

**ISLAMIC BANKING IN THE FRAMEWORK OF A
SOCIO-ECONOMIC MORAL ORDER:
THEORETICAL FOUNDATIONS**

Critical Analysis and Ethical Approach to a Value-based Economy

**ISLAMITISCH BANKIEREN IN HET KADER VAN EEN
SOCIAAL-ECONOMISCHE MORELE ORDE:
THEORETISCHE GRONDSLAGEN**

**Kritische analyse en ethische benadering van een op waarde
gebaseerde economie**

AHMAD MANSUR

Colofon

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Islamic Banking in the Framework of a Socio-economic Moral Order: Theoretical Foundations

Critical Analysis and Ethical Approach to a Value-based Economy

Islamitisch bankieren in het kader van een sociaal-economische morele orde: theoretische grondslagen

Kritische analyse en ethische benadering van een op waarde gebaseerde economie

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-

Propositions

To accompany the doctoral dissertation of
**Islamic Banking in the Framework of a Socio-economic Moral Order:
Theoretical Foundations**

Critical analysis and ethical approach to a value-based economy

1. Islamic morality, Islamic ethical values and moral norms are not that different from Christian and Western tradition of morality, ethical values and moral norms.
2. A values-based approach to economy or economics is not that different from the Islamic economic approach.
3. Doing the right thing is a matter of the realization of values. The realization of value occurs in five different spheres; i.e., the market [M] sphere, the governance or governmentality [G] sphere, the “*Oikos*” or the home [O] sphere, the social [S] sphere, the cultural [C] sphere. This thesis labels this approach as the Klammer model.
4. The value-based approach to economy or economics incorporates the standard economic approach.
5. There is actually no significant difference in the daily practice and operation of Islamic banking and conventional banking.
6. Islamic banking institutions do not practice what they have been preaching and theorizing.
7. Islamic banking institutions have not been doing the right thing, since they stick more to Islamic law than that they adhere to Islamic morality, Islamic ethical values and moral norms.
8. The failure of Islamic banks to adhere to Islamic morality, Islamic ethical values and moral norms in their operation and practicality, means that they fail to meet a value-based approach to economics, do not realize the important values in five different spheres, and therefore have not been doing the right thing.
9. In order for the commercial organizations (Islamic banking) to be able to doing the right thing, they must operate within the five different spheres in realizing values by embracing not only the logic of the market in the M sphere and the logic of the governance in the G sphere, but also the logic of the *Oikos* in the O sphere, the logic of the social in the S sphere and the logic of the cultural in the C sphere.

10. My long exposure to the Western thinking, culture, virtue ethics and ethical values have brought me to engage in an intercultural dialogue between Islam and the West, that ended up viewing Islamic banking not from an Islamic perspective only but also with the value-based approach developed by Western thinkers and ethicists to discover that both perspectives complement each other.
11. This dissertation is an invitation to further the dialogue between Islam and the West in order to find out the ideal to strive for and the right thing to do, while trying to alleviate cultural misunderstandings.

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My first encounter to a value-based approach to economics is when I studied my MA degree in economics of development in 2007-2008 at the International Institute of Social Studies (ISS-Erasmus), in the Hague, in a module entitled “feminist economics”, which was led by Prof. dr. Irene van Stavaren. My interest in both a value-based approach to economics and Western moral philosophy grew even more intensely during my PhD studies at Erasmus University Rotterdam. My thanks and gratitude to my colleague, the Reverend Waltraut Stroh the chaplain and the staff of the ISS-Erasmus when I studied my MA degree, who always encourages me to go further study and to make research of a value-based approach to economy for my PhD, until I was able to be admitted to Erasmus University Rotterdam.

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Chapter 1

1. Introduction



Chapter 1

1.1 Personal View, Observations and Experience

Being brought up in both a Javanese Muslim family and Javanese community, my actions and behaviour were predominantly influenced by a combination of Islamic and Javanese values, which invariably go hand in hand. Historically, the Javanese people believed in an extremely powerful and omniscient God, who is the sole creator of humankind, but ultimately lies outside the reach of human knowledge and experience. They believed that God came to Java first, even before he revealed himself to Hindus, Buddha, Christianity and Islam. This is why Javanese people are often welcoming of any type of religious belief within their community, albeit with the provisos that it does not set out to secularize their lives and that the religion adheres to the belief that there is only one God and that he is the sole creator of everything.

Being Javanese myself, I have been taught since early childhood the value of “*isin*” (shy) and “*sungkan*”, which can be translated as being respectful and polite to others. These two values have been inculcated within me long before I even came to recognize Islam as my religion. Indeed, these two values can be regarded as the driving force behind Javanese people’s proclivity to live their lives in harmony with their fellow humans, as well as with their surrounding community and environment. These values implore Javanese people to control unhealthy expressions of emotion and negative natural impulses, which, in turn, serve to maintain social harmony. This explains, in part, why my family would always remind me to be respectful, and to both show consideration for the feelings of others and take care of others. This sentiment was expressed in the following saying: “*Ojo ngisin ngisini, jagoen perasaane wong liane*”, which means please, don’t act shamefully and take care of the feelings of others. Through the instilling of these important values, I was ultimately taught not to be selfish and egoistic in my actions and behaviour, which predated my cognizance of being a follower of Islam.

While Islam is the largest religion in Indonesia, it is nevertheless able to accommodate, acculturate and assimilate Javanese culture, customs and values, or vice versa, which means that there are little fundamental differences between the two belief systems. Sometimes, it is the Javanese culture, customs and values which are said to be Islamized and practiced by Muslim Javanese (Indonesian)

people. Hence, the blurring of Islamic and Javanese culture, customs and values is simply unavoidable. The aforementioned Javanese cultural norms, customs and values continue to play an important role in the Javanese way of life. Indeed, local ancient wisdom and Javanese-style virtue ethics make a significant contribution towards the maintenance of harmony within the family sphere, or the *oikos*, as well as the broader social, cultural and even governmental and market spheres.

All of these virtue ethics and moral values are instilled not only by preaching, but also by elders in each and every generation serving as exemplary role models for younger citizens. These virtue ethics and moral values have been taught, both consciously and unconsciously, in the daily lives of the Javanese people until they have become ingrained in each of us. The firm upholding of the importance of harmony, love and caring for harmonious living, allied with the avoidance of enmity, hostility and conflict, which characterizes how the Javanese (Indonesian) opt to live, reminded me of what Hillary Clinton, the wife of the former US President Bill Clinton, said when she visited Indonesia in 2009: “...if you want to know whether Islam, democracy, modernity and women’s rights can co-exist, go to Indonesia.”

The most interesting feature of Javanese culture across the course of my entire life up until now is that luck, good fortune and wisdom are always present, even when something bad happens to us. For example, if I had an accident or experienced an unfortunate event which I subsequently told my family about, their response would typically be: “*Untung awakmu esek selamet*” (You are lucky that you are still safe). Such expressions are predicated on the notion that whatever happens to us is part of a greater destiny that God has for us, which we must be thankful for and totally submit ourselves to. It is because of the mercy and blessing of God, He who can do anything he wants and who is forever beyond our reach, that we are still alive and safe. In fact, even when someone dies, irrespective of the cause of death, we still continue to thank God and pray that we will also die in a state of “*Husnul Khatimah*” (Dying in a state of the beautiful closure of life in the eyes of God and with the pleasure of God).

This kind of cultural value that has been inculcated in me has led me to believe that I must always be grateful about whatever God has destined for me, and, conversely, that I must never act prejudicially nor think bad of God.

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Notwithstanding this, I believe that the Javanese value of faith and complete surrender to God, the one and only creator of everything, has helped Javanese people to survive and display resilience in the face of any situation or hardship that beset them. It is important to note however, that the value of total submission to God does not mean that man merely sits back and waits for his destiny to unfold, to the complete and utter detriment of his present life and future, as such as attitude only culminates in fatalism and reckless behaviour. In other words, man has to strike a balance between total submission to God and exercising the free-will that has been given to him by God, in order to navigate and eventually arrive at the good life. Harmonization between these two values is what is required in practice: on the one hand, they must display total submission to God and whatever fate and destiny God has granted us, while, on the other hand, they must exercise free-will through engaging in management, administration, and planning and by developing their capacities, capabilities, thoughts and ideas to make the best possible life for themselves.

Finding a balance and harmony between these two values has been ingrained in me by my family my entire family life, as well as being part of religious teaching, especially amongst those who are attached to the traditionalist Muslim organization known as NU (*Nahdhatul Ulama*). The Islamic theology or the religious teaching in NU adopts a centrist position between the respective theologies of *Qadariyyah* (belief in free-will) and *Jabariya* (the belief that everything is destined by God and man has no control over his actions).¹

Since most of the Javanese are attached to a NU organization, they invariably adopt the following position: they exert themselves as best as they possibly can and leave the results of their hard work and endeavor up to God to decide. This value of faith and surrender to God, (by balancing and harmonizing these two values), which I believe allowed the Javanese (Indonesian) people to persevere and economically survive when Indonesia was hit hard by the economic crisis in

¹ I have not cited a reference for the theologies of *Qadariyyah* and *Jabariyyah*, as it is considered general knowledge among Muslim traditionalist NU people. Indeed, almost everyone who belongs to Nu knows about this matter.

1998, and when almost every single Western- and Eastern economist predicted that Indonesia would socially, politically and economically collapse.

Undoubtedly, the crisis hurt Indonesia economically, socially and politically, however the Javanese (Indonesian) found a creative way to ride out the crisis, namely adhering to their core values of moderate living, collectiveness, mutual help and sharing of goods, either in the form of food and drinks or in the form of workforce, reciprocity, exchange, sharing and contributing to help each other. These values were generally manifested in the practice of charity and gift-giving, as well as by practicing what is known as “*Selametan*” in Javanese tradition.

“*Selametan*” is a communal ceremony that calls for mutual support and cooperation. Almost every Javanese “*Selametan*” tradition involves giving thanks to the meals provided by the organizer of the “*Selametan*”, which serves as an expression of our gratitude for God granting us mercy, blessings, safety, salvation and welfare. More specifically, we sit together and engage in prayer and rituals which are ordinarily led by the religious leader, which are designed to make all of us feel equal, so that we will want to stick together and maintain social coherence. When I was growing up in my village, my mother often took me to the Javanese tradition of “*Tahlilan*”, which was, and still is, carried out once a week in my village. This “*Tahlilan*” is a specific kind of “*Selametan*” tradition in Java, which, depending on the village and other circumstances, which was typically held once a week. This tradition was incredibly important and meaningful for me, specifically in terms of providing me with a sense of association, adherence, loyalty and collectiveness with society. These values and rituals have been practiced and passed down from generation to generation long before the economic crisis hit Indonesia.

Consequently, it is thus relatively worthless to seek to predict trends in Indonesia by applying mathematics, calculation and a whole host of sophisticated economic tools, as, simply put, Indonesia is incredibly unpredictable. However, this is not to say that these tools are completely worthless, as they can be effectively used as models to compare various results and scenarios. Rather, my point is that we should not overly rely on these models. To cite an illustrative example, in most circumstances when outsiders (such as the IMF and Western economists) make predictions based on these aforementioned tools, their results

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bare almost no resemblance to the situation in Indonesia. This is because, as I said earlier, Indonesia is an unpredictable country. Hence, outsiders tend to have a lack of knowledge of the internal situation in Indonesia, which means that they fail to take into account the behaviour of the Javanese people, who have continually demonstrated their capacity to adjust to the worst situations.

Indeed, the Javanese are capable of living with often limited resources and income. They live by the cultural value of “*Mangan ora mangan pokoke kumpul*,” which means that regardless of whether we have something or nothing to eat and drink, we live together. This cultural value has consequences irrespective of what happens to us, and enjoins us to have faith and to surrender to the God who provides and grants everything to his creatures, so that they can live a harmonious life and collectiveness and togetherness can be maintained.

This cultural value produces another value, namely the willingness to share and equally contribute, which manifests itself through reciprocity, redistribution and exchange, while, simultaneously, keeping greediness and avarice at bay. In so doing, it helps people to realize a collective sense of welfare, happiness and well-being. This cultural value signifies that people are to refrain from allowing their inner self (ego) to do whatever it wants. Despite the fact that God grants humans freedom via the ego that resides in the inner lives of humans that enables them to act freely, this freedom is limited to the freedom of others. Humans are engaged in an endless battle with their ego, insofar as it is our egos that always lead us towards wickedness. This cultural value of “*Mangan ora mangan pokoke kumpul*” also helps establish moderation and balance in one’s life, so that one does not spend money or consume goods either extravagantly or in a miserly fashion, but rather finds a balance between these two extremes.

As a Javanese Muslim, I am taught that I have to believe that life does not only pertain to this world, but rather that there is life after death, where everyone will be held accountable for what they have done over the entirety of their life on earth. This world is only the site of the test, while the goal of life is to seek the pleasure of God, which, among other things, involves serving humanity and striving for social welfare, happiness and well-being not only for ourselves but for others as well. Javanese traditions such as “*Selamatan*” and “*Tahlilan*” also strive

towards serving humanity and reinforcing adherence to society and social harmony.

As I grew older with the passing of time, I began to observe the life of Islam in Indonesia. I developed my capacity to write and read Arabic, by learning and studying Arabic in high school so as to be able to study “*Kitab Kuning*” (the Islamic classic books written in Arabic) and gain knowledge of Islam which is in the *Pesantren* of “*Nahdhatul Ulama*” (NU). Given that I am a Javanese Muslim and was inculcated into the Javanese culture and values, it is my experience that Islam in Indonesia is unique and different from Islam in other countries, especially in the Middle East. Specifically, Islam in Indonesia is considered to be moderate, less conservative and more tolerant, as well as favoring peace, harmony, collectiveness, mutual respect, which are all in accordance with Javanese culture and the belief of Indonesian Muslims, despite ethnic and religious diversity.

Many interested observers of Indonesia from Western, Middle Eastern or the Far East that I have ever met in Indonesia, or in the Netherlands when I did my graduate studies, wonder whether Indonesian people are truly Muslim or not. This is because, in their estimation, many Muslim Indonesians do not practice Islam in the way that it is practiced in other countries, especially in the Middle East.

For example, in contrast to Muslim women in the Middle East, one will easily find Muslim Indonesian women who do not wear headscarves (*Hijab*) or cover up their full-body in Indonesia. Indeed, many Muslim Indonesian women wear Western-style clothing, such as short skirts and jeans, albeit they wear female Muslim attire in the mosque during prayer. Once prayer is over however, they take off the traditional clothes which cover their entire body and change back into their everyday clothes. This is a common scene amongst Muslim Indonesian women.

With respect to the economy, my personal observation is that many Muslim Indonesian people do not care about whether they are under a Pancasila economic system, a capitalist economic system, or a socialist economic system, when it comes to their everyday activities and daily economic and financial transactions. However, irrespective of what type of economic system they are living under, almost all of them, especially Javanese people, uphold the aforementioned Javanese values and norms, even after the implementation of Islamic economics and an Islamic banking system in Indonesia.

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My initial views of Islamic banking

I began my undergraduate studies in 1992 in the faculty of economics and management in Malaysia at the International Islamic University, Malaysia (IIUM). I had been interested in economics prior to attending high school, as I began to observe the emergence of both Islamic economics and Islamic banking within Indonesia. Given that my interests are in virtue ethics, Javanese values and norms as well as Islamic values and norms, I am also interested in observing Islamic economics and Islamic banking, which are claimed to be value-oriented institutions. In 1992, Indonesia introduced the Banking Act no. 7 of 1992², which for the first time allowed a commercial organization to set up Islamic banking. Bank Muamalat Indonesia (BMI) was the first Islamic bank to provide services on the basis of profit sharing in Indonesia.

My initial view of the introduction and presence of Islamic banking in Indonesia was that it would help shape bring much needed nuance to the realm of banking institutions and financial transactions, in a way which would make it distinct from conventional forms of banking. More specifically, the hope was that it would contribute towards the realization of socio-economic justice, as well as the fair and equitable economic distribution of income and wealth through banking and financial mechanisms. Moreover, there was also hope that it would change the culture of the banking and financial system, as its emergence was inseparable from the call for alternate systems of economy based on Islamic ethical values and moral norms.

My optimistic view about the introduction of Islamic banking and finance in Indonesia, was predicated on the principles of justice, equality and morality that serve as the philosophical and ethical foundations of Islamic economics (Islamic banking), as well as the theoretical foundation of Islamic economics (Islamic banking) which is rooted in the *Quran* and the *Sunnah* as the source of the Islamic law, which I will discuss in the next chapter. Islamic law -as it is well-known- by its very nature embodies ethical principles in such a way that they are wholly

² Bank Indonesia. UNDANG-UNDANG REPUBLIK INDONESIA NOMOR 7 TAHUN 1992 TENTANG PERBANKAN SEBAGAIMANA TELAH DIUBAH DENGAN UNDANG-UNDANG NOMOR 10 TAHUN 1998

inseparable from one another, which is to say that Islamic law by definition is ethical. Given that Islamic ethical values ought to guide and pervade every aspect of human life, they should not be distinct from all spheres of human activity, including the economic, business and financial spheres (Wilson, 2001; Beekun and Badawi, 2005, Hasanuzzaman, 2003).

The Islamic ethical values and norms which derive from, among other sources, the *Quran* and the *Sunnah* are: the prohibition of interest (usury), the prohibition of dishonesty and deceptive practices, gambling, uncertainty or ambiguity in contracts, the prohibition of the concentration of wealth in a few hands, and its redistribution that is seen in calls for equity and equality as well as socio-economic justice, and the prohibition of unethical business activities and investment, such as producing and selling alcoholic drinks, hoarding, pornography and anything else that leads to social unrest and destruction, despite generating huge profits (Vogel & Hayes, 1998; Eisenberg, 2012; Lewis, 2011; Visser, 2013). The prohibition of these practices is also seen as a means through which to prevent people from taking advantage of naïve and weak people, who should be protected against the exploitation of the strong (Visser, 2013; Hassan, 2002; Saleh, 1986).

This optimistic view was supported by the rapid development and widespread establishment of discourses and studies of Islamic economics and Islamic banking and finance in Indonesia, as well as the formation of faculty and research centers in Islamic economics and Islamic banking and finance in universities, colleges, and schools that come under the umbrella of the Ministry of Religious Affairs in Indonesia.

However, over time, my view towards Islamic banking has shifted from enthusiasm to skepticism³ and from optimism to profound pessimism. Despite applying the principle of profit sharing and claiming to be an interest-free banking system, I consider that Islamic banking operates in contradistinction to Islamic ethical values and moral norms. I am not the only one with this view. In fact, my perspective is in accordance with many scholars, such as Siddiqi, Moreover, many

³ See also Widigdo, Aslam Mei Nur et al. (2016). How Islamic is Islamic Banking in Indonesia? in *Journal of King Abdulaziz University: Islamic Economics*, 2016, vol. 29, issue 2, 153-165

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of my students and colleagues who lecture at the State Islamic University in Indonesia (*Universitas Islam Negeri, Indonesia*) on the subject of Islamic banking share my opinion. Our shared contention is that Islamic banking is operating and practicing interest in a disguised, back-door form, and that, in fact, there are no substantive differences between Islamic banking and conventional banking in their capacities as intermediaries, despite the former's claims that they are operating in compliance with Islamic law.

Personally, I have no objection to Islamic banks practicing interest in a disguised form, provided the goal of Islamic banks is to sustain justice, equality and morality. This view is underpinned by teleological utilitarianism, according to which the greatest good is that which produces happiness for the greatest number of people. From this perspective, it is permissible for Islamic banking to use non-proper means, such as interest in disguise, if they are doing so in an attempt to strive towards achieving the desired ideal. Moreover, according to the maxims "*al-Darurat Tubih al-Mahdurat*" and "*Maslahah Mursalah*", which mean public interest or for the benefit of the public interest, it is permissible to deal with an interest-based banking system in financial transactions up to a certain point, because it is simply a practical necessity (Naseem Razi, 2014).

I derive this notion from the idea of a universal moral standard as proposed by Kant in his *Groundwork for the Metaphysic of Morals*. Such a standard heeds the values of human dignity and concurs with Aristotle's notion of virtue ethics, which calls upon all individuals (person or organization) to act ethically and virtuously in realizing values, and thus to do the right thing. These considerations must be considered by Islamic banks in their daily operations and practices. I discuss this issue in Chapter two, which is about ethical theory and the ethical foundations of Islamic banking.

I have stated that Islamic banking is supposed to operate in accordance with Islamic law, as well as Islamic ethical values that derive from the *Quran* and the *Sunnah*, such as the prohibition of interest (usury), dishonesty and deceptive practices, gambling, uncertainty or ambiguity in contracts. However, I have observed some unethical conduct on the behalf of Islamic banking

The first example of unethical conduct within Islamic banking is charging the profit margin or interest in a disguised form at a higher rate than what one sees

in conventional banking. How can this happen? This has occurred due to the higher costs incurred by Islamic banking compared to conventional banking, as result of the small market share that Islamic banking has. Indeed, by the end of June 2018, Islamic banking accounted for 5.70% of the Indonesian national banking and finance industry (OJK, 2018).⁴ Consequently, the financing and lending aspects of Islamic banking are incredibly expensive, and, hence, the interest rate is also higher.

This practice will undoubtedly negatively impact upon consumers, and thus can be classified as unfair treatment and unethical behaviour, insofar as it is in marked contrast to their espoused Islamic principles to bring about socio-economic justice, support underprivileged or marginalized people, and enhance fair treatment and equitable distribution of income and wealth. To be clear, I am not proposing that commercial Islamic banking organizations should convert to non-profit organizations. Rather, I am arguing that they ought to adhere to the Islamic ethical values and moral norms that they are founded upon, which demand a greater balance between being profit-oriented and displaying altruistic concern for other people and the environment as a whole. In short, profit generation should not come at the expense of others.

Another instance of unethical practices within Islamic banking is demanding further payment in cases of early settlement. It is obvious that the client will not share their profit and losses anymore in the remaining period, as the business has already been closed, and, as such, the repayment of the amount owed has already been settled. The appropriate maxim here is: *“he who shares the profit must equally share the loss”*. Therefore, it is wholly unethical and immoral for Islamic banking to follow conventional banking in continuing to demand the client pay the remaining profit margin for the remaining period. I can find no appropriate rationale for such a practice, either in Islamic religious faith, Islamic ethical values or in classical Western philosophy, such as Kant’s universal moral standard of

⁴ OJK (Otoritas Jasa Keuangan) is the financial service authority in Indonesia. It is an Indonesian government agency which regulates, monitors and supervises the financial services sector. See also OJK Snapshot June 2018, <https://www.ojk.go.id/id/kanal/syariah/berita-dan-kegiatan/publikasi/Pages/Snapshot-Perbankan-Syariah-Indonesia-Juni-2018.aspx>

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deontological ethics or Aristotle's virtue ethics. However, if Islamic banking must continue to impose such a penalty, then, at least in my estimation, it should only be imposed for no longer than one month, which is now the norm within conventional banking.

Islamic bankers may argue that this is not a problem since the contract is in accordance with Islamic law (*Shariah*), and that the borrower has no right to a rebate in his early settlement. Despite the fact that, theoretically speaking, this practice is permitted within Islamic law, it is nevertheless unethical from the perspective of the maxim, according to which: "*he who shares the profit must equally share the loss*". Indeed, such a practice can only lead to unfair, injustice and unethical practices, albeit Islamic bankers occasionally give some of the money back at their discretion or offer a gift (*hiba*) in return. This was certainly my experience when I entered into a contract by borrowing money from an Islamic bank (BPRS or Syariah small business bank).

What I want to stress here is that I want to go beyond Islamic law, rather than merely adhering to it, in part, because different scholars (Islamic jurists) have divergent opinions about the law and in terms of determining the true legal ruling (*Fatwa*) on specific issues, based on their respective interpretations of the *Quran* and the *Sunnah*.

A further unethical practice in Islamic banking pertains to financing (lending and borrowing), in which financial transactions require three parties occur and be accomplished, which often involves deception and dishonesty. This practice of Islamic banking in Indonesia is referred to as "Credit sale (Sale in credit) or deferred payment sale in the form of installment payment. The term credit sale is a kind of lending and borrowing money which is called by the term financing. I have observed first-hand that financing practices in Islamic banking typically involve dishonesty and deception, although not all financial transactions are defined by deception and dishonesty. Financial transactions ordinarily involve three parties to be accomplished. For example, let us say that I need to borrow a certain amount of money; I am not able to borrow this directly from Islamic banking. Rather, I have to bring a receipt from the seller with me to show the appropriate Islamic banking employees, which lists the specific commodities or other goods that I want to buy, in the case of both *Murabahah* transactions and

Mudarabah transactions.⁵ In this example, an Islamic bank is the first party, I am the second party and the seller is the third party. All of us are required for this financial transaction to be accomplished. How does this work precisely?

In their capacity as the first party, Islamic banks actually are able to purchase the sorts of commodities which often make it difficult for financial transactions to be effectively completed, if I (in my capacity as the second party) do not agree with these kinds of commodities. Therefore, in practice, it is always the second party who purchases the commodities. These types of distraction are complicated, and are often the site for deceptive and dishonest behaviour. A clear example of such deception and dishonesty is when I used the money that I borrowed from an Islamic bank in businesses and to buy commodities that were not listed in the receipt that I showed to them to secure the loan.

There is a lack of consistency in Islamic banking, specifically concerning financial transactions, between what it preaches and theorizes and what it actually does in practice. Hence, it is perhaps appropriate that Islamic banking changes its name to Islamic ethical banking, as a means through which to both remind itself and us about the importance of Islamic ethical values over Islamic Jurisprudence, and to give additional weight to ethical values and moral norms.

Up until now, I have described how Javanese (Indonesian) Muslims, such as myself, as well as Javanese (Indonesian) people in general live their lives. I have discussed my interest in a value-based economy from the perspective of Islam, Islamic economics, or Islamic banking as it is referred to in the financial sphere. I have explained that Islamic banking does not practice what it preaches or theorizes, and, in so doing, that it fails to live up to Islamic ethical values and norms, in part, because it closely adheres to Islamic law. This behavior prevails as a result of a dual-attachment to, on the one hand, the market-based logic of maximizing profits and, on the other hand, a governmental logic that prioritizes

⁵ The principle of a *Murabahah* transaction is a short-term transaction. It usually involves a cost-plus pricing of the financial transaction, which is a widespread practice in Islamic banking. Conversely, the principle of a *Mudarabah* transaction is a long-term transaction that involves investment, which is not common practice in Islamic banking, since it involves high risk financing. Most Islamic banks are reluctant to engage in this kind of financing and are instead relatively risk averse.

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meeting governmental rules and regulations, laws and procedures in its daily operations, while, simultaneously, putting aside the social and cultural logic of realizing moral values and religious ethical values.

As a lecturer in Islamic economics, my interest in a values-based approach to economics gained momentum when I was given the opportunity to study in the Netherlands in 2007-2008 at the International Institute of Social Studies (ISS-Erasmus) in the Hague. Although the prevailing economic view was the capitalist economic system, I also encountered a value-based approach to economics in a module entitled “feminist economics”, which was led by professor Irene van Stavaren of the International Institute of Social Studies (ISS-Erasmus), in the Hague. My interest in both a value-based approach to economics and Western moral philosophy grew even more intensely during my PhD studies at Erasmus University Rotterdam. As part of this process of completing my thesis, I have tried my best to deepen my knowledge and understanding of Western moral philosophy through reading the work of Western moral economists and scholars, such as McCloskey, Martha Nussbaum, Alasdair MacIntyre, Charles Taylor, Karl Polanyi, Arjo Klamer, etc., which opened my eyes to a value-based economy. Over time, I eventually came to realize that this approach, in essence, shares many similarities with Islamic economics, which I discuss in greater detail below.

1.2 What is meant by a Value-based Economy?

A value-based approach to economics is an integrative approach to economics or substantive economics, which views economics and the economy as being about more than merely trying to generate as much profit as possible or the types of satisfaction that are actuated by self-interested behaviour and economic rationality or rational choice, which predominates in standard economics. In contradistinction to standard economics, a value-based economy goes beyond market-based logic of merely generating maximum profit and satisfaction. A value-based economy not only operates in the market sphere, but also in other the governmental, social, cultural and household sphere. In other words, it encompasses all five spheres in which the economy operates.

More specifically, a value-based economy takes into account market logic via traditional mechanisms of supply and demand that determines the price of goods. It encompasses the governmental logic of abiding to the law and

procedures, rules and regulations, while taking into account social and cultural logics by complying with social and cultural values, and finally, it also considers the everyday values and moral norms that shape people's *oikos*.

What I find particularly interesting is that a values-based approach to economics is foundable and discernable in either Islamic economics or Western economics, despite the fact that we live in a capitalist economic system. It is well-established that the capitalist economic system is rooted in the concept of a *laissez-faire* economic market, in which the rational choice and rational economic decision-making model is actuated by self-interested individual behavior, whereby each individual strives to achieve the highest possible level of welfare, happiness and well-being for themselves, while, simultaneously, maximizing profit and satisfaction (Samuelson & Nordhaus, 2005; McKenzie, 1986; Mankiw & Taylor, 2011; Lipsey & Chrystal, 2011). This is because the market is an effective way to organize economic activity and trade, so that everyone can become better off (Mankiw & Taylor, 2011).

However, in light of new developments in Western moral thought, a *laissez-faire* perspective on economic markets and capitalist economic system has come under fire from an alternative perspective that posits that economics is not merely the study of wealth but also human character, ethical values, moral norms, both at the level of the individual and society more broadly. Interestingly, this new development in Western moral thought is not, in principle at least, all that different from the Islamic ethical values, out of which Islamic economics and Islamic banking emerged.

A value-based economy in Western economics is grounded in various notions of ethics, namely the teleological-utilitarianism (consequentialist) theory of ethics and economics, the deontological theory of ethics and economics and the virtue theory of ethics and economics. As will be discussed in the next chapter, these conceptions of ethics have been developed by Western moral philosophers and scholars⁶, and are rooted in both the Western- and Christian tradition of ethics.

⁶ Aristotle "*The Nicomachean Ethics*", Immanuel Kant "*Grounding for the Metaphysics of Morals*", Jeremy Bentham "*An Introduction to the Principles of Morals and Legislation*", Adam Smith "*Theory of Moral Sentiment*", as well as the recent development of moral thought by McCloskey, Martha Nussbaum, Alasdair MacIntyre, Charles Taylor, Karl Polanyi, Arjo Klamer, etc., which contribute to a value-based approach to economics. In

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Conversely, from its very inception, Islamic economics and Islamic banking has espoused that it is a self-conscious and value-oriented discipline that aims to deeply embed religious values, virtue ethics and religious insights into its theory and daily practice.

Islamic ethical values and moral norms are rooted in Islamic traditions, which originate from the *Quran* and the *Sunnah*, and are applied within both Islamic economics and Islamic banking (Qaradawi, 2001; Naqvi, 1981; Nienhaus, 2000; Chapra, 2009). Islamic ethical values are not only important to the economy, but rather play a dominant role in all aspects of Muslims' everyday lives (Walsh, 2007; Warde, 2000). Islamic ethical values serve to guide human behaviour towards the attainment of social bliss, social harmony, and, most importantly, spiritual salvation. Regarding this specific kind of value-based approach to economics, Nienhaus states:

While Western economists have tended to withhold value judgments and have only begun to return to the treatment of normative questions in the last few years, Islamic economics in contrast, has always defined itself as a science which makes explicit value judgments and links them to the findings of positive economics (Volker Nienhaus, 2000)

At this stage, it should now be clearer why Islamic economics can be considered as a value-based approach to economics, and why it is not all that different from the values-based approach to economics developed by the aforementioned Western philosophers and scholars. Both Islamic economics (Islamic banking) and Western value-based economics (ethical banking) are driven by a profound commitment to direct the economy to the realization of values, socio-economic justice, equitable and fairer distribution of income and wealth, and the creation of a just social order, which they seek to do by not only investigating formal economics in the free market system, but also substantive economics that encompasses individuals, as well as the social, cultural and environmental spheres.

the next chapter, I discuss how the deontological ethics, teleological ethics and virtue ethics serve as the foundation for a value-based economy.

For example, Klammer's notion of economics is that it is about studying the realization of values which are important for achieving our ideals (Klammer, 2016a). Hence, it is not merely about generating profit, but rather questioning what this profit is good for. If it is generated at the expense of others, then what is the point of accumulating it and what is it good for, if our ideal is actually to achieve welfare, happiness and well-being for all. Therefore, for Klammer, economics is not about the realization of values in the market sphere per se, but rather is also about the realization of values in the governmental sphere, as the government intervenes in the market when it is not functioning well by imposing rules and regulations, procedures and laws. However, the realization of values in these two spheres do not alone suffice for the economy to suddenly do right by everyone. Rather, it requires the inclusion of the three other spheres, namely the social, the cultural and the home or household sphere, to help strive towards the goods that are needed to achieve our ideal. These goods that we are striving for should be the embodiment of our most important values. In order to realize values, we must acquire and generate the goods, which, in turn, enable us to realize values. Ultimately, doing the right thing is about the realization of values (Klammer, 2016).

Another example here is Marshall's conception of economics as being about the study of wealth, and that it is part of humans' character to strive towards the achievement of the specific goals of welfare, happiness and well-being. Human character is shaped by our everyday work and is influenced by the religious ideals that we acquire from religious values, which are way more intense than economics. For Marshall, religious values encompass family affection, friendship and faith, which are located within the social, cultural and home spheres, respectively, and which are ingrained in us through our upbringing (Marshall, 2013). This idea is not wholly dissimilar to the economic ideas of Aristotle; according to Polanyi, whenever Aristotle touched on the question of the economy, he sought to develop its relationship with society as a whole (Polanyi, 1957a), which can be referred to as the community, nature and environment in which humans live their lives. Aristotle's notion is undoubtedly a comprehensive approach to the relationship between human beings and the economy, which, in my own estimation, is precisely what a value-based economy is all about.

The other example I would like to mention here is Polanyi's conception of economics as being compounded by two meanings with wholly independent roots:

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substantive and formal economics. The formal meaning of economics derives from the logical character of means-ends relationship, which signifies a set of rules that refer to rational choices between alternative uses of insufficient means. Conversely, the substantive meaning of economics derives from humans' dependency on their own nature and that of their fellow man, which pertains to the interchange between human nature and the environment (Polanyi, 1957b)⁷.

Polanyi introduces two concepts into economics: process and the thing that is instituted (institutions). Process implies motion or change, while instituted refers to economic elements that are grouped into social, cultural, ecological, technological, as well as market and governmental elements. All these elements are characterized by their own distinct sets of values. This means that economics does not only encompass the market mechanism of supply and demand, but also additional elements, such as the governmental, social, cultural and the home (household) elements, in order to do the right thing.

According to Klammer's terminology, doing the right thing and realizing values involves a five-sphere model of logic. I have opted to use Klammer's model of doing the right thing and realizing values in relation to Islamic banking, because it does not simply focus on humans' economic activity, but rather encompasses their activity in the political, social and cultural spheres, in a complex way. In this respect, Klammer's five sphere model of realizing value and doing the right thing takes into account all aspects of human life, from the very beginning in the *Oikos* up to and including their engagement in the social, cultural, government (governance) and market spheres, which, in my estimation, neither Polanyi, Marshall nor any other Western moral scholars for that matter, touch upon in the requisite level of detail.

For example, Polanyi introduces the pattern of reciprocity, redistribution and exchange in the economy, noting through recourse to Aristotle, that every kind of community that ever existed is dependent on a level of good-will amongst its members, which is expressed in acts of reciprocity, whether it be a kinship group,

⁷ Karl Polanyi idea of the "The Economy as Instituted Process", in Polanyi K., Arensberg, C., & Pearson, H. (1957). *Trade and market in the early empires: Economies in history and theory*

neighborhood, friendship, brotherhood, social organization or non-profit organization, etc. While Polanyi notes that they are more likely to bring about reciprocating behaviour, he fails to provide any degree of detail with regard to the sphere of human life. Conversely, Klammer also discusses notions of reciprocity, redistribution and exchange, but it is narrated in close detail regarding the sphere of human life. In a similar vein, Klammer borrows the notion outlined by Aristotle in the *Nicomachean* ethics that all human actions are directed towards the good. Once again, Klammer provides a detailed account with regard how this applies to the five-sphere model of logic, ranging from the *oikos* or the home sphere, to the social sphere, cultural sphere, government sphere and market sphere (Klammer, 2016). Below is how Aristotle expressed this in the *Nicomachean* ethics:

“Every art and every inquiry, and similarly every action and pursuit, is thought to aim at some good; and for this reason, the good has rightly been declared to be that at which all things aim.” (Aristotle & Ross, Book I)

Values are therefore embedded in everything, be it in humans, religion, culture and every other aspect of human life, including economics, which cannot be separated from these other domains. Simply put, it is values that drive us to act. Neglecting values -cultural values, moral values, religious values, virtue ethics- will only push the economy in the wrong direction, which, in turn, will make economic analysis go wrong (McCloskey, 1996; Klammer, 1983). Not only that, neglecting social, cultural, artistic, religious or ethical values (virtue ethics), while only focusing on the values of individualism and rationality in the market, that is, applying means-end calculations, maximum efficiency, best cost-output ratio, seeking maximum returns on capitals and assets, and maximum returns on profits, etc., as our measures of success and development, is what led to a profound disenchantment with the world and brought on the malaise of modernity (Taylor, 1991). As McCloskey says regarding neglecting ethical values:

“An economics that wants to get the economy right has to know about ethics. And an economy that wants to get its business right has to practice ethics.”
(McCloskey, 1996).

It is interesting to observe the ethical values or virtue ethics of prudence, temperance, courage and justice, which are regarded by Aristotle in the *Nicomachean* ethics as the four essential and greatest virtues, or cardinal virtues

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as they are also referred to. These so-called cardinal virtues profoundly influence human attitudes, actions and behaviour with respect to both doing the right thing and striving to realize ideals in human life. Alongside these, the Christian theologian Thomas Aquinas posited that three more-virtue ethics of faith, hope and love were required in order to complete the seven-cardinal virtues within Christianity (Klamer, 2016). These virtue ethics are wholly in accordance with Islamic ethical values and moral norms. Regarding this issue, Adam Smith notes that he who acts according to that rule of virtue ethics may be said to be a virtuous person (Adam Smith [1790], 1982; Coase, 1976).

Given that ethical values (virtue ethics) are a key part of all Abrahamic religions, be it Judaism, Christianity and Islam, in essence, the ethical values (virtue ethics) are about the same things. Since the followers of Abrahamic religions spread all over the world, ethical values (virtue ethics) both come from the West -via Western Christian and Jewish philosophers – and from the East -via Muslim philosophers, are about the same things. Hence there should not be an East-West dichotomy with regard to universal moral standards. Within the Islamic world, Muslims are not supposed to confine themselves to living in a closed-off society by building a great wall to separate themselves from the West, but rather are meant to open themselves up to and integrate themselves within the world and global society; Similarly, Western people are not supposed to misunderstand or even become hostile towards the world of Islam in the Eastern part of the world. It is therefore important to gain a clear picture and thorough understanding of different religious teachings -whether it be Jewish, Christianity or Islam- in order to avoid misunderstanding people from different religious backgrounds, and to include ethical issues in all aspects of life, including in relation to economics, business and finance (Wilson, 1997).

If one accepts that Abrahamic religions all have at their foundation the teaching of ethical values and moral norms, then a value-based economy grounded in Western Judeo-Christian moral thought is not all that different from what one finds in Islamic economics. Indeed, if Islamic ethical values, which are embedded in Islamic law, state that the objective of Islamic law (*Maqasid al-Shariah*) is to promote human well-being, to bring about benefits, along with deterring hardship and preventing harm (Al-Ghazali, 1937), then the objective of Islamic economics

can be said to be precisely the same as that of a value-based economy in the Western tradition.

Islamic law is the product of Islamic religion, which by its very nature embodies ethical principles. However, the fact that Islamic economics and Islamic banking are grounded in Islamic principles does not mean that commercial Islamic banking organizations have been doing the right thing necessarily in its banking practices and financial transactions with regard to the realization of Islamic ethical values. In fact, some studies have showed that it is the religious factor that underpins customers' choice to deal with Islamic banking, rather than due to their ostensibly ethical practices (Metawa and Almossawi, 1998; Naser et. al., 1999).

It is therefore important that Islamic banking finds a way to establish a link between what precisely constitutes ethical practices and the specific methods they employ when conducting financial transactions. Moreover, they must seek to provide a unique service to customers by appealing to their moral conscience, rather than merely relying on the good name of Islam and espousing that the product is *Shariah* compliant and in accordance with Islamic law. In this respect, Islamic banking needs to make a convincing moral and ethical argument for engaging in such financial transactions and banking practices if they are to both assuage skeptics who argue that Islamic banking is nothing more than a modified form of conventional banking that is merely operating under a different name, and truly ensure that Islamic banking is indeed striving for the good and doing the right thing

While there have been extensive studies of commercial Islamic banking organizations, they have hitherto investigated Islamic banking in relation to Islamic jurisprudence or Islamic law. The general conclusion of this body of research is that Islamic banking is de facto adhering to Islamic law, but failing to adhere to both Islamic ethical values and norms and the social and ethical goals prescribed by Islamic law. This is because Islamic banking is currently prioritizing market and governmental logics in its practices, in the form of maximizing profits and utility satisfaction, and failing to consider cultural and social logics.

The findings of previous research motivate me to bring much needed nuance to extant research on the cultural spirit of Islamic banking in its day-to-day practices and operations as a commercial organization, through recourse to both a

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value-based approach to economics developed by Western moral scholars and Islamic ethical values. In so doing, I seek to explore Islamic banking, not only in the market and governmental spheres, where it conducts its business and financial transactions, but also in the social, cultural and *oikos* spheres. More specifically, I will examine commercial Islamic banking organizations by drawing upon Klamer's five sphere model of realizing values.

1.3 Aims, Scope and Research Question

I have already underscored the principal motivation for conducting this research, as well as the key concepts and theorists upon which my research will be based. However, it is instructive to reiterate them here briefly. Firstly, Islamic banking is not operating in a way which is consistent with the Islamic values they are espousing, namely a lack of both ethics and sensitivity towards social, cultural and environmental issues. Secondly, in principle, Islamic banking is not wholly different from Western commercial banking institutions within capitalist and socialist economic systems; indeed, it is merely copying and modifying the practices of conventional banking, namely its prioritization of market and governmental logics when conducting its business and financial transactions. Thirdly, Islamic ethical values and the moral norms upon which Islamic banking is ostensibly based, share similarities with Western Judeo-Christian ethical values and moral norms, and, hence, the trend towards value-based economics in the West also fits in with the principle of Islamic banking. Finally, almost all research on Islamic banking has hitherto focused on its adherence, or lack thereof, to Islamic law, *halal* (lawful) and *haram* (unlawful) practices, as well as all having been conducted through the lens of an Islamic perspective.

What distinguishes this research from other studies is the focus on virtue ethics and moral values. The research seeks to explore the ways in which Western moral thought both aligns with and diverges from the practices of Islamic banking and Islamic ethical values and moral norms. More specifically, the study aims to investigate how Islamic banking is conducting its business and financial transactions, in order to assess if Islamic banking is doing the right thing and striving for the good to achieve the ideal, from the perspective of both Western moral thought on virtue ethics, ethical values and moral norms, and Islamic ethical values and moral norms. The study adopts an integrative approach to economic

study and a value-based approach to economics, by not only examining market and governmental logics, the logics that Islamic banking has thus far oriented its business and financial transactions towards, but also taking into account the social, cultural and home spheres.

The rationale for this is that *oikos*, social and cultural logics are as important as market and governmental logics in terms of their ability to influence Islamic banking to conduct its business and financial transactions in the right direction. In fact, I will argue that the cultural sphere, in which cultural values and religious values operate, is the most important of all the spheres in terms of its potential impact and influence on Islamic banking. This leads us to the primary question of the research, which is: “Has Islamic banking been doing the right thing?”.

1.4 Methodological Notes

The research method adopted in this study is more in line with a critical, constructivist and interpretive method of social science inquiry. This study is grounded in the ontological and epistemological stance, according to which the truth and the right thing to do, or the search for the truth and the right thing to do, are things that can actually be attained and realized not only through one perspective, but through multiple perspectives; In other words, one entity cannot claim that it possesses the singular truth about a specific entity. In this respect, I am investigating points of similarity and difference between Islamic ethical values (morality) and Western ethical values (morality) and virtue ethics that converge within a value-based approach to economics, which is used as a tool through which to critically analyze Islamic banking. In this research, I employ Western virtue ethics and moral values to critically analyze the operations of Islamic banking, in order to evaluate whether they are realizing values of doing the right thing in their banking business and financial transactions.

