—for no competent, not to mention master-level, ethicist would ever apply the norms in this way. (In fact, to do so would be a violation of the

tradition, as more than one master has noted!) Rather one would have to go further and show that the ethico-legal principles and the rules-cum-ethico-legal tests (dawabit) that govern a competent ethicist's application of the norms to a given real world circumstance **also** fail, routinely, to accomplish the aims of the law—since these principles are as much a part of Islamic ethics as the norms captured in the manuals (if not, in some ways, more so!). In the absence of such a demonstration, the matter is reduced to this: the critics are contending with contemporary experts in Islamic ethics about conclusions that the latter have reached as to the permissibility of some transactions that the former regard as prohibited (or vice-versa). This places the critics in the unenviable position of contesting with experts in the latter's field of expertise. Furthermore, such disagreement on select issues does not constitute the basis for a call for the creative destruction of fiqh al-mu`amalat. One has only to look at the standards published by leading ethicists in the area, such as AAOIFI Shariah Standard #20 on the "Synthesis [i.e. the Combination] of Contracts", to understand that contemporary Islamic ethicists 1) are aware of changes in contemporary finance that affect the application of the norms captured in the texts; 2) do **not** slavishly applying the norms found in the texts to contemporary financial issues; 3) insist nonetheless on building off of the centuries of effort captured in the texts through extension and elaboration (rather than reckless dismissal of the norms documented therein) and 4) are fully aware of the potential attempts by malicious financial engineers to circumvent the tradition's bright lines of usury, non-realizability, non-specificity leading to contention, misappropriation of wealth, inequity, etc. In short, contemporary Islamic ethicists use the nominate contracts as *analytical tools* when confronting modern transactions, in part because this type of analysis has proven (and continues to prove itself) useful in that it allows the ethicist to apply Qur'anic and

Sunnic guidance to contemporary financial issues reliably and predictably, provided that basic precepts and principles are also observed. In the face of this usefulness, the argument for dismissing such tools fails for yet another reason: when it comes to any field, it is the field's expert community itself that is best positioned to decide which concepts and techniques are most effective. Allah willing, we will have more to say about issues of internal consistency and legitimacy in contemporary Islamic financial ethics, but this should suffice for now.

Thank you for your attention. I look forward to your questions.