The vast majority of studies on Islam, whether they are socially, politically or economically focused, including studies specifically on Islamic economics and Islamic banking, predominantly rely on secondary data and take the form of huge literature reviews, comprising data from relevant publications, ranging from books and academic journals to magazines and newspapers, although there are a handful of studies that engage in fieldwork. This study primarily employs a deep understanding of literature, along with utilizing data gathered from field work, in

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the form of interviews with practitioners, academics and students, and class-based discussions in seminars. However, most of these interviews were conducted in an informal manner, based on my own experience that informal discussions and conversation prove to be a more expedient technique for getting people to open up and share their experiences of Islamic banking. Finally, I draw on my own first-hand experience of dealing with Islamic banking in the field.

1.5 Outline and Structure of the Book

This thesis is divided into seven chapters. **Chapter 1** describes the general background of the study, including my personal views, observations and experience of being a Muslim Javanese person who is living and studying in the West. In addition to this, the chapter also discusses virtue ethics, Javanese cultural and moral values, Islamic ethical values, and Western moral values, as well as my own experiences, views and observation concerning Islamic banking in Indonesia. The chapter concludes by outlining the focus, aims, research question, and methodology employed in the research. **Chapter 2** provides a review of extant literature on the ethical foundations of Islamic banking. Specifically, it explains that Islamic ethical values and norms constitute the basis of Islamic banking. **Chapter 3** presents an overview of the theoretical and philosophical foundations of Islamic banking through recourse to the framework of a socio-economic moral order. It elaborates on theories of how Islamic banking operates as a financial intermediary in its banking business and financial transactions, and illustrates how it can help to create and realize socio-economic justice and a more equitable distribution of income and wealth. **Chapter 4** comprises the analytical investigation of ethical banking and normative economics, which is rooted in Western philosophical theories of ethics, such as deontological ethics, teleological ethics and virtue ethics and economics. Next, the chapter proceeds to delineate points of similarity between these aforesaid theories and Islamic ethical values. **Chapter 5** presents a descriptive analysis and investigation of the similarities and differences between Islamic banking and conventional ethical banking, specifically with regard to how they each meet ethical expectations in their operations. To achieve this, I cite the examples of Triodos Bank Netherlands and Bank Muamalat Indonesia (BMI). **Chapter 6** discusses and analyses Klammer's five sphere model of realizing value and doing the right thing, before proceeding

to assess, through recourse to Klamer's five sphere model, whether or not Islamic banking does the right thing. **Chapter 7** provides a conclusion to the thesis, before proceeding to provide suggestions for how future research can build upon the findings of this study.

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2. Ethical Theories and Ethical Foundations of Islamic Banking



2.1 Introduction

Before unpacking the ethics of Islamic banking, we must first understand what precisely ethics is, and what is meant by morality, morals and values. The terms “ethics and morality” are often treated as if they are synonymous with one another. However, they are in fact different: morality pertains to values concerns human conduct, whereas ethics is the branch of philosophy that ruminates on morality (Shaw, 1990).

Ethics is synonymous with good character, insofar as our actions and behaviour basically are aimed towards good goals/objects or serving the purpose of that which is considered to be good. In this respect, ethics can be understood as the study of character, which, ultimately, distinguishes between good and bad, right and wrong, virtuous and non-virtuous human attributes and conduct (Shaw, 1990). The word ethics derives from the Ancient Greek “*ethikos*”, which itself derives from the word “*ethos*” that means habit, custom and tradition. It deals with moral principles that govern a person’s behaviour or how they conduct an activity (Shaw, 1990; Hornby & Cowie, 1989). Ethics can thus be said to be the study of the principles of purposeful human conduct and behaviour, which constitutes either part or all of the intentions of the moral agent qua person who is acting and behaving. Therefore, ethics is ultimately about the way we behave and the values that we hold (Livia Iacovino, 2002). Ethics may also be defined as moral norms, according to Geoffrey and Hazard (1995), who view ethics as a set of norms which is shared by a group or society on the basis of mutual and usually reciprocal recognition.

Ethics can also be defined as the study of human practical reasoning and intellectual reasoning over our conduct and behaviour concerning what is right or wrong, good or bad, as well as duty and obligation, virtue and fairness, freedom, rationality, choice, and so on (Blackburn, 2016). Velasquez defines ethics as the principles of behaviour and conduct which govern an individual, a group or society. For Velasquez, ethics is also the study of morality (Velasquez, 2012). Within philosophy, ethics comprises theoretical inquiry into what is good and bad, what is just and unjust, what is right and wrong and what ought to and what ought not to do (Beauchamp and Bowie, 1979). Rachels purports that ethics represents a set of moral principles, rules of conduct, and values (ethical values),

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in which we act and behave based on the application of intuitive reasoning and intellectual reasoning. In other words, actions and behaviour must be conducted in the best possible way by utilizing these forms of reason in such a way that ensures that equal weight is given to one's own interests and the interests of those who will be affected by what we do (Rachels, 2003).

Ethics can also be defined as the philosophical inquiry into the nature and grounds of morality, in which morality means moral judgments, standards, and rules of conduct (Taylor, 1975). Here, once again, the term "ethics and morality" are used as if they were one in the same. However, morality is meant to indicate values and pertains to human action and conduct, whereas ethics concerns the study of these areas (Shaw, 1990). Given that ethics deals with human actions and behaviour, it ultimately can be said to assess whether a particular act, behaviour, choice and decision taken by an individual is right or wrong, good or bad, ethical or unethical, moral or immoral. Hence, it is critically important to understand the concepts, theories and prevailing schools of ethical thought within the Western tradition of ethics.

Ethical theories which provide us with the foundations of how to come to the right choice and engage in good decision-making are important, insofar as even if people apply the same information and same rules, they will still inevitably encounter a variety of choices and display profound differences in terms of their decision-making. Hence, developing a strong understanding of the concept of ethics would help us to make the right choices and good decisions amongst the available options when faced with ethical dilemmas in our daily lives. There are manifold conceptions of ethics within the Western philosophical tradition. However, this chapter opts to delineate three specific theories of ethics, which I consider to be the most relevant to the study of a value-based economy, namely: the deontological theory of ethics; teleological (consequential) theory of ethics; and virtue theory of ethics. While I discuss these ethical theories in relation to economics in the next chapter, this chapter focuses on ethics from an Islamic perspective and in relation to Islamic economics.

Ethics and morality within the Islamic tradition are referred to as “*Khuluq*” (singular) or “*Akhlaq*” (plural) and “*Adab*”.⁸ Both in Arabic and Indonesian, the words “*Akhlaq*” and “*Adab*” (ethics and morality, respectively) are generally seen as synonymous with one another and are often used interchangeably when referring to character, attitudes, behaviour, manners and etiquette that connotes good things and good behaviour (Siddiqui, 1997). Some Muslim Scholars differentiate ethics from morality, whereby ethics or “*Akhlaq*” indicates “moral philosophy”, while morality or “*Adab*” signifies the actual practices of moral philosophy (Hashi, 2011). In an Islamic context, the concept of ethics is employed to describe the concept of goodness or “*Khayr*”, “*Birr*” (righteousness), “*Qist*” (equity), “*Adl*” (equilibrium and justice), “*Haqq*” (truth and right), “*Ma’ruf*” (Known goodness and approved), or “*Taqwa*” (piety). Pious actions are described as *Salihat*, while impious actions are described as *Sayyi’at* (Beekun, 1997).

Therefore, Islamic ethics, or “*Akhlaq*” in the Islamic tradition, is generally regarded as a moral philosophy that examines how we know what is good and bad, what is right and wrong, what is proper conduct and what is improper, and enjoining us to do what is good (*al-Ma’ruf*), while, simultaneously, forbidding us from doing what is evil (*al-Munkar*). It is acquired by nurturing the soul and giving exercise to it, so that it will act in such a way that results in habitual actions and behaviour. However, since humans have both angelic- and satanic characteristics in their soul, they sometimes do bad things and act improperly or unethically. What separates the good from the bad however, is that good people will repent to God after engaging in bad behavior, and seek to nurture the good and right actions and behaviour. Conversely, morality “*Adab*” typically refers to

⁸ See the Quran *Surah* 68: 4. [وفي الآية الكريمة: "وإنك لعلی خلق عظیم"], This means: “And indeed, you are of a great moral character”.

See also the *Sunnah* [(الجامع الصغير عن ابن مسعود): "أدبني ربي فأحسن تأديبي"],

This means: “My Lord has taught me excellent manners and perfected my manners”.

[وفي الحديث الشريف: "خير الناس أحسنهم خلقاً و أنفعهم للناس"], This means: “The best people amongst you are those who are the most useful and beneficial to others, and those who have the best manners and character”.

[وفي الحديث الشريف: "إنما بعثت لأتمم مكارم الأخلاق"], This means: “I have been sent for the purpose of perfecting good morals and to uphold and complement ethical values”.

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actual human actions, conduct and behavior; however, I tend to both view and use them as interchangeable terms. The idea here is that the good and the right thing can be realized by engaging in good actions and righteous behaviour (*Adab*), accompanied by and safeguarded by God-consciousness, God-fearing piety, self-restraint, and continual forbearance (al-Attas, Abd-Allah, 1890).⁹

Al-Ghazali, in the *The Proof of Islam*, argues that human consists of two forms, physical body (*khalq*) and spiritual form or soul (*khuluq* or *akhlaq*), which cannot be separated from one another. Our actions are thus driven by the soul. If a human has a good soul (inner beauty), then they will produce good and righteous actions, but if they have bad souls (inner beast), then they will engage in bad and wrongful actions (Abdul-Quasem, 1975; Adibah, 2013; Al-Ghazaly, 2004)¹⁰ The Arabic word “*Khuluq*” (singular) and “*Akhlaq*” (plural) derives from the word “*Khalq*”, which means creation or to create. The words “*Khaliq*” (the Creator) and “*Makhluq*” (the creature) also derive from the term “*Khalq*”. The argument here is that there ought to exist a good, hierarchical based relationship between God “*Khaliq*” (the Creator) and “*Makhluq*” (the creatures), as well as a good horizontal relationship between creatures and other creatures or humans and the universe.

The primary sources for Islamic ethical values and morality are the *Quran* and the *Sunnah*, in which according to Siddiqui (Siddiqui, 1997), Islamic ethics comprises four aspects: (1), *Iman* or belief in the oneness of God, (2), *Islam* or surrender oneself to God, (3), *Taqwa* or God-consciousness, God-fearing piety,

⁹ See ‘Attās, ‘Abd Allāh Ibn ‘Alawī al-. (1890). *Al-Durar al-bahiyya fī al-aḳlāq al-maraḳḳiyya* or “the beautiful pearls of the good act and behaviour”.

الدرر البهية في الأخلاق المرضية و الآداب الدنيوية علي وفق الأحوال الزمانية والأغراض الأخروية علي حسب الأحوال الخيرية.

”وقد صح أن الحسن ليس تأدب # إذا حاز تقوي الله في كل أحيان.“

This means: “it is really of the right thing that virtue is obtained by good actions and righteous behavior, accompanied by a God-consciousness, God-fearing piety and self-restraint.”

¹⁰ See also Al-Ghazali’s book *Ihya Ulum al-Din* or The Revival of the Religious Sciences in Third Quarter: *The Ways to Perdition (Rub’ al-muhlikat)*. There, al-Ghazali explains in great detail the soul of *ruh*, *nafs* and *qalb*. Accessed on 25 September 2018 <https://www.ghazali.org/ihya/ihya.htm>

and (4), *Ihsan* or benevolence, kindness and good deeds (Siddiqui, 1997). This means that Islamic ethics and morality is transcendental, in that it is based on the divine law of God, which is referred to as Islamic law. From this perspective, ethical behaviour and morality concerns the way we behave and the values we hold, which are embedded in humans and cannot be separated from each other when living our lives.

Given that each of us have our own sets of values that orient us in life, there is a strong relationship between ethics, morality, values and the limits of human reason itself. Since values can also be held as a moral position (ethical values or Islamic ethical values), for the most part, one ought not to confront and challenge the values held by others; for example, in Indonesia, one deeply held ethical value is that one should use their right hand when eating, and it would be inappropriate to challenge this by stating that it is perfectly fine to eat with either your left or right hand. Moreover, if one confronts someone else and states that their own values are superior to theirs, then it will invariably engender enmity, confrontation, and perhaps even hatred. This is because the values that people hold are their own concern, and, hence, their choice to live in accordance with these values ought to be respected. This relativistic position is partially grounded in the principle of mutual respect (Taylor, 1991). This view is in line with the Quranic view, which states that Muslims should always maintain the highest level of respect towards others, even towards those they may vehemently disagree with, and refrain from insulting other people's religious beliefs (The *Quran Surah al-An'aam*, 6: 108).

In a similar vein, Klammer purports that values have specifically moral connotations, namely honour, benevolence, solidarity or honesty, within the Western moral philosophical tradition. With respect to virtue ethics, values come in the form of virtuous behavior, such as being courageous, prudent, just, temperate, faithful, hopeful and being a loving person, and so on and so forth (Klammer, 2016b).

The principal focus of this chapter is to investigate the ethical foundations of Islamic banking, but before I can do so, I must first discuss the underlying principles of Islamic ethics and values.

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2.2 Principles of Islamic Ethics and Values

Islamic ethics in its entirety is predicated on the belief that there is only one God, who is the creator of everything, while man is His “*Abd*” or servant as well as His “*Khalifah*” (trustee and vicegerent on earth), in which all other creations have declined to accept this duty.¹¹ The creation of humans and their existence on earth is the result of the divine plan of God, on the basis that humans are delegated to manage, preserve, prosper and improve life on earth in accordance with divine law, or what in Islam is called Islamic law. The resolution and provision of Islamic law derives from the discipline of Islamic jurisprudence or “*al-Figh*”, in which humans have to try their best and attempt, in their capacity as a trustee or vicegerent on earth, to understand Islamic law as it is outlined in the *Quran* and the *Sunnah*, which constitute the primary sources of Islamic ethics and morality. In addition to this, having a deep understanding of the *Quran* and the *Sunnah* equips Muslims with the capability and capacity to produce what Muslims call *Ijma*, *Qiyas* and *Ijtihad*, which can be understood as an additional source of Islamic law, alongside the *Quran* and the *Sunnah*.

Islamic law by its very nature is the embodiment of ethical principles, and, indeed, the two are inseparable, insofar as Islamic law by definition is ethical in nature. For example, when the *Quran*¹² commands that all contracts must be consensual and agreed upon by all parties involved, that they must be free from coercion, deception, misrepresentation or fraud, that they must be made in good faith by the parties involved, who must make every effort to honour their promises, it can be said to be articulating and embracing virtue ethics and morality, in the same way that Kantian ethics would apply here.

Islam (and, one might say, other religions) from its very inception encouraged humans to observe virtue ethics and good morality in their actions and behaviour. The prophet Muhammad (saw) says that “he has been sent for the

¹¹ The *Quran Surah al-Ahzab* (QS, 33: 72). “Indeed, we offered the Trust to the heavens and the earth and the mountains, and they declined to bear it and feared it; but man [undertook to] bear it. Indeed, he was unjust and ignorant”.

¹² See the *Quran, Surah Surah an-Nisa’* (QS; 4: 29), *Surah ar-Rahman* (QS; 55:9), *Surah al-An’am* (QS; 6: 152), *Surah al-Isra’* (QS; 17: 34-35), *Surah al-Maidah* (QS; 5: 1), *Surah al-Muthaffifiin* (QS; 83: 1-4), *Surah an-Nisa’* (QS; 4: 58).

purpose of perfecting good morals and to uphold and complement ethical values". The prophet also says that the best people amongst you are those who are the most useful and beneficial to others, and those who have the best manners and character. This Islamic teaching in the *Sunnah* reminds us that humans may fall prey to wrongful behaviour and commit evil acts, since humans have been equipped with a soul (of which the ego forms part)¹³, comprising both angelic and satanic characteristics (Al-Ghazali, 2004), which, in turn, leads the ego to seduce us and lead us to commit evil acts and wrongful behaviour. However, I am of the belief that human beings have been created as perfect creatures, who have pristine innate instincts and good character¹⁴, which enable us to rationally differentiate between good and bad, right and wrong.

Islamic belief posits that since human existence is a product of God's design and His divine plan necessitates that we act as His servant and vicegerent on earth, that God has endowed and empowered humans with the qualities of intellectual reasoning and intuitive reasoning, knowledge, free-will and guidance. Consequently, humans are raised to a unique position above any other creation, on the condition¹⁵ that we uphold virtue ethics and morality in our lives. Failure to do will result in humans sinking to the position of an animal, which occupies the lowest position, or even worse as is stated in the *Quran*.¹⁶ This understanding of

¹³ See Al-Ghazali's work *Ihya Ulum al-Din* or The Revival of the Religious Sciences in Third Quarter: *The Ways to Perdition (Rub' al-muhlikat)*. There, al-Ghazali explains in great detail the soul of *ruh*, *nafs* and *qalb*. Accessed on 25 September 2018 <https://www.ghazali.org/ihya/ihya.htm>

¹⁴ This belief is based on the Islamic religious belief that every human being is born in a state of *Fitrah*, in which *Fitrah* refers to pristine innate instincts or good character.

¹⁵ The *Quran Surah al-Baqarah* (QS, 2:30-32), And [mention, O Muhammad], when your Lord said to the angels, "Indeed, I will make upon the earth a successive authority (QS, 2: 30). And He taught Adam the names - all of them. Then He showed them to the angels and said, "Inform Me of the names of these, if you are truthful (QS, 2:31). They said, the Exalted are You; we (angels) have no knowledge except what You have taught us. Indeed, it is You who is the Knowing, the Wise (QS, 2: 32).

¹⁶ The *Quran Surah al-Baqarah* (QS, 17:70), And We have certainly honoured the children of Adam and carried them on the land and sea and provided for them of the good things and preferred them over much of what We have created, with [definite] preference. The *Quran Surah al-A'raf* (QS, 7:179), And We have certainly created for Hell many of the jinn and mankind. They have hearts with which they do not understand, they have eyes with which

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the relationship between God as the sole creator and human beings as His servants, vicegerents and trustees on earth, means that humans should choose to prosper the earth by making the best use of resources to establish a moral social order. In other words, humans can be said to be acting ethically when they are both acting in a way that contributes to the improvement of life, not only for fellow human beings, but also for all other creatures, the environment and the entire universe, and acting in line with the Islamic law or the divine teachings of God, and vice versa.

This conception implies that Islamic ethics is transcendental, in the sense that everything that is deemed to be ethical and moral actions and behaviour ultimately derives from God, by virtue of the divine revelation otherwise known as Islamic law. In this respect, the source of Islamic ethical values and morality transcend human desires and culture, which is why it can be considered as a universal moral code of conduct.

However, there are different interpretations of Islamic law amongst Muslim Jurists and scholars in '*Ilm al-Fiqh*', i.e., the discipline of Islamic jurisprudence, which means that there is no consensus over what conduct, actions and behaviours are regarded as ethical or unethical, moral or immoral, proper or improper. Indeed, this often depends on the circumstances, local values, culture, local wisdom, rather than specifically what is *Halal* and *Haram*, or lawful and unlawful per se. The example of smoking is a case in point here: some Muslims see smoking as ethical conduct, whereas others see smoking as unethical and as a *haram* act from the perspective of Islamic law. This again serves to illustrate that ethical behaviour and moral actions concern the way we behave and the values we hold, and that these values are ingrained in humans and, as such, cannot be separated from one another in our daily lives.

Another example of the heterogeneity of interpretations of Islamic law concerns the fact that Javanese people have specific beliefs, which are embedded in their culture and values, that it is taboo for a wedding to take place in the month

they do not see, and they have ears with which they do not hear. Those are like livestock; rather, they are more astray. It is they who are the heedless.

of *Sura*¹⁷, due to the fact that it is regarded as a sacred month. Hence, opting not to have a wedding during this period is a good to strive for and is an instance of ethical conduct and moral behaviour, whereas in other parts of the world Muslims will hold weddings during this period and nevertheless deem the behavior to be ethical. The reader may well be thinking, why is it good not to get married in this month? I do not have the answer for this necessarily; all I can say is that, as someone who is Javanese, I have been told for my entire life that I must live modestly, decently, whilst also displaying temperance during this particular month, which translates into not having parties, festivities or living an extravagant life. Of course, this does not mean that during other months of the year I am free to lead a life of extravagance, rather it is about exercising self-constraint and living modestly.

Another example which illustrates how context, local wisdom, and cultural values can result in different forms of action and behaviour being classified as ethical or unethical, is the fact that Indonesian Muslims living in the city of “*Kudus*” in Central Java Indonesia act ethically by not consuming meat from cows. Instead, they prefer to consume buffalo meat as a means through which to show appreciation and respect towards the older traditions of Javanese Hindu people, who also do not consume cow meat. Although Islamic religious values allow Muslims to consume cows as *halal* food, for them consuming cow meat would cause offence to their fellow Hindus and thus is avoided. In this particular case, it is worth mentioning that opting not to consume cow meat is not regarded as an act that goes against Islamic religious teaching, since the intention is not to make it *haram* food, but rather the intention is to show respect and refrain from offending fellow Hindus.

This is what I refer to as values that can be regarded as a moral stance, insofar as values are something that are embedded in our inner selves and, as such, are held by everyone. These values may stem from religious belief, such as, for example, when offending others is not be allowed within someone’s religion, but

¹⁷ *Sura* is the first month in Javanese calendar, they are: (1. *Sura*, 2. *Sapar*, 3. *Mulud*, 4. *Bakda Mulud*, 5. *Jumadil Awal*, 6. *Jumadil Akhir*, 7. *Rejeb*, 8. *Ruwah*, 9. *Pasa*, 10. *Sawal*, 11. *Sela*, 12. *Besar*).

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it can equally pertain to social practices, as foreign Muslims who visit *Kudus* may well choose to consume cow meat that they brought with them, which would be perfectly ethical for them since it is a *halal* food. Therefore, one ought not to challenge -albeit with some exceptions- other people's values which differ from their own, based on a relativistic perspective that is partly grounded in the principle of mutual respect, even if their values can be deemed to not be Islamic from the perspective of other Muslims.¹⁸ Indeed, it may be the case that their traditions, mores and customs are better than ours, and that their values have a strong moral connotation, such as, for example, respect, benevolence, solidarity or honesty, which corresponds to the aforementioned moral philosophy (Taylor, 1991; Klammer, 2016b). Simply put, we should not look down upon and/or underestimate other people's values.

I view the aforementioned case as examples of ethical values and moral norms that operate within the social and cultural spheres, and which can be considered as Islamic, provided they are not in opposition to Islamic law and are in accordance with the objective of Islamic law, that is, to promote benefits and prevent harm.

If tribes, ethnic groups and nations can be said to have their own distinct values, then so too can religions be seen to have distinctive values. Muslims cannot be separated from the Islamic traditions and values inscribed in their behaviour, and so it is for Christians, Jews, Hindus, Buddhists and other religious groups. My own conduct, actions and behaviour are wholly influenced by both Islamic ethical values and Javanese social and cultural values and moral norms.

All religions have their own distinct values which influence their behaviour, but for the all three Abrahamic religions -since they have the same root-, they can be said in the economic sphere that they share the same basic purpose: socio-economic justice, a more equitable distribution of income and wealth, achieving happiness, welfare and well-being, balance and harmony in life, ensuring equality of opportunity for all, securing a decent standard of living for all, individuals to

¹⁸ The *Quran Surah al-An'aam* (QS, 6: 108) "*And do not insult those they invoke other than Allah, lest they insult Allah in enmity without knowledge...*"

achieve full-sufficiency, fulfilling material needs as well as spiritual needs and so on. In reality, these types of values will all overlap, interact and intersect in human behaviour.

It should now be clear that there is a strong relationship between ethics, morality, values and the limits of human reason, namely the fact that humans are unable to prove the existence of God, as it is transcendental in Islamic ethical values. Values, irrespective of whether we are talking about Islamic ethical values or Javanese cultural values, are not merely an expression of underlying drives and desires, but rather are also instrumental in our continuing attempts to strive for the good, and achieve the ideal. That is to say, values are employed to serve specific goals and purposes and manifest in every society as morals, ethics and laws. However, just because Islamic ethical values and Javanese ethical values merge and integrate with one another, this is not to say that Islamic ethical values cannot also merge and integrate with local cultures and wisdom in any other part of the world.

Ethics, morality and values, which are a product of religious teaching and the postulates of religion, such as Islamic ethical values or Christian ethical values, can be considered as a priori knowledge and as being inseparable from religion, insofar as they are taught and serve as the foundation for a religion's ethical system, such as how the *Quran* and the *Sunnah* provide the foundations for the ethical system in Islam. Before delineating the ethical foundations of Islamic banking, it is instructive to summarize that the principles of Islamic ethical values are universal, despite the heterogeneity of interpretations and opinions, especially with regard to local wisdom, culture and practices.

First, Islamic ethical values are transcendental, in the sense that the ultimate arbiter of what is ethical and unethical, good and bad, right and wrong, or proper and improper, is God himself.

Second, Islamic ethical values constitute a universal moral standard and universal code of ethical conduct in terms of universal justice and equality, in which humans must be treated justly and equally, without discrimination or favoritism, irrespective of religion, culture, race, ethnicity or nationality. However, the interpretation of Islamic ethical values by local cultures, local wisdoms and local practices is also permissible, provided this does not violate

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Islamic law, which is what one sees in the case of Javanese local culture, wisdom and practices.

Third, human conduct is judged to be ethical if it is based on good intentions (motive) and involves the use of good means, as well as being in accordance with Islamic law (Islamic ethical values and norms). On the contrary, human conduct is deemed to be unethical if the means being used to realize a goal or achieve a certain end are evil in their intent (bad motives), which is to say that the ends do not justify the means. This is the case, because good intentions (motives) and good means (ways) of conduct are generally assumed to produce good acts and good outcomes, and, as such, are unable to turn immoral acts into good ones, while good outcomes are not able to morally justify employing immoral means or one's bad intentions.¹⁹

Fourth, although humans are endowed by God with free-will in their soul and ego (*ruh*, *nafs*, *qolb*), free-will must be exercised in conjunction with accountability and justice, and must not be used at the expense of others, since God rewards the righteous and punishes wicked acts. Humans have free-will and choice over whether to act good or evil, rightly or wrongly, however, they can only choose good over evil and right over wrong if they employ both their intuitive and intellectual forms of reasoning. In Islamic tradition, the ego is destined to draw us towards evil²⁰, and, hence, there is an endless battle to balance out egoism with altruism, in order for good actions and virtuous behavior to come to the fore. One's freedom is also limited by other people's freedoms, as well as being subject to Islamic law. An illustrative example here is the case of pornography or nudism, which is strictly prohibited by Islamic law and thus constitutes an unethical and immoral act, since one of the underlying principles of Islamic ethics is public decency, which manifests in a dress code designed to cover up human bodies.

¹⁹ The *Sunnah* or *al-Hadith* narrated by Bukhari & Muslim “*Verily actions are by intentions, and for every person is what he intended.....*”.

²⁰ The *Quran Surah Yusuf* (QS, 12: 53), “....., *Indeed, the soul is a persistent enjoiner of evil, except those upon which my Lord has mercy,.....*”.

Finally, Islamic ethical values constitute a key part of Islamic law's objective to prevent the hardships of life and eliminate corruption, while, simultaneously, helping to improve the welfare, happiness and well-being of everyone.

In reality, there are specific instances where humans are forced to conduct unethical acts, or otherwise be subjected to physical harm and even death, such as, for example, being forced to eat *haram* food or unlawful meat if they otherwise would starve to death. In such circumstances, they would be allowed to, and, indeed, it would even be ethical for them to, consume *haram* food, but only an amount that is sufficient to sustain their life, according to Islamic jurisprudence. These sorts of incidents come under the maxim of "*al-Darurat Tubih al-Mahdurat*", which means that necessity makes prohibited things permissible, but under very strict rules. For example, the combination of the maxim of "*al-Darurat Tubih al-Mahdurat*" and the maxim of "*Maslahah Mursalah*", which means for the benefit of public interest, would make it permissible, to some extent, to apply interest to a financial transaction, insofar as it is a kind of necessity (Naseem Razi, 2014).

Given our focus on banking practice, it is worthwhile to note that financial interest rates in banking practices are permissible on the condition that the spirit of that financial transaction is aimed toward benefitting the public interest through the spirit of mutual benefit, mutual help and the spirit of assisting one another to improve the welfare, happiness and well-being of society as a whole. Once the issue of necessity disappears however, then the banking practice of applying interest in financial transactions must be abandoned. Having unpacked precisely what ethics, morality, values are, as well as discussing the underlying principles of Islamic ethics, morality and values, it is now time to investigate the ethical foundations of Islamic banking.

2.3 Ethical Foundations of Islamic Banking

Islam provides Muslims with a complete blueprint for life, rules of the game and code of conduct that serves to guide all facets of their existence. The *Quran* and the *Sunnah* do not only deal with spiritual matters, but also prescribe how Muslims ought to conduct their everyday lives in a physical sense. Islamic ethical values, morality and virtue ethics, as ordained by the *Quran*, provide a binding and unifying function for all Muslims, which also serves as the foundation for

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social and economic behaviour (Abbasi et al., 1989). Islam provides humans with an ordained worldview from God concerning how they ought to act, behave, and conduct their lives. Muslim scholars posit that the moral and ethical code for individual and social conduct, as prescribed in the *Quran* and the *Sunnah*, encompasses various spheres of life, including economics, banking institutions and financial transactions (Zubair Hasan, 2016; Choudhury, 2015; Chapra, 2009).

Islam is a monotheistic religion, and this is also the case with respect to the Islamic worldview. It is neither secularistic nor atheistic, in the sense that it does not dichotomize the divine sphere (religious life) and mundane sphere (worldly life), the secular and spiritual, body and soul, life in this world (*Dunya*) and life in the hereafter (*Akhirah*). Neither is there a dichotomy between state and religion; in fact, they are wholly fused together²¹ (Baldwin, 1990). I have already noted that Islamic ethics and morality is transcendental, in that it is based on the divine law of God, and that Islamic law by definition is ethical in nature. It should also now be clear that Islamic ethical values and morality are the dominant guiding force of human actions and behaviour. For this reason, human activity cannot be divorced from the ethical positions one adopts, which is conditioned either by the religion one is attached to (Wilson, 1997) or the social arrangement and culture in which the person lives, which includes the sphere of economic activities and financial transactions (Klamer, 2003;2016; McCloskey, 2006).

Given that ethical systems are rooted in particular worldviews, every economic system has a distinct set of values and characteristics that distinguish it from other systems. These moral norms and ethical principles are implicitly incorporated into the notions, concepts, ideas and thoughts, assumptions, ideals and even theories of economics (Spengler, 1980; Wilson, 1997). This highlights the fact that no form of scientific knowledge or scientific discipline is value-free. From this perspective, Islamic economics and Islamic banking and finance are not value-free either, but rather are influenced by Islamic ethical values that are rooted in Islamic religious faith.

²¹ This notion does not mean that Muslims have to establish an Islamic state. From my own perspective, an Islamic state is unnecessary given that everyone is free to worship and serve God in accordance with their own beliefs.

Since religious ethics are practically inseparable from human conduct, attitudes and behaviour, all religions can thus be said to share the same basic purpose of human life, such as socio-economic justice, equitable distribution of income and wealth, realization of welfare, happiness and well-being, and achieving balance and harmony in life by fulfilling both material and spiritual needs. The Islamic ethical worldview is predicated on the fundamental belief that life and existence come into being as a result of the will, desire and design of the one God and only creator. The concept of the oneness of God (*Tawheed*) is essential in every Islamic discourse, and, in fact, takes precedence over everything else. There are at least three fundamental principles that the ethical foundations of Islamic economics and Islamic banking are based on: the oneness of God (*Tawheed*), viceregency (*Khilafah*), and justice (*'Adalah*). Although scholars differ in terms of the specific words that they use, the essence of these principles are nevertheless the same.

Rafik Beekun (Beekun, 1997) posits that the ethical foundations of Islamic economics and Islamic banking are: (1) Unity (*Tawheed*), which means the totality of integrated existence of the universe; (2) Equilibrium (*'Adl*), which means a sense of balance among the various facets of human life; (3) Free-will (*Ikhtiar*), or the level of autonomy that humans have to act without external coercion, while still being subject to Islamic law and adhering to the limits set by God with respect to acting as His vicegerent on earth; (4) Responsibility, which pertains to how everybody is held responsible for all of their actions; (5) Benevolence (*Ihsan*), which refers to those actions that are carried out by humans without any expectation of getting anything in return.

Syed Haider Naqvi (Naqvi, 1978; 1981) contends that the ethical foundations of Islamic economics and Islamic banking are: (1) Unity (*Tawheed*); (2) Equilibrium (*al-'Adl wa al-Ihsan*); (3) Free-will (*Ikhtiar*); and (4) Responsibility (*Fardh*). Conversely, Umer Chapra (Chapra, 1992) and Gillian Rice (Rice, 1999) purport that the ethical foundations of Islamic economics and Islamic banking is based on: (1) The oneness of God (*Tawheed*); (2) Trusteeship or viceregency (*Khilafah*); (3) Justice (*'Adalah*).

Umer Chapra (Chapra, 1979; 2009) pus forward the additional point that the objective of the Islamic economic order and Islamic banking and financial

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institutions is grounded in the ethical foundations of: (1) economic welfare and well-being within the framework of Islamic morality, Islamic ethical values and moral norms of Islam; (2) universal brotherhood and justice; (3) equitable distribution of income; and (4) freedom of actions, speech and expression of every individual within the context of social welfare (i.e., the balance between egoism and altruism).

Despite these aforementioned differences regarding what precise postulates or axioms govern and provide the Islamic ethical foundations for Islamic economics and Islamic banking, the general essence of their respective arguments is the same. For the purposes of this research, I will focus on three of the abovementioned axioms, namely: the oneness of God (*Tawheed*); trusteeship or viceregency (*Khilafah*); and justice (*'Adalah*). Firstly, let us investigate the concept of unity or the oneness of God.

2.4 Axiom of Unity or the Oneness of God

A fundamental component of Islamic ethics, which also serves as the basis of its system and institutions, is the belief in the oneness of God (*Tawheed*). Indeed, all scholars (whether Western or Eastern) who write about Islamic economics and Islamic banking and finance emphasize the importance of this principle. The concept of the oneness of God (*Tawheed*) encompasses every sphere of human life²² and human activity, both individually and collectively. It embraces the life of all creatures from the perspective of nature and the environment, as well as from the perspective of individuals and social life that reflect unification (Badawi, 1991). The main idea here is that there should be unity of ideas and actions in a human's existence and consciousness. All life is essentially unity (Asad, 1993), in the sense that everything is inter-connected. The concept of the oneness of God (*Tawheed*) denotes that the universe is one from the

²² Here, by using the phrase every sphere of human life, I am referring explicitly to Klammer's five sphere model of realizing values and doing the right thing, which comprises: market sphere, government sphere, *oikos* sphere, social sphere and cultural sphere. The cultural sphere both encompasses and is embedded in all other spheres.

perspective of divine essence, however from the perspective of relativity, there exists the polarization between the microcosm and macrocosm.

Human beings are fundamentally of one kind and constitutes a singular entity (Asad, 1993), despite the multiplicity of humans in the world. In this respect, they are created as one being (despite consisting of body and soul) and will ultimately return to God as a single being that will subsequently be invisible from the perspective of our material life. In a series of verses, the *Quran* exhorts humans to take collective and unified social action, as well as to preserve and protect the collectivity from all elements of disunity and disorderly life. Such collective social action may take the form of equality in opportunity and non-discriminatory behaviour (Iqbal, & Abbas Mirakhor, 2017).

Within Islamic belief, human beings are a microcosm (*'Alam Shagheer* or small world), while the universe is a macrocosm (*'Alam Kabeer* or large world), who are not wholly distinct entities, but rather form a continuous existence until the end of time. This is because the concept of soul and body does not only apply to human beings, but rather to all beings, who all possess the dimension of spirituality and materiality and are in total submission to God in terms of their actions and behaviour. Because of the inter-relatedness of all beings, every single being must strive to act ethically and in a good manner, because the act of one being subsequently affects other beings, not to mention being itself. Ultimately, good acts result in good returns and rewards, and vice versa.

Based on both the concept of the oneness of God and the principle of unity and equality, within Islam, there is no such thing as one human being superior to another or dominating them. Indeed, as the Islamic postulate goes: *"No Arab has superiority over any non-Arab and no non-Arab has any superiority over an Arab; or no person has superiority over another person"*.

In Islam, the criterion for receiving honour in the eye of God is righteousness and honest living. Of course, these ethical values are shared across all religions, insofar as religion is the driving force in promoting ethics. All religions teach their adherents that God is essentially ethical (Wilson, 1997), and even Izutsu (2002b) posits that morality in Islam has its origin in religion.

God acts towards human beings in an ethical manner by virtue of justice, prudence, temperance, courage, love, helpfulness, generosity, benevolence and all

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other forms of goodness. In so doing, God reveals himself as the God of infinite goodness and benevolence, as well as being merciful, gracious, forgiving and peaceful. In return for such treatment from God, humans are expected to reciprocate by responding to these Divine initiatives in a similarly ethical fashion (Izutsu, 2002a). Not only must people seek the pleasure of God, they must also believe that their success in life and hereafter is dependent on their actions, behaviour, performance conduct in their life on earth, for which they are held accountable by God.

The primacy of accountability outlined above adds a new dimension to the valuation of things and everything that people do over the course of their lives (Siddiqi, 1981). The adoption of this virtue ethics, which stems from the concept of the oneness of God (*Tawheed*), has a series of implications for business ethics in the economy and for financial transactions. Specifically, it impacts upon cooperation and partnership, solidarity and collectiveness, honesty and fairness, trust and equality of effort and opportunity, brotherhood and sisterhood (Abu Sulayman, 1976), through which people assist each other to create balance and harmony in life, preserve and protect collectivity, unity and cohesiveness, as well as in terms of preventing disunity and social disintegration.

All of these ethical values or virtue ethics must be implemented by human beings, who are chosen by God to be His vicegerent on earth, to guard and govern the life on earth so that it functions in a state of balance and harmony, at both the individual and societal level, as part of the universe. The next axiom that will be discussed is vicegerency or trusteeship.

2.5 Axiom of Vicegerency or Trusteeship

Within Islam, the ultimate purpose of human creation is to worship (serve) God, to seek the pleasure of God and to be in total submission to God. This is not only the case for human beings²³, but also for all creatures who are created to

²³ *The Quran Surah al-Hajj (QS, 22; 18) "Do you not see that to Allah prostrates whoever is in the heavens and whoever is on the earth and the sun, the moon, the stars, the mountains, the trees, the moving creatures and many of the people? But upon many the punishment has been justified. And he whom Allah humiliates - for him there is no bestower of honour. Indeed, Allah does what He wills".*

worship God the Creator, the Omnipotent, the Omniscient and the Omnipresent. The *Quran* mentions that genies (*al-Jinn*) and men (*al-Ins*) were only created to worship or serve God.²⁴ Worshipping means seeking the pleasure of God, total submission and devotion to God, serving God and showing Him piety and dedication. This verse implies that all acts and behavior, whether it be material or spiritual, must be in accordance with what God has ordered. Consequently, every act is in fact an act of worship. A good act will result in good rewards, and, conversely, a bad act will result in punishment in either this life on earth or hereafter.

This concept of vicegerency originates from the event told in the *Quran*²⁵ that God created humans to act as His vicegerents, trustees, representatives and servants and stewards on earth, to worship and to serve God as well as to prosper, preserve and improve life on earth. This trusteeship was offered to other creatures, such as the heavens, earth, mountain, etc., but they all declined/or were incapable of carrying out the task, while humans alone dared to take it on.²⁶ Humans are expected to be honest (*al-Sidq*) and fair (*Siddiq*) when carrying out this responsibility and accomplishing their mission as the trustees of God. Although humans are bestowed with free-will, independence and personality, they have to strive for goods and to fulfil the divine plan in order to act in a way that it not contrary to their nature.

This is because the nature (*Fitrah*) of humans is good, pure and free from any spiritual and moral flaws, provided these qualities do not become corrupted over the course of their lives.²⁷ Therefore, humans are expected not to deviate from

²⁴ The *Quran*, Surah al-Dharyat, (QS, 51:56) “I have only created Jinns and men, that they may worship (serve) Me”.

²⁵ The *Quran* Surah al-Baqarah (QS, 2: 30), “And when your Lord said to the angels, “Verily I am going to make in the earth a vicegerent. They said: ‘Will You put on the earth one who will make there (on earth) mischief and will shed blood? He said, ‘I know what you do not know”.

²⁶ The *Quran* Surah al-Ahzab (QS, 33:72). “Indeed, we offered the Trust to the heavens and the earth and the mountains, and they declined to bear it and feared it; but man [undertook to] bear it. Indeed, he was unjust and ignorant”.

²⁷ The *Quran* Surah al-Rum (QS, 30: 30). “So, direct your face toward the religion, inclining to truth. [Adhere to] the *fitrah* of Allah upon which He has created [all] people. No change

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their inherently good nature in all aspects of their lives. They are required to improve and rehabilitate the earth through their efforts and initiatives, rather than to destroy it. They can do the former by making the best use of the available resources (capital, human and natural resources) and by endeavoring to fully utilize the virtue ethics that were bestowed within them by God, rather than corrupting them. In other words, humans must choose welfare, prosperity and well-being over misery, pain and suffering.

Choosing evil deeds, wrong doing and any other unethical acts is, in fact, considered to be a violation of trust, a violation of primordial covenant, a violation of the very first agreement, and a violation of the very purpose for creating human beings in the first place.²⁸ Given that humans were created in the best of stature,²⁹ any deviation from ethical conduct and the divine path serves to return humans to the lowest of the low.³⁰

The concept of vicegerency or trusteeship is predicated on balance and harmony. Since humans are equipped with a body and soul, both a demonic (ego) and animal character and an angelic and divine character, humans in their actions should not merely seek to maximize their own utility and interest, but rather the utility and interest of all other creatures by virtue of building an intimate relationship with God, their fellow human beings and the universe. The concept of vicegerency and trusteeship thus automatically obliges humans to act not only to maximize their satisfaction, in terms of fulfilling material needs, but also to fulfil spiritual needs, such as religious spirituality and morality, and act in the interest of society as a whole, by striving for balance and harmony (Naqvi, 1978;

should there be in the creation of Allah. That is the correct religion, but most of the people do not know”.

²⁸ *The Quran, Surah al-Dhariyat, (QS, 51:56) “I have only created Jinns and men, that they may worship (serve) Me”, and Surah al-A’raf (QS, 7:172) “when your Lord took from the children of Adam - from their loins - their descendants and made them testify of themselves, [saying to them], “Am I not your Lord?” They said, “Yes, we have testified”.*

²⁹ *The Quran Surah al-Teen (QS, 95: 4). “We have certainly created man in the best of stature.”*

³⁰ *The Quran Surah al-Tin (QS, 95: 4-5). “We have certainly created man in the best of stature, Then We return him to the lowest of the lower”.*

Izutsu, 2002a; Haneef & Furqani, 2016; Rice, 1999; Chapra, 2009). This Islamic ethical worldview defines and guides human actions and behaviour in all aspects of life, whether in the vertical relationship between God and humans or in the form of horizontal relationships between humans and other humans, as well as other creatures, nature and the environment. These ethical relationships also apply to various disciplines of knowledge, such as, among other things, economics, banking and financial institutions.

Because of these ethical relationships, humans qua vicegerents on earth are required to establish socio-economic justice, a moral social order and moral well-being on earth. They must choose to enhance the earth rather than to destroy it, to preserve the earth rather than to damage it, to make the best use of resources rather than to waste them, to enhance welfare, well-being and life overall, rather than corrupting and excessively exploiting economic resources, since resources must also be disposed of in such a way that protects the welfare and well-being of everyone, rather than polluting the earth where we live (Al Faruqi, 1976). Of course, no one is authorized to destroy or waste God-given resources, though, of course, humans have the potential to commit such unethical deeds by virtue of being granted free-will (Naqvi, 1978).

However, through the application of intellectual reasoning (*al-Aql*), which other creatures do not possess, humans have the capacity to opt to live a good life, defined by the realization of welfare, happiness and well-being. Moreover, intellectual reasoning allows humans, on the one hand, to conquer and subjugate other creatures and utilize them in ways to benefit the earth, while, on the other hand, it helps them choose the right path from the wrong path, the angelic path from the evil path.

Life on earth is about undergoing trials and tests, as well as trying our best to implement the ethical ideal as outlined by God through His revelation into real action and concrete practices. Within Islam, morality and ethics guide human behaviour towards the attainment of social bliss, welfare, happiness, and spiritual salvation, both in an individual and societal context. Hence, anything that runs counter to basic Islamic morality, Islamic ethical values and moral norms simply cannot be accepted within the Islamic world (Naqvi, 1981). Above all, morality and ethics must dominate human action and behavior, as opposed to desire, ego

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and free-will. This is because human desire is inexhaustible. Hence, we soon tire of everything that we acquire over the course of our lives. It is only our attachment to God that can satisfy us. It is worthwhile to note here that humans will not feel satisfied by anything except the remembrance of God, which, ultimately, makes us feel satisfied and able to rest.³¹ Therefore, the free-will that is bestowed upon us by God must be directed toward fulfilling the divine pattern, since human will is perfected only when it reflects the divine will (Eaton, 1987).

This total submission to God, that is, directing human will to the will of God, is a fundamental feature of Islamic ethical values, since everything on earth has been created for humans. Humans have freedom and choice over how to use and utilize the bounties and blessings conferred upon them and where to direct their allocation, but at the same time we must carry out our duties and responsibilities towards God, both as human beings and servants of God and as vicegerents and representatives of God- to prosper and establish a just social order on earth. This is because God has made us superior to many of His other creatures, not to mention that everything in the heavens and on earth have been created for the sake of humans, and have been made to be subjected and subservient to humans as part of their fulfilling their role as vicegerents on earth.³²

Free-will necessitates that humans must be accountable to God for their deeds.³³ Free-will does not mean that humans can do whatever they want to do. However, Islam does respect individual freedom, be it freedom of speech, freedom of expression, freedom of thought, freedom of action, freedom to acquire wealth, etc., as long as that freedom is undertaken within the context of social welfare and in compliance with the objectives of Islamic law (Chapra, 1979; 2009).

³¹ *The Quran Surah al-Ra'd* (QS, 13:28). “Surely in the remembrance of Allah do hearts find rest”.

³² *The Quran Surah Luqman* (QS: 31:20) “Do you not see that Allah has made subject to you whatever is in the heavens and whatever is in the earth and amply bestowed upon you His favours, [both] apparent and unapparent? and *Surah al-Baqarah* (QS, 2: 29) “It is He who created for you all of that which is on the earth”.

³³ *The Quran Surah al-Tur* (QS: 52:21) “...each individual is in pledge and accountable for his deeds”.

God's bestowal of free-will and freedom constitutes one of the essential ingredients of Islamic faith, with respect to humans serving as God's vicegerents on earth. It implies that humans are individual by nature and have the right to determine their own destiny. However, the ethical way to exercise these individual rights is to place societal interests and benefits above individual interest, in order to establish a more noble society. In other words, humans are bound to help establish a just social order and create socio-economic justice. It is therefore the task of humans as vicegerents on earth to find the correct balance and equilibrium between their individual rights and societal responsibilities, based on Islamic ethical foundations, as a means through which to realize economic justice.

The concept of vicegerency has three implications for the sphere of Islamic economics and Islamic banking. First, the right of ownership and the freedom of exchange must be respected. Second, all contracts must be enforced. Third, one's primary source of entitlement and ownership must be acquired via the means of work (Uthman, 1999), in order for individual freedoms and individual self-interest not to defy and violate the collective and public interest. Individual free-will and freedom must be balanced with social responsibility, since social justice is an aspect of universal equilibrium, which forms the cornerstone of the Islamic ethical system.

As a matter of fact, social justice is not only to be achieved in the economic sphere, as in to establish socio-economic justice, but rather must also take place in the political and cultural sphere, as well as all other aspects of human life. It (the value of justice) even calls for a simultaneous adjustment in all aspects of human life, as ordained by the axiom of Unity and axiom of vicegerency, since it is humans who are the principal actors in this world, and who must bear the task and responsibility associated with being vicegerents on earth to conquer everything under their control and administration. The next axiom to be discussed in relation to the ethical foundations of Islamic economics, banking and finance, is the axiom of justice.

2.6 Axiom of Justice (*al- 'Adalah*)

The history of justice is as old as the history of humanity itself. The concept of justice is of such paramount importance within all religious teaching, that all religions command their people to treat justice as a virtue and to avoid injustice.

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The notion of justice has also been a key issue within the history of philosophy. The Greeks conceived of justice as “the virtue of the soul and action”. Here, justice is a virtue, because it is a value that pertains to behaviour (Klamer, 2016). For the Greeks, justice thus meant goodness as well as a willingness to obey laws. Before discussing the concept of justice in the Islamic context, (since justice is a concept which is not only discussed in the Islamic (Eastern) world, but also in the Western world), it is instructive to first discuss the concept of justice in the context of the Western tradition of moral philosophy, which I will do so through recourse to the work of Michael Sandel in his book: *Justice, what’s the right thing to do* (Sandel, 2010). Sandel explores three approaches to justice, namely welfare or utility maximization, freedom and virtue, which I consider to encompass moral philosophy and what is considered to be just and the right thing to do, from the perspective of the teleological (consequentialist), deontological, libertarian (freedom) and virtue approach to ethics and justice.

The first approach to justice I will discuss comes from the teleological-utilitarianism (consequentialist) school of thought, which is associated with Jeremy Bentham (1748-1832), who is also regarded as the father of utilitarianism, and John Stuart Mill (1806-1873). According to this teleological conception of justice and morality, “An action is right if and only if it produces the greatest balance of pleasure over pain for everyone” (Boatright, 2012; Sandel, 2010). Therefore, the principle of morality and what is just to do is to maximize the general welfare, to maximize utility and happiness for the community, and to maximize the overall balance of pleasure over pain, or secure the greatest good for the greatest number of people. However, there are difficulties associated with calculating utility, that is, that some actions produce more pleasure for us than others (Boatright, 2012). Moreover, this approach fails to give adequate weight to human honour and dignity (Sandel, 2010), as well as failing to respect individual rights, such as an individual’s right to freedom of speech and expression, due to the fact that their voice has not been heard, in favor of the majority.

However, John Stuart Mill (1806-1873), when defending individual liberty in his book *Liberty*, argues that individuals in reality are still able to have absolute independent and absolute rights over themselves, their bodies and minds within their community, society and state, provided they do not harm others (Sandel,

2010). Within this perspective, collective happiness and welfare are combined with respecting human rights or individual rights. I have my own view to add to this teleological conception of justice, which is that such individual liberties and human rights must take into account the honour and dignity of every individual and the possibility of coexistence with others of different values, faiths, philosophies, and cultures in society, otherwise it will be society that is granted the power to prevent actions and behaviour that harm other individuals. Within this formulation, individuals are free to act within the context of society, in order to establish a just social order and realize socio-economic justice.

The second approach to justice I will discuss views justice in terms of respecting people's freedom of choice, either in terms of the actual choices that people make in the free market (the libertarian view) or the hypothetical choices people would make starting from a position of equality (the liberal egalitarian view), which is in alignment with Sandel's own views (Sandel, 2010). With regard to the view that justice is related to respecting people's freedom of choice in the free market, the libertarian position is that people should be allowed to freely choose whatever they want to do (in terms of what they produce and consume or sell and buy) and left alone to freely engage in free market exchanges. However, a utilitarianism perspective posits that freedom of choice should be exercised in ways that do not hurt anybody else, since the underlying spirit of the free market is to promote the general welfare of all parties who are involved in a deal, and to ensure that no party gets hurt. The underlying assumption, here, is that this kind of conduct will make them better off, which, in turn, increases overall utility.

For Immanuel Kant (1724-1804), freedom must be considered in relation to autonomy and human dignity. For Kant, humans are rational beings who are capable of reasoning and, as such, worthy of respect and honour, capable of acting and choosing freely as autonomous beings, as well as having the capacity to feel pleasure and pain (Sandel, 2010). Kant's contention that one should never treat another human as merely a means to an end, implies that respecting human dignity means treating persons as ends in and of themselves. From this perspective, freedom must be articulated through recourse to Kant's moral philosophy and conception of human autonomy.

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Humans act autonomously in accordance with the law that they made and do something for its own sake, as an end for itself (Sandel, 2010). Here, the morality of a deed is not judged by its consequences, but rather is judged on the basis of whether the intention (motive) behind the deed was a good one. Only the motive of duty can confer moral worth upon an action, as opposed to desire, preference or any other inclination. Sandel cites an example of providing aid to others to illustrate this point. If one provides aid to another simply for the pleasure it gives him, then his action can be said to lack moral worth; however, if it is done for the sake of one's duty to help other human being, then it is an act that can be said to have true moral worth (Sandel, 2010). Of course, duty and inclination typically co-exist and are difficult to disentangle.

For Kant, autonomy is when a person acts freely in accordance with the law that they make or set for themselves, and if anything, or any external factors, influence their decision to act, then a person cannot be considered as acting freely, as they are instead subjugated to external factors. This is difficult in reality, given that our actions are often influenced by external factors, not to mention that in a societal context the law is based on contracts and consensus between the parties involved, which means that autonomy and heteronomy coexist.

However, Kant posited that everything in nature works in accordance with laws or natural law, such as the law of causality or the law of cause and effect, which includes humans qua natural beings who are also subjugated to natural law. This is because for Kant, all action is governed by laws of some kind or other (Sandel, 2010), so that if we are capable of acting in accordance with those laws, then we are also capable of freedom and acting freely, on the condition that those laws are not imposed on us, but rather are laws that we have given ourselves, and, ultimately, it is reason that commands the will.

As rational beings, humans have the capacity of intellectual reasoning and intuitive reasoning, which determines their will to choose freely and independently from the dictates of inclination about what is the right thing to do and what constitutes a moral act. However, Kant's idea of reason is that of "pure practical reason", which legislates a priori, regardless of empirical ends, and thus cannot be viewed as instrumental reason (Sandel, 2010). Regarding this command, Kant introduces the conditional and unconditional imperative, or the hypothetical and

categorical imperative. It is only the categorical imperative, Kant argues, that can qualify as a moral imperative (Sandel, 2010), insofar as categorical imperatives produce a universal moral standard or universalize a maxim and treat humans as ends in themselves as opposed to mere means to an end. By way of contrast, hypothetical imperatives use instrumental reason: if you want X then do Y, or if you want to pass an exam, then you must study hard.

My own view with regard to Kant's idea of justice, is that since humans are social beings, natural beings and rational beings, justice in the context of Kant's idea of freedom, autonomy and dignity thus signify social consensus and social contract in the social sphere, insofar as when laws are agreed by the public as whole, then it can be said, in principle at least, that it is a just law. However, there is another proposition related to the theory of justice concerning the hypothetical choices that people would make from a starting position of equality. Justice as fairness requires the initial situation to be fair or in the same position and level as the initial situation. One feature of justice as fairness is that the parties should be viewed in the initial situation as rational and mutually disinterested. In other words, they are conceived as not taking any interest in the other party's interests. (Rawls, 1999). The main point being made by Rawls here is that, the principles that free and rational persons who are solely concerned with furthering their interests are prepared to accept from a starting position of equality defines the fundamental terms of their association (Rawls, 1999). This calls for the provision of equal basic liberty for all citizens, such as freedom of speech and freedom of religion as a principle of theory of justice, as well as a concern for social and economic equality, but, interestingly, does not require the equal distribution of income and wealth (Sandel, 2010). However, in reality, this starting position of equality is rarely in existence, given the manifold differences in human talent, efforts, incentives and background that one sees in society at large.

Therefore, when inequality exists there should be affirmative action to fix and improve prior wrongdoing and injustice, in order to improve the lives of the least advantaged people or to provide benefits for the least well-off people (Rawls, 1999; Sandel, 2010), in addition to promoting diversity in talent, effort, culture, values etc., as a social good, while, simultaneously, endeavoring to reduce inequality in the economic sphere by improving the lives of destitute and

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marginalized people as part of a broader realization of a just social order and socio-economic justice.

The third approach to justice frames it in terms of the cultivation of virtue and reasoning about the common good (Sandel, 2010). Sandel relates justice to “*telos*” and “honour”, by drawing upon Aristotle’s (384-322 B.C.) theory of justice. The first notion that justice is teleological, means that we must find out the *telos*, purpose, the end or essential nature of the social practice in question. The second notion that justice is honorific means that we must engage in reason about the *telos* of a specific practice, before proceeding to then employ reason or argue about what virtues this specific practice should honour and reward (Sandel, 2010).

For Aristotle, all things in the universe have a purpose, a function, an end and “*telos*”; within this perspective, happiness is an activity of the soul that expresses virtue (McMahon, 2004). Aristotle sees justice in terms of people being given what they deserve and each person receiving their due. Suppose we are tasked with distributing particular goods, such as guitars or flutes. Who should receive the best one? Aristotle would answer that the best guitar or flute player should receive the best instrument. For Aristotle, justice is a question of putting things in their rightful place. However, justice is not only about the right way to distribute things, it is also about the right way to value things (Sandel, 2010). Aristotle believes that debates about justice are unavoidable, as are debates about honour, virtue, and the nature of the good life. Justice and doing the right thing must be connected to the good life. The achievement of a just society necessitates reasoning together about the meaning of a good life, and fostering a public culture that is hospitable towards the disagreements that will inevitably arise (Sandel, 2010).

Within Islamic tradition, justice is virtue ethics that deserves its own place in the set of axioms. The *Quran* describes justice in two words; “*adl*” and “*qist*” (Bekun & Badawi, 2005). The first (*adl*) means “equity and balance” while the second (*qist*) means “share, portion, measure, allotment, [or] amount”. Under this axiom, people are encouraged to act justly towards everyone, both in terms of their vertical relationship with God and horizontal relationship with others and the wider universe. This also means that everyone and everything should be accorded

their proper due. Acting justly in this life means that one can expect that God will display similar justice towards them in both this life and the Hereafter.³⁴

Sabri Orman, in the text *Al-Ghazali on justice and social justice* (Orman, 2018), purports that al-Ghazali provides many definitions of justice in the book of *Ihya Ulum al-Din*.

“The first, justice is giving everybody what is their due” (Ihyâ: III, p. 368). The second, justice is a situation where a person gets no less or no more than his due. (Ihyâ: III, p. 181). The third, justice is putting things and matters to their proper places as specified by Islamic law and custom (Ihyâ: III, p. 369). The fourth, in reference to human behavior, he defines justice as being free of excess and deficiency, and keeping a balance between the two extremes (Ihyâ: IV, p. 103), or keeping the two in balance in referring to human attitudes towards hope and fear (Ihyâ: II, p. 337)” (Cited in Ormans, 2018)

Al-Ghazali sees a strong link between justice and reason, in which justice is a product of a mature intellect and rigorous intellectual reasoning. The maturity of one’s intellect determines their ability to see things as they are and reach their internal truth, rather than being deceived by appearances. Al Ghazali posits a connection between justice and satisfaction of God-giving and distributing or “*al-Qana’ah*,” and claims that there cannot be justice without having “*al-Qana’ah*,”³⁵ (Orman, 2018). In the individual sphere, al-Ghazali views that one must subject desire and anger to the dictates of reason and religion, as subordinating reason to desire and anger would only lead to injustice. This moral conduct in the individual sphere can also be extended into the social sphere, which consists of many individuals.

³⁴ *The Quran Surah al-Maidah* (QS, 5: 8). “Be just! For justice is nearest to righteousness and piety”, and *Surah al-Baqarah* (QS, 2: 279). [thus] you do no wrong, nor are you wronged or deal not unjustly and ye shall not be dealt with unjustly.” See also *The Quran Surah al-Hujurat* (QS, 49: 9). “for God loves those who are fair and just”.

³⁵ The word “*Al-Qona’ah*” is Arabic, and connotes the satisfaction of self (*nafs*) through the distribution of means and everything we get and acquire without being greedy. It (*al-Qona’ah*) means to be thankful for every single thing that we have. It (*al-Qona’ah*) is the feeling of being satisfied with the blessings, distributions, gifts and God-giving that God has bestowed upon us, and the absence of jealousy and greed from our hearts.

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Al-Ghazali explains and discusses the issue of justice in his book *Counsel for Kings*, where he presents a parable that justice is akin to the light of the sun when providing advice to kings or rulers, and that the sun of justice should first rise in the heart of an individual, namely the ruler himself, before it is then reflected on his relatives and finally the remainder of society. From this perspective, if one were to seek the light somewhere other than in the sun itself, then they would be looking for that which is impossible, and trying to attain what is ultimately unattainable (Orman, 2018). The same logic applies to the head of the household, who must first be a good member of the household, before seeking to reflect this outward onto relatives and the surrounding community. Precisely the same logic also applies to every social being.

From my perspective, while I consider that justice must start from within individuals, I also believe that a ruler should seek to enlighten their people through their wisdom and just behaviour. It is difficult to imagine a ruler who would demand just behavior from their people, while they themselves are wholly unjust or merely acting in a just way to enhance their reputation and gain honour and respect from their people. The same applies to individuals in the individual sphere and in the social sphere: there must be a balance and harmony in the form of justice from both sides.

Justice is thus a concept that is characterized by balance and equilibrium. It requires doing things in a proportionate manner and avoiding extremes. It encompasses balance and harmony of the universe, which humans are part of and never will be inseparable from it as one being. The idea of social justice is only one aspect of universal equilibrium. This is because equilibrium, at the absolute level, is the supreme attribute of God, insofar as He has created the universe with a balance to maintain an equilibrium in nature.³⁶ Having stated the axiom of Justice in Islam, I will now extend this discussion by considering the implication of this conceptualization of justice for both economics and the banking and finance sector.

³⁶ *The Quran Surah al-Furqan* (QS, 25: 2). "He has created each thing (everything) and determined it with precise determination".

The concept of justice qua balance, harmony and equilibrium is a core issue not only in the economic, banking and financial sphere, but also within many academic disciplines. Economic equilibrium is a key part of maintaining the balance and harmony of the universe, in order to establish socio economic justice and the equitable distribution of income and wealth. It suggests balance across production, consumption and distribution functions within society. It calls for a fair usage of all resources at both an individual and collective level and discourages waste and excessive usage of resources. It signifies that inappropriate concentration of wealth or power is both inimical to social equilibrium and natural harmony in the universe, insofar as these both undermine the existence of a just social order. This is because power tends to corrupt, while a restrictive concentration of wealth tends to lead to the domination of some groups over others.

Concentration of power and wealth can lead to resources and production being directly allocated in the interests of the few, rather than society at large. It can also lead to the misallocation of resources, which runs contrary to the notion that we must prosper the earth by making the best use of resources and fully utilizing the virtue ethics that are inherent in humans rather than corrupting them. It is for this reason that the production of excessive luxurious goods are discouraged and even prohibited within Islamic economics, as it constitutes a waste of resources. This is based on the notion that resources bestowed on humans by God, and, as such, must never be utilized extravagantly, although they are allowed to be privately owned (Chapra, 1999).³⁷

Consumption and spending must also be done in such a way that is neither to meagre nor lavish, but rather somewhere in between these two extremes.³⁸ If you are only buying incredibly expensive goods to flaunt your lifestyle, rather than because you need the item, then why bother to purchase it in the first place?

³⁷The Quran Surah *al-Nur* (QS, 24: 33). “*And give them of the wealth of God which he has given you*”, and Surah *al-A’raf* (QS, 7: 31). “*...eat and drink and be not extravagant; surely He does not love the extravagant*”.

³⁸ The Quran Surah *al-Furqan* (QS, 25: 67). “*And [they are] those who, when they spend, do so not excessively or sparingly but are ever, between that, [justly] moderate*”

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Unconsciously, you have only done an injustice toward yourself. Moreover, if you want to consume something beyond your capacity and your capability to buy it, then you will fall down into the debt trap which, in fact, is wholly unnecessary provided you do not do injustice to yourself. If many people were to act in this way, then it would create disequilibrium in the economic social order.

Islam does not tolerate conspicuous, extravagant and excessive consumption, and instead promotes a moderate stance between the sufficiency threshold and the prodigality frontier. Given that this type of consumption becomes an act of worship and a means through which to serve God by satisfying one's present needs in this world and being rewarded in the Hereafter, the exercising of moderation in consumption can also be regarded as a rational act that leads to happiness, welfare and well-being, both in this life and the Hereafter (Syed Agil, 1992; Anas al-Zarqa, 1992). In the prevailing Islamic economic order, Human needs must be categorized into essentials and necessities (*daruriyyat*), conveniences and complementarities (*hayiyyat*) and ameliorations, improvement and refinements (*tahsiniyyat*), both with respect to production and consumption activities (Fahim Khan, 1992).

The commitment of Islam to justice and equilibrium demands that people take care of the basic needs of the poor in their society. Of course, self-interested behaviour, which drives people to acquire profit and private property through their own initiative, motivation, efficiency and enterprise, does not mean that people are indifferent towards or have no sympathy for others. However, self-interested behaviour that does not take into account the interest of others only leads to disequilibrium, and undermines the realization of a just socio-economic order. Consequently, self-interested individual behaviour must be balanced with altruistic behaviour.

An additional factor that can lead to disequilibrium is to allow resources and wealth to sit in an idle state, without trying to employ them within productive activities. Indeed, Islamic ethical values teach us that all wealth should be productive and that people must not stop the circulation of wealth after they have acquired it, as it will reduce the momentum of the circulation (Chapra, 1992). Islam can thus be said to not approve of wealth concentration and circulation

amongst only the economic elites.³⁹ This only serves to exacerbate inequalities in living standards amongst people in society. This, in turn, leads the powerful to dominate the powerless, which is not desirable, insofar as humans are created in a state of dignity.⁴⁰

Of course, there has been and always will be inequality between the rich (the haves) and the poor (the have-nots) until the end of time, and, indeed, Islam does not deny this fact; however, the goal of Islamic economics is to ensure that the basic needs of all are fulfilled, that there is equality of opportunity for all, and that the concentration of wealth amongst a small cabal in society is prevented (Siddiqi, 1992). One way of fulfilling the basic needs of the poor is to provide them with sufficient income through which to live in a dignified manner, and to supply them with the means through which to earn income that enables them to meet their basic needs (Visser, 2019)

In line with this concept, Islamic banking must take up the role of safeguarding this ethical value and creating a just social order, by way of redistributing income and wealth through the banking system and market mechanisms, such as, for example, by charging a rate of return (interest) that is no higher than that found in the conventional banking system. By ignoring this ethical code of conduct and moral values, Islamic banking would be seen as supporting, and indeed even reinforcing, the unequal distribution of capital, which is what the banking system tends to do in general. As a matter of fact, the banking system is designed to favor those who can afford to deal with that system, as noted by Chapra, who states that: *“while deposits come from a broader cross-section of population, their benefits mainly go to the rich”* (Chapra, 2006). What I am arguing here is that it is time for Islamic banking to help establish a just socio-economic order, by taking a lead role in providing a decent life and a fair standard of living for all members of society through the banking system and market

³⁹ *The Quran Surah al-Hashr (QS, 59: 7) “...So that wealth does not concentrate in the hands of those who are rich among you...”.*

⁴⁰ *The Quran Surah al-Isra' (QS, 17: 70) "Surely, we have honoured the children of Adam. We have put the land and the sea under their control, given them sustenance and have exalted them above many of those whom We have created"*

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mechanisms. I discuss this very point later in the following chapter on Islamic banking vis-à-vis conventional ethical banking.

It should hopefully now be clear that the three axioms: the axiom of the oneness of God, the axiom of vicegerency or trusteeship and the axiom of justice, constitute the ethical foundation of Islamic economics and Islamic banking, and thus explicitly inform all aspects of how Islamic banking conducts its businesses and financial transactions through the banking system and market mechanisms. The hope is that the Islamic ethical values and moral norms that are embedded in Islamic banking will lead it to operate its businesses and financial transactions in such a way that provides a unique quality of service to customers and differentiates it from conventional banking, by appealing to people's moral conscience.

Before concluding this chapter, I first want to reiterate the main ethical principle of Islam, and delineate its differences to the aforementioned Western theories of ethics.

The principles of Islamic ethics and moral norms can be understood as follows. First, it is transcendental, in the sense that the ultimate arbiter of what is ethical and unethical, good and bad, right and wrong or proper and improper, is God Himself.

Second, it is a universal moral standard and universal code of ethical conduct, both in terms of universal justice, equality irrespective of religion, culture, race, ethnicity, nationality, while also being able to accommodate local wisdoms and local cultures, provided these do not deviate from Islamic law. While this second principle is analogous to Kant's principle of ethics and justice, Kant's concept of ethics and justice is based on both human reason and the ability to make laws for themselves and the social contract and social consensus, whereas in Islam, the social contract and social consensus cannot be in opposition to Islamic law.

Third, human conduct is deemed to be ethical if it is based on good intentions (motive) and involves the exercising of good (way) conduct, as well as being in accordance with Islamic law (Islamic ethical values and norms). From this perspective, the end does not justify the means, which, once again, echoes Kant's conception of justice and moral actions.

Fourth, while humans have free-will and free choice over whether they act good or evil, rightly or wrongly, ultimately, they have to choose to do good over evil, and right over wrong by employing their intuitive reasoning and intellectual reasoning to cultivate virtue and reasoning about the common good. This, yet again, has strong parallels with Kant's idea of "pure practical reasoning" which legislates a priori, irrespective of empirical ends, and cannot viewed as instrumental reason, which instead produces an unconditional (categorical) imperative.

Fifth, according to Islamic jurisprudence, if a person finds themselves in a difficult situation and perhaps risks extreme punishment or even death if they do not act in a certain way, even if it is considered an unethical act in Islam, such as consuming *haram* food or unlawful meat, they are allowed, and indeed it is considered ethical for them, to consume the *haram* food at the level required for subsistence. This appears to be in accordance with teleological utilitarianism (consequentialist), albeit within Islam this unethical act is only permitted under strict and specific conditions.

Above all, I view Islamic ethical principles as sharing a strong similarity with both Aristotle's virtue ethics and Kantian ethics. For Aristotle, the cultivation of virtue and reasoning about the common good constitutes the basis of ethical conduct, justice and doing the right thing. This involves, first, defining moral conduct, justice and the right thing to do, which requires us to figure out the *telos*, purpose, end or essential nature of the social practice in question. The second step, i.e., the honorific element, involves reasoning about the *telos* of a practice, in part, to reason or argue over what virtues it should honour and reward.

2.7 Conclusion

Islamic ethical values and moral norms are the foundation of Islamic banking and the Islamic worldview. This worldview emanates from the fundamental belief that life and existence come into being as a result of the will, desire and design of God, the one and only creator. The Islamic conception of the oneness of God (*Tawheed*) must therefore take precedence over all discussions on the nature of the universe. Almost all extant research on Islamic economics, Islamic banking and finance posit that the Islamic worldview is based on three fundamental principles: the oneness of God or theism (*Tawheed*), viceregency (*Khilafah*), justice

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(*'Adalah*). Although scholars differ with respect to the words they use, the essence of their arguments are the same.

The Islamic ethical worldview states that the purpose of all creation is to worship and serve God. Humans are chosen as God's vicegerents on earth to prosper the earth and preserve everything which has been granted to them, for the purposes of using and disposing of them in a proper manner and in accordance with an ethical way of life, in order to maintain balance and harmony in society. It is therefore important to keep in mind that Islamic ethics comprises a set of tools and instruments through which to realize welfare, happiness and well-being in both the present life and the Hereafter. Consequently, the ideal or the goal that we are all striving for is the realization of welfare, happiness and well-being, which, according to al-Ghazali (2004), first starts with knowing oneself. As al-Ghazali says, a happy person is someone who knows themselves, because, they who knows themselves, knows their Lord.

Islamic ethics and morals are thus instruments that guide and drive both humans and business organizations to do good, and help support the realization of a just social order and socio-economic justice, equitable distribution of income and wealth, realization of welfare, happiness and well-being, achieving of balance and harmony in life, ensuring equality of opportunity for all, securing a decent standard of living for all to achieve full-sufficiency, and the fulfilling of both material and spiritual needs.

Having discussed both ethical theories and the ethical foundation of Islamic banking, the next chapter turns to investigate the theoretical foundations of Islamic banking within the framework of a socio-economic moral order.

Chapter 3

3. Theoretical Foundations of Islamic Banking within the Framework of a Socio-economic Moral Order



Chapter 3

3.1 Introduction

Islamic law exhorts that, financial dealings and financial transactions must be free from interest, uncertainty, speculation, oppression and gambling, which, in turn, lead to exploitation and unjust practices in the economy. The objective of Islamic banking is the same as that of Islamic economics, namely: to help establish socio-economic justice, the equitable distribution of income and wealth, economic welfare, happiness and well-being within the framework of the moral norms of Islam, universal brotherhood and the freedom of the individual within the context of social welfare (Chapra, 1979; 1982; Lewis, 2011). Since debt-based financing is associated with an interest-based banking system, within Islamic banking it is replaced by equity-based financing, which ostensibly supports fairness and justice alongside ensuring the stability of financial dealings.

Equity-based financing shares both risk and liability amongst both the providers of capital (lenders) and entrepreneurs (borrowers), so as to justify a return to both parties in the transaction, while debt-based financing involves interest payments. In addition to this, debt-based financing in the conventional banking system is prone to a high degree of risk and speculation, such as the sale of credit default swaps (CDS), which enable multiple debts to be created on a particular asset without any real underlying asset transaction being made possible by CDS. In addition to the high degree of risk and speculation, debt-based financing also ordinarily (re)produces the concentration of wealth within those individuals and corporations who are deemed to be credit-worthy.

The equity-based financing practiced by Islamic banking does not mean that this mode of financing is entirely free from moral hazard. Rather, there are agency problems and moral hazard, especially in the financing of *Mudarabah* contracts, in which the provider of the capital (*Sahib al-Maal*) bears the entirety of the potential financial loss. Theoretically speaking, this specific mode of financing can create a moral hazard for the entrepreneurial party and lead them to act unethically and imprudently in terms of the managing and running of their business. In the event of such negligence, the business becomes prone to higher risk and even greater financial losses. These losses are ultimately borne by Islamic banking, or, to be more accurate, borne by the depositors and people who save

their money within that particular Islamic bank. It is these sorts of agency problems and moral hazard that will be discussed in this chapter.

The key features of equity-based financing within Islamic banking, namely the principle of profit sharing and risk sharing, as well as the concept of prudence, such as the ban on speculation, gambling and uncertainty in contracts, has made it difficult for Islamic banking to expand further by seizing a greater market share within the banking and finance industry. In Indonesia, Islamic banking was only able to seize 5.70% of the national banking and finance industry (OJK, 2018).⁴¹ by the end of June 2018. This is despite the fact that financial analysts have argued that Islamic banking was more resilient than conventional banking in dealing with the global financial crisis in 2007-2008, due to its ethical principles, such as the value placed upon justice, the sharing of risk and equity-based mode of financing.

Most people, irrespective of their financial expertise, are able to name most of the major investment banks and explain their capitalization problems and describe how the mortgage crisis developed in 2007–2008. In addition to this, the financial crisis also stemmed, in part, from the fact that ethical considerations were not yet part of the culture of these financial organizations (Langton et., all., 2011). The ability of Islamic banking and finance to mitigate and minimize the effect of the financial crisis during the global and regional economic downturn was far more pronounced than that of its traditional counterpart. This resilience derives from the inherent features and characteristics of Islamic banking itself, especially its adherence to Islamic law, which, as aforesaid, is the embodiment of Islamic ethical values and moral norms.

This chapter discusses the theoretical foundations that pave the way for Islamic banking to operate in accordance with Islamic law. To be clear, Islamic banking does not necessarily set out to challenge the existence of the conventional banking system that is well-established, nor does it seek to challenge the efficiency

⁴¹ OJK (Otoritas Jasa Keuangan) is the financial service authority of Indonesia. It is an Indonesian governmental agency which regulates, monitors and supervises the financial services sector.

See also OJK Snapshot June 2018, <https://www.ojk.go.id/id/kanal/syariah/berita-dan-kegiatan/publikasi/Pages/Snapshot-Perbankan-Syariah-Indonesia-Juni-2018.aspx>

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of the modern commercial banking system; rather, Islamic banking sets out to offer people the possibility that they can link and integrate their religious beliefs with modern commercial life, and in so doing, attempts to differentiate itself from conventional banking and purely market-based logic.

Islamic banking's adherence to Islamic law means that it must act in accordance with Islamic ethical values and moral norms, insofar as Islamic law is by its very nature the embodiment of ethical principles, which cannot be separated from one another. For example, when the *Quran* commands that all contracts must be consensual and agreed upon by all parties involved, the contract must be free from coercion, deception, misrepresentation or fraud, the contract must be made in in good faith by all parties involved, and make every effort to honour their promises, it thus can be said to be articulating and embracing virtue ethics and morality. Theoretically speaking, Islamic banking is a financial institution with ethical responsibilities, which are grounded in Islamic law (*Shariah* principles). Consequently, Islamic banking is expected to promote not only the equitable economic distribution of income and wealth, but also to promote socio-economic justice and welfare in society.

This chapter discusses the theoretical foundations of Islamic banking within the framework of a socio-economic moral order, as well as the financial instruments that are utilized in the banking and finance industry, both with respect to transaction deposits and in terms of the financing of equity-like instruments, such as equity partnership contracts (*Mudarabah*) and (*Musharakah*), debt-like instruments in the form of sale and purchase contracts, such as cost-plus financing (*Murabahah*), leasing (*Ijarah*), forward purchases (*Bay' al-Salam*), and commissioned manufacturing (*Bay' al-Istisna'*). These contracts are the most common and widely utilized by Islamic banking institutions in their daily operations. These types and characteristics of contracts are in accordance with Islamic principles, which differentiates the banking and financial operations of Islamic banking from those observed in conventional banking.

3.2 Religious and Legal Background of Islamic Banking

It is well-known that businesses in the banking and financial sector make their money by charging interest on loans, while, simultaneously, attracting

depositors and savers by paying them interest that is lower than the interest charged on the loan. However, Islamic banking operates differently in the sense that it does not charge interest on loans or any other form of financing. While Islamic banking shares the same purpose as conventional banking, it is distinguished from its counterpart by the fact that it operates in accordance with Islamic law and Islamic jurisprudence (*Fiqh al-Muamalat*). The basic principle of Islamic banking is the prohibition of interest and replacing it with the principle of sharing of profit and loss (PLS).

Within an Islamic tradition, all aspects of life, including within the sphere of economic life, banking and financial transactions, must adhere to Islamic law, which prohibits earning money from money alone. In fact, in Islamic law, all commercial transactions and contracts must be free from the elements of interest or usury, uncertainty (*Gharar*), gambling (*Maisir*) and other prohibited activities categorized as unlawful (*haram*), such as investing money in alcoholic beverages, pornography, *non-halal* foods and socially harmful activity.

Rather than transacting and earning money on money alone, Islamic banking permits financial transactions based on assets and investments in terms of joint ventures, provided that this is done via the PLS mechanism. Hence, Islamic banking is considered to be operating correctly when the internal processes, procedures and financial transactions are in compliance with the rules prescribed by the *Qur'an* and the *Sunnah*, as well as other relevant sources of Islamic jurisprudence, such as *Ijma*, *Qiyas* and *Ijtihad*.

Ijma, *Qiyas* and *Ijtihad* are consulted when there is an issue concerning legal aspects that are not addressed by the *shariah* in the *Quran* and the *Sunnah*. Therefore, the structure of Islamic banking is firmly rooted in the *Qur'an* and the *Sunnah*, or the teaching of the prophet Muhammad and subsequent interpretations of these sources of revelation by his followers (Visser, 2013; Vogel and Hayes, 1998) such as in *Ijma* and *Qiyas* and *Ijtihad*.

Rather than being a codified body, Islamic law (*Shariah* rule) is in fact flexible, albeit it is subject to morality, ethical values and virtue ethics. It should be viewed as a never-ending and ever-expanding interpretation of religious law.⁴²

⁴² Therefore, one finds different opinions with regard to the legal standing of one issue, which is not clearly addressed by the *Quran* and the *Sunnah*; for example, smoking to some

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The resolution and provision of *Shariah* rule derives from the discipline of Islamic jurisprudence (*al-Fiqh*), and humans' attempts to understand Islamic law based on the *Quran*, the *Sunnah* and other sources such as *Ijma*, *Qiyas* and *Ijtihad*.

Below are the main sources of Islamic law, which, in turn, govern Muslim people's lives, not only in the economic, banking and financial sphere, but in all aspects of their lives.

1. The *Quran*; Muslims believe that the *Quran* is the actual word and speech of God transmitted through the prophet Muhammad
2. The *Sunnah*; this is the prophet Muhammad's sayings and deeds, which are known as the *Sunnah* or *al-Hadith* (tradition). The *Sunnah* provides further elaboration and insight into the meaning of the *Quran*
3. *Ijma* (consensus); is the agreement and consensus with regard to legal ruling or *Fatwa* of the Islamic community produced by Muslim scholars and experts, in order to standardize legal theory for the purposes of legal decision-making (consensus decision-making) and to solve the problem of individual, social and regional differences of opinions, as well as universal and local values and culture.
4. *Qiyas* (analogy); is the deduction of legal prescriptions from the *Quran* or *Sunnah* via analogic reasoning. This technique is one of the main avenues for the evolution of *Shariah* rule or Islamic law.
5. *Ijtihad*; refers to the personal efforts and opinions of qualified *Fiqh* scholars or Islamic jurists to determine the true legal ruling or (*Fatwa*) on a particular issue based on the *Quran* and the *Sunnah*. It can be demanding, because it is not addressed by *Shariah* or Islamic law, but is required to come to a legal solution.

Indonesian Muslims is unlawful (*haram*), whereas for others it is lawful (*halal*). Interest rates in the modern banking and financial system are regarded as unlawful (*haram*) to some Indonesian Muslims, and therefore must be replaced by the principle of PLS, while others regard it as lawful (*halal*) as long as it leads to a beneficial ending, such as equality or equity, the equitable economic distribution of income and wealth, social justice, etc., and no parties are hurt or injured, such as in the case of ethical banking.

The application of Islamic law within modern commercial life, such as in modern banking and financial systems, can be challenging, in that there are manifold prohibitions to avoid and duties to undertake for Islamic banking to operate. Earning money solely from money is prohibited in Islamic banking, because the practice deflects money away from its principal function as a medium of exchange, and within Islamic belief exchanging the same material thing (such as gold with gold or dates with dates) is not permissible. The prohibition of interest, the prohibition of financial transactions that are backed by artificial assets, the prohibition of dealing with unjust practices, such as gambling, the prohibition of *Ghabn* in transactions which imply deception, misrepresentation or cheating, the prohibition of *Gharar* in transactions which imply speculation and uncertainty (Vogel & Hayes, 1998; Eisenberg, 2012), do not as one might expect serve to limit the business of Islamic banking. In addition to this, Islamic banking has the responsibility of encouraging moderation, the fair distribution of income and wealth, balance and harmony in life, and assisting underprivileged and marginalized people. The duty-based theoretical foundations of Islamic banking are challenging in practice, as some may consider that these aforesaid restrictions limit and constrain Islamic banking from conducting its business in the financial sector.

However, this may not necessarily be the case; for example, the prohibition of interest, on the grounds that interest generates injustice and exploitation, by virtue of the fact that it exacerbates the tendency for wealth to accumulate in the hands of the few, while Islamic teaching exhorts that wealth must be circulated among as many people as people. It does not approve of wealth concentration and circulation amongst only rich people.⁴³ Interest allows people to earn money from money via an unjust and exploitative practice that requires no effort or work, while Islamic teaching teaches that wealth should be utilized in a productive capacity and people are prohibited from stopping the circulation of wealth after they have acquired it, as it will reduce the momentum of circulation (Chapra, 1992). The extract below shows how the unjust and exploitative practice of interest operates:

⁴³ *The Quran Surah al-Hashr (QS, 59: 7)* “...So that wealth does not concentrate in the hands of those who are rich among you”

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Consider that you borrow \$1,000 over 7 years with a compound interest rate of 10.41%. By the end of 7 years or in due time, you will have to pay an amount that is double to the original loan, namely: $Na = Nt (1 + i)^n$ where $Na = 1000 (1 + 0.1041)^7$, using this formula, the amount will be \$2,000.133 and after 14 years you will have to pay an amount of \$4,000.53, which is quadruple the original loan and after 21 years, you will have to pay an amount of \$8,001.60, which is eight times the original amount.

The above example of how compound interest rates work is common practice in the banking industry, and is an unjust and exploitative mode of earning money on money without exerting any effort or engaging in real economic activity. In this example, it is noted that the same amount could be lent again to new borrowers after seven years. The interest-based banking system will not write-off or stop this debt, even though many borrowers are unable to repay their loans within a specific time period, and the process of due payment will instead continue. One can discern how the interest-based banking system creates debt-traps in modern commercial life via its business practices.

In contradistinction to an interest-based banking system, Islamic banking espouses itself to be an interest-free banking institution, which operates under the guidelines of Islamic law (*Shariah* rule). Islamic banking distinguishes itself from its conventional counterpart in several respects. Besides being an interest-free banking system, Islamic banking considers the relationship between a bank and its customer not to be one of debtor and creditor, but rather of seller and buyer and/or between investor and working partner, whereby both parties bear and share profit and risk when conducting business together.

Given that profit is not the sole objective of Islamic banking, it must ensure that all money that is invested is in accordance with Islamic law. There is also an Islamic legal advisory board comprising Islamic scholars and jurists who oversee the performance and operation of Islamic banking, in order to keep it aligned with Islamic law (*Shariah* rule).⁴⁴ The principles of PLS requires Islamic banking to

⁴⁴ In the case of Indonesia, there is a *Shariah* advisory board (DPS or *Dewan Pengawas Syariah*) at the institutional level, as well as a national *Shariah* board (DSN or *Dewan Syariah Nasional*), which comes under the umbrella of the Indonesian council of Islamic scholars, or MUI as they are otherwise known (MUI or *Majlis Ulama Indonesia*) at the

create and offer products and services that are compliant with Islamic law, both on the savings and deposit side of things, as well as on the financing side of the equation, in order to help customers to benefit from Islamic banking on the condition of the PLS mechanism.

3.3 Financial Instruments in Islamic Banking

While Islamic banking is an intermediary financial institution that engages in similar business to that of conventional banking, in terms of receiving deposits and lending money, it neither pays nor charges interest. In fact, Islamic banking is reluctant to even use the word lending money, and instead prefers to use the word financing investment or business, since the relationship between Islamic banking and its customers is not one between a debtor and creditor, but rather between partners who engage in the PLS mechanism. As far as the financial instruments used in Islamic banking are concerned, there are two types of products: deposit funds, which is where depositors and savers put their money and funds in Islamic banking, and financing funds, which is where Islamic banking conducts its intermediary role by channeling the money and funds into various businesses and investments in conformity with Islamic law.

1. Deposit Funds

As far as transaction deposits are concerned, there are two types of contracts in Islamic banking institutions (Bank Indonesia, 2008), namely:

- (1). *Wadiah* contract, which is a goods or money custody between the owner and the entrusted party with the obligation that the entrusted party could return the goods or money at any time (Bank Indonesia Book, 2008).
- (2). *Mudarabah* contract, which is a partnership contract between the fund owner (*Sahib al-maal*) and fund manager (*Mudarib*) who share the

country level. So, in every Islamic banking institution, there is a *Shariah* advisory board whose duty is to oversee the performance and the operation of their own Islamic banking institutions, in order to ensure that they are in accordance with Islamic law. Conversely, the duty of the national *Shariah* board is not only to monitor them to track whether they are adhering to *Shariah* rule, but also to settle disputes and differences if there are differences of opinion with regard to a legal ruling or *Fatwa* between a member of the Islamic banking *Shariah* advisory board and another Islamic banking *Shariah* advisory board.

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business profits in accordance with the contract (Bank Indonesia Book, 2008).

In *Wadiah* contracts, Islamic banking guarantees the return of funds or the nominal value to customers at any time that customers demand their funds, which takes the form of demand deposit accounts. However, when the contract takes the form of a saving deposit and time deposit account, then the fund can only be withdrawn based on a specified requirement agreed in advance between the Islamic banking institution and the customers. In this form of deposit contract, Islamic banking acts as the party receiving the funds, while the customers act as the party placing the funds. Islamic banking may or may not give any return or reward to customers. Islamic banking may charge customers administrative fees, which take the form of expenses related to account management and custody.

This kind of transaction deposit is known as a *Wadiah* contract in Islamic banking institutions, or, alternatively, as current accounts that while they bear no interest, Islamic banking is nevertheless obliged to pay the principal sum to depositors or savers on demand. However, when transaction deposits take the form of a *Mudarabah* contract, in which Islamic banking institutions act as a fund manager (*Mudarib*), while the customers who deposit their money act as the fund owners (*Sahib al-Maal*), then the PLS mechanism comes into play, with both parties sharing profit and loss according to the pre-determined rate agreed in advance, but not in terms of the nominal value.

This account is known as an investment or savings account, and through the principle of PLS, Islamic banking, theoretically at least, is able to provide pro-cyclical protection to itself in the event of adverse conditions, so that profit rates decline during bad periods and increase in good periods. In contrast to the conventional banking system, which have a fixed rate of interest, Islamic banking determines this ex-ante, insofar as it pays a return based on any profits generated from its investment, which is why the nominal value of a *Mudarabah* contract on an investment deposit is not guaranteed (Bank Indonesia Book, 2008; Vogel & Hayes, 1998; Visser, 2013).

2. Financing Funds

In addition to the financial instruments for transaction deposits, Islamic banking also provides financial instruments in its financing side, in order to channel its funds into several businesses and investments in accordance with Islamic law. Islamic banking is supposed to offer financial instruments, which are consistent with the religious beliefs and cultural characteristics of Muslim societies. Since interest is prohibited, debt contracts should also be excluded; hence, the prevailing contracts in Islamic banking should emphasize the profit & loss sharing (PLS) principle or equity-based contracts.

However, instead of operating via equity-like instruments, Islamic banking is, in fact, frequently operates in debt-like instruments in its financing businesses, such as in the example of the principle of cost-plus pricing (*Murabahah*), leasing (*Ijarah*), forward purchasing (*Bay' al-Salam*) and commissioned manufacturing (*Bay' al-Istisna'*). This mark-up or cost-plus pricing of financial instruments is widely used in Islamic banking operations, despite widespread dispute amongst Muslim scholars over whether it is acceptable, insofar as it implies a fixed return on investment for Islamic banking, which means that this financing technique may open a back door to an interest-based banking system. It is referred to as a debt-like instrument not in terms of the payment of interest, but because of its similarity to the debt instruments used in the conventional banking system. There is a formal equivalence between cost-plus pricing or mark-up financing and debt, both in terms of complete contracts and control over foreclosure rights (Hart and Moore, 1998).

In addition to debt-like instruments, there are also equity-like instruments, such as *Mudarabah* and *Musharakah* contracts. These are referred to as equity-like instruments, insofar as they involve capital equity participation (Mirakhor & Zaidi, 2007; Vogel & Hayes, 1998; Saeed, 1999; Visser, 2013; Iqbal, & Mirakhor, 2011; Kettell, 2011; Usmani, 1998). As far as Islamic banking is concerned, there are two types of equity-like instruments for partnership contracts in the financing side of the business: *Mudarabah* and *Musharakah*.⁴⁵

⁴⁵ There are four major types of partnership which are used in Islamic financing (Vogel & Hayes, 1998). These are: (1), *Shirkat al-Wujuh*, (2), *Shirkat al-Abdan*, (3), *Shirkat al-Inan* or *Musharakah* and (4), *Shirkat al-Qirad* or *Mudarabah*. The most commonly used forms

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3.4 Equity-like Financial Instruments (*Mudarabah*)

Mudarabah or trust financing contracts.

A partnership contract is when Islamic banking acts as a provider of capital (*Sahib al-Maal*) to finance projects or businesses run by the working partner or entrepreneur (*Mudarib*), who provides labour, business arrangements and management skills. In this contract, the ratio of profit sharing or the proportionate share of returns in profit is agreed at a pre-determined rate through the mutual consent of both parties. However, in the case of losses, the losses will be borne solely by Islamic banking in its capacity as provider of capital (*Sahib al-Maal*), while the entrepreneur (*Mudarib*) bears losses by receiving nothing in return for their expended working time, effort and management skills they have provided (Khan, 2003; Saeed, 1999; Visser, 2013; Vogel & Hayes, 1998; Warde, 2000). This *Mudarabah* contract is regarded as an ideal way for Muslims to conduct businesses in joint ventures, due to the fact that the principle of mutual trust, profit-sharing and loss-sharing is equally spread across all involved parties (Thomas, et., al., 2005). However, compared to *Musharakah* or venture capital contracts, *Mudarabah* contracts do not allow Islamic banking, in its capacity as the provider of capital (*Sahib al-Maal*), to participate in the affairs of the businesses that are managed and run by the entrepreneur (*Mudarib*). Therefore, *Mudarabah* contracts in Islamic law, by their very nature, are based on a fiduciary relationship (mutual trust relationship), in which the entrepreneur (*Mudarib*) manages and administers the *Mudarabah* asset in a trusting and prudent manner, and is not liable for any losses or impairments of the asset, unless these losses and impairments are the result of misconduct or negligence by the entrepreneur (*Mudarib*).

There are two types of *Mudarabah* contracts, which are described below (Visser, 2013; Usmani, 1998; Vogel & Hayes, 1998).

- a. Restricted *Mudarabah* contracts (*al-Mudarabah al-Muqayyadah*), in which the provider of capital (*Sahib al-Maal*) can specify what kind of

of financing in modern commerce by Islamic banking and finance is *Mudarabah* and *Musharakah*. For more discussion, please see *Islamic Law and Finance, Religion, Risk and Return*, by Frank E Vogel and Samuel L. Hayes

businesses and projects to invest in, as well as specifying the time period, type of business and projects and other conditions. This gives the working partner (*Mudarib*) absolutely no freedom, and instead demands that they conduct their business or projects within the framework and specified terms and conditions of agreement.

- b. Unrestricted *Mudarabah* contracts (*al-Mudarabah al-Mutlaqah*), in which the provider of capital (*Sahib al-Maal*) does not specify what businesses or projects the working partner can engage in (*Mudarib*), which means they are free to conduct their business or projects in any way they see fit.

Although, as aforesaid, there are restricted and unrestricted *Mudarabah* contracts, the common practice in Islamic banking system is that when depositors and savers deposit their money in Islamic banking institutions, it is considered to be an unrestricted contract. The first tier of a *Mudarabah* contract implies that Islamic banking will act as the fund manager or entrepreneur, while the working partner and the depositors and savers act as the provider of the capital (*Sahib al-Maal*). The first-tier of a *Mudarabah* contract also implies that depositors and savers demand returns on the profit from the money they have deposited or invested in Islamic banking at an agreed pre-determined rate; however, at the same time, both parties also engage in the principle of PLS, which means they share the losses either suffered by Islamic banking or incurred in the business itself. Based on this principle, Islamic banking does not guarantee the full return of the nominal value of the money invested in an Islamic banking institution.

The first-tier of a *Mudarabah* contract relates to the second-tier of a *Mudarabah* contract, in which Islamic banking acts as the provider of capital (*Sahib al-Maal*) and provides financing to the entrepreneur or the working partner (*Mudarib*) in order to conduct their businesses or projects. The profit or losses in the second tier of this contract are shared between the Islamic bank and entrepreneurs, and then the Islamic bank shares its profit or losses from the second-tier contract with its depositors and savers. This is what is meant by a two-tier *Mudarabah* contract within Islamic financing, which allows Islamic banking to go between depositors or savers (investors) and fund managers in order to direct funds to productive or profitable uses.

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3.5 The Problem of Agency and Moral Hazard in *Mudarabah* Types of Contracts

Since the provider of capital (*Sahib al-Maal*) has to bear all the losses in a *Mudarabah* contract, while the working partner (*Mudarib*) bears no losses and has complete authority over running their business affairs, the problem of agency and moral hazard becomes an issue (Bacha, 1997).

First, theoretically speaking, *Mudarabah* contracts do not allow the provider of capital (*Sahib al-Maal*) to participate in the business affairs of the working partner (*Mudarib*), which would only exacerbate the problem of agency and moral hazard.

Second, since profit is revenues less costs that will be shared, the working partner (*Mudarib*) is incentivized and motivated via their own self-interest (*Mudarib*) to increase the costs that are accrued to them as benefits, while Islamic banking remains unaware of this hidden intention of the working partner and their moral hazard. Increasing costs, by, for example, allocating overheads and other costs, or engaging in transfer pricing and pricing manipulation, are just some of the ways to minimize the sharing of profits (Bacha, 1997). Bacha (1997) goes onto suggest that if a company who is acting as the working partner (*Mudarib*) resorts to *Mudarabah* financing in order to finance a single project or to establish a new subsidiary, then the Islamic bank is acting as the provider of the capital (*Sahib al-Maal*) who provides the financing, and Islamic banking can then only claim those profits that are earned by the project or subsidiary, rather than the company as a whole. Since the profits to be shared are dependent on costs, companies are incentivized to commit moral hazard and act unethically, through allocating as much overheads and other costs to the *Mudarabah* financed project or subsidiary as possible.

Third, despite the fact that the provider of capital (*Sahib al-Maal*) can make the working partner (*Mudarib*) liable for those losses incurred in the day-to-day running of business affairs that stem from their own negligence and dishonesty, in the absence of collateral, it often proves difficult, costly and time-consuming to establish in a court of law that someone is guilty of misconduct.

However, there are some solutions that can help to minimize or even eliminate the problem of agency and moral hazard in *Mudarabah* contracts.

- (1). The first solution is that there should be prior agreement over and subsequent monitoring of costs (Bacha, 1997), including, how costs are to be enumerated, which costs are allowed, the use of industry benchmarks and best-practices, as well as the use of equity kickers or reimbursement in the form of giving up part of equity to the provider of the capital (Islamic banking), in order to hold the working partner (*Mudarib*) responsible, and, in turn, reduce or eliminate the problem of agency and moral hazard (Bacha, 1997).
- (2). The second type of solution is that the working partner (*Mudarib*) should contribute some capital or collateral in the business or individual project, or the working partner (*Mudarib*) should be required to bear responsibility for specific losses that are agreed upon in advance (Karim, 2000).
- (3). The third type of solution is that Islamic banking should guarantee investment deposits, which are referred to as *Tabarru*⁴⁶ in Islamic teaching, which is to say that Islamic banking must compensate for any losses incurred by depositors (Khan, 2003).
- (4). The fourth type of solution is to double-check the behaviour of the *Mudarib*, in the sense that if they want a repeat loan, then they have to have showed good results.

These kinds of solutions could be introduced and used as covenants in *Mudarabah* contracts, in order to reduce or even eliminate the problem of agency and moral hazard. This is because *Mudarabah* contracts are wholly distinct from those used by venture capitalists, which typically include several covenants to deal with the problem of agency and moral hazard.

⁴⁶ *Tabarru* is an Arabic word that means donation, charity, gift and contribution, specifically in the form of assets and benefits that are given by persons to Islamic banking organizations as a way to do a good deed or be pious, without any consideration for any future returns.

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3.6 Equity-like Financial Instruments (*Musharakah*)

Musharakah or partnership contracts

Musharakah literally means sharing, and is a partnership contract between two or more parties who are part of joint enterprise, in which both partners share the profit and losses of the enterprise, provide and contribute capital to the business, and both take part in projects or any kind of asset transactions. In a *Musharakah* contract, it is not necessary for all parties to take part in the management or day-to-day running of the business. It Rather, it is possible that certain parties will have responsibility for management, while others will act as a sleeping partner (Usmani, 1998; 1999; Visser, 2013). PLS must be borne in proportion to the capital put up by each party.

There are several major differences between *Mudarabah* and *Musharakah* arrangements (Usmani, 1998; 1999; Vogel & Hayes, 1998), which are as follows:

1. In a *Musharakah* arrangement, all partners invest, whereas in a *Mudarabah* arrangement, investment comes solely from the provider of capital (*Sahib al-Maal*).
2. In a *Musharakah* arrangement, all partners are allowed to participate in the management of the business and can work for it, while in a *Mudarabah* arrangement, the provider of the capital (*Sahib al-Mall*) has no right to participate in management operations, which instead the sole province of the working partner (*Mudarib*).
3. In a *Musharakah* arrangement, all partners engage in the PLS mechanism, based on their respective ratio of investment, but there exists different opinion amongst Muslim scholars in Islamic jurisprudence that ratio of profit may differ from the ratio of capital invested in the investment according to the agreement of the partners. However, the loss must be divided according to the ratio of capital invested into the business by each respective party (Usmani, 1998). Conversely, in a *Mudarabah* arrangement, the partners share profit according to an agreed pre-determined rate of return, but loss, if any, is borne only by the provider of the capital (*Sahib al-Maal*), because the working partner (*Mudarib*) does not invest anything. Ultimately, the lose out on the time and effort

they exerted managing and running the business, and their labour is in vain, because their work bears no fruits for them.

This principle only applies if the working partner (*Mudarib*) has exercised due diligence and acted prudently, which is ordinarily required for this type of business, but if it is found that they have been negligent or dishonest, then they shall be held liable for any losses (Visser, 2013, Usmani, 1998).

4. In a *Musharakah* arrangement, partners' liabilities are normally unlimited. Therefore, if the liability of a business exceeds its assets and the business enters into liquidation, then all outstanding liabilities shall be borne pro rata by all partners. However, if all partners agreed that no partner shall incur any debts during the course of the business' operation, then all exceeding liabilities shall be borne by the sole partner who incurred the debt and violated the aforesaid condition.

On the contrary, liability in a *Mudarabah* arrangement is borne only by the provider of the capital (*Sahib al-Maal*), albeit it is limited to the amount of their initial investment, unless they have explicitly permitted the working partner (*Mudarib*) to incur debts on their behalf (Usmani, 1998).

5. In a *Musharakah* arrangement, all the assets of the *Musharakah* become jointly owned by all partners when they put in their capital and combine it in a joint pool. Profit and loss will be shared at an agreed pre-determined rate in accordance with their respective proportion of investment, while each party will benefit from an appreciation in the value of the assets, even if the profit was not accrued through sales. Conversely, in a *Mudarabah* arrangement, all goods purchased by the working partner (*Mudarib*) are solely owned by the provider of capital (*Sahib al-Maal*). Hence, the working partner (*Mudarib*) can only earn their share of the profit in the event that they sell the goods and receive the profits from these sales. As such, they are not entitled to claim their share of the assets themselves, even if their value has increased (Usmani, 1998).

Despite these aforesaid differences between the types of partnership, there are also some similarities between them (Vogel & Hayes, 1998), namely:

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- a. return of capital cannot be fixed in advance but must be a proportion of the profits. In other words, profits must be shared based on percentages rather than fixed sums.
- b. capital, rather than labour, is liable for the financial risks associated with the venture. In other words, any potential losses fall solely on capital.

3.7 The Problem of Agency and Moral Hazard in *Musharakah* Types of Contracts

In contrast to *Mudarabah* contracts, where the provider of the capital (*Sahib al-Maal*) is not allowed to participate in managing and running the businesses or projects, a *Musharakah* contract requires that all partners must participate in managing and running the businesses or projects. However, when Islamic banking acts as the provider of the capital (*Sahib al-Maal*), the entrepreneur or working partner (*Mudarib*) is still able to engage in deceitful behavior, driven by pure self-interest, which, due to the asymmetry of information, Islamic banking is wholly unaware of. This is because entrepreneurs have a far better grasp of their own collateral, industriousness and business prospects than Islamic banking does.

Given this fact, it is vitally important for Islamic banking to recognize the true characteristics of their working partner and entrepreneur, as well as having an accurate assessment of the quality of the proposed business or project. Moreover, it is simply impossible for the employees within an Islamic banking company to become involved in the daily management of a business.

In response to this type of partnership contract, Islamic banking must demand collateral from the entrepreneur or working partner, in exchange for financing. Besides this difficulty, there are additional obstacles that Islamic banking faces when it is engaging in either *Mudarabah* or *Musharakah* contractual arrangements.

In first-tier *Mudarabah* types of deposits, since deposits in this particular instance are considered to be partnerships, the law permits that either partner can terminate the contract at any time (Visser, 2013). This raises several questions. For example, what happens if the partners -depositors and savers- withdraw their savings and deposits and terminate their partnership? How can Islamic banking offer depositors different maturities and liquidity options? How can Islamic

banking tolerate inevitable mismatches between the maturities of various deposits or investments and still be able to pay the depositors the precise return on their investments? Finally, what if the money invested by Islamic banking in second-tier *Mudarabah* arrangements have accrued losses?

To respond to these aforesaid issues, Islamic banking offers public *Mudarabah* in the event that one party terminates the arrangement, so that if the termination occurs in the first-tier of a *Mudarabah* contract, then it is unlikely that Islamic banking will terminate its second-tier *Mudarabah* contract with the entrepreneur or working partner, which means that the *Mudarabah* arrangement continues unaffected by the change of membership.

With regard to the issue of different maturities and liquidity options, not to mention the ability of Islamic banking to share the profit precisely at the agreed upon rate of return, Islamic banking uses accounting techniques and various assumptions, such as pro-rating, to determine the rate of return, rather than basing it on actual liquidation, but constructive conjectural equivalent to a liquidation (Vogel & Hayes, 1998). In the event of losses, it is highly unlikely that Islamic banking will share the losses with their depositors and savers; rather, they will use funds deriving from charity (*Tabarru'*) to compensate for the losses.

These difficulties that Islamic banking faces in *Musharakah* and *Mudarabah* contracts, which prevents Islamic banking from competing with conventional banking in the area of financing in equity-like instruments, especially with respect to businesses that require a higher-level risk, in which the higher the risk, the higher the level of profit. On the financing side, in addition to equity-like instruments, there are also debt-like instruments.

3.8 Debt-like Financial Instruments

There are many types of contracts in the debt-like instruments that Islamic banking and financial institutions use to finance businesses; however, there are four which can be considered to be the most prevalent and widely used in banking and financial dealings. I describe each of these in turn below.

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(1). *Murabahah* or Cost-plus Pricing or Mark-up Sales

Murabahah is cost-plus pricing or mark-up sales, in which Islamic banking, on the behalf of an entrepreneur, purchases assets or products and resells them to its customers (entrepreneurs) at a pre-determined price, which covers the original cost, plus the negotiated margin of profit. Payment can be made in the future in a lump-sum or via installments, while ownership of the assets or products resides solely with Islamic banking until the payment is received in full. The principle of a *Murabahah* contract is that Islamic banking acts as an entrepreneur, and, as such, must take constructive and actual possession of the products prior to selling them to their customers. A *Murabahah* contract is typically a short-term contract, and is a highly popular form of financing used by Islamic banking world-wide.

Advantages of *Murabahah* Contracts

While, of course, no conventional banking or financial institution engages in the trading of goods and services, the principle of a *Murabahah* contract enables Islamic banking to act as an entrepreneur that can then subsequently purchase and sell products to its customers. To be clear, Islamic banking institutions only purchase products if there is already a customer (or customers) who wants to buy these products. The other advantage is that Islamic banking institutions are likely to generate profit from the first sales that they make, before then proceeding to generate additional profits from the second sale to its customers through mark-up sales.

Criticisms of *Murabahah* Contracts

Murabahah contracts, whereby one sells a commodity for a deferred price and deferred payment, which includes the original price of the commodity plus an agreed profit that is added to the cost, have been heavily criticized. Although some proponents argue that even within *Murabahah* contracts, Islamic banking assume all of the risk, either in the form of taking ownership of the goods or in terms of clients potentially defaulting. With respect to the risk associated with taking ownership of the goods, this can occur during the time interval between the first and second sale. In this case, it is Islamic banking that bear the risk of goods being damaged, destroyed or becoming defective during that period of time. However,

such risks could be eliminated by appointing the customer as an agent of Islamic banking who then proceeds to purchase and obtain the goods, which serves to reduce or even eliminate any potential errors in buying goods. With regard to protecting themselves against either clients defaulting or customers breaching their promises over the goods that are purchased, Islamic banking can demand that all purchases are bound by a binding promise agreement. In other words, Islamic banking will not purchase any goods unless there is a binding promise in place.

Therefore, in *Murabahah* financing, Islamic banking tends to bear no risk, whether in terms of risk related to goods, risk related to clients or risk related to the payment itself (Saeed, 1999; Vogel & Hayes, 1998). A further criticism is that, in financing *Murabahah* contracts, Islamic banking cannot avoid using the interest rates of the Jakarta Inter Bank Offered Rate (JIBOR) as a benchmark for the profitability that it requires from its clients. The prevailing interest rate, inflation, monetary policy, expected rate of profit from these goods, as well as the marketability of the goods are all factors that influence the mark-up pricing (cost-plus financing) of the products offered by Islamic banking in its operations.

Even though *Murabahah* contracts or mark-up pricing instruments are widely used in the Islamic banking and financial system, its acceptability under Islamic law is heavily disputed on the grounds that it implies a fixed return on investment. Hence, although some deem it to be permissible, this practice should nevertheless be avoided or restricted (Siddiqi, 1983), insofar as it is feared that mark-up financing potentially opens up a "back door" to interest-based banking practices, in light of the similarities, in essence, between mark-up prices and interest rates (Saeed, 1999). My own perspective is that there are no substantive differences between these practices, other than the terms used to describe them. This is in accordance with Kuran (2004), who similarly posits that there are only semantic differences between mark-up prices and interest. From an economic standpoint, *Murabahah* contracts are equivalent to interest-based loan contracts, insofar as Islamic banking bears no risk and the client pays for the time value of money.

(2). *Ijarah* or Leasing

Ijarah means to lease or rent something to someone. Within Islamic jurisprudence the term *Ijarah* refers to two things: first, the use of services

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provided by human beings; and second, both the use of an usufruct of assets and property or selling an usufruct (Vogel & Hayes, 1998; Visser, 2013; Usmani, 1998). The former pertains to employing the services of a person in return for a wage or salary, while the latter refers to the transfer of an usufruct of a particular asset or property to another person in exchange for the rent owed to them. In the modern interest-free banking system, *Ijarah* financing involves leasing and is considered as a type of sale in which Islamic banking purchases the asset and allows the entrepreneur to use it for a fixed charge and specified period of time. Through this instrument, Islamic banking rents certain assets for a specified period of time for a rental price that is mutually agreed between both parties and which is reflective of both the cost of the asset and the time value of money.

Since *Ijarah* or leasing involves transferring ownership of an usufruct from the lessor (Islamic banking) to the lessee, the former (Islamic banking) must not only be the owner of the assets involved, but also must be able to transfer the ownership of its benefits to the lessee. Ownership of the asset can either remain with the bank or it can be incrementally transferred to the entrepreneur in a rent-to-own contract; alternatively, the leasing contract ends with ownership being transferred to the lessee, which is referred to as *Ijarah Muntahia bi al-Tamlik*.

Ijarah is one of the most popular financing contracts used within Islamic banking and financial institutions, for, among other things, property financing, vehicle financing, project financing, and so on. Despite its similarity to leasing practices in the conventional banking system, it is nevertheless considered to be permissible from the perspective of Islamic jurisprudence, insofar as this specific mode of financing is asset-based, which means that there is a level of risk assumed by Islamic banking. In this case, Islamic banking owns the asset for a given period. If that asset accrues damages during this leasing period, then both the risk and subsequent losses will be borne by Islamic banking.

However, since Islamic banking actually transfers this risk onto the client, by virtue of requiring them to put up collateral and pay for insuring the asset, no risk is actually borne by Islamic banking (Saeed, 1999; Kuran, 2004). Given that the risk is not shared, there would thus be no reason for Islamic banking to demand profit sharing. After all, the maxim is as follows: “*he who shares of the profit must equally share of the loss*”. Islamic banking uses the PLS mechanism to comply

with religious teaching on the prohibition of interest in financial transactions (al-Omar & Abdel-Haq, 1996). It is therefore unfair and unjust practice to demand profit sharing, if this is not also balanced out by sharing the risk and losses associated with the business conducted by both parties.

(3). Bay' al-Salam or Trust Sale of Forward Purchase

Bay' al-Salam is a form of forward contract. It is a sale contract in which the buyer pays in full in advance for goods that will be received at a later date (Visser, 2013). This mode of financing is ordinarily used to finance the costs involved in the future production of a manufactured product, which enables the producer to employ the money or capital that is paid in advance as working capital to purchase the raw materials that are required to produce the commodity (Abdul-Rahman, 2010). For example, this form of financing allows small farmers, who need to be paid in full upfront, to sell their agricultural products in advance, which, in turn, enables them to grow their crops and feed their families up to the time of harvest. Similarly, through upfront payment in full, import/export merchants are able to conduct their businesses by selling the goods in advance via deferred delivery without having to deal with the interest loans system (Usmani, 1998).

This mode of financing can contribute to economic well-being, insofar as it removes the liquidity shortages for one party and forces the other party (buyer) to put up a substantial amount of money in advance, which in economics is referred to as a "trust sale", while, simultaneously, meeting the buyer's requirements once the commodity is delivered. In the context of a modern banking application, there should be customer who demand commodity to be delivered to him at specified time. Since Islamic banking is a financial intermediary institution, and, as such, is not the entity that is dealing with certain businesses, such as, for example, agriculture businesses, a *Bay al-Salam* contract is used, which involves a third party acting as the supplier of the commodity (a farmer) and Islamic banking acting as the provider of the funds.

It is instructive to cite an example here of how this works in practice. Suppose that customer (A) who belongs to an Islamic banking institution requires 1000kg of mangoes to be delivered at a specified time period; in this instance, Islamic banking would contract a supplier (a farmer) to supply the goods (mangoes) at the same specified time period demanded by the customer. Islamic banking generates

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profit by charging the customer a price that is higher than the amount that they paid in advance to the supplier of the commodity (farmer). Hence, in this example, Islamic banking pays Rp.15.000.000 in full upfront for 1000kg of mangoes from the supplier, before subsequently selling them to the customer for Rp.17.000.000, which means that Islamic banking will earn the differential of Rp.2.000.000 for this parallel *Bay' al-Salam* contract.

This parallel *Bay' al-Salam* contract involves two transactions: the first transaction is between Islamic banking and the customer; and the second transaction involves Islamic banking and the supplier of the commodity. However, generally speaking, it is highly unlikely that Islamic banking would directly contact and subsequently contract to a supplier of a particular commodity. Given that Islamic banking is not an entity which is involved in the agricultural sector, in practice, what would really happen is that customer (A) would come to Islamic banking to ask for financing to purchase a certain amount of mangoes that need to be delivered at a specified moment. If the price of that commodity is Rp.15.000.000 for 1000kg of mangoes, then Islamic banking would then pay the supplier an in full cash payment in advance, before then proceeding to charge customer (A) the amount of Rp.17.000.000, whereby customer (A) must pay Islamic banking either via a lump-sum or in installments for a specified period of time. It is carried out in this way, because Islamic banking has no knowledge and understanding of the agricultural sector, whereas customer (A) knows specific information, such as the price of mangoes, time of harvest, etc., which is why this type of financing is referred to as debt-like instruments.

(4). *Bay' al-Istisna'* or Commissioned manufacturing

Istisna' means an order or request to manufacture something. Therefore, *Bay' al-Istisna'* is the term used to describe a buy and sale transaction, where one party agrees to buy goods produced by a second party, and in which there is clear agreement between both parties about the specified criteria and requirements, as well as what future specified date the payment shall be made. In other words, it is a kind of sale in which the commodity that is being bought and sold does not yet exist (Visser, 2013; Usmani, 1998). In this respect, a *Bay' al-Istisna'* contract requires asking someone to construct, build or manufacture goods or assets into

existence in accordance with agreed specified criteria and requirements, along with an obligation from the manufacturer or producer to deliver them to the customer upon completion. A *Bay' al-Istisna'* contract thus can be said to create a moral obligation on the behalf of the manufacturer to manufacture or produce the goods and subsequently deliver them to the customer. However, if the manufacturer or producer has not yet started the work, then either party is able to cancel the contract after giving sufficient notice to the other party. In the event that the manufacturer or producer has started the work, then the cancellation cannot be done unilaterally (Usmani, 1998).

This particular mode of financing is widely utilized in the financing of house construction, on the grounds that it provides payment flexibility between the manufacturer and the buyer. This is because the contract does not demand that the buyer has to pay in advance, such as in a *Bay' al-Salam* contract, or that the manufacturer should only receive a lump sum payment upon delivery; rather, both parties are able to set an agreement and arrange an appropriate time schedule for payment (Visser, 2013). In a *Bay' al-Istisna'* contract, Islamic banking acts as a manufacturer or producer, insofar as customers can approach Islamic banking to either ask for financing of house construction or to manufacture the desired assets to certain specifications. In the case of financing house construction, if the customers do not have their own land, then they can ask for Islamic banking to finance both the house construction itself as well as the purchasing of the specified piece of land upon which the house is to be built. However, if Islamic banking is only acting as a financial intermediary, and, as it does in certain circumstances, does not want to produce the item or construct the house for the customer, then it can opt to use two mutually independent *Bay al-Istisna'* contracts, which is referred to as parallel *Bay' al-Istisna'* contracts.

In such parallel *Bay' al-Istisna'* contracts, the first contract is between Islamic banking and the customer who has come to the bank to request financing for a project or asset -e.g., financing house construction- which fits the specifications of the customer. In such case, Islamic banking then enters into a second contract with a third party (a manufacturer) to build the house in accordance with the specifications outlined by the customer in the first contract. When the manufacturer has completed the project, or in this case the housing construction, then, theoretically, it must deliver that product or the house to the

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bank; however, for the sake of simplicity, in practice it is the manufacturer who ordinarily delivers the product directly to the customer. The bank then pays the manufacturer for the product or house, and the customer pays the bank according to the agreed payment schedule. The bank marks up the manufacturer's price in the contract with the customer in order to secure a profit.

In addition to these four types of financing contract, there is also a *Qard* financing contract. This mode of financing is purely a debt contract between a lender and borrower, without any references to market mechanisms; rather, it is a social contract whose sole aim is to contribute to humanitarian causes, help destitute and marginalized people, and promote individual welfare. While this transaction of lending and borrowing of funds (*Qard* financing) is done without any remuneration or PLS, the borrower is obligated to repay only the principal on a loan, which can be done via either a lump sum payment or on an installment basis over a specified period of time.

In some circumstances, this mode of financing is required to help establish the socio-economic moral order without any reference to market mechanisms, since Islamic banking is a financial institution which is predicated on ethical and moral responsibilities, which originate from Islamic ethics. Therefore, Islamic banking has the potential to be a truly ethical form of banking, which both promotes and practices more ethically and morally conscious practices. Despite this potential, there is evidence that suggests that the current practices of Islamic banking are not in accordance with its espoused goals, which are grounded in Islamic morality, Islamic ethical values and moral norms that seek to enhance justice, equitability, economic well-being, and, in turn, engender a socio-economic moral order.

3.9 Islamic Banking and a Socio-economic Moral Order

Islamic banking is a financial intermediary like any other conventional banking institutions that serves as a middleman between diverse parties in order to facilitate financial transactions. However, as aforesaid, Islamic banking as a financial intermediary must strictly adhere to the rule that the money invested must have derived from real economic activities and that any financial business transaction must be linked to tangible assets. In this respect, it is a financial

institution with explicit ethical responsibilities, which derive from the ethical and moral teachings of Islam itself. Hence, it is not only expected to promote equitable economic distribution of income and wealth, but also to promote justice, equity, morality and welfare across society at large.

Islamic banking and Islamic economics are based on justice, equity and morality, which is reflected in Islamic principles that prohibit certain practices and behavior, such as: the prohibition of interest (usury), which includes interest on debt in any form; the prohibition of uncertainty or ambiguity in contracts; prohibition of speculation, oppression and gambling, which culminate in exploitation and unjust economic practices; the banning of immoral business activities and investments, such as the production and sale of alcoholic drinks and liquor, hoarding, pornography, harmful and destructive products, and so on; prohibition on dishonesty and deceptive practices; protection of rights and ownership; adherence to profit and risk-sharing or reward and risk-sharing; fulfilment and sanctity of contracts; prohibition of the concentration of wealth in the hands of the few; and the redistribution of income and wealth by way of charity and alms tax (*Zakat*).

These virtue ethics originate from Islam and serve as pillars for the establishment and realization of a socio-economic moral order. It is therefore important to keep in mind that Islamic banking and the existence of a socio-economic moral order are wholly intertwined, and, as such, are inseparable. That is to say, the *raison d'être* of Islamic banking is to help establish a just socio-economic moral order, which, at the very least, could be measured by the existence of both an equitable distribution of income and wealth and enhanced moral and economic well-being. Islamic banking must not sacrifice these central tenets of justice, equity and socio-economic well-being merely for the sake of increasing profitability and strengthening their market share, or for the sake of expanding its operations into the global financial system. Rather, Islamic banking must strike a balance between profitability, sustainability and providing social benefits to the wider community around it. In other words, if Islamic banking does not contribute to a socio-economic moral order, by providing societal benefits, socio-economic development, economic welfare and well-being, then there is no reason for setting up Islamic banking within Muslim communities.

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Based on this ethos and Islamic religious belief, it is prohibited for Islamic banking to invest money in production activities that sell harmful products, irrespective of the large profits they generate, prohibited to get rid of unprofitable businesses which are socially beneficial, not to mention prohibited to downsize the workforce in order to cut costs and increase profits, which, ultimately, contributes to unemployment.⁴⁷ All of the prohibitions listed above are not the way that Islamic banking ought to be conducting its business and financial transactions. Some analysts posit that the inherent characteristics of Islamic banking are more resilient against the deleterious effects of financial crises and other external shocks, such as the global financial crisis in 2007–2008, that wreaked havoc upon conventional financial and economic institutions.

The most significant characteristic of Islamic banking which can aid the establishment of a socio-economic moral order is the requirement that financial transactions must be linked to the real economy and tangible assets. This principle effectively rules out the practice of financialization (i.e., making money from money) in the banking and financial system, where investors behave more like gamblers whose sole interest is speculating and betting on price fluctuations for short-term profit, with little to no regard for whether it leads to the collapse of national economies.

These specific features of Islamic banking derive from the Islamic belief that humans are representatives of God and act as His trustees or vicegerents on earth, and that God is the real owner of the heavens and earths and everything in the universe. Everything on earth has been created for humans who are entrusted as God's representatives, and, at the same time, are liable and responsible for establishing a just socio-economic moral order on earth. Given that resources are limited, humans must use these resources honestly and wisely to meet their needs.

⁴⁷ The junction here is about doing *Ihsan* in Islam. *Ihsan* generally means goodness/kindness or benevolence of whatever kind or good to any creature of Allah. *Ihsan* is part of the Islamic ethical foundation. See the Quran *Surah al-Nahl* (QS; 16: 90). “Indeed, Allah orders justice and good conduct and giving to relatives and forbids immorality and bad conduct and oppression”. And *Surah al-Baqarah* (QS; 2: 195) “And spend in the way of Allah and do not throw [yourselves] with your [own] hands into destruction [by refraining]. And do good; indeed, Allah loves the doers of good”.

Excessive exploitation only leads to the depletion of natural resources, the loss of biodiversity, and, ultimately, the extinction of the species. Similarly, hoarding wealth only leads to denying others of the use of such wealth. Concentration of wealth among a wealthy minority only leads to widespread poverty and famine, as well as the domination and exploitation of the wealthy and powerful over the powerless poor.

Having discussed ethical theories, ethical foundations, as well as the socio-economic moral order and theoretical foundations of Islamic banking, at this juncture I now turn my attention towards investigating the operations of Islamic banking within Indonesia, in order to critically assess whether their theories and practices are in accordance with Islamic ethical values and moral norms. That is to say, I shall investigate whether there are differences between what Islamic banking in Indonesia is theorizing (theories) and what they are implementing (practices) in their operations?

3.10 Differences Between the Theories and Practices of Islamic Banking in Indonesia

I discussed the issue of Islamic banking theorizing one thing, while, simultaneously, implementing something wholly different, in Chapter one, where I referred to three specific examples of unethical practices by Islamic banking in Indonesia.

The first unethical practice concerns charging the profit margin or interest in a disguised form at a higher rate than what one observes in conventional banking. I also mentioned that this practice stems from the higher costs incurred by Islamic banking in its operations compared to conventional banking, as a result of the smaller market share that Islamic banking has in Indonesia: as of the end of June 2018, it accounted for 5.70% of the Indonesian national banking and finance sector. This makes the financing or lending side of Islamic banking expensive, which, in turn, leads to both costs and interest rates being higher.

This practice definitely has a deleterious impact upon customers, and can thus be considered as unfair treatment and unethical behaviour, since the spirit of Islamic banking is to help create socio-economic justice, support underprivileged or marginalized people, and to create an equitable distribution of income and wealth. This does not mean that Islamic banking as a commercial organization

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should convert to operate as a non-profit socially oriented organization. Rather, it suggests that their practices ought to embody Islamic ethical values and moral norms, which prioritize finding a balance between profit generation and showing altruistic concern for others and the wider environment. Simply put, profit generation ought not to be at the expense of others.

The second issue pertains to Islamic banking demanding additional payment from customers in the case of an early settlement, irrespective of whether they offer a discount (rebate) to their customers. There is no uniformity, and a general lack of agreement, about the exact percentage of the amount of rebate given to customers; instead, it depends on individual bankers or managers of Islamic banks, which is also prone to oppression to customers. From my own perspective, it is imperative that there is clarity over the precise percentage of rebate given in the case of early settlement. In addition to this, the client should not have to share the profit and loss anymore during the remaining period, as the business has already been closed, and the repayment of the amount of money has already been paid off. The appropriate maxim here is: *“he who shares of the profit must equally share of the loss”*, and failure to do so only leads to the conducting of unfair, unjust and unethical business practices.

I do not see a legitimate reason for this practice, from the perspective of Islamic religious faith and ethical values or Western ethical thought, such as Kant’s universal moral standard of deontological ethics and Aristotle’s virtue ethics. If Islamic banking insists upon imposing such a penalty, from my perspective, the fair thing to do would be to impose this for no longer than month, as is the case within conventional banking, and ensure that it is clear in the minds of customers in the event of early settlement. This is what I experienced when I entered a contract with and borrowed money from the Islamic bank (BPRS or Syariah small business bank)

The third issue occurs within the financing side of Islamic banking. I have observed that the practice of financing in Islamic banking often involves dishonesty and deception, although, to be clear, I am not saying that all kinds of financial transactions involve deception and dishonesty. Typically, three parties are involved for a financial transaction to be accomplished. It is instructive to cite an example here. If I need a specific amount of money, I am not able to just borrow

this directly from Islamic banking. Rather, I have to bring along to the bank and show the employees the receipt from the seller explicitly listing the items or commodities that I want to buy, which is the case for both *Murabahah* and *Mudarabah* transactions. In this example, there are three parties involved in this transaction: the Islamic bank is the first party, I am the second party, and the seller is the third party.

In their capacity as the first party, Islamic banking actually has the ability to purchase the sorts of commodities (such as building materials) that often make it difficult for the financial transaction to be accomplished, if I as the second party do not agree with these kinds of commodities. Therefore, in practice, it is always the second party who purchases these sorts of commodities. In this kind of financial transaction, not only are there complicated financial transactions involved, there are also agency problems in the form of deceptive and dishonest behaviour. A clear example of such deceptive and dishonest behaviour would be if I were to use the money that I borrowed from Islamic banking to buy other commodities or shop in alternative businesses from those that were explicitly cited in the receipt that I originally showed at the bank.

The fourth issue pertains to Islamic banking preaching and theorizing about the principle of PLS at a pre-agreed ratio and specified rate of return, which, in reality, is no different from interest rates within the conventional banking industry. Moreover, Islamic banking in its practices cannot avoid using the interest rates from JIBOR as a benchmark for generating the profit that it requires from its clients. The prevailing interest rate, inflation, monetary policy, expected rate of profit from these goods, as well as the marketability of the goods are all factors that influence the mark-up pricing or cost-plus financing or *Murabahah* contracts on the products offered by Islamic banking. This practice of Islamic banking confirms that, in contradistinction to what it claims, it absolutely does operate using interest rates.

If there are no risks to be shared, then there is no reason for Islamic banking to demand profit sharing, as per the maxim: “*he who shares of the profit must equally share of the loss*”. The PLS mechanism is used by Islamic banking so that it is in compliance with Islamic faith. Consequently, it is unfair, unjust and unethical practice to demand profit sharing, if the risks and losses are also not

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shared in any of the businesses involving Islamic banking and other parties. I examine this in more detail in Chapter 5. The next chapter compares Islamic banking to conventional ethical banking, by investigating how the ethical theories in Western moral thought serve as the basis for ethical banking within the capitalist economic system.

3.11 Conclusion

Islamic banking is self-conscious, value-oriented and an ethically grounded form of banking, which bases its operations on Islamic faith and Islamic ethical and moral values. The specific features of Islamic banking that have been discussed above are sufficient for Islamic banking to be able to effectively carry out its responsibility of establishing a just socio-economic moral order through creating an equitable economic distribution of income and wealth, supporting real economic activities by linking all financial transactions to tangible assets, as well as avoiding the practice of financialization (making money from money) and other unethical financial practices. It is these reasons that are supposed to differentiate Islamic banking from conventional banking.

The specific nature of the financial instruments used within Islamic banking, which ostensibly operates as an interest-free banking system that is compliant with the key tenets of Islamic law, are designed to change the behaviour of the economic agents who are involved in financial transactions and financial dealings, from debt-based financing to asset-based financing, to encouraging trading and exchanging in commodities and assets which involve PLS, as well as in terms of promoting social solidarity and avoiding moral hazard. Despite criticism that Islamic banking is still far from realizing its ethical goals, and, in fact, is an interest-based banking operation that is different in name only, the endless endeavor to monitor and correct while striving towards the attainment of an ideal is something that has to be done. From this perspective, every effort to correct and improve ethical banking warrants appreciation and respect, especially as it pertains to providing an alternative to the financial dealings and financial transactions that one observes in the conventional banking system.

Such criticism has to make Islamic banking realize that it cannot attract more clients by merely espousing that it acts in accordance with Islam; rather, Islamic

banking must also attract customers by make convincing moral arguments for their business operations and their financial transactions, and ensuring that these practices are, in fact, in line with what they espouse.

The next chapter continues to discuss Islamic banking in relation to conventional ethical banking. While, of course, the former is an example of ethical banking that ostensibly has interest-free banking at the center of both its theory and practice, the latter is a form of ethical banking that operates within an interest-based banking system. The comparisons between these two distinct forms of ethical banking are interesting, insofar as both of them claim to be examples of ethical banking and seek to positively impact upon economic growth and development in a sustainable way through their financial intermediary function.

Comparing these two types of ethical banks is also interesting, because almost all my colleagues (lecturers from the State Islamic university), and most Indonesian people I would say still think that it is only Islamic banking that operates on the basis of Islamic law, and embeds the Islamic ethical system within their day-to-day operations. In fact, this is exactly what I thought before I came to study in the Netherlands.

This perception is widespread in Indonesia, for the simple reason that from a very young age we are inculcated into the belief that Western economic and banking systems are inherently capitalistic, and, in turn, associated with exploitation, self-interested behavior and the maximization of profit and satisfaction, which are all considered to be destructive from the perspective of Islam. Moreover, the prevailing banking system is an interest-based banking system, which proponents of Islamic banking argue can only produce injustice and exploitative practices, uncertainty, gambling and rent-seeking behavior, whereby the rich get richer and the poor get poorer. Furthermore, so the argument goes, all of these practices are supported by Western philosophical thought, which, off course, are neither Islamic nor in harmony with Islamic philosophical thought.

However, when I came to the Netherlands to study, I found out that there are a few banking institutions in Netherlands that ostensibly operate as ethical banks, which are grounded in a Western ethical system that I discuss in Chapter 4; indeed, even some Muslim scholars conclude that some aspects of Western ethical banking (for example, Triodos Bank) are better than Islamic banking, both

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theoretically and in terms of their performance (Tariqullah Khan & Amiirah, 2017).

Since Western ethical banking institutions are operating on the basis of the Western ethical system or in accordance with the Western philosophical foundations of ethical thinking, it is important to discuss these at length before comparing conventional ethical banking vis-à-vis Islamic banking. Hence, the next chapter elucidates the foundations of ethics within the capitalist economic system, before then proceeding to show how conventional ethical banking is grounded in different ethical theories, namely deontological, teleological and virtue ethics. Why is this important to discuss? Well, simply put, these ethical theories form the very basis of ethical banking in the Western world

Chapter 4

4. Normative Economics: Ethical Banking and its Foundations in Teleological, Deontological and Virtue Theory of Ethics and Economics



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4.1 Introduction

It is well-known among people in Indonesia that the Western economic and financial and banking system is capitalistic (which many in the East see as being synonymous with unjust practices, exploitation, uncertainty, gambling and a whole host of other destructive and deeply unethical economic practices) and, as such, is predicated on an interest-based system of finance. However, despite this prevailing belief, there are some economic and banking institutions that place significant emphasis on embedding morality and ethics within both their theories and practices, such as Triodos Bank in the Netherlands. Indeed, some Muslim scholars have asserted that the performance of Western ethical banking institutions such as Triodos are, at least in certain respects, better than Islamic banking, both in terms of theory and practice.

Driven by my own curiosity with regard to Western ethical banking institutions that seek to embed morality and ethics within their operations, in Chapter 5, I compare and contrast Triodos Bank in the Netherlands to Islamic banking in Indonesia. However, before I can do this, I must first delineate in this chapter the underlying ethical foundations and ethical systems of Triodos Bank and other Western ethical banking institutions.

Western ethical banking, despite still being an interest-based banking system, differs in manifold respects from the principal foci of the conventional banking system, such as, among other things, profit maximization, financial speculation, uncertainty, oppression and gambling, which, in turn, leads to exploitative and unjust economic practices, at least from the perspective of an Islamic economic system. A Western, or capitalist, form of ethical banking, such as Triodos Bank Netherlands⁴⁸, is an interest-based banking system that operates on the basis of environmental, social, moral and ethical values, such as justice, equality, environmental preservation and conservation, assisting underprivileged people, provision of social housing, and so on and so forth. For example, it is claimed that

⁴⁸ I conducted interviews with Dutch people who have dealt with Triodos Bank and those who are interested in ethical banking and finance in the Netherlands. See also the website of Triodos Bank in the Netherlands.

all funds deposited are invested in projects and companies that value people and animals, as well as nature and the environment. The guiding principle here is that profit need not come at the expense of environmental deterioration and degradation. It is also believed that culture is a powerful driver of positive change, insofar as it inspires creativity and innovation in business, as well as providing lasting opportunities for personal development.

The notion that humans have egos and engage in both self-interested and rational forms of behaviour in order to maximize profit (gain) and utility (satisfaction) at the highest level, does not justify everyone doing whatever they want to do. Rather, there are rules and obligations, rights and duties, morals and norms, as well as both egoistic interests (individual interests) and altruistic interests (social interests) that everyone must adhere to in order to realize a just socio-economic order, predicated on justice, balance and harmony. This is what Sen (1987) refers to as the inadequacy of self-interested behaviour, when confronted by ethical approaches that emphasize rights and freedoms.

The ethical banking that forms part of the global financial and banking system within the capitalist economic system is a morally driven banking institution, which places notable emphasis on ethical values and moral norms, both theoretically and in practice. The concern of ethical banking is not only to provide financial services for people via its banking business and financial transactions, but also to help improve human life across the individual, social, cultural and environmental spheres, for the ultimate betterment of the entire universe.

The underlying ethical system upon which ethical banking is predicated is rooted in the worldviews of the Western economic system, which is a value-based economy that is grounded in a particular set of values. Specifically, it is rooted in the Judeo-Christian and Western tradition of ethics. These ethical principles are implicitly incorporated within the notions, concepts, assumptions, ideals and even theories of mainstream economics (Spengler, 1980; Wilson, 1997a).

This ethical system can be traced back to three main schools of ethical thought, which I will discuss in turn in this chapter. The first of these schools of thought is teleological-utilitarianism or a consequentialist theory of ethics and economics, which focuses on the consequences of actions, irrespective of the means that are employed. In other words, provided the consequences of an action

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are good, then such an act can be deemed to be ethical. The second school of thought is the deontological theory of ethics and economics, which focuses on the rules and regulations that form the backdrop to an action, irrespective of whatever the consequences are. In other words, an act must be undertaken with good intentions (motivations) and acted out in a good manner. The well-known phrase that encapsulates the essence of this approach is that the end does not justify the means. The third school of thought is the virtue theory of ethics and economics, which concentrates on the traits and character of the agent, their individual act and behavior, as well as their general way of life.

Despite differences in terms of their principles, views and concepts, these three ethical and economic schools of thought nevertheless complement each other, particularly in terms of how they have come to shape ethical banking and economics. Indeed, I would argue that these schools of ethical and economic thought of ethics and economics profoundly impact (and indeed ought to) upon ethical banking, in such a way that enables them to embed ethical values and moral norms driven by environmental and social responsibility and virtue ethics within their financial services and banking businesses. The consequence of this is that ethical banking is not reluctant to provide its financial services to lower-income neighborhoods, such as through assisting underprivileged people to buy affordable houses, or lend money to environmentally and ecologically friendly projects on these grounds, which would simply not be the case within conventional banking.

Consequently, lower-income individuals who previously had no access to banking and financial services are now able to access them via ethical banking. Underprivileged people who previously had less opportunities to save and borrow money, which, in turn, result in them being trapped in low-income communities and the poverty cycle, are now able to improve their lives, well-being and living standards with the help of ethical banking.

Enhancing the quality of life and improving the welfare of poor communities and underprivileged people unquestionably benefits both the country and world as a whole, since raised national income (at both an individual level and social level) increases the national tax revenues, while, simultaneously, lowering the number of people who are dependent on government aid. In addition to this, the harmful

exploitation of humans, the environment and ecology can be minimized through the presence of ethical banking, insofar as its mission does not focus merely on profit generation, returns on capital and other economic calculations, but rather also emphasizes the incorporation of ethical values and moral norms within its banking businesses and financial transactions. I discuss ethical banking in depth in the next chapter, when comparing and contrasting ethical banking vis-à-vis Islamic banking.

However, in this chapter, I first investigate the ethical foundations of normative economics and ethical banking, which, I and others argue, is rooted in three ethical and economic schools of thought: teleological-utilitarianism or a consequentialist theory of ethics and economics; the deontological theory of ethics and economics; and the virtue theory of ethics and economics. After examining each of these in turn, I conclude the chapter by examining how these three ethical and economic schools of thought have impacted upon ethical banking, in terms of its performance and actions in the banking and financial system.

4.2 Teleological-Utilitarianism or Consequentialist Theory of Ethics and Economics

The word teleology originates from the Greek word “*telos*”, which means “a goal or purpose or an end” and “*logos*” (science). This points to the fact that what humans do in their lives has purpose. While an action cannot in and of itself be either good or bad, the outcome or impact of this action upon involved parties can either be positive or negative. This theory of ethics assumes that the underlying decision to engage in certain conduct must always be based on an assessment of the respective outcome. It is for this reason that it is well-known for being a consequences-based approach to ethics, insofar as it adheres to the notion that the end always justifies the means. Hence, if we want to know whether an act is right or wrong, we must solely focus on the results of that act. An action is thus considered to be right or ethical if it promotes happiness, and unethical if it produces pain, not only in terms of the happiness or pain incurred by the performer of the action, but also with respect to everyone affected by the action. If the ends justify the means, then, at least according to this teleological theory of ethics, it is possible for someone to do the right thing despite having bad motives.

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Both the 18th-century philosopher, Jeremy Bentham, and the 19th-century scientist, John Stuart Mill, are considered to be the founding fathers of teleological utilitarianism or a consequentialist theory of ethics. However, it was John Stuart Mill who coined the term “utilitarianism” itself (Mill, 1879). This theory assumes that efficiency and the pursuit of a higher level of satisfaction constitute the basis of human morality. As Mill said:

The creed which accepts as the foundation of morals, Utility, or the Greatest Happiness Principle, holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness. By happiness is intended pleasure, and the absence of pain; by unhappiness is pain and the privation of pleasure. (Mill, 1879. Chapter II, What Utilitarianism is)

As one can discern above, for John Stuart Mill (1806-1873), “An action is right if and only if it produces the greatest balance of pleasure over pain for everyone” (Taylor, 1975; Donaldson & Werhane, 1996; Boatright, 2012; Sandel, 2010). That is to say, the principle of morality and the right thing to do, from the perspective of this approach, is to maximize the general welfare, to maximize utility and happiness for the community, and to maximize the overall balance of pleasure over pain, or the greatest good for the greatest number of people.

This teleological-utilitarianism theory of ethics and economics is often contrasted with a deontological theory of ethics and economics, in the sense that, while the former stresses the results and outcome, irrespective of the means employed, the latter stresses the means irrespective of the results and outcomes. However, it is my contention that the teleological-utilitarianism theory of ethics and economics complements a deontological ethical and economic school of thought, and that the two can, in fact, be reconciled and harmonized in reality, to produce a good result. By this, I mean that the “*telo*” or purpose can be achieved through both good intentions (motivations) and good means (way) of conduct, in order to attain a good result. Relying solely on good intentions (motivations) and good means (way) of conduct, without any consideration of how to achieve a good result is patently absurd. Conversely, relying solely on achieving a good result without any consideration of the underlying goodness of either the intention

(motivation) or means (way) of conduct employed to achieve it, means that it is wholly possible for the right thing to transpire based on a bad intention (motivation) and bad conduct. However, if the same result can also be achieved through good intentions (motivation) and good means, then surely it would be better to achieve a good result based on good intentions (motivations) and good conduct.

This raises the following question: what if a particular situation made it impossible for us to achieve a good result, other than through bad intentions (motivations) and bad means (way)? The answer to this question would likely be that the use of slightly bad means to achieve a good result would be the preferred choice. In this situation, it is likely that a virtue theory of ethics would lead us to engage in a proper act by making a proper choice and engaging in good decision - making, either by way of employing either rationality or intuition, that is, by finding a balance between reason and emotion, which Martha Nussbaum has shown to be part of ethical reasoning (Nussbaum, 2001). Alternatively, this could be achieved by way of employing an affective-normative factor, that is, an inner moral and emotive feeling, which drives humans to make choices and decisions in order to realize goals (Etzioni, 1988). This virtue theory of ethics and economics will be discussed later in this chapter.

If a lie is not the right act, then we should never lie to anybody. However, if telling a lie in a certain situation will save you from a being killed, then what are we supposed to do? Or, consider those situations in which some families in developing countries are forced to put their children to work in factories and mines, etc., without which their family would not survive. What should they do in those circumstances? Of course, one hopes that when certain countries become more economically developed, then ethical economic behaviour will also prevail within that country. This is because when societies grow richer, their willingness to pay for ethical behaviour also increases. This occurs either through governmental enforcement or through individual choice. Consequently, both moral and regulatory sanctions have been found to work better in richer countries, in turn, leading to more ethical behaviour and enhanced moral well-being (Shleifer, 2004).

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Therefore, it is not always so straightforward in reality for people in critical situations to act ethically. Consider here, for example, a person who is hungry and desperately in need of food, but who can find no food or anyone to help him. In this situation, it is likely that he will resort to stealing whatever he can –food or drink- in order to survive, despite the fact that he knows that stealing is unethical behaviour. The same situation applies with respect to child labour in developing countries, where children work purely so that they can survive and earn a livelihood for themselves and their whole family. Hence, although the intention (motivation) or means (way) of conduct might not be good in these aforesaid examples, the result can surely be said to be good. However, intense and endless effort must be exerted in order to achieve the combination of good ends, good intentions (motivation) and good means.

There is an old proverb in Indonesia that “to kill the mouse, we should not burn the warehouse of the paddy (rice)”. In other words, we cannot destroy the wheat or rice that is stored in our warehouse simply to kill a mere mouse. Of course, our intention in this case is good, ridding the warehouse from the mouse, but the outcome of a burnt down warehouse and destroyed rations is even worse. So, although our intentions to kill the mouse are good and we did this successfully, ultimately, we forgot the true way and proper means by which to overcome the mouse and preserve our wheat or rice and the warehouse, which is to act properly in the realization of the good.

Similarly, in terms of developing a nation, for example, is it wise and moral behaviour to build a country via largely foreign resources, both in term of excessive monetary borrowing and foreign human resources, while, simultaneously, subordinating and marginalizing the local people in the country? Or, alternatively, is it wise and moral behaviour to excessively exploit both our natural and human resources for the sake of development without taking care of the environmental balance, or the balance between the material and spiritual fulfilment of human needs? While, on the one hand, we would probably achieve our goal of developing the country physically, in terms of infrastructure, communication systems, public transportation, public roads, and so on, on the other hand, we forget to develop local people by upgrading their living standards, developing their knowledge and skills, whether it be technical, emotional or

communication skills. Similarly, we could probably achieve our goal to develop the country at the expense of environmental degradation and deterioration of natural resources. However, in this matter, one should not forget that human beings are not only the means of development, they are the ultimate goal, end and means of development in this life (Ul Haq, 1998).

The battle between the two divergent schools of ethics and economic thought, teleology and deontology, is well-established. While the former focuses on the progressive satisfaction of desire and attainment of ends, the latter envisaged human life in relation to obedience towards laws (Ross, 1939). However, despite their differences, these two perspectives are each expedient in specific circumstances, and, indeed, often complement one another in reality.

Criticisms of Teleological-utilitarianism or Consequentialist Theory of Ethics and Economics

The principle of the greatest good for the greatest amount, which posits that the right choice and true moral conduct is that which ultimately maximizes the balance of happiness over pain, is very difficult to measure and calculate, insofar as individual preferences differ from one another and, hence, cannot be counted equally. In fact, it is only possible if it is simplified to a single common currency, such as when one does a cost-benefit analysis. In other words, one encounters problems and difficulties when attempting to calculate utility, which is that some actions produce more pleasure for us than others (Taylor, 1975; Kaptein, & Wempe, 2002; Boatright, 2012; Sandel, 2010). Not only is it difficult to measure and compare the goodness of the consequences of an act, it is also difficult to predict the future consequences of an act. Another criticism pertains to the fact that this approach does not give adequate weight to human honour, dignity and individual rights (Sandel, 2010), or, to put it even more strongly, completely fails to respect individual rights, such as individuals' right to freedom of speech and expression, insofar as their voice has been silenced in favor of that of the majority.

However, John Stuart Mill (1806-1873), in his defense of individual liberty in his book *On Liberty*, purports that, in reality, individuals are still able to have absolute independence and absolute rights over themselves, their body and mind within their community, society and state, provided they do no harm to others (Sandel, 2010), which serves to combine collective happiness and welfare with

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respecting individual human rights. This position appears to promote accord and establish a social contract, since humans by their very nature are social beings who live their lives as part of a broader community.

However, generally speaking, a teleological-utilitarian perspective typically tends to ignore the intrinsic qualities of actions themselves, and instead focuses on the rightness or wrongness of the results of the actions. That is to say, to return to our earlier example, insofar as child labour results in increased pleasure and happiness, then it is justified as being a good act and, as such, can be regarded as the right thing to do. If telling a lie will save someone and perhaps an entire village from being killed, then it is justified that telling a lie in this instance is good and, as such, the right thing to do. In this respect, it can be regarded as a results-oriented perspective, which ignores the means and motives of actions.

Examples of Justified Acts from the Perspective of Teleological-utilitarianism or Consequentialist Theory of Ethics and Economics

The purpose of teleological-utilitarianism is to answer the practical question of “what ought a man to do, in order to produce the best consequences possible.” With respect to the economic sphere, the following question: “should I employ child labour in the production process?” is indeed one that demands a clear answer. If one strictly adheres to the moral rule of deontological economics, then the answer is definitively, no. However, in a socio-economic situation in which children simply must work to sustain both their own lives and that of their families, the (un)ethicality of child labour undoubtedly requires more elaboration and consideration. In terms of this issue, I am convinced that good intentions (motivations) or good means (way) of conduct will result in good consequences. For example, if there are no good intentions underlying the use of child labour in the production process, and instead they are merely being used as a means to an end for a corporation to generate huge profits, then it is unquestionably an example of labour exploitation.

However, when specific situations force corporations to employ child labour, such as if poverty is widespread across the region or if they need to work in order to survive and earn a livelihood for themselves and their families, then it is justified to do so, provided it results in the best consequence possible. This does not mean

that the practice of child labour should persist in the long-term; rather, it should be viewed as a temporary process which must be ended at some point. If this practice result in greater happiness, pleasure and benefit for most of the people involved, then it is good to proceed with it, until a longer-term solution is found.

Another example of a dilemma is when an entrepreneur is interested in investing in a country, where a corrupt government is in power, which raises the following question: “should they bribe the government or not?”. In a competitive market in which every firm is forced to pay bribes or otherwise be forced to shut down their business, what should the firm do? According to the deontological and virtue ethics schools of ethical and economic thought, this practice should not be implemented as it is not good to engage in bribery. However, provided the consequences of this bribery result in greater pleasure, happiness and benefit for the greatest number of people, then, from the perspective of a teleological-utilitarianism or a consequentialist theory of ethics and economics, it is right for one to engage in bribery in the above situation.

An additional example is when corporations manipulate their earnings in their annual financial reports. In situations where they are forced to make investment decisions, some corporations will manipulate their earnings to help sustain a high valuation, to reduce the cost of capital, make acquisitions for stocks or even to issue new shares. When a corporation’s stock and share value is high, it of course attracts people to buy shares in the company, which, in turn, increases their capital. This can be done in many ways, from changing the rate of return assumptions to showing higher earnings or using accruals to drive up their earnings (Bergstresser et al., 2004; Shleifer, 2004). These financial accounting reports are generally known as Pro Forma Earnings, which are based on certain assumptions and projections of future earnings, and, as such, are not in accordance with the Generally Accepted Accounting Principles (GAAP).

In situations where firms have no choice but to manipulate their financial accounting report to present a high valuation, in order to avoid being acquired by another established firm, then this strategy is often adopted. Of course, this choice is not a good one from the perspective of deontological and virtue ethics and economics, but for a teleological approach to ethics and economics, it is fine for a

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firm to engage in this, provided the ends and purpose will be good for the greatest number of people, that is, shareholders, stockholders and customers.

From my own perspective, I believe that this kind of act should only be undertaken in the short-term, as long-term manipulation and deception will not be tolerated once people, whether insiders or outsiders, are aware that management has misreported the financial health of the company. Moreover, it is impossible to objectively measure the precise benefit of that action from one person to the next or for a larger group of people. In addition to this, the Paretian principle or “Pareto Optimality Theory” states that we can only identify situations in which no one can be made better off without making someone else worse off. Therefore, it is vital to cast a critical gaze upon the utilitarian foundations of economics. Simply put, we must go beyond utilitarianism and pay closer attention to both deontological ethics and virtue ethics in order “to do justice to ethics in economics” (Van Staveren, 2007).

In a similar vein, McCloskey, in her book *On the Bourgeois Virtues: Ethics of an Age of Commerce* (McCloskey, 2006), emphasizes virtue ethics in relation to business, economics and the economy. McCloskey even goes so far as to call for a return to the moral values espoused by Adam Smith in *Theory of Moral Sentiment*, which, according to McCloskey (2008), may well have served economics better. In addition to this, McCloskey also calls for a return to the more nuanced Smithian view of capitalism — one that incorporates both S-values and P-values. S-values stand for sacredness and sympathy, which she purports accounts for the less “rational” workings of commerce, such as conversation, negotiation, and trust. P-values stand for profit and prudence. The combination of these S-values and P-values is expedient for explaining how capitalism operates at its best.

Notwithstanding its criticisms and weaknesses, the purpose of a teleological-utilitarian or a consequentialist theory of ethics and economics is to answer what ought to be done in a situation in which there is no choice but to choose. It is not merely a question of doing or not doing something or another. Rather, life is all about making choices, and the business and economic spheres are no different in that respect. If we do good and this also happens to be the right thing to do, then

everybody will be happy and pleased; however, sometimes it is incredibly difficult to do good and for it to be right at the same time. To once again return to the aforesaid example of someone being forced to lie in order to avoid both themselves and their entire village being killed, what are they supposed to do in such a situation? With respect to the other example of parents having no choice but to let their children work in the production process in order to survive, once again, what are they supposed to do in such a situation? Therefore, in such critical situations where there is often no choice but yet we are forced to choose, within a teleological ethical and economic school of thought, provided the result or the end is good, we can engage in that action.

Given that the central tenet of this approach is that the most ethical choice is the one that produces the greatest good for the greatest number, decisions are thus evaluated on the basis of their consequences. It is therefore wholly rational in a utilitarian perspective for individuals to decide to engage in an action that provides them with the greatest utility, or, similarly, for an entire society to decide to engage in an action that produces the greatest utility for the greatest number of its members (Lewin, 1988). Here, what is best for a society is merely the sum total of what is best for each individual, while what is best for the individual is best understood by the individual themselves.

The teleological-utilitarianism or consequentialist school of ethics and economic thought differs from a deontological approach to ethics and economics in a number of respects, insofar as the former focuses on the result of the game, while the latter focuses on the moral rules, duties and obligations, which guides us to play the game in the proper spirit, to commit just acts and do the right thing (Jonsson, 2011). At this point, we will now discuss the deontological theory of ethics and economics, or duty-based ethics as it is otherwise known, which is associated with the philosopher Immanuel Kant (1724-1804), who argues that morality is not about maximizing welfare, happiness, well-being or any other end for that matter, but rather is about respecting persons as ends in themselves (Sandel, 2010). However, before I proceed to examine the deontological theory of ethics and economics, allow me to first elaborate how a teleological theory of ethics and economics can be applied to Islamic banking.

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4.3 Islamic Banking and a Teleological-Utilitarian or Consequentialist Theory of Ethics and Economics

As aforementioned, a teleological theory of ethics is predicated on the notion that the morality of an action depends on the results the action generates. An action that brings about an overall increase in the level of happiness or pleasure is thus considered to be morally good, while an act that results in suffering or pain is considered to be morally bad. Alongside this, there are essential conditions (*sine qua non*) for an event to be considered as truly ethical within a teleological approach, which are as follows: (i) the consequences of an act (ii) for persons or personalized beings (iii) that are compared with a moral judge's ideal concept of the recipient (Ashby, 1950).

A teleological theory of ethics and economics is also referred to as a consequentialist approach, which posits that an act can be regarded as ethical conduct provided it produces the best consequences and the most good. The approach centers around the question of what we ought to do in order to produce the best possible consequences. It does not abandon egoism or egoistic self-interested behavior, which decrees that every person has to act rationally to maximize their own self-interest, such as to avoid pain, generate maximum satisfaction and other things related to the maximizing of self-interest, as it is in humans' nature to do so. Simply put, it is irrational for humans to ignore their self-interest. If everyone is to pursue their own self-interest, then ultimately it benefits society, and, as such, is the best possible way to promote the general good.

This is because people are generally the best judges of what is in their own interest, and, moreover, are much more motivated to work hard to benefit themselves than they are to achieve any other goal. Although an individual's free-will is constrained by the free-will of others, there is still room for equilibrium to be established via developing a win-win solution for all. However, as one observes in the case of the prisoner's dilemma, this is not always the case if everyone sets out to maximize their own self-interest, as this only leads to absolute disaster.

As well as this consequentialist element, it is also known as utilitarianism, which means that individuals should work towards producing the greatest happiness for the greatest number of people. Within utilitarianism, individuals

decide to perform actions that provide them with the greatest utility, while a society decides to engage in actions that will produce the greatest utility for the greatest number of people. In other words, individuals should strive towards maximizing people's happiness, as they themselves also belong to this broader community. That is to say, their own happiness also matters as a unit. Here, one can certainly see how it differs from altruism, which, ultimately, puts other people's happiness above our own individual happiness.

Utilitarianism, to some extent, can thus be understood as promoting a particular type of egoistic behavior, albeit one which emphasizes the maximum amount of happiness for the maximum number of people, as well as the greatest pleasure for the greatest number of people. What is interesting about the teleological theory of ethics and economics is that morality is dependent on the outcome, irrespective of the motives and intentions for performing the action, which is to say that it determines right from wrong by the outcome (i.e., the "end justifies the means"). Hence, utilitarianism holds that the most ethical choice is that which produces the greatest good for the greatest number. This view is in contradistinction to Islamic economics and Islamic banking.

The Islamic school of economic thought both founded on and embedded in Islamic ethics and moral values. Hence, it will simply never tolerate bad motives or wicked intentions behind achieving a particular goal. Here, deeds and actions are solely a result of the intentions of the actor, and an individual is rewarded only according to their original intention.⁴⁹ On this point, there is a very clear distinction between the teleological and Islamic schools of economic thought. For the former, the end goal justifies the means (bad means or bad intention and bad motivation), while for the latter the end goal never justifies bad means, bad intentions and bad motivations to achieve the goal.

⁴⁹ *Al-Hadith of al-Bukhari and Muslim says that "it is narrated by 'Umar Ibn Khatab, that he heard from the messenger of Allah (praise be upon him), that verily actions are by intentions, and for every person is what he intended".*

عن عُمَرَ بْنِ الْخَطَّابِ رَضِيَ اللَّهُ عَنْهُ عَلَى الْمُنْبَرِ قَالَ: سَمِعْتُ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ يَقُولُ: إِنَّمَا الْأَعْمَالُ بِالنِّيَّاتِ وَإِنَّمَا لِكُلِّ امْرِئٍ مَا نَوَى ..

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Of course, it is difficult to know and measure someone's intentions are good or bad when engaging in any act or behavior, but what we can know is the outcome of the action. When the outcome is good, then the act is good, and vice versa. This view is in accordance with teleological economics, which purports that it is justifiable or right even to perform an act, provided the outcome is good, that is, it produces the greatest good and greatest utility for the greatest number of people.

Islamic economics differs from teleological economics in this respect, insofar as Islamic economics simply will not tolerate bad intentions and bad motivations behind any action. This is because Islamic economics is grounded in Islamic law, Islamic teachings, from which it derives its worldview and goals and operational strategy. The goal of Islamic economics is always in line with the goal of *Shariah* (*Maqasid al-Shariah*), which refers to human well-being (*al-Falah*) and the good life (*al-Hayat al-Tayyibah*). Here, the utmost importance is paid to brotherhood and socio-economic justice, which can only be realized by achieving a balance between humans' material and spiritual needs (Chapra, 1992).

Hence, lying is not permissible, which also means that lying is not permissible within Islamic economics. This is the rule of the *Shariah*, which is analogous to that within deontological economics, which states that everybody is required to act only in accordance with a maxim or a rule. However, within Islamic economics, if someone encounters a situation in which there is no way to survive other than lying, albeit not excessively, then it is, at least to some extent, tolerable.

This kind of act is tolerable as a result of Islamic jurisprudence, which states: "*al-Dharurat Tubihu al-Mahdhuraat*⁵⁰" or "*legem non habet*" (See also Chapter 2). This Maxim decrees that the violation of a law may be excused by necessity. This rule derives from the Quran, which states:⁵¹

He has only forbidden to you dead animals, blood, the flesh of swine, and that which has been dedicated to other than Allah. But whoever is forced [by

⁵⁰ الضرورات تبيح المحظورات

⁵¹ Al-Quran, *Surah Al-Baqarah* (2: 173). See also *Surah Al-An'aam* (6: 145), *Surah Al-Ma'idah* (5: 3), *Surah al-Nahl* (16: 115).

necessity], neither desiring [it] nor transgressing [its limit], there is no sin upon him. Indeed, Allah is Forgiving and Merciful. The Quran Surah al-Baqarah (QS; 2: 173)

Based on the above maxim or rule, it is thus permissible, for example, for someone to eat a dead animal if they have no hope of finding anything else and are likely to die of hunger. Similarly, to return to an earlier example from the economic sphere, child labor is permissible to the degree that it is an absolute necessity, insofar as the child and their family would otherwise die of hunger. However, as aforesaid, this regrettable practice should not continue in the long-term, as the maxim or rule clearly states that parents are responsible for their children's lives, as is the society where the child lives and the government who also has a responsibility to provide welfare to its people. This harks back to the objective of the *Shariah*, which is to enhance human well-being and fulfill humans' material and spiritual needs in a balanced fashion.

Another key issue pertains to the permissibility shown towards an interest-based banking system. under the following maxim: "*al-Darurat Tubih al-Mahdurat*". Muslims are divided over the issue of permissibility towards an interest-based banking system, with some deeming it *halal* (lawful) and others *haram* (unlawful). With respect to the first group, an interest-based banking system is permissible as long as it does not harm other parties involved with Islamic banking. The combination of the maxim "*al-Darurat Tubih al-Mahdurat*" and the maxim "*Maslahah Mursalah*" (which means in the public interest or for the benefit of the public), it is permissible to deal with an interest-based banking system via financial transactions to a certain point, since it is kind of a necessity in modern societies (Naseem Razi, 2014).

However, it is worthwhile to note here that interest rates in Islamic banking is permissible on the condition that the spirit of that financial transaction is dedicated towards benefitting the public interest, that, it is in the spirit of mutual benefit, mutual help and the spirit of assisting one another to realize welfare, happiness and well-being for society as whole. As discussed in Chapter 2, once necessity is no longer an issue, then society must wholly abandon the practice of applying interest within financial transactions in the banking industry.

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In this case, both teleological and Islamic economics share the same goal, namely the goodness of the outcome. However, they differ with respect to their motives and intentions, in the sense that teleological economics cares neither what the motive is, nor what the intention nor means to bring about the goal are, whereas Islamic economics does care about motive, intentions and the means employed to achieve the goal. With regard to this point, the Islamic economic school of thought is strictly rooted in Islamic Jurisprudence, namely the requirement: “it is permissible to do it provided there is no other way to do it or it is essential for one’s survival”, but nevertheless it must be undertaken in as virtuous a fashion as possible. This echoes Nussbaum’s (1999) position that it could change as the circumstances themselves change. This is because virtue is not an “end”, but rather is a “means” to an end (Fisher and Lovell, 2009).

Furthermore, Nussbaum posits that while action can be undertaken based on emotion, this will not be free from ethical reasoning, and, hence, one should always strive to find a balance between reason and emotion, which for her is intuition (Nussbaum, 2001). In this respect, Islamic economics is closer to, or even identical to, virtue economics than it is to teleological economics.

In addition to that, in the sphere of rationality, Islamic economic does not adhere to the view, according to which an ethical act provides the greatest level of satisfaction and utility for the greatest number of people. From the perspective of Islamic economics, rationality means that economic agents, which in this case refers to Islamic men, must behave and act in accordance with the rule of *Shariah* or Islamic law, whose aim is to create a balance society (Syed Agil, 1989; Chapra, 1979). This behavior does not necessarily eliminate egoistic behavior, but rather reconciles humans’ egoistic tendencies with their altruistic ones. Islamic economics is not alone in recognizing altruistic behavior; indeed, many economists recognize altruistic behavior (Coase, 1979), including Adam Smith in his *Theory of Moral Sentiment*, where he states:

How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it. (Adam Smith, 1759. Section1, part1)

It is therefore wholly rational for economic agents to behave both altruistically and egoistically in an attempt to reconcile them, as fit is simply not possible for humans to be entirely devoid of emotion in their actions. The rational economic agent in Islamic economics is therefore the person who acts in compliance with the rule of *Shariah* (Islamic teaching): *Quran* and the *Sunnah*. It is also rational for Islamic banking not to invest in the production of goods that are harmful to society, despite the large profits they may generate, which may well be good for the company (Islamic banking organization) but are not good for society or the broader environment. Examples of this would be to finance companies that are producing weapons, alcoholic drinks or financing destructive developers who are not environmentally conscious, or financing companies which purposefully employ child labour. In all these aforesaid examples, the bank would merely be concentrating on the results, without any consideration of the means that are employed to achieve the results. It is at this point that I now turn my attention towards a deontological theory of ethics and economics.

4.4 The Deontological Theory of Ethics and Economics

The word deontology derives from the Greek word “*deon*”, which means duty or obligation and the word “*logos*” (study or science). Deontological ethics states that everybody is morally obligated to act in accordance with a certain set of principles and rules or universal moral laws and universal moral standards. From this perspective, an action is good and ethical not because of the result of the action, but because of the specific characteristics of the action itself. This is because the deontological theory of ethics and economic school of thought rejects the idea that it is acceptable to utilize any kind of means to achieve a goal, and instead posits that an end or goal must be achieved through good intentions (motivations) and good means. Therefore, it strongly asserts that the ends never justify the means, and in order to achieve good ends, one should thus always utilize both good intentions (motivations) and good means (Taylor, 1975; Boatright, 2012; Velasquez, 2012; White, 2011).

The deontological approach to ethics and economics purports that morality is a duty or a moral rule that ought to be followed, while the intended maxim of the action must be so reasonable as to become a universal law. In other words, universal moral standards must guide human behaviour in the attainment of

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welfare, happiness, well-being, social bliss, social harmony, noble life, socio-economic justice and a just social order. Accordingly, what runs counter to the ethical values of universal moral standards cannot be accepted, and is thus rejected from the perspective of a deontological approach to ethics and economics.

It is was Immanuel Kant (1724-1804) who advocated for the categorical imperative, which is based on the maxim or principle that is humans' will (the faculty of deciding, choosing and acting) that should rationally guide everyone to act in the same way in similar situations. For Kant, for an act to be considered as a universal moral standard or universal moral law, it must first be tested. Only if the maxim or the principle passes the categorical imperative test is it then permissible for everyone to perform this act; however, if it fails the test, then everyone is prohibited from performing such as act and it is subsequently rejected (White, 2011). As well as this, the deontological theory of ethics and economics is predicated on the application of reason, rather than mere feeling or human sense, where reason is considered to be the source of moral rules, which are expressed through humans' will and capacities. Here, the moral problem is a rational problem, which, ultimately, involves finding out what is the right moral rule that applies to that given situation (van Staveren, 2007). In other words, the search for what would be the moral thing to do in a particular situation must always involve reasoning if one is to come a conclusion about what is just and the right thing to do.

There are two kinds of duties deriving from the categorical imperative: perfect duties and imperfect duties (White, 2011; 2015). Perfect duties are very strict, in that there are no exceptions for deviating from them, such as the duty not to lie, which admits of no exceptions in the interest of preferences or inclinations. Conversely, imperfect duties are not very strict, and, because of their generality and flexibility, thus allow for a degree of latitude in their execution, such as in the case of the duty of beneficence. This duty of beneficence does not require ascetic sacrifice, but merely a sincere balancing of self-interests with the interest of others (White, 2015).

The Concept of Autonomy and Dignity

The concept of autonomy or (inner freedom) refers to the capacity of every rational being to make choices according to laws that they set for themselves, without undue influence or pressure from either external pressures or internal desires, emotion and inclination (White, 2011). An action is thus deemed to be right and moral, insofar as it corresponds with these laws (duties). A moral or ethical person is thus someone who is solely motivated by these laws (duties) to perform particular actions. It is the motive of duty alone that thus confers moral worth upon an action. In other words, the underlying motivation for an action must be based on obligation and well thought out (reasoning) prior to the action taking place, with no credence being given to desire, emotion, preference or any other inclination in the performance of a moral action (Sandel, 2010; White, 2011; 2014). Of course, in reality, duty and inclination co-exist together and are incredibly difficult, if not impossible, to disentangle from one another.

The concept of autonomy signifies that autonomous will (the faculty of deciding, choosing and acting) should neither be subjugated to any interest nor subjected to any pressure; rather, it should only be subject to the laws that people set for themselves, as well as others in society who are bound by the same laws. Given that people set their own laws for themselves, both within their respective individual lives and within a societal set-up, they can be said to be acting freely and in accordance with laws (duties) or acting out of respect towards those laws (duties).

For example, if someone sets for themselves the rule that “I shall not lie” or “I shall not kill anybody”, then they are not limiting their freedom or autonomy, but rather are disciplining themselves to do the right thing and act morally (White, 2011). This is what is meant by autonomy of the will in the “kingdom of ends”, which implies that each person has a dual role to play, both as a legislator or a sovereign and also as a subject, who is obligated to obey the very rule that they themselves made (Taylor, 1975).

In this respect, if everyone began to lie, then the value of truth itself would become utterly worthless. People would no longer be able to trust one another, since lying will have become so prevalent within society at large. Resultantly, the absence of trust would pose manifold problems for everyday life, including within

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economics and business transactions. Mutual trust and not lying to one another constitutes a general standard for conducting businesses, without which any business would not be able to prosper in the long-run, since ethical behaviour is good for long-term profitability (Wilson, 1997a; Kotkin et., all., 2010). Indeed, Etzioni sees “trust” as being absolutely pivotal to the economy, as well as business and financial transactions. Of course, trust is also crucial for social relations, as without it, society would descend into a state of absolute chaos, in which currency would no longer be used, saving would make no sense and transaction costs would rise precipitously (Etzioni, 1988).

The concept of autonomy implies a responsibility to follow the dictates of one’s own moral judgement and commitment to certain rational constraints. Some live up to these commitments and others do not, but it is only by doing so that a person can be regarded as being sincere and true to themselves, thus preserving their integrity and dignity (White, 2011). However, this confers that in the context of social life the law is made based on contracts and consensus between all parties involved (Anscombe, 1958). In fact, the reality is that our actions are often influenced by external factors that are difficult to avoid and sort out, which means that humans tend to co-exist in a state between autonomy and heteronomy (Sandel, 2010).

The concept of dignity can be defined as a state of unconditional and incomparable worth that, in turn, demands respect from all persons, in the sense that one is unable to put a price on one’s dignity, while whatever has a price is interchangeable with something else (White, 2011).

Based on this concept of the autonomy and dignity of human beings, and having recognized the equal dignity of all persons, people must rationally act out of respect and consideration for others. It is this which leads Kant to develop the categorical imperative (unconditional imperative), as a formalization of “the moral law”, against which plans of action or the maxim itself must be tested. If the maxim passes the categorical imperative test, then it is permissible to be applied universally. However, if it fails it is subsequently prohibited, thus resulting in a duty not to act based on that maxim. For example, the maxim of deceiving or lying

would certainly be rejected by the categorical imperative, on the grounds that it fails to respect the dignity of others (White, 2011).

This universal moral standard or universal moral law is not intended to limit people's behaviour in their daily lives or limit people's freedom to act; rather, it seeks to enhance their ability to conduct their affairs and business in every aspect of their lives. From this perspective, limitations are deemed to be necessary to ensure that everybody is free to act, and that businesses act in such a way that preserves the autonomy and dignity of human beings. Such constraints are often concerned with ensuring free markets, namely that there is fair competition and development within the market. Such universal moral laws are meant to preserve and protect property rights, establish the rules of the game in free competition and market mechanisms, observe anti-trust laws, prohibit insider trading, and put in place anti-dumping regulations, and so forth (Van Staveren, 2007). It was Immanuel Kant himself who formulated the well-known principle for setting up the universal rule in his categorical imperative.

I start by discussing the categorical imperative within Immanuel Kant's deontological approach to ethics, before then relating it to economics.

The First Formula of the Categorical Imperative States:

"Act only according to that maxim by which you can at the same time will that it should become a universal law" (Kant, Groundwork of Metaphysics of Morals).

This first formula of the categorical imperative requires of us fairness, mutual respect and mutual understanding as well as the preservation of human dignity. In this case, it is justifiable and rational for somebody to demand others to act in a similar way to them within an analogous situation. That is to say, given that humans are duty-bound to perform that act, they also have the right to demand others to behave in the same way in accordance with that maxim. Technically, there are two different understandings of consistency within Kant's ethics: *consistency in conception* and *consistency in the will* (White, 2011; 2009).

Consistency in conception is what we have discussed above, that is, perfect duty and imperfect duty. An act must be tested to be considered worthy of becoming a universal moral standard or universal moral law. An act must be based

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on obligation and be well thought out (reasoning) before one engages in it (White, 2011). However, the idea of reason for Kant is that of “pure practical reason”, which legislates a priori, irrespective of the empirical ends, and is not viewed as instrumental reason (Sandel, 2010). Conversely, consistency in the will derives from the formula of autonomy and is commonly known as the formula of the law of nature (White 2011).

“Act as if the maxim of your action were to become through your will a universal law of nature” (Kant, Groundwork of Metaphysic of Morals).

This formula calls for humans to act in a teleological or goal-oriented manner, on the basis of natural laws as well as human nature, which is subsequently reified into the above maxim. This idea is very similar to MacIntyre’s conceptualization of human beings as having a specific nature and wanting certain goals in life. Based on this nature, humans have certain aims and goals, such that they move by nature towards specific *telos* (MacIntyre, 2007). This consistency in the will demands that universalized maxims should not contradict the objective ends, which are dependent on the valid motives of every rational being, such as the motive of humanity, which is based on dignity and our own survival, which in itself is based on the teleology of human nature (White, 2011). With regard to this point, Sandel purports that, according to Kant, everything in nature works in accordance with laws or natural laws, such as causality or cause and effect, to which humans, in their capacity as natural beings, are also subjugated. This is because, for Kant, all action is governed by laws of some kind or another (Sandel, 2010).

These two aforesaid types of consistency, in turn, produce what is known as categorical imperatives and hypothetical imperatives. Categorical imperatives call for universal moral standards or universalize a maxim by treating human as ends in themselves, rather than merely as means, while hypothetical imperatives imply the use of instrumental reason: if you want X then do Y, such as in the case of the golden rule, if there exists inclination, emotional preference and desire. The golden rule states: *“Treat others how you wish to be treated”* or *“Do unto others as you would have them do unto you”*. This saying tells us about the law of reciprocity in human relationships and its primacy in living an ethical life.

Consequently, it is wholly rational to demand that others do not cheat you if you do not cheat them. If you speak politely to others, they will surely speak to you in the same manner. If you behave ethically towards others, then they will certainly behave in precisely the same way to you. Human beings do not live alone, humans by their very nature are social creatures and social beings, which is why they possess both the rights and obligations or duties in this life, be it a duty to God, a duty to oneself, as well as a duty towards other fellow humans and the environment by preserving it, nurturing it, safeguarding it and developing a sustainable way of life. Here, rights and duties are related in such a way that one person's rights probably necessitates a duty for another person.

Consider here, for example, the case of selling a product in the marketplace: when person A has already paid for the food that he bought from person B, then A has the right to that food; it does not matter whether he will eat it or give it to another person who is in need of that food. Similarly, B has the duty and obligation to supply the food to A. Here, A has both the right to the food and an obligation to pay, whereas B has the right to receive payment and the obligation to deliver the food to A. From this perspective, all people and all creatures have the right not to be harmed by others, provided they do not harm others.

However, the golden rule can be categorized as both a hypothetical imperative, if it involves inclination, emotion, preference, consequences, and a categorical imperative, if it is free from such inclination, such as in the case of telling the truth, being trustworthy, not harming, not lying, and so on, which we set for ourselves as the law (duty), rather than it being imposed by others. However, in reality, it is incredibly difficult to disentangle duty from inclination.

Consider, for example, how the deontological ethical school of thought views the accumulation of money and wealth. Different persons are likely to have different motives for accumulating income and wealth. Some people may be driven by the motive of achieving greater pleasure and happiness when they are able to accumulate such power, income and wealth. Another person may be driven by the motive of achieving a higher social rank and status within their community, or in order to be able to dominate others. Others may be driven by the motive of being able to help others, especially monetarily, after they have accumulated this income and wealth. In this case, so long as our motives are driven by selfish

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inclinations, then our acts or our decision-making will never truly be ethical and, in fact, it will be absolutely immoral.

However, so long as the motives that drive us to do something or to make a certain decision and perform such an action are not based on inclinations, emotions, preferences, personal egoistic interest and selfishness, but rather are driven solely by performing one's duty, based on rational obligation, and in accordance with laws or natural laws, such as the motive of humanity, which is based on dignity and our own survival, which itself is based on the teleology of human nature, then it can be considered to be good and moral behaviour.

The Second Formula of the Categorical Imperative States:

"Act in such a way that you treat humanity, whether in your own person or in the person of any other, never merely as a means to an end but always at the same time as an end" (Kant, *Groundwork of Metaphysic of Morals*).

The second formula of the categorical imperative requires us to perform the duty not to use a person as merely a means to achieving an end. It is not ethical to utilize human beings as merely tools to achieve goals. Indeed, the perseverance of autonomy and dignity requires that human beings must be seen and treated as ends in themselves, rather than merely as means. Despite differences in social strata, in the form of income and wealth, intellectual intuition and intellectual reasoning, differences in race, culture and religion, the concept of dignity demands that everyone is worthy of respect from all persons, no matter how rich and poor a person is.

This formula is explicitly grounded in the essential dignity of human beings as rational beings, and, in this respect, can be said to be very humanistic (White, 2011), insofar as dignity requires respect from all persons, and being treated as ends in themselves. Consequently, human beings are to be viewed at the center of all aspects of development, whether it be socially, politically or economically. Consider here, for example, the production processes within organizations. Producers or managers are not supposed to see their employees as merely a means in the process of production to produce a certain amount of products or to achieve a certain target of market share. Rather, producers or managers must treat their employees not only as means, but also as ends in themselves.

It is true that we can use anything, including people, as means to achieve our ends or goals. Indeed, corporation directors, as well as lower-level managers, have the power and capability to utilize all of the resources in their corporation, including their employees, as a means through which to achieve their goals, by allocating them to perform specific roles and services which are in accordance with their expertise and specialisms, in order to produce the best possible result for the corporation. Similarly, producers have the power and ability to use their factory workers as a means in the process of production to produce the required goods and secure as large profits as possible.

However, by using people only to get what we want and disrespecting their humanity, autonomy and dignity in the process, by, among other things, discriminating in the form of salary payment, race and religion, failing to provide employees with proper working conditions or a proper living wage, as well as treating them unequally, these acts are certainly all in contravention of the universal moral rule. It is therefore the duty of every person, corporation, organization and country to treat people/employees in such a way that takes their humanity, autonomy and dignity into account, by, among other things, paying them a living wage, guaranteeing a universal decent livelihood, and not treating them as merely means to achieve a specific end.

The Third Formula of the Categorical Imperative States:

“Therefore, every rational being must so act as if he were through his maxim always a legislating member in the universal kingdom of ends.” (Kant, Groundwork of Metaphysic of Morals).

The third formula of the categorical imperative requires everyone to act in accordance with the universal law and be bound by that universal law. This formula teaches us that every person sets the moral law for themselves, that the law must be universalizable for all rational persons, and that the ultimate goal is ethical behavior and the attainment of the “kingdom of ends”, which is an ideal state of the world where every individuals’ goal (ends) co-exist in a harmonious moral community (White, 2011). In other words, within this utopian vision, there exists mutual trust and understanding and a social contract and consensus.

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For example, if there is social contract and consensus over the law of not smoking inside certain public venues, then all rational beings have to follow the rule that they set for themselves. Hence, if someone insists on smoking in these prohibited areas and believes that they are the only one doing so, then what will happen if everybody follows suit and does precisely the same thing?

The same situation applies in all you can eat restaurants, which advertise that you can eat as much as you can for a specific price. The moral duty should tell us that we should not abuse this policy by eating to excess or being wasteful, but rather we should consume a reasonable amount of food and drink. This kind of act is regarded as a rational and moral act. It is not rational if everyone consumes food and drink to excess, without any consideration of what they can realistically eat and drink, as if everyone does this, then there will be lots of leftovers that will need to be thrown out, which is wasteful.

The same rule applies in the case of housing and real estate developers, who have a duty to take care of the environment and preserve it from degradation by, among other things, replanting trees and making places green and clean and a healthy environment for people to live in. It would go against the moral rule if developers were solely concerned with generating profit without any concern for environmental degradation, deforestation, depletion of natural resources, extinction of species and the loss of biodiversity. From this perspective, it is wholly immoral to grow and develop economically, politically or socially at the expense of environmental degradation, deforestation and other externalities.

The existence of a harmonious moral community necessitates striking a balance between rights and obligations, which takes the form of a social contract and consensus that ensures that all rational beings act in accordance with the laws (duties) that they have set for themselves. Given that humans' acts affect others, not to mention that we are also equipped with egos and altruistic tendencies, balancing rights and obligations is a key factor in creating and realizing justice and fairness in decision-making. It is not meant to limit one's freedom to act; rather, balancing rights and obligations is meant to create a just socio-economic order and foster our moral development by combining self-interested behaviour and altruistic behaviour. It is also meant to harmonize individual rights and social

responsibilities, insofar as it allows humans to execute their individual right to maneuver themselves within the societal set-up, for the purposes of establishing a noble society.

Criticisms of the Deontological Theory of Ethics and Economics

As aforesaid, it is often difficult to differentiate between duty and inclination, as well as autonomy and heteronomy (action that is influenced by forces outside the individual or external forces), when assessing an action or behaviour (Sandel, 2010). The other criticism is that not all moral problems can be solved by rules, and the deontological school of ethics has no criterion for dealing with conflicting rules (Van Staveren, 2007; Velasquez, 2012), which is problematic given that human life is complex and different circumstances call for different actions, especially with regard to local wisdom and local cultures.

Having discussed the deontological theory of ethics and economics, I will now turn my attention to delineating the virtue theory of ethics and economics. However, before I do so, let me first discuss the deontological theory of ethics and economics in relation to Islamic banking.

4.5 Islamic Banking and the Deontological Theory of Ethics and Economics

Deontological economics is a value-based economy, which regards morality as a duty, or a moral rule that ought to be followed, while the intended maxim of the action should be sufficiently reasonable that it becomes a universal law. From this perspective, actions are morally right if they conform to a relevant principle or duty. This maxim can be based on religious belief, rights, a belief in fairness, an intrinsic valuation or something else, if there are universalizable moral duties (Van Staveren, 2007). Van Staveren (2007) cites the example of how a belief that people deserve a minimum living wage may lead to the formulation and enforcement of a living wage.

Another example of how a deontological economic perspective is embedded within Islamic economics is the enforcement of paying *Zakat* or religious tax for those who meet the necessary criteria of wealth, those who possess wealth to the

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value of *Nisab*⁵², or those who are deemed to be rich according to Islamic rule. Everybody must follow this maxim or universal moral rule, otherwise they will be deemed to not be an ethical person. Another example is the ban on interest (*Riba*), the ban on uncertainty (*Gharar*) and gambling (*Maisir*) and the ban on unlawful (*Haram*) goods and services (Visser, 2019,) which is reflected in *Maqasid al-Shariah* when dealing with the Islamic financial and banking system.

With regard to the motives for someone's actions, Islamic economics simply does not tolerate bad motives or intentions, irrespective of the results, which is analogous to the basic proposition of Kant's deontological theory of ethics, according to which the ethicality of people's actions is not dependent upon the consequences of the action itself, but rather should be dictated by a categorical imperative that fulfills a certain duty. Hence, it is not about measuring the amount of overall pleasure that a certain action generates or how much pain can be averted to achieve the greatest amount of happiness.

Of course, it is wholly possible that good motives and good intentions will not in and of themselves produce satisfying consequences, or achieve the result wanted, but, generally speaking, good motives and good intentions will yield good results in the long-term. When dealing with market mechanisms, for example, neither deontological economics nor Islamic economics tolerate any businesses that generate huge profits at the expense of other people by exploiting their employees, underpaying them, or making false financial reports to overvalue their share price to convince other people that the stock is worth buying. Moreover, neither approach will tolerate businesses not conforming to the universal moral standard or the rule of not polluting the environment in their production processes, which harms the environment. Even at moments of severe competitive pressure, these practices are absolutely rejected, insofar as they do not derive from good motives and intentions.

This is because they deviate from the moral duty or the universal moral standard, which requires us to display fairness, justice and mutual respect, alongside seeking to preserve human dignity. When everyone finds out about the

⁵² *Nisab* is the minimum amount of wealth that a Muslim must have before he is obliged to *Zakat*.

unethical practices of such businesses, then eventually people will stop doing business with them, and these companies will lose their market share (Shleifer, 2004). This enforcement of moral rules does not seek to limit people's choices; rather, these limits are necessary to ensure that people are free to trade and that they will not restrict other people's freedoms to trade. Such constraints are often concerned with ensuring free markets, ranging from protecting property rights to setting rules for free competition, such as anti-trust laws, prohibitions on insider trading, and anti-dumping regulations (Van Staveren, 2007). This is the rule that requires us to display fairness, justice and mutual respect, in conjunction with fostering a form of freedom based on autonomy and dignity.

When the world ceases to expect that everyone will act virtuously and ethically, then a universal moral standard is needed to guide humans towards acting in the correct manner. This moral rule then must be followed as a duty. This does not set out to impinge upon incentivizing people, but rather attempts to lead humans to act in accordance with the agreed moral rule as opposed to merely following their egos and desires. Simply put, it does not attempt to reduce efficiency, but could help to reduce negative externalities (Van Staveren, 2007).

With respect to this matter, deontological economics and Islamic economics both not only posit that humans are obliged to act in accordance with a universal moral standard, but also position humans at the center of all development, which, in turn, means that they view them as an end, as opposed to merely means to an end. They both emphasize that ethics is of paramount importance to the economy, without which, the economy would deviate from the right path.

The universal moral rules that are enforced through legal measures do not presume that humans are inherently bad by nature; rather, they presume that they are inherently good by nature, and, as such, that they can help to ensure that our motives and intentions are good and that we are acting ethically. From this perspective, it is unethical if somebody who does not want to be cheated on themselves cheats repeatedly with others. Similarly, it is unethical to espouse a belief of some kind and then act in a way which is wholly at odds with their espoused views. Precisely the same logic and principles apply when we discuss these ideas in the context of Islamic economics, which is predicated on the teachings of the *Quran* that states:

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“O you who believe! Why do you say that which you do not do? Most hateful it is with Allah that you say that which you do not do” The Quran: Surah Al-Saff, (QS; 61: 2-3)

This is because we are required to act in accordance with the maxims which harmonize the kingdom of ends, in which everybody is bound by the universal moral law. In a similar vein, it is unethical if someone insists on smoking in a “No Smoking area”, it is unethical for someone to consume food and drinks to excess at an all you can eat restaurant, without paying any consideration to how much they can realistically drink and how much waste they may be generating through their behavior, especially if others follow suit. Simply put, prodigality, extravagance and waste are not praiseworthy values, but rather are disgraceful.

People ought to act only in accordance with maxims that harmonize with a possible kingdom of ends. This position is of course in line with what is advocated by Islamic economics, which is predicated on the ethical and moral norms outlined in the *Quran* that state:

“and eat and drink, but be not prodigal. Lo! He loveth not the prodigals.”
The *Quran* Surah al-A’raf, (QS; 7: 31)

The other value which is in line with the deontological school of economics is expressed in the following verse from the *Quran*:

“And those, who, when they spend, are neither extravagant nor niggardly, but hold a medium (way) between those (extremes)”. The *Quran* Surah al-Furqan, (QS; 25: 77)

Simply put, the principles of ethics and justice outlined in the deontological approach to ethics and economics is the same as that within Islamic economics, with the exception that Kant’s notion of ethics and justice is grounded in human reason, who set up the law for themselves, which is based on the social contract and consensus. This is in contradistinction to Islamic economics, in which the social contract and consensus cannot be in opposition to Islamic law, such as the consensus of people in a community to the consensus that alcoholic drinks that it is *Halal* and it is ethical act to drink alcoholic drinks. This kind of social contract

or consensus simply would not be tolerated in Islamic teaching, given that Islamic ethics are transcendental, rather than grounded in human reason.

However, in Islamic tradition consensus and the social contract very rarely deviate from the good life. This is because in Islamic teaching the social contract or consensus is generally undertaken or acted (done) through deep examination and interpretation of the *Quran* and the *Sunnah*, as well as by using human intellectual reasoning and intuitive reasoning to reach to the good life. Therefore, in Islamic tradition it is assumed that people (when they gather to make the social contract or consensus) will not agree about falsehoods in human nature. Rather, scholars and other educated people will debate many subjective ideas or notions or opinions in an attempt to establish a consensus or a social contract, before finally reaching an objective result that is intended towards the realization of the good life.

Furthermore, in Islamic ethics or Islamic economics, it is permitted, albeit only to some extent, to violate the law (Islamic law), which differentiates it from deontological economics. This is Islamic accepts that there are situations in which we might be forced to perform a prohibited act out of sheer necessity, such as eating a dead animal, but this should only be done if our very survival is at stake, and must be undertaken in as virtuous a fashion as possible. In this circumstance, it is allowed and ethical even for people to consume *Haram* food at the minimum level required to sustain their life. This is justified under the maxim “*al-Darurat Tubih al-Mahdurat*”, which means that necessity makes prohibited things permissible. With respect to this point, Islamic economics differs from deontological economics, but agrees with a teleological-utilitarian theory of economics about the importance of the consequences of the act itself.

After exploring at length Islamic economics and both a teleological-utilitarian and deontological theory of ethics and economics, I have opted to draw upon the virtue theory of ethics and economics to analyze Islamic banking as a value-based approach to the economy, due to the fact that it bears greater resemblance to virtue theory of ethics and economics than it does to the deontological and teleological-utilitarian schools of ethics and economics. Before discussing Islamic banking through recourse to the virtue theory of economics, I must first unpack precisely what the virtue theory of ethics and economics is.

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4.6 Virtue Theory of Ethics and Economics

The virtue theory of ethics originates in ancient Greek and is associated with Aristotle (384 – 322BC). In *the Nicomachean Ethics*, Aristotle proposes that there are four cardinal virtues, which are cardinal insofar as they inform all actions directed at the realization of values (Klamer, 2016). Klamer (2016) delineates the four cardinal values as follows:

1. *Prudence*: acting thoughtfully, cautiously, with foresight and considering the relevant circumstances.
2. *Temperance*: doing not too much and not too little, knowing the right middle ground between the extremes.
3. *Courage*: overcoming fear in order to do the right thing.
4. *Justice*: doing so with regard for the feelings and interests of others.

The Christian theologian Thomas Aquinas subsequently added the following three theological virtues to complete the seven cardinal virtues (Klamer, 2016):

1. *Faith*: trusting yourself, your intuition, your background, your karma, the supernatural, God.
2. *Hope*: trusting that some good will come of your action.
3. *Love*: feeling deeply connected with the other, others and accepting the other as he or as she.

The virtue theory of ethics is a broad term, but it can be said to emphasize the role played by traits, character and virtue in moral philosophy. In contradistinction to both the deontological approach that emphasizes duty or moral rules, and the teleological-utilitarian approach that emphasizes the good consequences or good results of an action, the virtue theory of ethics emphasizes virtue and moral character. It stresses the importance of developing good habits of character, such as benevolence, prudence, courage, justice, and so on and so forth. Once a person has acquired benevolence, for example, they will then habitually act in a benevolent manner. In this respect, the principle questions which it seeks answers to are: “How should I live?” and “What is the good life?”

Consider the example here of someone who needs help. Deontological ethicists would help insofar as doing so is in accordance with the moral rule, and

thus they would do so for the sake of adhering to the law (duty), without any inclination, emotion or preference. Conversely, teleological-utilitarian ethicists would weigh-up the consequences of helping the person, in order to assess whether helping would maximize happiness and well-being for the largest amount of people. Finally, virtue ethicists would view helping the person who needed it through the prism of being charitable or benevolent.

The above example should hopefully illustrate the primacy that virtue ethics accords to individuals' traits and character as the key elements in ethical thinking and behavior, rather than, say, rules about either the act itself or the consequences of the act. Ultimately, it is these specific personal traits that guarantee that someone will make the right decision when faced with a moral dilemma and subsequently engage in moral conduct. However, different circumstances call for different virtues, and, as such, it is difficult to make virtues uniform across time and culture, as they change as circumstances change (Nussbaum, 1999). This is because virtue is not an "end" but rather is a "means" (Fisher & Lovell, 2009). However, if virtue is also happiness itself, then being a virtuous person is also to be a happy person. That is to say, virtue can simultaneously be both a "means" and an "end" in itself.

To illustrate how different circumstances call for different virtues, let us consider Indian culture. In Indian culture, cows are thought to be sacred and, hence, are deeply respected. Therefore, it is unethical to slaughter or eat the meat of a cow. It is Indian culture that informs Hindus' choice to neither consume, slaughter nor eat the meat of a cow. However, in other parts of the world, it is ethical to sell and consume the meat of a cow. Different circumstances thus require different actions, in order to be considered ethical behaviour. The virtue theory of ethics and economics not only sets out to answer the question of "which choice is ethically justified?", but also attempts to answer the following question of "what would an ethical person do?", which serves to position the character and nature of the agents front and center, rather than the action of the agents (McMullen, 2012).

Given that virtue ethics are contextual, in order to determine what constitutes a just and moral act or the right thing to do to realize a just socio-economic order, we must reason together about the meaning of a good life, and attempt to foster a public culture that is hospitable towards the inevitable disagreements that will

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arise (Sandel, 2010). In this matter, it is possible for individuals to make a choice or decision based on their intuition, which is a balance between reason and emotion, as opposed to only being based on their reason and desire or a universal moral rule (Van Staveren, 2007). Similarly, Etzioni purports that the choice or decision to realize the goal that people are pursuing, is not only based on logical/empirical considerations, but rather is also based, either in part or solely, on normative-affective factors, which are dominated by values and emotions (Etzioni, 1988). Nussbaum has also demonstrated that emotion is a key component of human reasoning, and, as such, are part and parcel of the system of ethical reasoning, which involves judgments that acknowledge human vulnerability (Nussbaum, 2001).

In other words, emotion can be the subject of moral judgments, and, hence, can also constitute the basis for moral judgment (De Sousa, 2001). Emotions have cognitive value, and so the logical conclusion is that they must also have some ethical value as well. Consider here, for example, the act of grief. If a person loses the most important person in their life, such as their father, then that person will be affected by grief much more than if they lost a friend.

Virtue is a value that pertains to behaviour and it is internalized behavioural value. Virtue takes training and endless practice for someone to be able to get used to it and become accustomed to doing it throughout their life (Klamer, 2016). Although it is undoubtedly hard in the beginning, you will eventually enjoy it as you become accustomed to it. MacIntyre espouses the following view with regard to virtue in his book *After Virtue* (MacIntyre, 2007):

"A virtue is an acquired human quality the possession and the exercise of which tends to enable us to achieve those goods which are internal to practices and the lack of which effectively prevents us from achieving any such goods " (After Virtue 191).

Since virtues are internalized characteristics of behaviour that are directed towards the good, and a virtuous person is someone who acts upon their ethical values, it is sometimes difficult to find the best and most suitable virtue to apply in the event that there is conflict between them. For example, when I am teaching my high school students, I sometimes experience conflict between displaying

compassion and honesty when grading a failing student's exam. If I were to be completely honest, then I would fail the student, but if I were to be compassionate, then I would give them a low mark that nevertheless ensures that they still pass the exam.

If I were to use procedural rationality (Klamer, 2016), which is strictly in accordance with rules and calculations, then certainly I would fail them. However, when I use substantive rationality (Klamer, 2016), in the sense that I gather together the important values and virtues that are most relevant to helping me come to a decision, then in certain cases, I fail the student, but sometimes I do give them a pass.

Let us consider an alternative scenario in which you are running a business. Unfortunately, there are manifold negative externalities of the production process, such as environmental deterioration stemming from the disposal of waste. The first choice one has is to willfully ignore these negative externalities, and simply focus on yielding maximum profits from the production process. This choice will likely result in the rapid expansion of your business, which, in turn, will enable you to acquire more and more money. However, you could also choose the second option, which is to put ecological and environmental preservation at the forefront of your business, in which case you will probably generate lower profits and slow down the expansion of your business, if not halt it entirely. Of course, every businessman hopes that they can generate large profits, while, simultaneously, caring for their surrounding community and society more broadly, and preserving the environment for the sake of cultivating virtue, the common good and the good life.

Criticisms of Virtue Ethics in the Absence of Duty-based Ethics within a Highly Competitive Market

Consider, for example, how wrong the economy would be if ethics played no part in it whatsoever (McCloskey, 1996). Suppose that you run your own production business. If as a producer or seller, you are able to sell your product at the market price through market mechanisms and make a great deal of profit, then this would constitute a right moral judgement. You have done a good job, in terms of both efficiency and resource allocation. You have been successful in minimizing costs and maximizing profits. In this case, your self-interested behaviour in seeking to accrue maximum profits is deeply embedded within you.

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You are not only able to earn money from your good job to feed both yourself and your family, but you are also able to produce valuable and beneficial products for consumers. Here, the value of hard work is embedded in you.

In this above example, it is difficult to discern any greed or immorality, if a person is able to do the right thing at the right place and is able to operate in the economy while striking a balance between two extremes. This corresponds to what McCloskey said in *The Bourgeois Virtues*, “*Capitalism has not corrupted our souls, it has improved them*” (McCloskey, 2006).

However, when you try to earn large profits at the expense of others, only then must the market mechanisms of capitalist economics be corrected and directed towards some good, due to the omission of ethics in this purely profit-based approach. This is particularly prevalent within more competitive markets, where there is an increased likelihood of individual entrepreneurs or business organizations engaging in unethical behaviour (Shleifer, 2004). For example, in the midst of extreme competitive pressure, individual entrepreneurs or business organizations may seek to, among other things, limit the maneuvering of other competitors when distributing their goods and services to win the market share. However, in the long-term markets will reward virtuous behaviour and punish unethical behaviour (Kotkin, et al., 2010), because to be prosperous in the long-term, individuals and business organizations must maintain general standards in their business practices, such as trust, stewardship, good service and good treatment, alongside paying close attention to consumer satisfaction.

Consequently, a balance must be struck between the motive of maximizing profits and satisfaction and self-interested individual behaviour, or, phrased otherwise, a harmony between individual rights and social responsibilities. Individual rights, of course, must be factored in appropriately, in order to enable people to effectively maneuver within the societal set-up to establish a noble society and realize socio-economic justice. Indeed, harmony is an incredibly important part of life, whether it be in the form of balancing humans’ egoistic tendencies with their altruistic tendencies, balancing rights and obligations, balancing self-interested behaviour and altruistic behavior, or showing concern for others’ interests, balancing maximum profit and satisfaction seeking with

benevolence, generosity and philanthropy. These internalized virtues help humans to engage in ethical behaviour while still operating within a capitalist framework.

Of course, it is not a straightforward task for a person who has internalized moral consciousness and virtue within their behaviour to carry out this task and responsibility of balancing individual rights and social obligations, finding harmony between self-interested individual behaviour and altruistic behavior, in order to establish the common good and the good life, as well as achieving harmony in the universe. From this perspective, domination and exploitation of individuals by society, or vice versa, can be classified as unethical behaviour. Further, it is unethical for individuals to commit offenses and transgression against society and vice versa. Similarly, Charles W. Morris wrote the following regarding the balance between individual and societal moral obligations:

Neither the individual nor society is subordinate to the other, nor is either a means to the other, but each is the condition of the other. The moral obligation of the individual is to act in the light of the social consequences of his proposed acts; the moral obligation of society is to prepare the conditions under which moral behaviour of the individual is possible. (Morris, 1927)

Given that some people are not able to control their ego, the ego, albeit only to some extent, can drive people to deviate from the right path. In such cases, virtue ethics ought to be complemented with deontological ethics. Of course, it would be unrealistic to expect all people to act ethically and virtuously all the time. In the absence of a legal rule or maxim that must be followed and obeyed by all people concerned (Van Staveren, 2007), there will always be individuals or groups of people who will take advantage of market mechanisms or accrue profits at the expense of others. Indeed, economic activity itself allows manifold opportunities for economic agents to behave virtuously or succumb to vice.

While the implementation of moral enforcement or moral rules would certainly limit the availability of these aforesaid choices, it will not reduce people's freedom within free market mechanisms; rather, it would ensure both the existence of a good and positive free market, and that people are free to trade, in spite of the enforcement of moral rules within legal measures and regulations, such as protecting property rights, anti-trust laws, prohibition of insider trading and anti-dumping regulations. As Van Staveren (2007) notes:

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“..., moral rules limit choices, but these limits are necessary to ensure that people are free to trade and that they will not reduce other people’s freedom to trade. Such constraints are often concerned with ensuring free markets; they range from protecting property rights to rules for free competition, such as anti-trust laws, prohibitions on insider trading, and anti-dumping regulations. These are all examples of deontological ethics – universal moral rules that are enforced through legal measures.”

However, if virtue ethics are nurtured and become habit, then people will habitually behave in a virtuous manner. Only once someone has begun to act in such a way habitually can they truly be classified as both a capitalist and a virtuous person. Once someone has achieved this dual-role as the virtuous capitalist, in response to the highly competitive pressures of the market, they will opt for balance and harmony between generating profits and cultivating virtue and the good life. In other words, although they may generate smaller profits than perhaps they would otherwise, they are nevertheless happy in their business life, for the simple fact that they are behaving virtuously and, in so doing, contributing to the good life, such as by helping to mitigate the effects of climate change.

Happiness comes to those who choose to live in harmony with others, not in a hedonic sense, but rather in terms of material, emotional, mental and spiritual happiness, which, ultimately, leads to a meaningful life. Hence, our happiness does not belong to only us alone, but rather also to people and other creatures around us, who also enjoy together with us. This is one way of translating and defining “*eudaemonia*” or happiness. According to MacIntyre, “*eudaemonia*” or happiness not only denotes subjective well-feeling, but also refers to both behaving well and faring well in life and prospering (MacIntyre, 1967).

This is because every enquiry, activity and practice aims toward some good, whether it be “the good” or “a good” at which human beings characteristically aim (MacIntyre, 2007; Klamer, 2016). Aristotle designates “good” as *eudaimonia*, noting that both excellent character (good) and intelligence (intellectual reasoning) cannot be separated from one another, which is to say that humans cannot have practical intelligence unless they are good (MacIntyre, 2007). From this perspective, a rational and ethical act would be one that is equally weighted

between altruism and egoism. Of course, a person may also pursue a goal, such as promoting welfare or happiness, in the interest of some group, such as for a family or a community, etc., which, in fact, differs from their own self-interest (Klamer, 1989).

Virtue Ethics and the Rational Fool

Virtue ethics, which is predicated on personal character traits that are habitually acted upon, guarantees that the correct choice will be made when confronted with an ethical dilemma. Here, it is the character of the person that is the focus of attention, both with respect to being an ethical and virtuous person and their choice of action. There is no universal moral standard underlying moral conduct; rather, the emphasis is on how contextual factors and the prevailing social values impact upon conduct (Van Staveren, 2007; Jonsson, 2011). The advantage of internalized virtues in individuals is that they themselves can rationally direct their acts and behaviour in accordance with virtue ethics, and, in turn, act upon these important values.

A value-based approach to economy posits that people, organizations and governments must act in order to realize values. In realizing values, they valorize what is important to them, which is inconceivable from the perspective of standard economics (Klamer, 2016) or what Amartya Sen refers to as the “rational fool” (Sen, 1977). Sen draws a distinction between sympathy and commitment, when citing an example to illustrate his notion of the rational fool:

“There are two boys who find two apples, one large, one small. Boy A tells boy B, “You choose.” B immediately picks the larger apple. A is upset and permits himself the remark that this was grossly unfair. “Why?” asks B. “Which one would you have chosen, if you were to choose rather than me?” then replies A, “The smaller one, of course”. B is now triumphant: “Then what are you complaining about? That’s the one you’ve got!” B certainly wins this round of the argument.”

In the above story, both boy A and B are triumphant and happy with the outcome, and thus neither of them experiences any loss. There may well be several reasons why A would choose the smaller apple rather than the larger one. For example, A may be expressing commitment, sympathy or respect towards B. It

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may also be the case that once A has given his word, he will keep it and comply with it. Alternatively, there may be ulterior motives in A's heart, such as affection or a need to make others feel pleased and satisfied with him. In this case, A is attempting to realize the value of friendship, as well as a harmonious life, for his own benefit, not only in the short-term, but rather in the long-term. This story can be extended as follows:

Let us consider a scenario in which both A and B opt to choose the larger apple, if they were given the chance to choose first. In other words, if A asks B to choose first, then B would choose the larger apple, and if A is asked to choose first, then A would choose the larger one. In this case, one of the two would be the winner and the other would be the loser. However, let us say, for example, that when A asks B to choose first, B replies to A that they can choose first. In this scenario, who would be the winner and who would be the loser? The answer is that neither of them would be losers, and that they would both be winners. This is because both would profit from the relationship and this economic interaction. Both would valorize the value of friendship, compassion, caring and love for each other. They would have made the value of friendship become real by generating goods, albeit intangible goods in the form of friendship, caring, love, togetherness and a harmonious life (Klamer, 2016).

Thus far, I have discussed normative ethics and economics, which serve as the foundation for the normative economic system that ethical banking operates within. Before discussing ethical banking and normative economics in greater detail, I must first discuss Islamic banking vis-à-vis the virtue theory of ethics and economics.

4.7 Islamic Banking and Virtue Theory of Ethics and Economics

Islamic economic and Islamic banking place emphasize the importance of both humans acquiring good character traits and the universal moral law or rule of the game, for leading a good and decent life, and in order for everyone to try their utmost to act ethically and virtuously. Moreover, Islamic banking stresses the importance of good motives and good intentions in the realization of goals, rather than the ends justifying the means. Conversely, virtue theory of ethics and economics focuses on individuals' traits and character as the key aspect of ethical

thinking, rather than focusing on the rules or the acts themselves. These distinct personal traits are what ultimately guarantee that people will make the right choice and engage in moral conduct when confronted with ethical dilemmas. However, different circumstances call for different virtues, and, as such, it is difficult to turn a virtue into a uniform virtue, insofar as they are contextually and temporally bound.

It is my contention that there is no contradiction or difference between virtue economics and Islamic economics with regard to ethical behaviour in human interaction and in the broader societal context. Both of them propagate a value-based approach to economics, as well as encouraging individual freedom as a means through which to enable humans to maneuver themselves within the societal set-up to establish a noble society and realize socio-economic justice. Similarly, both also encourage good means, good process, good intentions, good motivations and good reasoning, while also accounting for the fact that humans sometimes need to use their intuition when engaging in action.

A good example of how virtue theory of ethics and economics and Islamic ethics and economics complement one another is how the people (mostly Muslim people) in “Kudus” in Central Java Indonesia view consuming the meat from a cow. As aforesaid, rather than consuming meat from a cow, they prefer to consume buffalo in order to show both appreciation and respect towards the older traditions of Hindu Javanese people, despite the fact that it is lawful to consume the meat from a cow according to the prevailing universal moral standard or universal rule of the Muslim community. In this case, both local culture and virtues influence individuals to act ethically and rationally.

From its inception, Islamic banking, which is part of Islamic economics, has espoused that it applies Islamic ethical values and morality that derive from the *Quran* and the *Sunnah* within its business operations and financial transactions. In other words, it aims to incorporate ethical and religious insights into its theory and practice by drawing upon religion as the source of its ethical values. In Islamic economics, everybody is free to pursue their goals, but individual freedom is limited by the freedom of other individuals. Therefore, rules of the game are required, to ensure that people do not deviate from doing the right thing.

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Islamic economics (Islamic banking) does not solely focus on the character and nature of economic agents, who have acquired good character traits, which, in turn, theoretically at least, provides them with the tools to be able to engage in good and ethical behavior, it is also concerned with whether the action is compliant with the moral standards or the universal moral rule. That is to say, even virtuous people can slip and succumb to wrongdoing and unethical behavior when there are no moral standards, in terms of a universal law or universal moral rules that are enforced through legal measures. In this matter, Islamic economics goes hand-in-hand with deontological economics. This is because every human has been equipped from birth with an ego, and within Islamic teachings, the ego generally leads humans to wrongdoing⁵³. However, humans are also created as perfect creatures and have pristine innate instincts or good character, which enable us to rationally use our intellect to differentiate between good and bad, right and wrong, before then proceeding to take the right and good path. Human nature is neither evil nor wicked, but rather good, insofar as we are born with a good character (*Fitrah*)⁵⁴ and good natural dispositions. Given this state of being, human can employ their reason (intellectual reasoning and intuitive reasoning) in accordance with their good character (*Fitrah* or pristine innate instinct).

Humans must find a balance between their ego and reason in their ongoing endeavor to act ethically and virtuously. Only if individuals were able to wholly conquer their ego and habitually act in a virtuous manner in their life, would we be able to aside the rules of the game. However, humans are not supposed to entirely rid themselves of their ego, and, moreover, it is simply not possible to do so. Consequently, humans are still in need of the rules of the game to guide them along the right path and prevent them from deviating from it. It is the ego that always lures humans into temptation, and, in so doing, directs humans down the path towards wrongdoing. In addition to this, we cannot expect all people to act

⁵³ The Quran Surah Yusuf, (QS; 12: 53) "*And I free not myself (from the blame). Verily, the (human) self is inclined to evil, except when my Lord bestows His Mercy (upon whom He wills). Verily, my Lord is Oft-Forgiving, Most Merciful.*"

⁵⁴ This belief is based on the Islamic religious belief that every human being is born with *Fitrah*, with *Fitrah* meaning pristine innate instincts or good character.

ethically and virtuously in every circumstance, in the absence of legal rules or maxims that must be followed and obeyed by all people.

Based on the above discussion, Islamic economics (Islamic banking) occasionally goes hand-in-hand with teleological economics, such as in the example of being permitted to eat *Haram* food (bad means) in order to survive (good end), or the example of some Muslim people dealing with the interest-based banking transaction provided it does not harm others (the economic agents they are dealing with) and results in a win-win result or produces happiness for both borrowers and lenders. Islamic economics (Islamic banking) also sometimes goes hand-in-hand with deontological economics, insofar as it sets up the rule as a universal moral standard or universal law.

However, human life is complex and different circumstances call for different virtues and actions, especially with regard to local wisdom and local culture, not to mention that not all moral problems can be solved by rules, particularly when dealing with conflicting rules (Van Staveren, 2007; Velasquez, 2012). It is precisely here that virtue economics can play an important role, insofar as virtue economics focuses on the personal character traits that lead us to habitually make the right decision with regard to moral actions. It is thus the person who is front and center, both in terms of being an ethical and virtuous person and in terms of their choice of action. There is no moral standard driving moral conduct; rather, contextual factors and hegemonic social values are what underpin moral conduct.

It is for this reason that Islamic economics (Islamic banking) can be said to more closely fit virtue economics in the first order, more closely align with deontological economics in the second order, and better fit teleological economics in the third order.

This is based on the fact that Islamic ethical values and moral norms are:

First, transcendental, which is to say that the determination over what is ethical and unethical, good and bad, right and wrong or proper and improper, derives from the *Quran* and the *Sunnah* and subsequent interpretations by Muslim scholars and intellectuals. Here, both virtue and deontological schools of ethics and economics have a role to play.

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Second, are a universal moral standard and universal code of ethical conduct in terms of universal justice, equality irrespective of religion, culture, race, ethnicity, nationality, but is also able to accommodate local wisdom and local culture, provided it does not deviate from Islamic law. This is the same as a deontological conceptualization of ethics and justice, which are based on both humans' ability to reason and make the law for themselves and the social contract and consensus, although in Islam, social contract and consensus cannot be in opposition to Islamic law. Here, the virtue and deontological schools of ethics and economics both have a role to play.

Third, human conduct is judged to be ethical if it satisfies good intentions (motivation) and good means (way) of conduct, as well as if it is in accordance with Islamic law (Islamic ethical values, morality and norms). It states that an end does not justify the means. Here, the virtue and deontological schools of ethics and economics both play a role

Fourth, it is permitted in Islam for someone to engage in an unethical act if their life was in danger, such as, for example, if they were starving and thus had no choice but to consume *haram* food or unlawful meat. While doing so is unethical in normal condition, in certain circumstances such as that above it would be acceptable, if not even ethical, to do so, provided it was only done at the level needed to sustain life. Similarly, employing child labour or dealing with an interest-based banking system when conducting financial transactions are also permitted, as long as it does not hurt others who you are dealing with. Here, teleological ethics and economics plays its role, but in Islamic economics it takes it with the strict rule.

Fifth, while humans have free-will and free choice over whether to act good or evil, right or wrong, we should choose good over evil, and right over wrong by employing our innate intuitive reasoning and intellectual reasoning capacities, by cultivating virtue and reasoning about the common good. Here, virtue theory of ethics and economics plays its role in terms of striving towards the good life.

From the above discussion, I have come to the conclusion that Islamic economics (Islamic banking) fits more with virtue economics in the first order than it does with deontological economics, and very rarely fits with teleological

economics. Before I conclude this chapter, I will proceed with my discussion of ethical banking (as well as Islamic banking which is part of ethical banking) and normative economics.

4.8 Ethical Banking and Normative Economics

Moral conduct and ethical value are ought to be in the moderate position between two extremes. The value of courage for example, should be done in such a way that lies at the middle of one extreme, namely cowardliness, and the other extreme, namely recklessness. Only when one adopts such a centrist position can they be said to be acting morally. At the individual level, it is important to establish a balance between our egoistic tendencies (self-interested individual behaviour) and altruistic tendencies (concern for the interests of others).

Ethical banking, despite operating within an interest-based banking system, declares that it incorporates ethical values, especially virtue ethics, and moral norms within its banking business and financial transactions. For Rodney Wilson, ethical banking's ethical policy encompasses five major areas of concern: human rights, armaments, trade and social involvement, environmental impact and animal welfare (Wilson, 2003). In this respect, ethical banking is supposed to not be channeling its funds to any businesses that are violating human rights, either implicitly or explicitly, such as in the case of manufacturing companies that are violating human rights in their manufacturing and production facilities. Moreover, ethical banking is not supposed to finance the manufacturing of weapons that certain regimes will use to commit state-sanctioned violence. It is also not supposed to invest its money in individuals and/or commercial organizations that are involved in any practices that have a deleterious impact on the environment, exploit factory farming, deplete natural resources, or to a loss of biodiversity or the extinction of the species.

Rather, to put it simply, ethical banking has to invest funds in businesses that are beneficial to human beings and other creatures as well as the universe. It should not deal with socially harmful investments, despite the large profits they may generate. Since ethical banking is a commercial organization run by individuals, it can be understood as an attempt to concretize the beliefs and values of the individuals who established and run ethical banking institutions (such as employees, shareholders and its members), as well as individuals who have been

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influenced by the emergence of ethical banking (Wilson, 1997b). In other words, shareholders, employees and other stakeholders are considered to be acting in accordance with a set of beliefs and values that are ethical and in accordance with moral norms.

The integrative approach of a value-based economy does not hinder ethical banking organizations from making profits and ensuring the long-term sustainability of their business, however applying these values is compatible with the capitalist economic system in the long-term. Consider here, for example, the value of sympathy. Being sympathetic and concerned about the interest of others can help individuals and businesses to provide their customers with a better product and treat them better, which, in turn, will lead to further profit. Conversely, being apathetic and indifferent towards one's customer-base is likely to lead to customer dissatisfaction, and eventually lead them to turn to your competitors. This serves to illustrate the way in which a market economy often encourages ethical behavior, rather than unethical behavior.

With regard to banking and financial practices, the enforcement of moral rules does not necessarily hinder ethical banking's ability to be creative, efficient and effective in their business practices, nor does it reduce their incentive to be profitable; rather, what it does is enhance fair competition and positive freedom within the banking industry due to the fact that people are following duties and moral rules.

By conducting business in this way, ethical banking will not invest its funds in activities that are harmful to society, or within other socially undesirable investments. In this respect, ethical banking's investment decisions are not solely based on typical financial criteria, such as risk and returns, but rather also what actions and activities are good for the realization of their ideals, such as opting to invest in projects that value people and animals, nature and the environment.

Ultimately, it is values that drive people to act, not merely self-interested behaviour and the maximization of profit and satisfaction. The values of environmental preservation and conservation, the values of assisting marginalized people, the value of assisting the provision of social housing, and so on and so forth, are the kinds of values that drive people and ethical banking institutions to

act. In this way, moral rules can thus be regarded as tool and instruments to be used in striving to achieve the moral good.

4.9 Conclusion

The type of ethical banking which is part of the global capitalist financial and banking system is an interest-based banking system that not only provides financial services to help people improve their businesses and life circumstances, but also for the betterment of all other beings and the entire universe. It is a values and morally driven banking institution, which puts morals and virtue ethics at the forefront of its business practices and corporate ethos. The ethical system of conventional ethical banking has a distinct set of values that is rooted in the prevailing worldview of the Western capitalist economic system.

This ethical system can be traced back to the three main schools of ethical thought, namely: teleological-utilitarianism or a consequentialist theory of ethics; deontological ethics; and virtue ethics. Teleological-utilitarianism focuses on the consequences of actions, irrespective of the means deployed. Hence, as long as the consequences of an action are good and result in the maximum satisfaction or happiness for the maximum number of people, then such an act is said to be ethical. A deontological theory of ethics and economics focuses on rules and regulations for any action, as well as the good intentions (motivation) and good means (way) of engaging in the act. This approach is summed up in the famous expression: the ends do not justify the means. The virtue theory of ethics and economics focuses on the character and traits of individuals or economic agents, as well as their individual behaviour and way of life.

I believe that the ethical banking institution that exists within the capitalist economic system of normative economics brings additional nuance to the interest-based banking system, insofar as it places greater weight on ethical values and moral norms, which I believe help to create a better life, socio-economic justice, and a greater sense of harmony in the universe. It is also my contention that, in so doing, ethical banking enhances efficiency and effectiveness, in the form of reducing transaction costs, encouraging trustworthiness, stewardship and mutual honour, minimizing negative externalities, driving innovation, and paying more attention to consumer satisfaction.

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In so doing, normative economics rewards ethical entrepreneurs, businessmen and bankers, who can take advantage of the long-term gains to be yielded from virtuous habits and high ethical standards, even when under severe competitive pressure from free-market competition. This is because the free-market generally punishes deceitful behaviour, while, simultaneously, rewarding ethical behaviour. If this is in fact the case, then I believe that capitalism as an economic system will never die and could exist until the end of time. Moreover, if this is truly the case, then it is also possible for economic agent, businessman and bankers alike to simultaneously be capitalists and virtuous people.

Chapter 5

5. Islamic Banking vis a vis Conventional Ethical Banking; The Case of Bank Muamalat Indonesia (BMI) & Triodos Bank Netherlands



Chapter 5

5.1 Introduction

Banking and financial institutions are now integral to contemporary societies and are instrumental to the global economy. Indeed, almost every country has its own banking and financial institutions, whose primary function is to act as an intermediary that collects and channels funds both from and to the public (Miller, & VanHoose., 1993). The banking industry accepts deposits from people who have surplus money and channels it to those who do not have enough money to carry out a desired activity, such as consumption or investment. One almost has no choice but to engage with banks in their capacity as an intermediary, insofar as it is almost impossible to directly lend between savers and borrowers without requiring some sort of financial transaction to be completed.

Directly lending money almost certainly requires a double coincidence of wants between the involved parties (lenders and borrowers). People with surplus funds and savings must find someone who simultaneously needs to borrow a certain amount of money, who they subsequently lend it to for an agreed period of time. In addition to that, direct lending necessitates a contract qua legal framework, which will have to be negotiated in the absence of mutual trust between the parties. Since the banking industry earns profit from interest, in addition to service and administration fees, transactions that involve a principal payment as well as interest must be accounted for. This profit derives from the bank's ability to lend money at slightly high rates of interest, while, simultaneously, receiving money on savings and deposits by paying lower rates of interest.

It is well-known that interest means "price", while the rate of interest is the factor which brings the demand for investment and the willingness to save into equilibrium with one another. This is the ideal case in which one deals with the banking system. However, there are also cases in which people need money for consumption, rather than for investment. Investment represents the demand for investible resources, saving represents the supply, whilst the rate of interest is the 'price' of investible resources at which the two are equated (Keynes [1936], 2018; Rogers, 1989). Therefore, if there is a high demand for money, then the banking industry can increase the price or rate of interest and vice versa.

Since Islamic law prohibits the practice of interest, the establishment of financial and banking institutions in an economy must be free from any kind of interest, that is, it must be an interest-free banking system. This raises the following question of how Islamic banking can generate profit if it neither charges any interest in its operations nor pays and receive interest? The answer is that it does so by changing the principle of interest into the principle of PLS and risk-sharing (Visser, 2013; Mills & Presley, 1999; Saeed, 1999; Vogel, & Hayes, 1998). This profit-sharing and risk-sharing principle operates at a pre-determined rate and ensures that capital (investors), the user of the funds (entrepreneurs), as well as both the supplier and borrower of the funds all share the risk. Hence, if the returns are favorable, then they will prosper, but if the returns are not favorable, then they will suffer together.

In their capacity as a financial intermediary, Islamic banking conducts its business in much the same way that a conventional bank does, with the crucial difference being that it is subject to Islamic law. Islamic banking never charges any interest to its customers and clients, due to the simple fact that interest is prohibited under Islamic law; however, the rationale for prohibiting interest must be commensurate with the inherent difficulty of the task, since the primary rationale for it is the establishment of justice (Chapra, 2000). Moreover, within the Islamic financial and banking system, money is not treated as a commodity, but rather is treated as a medium of exchange, in that it does not earn any return unless it is being used for business, investment and projects by converting it into actual capital along with effort and working. The proportionate returns for Islamic banking and its clients are dependent on many factors, such as the priority of the businesses, investments and projects with regard to the value added or concerning their contribution to increasing employment, the degree of the risk involved, social interests, and so on and so forth.

Given that the relationship between Islamic banking and its clients is not between a creditor and debtor, but rather between the provider of the funds and the user of the funds, Islamic banking never charges interest and instead applies the principle of profit-sharing and risk-sharing. In this respect, Islamic banking treats its clients as partners, investors, traders, buyers and sellers. That is to say, on the one hand, when Islamic banking deals with the depositors or savers of the money, it acts as an investor and entrepreneur who invests and uses the money

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within several businesses and projects which generate income and profit for the bank. Islamic banking then shares the returns and profits to its depositors and savers of the money at certain pre-determined rates of return, but it is very unlikely that Islamic banking shares the losses of the businesses and project generated income to its depositors and savers.

On the other hand, when Islamic banking deals with investors or entrepreneurs who are borrowing the money, it acts as an investor and provider of the capital, with an agreed pre-determined rate of return. Theoretically speaking, if the entrepreneurs or borrowers generate profits in their projects or businesses, then they share the returns and profits with the bank at a pre-determined rate of return and vice versa; however, if they generate losses, then they also share that loss. It is highly unlikely that Islamic banking shares these losses, insofar as it always strives to ensure that the businesses and projects they finance are profitable and unlikely to ever incur losses. Of course, sometimes these businesses do incur losses, or the risk is shifted by the bank by requiring the client to put up collateral and pay for insuring the assets, so that there will be no risk borne by the Islamic bank.

Therefore, Islamic banking in its operations invariably chooses less risky businesses and projects to financially invest in and in terms of channeling funds. The best aspect of Islamic banking as a financial intermediary is that it does not, and, indeed, cannot charge additional money (penalty and compounded interest) in the event that the borrowers default on the loan.

Islamic banking, which is part of Islamic economics, espouses to be a type of ethical banking, both in theory and practice, that is in full accordance with Islamic law. The core business of Islamic banking is to prohibit the practices of interest, speculation, manipulation, gambling and all other forms of unjust practices, which are morally wrong and devoid of virtue ethics. Conversely, ethical banking operates within the context of conventional banking, that is, it is part of the interest-based banking system, but consciously strives to adhere to ethically conscious practices within the individual, social, cultural and environmental spheres. Assuming that theology and philosophy are the important drivers in terms of promoting ethical values, moral norms and virtue ethics in human life, then,

theoretically at least, there is almost no difference between Islamic banking and ethical banking, insofar as they are both influenced by the same theological and philosophical roots -be it Judaism, Christianity and Islamic ethics.

However, the prevailing perception of Islamic banking is that, despite the principle of profit-sharing and risk-sharing, it continues to apply interest, just in a disguised form. In other words, there is no substantive difference between Islamic banking and conventional ethical banking with respect to their practices as intermediaries, although Islamic banking is ostensibly compliant with Islamic law. As discussed in previous chapters, there is skepticism towards Islamic banking, on the grounds that it opens up a back door to alternative interest-based banking practices, and, in so doing, that it fails to adhere to Islamic ethical values.

Islamic banking ought to consciously avoid giving precedence to legal forms over ethical substance, in order to reduce the gap between moral ideals and practical realities. In this respect, Islamic banking *de facto* fails to adhere to Islamic ethical values in its day-to-day operations (Siddiqi, 1981; Musa, 2015; Mansour et., al., 2015; Ahmed, 2011; Balz, 2010; Nienhaus, 2011). This is because the *Quran* and the *Sunnah* are the primary sources for Islamic legal forms and Islamic ethical values and moral norms. The principles of Islamic law are central tenets of Islamic economics and Islamic banking, insofar as they provide a set of ethical and legal rules which are built into the Islamic financial industry (Ayub, 2007; Qaradawi 1995; Walsh, 2007).

In addition to this, the practice of being *Shariah* compliant within the Islamic paradigm, as well as within Islamic economics, does not mean that one must stick merely to the legal ruling of Islamic law; rather, the *Quran* and the *Sunnah* stress that prime consideration must be given to ethics, virtues, moral consciousness and welfare, in which the religious bond requires humans to submit to the *Shariah* by committing themselves to contractual obligations (Dusuki, 2008). Religious bonds demand a commitment to both moral and social norms as guided by *Sharīah* (Mubbsher M Khan & Usman, 2016). As aforesaid, this means that humans should not work in a self-centered manner, but rather balance their rights and responsibilities towards society (Chapra, 1992).

However, scholars have posited that it is unfortunate that the word “ethical” is used as a label which is equated with Islam, due to the fact that Islam is not only

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concerned with ethics, but also with the law (Islamic law). Hence, such scholars argue, Islamic banking ought to attempt to make a stronger link between what constitutes ethical practice and the specific methods that they utilize when conducting financial transactions, as opposed to simply equating ethics with Islam (Wilson, 1997). In other words, Islamic banking ought to be explicit about why the methods that they use to conduct financial transactions and money allocation are ethical, in the same way that conventional ethical banking in the capitalist economic system does.

Conventional ethical banking is believed to be a banking system that embraces environmentally and socially conscious practices (Tariqullah Khan & Amiirah, 2017), and Islamic banking should look to do something similar in its theories and practices, as opposed to just espousing that it acts in accordance with the legal rule of *Shariah*. Moreover, Islamic banking has been said to be less concerned with giving more weight to ethics over legal forms in practice, since ethics and moral norms are seen as voluntary rather than an obligation (Belabes, 2013; Ahmed, 2011).

Of course, the expectation is that if Islamic banking succeeds in prioritizing ethical concerns over legal forms, then it can positively contribute towards economic development and harmonious balance in society and the entire universe, by virtue of helping to realize socio-economic justice and the equitable and fair economic distribution of income and wealth through banking mechanisms. Alternatively, at the very least, Islamic banking can contribute to improving people's quality of life, promoting human dignity and facilitating social and cultural prosperity, such as Triodos Bank Netherlands does in their operations. In the present chapter, I compare and draw a distinction between Islamic banking (BMI) and conventional ethical banking (Triodos Bank Netherlands).

Given that Islamic banking is a type of ethical banking that is predicated on Islamic ethics and moral values, while conventional ethical banking has its roots in classical Greek and Western philosophical and moral thought, such as teleological, deontological and virtue theory of ethics, both, in theory at least, claim to be conducting their banking businesses and financial transactions in adherence with ethical values, moral norms and virtue ethics.

In this chapter I investigate both the similarities and differences between Islamic banking and conventional ethical banking, in terms of both how they operate as intermediaries and how capital input (money deposits and savings) are transformed into value output through banking mechanisms. However, first I must elucidate precisely what is meant by ethical banking.

5.2 What is Meant by Ethical Banking?

In the previous chapter, I already unpacked the philosophical and ethical foundations of Islamic banking and conventional ethical banking. However, to further get a handle on precisely what ethical banking is, it is instructive to refer to the definition of ethical banking proposed by the European Federation of Ethical and Alternative Banks and Financiers (FEBEA⁵⁵) in their pamphlet *What really differentiates ethical banks from traditional banks*. The criteria put forward by FEBEA is highly expedient for my purposes in this research, particularly in light of the value that they place on transparency, such as the fact that there should be transparency over the salaries of employees within ethical banking.

According to FEBEA (2012), there are at least five things which deserve attention as far as ethical banking is concerned, which I discuss in turn below.

The First is the Role of Ethical Banking

The purpose of an ethical bank is to work for the common good and to ensure the right to receive credit through banking and financial mechanisms, which consists of raising money and reallocating it in the form of credit for cultural, social and environmental projects (FEBEA, 2012). It should stand for sustainable development, social inclusion, socio-economic development and helping to develop a public awareness that profit is not the only goal when conducting business in the economy.

⁵⁵ FEBEA, 2012. (the European Federation of Ethical and Alternative Banks and Financiers), booklet on “*What really differentiates ethical banks from traditional banks?*” See also <https://www.febea.org/febea/news/ethical-finance-0> (Accessed on 5 June, 2019)

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The Second is the Origin of Money

The money that ethical banking collects from the deposits and savings of its customers should be used in real economic activity. Ethical banks do not accept dirty money generated from illegal economic activity, such as highly polluting industries, money laundering or any undeclared money, because it is in contradistinction to the objectives of ethical banking.

The Third is the Destination of Money

The money should only be channeled into economic activities which have a positive impact on human development and contribute towards social, cultural and environmental improvement. It should also be channeled to more vulnerable segments of the population (marginalized and destitute people) and the most socio-economically deprived areas in order to engender social integration, cultural improvement and increase employment. In this respect, the value of social, cultural and environmental impact is inseparable from the value of economic impact. By conducting its business in this way, ethical banking thus treats its customers as if they are partners in a relationship, rather than being in a creditor- debtor relationship, which is the situation in non-ethical banking relationships.

Through adopting an integrative approach, ethical banking always systematically evaluates the social, cultural and environmental impact, as well as the economic impact, of its activities, projects or the institutions it finances. This process of thoroughly assessing manifold aspects of each and every project they fund enables ethical banks to carry a very low level of risk (FEBEA, 2012).

Another consequence of this integrative approach is that ethical banking never finances any project or activity involving "controversial" sectors, such as tobacco, alcohol and gambling industries, weapons, nuclear energy, pornographic productions or gratuitously violent productions, exploitation of animals, collaboration with oppressive governments, human rights violations, and so on and so forth (FEBEA, 2012).

In addition to this, ethical banking also pays special attention to supporting initiatives geared towards self-employment and both female and youth entrepreneurship, often through microcredit and microfinance (FEBEA, 2012).

The Fourth is the Criteria and Values for the Use of Money

According to these criteria, investments are managed transparently, with some ethical banks even giving their customers the opportunity to decide where their money will be channeled or invested. This bares a strong similarity to the principle of *Mudarabah Muqayyadah* in Islamic banking, as well as *Mudarabah Mutlaqah*.⁵⁶ When granting a loan, ethical banks do not only consider the collaterals or real guarantees, but also considers the value of the personal and social guarantees provided by the local networks in which the funding is channeled and allocated, such as in the case of solidarity lending in microfinancing.

Ethical banking should ensure that it supports transparent financial practices and processes at all times, which is why undeclared money should never be accepted by any ethical bank. It also avoids financial speculation on the money it invests, and instead favors long-term and real economic activity. Furthermore, ethical banking does not use derivatives and trading activities for credit purposes; rather, its income and profit mainly derive from the interest charged on loaned money, which is being used in business activities by its customers.

The Fifth is the Conditions for Bank Management

Although profit is not the only objective of ethical banking, generating a fair profit is nevertheless essential for the sustainability of ethical banks and the industry as a whole. Profits should once again be reinvested in the social objectives of the bank itself. Management in ethical banking are to have full knowledge of their clients and the projects they are funding, by ensuring that they have strong roots in the territory in which they are operating, and by having a good socio-economic network.

The value of participation of ethical banking employees, shareholders and members is vitally important for allowing them to directly influence the management strategies of the bank. In addition to the value of participation, the

⁵⁶ *Mudarabah Muqoyyadah* is where Islamic banks give customers the opportunity to decide where their money is to be invested, while *Mudarabah Mutlaqah* is where Islamic banks are free to decide where the money will be invested without requiring customers' consent. Also refer to *Islamic Finance, Principles and Practice* (Visser, 2013).

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value of transparency is also fundamental for all aspects of management in ethical banking. For example, ethical banks annually ought to publish the salaries of its employees to ensure full transparency over its financial operations (FEBEA, 2012).

According to FEBEA, a bank that wishes to be classified ethical must meet the criteria listed above. Rodney Wilson puts forward similar criteria for ethical banks to that outlined by FEBEA. Specifically, he purports that a bank's ethical policy should positively address five major areas of concern, namely: human rights, armaments, trade and social involvement, environmental impact and animal welfare (Wilson, 2003). Similarly, Belabes posits that any attempts to integrate ethics into economics and finance should focus on human rights, social and cultural rights or the balance between respecting individual rights and social obligations, including the right of environmental preservation from the start of production, distribution and consumption (Belabes, 2013).

The aforementioned criteria from FEBEA provides an excellent measure against which to judge any bank that wants to be designated as truly being an ethical bank. In this respect, I would contend that the criteria set by FEBEA are also wholly applicable to Islamic banking, if Islamic banking truly wants to be classified as a type of ethical banking. Thus far, this research has observed that Islamic banking fails to adhere to Islamic ethical values and moral norms, and, moreover, that is not yet able to go beyond Islamic law, since it adheres more to Islamic law than it does to Islamic ethical values and moral norms. The implication here is that, generally speaking, Islamic banking simply replicates conventional banking, namely in terms of operating based on the profit motive, while, simultaneously, adhering to Islamic law (*Shariah* principles) and *Halal* (lawful) or *Haram* (unlawful) requirements. Islamic banking thus appears to be reluctant to go beyond Islamic law to more closely adhere to Islamic ethical values and moral norms.

Despite the fact that Islamic banking has failed to adhere to Islamic ethical values and has failed to meet the social and ethical goals prescribed by Islamic law, it is still relevant and interesting to compare and contrast Islamic banking, which ostensibly operates as a free-interest based banking system, to conventional

ethical banking, which operates within an interest-based banking system. As outlined in the previous chapter, this is because Islamic law by its very nature embodies ethical principles, which means that Islamic law and the Islamic ethical values system cannot be separated from one another, and, as such, Islamic law by definition is ethical in nature.

5.3 Islamic Banking and Conventional Ethical Banking

I have discussed the features and characteristics of ethical banking as described by FEBEA, and noted the applicability of their criteria for Islamic banking as well. In addition to this, I have elaborated the ethical and philosophical foundations of both Islamic banking and conventional ethical banking in previous chapters. Since both claim to be types of ethical banking, comparing and contrasting Islamic banking and conventional ethical banking, should help to identify their distinct features and characteristics, as well as some similarities between them, deriving from their similar theological and philosophical foundations, which determine the way in which they conduct their banking business and financial transactions. Above all, there are two key differences between the two types of ethical banking, which are quite important and readily noticeable.

The first difference pertains to the foundations of their respective operations. Islamic banking is based on principles of Islamic law and Islamic ethics and moral values, both theoretically and in practice, while conventional ethical banking is based on the principles of virtue ethics, ethical value system and moral values, as outlined in Western and Greek philosophical thought.

The second difference is that Islamic banking applies the principle of profit-sharing and risk-sharing, while conventional ethical banking is an interest-based approach to banking.

The third difference is that although both Islamic banking and conventional ethical banking are profit-oriented organizations that aim to generate profitability and maintain their long-term sustainability, conventional ethical banking (Triodos) explicitly declares that profit is not the sole objective and that it should not be generated at the expense of other economic agents or the wider environment, which is not explicitly declared in Islamic banking.

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The fourth difference pertains to the introduction of benevolent lending and deposits (*al-Qord al-Hasan*) and Islamic tax (*Zakat*) in Islamic banking, which is not found in conventional ethical banking. Litardi et al. posit that as a result of the *Tawheed* paradigm, Islamic economics has philanthropy embedded at the center of its corporate social responsibility (CSR) agenda, while conventional economics does not, which thus constitutes a real difference between the two approaches (Litardi et., al., 2019). In the Green Paper *Promoting a European framework for Corporate Social Responsibility*, CSR is defined as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis” (European Commission, 2001).

Besides these aforementioned differences, the two approaches to ethical banking also share some similarities in terms of their features and characteristics, such as building partnerships and relationships with clients, rather than the relationship being one between creditor and debtor. An additional similarity is that both are monitoring their clients and their businesses to ascertain where and how their money is being allocated, so that understanding and knowing the nature of their clients’ businesses is of paramount importance. Furthermore, both Islamic banking and conventional ethical banking refuse to invest their money in businesses and/or production activities involving oppression, speculation, gambling etc., or which are harmful to society and environment. As well as this, both Islamic banking and conventional ethical banking strive to ensure that their money is linked to real economic activities, which are hoped to positively contribute to economic development and environmental sustainability, equality, as well as the equitable economic distribution of income and wealth.

Having discussed the characteristics and features of both Islamic banking and conventional ethical banking, it is understandable that, theoretically at least, there is almost no difference between the two, with the exception of interest, which is technically prohibited within Islamic banking but in practice operates in the same way that it does in conventional banking, just under another guise. Finally, the benevolent lending and depositing, as well as Islamic tax, that one sees in Islamic banking is simply not applicable in conventional ethical banking.

However, to investigate further the similarities and differences between the two, I will present the annual reports and balance sheets of BMI, which was the first Islamic bank established in Indonesia, and Triodos Bank Netherlands.

5.4 Contrasting Triodos Bank and Bank Muamalat Indonesia (BMI)

Every organization's management engages in strategic planning in order to help establish their priorities and resource allocation, to strengthen their operations and to ensure that everyone is working toward common goals and objectives. Therefore, almost every organization has a vision and a mission. A vision clearly delineates what the organization hopes to become in the future, while a mission explicitly outlines what the organization is going to do, how it is going to do it, and why it is doing it in this way to achieve the organization's future goal.

A Vision and Mission

BMI has a vision to be the best Islamic bank, as well as one of the top ten banks in Indonesia with a strong regional presence. The mission of BMI is to develop an excellent and sustainable Islamic financial institution, which places emphasis on entrepreneurialism, the principle of prudence and excellent and professional human resources, a strong adherence to Islamic values, allied with an orientation towards innovative investments that seek to optimize these values to the benefit of all their stakeholders (Annual report, 2018). The core values of BMI, as stated in its 2018 annual report are integrity (Islam), openness and responsiveness (modern) and competence and excellence (professionalism).

Triodos Bank's vision and ambition is to promote human dignity, engage in environmental conservation and improve people's quality of life in general. In accordance with this vision, Triodos Bank's mission is to create a society that improves people's quality of life, place human dignity at the forefront of its operations, and to enable individuals, institutions and businesses to use money more consciously in ways that benefit people and the environment, as well as offering customers sustainable financial products and a high-quality service (Annual report, 2018).

The key to fulfilling this vision, ambition and mission is to implement a responsible approach to business, predicated on transparency and using money

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more consciously, by, among other things, investing in a sustainable economy and financing projects or economic activities that benefit people and the environment, and, ultimately, create a society that enjoys a better quality of life (Annual report, 2018).

When comparing the banks' respective visions and missions, I would contend that Triodos bank's mission is very clear and explicitly states that it wants to promote human dignity, environmental conservation, as well as enhancing people's quality of life through sustainable economic development and ethical business practices. Conversely, I do not see any explicit mission outlined by BMI in their annual report, certainly not in terms of promoting environmental conservation. The only exception in this regard is that BMI states that it is striving to enhance the role of entrepreneurs in economic activities, in conjunction with espousing that they are strongly adhering to ethical values, the core of which are integrity (Islam), openness and responsiveness (modern) and competence and excellence (professionalism). The hope is that these values will ultimately benefit all stakeholders in the economy, which implies promoting human dignity and enhancing people's quality of life. Both types of ethical banking are predicated on transparency and accountability in the conducting of their banking businesses and financial transactions, such as by using money consciously.

Lending Money (Loan) or Financing Products

In its business banking operation, Triodos Bank only lends money to organizations who are actively working towards bringing about positive and lasting change. As well as this, they strive to ensure that these organizations are also in line with the bank's ethos of promoting human dignity, environmental conservation, sustainable economic development, and enhancing people's quality of life in general. More specifically, the bank's lending practices focus on three key areas: (1) nature and the environment; (2) culture and welfare; and (3) social business.

Figure 5.1 provides a breakdown of the distribution of the loans provided by Triodos, which is taken from their 2018 Annual report.

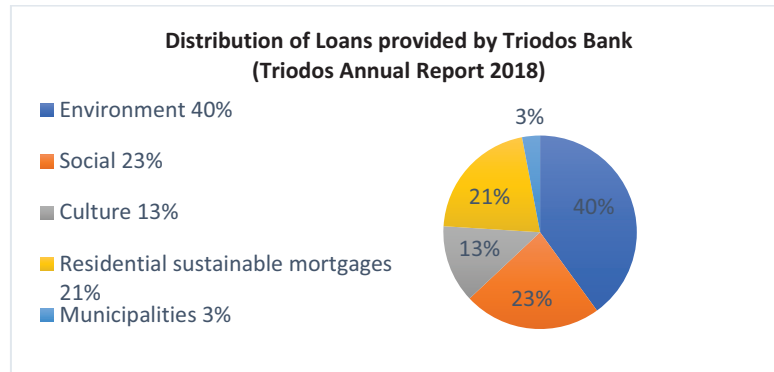


Figure 1: Triodos Bank channeling and distribution of loans

The highest percentage of the loans provided by Triodos Bank are concerned with the environment, which strongly indicates its espoused focus on environmental preservation. This is followed by concern for social matters, and then provisions for residential sustainable mortgages, culture and municipalities. In addition to this, according to a Triodos Bank booklet printed in 2004,⁵⁷ Triodos Bank has a clear lending criteria for identifying and subsequently selecting what projects it wants to lend money to, which I will now discuss.

Triodos Bank's Lending Identification and Selection Criteria

There are at least five measures that are assessed by Triodos Bank in its lending criteria. The first step involves identifying whether or not the project and business investment is sustainable or innovative. The second measure involves only selecting projects that benefit society, the environmental, humans and other creatures. The third is looking at the motivations expressed by people in their loan application. The fourth involves taking a closer look and ensuring to select an appropriate project that is able to measure the potential negative impacts of the activity, for organizations, people and the environment, and then trying to avoid these potential negative impacts. The fifth and final measure is to finance projects with clearly defined assets. These five criteria are written in the booklet as follows:

⁵⁷ Triodos Bank, 2004. Booklet on *Triodos Bank's Approach to Lending*. Accessed on 27 June 2018.

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The criteria for Triodos Bank's lending process

The criteria for Triodos Bank's lending process.

1. Identify sustainable sectors where the Bank can help projects to innovate and businesses to emerge and develop;
2. Select projects which will bring real and meaningful benefits for the wider community - for which creating cultural, social and environmental added value is as important as meeting commercial and financial targets;
3. Closely consider the motivations of the people involved in a loan application;
4. Ensure each selected project meets absolute criteria which measures the potential negative impact of an organization's activity on people and the environment; and
5. Finance clearly defined assets, activities or projects within each organization.

The source: Triodos Bank, 2004. Booklet on "Triodos Bank's Approach to Lending" Accessed on 27 June 2018

Table 1: Triodos Bank criteria for lending process

Triodos Bank always closely examines and conducts a survey for every loan application, in order to make sure that it meets its overall objectives. Triodos Bank identifies and finances business investments and projects that will yield added values, such as social, cultural and environmental values, along with financial credibility within different sectors. These kinds of measures and scrutiny ensure that Triodos Bank truly is an ethical bank in every respect, and, as such, serves to distinguish it from the conventional banking industry.

For this reason, Triodos Bank classifies its operations within three main sectors: nature and the environment, culture and society, and social business, as shown below:

Triodos Lending Identification in Financing Projects	
1. Nature & Environment	Triodos Bank finances sustainable environmental businesses and initiatives. It refers to certification from respected bodies (such as SKAL, Biogarantie and the Soil Association) to guide decisions about organic food and farming loan applications. Areas considered for lending include:
	<ul style="list-style-type: none"> Organic farming (for example, arable, dairy, meat, poultry, forestry, horticulture)

<ul style="list-style-type: none"> • Organic food (for example, shops, butcheries, food processing, restaurants) • Renewable energy (for example, wind, solar, hydro, biomass) • Eco-development (for example, shared workplaces, property development, nature development) • Environmental technologies (for example, recycling, transport)
<p>2. Culture & Society</p> <p>Triodos Bank finances businesses and initiatives that help people to develop and act as free and responsible citizens. It does not finance organizations which put financial and commercial objectives before people. Lending applications are considered in:</p> <ul style="list-style-type: none"> • Education (for example, schools, training and conference centers) • Childcare (for example, day care centers, kindergartens) • Health care (for example, medical centers, therapeutic farms, care for elderly people, hospices) • Art & Culture (for example, visual arts, performing arts, cultural centers, film & media) • Philosophy of life (for example, meditation centers, religious and spiritual groups) • Community projects (for example, social services, migrant integration, community buildings)
<p>3. Social Business</p> <p>Businesses whose key objectives are to add value to society and the environment are the heart of Triodos Bank's lending decisions. Triodos Bank refers to respected fair-trade labels recognized by the Financial Labelling Organization (FLO), an international fair-trade organization, much as it does with its work in the organic sector.</p> <ul style="list-style-type: none"> • Retail non-food (for example, toys, books, clothing) • Manufacturing (for example, printers, publishing) • Professional Services (for example, consultancy, research, building contractors) • Recreation (for example, parks, camping sites, eco-tourism) • Housing (for example, housing associations) • Fair Trade (for example, fair trade shops, wholesale trading) • Development cooperation (for example, micro finance, certified FLO products, certified organic products). <p>The source: Triodos Bank, 2004. <i>Booklet on Triodos Bank's Approach to Lending</i> Accessed on 27 June 2018</p>

Table 2: Triodos Bank lending identification in financing projects

In addition to the criteria and identification set up by Triodos Bank with respect to lending money and financing projects, Triodos Bank also ensures that,

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at least to the best of its knowledge, they will not finance any of the following business activities, which it classifies under three headings: non-sustainable products and services, such as gambling and speculation-based businesses, pornography, chemical weapons, and so on; non-sustainable working processes, such as animal experimentation, genetic engineering (debatable to some extent), agricultural production that fails to display sufficient concern for the environment; non-sustainable products and processes, which are in non-compliance with Triodos Bank's philosophy of ethical banking.

Below, are the specific business activities that Triodos Bank will not finance under any circumstances:

Triodos Bank's Classification of Excluded Business Activities

Business activities classified by Triodos Bank.

1. **Non-sustainable products and services** which consist of the fur industry, gambling, environmentally hazardous substances, pornography, tobacco, the weapon industry which includes conventional weapons and non-conventional weapons such as nuclear energy, chemical and biological weapons.
2. **Non-sustainable working processes** including intensive agricultural production without concern for animal welfare and environment, corruption, financially supporting dictatorial regimes, animal experimentation, genetic engineering, breach of legislation, codes of conduct or convention, such as breaches of environmental conventions, breaches of labour and other conventions, breaches of international codes and conventions, breaches of fundamental labour rights.
3. **Other non-sustainable products and processes** which are not covered by the above criteria, but in any case, contradict the philosophy of Triodos Bank.

The source: Triodos Bank, 2004. Booklet on Triodos Bank's Approach to Lending, Accessed on 27 June 2018

Table 3: Triodos Bank classification of excluded business activities

Having now established the lending money identification and selection criteria of Triodos Bank Netherlands, at this juncture I now turn to discuss BMIs lending identification and selection criteria of lending money (loans) and financing products.

Bank Muamalat Indonesia (BMI) Lending Identification and Selection Criteria

In a similar vein to Triodos Bank, BMI also has set criteria and identification when it comes to financing projects or lending money to its customers and organizations who are *Shariah* compliant or operate in accordance with Islamic law. The total amount of money lent by BMI in 2018 was Rp33,559.3 billion, and all of the different types of loan were in accordance with Islamic law.⁵⁸

Bank Muamalat Indonesia Lending Identification

1	<i>Murabahah</i> Financing (Loan)	Rp15,632 billion	46.58%
2	<i>Istishna</i> Financing (Loan)	Rp4.3 billion	0.01%
3	<i>Qardh</i> Financing (Loan)	Rp755 billion	2.25%
4	<i>Mudharabah</i> Financing (Loan)	Rp438 billion	1.31%
5	<i>Musyarakah</i> Financing (Loan)	Rp16,544 billion	49.30%
6	<i>Ijarah</i> Financing (Loan)	Rp186 billion	0.55%
	Total	Rp33,559.3 billion	100%

Table 4: Bank Muamalat Indonesia (BMI) lending identification

The above table shows how the funds or loans were distributed in Bank Muamalat Indonesia (BMI). As one can discern in figure 2 below, BMI channeled its funds more into *Musharakah* loans than *Murabahah* loans, with percentages of 49.30 % and 46.58%, respectively.

⁵⁸ For terminology on Islamic banking financing products, such as *Mudarabah*, *Murabahah*, *Istishna*, *Ijarah* etc., please refer to the previous chapter.

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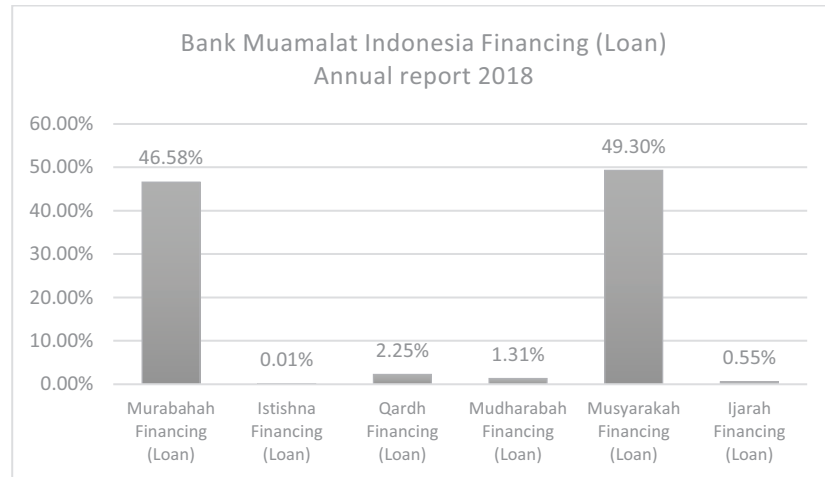


Figure 2: Bank Muamalat Indonesia (BMI) financing and distribution of loans

The largest types of loans made by BMI were *Musyarakah* loans, followed by *Murabahah* loans. These two modes of financing are very popular in Islamic banking practice, insofar as they are less risky than the other modes of financing, such as *Mudharabah*, which are prone to much higher risk, and, as such, should be avoided. In addition to these types of loans, BMI also explicitly offers the following types of loans:

1. *KPR iB Hijrah (Islamic Banking or iB residential mortgage)*
2. *Financing Pension iB Hijrah (iB pension)*
3. *Financing iB Multiguna Hijrah (iB multifunction)*
4. *Financing iB Asset Refinance Hijrah (iB asset refinance)*
5. *Financing iB Modal Kerja Hijrah (iB working capital)*
6. *Financing iB Modal Kerja Konstruksi Developer Hijrah (iB working capital for construction)*
7. *Financing iB Modal Kerja LKS Hijrah (iB working capital for LKS)⁵⁹*
8. *Financing iB Investasi Hijrah (iB investment)*

⁵⁹ LKS is Lembaga Keuangan Syariah or *Shariah* Banking Institutions, while *Hijrah* means to move away from dealing with an interest-based banking system to a *Shariah* banking system, which is ostensibly interest-free.

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9. *Financing iB Properti Bisnis Hijrah (iB property businesses)*
 10. *Financing iB Pembiayaan Rekening Koran Syariah Hijrah (iB Bank account financing)*
 11. *Financing iB Koperasi Segmen Konsumer Hijrah (iB co-operation for consumers' segment)*
 12. *Financing iB Multifinance Hijrah (iB multi-finance)*

These financing products are assessed by the *Shariah* Supervisory Board, whose responsibility it is to ensure that the distribution of loans and financing made by BMI is in accordance with the legal rulings or *fatwa* of the National Sharia Council - *Majelis Ulama Indonesia* (DSN-MUI).

Notwithstanding loans, BMI also contributed funds to charitable organizations for the sake of CSR, which amounted to Rp11.365.566.377 (as stated in its 2018 annual report) and comprised:

1. *Economic Social Trust Fund Rp130.577.815 equal to 1.15%*
2. *Education (Muamalat School of achievement) Rp3.170.725.000 equal to 27.90%*
3. *Humanity for fast reaction of Muamalat Rp3.038.264.066 equal to 26.73%*
4. *Humanity for infra-structure aid Rp3.883.566.000 equal to 34.17%*
5. *Humanity for human aid Rp1.053.699.896 equal to 9.27%*
6. *Humanity others Rp88.733.600 equal to 0.78%*
7. *Environment or Green Campaign Rp0 equal to 0.00%*

As part of its CSR agenda, BMI cooperates with Baitul Maal Muamalat (BMM)⁶⁰, to ensure that the distribution of CSR is effectively targeted and achieves the organizational objectives. The CSR agenda of BMI comprises four aspects: environment; workplace health and safety and employment practices;

⁶⁰ BMM) is a *Zakat* institution which was established by and remains affiliated to BMI, principally to organize and distribute *zakat* funds (*Zakat Maal*) to those who are eligible to receive *zakat*, or to help provide social and cultural needs, such as infra-structure, education, developing people's quality of life, etc., which is in accordance with Islamic law or the *fatwa* posited by Muslim scholars, especially the National Sharia Council or *Majelis Ulama Indonesia* (MUI).

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social and community development; and responsibility for goods and/or services, which are described in more detail below:

1. *Taking responsibility for economic goods and services, such as social trust funds.*
2. *Social and community development, especially via educational initiatives.*
3. *Humanity in the form of workplace health and safety and employment for*
 - (a) *fast reaction aid,*
 - (b) *infra-structure aid,*
 - (c) *cash gift-giving, and*
 - (d) *other kinds of humanity promotion.*
4. *Environmental preservation and conservation*

Figure 3 below presents the distribution of money channeled into CSR initiatives, as stated by BMI in its 2018 annual report.

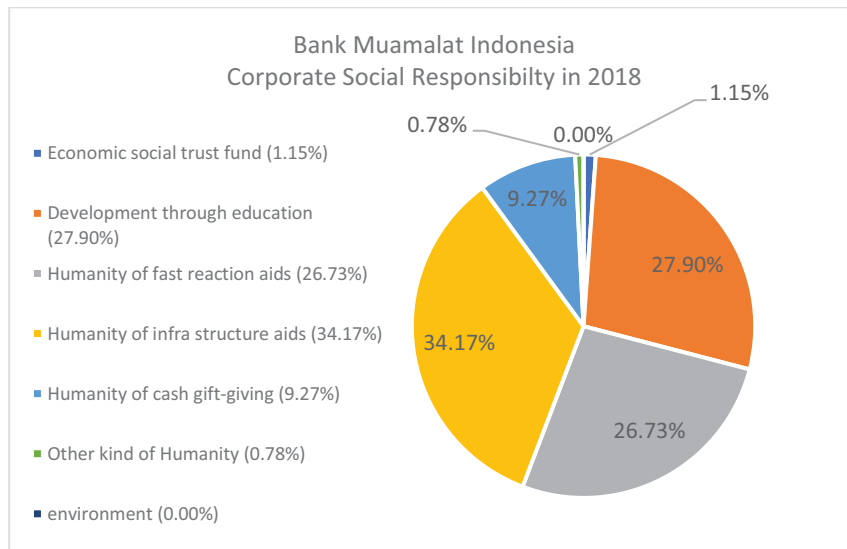


Figure 3: Bank Muamalat Indonesia (BMI) corporate social responsibility

The CSR remains an important aspect in how BMI builds a harmonious relationship with its various stakeholders. This harmonization can be accomplished through all parties displaying a strong commitment, with the

implementation of a CSR agenda being one of the ways to accomplish this mission.

It is worthwhile to note here that the highest percentage of Triodos Bank's loans are channeled into the environment (40%), followed by concern for social matters (23%), provision for residential sustainable mortgages (21%), culture (13%) and municipalities (3%), respectively. Conversely, the highest percentage of BMI's charity funds are channeled into humanity of infra structure (34.17%), followed by concern for development through education (27.90%), humanity of fast reaction aids (26.73%), humanity for cash gift-giving (9.27%), social trust funds (1.15%), other kinds of humanity (0.78%), and environment (0.00%), respectively.

It is understandable that BMI recorded its contribution towards the environment as zero, given that Indonesia is a developing country in which the prevailing belief is that environmental conservation and preservation is the responsibility of every individual as well as the state. In this respect, it is my contention that BMI is attempting to assert here that addressing the problem of environmental deterioration, climate change, depletion of natural resources, loss of biodiversity and extinction of the species is not the responsibility of BMI alone, but rather is the responsibility of each and every citizen as well as the Indonesian state. Although it is not clearly stated, BMI does contribute to environmental preservation; indeed, in its annual report, BMI states that via its CSR agenda it supports environmental campaigns.

How the Banking Business is Conducted and Value Creation

Every commercial organization has its own strategic planning, which directly informs how the business conducts its business in such a way that transforms capital input into values output, or the expected output that matches the stated organizational goals and objectives. According to their 2018 annual report, Triodos Bank's strategic planning and business model is as follows.

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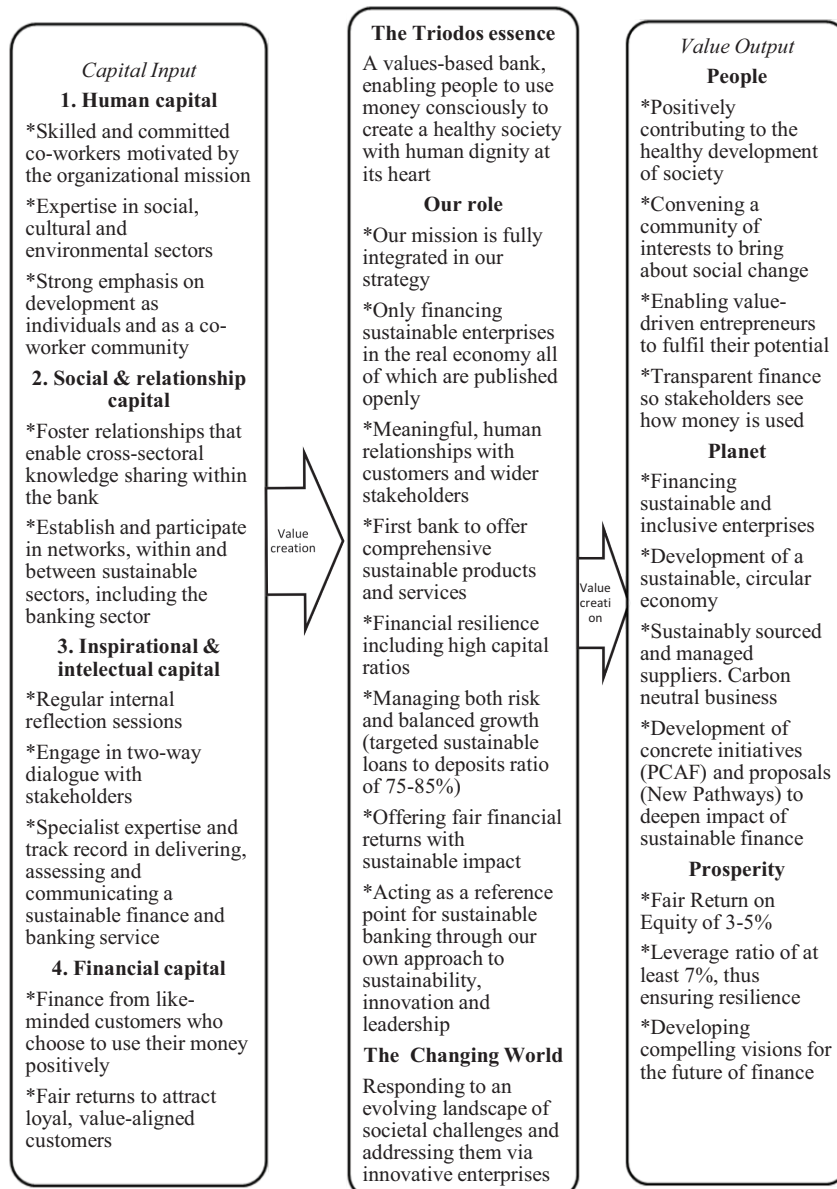


Table 5: Triodos Bank Strategic planning and business model

The above strategic planning and business model developed by Triodos Bank can create values by transforming capital inputs into value outputs. These inputs

include the skills and entrepreneurship of the people within the Triodos organization itself, as well as savings and deposits from customers, and via Triodos' core products and services. It transforms these inputs into value outputs, so that they make a positive contribution to the development of a healthy society and green environment, so that they be able to progress and flourish on earth and within our planetary limits (Triodos Annual report, 2018). Triodos has a clear business strategy so that it can be more resilient in the long-term, which includes using deposits rather than borrowing from other banks to lend to sustainable enterprises. It maintains a healthy balance between loans and deposits and healthy levels of capital, which are well above regulatory requirements.

BMI conducts its banking business in such a way that is guided by its core values, when transforming capital input into value output through the financial products and services that it offers to its customers and organizations that match the objectives of Islamic economics. In so doing, BMI establishes the following core set of values, namely: Islamic, modern and professional.

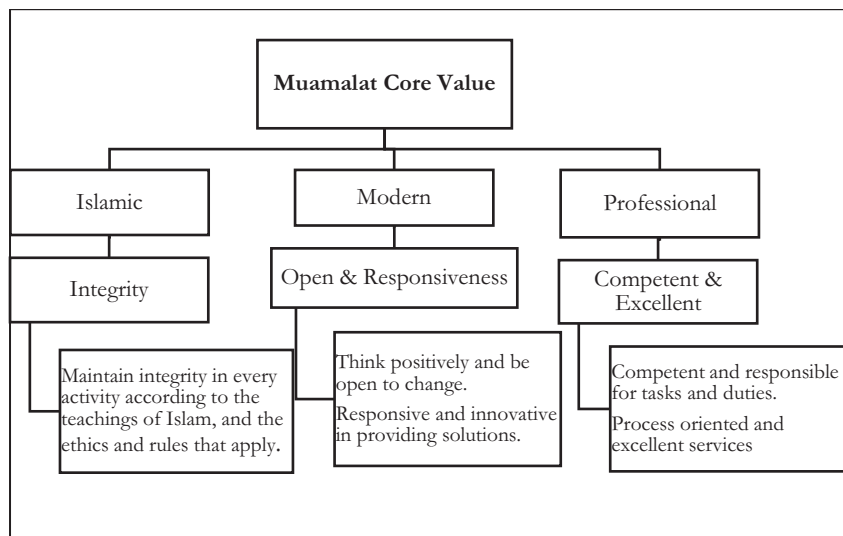


Table 6: Bank Muamalat Indonesia (BMI) core set of values

In a similar vein to how Triodos Bank conducts its banking business and creates value, BMI transforms the capital input that consists of human and

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financial capital and social and cultural capital into value output through financing mechanisms that are in accordance with Islamic law, which embodies an Islamic ethical value system in order to realize the value output. The value output can be seen in its annual report, such as contributing towards enhancing people's quality of life, promoting greater prosperity for the organization, as well as its employees, shareholders, stakeholders and the surrounding community and environment. However, it does not state clearly how it contributes to the planet in terms of environmental conservation.

Monitoring the Use of Funds or Loans

Triodos Bank's lending practices are primarily focused on small and medium-sized enterprises (SME) or small and medium-sized business organizations and social organizations and charities. The rationale for this is that allows them to both maintain a close connection with and monitor the people who run these organizations, alongside helping allowing them to track how a loan is actually being utilized.

By using this kind of mechanism to channel and lend money, loans are thus able to be made in such a way that allows Triodos Bank to monitor, such as when financing a specific asset. Triodos Bank is also concerned with sustainable development, and although they also lend money to larger businesses and initiatives whose primary focus is not necessarily on bringing about positive social and environmental value, these organizations are nevertheless expected to operate specific projects or assets that are clearly and directly connected to sustainable sectors and sustainable activities.

Such monitoring is conducted to ensure that loans meet the objectives set out in Triodos Bank's core mission, as well as to guarantee that loans are being used in real economic activity.

Similarly, BMI also conducts monitoring on the funds (loans) that it lends to its customers and to organizations, primarily in terms of whether they are compliant with Islamic law and viable (less risky) to do business with.

However, there is a specific mode of financing in which Islamic banking is unable to intervene and monitor the projects or businesses of the second party,

namely *Mudarabah* contracts, which explains why they are infrequently used in Islamic banking.

In contrast to *Mudarabah* contracts, which make it very difficult for Islamic banking to closely monitor the use of funds (loans), the other mode of Islamic financing, namely *Musharakah* contracts, gives Islamic banking the right to monitor both the use of the funds and the operations of the business.

This is analogous to what one sees in ethical banking, insofar as the financing activities in Islamic banking are clearly connected to sustainable sectors or economic activities that are congruent with the bank's mission, and correspond to the broader objectives of Islamic law, which is to promote well-being, bring about benefits and prevent harm, to deter hardship, and, of course, that they should be connected to and used in real economic activity.

Before bringing this chapter to a close, let me first describe and clarify the points of similarity and difference between Triodos Bank and BMI with respect to their banking practices and financial transactions.

5.5 The Similarities Between Triodos Bank and Bank Muamalat Indonesia (BMI)

The similarities between Triodos Bank and BMI can be discerned from their annual report. Below, I discuss the main similarities between the two modes of ethical banking, beginning with the fact that they both have an internal Supervisory Board.

Internal Supervisory Board

Triodos Bank has a Supervisory Board, whose responsibility it is to supervise and review the activities and decisions made by the Executive Board. Alongside this, The Supervisory Board also supervises and reviews Triodos Bank's operations. The Supervisory Board is also engaged at an early stage in formulating the strategy for realizing Triodos Bank's mission. Finally, the Supervisory Board monitors Triodos Bank's business operations and advises the Executive Board, for the purpose of benefitting the bank's business interests.

BMI has the *Shariah* Supervisory Board, whose duties and responsibilities are to assure that the Bank is operating in accordance with *Sharia* values as well as the principles of Good corporate governance. To meet these requirements, the

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Sharia Supervisory Board actively engages in a series of meetings, including their own internal meetings, meetings with the Board of Commissioners and Board of Directors, as well as meetings with the Senior Management who are positioned just below the Board of Directors in the organizational hierarchy. The *Sharia* Supervisory Board also reviews the Standard Operating Procedure (SOP) and policies of the Bank, in order to provide recommendations and sharia-based opinions.

Value Output Banking Approach in People, Planet and Prosperity (profit).

Both banks are environmentally-friendly, green and committed to sustainable practices that seek to enhance people's quality of life, enrich the environment and surrounding social community, as well as preserving the long-term sustainability of their own organizations.

SME Financing and Risk Management

Both banks are dedicated to supporting the economic development of SME, although they also finance large corporations; particularly in the case of the latter, the banks ensure that these organizations are operating in accordance with the respective values of the Bank, which is done through monitoring the use of funds (loans).

Notwithstanding this, to ensure the sustainability of their operations, both Triodos Bank and BMI have internal mechanisms for monitoring the risk associated with their banking businesses and financial transactions, as well as for ensuring that they are compliant with their ethical value systems. BMI does this by setting up a risk monitoring committee and *Shariah* Supervisory Board, while Triodos Banks also sets up a risk management committee to ensure the long-term resilience of their business.

Corporate Social Responsibility (CSR)

Unquestionably, both banks have implemented CSR agendas within both their banking business operations and financial transactions, which is reflected in their value outputs. Good corporate governance, transparency, accountability, professionalism, fairness and caring about people's dignity and quality of life, social and cultural welfare, as well as showing concern for the planet and

environment are the primary ways through which the two banks seek to realize a healthy and sustainable banking business within a competitive market. This is reflected in their compliance with the applicable provisions and commitments from the financial services authority and/or other parties, ethical values and moral norms, as well as BMI's compliance with Islamic law and adherence to the Islamic ethical value system.

5.6 The Differences Between Triodos Bank and Bank Muamalat Indonesia (BMI)

Given that both banks claim to implement ethical values and moral norms within their respective operations, the differences between them are limited, with the exception that Triodos Bank operates within an interest-based banking system and explicitly expresses concern for the environment in its 2018 annual report.

Below, I delineate the primary differences between Triodos Bank and BMI, based on my analysis of their respective annual reports from 2018.

Interest-based Banking System vs PLS principle

As aforesaid, Triodos Bank is an interest-based banking institution that is predicated on an ethical value system that can be traced back to Greek philosophers and Western moral philosophical thought, and seeks to realize these ethical and moral values in its business operations and financial transactions.

Conversely, BMI operates on the PLS principle, which is based upon Islamic law, and strives to adhere to the Islamic ethical value system and moral norms in its business operations and financial transactions. I have discussed the PLS principle and Islamic value system at length in the previous chapter, where I raised concern over whether, in fact, the PLS principle is truly an interest-free banking practice or if it is merely functions in precisely the same way as interest, but does so in a disguised form.

Concern for the Environment

Triodos Bank clearly states its concern for environmental conservation in its integrated financial report and balance sheet within its 2018 annual report. The same cannot be said of BMI, as the bank's annual report and financial report and

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balance sheet, as well as its CSR report, make zero mention of contributing to the environment.

Conversely, Triodos Bank believes that profit ought not to be at the expense of environmental degradation and deterioration. It believes that culture is a powerful force for positive change, driving creativity and innovation within the business sector, as well as providing lasting opportunities for personal development. It also explicitly states that it has a fair return of between 3-5% on assets or returns on capital or profitability, while there is no mention of this in the annual report of BMI. One argument is that, since BMI is operating within a developing country, environmental concern is simply not a priority and, in fact, is somewhat neglected. Above all, BMI is focused on the profitability; existence and sustainability of their corporation, rather than focusing on how they as a company can contribute towards environmental conservation and improvement, as it is not only the responsibility of Islamic banking to contribute to the environment in a developing country, but rather is the responsibility of everyone, as well as the state.

These are the key similarities and differences between Triodos Bank Netherlands and BMI. Previous research has also compared Islamic banking in Bangladesh to Triodos Bank Netherlands (Tariqullah Khan & Amiirah, 2017). More specifically, the authors compared Islamic Bank Bangladesh limited (IBBL), which is the best Islamic bank in Bangladesh, with Triodos Bank Netherlands, and concluded that “Triodos Bank has some significant leads over IBBL regarding ethical practices, since it only promotes sustainable businesses” (Tariqullah Khan & Amiirah, 2017).

From the above investigation of Triodos Bank and BMI, I would contend that Islamic banking is therefore in need of ethical reform and more strict ethical adherence to Islamic ethical values and moral norms, as opposed to merely sticking to Islamic legal ruling, and that Triodos Bank serves as an exemplar for BMI to follow.

5.7 Conclusion

It is interesting to compare Islamic banking and conventional ethical banking, for the simple reason that both claim to be embed ethical principles at the core of their banking businesses. Islamic banking operates on the basis of Islamic

law, which by its very nature embodies Islamic ethics, while conventional ethical banking has been proven to be ethical, insofar as they are found to be in compliance with the criteria established by FEBEA. Interestingly, the criteria outlined by FEBEA is actually in line with Islamic teaching and Islamic ethical values and moral norms, with the exception of applying interest.

The investigation presented in this chapter shows that there are more similarities than there are differences between the two types of ethical banking. Both try their utmost to transform capital input into values output, in terms of promoting human dignity, improving people's quality of life, building good relationship with their customers or partners to create a better environment and healthy community in the social and cultural sphere. Moreover, both attempt to create sustainable businesses and transform the capital input in the real economy as much as possible by avoiding the practice of speculation, gambling, uncertainty, as well as by banning any kinds of businesses that harm people, animals and the environment, or what FEBEA refers to as non-sustainable products and services and non-sustainable working processes.

The chief difference between the two banks concerns the fact that BMI claims to be an interest-free bank, while Triodos Bank operates within an interest-based banking system, albeit it does so very carefully so that the interest will not be burdensome for its customers and partners when running their businesses. In addition to that, for Triodos Bank, returns on assets and capital or profitability is not their primary purpose (they set fair profitability at around 3 to 5%); rather, they are primarily concerned with how they as an institution can contribute to humanity and sustainability and environmental conservation, which cannot necessarily be said of BMI.

Another difference pertains to Triodos Bank's concern about the environment, which is explicitly stated in its integrated financial assessment within its 2018 annual report; once again, there is no such mention of environmental concern in the 2018 annual report of BMI.

The final differences concern how the two banks implement their CSR agenda; Triodos Bank undertakes its CSR agenda by integrating everything within the Bank itself, while BMI implements its CSR agenda by setting up a subsidiary company or affiliated organization, that is, BMM, which is ultimately responsible

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for carrying out philanthropic activities, including collecting and distributing *Zakat*.

Therefore, the conclusion of this chapter is that Triodos Bank is superior to BMI with respect to ethical banking, especially when it comes to the cultural environment, ethical system and moral norms. This is due to the fact that Islamic banking is more concerned with complying with Islamic law than it is with adhering to Islamic ethical values. In other words, while Islamic banking should be striving to go beyond Islamic law, Islamic banking is de facto failing to adhere to Islamic ethical values. Ultimately, this failure to adhere to Islamic ethical values means that Islamic banking is deviating away from doing the right thing, since doing the right thing is a matter of realizing values, which I will discuss in the next chapter through recourse to Klammer's model of realizing values and doing the right thing.

Another way in which Triodos Bank can be said to be superior to BMI, is in terms of how Triodos Bank explicitly states how it consciously transforms the capital input into value outputs. Alongside this, Triodos Bank also explicitly acknowledges its concern for environmental conservation and to create better living organisms in the universe is within its integrated financial statement and annual report. From my own perspective, I consider this commitment to be significant in terms of combating and reducing environmental deterioration, depletion of natural resources, loss of biodiversity, as well as the extinction of the entire species, in addition to helping create better living organisms and achieve a harmonious life between living beings in the universe.

The aforementioned strengths of conventional ethical banking qua Triodos Bank Netherlands in comparison to Islamic banking qua BMI, in terms of fair profitability while maintaining low costs, environmental conservation and integrated CSR and better implementation of practices designed to benefit the cultural environment, which, in part, derive from the cultural environment and ethical system in which Triodos Bank operates, makes it superior to BMI.

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6. Islamic Banking and the Klammer Model in Realizing Values and Doing the Right Thing



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6.1 Introduction

Islamic banking is part of Islamic economics and is based on the philosophy of justice, equity and morality. It is ostensibly a self-conscious and value-oriented practice that aims to incorporate ethics and religious insights into its theories and practices by virtue of placing religion as the source of its ethical values. The overall mission of Islamic banking is to help establish a just social order, as well as ensuring socio-economic justice, a fair and equitable distribution of income and wealth and the moral well-being of the entire community. This mission of Islamic banking is the ideal that Islamic banking should thus be striving towards, which also encompasses the values and virtues that it wants to realize. In this respect, the Islamic banking's founding principles and ethos can thus be said to differ, and, indeed, they ought to differ, from the spirit of conventional banking, which is instead based solely on income generation and wealth and profit maximization.

Their ideals stipulate and demand that Islamic banking should not base the measurement of their organizational performance solely on the conventional criteria of financial profitability, but rather also on the social benefits that they produce. That is to say, they should measure their success in terms of how their core values are incorporated and realized in the process of conducting their economic activities. This is of paramount importance, because neglecting values, whether they be cultural values, moral values, religious values, will only direct economics and the economy in the wrong direction and make economic analyses incorrect (McCloskey, 1996; Klammer, 1983; Taylor, 1991).

The ideal of Islamic banking is predicated on the core principles of Islamic law, which, as aforesaid in Chapters 2 and 3, by its very nature embodies ethical principles and thus cannot be separated from one another. The objective of Islamic law (*Maqasid al-Shariah*) is to promote human well-being, to produce benefits and deter hardship, and to prevent harm (Al-Ghazali, 1937). He (Al-Ghazali) also defines *Maqasid al-Shariah* in his book of "*Ihya Ulum al-Din*", as noted by Visser (2019), the safeguarding of:

- (a) people's religion, which is broadly defined as their way of life
- (b) their life or soul
- (c) their family or offspring

-
- (d) their property or wealth
 - (e) their intellect or reason, which is also interpreted as their dignity.

The *Maqasid al-Shariah* constitutes the core principles of Islamic law, which, ultimately, govern and underlie the characteristics and operations of Islamic banking. Some of the underlying characteristics and operations of Islamic banking can be traced back explicitly to specific prohibitions within Islamic law, namely: the prohibition against uncertainty or ambiguity in contracts; the prohibition against speculation, oppression and gambling, which leads to the elements of exploitation and unjust practices in the economy; the ban on immoral business activities and investments, such as the production and sale of alcoholic drinks, hoarding, pornography, harmful commodities, destructive products; and the prohibition against dishonesty and deceptive practices. As well as these aforementioned series of prohibitions, Islamic law also ensures the protection of rights and ownership, adherence to profit and risk-sharing or reward and risk-sharing, as well as the fulfilment and sanctity of contracts. With respect to the prohibition against the concentration of wealth in the hands of the few, Islamic banking sets out to avoid such practices via the redistribution of income and wealth through banking and financial mechanisms (Chapra, 1992)

However, in the case of *Bank Muamalat Indonesia* (BMI), the redistribution of income and wealth is undertaken through banking and financial mechanisms by BMI, as well as by way of charity and alms tax or *Zakat*,⁶¹ which is actually performed by *Baitul Maal Muamalat* (BMM), a subsidiary of BMI. Hence, BMI translates and interprets the Quranic teaching⁶² into its practices and operations by setting up BMM to redistribute wealth through charities and alms tax or *Zakat*, which it received from Muslim customers who are obliged to pay alms tax or *Zakat*.

Despite the fact that some authors are critical of the effectiveness of *Zakat*, on the grounds that it only contributes a small portion of the redistributed wealth

⁶¹ See Annual Report 2018 Bank Muamalat Indonesia (BMI).

⁶² The *Quran Surah al-Hashr* (QS, 59: 7) "...So that wealth does not concentrate in the hands of those who are rich among you...".

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and brings in low amounts of money (Visser, 2019), others argue that *Zakat* should not be seen as a replacement for tax per se, but rather a mechanism through which Muslim society provide a safety net for the poor and the destitute (Chapra 1992).

In addition to this, Islamic banking was established with the express objective of helping to realize a just social order, socio-economic justice, and the equitable distribution of income and wealth. Moreover, it should strive to continuously endeavor to reduce the human and civilizational crisis in the social and cultural spheres, in the form of environmental degradation, climate change, depletion of natural resources, extinction of species, economic instability, famine and widespread social unrest resulting from human foolishness and misdeeds (as discussed in the previous chapter).

It is therefore important for Islamic banking not to sacrifice these important principles or values merely for the sake of increasing profit, to solely focus on the market sphere, or to observe and obey the governmental sphere, while, simultaneously, forgetting the home, social and cultural spheres. This is because these other three spheres also provide avenues for Islamic banking to strive towards the good and achieve their ideals by realizing important and relevant values and doing the right thing.

Klamer's five sphere model puts forward a worldview that inspires us to look beyond market and governmental spheres, which are seen as the common practices of commercial organizations (business entities), and as being prevalent across the globe. Conversely, Klamer encourages us to recognize the human role, not only as individual and social beings but also as cultural beings, whereby the value of social and transcendental relations plays a significant role in daily life, as well as in terms of the values of the market, profitability and utility.

In this regard, I view Klamer's model as providing a blueprint for how to achieve harmony and balance in life as human beings, that is, how to strike a balance between individual self-interested behaviour in the market [M] sphere and altruistic behaviour in the social (S) + cultural [C] spheres, the profitability and sustainability [M] + [G] of individual and organizational life and the life of other creatures and the broader environment [C]. Of course, in order to perfect Klamer's model, we need to have developed a good personality or have become an

integrated person, or even a religious person in the home sphere or the *Oikos* [O], all of which are embedded in the cultural [C] sphere.

Without a clear picture of those spheres, we are unable to make sense of personal, social and cultural goods, and will thus fail to get a clear understanding of how artistic, scientific and religious practices, among other things, are to work in our life (Klamer, 2016). This is because what matters most to many people is market and governmental logics in the market [M] and government [G] spheres. From my perspective, Klamer's model is a comprehensive approach to a value-based economy, specifically with regard to realizing values and doing the right thing.

Doing the right thing is a matter of realizing our values, and to realize our values we need to acquire goods. These goods can be tangible, such as tea, coffee, rice, meat, milk etc., or intangible like ideas, love, friendship, honesty, and so on. Ultimately, it is these goods that enable us to realize values. A value-based approach to the economy is about the realization of values. It is not merely about the calculation of the most economical application of a means to a given end, such as maximizing efficiency, maximizing returns on capital and asset, and maximizing returns on profit, etc., as the sole measure of success and development, but rather is concerned with how values are incorporated and realized in the process of carrying out these very economic activities.

In this respect, values can be understood as both the product, and the qualities, of our engagement with the world around us and the people who inhabit it, which is to say that they are the product and qualities of social interaction and social construction. Consequently, values are relational concepts, insofar as they do not stand for themselves, but rather have to be related to other things. In other words, because values are abstract, they must be acted upon and, indeed, only come into being via the interactions between people and the interactions between people and things. We value things, or the characteristics of things, in comparison with other things (Klamer, 2016). However, despite the fact that values are an abstract notion as opposed to objective facts, they nevertheless play an integral role in terms of conditioning and directing people towards acting and behaving in accordance with these values.

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For Klamer, values serve an important function in everyday life. Values play a critical role in our relationships and interactions, which testifies to their social or cultural character (Klamer, 2003). Consider, for example, the value of trust: Fukuyama (1995) purports that business relations between people in prosperous countries tend to be based on trust, such as in Germany and Japan, and, hence, the value of trust is a key component of how market economies function. This is because trust is a value in and of itself, as well as being a shared good that is inherent to certain relationships (Klamer, 2016).

In this chapter I want to explore and investigate Klamer's five sphere model, which he delineated in his book: "*Doing the right thing; a value-based economy.*" More specifically, I set out to examine the extent to which Islamic banking operates in accordance with this model as part of doing the right thing. The objective of this chapter, and the thesis as a whole, is the same as that outlined by Klamer (2016) in his aforementioned book:

My objective is a moral one as it is my purpose to figure out what is the right thing to do. What is the right strategy for the realization of values? I offer the model of the five spheres to inform worldviews of people and organizations seeking the right thing to do (Klamer, 2016 pp.143).

Based on this model, I will also argue that in order for commercial organizations such as Islamic banking to do the right thing, it has to operate in accordance with these five spheres in order to realize its espoused Islamic values and do the right thing. That is to say, it must go beyond merely market and governmental logics, as they alone are insufficient for realizing their values, to instead embrace the home, social and cultural spheres. I will begin my investigation and analysis in this chapter by providing a prologue on Islamic banking and the Klamer model, followed by a discussion of Islamic banking, the market sphere and market logic, governance sphere and governance logic, followed by a discussion of the respective logics of the home, social and cultural spheres.

6.2 Islamic Banking and the Klamer Model

Doing the right thing is a matter of realizing values. The realization of values, in turn, signifies and calls for the valorization of values and being

cognizant of them. In order to valorize values, we must make them (relevant values) real, which involves engaging in a specific practice or even multiple practices (Klamer, 2016). Valorization is thus an inherently social process, insofar as it requires others to recognize and be interested in the values that we generate or offer to them.

Within standard economics, valorization designates the realization of money, when sellers succeed in selling their goods to buyers for a certain price agreed by both parties. Sellers offer goods for a particular price with the expectation that other people are willing to pay this price in exchange for the goods. Here, the law of supply and demand prevails, and, ultimately, it is price which rules the market.

In this sense, for banking institutions, valorization involves providing financial services that are attractive and valuable to other people, which, in turn, allows banking institutions to perform their financial intermediation by either receiving funds from depositors and then lending them out to borrowers or receiving money and deposits from people with disposable income and channeling them towards those who do not have enough money to carry out a desired activity or to invest in projects or businesses. This valorization of banking institutions in the market is simply done by lending out money at slightly higher rates of interest, while, simultaneously, receiving money on savings and deposits by paying lower rates of interest to generate profit.

This is the logic of the market, whereby private goods are traded, and economic agents are driven by self-interest and the maximization of profit and satisfaction. However, when market logic ceases to function well or veers in the wrong direction and becomes unstable and unjust, then governmental intervention is required to stabilize the market and redirect market mechanisms along the right path.

However, the market sphere alone does not suffice in terms of doing the right thing, and thus we need the governmental sphere (governance) to provide something that the market itself cannot provide, such as law and order, regulation and procedures, public goods, such as roads and other public infrastructure, as well as, among other things, a judiciary system in the form of rewards and punishment. These two spheres are also not enough in and of themselves to do the right thing, and thus require the three additional home, social and cultural sphere. Let me

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continue to investigate and elaborate on how Islamic banking fits into and operates within each of the five spheres needed to realize values and do the right thing.

6.3 Islamic Banking, the Market [M] Sphere and Market Logic

The market [M] sphere is good for commodities, and other tangible and intangible goods and services that we need in order to realize our values. The market does not deliver shared goods and ultimate goods, such as a good family, knowledge, art, or enlightenment. In this respect, the market is usually not good for the realization of collective goods (Klamer, 2016). Within standard economics, the market is seen as the main option through which to valorize goods. Valorization in the market sphere implies the realization of an amount of money in transactions with others, which is referred to as price. Valorization requires that others are interested in our goods, that is, that they recognize that this particular good is good for them, and that it is valuable and worthwhile to them.

In the market sphere, the price of a good is its exchange value, and is the answer to the perennial question: “how much does *that* cost?”. In this sense, standard economics wholly equates value with price. Ultimately, it is the price of thing that determines whether or not it is worthwhile and valuable. Simply put, the price of things corresponds to the willingness of someone to pay an agreed price in order to acquire those things (Klamer, 2016).

The market regulates by means of prices and financial rewards, which is to say that the market rewards those who are efficient in their production, able to offer good commodities, and thus generate profit, while, simultaneously, punishing those who are inefficient and just breaking-even or suffering losses by driving them out of the market. The market thus can be said to punish bad ideas and bad products, and reward good ideas and products, thus making good entrepreneurs rich and casting others into poverty. This is why economists like to say that the market provides incentives to do the right thing, without the involvement of any kind of authority or government (Klamer, 2016).

Given that the prevailing logic in the market sphere is predicated on market mechanisms and the free market system in which supply and demand is what ultimately determines the price equilibrium, market can be said to be ruled by price. The market mechanisms demand competition and efficiency, for the simple

reason that inefficient businesses will be driven out of the market. It is this competition which is said to foster innovation and creativity. Therefore, the realization of positive values come about when markets are efficient and are able to stimulate creativity, innovation, effectiveness, entrepreneurship, fair trade, honesty, just treatment, and so on and so forth. Markets are also thus instrumental to the realization of material welfare, in the sense that everyone is encouraged to offer the best possible goods to gain entry into the market, whether in the form of creativity, innovation and development of goods and services as well as in terms of efficiency, so that efficient businesses will be rewarded and inefficient ones will be punished by being driven out of the market. These rules of the game are supposed to make everybody better off in the market sphere.

In its capacity as a financial intermediary, Islamic banking, theoretically at least, channels savings into investments. The funds flow from those who have surplus funds to those who have a shortage of funds through banking mechanisms and the financial system (Miller & VanHoose, 1993; Luckett, 1984). It is believed that the financial system is closely linked to economic performance, in that economic growth and development creates demand for particular types of financial arrangements, which the banking and financial system then automatically responds to. When the economy is booming, this tends to increase the demand for more money for investments, for greater productivity, as well as boosting the volume of products and commodities that are produced in order to meet the growing demands of consumers as result of an increase in income level.

In this case, if there exists excess demand for money in the market, then it would likely lead to either a rise in the rate of return (interest rate for Islamic banking) or an increase in the interest rate offered by banking and financial institutions. This, in turn, will likely contribute towards inflation. This happen because demand for money shifts out the demand curve when the nominal level of output increases. When the quantity of money demanded increase, the price of borrowed money (interest rates) also increases, and causes the demand curve to increase and shift to the right. Inflation will happen, because people and financial institutions expected inflation to happen. In this case, lenders demand a higher interest rate to compensate for this inflation, and borrowers are willing to pay a higher rate because inflation reduces the value of the money they repay. Thus, an increase in expected inflation increases interest

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rates. While this does not matter if it is only slight inflation, however, if it leads to high inflation then the government has to intervene to correct the market. This is because the logic of the market is driven by individual self-interested behaviour and the maximization of profits and satisfaction.

However, for Islamic banking to truly do the right thing, it has to keep applying and realizing positive values within the market sphere, while, simultaneously, via its banking and financial systems striving towards the attainment of its ideals, namely, maintaining the balance between organizational interests and social interests. That is to say, Islamic banking must balance the profit motive with providing a host of social benefits to the wider community and environment. In this case, it is recommended that Islamic banking not worsen the situation during periods of inflation, by following the market logic to either increase interest rates or the rate of return solely to increase profitability, without paying due consideration to other socio-cultural factors, especially those who are marginalized and destitute.

Islamic banking thus must not give into the prevailing profit maximization practices of conventional banking within the sphere of market, in the sense that they should not get rid of unprofitable but socially beneficial lines of business or investment, reduce the workforce in order to cut costs, in turn, contributing to unemployment, or moving away from providing microfinance in order to empower underprivileged people, even during periods in which the economy is constricted. It should not do succumb to merely market logic, because Islamic banking (Islamic economics) is predicated on justice, equity, morality, and the fair and equitable distribution of income and wealth, as well as the building of a just social order and provision of socio-economic well-being to the whole community, while, simultaneously, eliminating the values of greed, exploitation, and the violation of human rights and dignity.

Leaving the underprivileged and marginalized people out of the market and having no access to market and financial dealings, is not the good Islamic banking should be striving towards. Neither is it the right thing to do to invest money in profitable, but ultimately socially harmful and destructive products/services, which lead to the degradation of the environment, depletion of natural resources, the loss of biodiversity and extinction of the species. It is not good to lay off

employees in order to cut costs and increase profit, especially during economic crises. It is not good to strive towards investment decisions purely being based on financial criteria, such as risk and returns. Rather, it is important that Islamic banking strives towards those goods that help it achieve its ideals, and which embody their core Islamic values.

It is therefore important for commercial organizations like Islamic banking to go beyond the market sphere and market logic to realize their values and do the right thing. Moreover, the free-market system does not always function well, and requires governmental intervention to direct the market back along the right path, when it veers in unexpected or wrong directions. At this juncture, I will now consider the government (governance) [G] sphere, governmental logic and Islamic banking.

6.4 Islamic Banking, the Governance [G] Sphere and Governance Logic

The governmentality or governance [G] sphere is good for the realization of a range of public or social and societal values, including, among other things, justice, security, education, healthcare, public infrastructure, public transport, and so on. State leaders, such as politicians and governors, are always looking for what mechanisms are best to get people to do the right thing politically and economically, how to prevent them from abusing subsidies and welfare provisions, to encourage people to be efficient, productive and creative, innovative and entrepreneurial, and motivate them to do the right thing (Klamer, 2016). This requires politicians, governors and state leaders to provide people with good examples and even serve as exemplars themselves of positive values.

In contradistinction to the logic of the M sphere, whereby market mechanisms work automatically without the involvement of any authority and does not restrict the freedom of anyone who participates in it, the logic of the governmentality or governance [G] sphere is a more formal logic based on rules and regulations, standard operating procedures and laws. The logic of G is administrative and bureaucratic, in the sense that it is the logic of control, the logic of structure, or predictability based on the previous performance and reports, such as financial reports and other organizational reports.

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Within this G logic, the government can enforce the legal measure through a variety of rules and regulations, including protecting property rights, anti-trust laws, prohibition of insider trading and anti-dumping regulations, in order to ensure the values of equality, justice and fair play. It is not meant to limit individuals' freedom, insofar as individual freedom is limited by the freedom of other individuals. This enforcement of moral rules within legal measures does limit the available choices, but it does not reduce the freedom of people in the free market; in fact, it is the very thing that ensures the existence of a good and positive free market (Van Staveren, 2007).

The logic of G regulates through the means of rules, procedures, laws that everyone must follow, and makes use of the judiciary system if necessary, by providing rewards and punishment. This is the logic of how the government works, and, moreover, of how commercial organizations work, including banking and financial institutions. Therefore, the logic of the governmental (governance) sphere also applies to organizations, which is the case with Islamic banking in Indonesia where the Islamic banking authority sets rules for employees to follow; for example, there is a dress code for female employees stipulating that they wear attire that is in accordance with Islamic ethics, such as wearing a headscarf (*Hijab*).

In the governance [G] sphere, when we take business organizations into account, such as Islamic banking, it becomes evident that this sphere involves more than the market [M] sphere. This is because our interactions largely take place both within organizations and with organizations, inasmuch as we typically spend five days a week working and receiving a salary from organizations. In this sense, the influence of the governance [G] sphere is pervasive in our everyday lives. We are ruled and regulated by them, we receive income or benefits, we pay taxes and fines, and so on and so forth (Klamer, 2016).

Resultantly, one could argue that the governance [G] sphere becomes even more dominant when we take business organizations into account. They operate in accordance with the G logic, they have bureaucracies that assign functions to their employees, they have their own standard operating procedures within their systems and operations, and work in accordance with all kinds of rules, procedures and contracts. Simply put, they all stand for what one could call a 'managerial culture' (Klamer, 2016), which is represented by the fact there is a dress code for

female employees within Islamic banking stipulating that Muslim women wear headscarves (*Hijab*) in their workplace. Generating a fair profit is necessary for the long-term sustainability of the bank, insofar as it contributes towards social benefits as opposed to maximizing profits, as seen in the example of Triodos Bank Netherlands, which applies a fair profit margin of 3–5%.

Within the G sphere, both management (directors, managers) and shareholders have influence over shaping the organizational culture through the imposition of rules and regulations. Managerial culture generally derives from the organizational culture or broader national culture, which strongly influences organizational behaviour and performance, as well as how all personnel within the organizations behave.

Islamic banking and corporate culture in the G sphere

Corporate culture has a strong influence over the behaviour of all employees within commercial organizations, and Islamic banking organizations are no different in this respect, insofar as their corporate culture also influences and shapes firms' performance (Kotter and Heskett, 1992; Robbins and Judge, 2011). For Islamic banking organizations, Islamic values are an inherent feature of their corporate culture. Hence, it is the task of management to translate and embed Islamic values within their organization's corporate culture. This is because corporate culture refers to a system of shared meaning that is held by members of commercial organizations, which serve to distinguish them from other companies or commercial organizations (Robbins, 1998; Kotter and Heskett, 1992; Robbins and Judge, 2011). This corporate culture can take the form of rules and procedures imposed upon employees either from the managerial level or from the shareholders of the commercial organizations, such as is the case in Islamic banking.

There are distinctions in terms of the focus, emphasis, purpose and services provided between commercial organizations and governmental (state) organizations in the G sphere. This is because every organization has its own corporate culture, which comprises the soul and character of that organization (Islamic banking) and shapes the daily activities within these organizations (Hofstede and Minkov, 2010). Each type of organization has its own distinct

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characteristics, including social and cultural organizations. According to Klammer, these are (Klammer, 2016):

Governmental organizations. Generally speaking, this type of organization serves the public interest or societal purposes. It aims to make improvements to the quality of life in both the social and home spheres. It also sets up rules and regulations in the market and governmental spheres.

Commercial organization. This type of organization is profit-oriented and thus focuses on the respective logics of the market and governmental spheres. From the perspective of standard economics, it can be said to try to maximize profits and satisfaction for its shareholders.

Social organization. This type of organization is a non-profit organization that seeks to realize social or societal goods, both for their stakeholders and for the surrounding community. An NGO is a typical example of this kind of organization, as well as an Islamic boarding school in Indonesia called *Pondok Pesantren*. Despite being a non-profit organization, it also tries hard to improve the quality of life in the governance [G], the social [S] and home [O] spheres.

Cultural organization. This type of organization aims to realize cultural or artistic goods for their stakeholders. An example of such an organization is museums, music bands and orchestras. This is because they (the people who belong to that organization), want to realize cultural values and inform the public about their goal, by establishing this type of organization, such as in the example of “music of dangdut”, which is a popular type of music in Indonesia.

Of course, in order for these organizations to distinguish themselves from each other, they all require a variety of goods that they must generate in order to realize values to achieve their ideals.

However, since commercial organizations are operating in the market, that are selling and buying, producing and consuming, as well as being players in market mechanisms, the influence of the G and the M spheres are both pervasive. Therefore, I deem that they both carry more or less the same weight.

Since commercial organizations are profit-oriented, the logic of commercial organizations in the G sphere is that of profit generation, which is the same as that

in the M sphere; moreover, their purpose is instrumental in the sense that they are seeking maximum financial gains from the perspective of standard economics. However, for Islamic banking, it is not necessary to do this, because the spirit of Islamic banking is not only about profit generation per se, but rather also about social responsibility by contributing to a wide range of social causes, such as a just social order, morality, equitable distribution of income and wealth, socio-economic justice and well-being for the entire community which are more important than merely seeking profitability.

For Islamic banking institutions, when operating within the G logic, such as by engaging in administrative and bureaucratic assignments, they must do so in accordance with Islamic law, which provides the standard operating procedures for their systems and operations, as well as serving as the basis for all kinds of rules, procedures and contracts. Collectively, these make up a managerial culture, which, as aforesaid, derives from the broader organizational corporate culture that are predicated on Islamic values.

The need for three more spheres

Islamic banking must comply not only with the market [M] and governance [G] spheres, but also must take into account the cultural [C], social [S] and home [O] spheres. This is due to the fact that merely relying on the M and the G logics is insufficient for them to realize the important and relevant values that are required for them to do the right thing. Rather, we must ask, first and foremost, what goods do people or organizations (Islamic banking) want to strive for? We also need to consider what virtue ethics underpin their actions and in what ways these actions are valuable not only to themselves and their organizations, but also to other people, society and the wider environment.

Human action is goal-oriented, and the goals of human action are closely aligned with our ideals. In other words, human action is about our *telos* or purpose. Therefore, the question that we must ask any individuals, organizations or societies who are engaging in action is the following one: “What is the action good for?” The next question is “What is that good for.” This is because one good will lead to another, and one good will serve another (Klamer, 2016). In this case, the goods and values can be said to be instrumental in the sense that their realization serves other goods and values. In other words, we own a house in order to be able

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to create a home. Here, the house is merely an instrument for the attainment of our goal, which in this example is a good home, while the home, in turn, may be good for something else, like love, affection and care.

Similarly, despite the fact that banking institutions (Islamic banking) already comply with market and government logics, they must still nevertheless ask the question: “What is the action good for?” Is generating huge profits, while, simultaneously, contributing to the destruction of the environment or harming social life, a good to strive for? Similarly, is it socially beneficial to lay off employees to cut costs, thus contributing to unemployment, in order that you can increase your profits?

Ultimately, it is about questioning the goods that we are striving for, as opposed to myopically viewing profitability as the sole value worth pursuing. Since the goods to strive for embody important values, it is important for Islamic banking strive to provide high quality services that appeal to customers’ moral conscience, contribute to positive development and employment, and strive to avoid engaging in exploitative and environmental destructive practices, in order for them to do the right thing. To achieve this, we need to include the other spheres in Klammer’s model, namely cultural, social and home spheres, in addition to the market and governance spheres. First, I will discuss the home sphere.

6.5 Islamic Banking and the Home Sphere or the “*Oikos*” [O] and the Logic of the “*Oikos*” or Home Logic

The home sphere or the “*Oikos*” [O] for me is the most basic and important of all the spheres in Klammer’s model of realizing values and doing the right thing. At home, we learn from our parents and other members of our family how to lead our lives, how to strive for certain goods, as well as how to act upon our values. At home, we realize important values that are specific to the home or “*Oikos*” [O], such as love, affection, trust, honesty, loyalty, self-discipline, integrity, memories and care. These values are deeply embedded in us and profoundly shape our lives, not only in the home sphere but also in the social sphere, in terms of the surrounding community, nation and even international community, culturally, economically and politically speaking.

In addition to that, it is also important to practice certain values, such as concern for others (altruism), generosity, concern for the environment, animals and other creatures, inter-faith harmony, caring for the elderly, gender equality and inclusivity, which all serve to equip the member of the “*Oikos*” in how to develop relationships, not only with family members but also with other people.

Although to some extent, it is difficult for family members to support each other when engaging in certain kinds of work, job and careers—such as in the case of parents supporting their children or spouses supporting one another— when children are able to convince their parents about either the good that a certain type of work will produce or why it is meaningful to them, then eventually parents will endorse and support their children to pursue this career goal.

There is extensive evidence pointing towards the difficulties that can arise in the relationships within the *O* sphere. For example, my own parents simply would not tolerate me pursuing a career in sport or the artistic sector, and stated their preference for me to work in teaching and education. Unsurprisingly, parents who believe that there is no viable future in football or art are highly likely to oppose their children pursuing a career in these fields. However, with the passing of time and if their children are able to convince them that their choice was right and valuable for their life and future, then parents will invariably come to endorse and support children in their choice.

The logic in the *Oikos* [O] is characterized by in the interdependency of sharing, contributing, collectiveness and togetherness, insofar as members share goods and need to contribute to the family, and, as such, are dependent upon each other. This interdependence can take the form of loyalty, family ties, intimacy, caring, affection and love. It is for these reasons that the *Oikos* is said to be good for social and intimate goods.

The logic in the *Oikos* [O] involves respecting the culture of the family, respecting shared goods and shared values, respecting each members’ respective position and role within the family. Parents respect their children by caring about them and showing them love, while children display respect for their parents by honoring their role at the head of the family.

The inculcation of morality, ethical values and moral norms begins at home, due to the simple fact that most people grow up and are raised in the home sphere,

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which means that the realization of values also begins at home. In light of this, the home is thus a crucial sphere for the valorization of many kinds of goods, which we acquire via our upbringing, such as knowledge and skills, values and norms, and so on, which are of vital importance for how we live the rest of our lives. Since the realization of values begins at home, all people start the process of valorization at home. The valorization of values or of making real important and relevant values is carried out, not via being passively preached at, but rather by actively practicing and engaging in exemplary actions. For example, if children or their family members see their parents working hard, being disciplined, tolerant, honest, respectful and treating others with respect and honor, then these values will become ingrained in them even without their parents necessarily preaching to them about it.

The “*Oikos*” [O] or the home sphere is fundamental in terms of creating and building a good home and good values that are required for every member of the “*Oikos*” to lead a good life. For example, as a Javanese Muslim I was brought up to respect women. This is an important value, since it is women who give birth. When they are being honored, they will surely also honor their children, love them and educate them to the best of their abilities. This is not because I am a supporter of gender equality, but because I learned about the value of honoring women later on in the *Hadith* (the *Sunnah*) narrated by Ibn Asakir, which states that: “*The respectful man is he who respects the women, and the disgraceful man is he who humiliates or dishonours the women.*”⁶³

⁶³ *Al-Hadith* (the *Sunnah*), is narrated by Ibn Asakir and states that the Prophet says: “*The best of you is the best for his family, and the respectful man is he who respects the women, and the disgraceful man is he who humiliates or dishonours the women.*”. Taken from the collection of Sunan Tirmidzi, *al-Hadith* number 3830

عن علي بن أبي طالب رضي الله عنه عن النبي صلى الله عليه وسلم قال: خيركم خيركم لأهله ، وأنا خيركم لأهلي ، ما أكرم النساء إلا كريم ، ولا أهانهن إلا لئيم . (رواه ابن عساکر)، في "تاريخ دمشق" (13/313) "وعنه ابن أخيه في الأربعين في مناقب أمهات المؤمنين" (109) . "وعن عائشة رضي الله عنها قالت قال رسول الله صلى الله عليه وسلم : (خَيْرُكُمْ خَيْرُكُمْ لِأَهْلِهِ وَأَنَا خَيْرُكُمْ لِأَهْلِي) رواه الترمذي (3830).

See also the *Quran* below, which places emphasis on the important of the logic of *Oikos* or the home sphere

“*Protect yourself and your families from getting into hellfire*” (al-Tahrim QS, 66: 6)

The “*Oikos*” [O] sphere is important inasmuch as it constitutes the beginning point where every individual learns about what values are conducive to living a good life, along with being required as member of a family to not only support each other by being good, virtuous and righteous, but also to protect ourselves and our family from straying into the hellfire. That is to say, we are required to create a good “*oikos*”, since a good *oikos* is good in itself and produces good consequences, while a bad *oikos* is bad in itself and produces bad consequences.

This is the way through which we come to realize our values; we start from the home by learning about and coming to understand what values are important and relevant for us to realize in order to do the right thing. This is because, when striving for goods, we need to know what is important to us in our lives, and how important it is to us. In so doing, we come to know what values are relevant to us as well as others, and how valuable and interesting others find our goods and values.

Since life starts at home or in the “*Oikos*” sphere, a good *oikos* is both the goal and the end. This is because a good *oikos* is capable of inculcating good character, traits, love, intimacy, caring, nobility, dignity, autonomy and any other positive values within members of our *Oikos*, allied with producing good consequences in their lives, insofar as positive values are ingrained in them. A good *oikos* is the good to strive for, and the goods to strive for embody the important values, and doing the right thing is a matter of realizing values. It is therefore important to realize the positive values that bolster and foster the *Oikos* in order for the *Oikos* to be considered as good. The negative values associated with the *Oikos* will only result in bad consequences.

Islamic banking and a good *oikos* [O]

It is important to note that a good *oikos* is both good in and of itself and in terms of the consequences it produces, while a bad *oikos* is bad in and of itself and

“Our Lord, grant us from among our wives and offspring comfort to our eyes and make us an example for the righteous”. (al-Furqan, QS, 25: 74)

“My Lord, enable me to be grateful for Your favour which You have bestowed upon me and upon my parents and to work righteousness of which You will approve and make righteous for me my offspring. Indeed, I have repented to You, and indeed, I am of the Muslims”. (al-Ahqaf, QS, 46:15)

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in terms of the consequences it brings about. This signifies that people who are raised and instilled with the values of integrity, trust, affection, honesty, loyalty, self-discipline, caring, as well as other positive values such as concern for others (altruism), generosity, concern for the environment, animals and other creatures, inter-faith harmony, caring for the elderly, gender equality and inclusivity will be able to influence and enlighten their surrounding social life and community, including within their workplaces, such as commercial organizations (Islamic banking institutions), with their positive attitudes.

They will surely do better in their careers and bring more joy to their workplaces and colleagues than those who behave otherwise, insofar as they will infuse their workplaces with positive attitudes, behaviour and excellence products. In other words, a good *oikos* will more likely than not produce a good working environment.

In the context of Islamic banking institutions, these kinds of people will establish relationships characterized by love, care, loyalty, intimacy, and supporting one another to carry out one's duty, in the sense that they will remind one another of what they have to do and will accomplish their task through effective team work. Hence, growing up within a good *oikos* will lead them to not be careless and individualistic, greedy, avaricious, apathetic and helpless, insofar as all these kinds of negative values can only be produced in a bad *oikos*.

Consequently, a bad *oikos* can influence Islamic banking institutions' performance and policies by bringing bad attitudes into the workplace and producing bad consequences, in the sense that bankers and managers within Islamic banks would be more likely to behave carelessly towards environmental sustainability, and thus continue to invest in projects that generate high profits, but are not socially beneficial and, in fact, contribute towards environmental degradation and deterioration. Moreover, a bad *oikos* that, in turn, produces values of carelessness, greed, apathy (no empathy) and helplessness in Islamic banking organizations will more likely force managers to set aside and eliminate marginalized and destitute people from access to financial support, thus constituting a betrayal of their ideal to realize socio-economic justice through financial and banking mechanisms.

The home sphere or the “*Oikos*” is thus the most basic and important sphere for all individuals, inasmuch as when they enter outside their home sphere, they connect to other people, interact and communicate with other members of their society and community, as well as in the wider environment and organizations where they work. In this respect, they can be understood as forming another family member or a second *Oikos* in their workplaces, such as within Islamic banking institutions, which although it is not really the home sphere can nevertheless operate as if it were the home sphere.

Resultantly, it appears that there is a strong degree of overlap between the home, social, cultural, market and government spheres, but that we need the distinctions to differentiate the spheres from one another, so that we are clear about both what makes these spheres different and why these differences matter when we are realizing our values. Thus far in this chapter I have discussed and investigated the market, government and home spheres, with an especial focus on how commercial organizations such as Islamic banking fit into and ought to operate within these specific spheres in order for them to be able to realize their values and do the right thing. The remaining spheres of the Klammer model are the social and cultural spheres, which I will discuss and investigate in turn below.

6.6 Islamic Banking, the Social [S] Sphere and Social Logic

The social [S] sphere is the sphere that lies outside our *Oikos*. It is the logic that pertains to relationships and networking. It is the logic of informal social relationships, reciprocity, contributions, exchanging of gifts, participation, cooperation, togetherness and collaboration between members of society, such as school communities, religious communities, organizational communities or group communities or political parties, and so on and so forth. Within the social sphere, people are partners, friends, acquaintances, colleagues, members, comrades, contributors, donors, supporters and participants, whom we do not feel connected to in the same way that we do with those that belong to our *Oikos* (Klammer, 2016).

The social sphere provides social mechanisms in the form of social control, whereby self-interested behaviour is balanced out with socially-oriented behaviour, while egoistic behaviour is harmonized with altruistic behaviour for the purposes of engendering social coherence, social harmony and a collective sense of togetherness. In other words, the social sphere is the theatre in which

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individuals execute their individual rights to maneuver themselves within the societal set-up to bring about the establishment of a noble society and just social order. It is here that Islamic banking carries out its mission to realize socio-economic justice, a fair and equitable distribution of income and wealth, and the enrichment of the moral well-being of the entire community, as well as the sphere in which it seeks to display co-operative and collective economic behaviour with regards to the redistribution of wealth and resource allocation through financial and banking mechanisms (Mannan, 1992).

Islamic banking can do anything in accordance with market and governance logics, but when it comes to the logic of the social, Islamic banking has to compromise and follow prevailing social mechanisms in the form of social control, reciprocity, co-contribution, social coherence and harmony when seeking to realize its relevant values and do the right thing, such as in the case of Muslim women adhering to the dress code of wearing a headscarf (*Hijab*) or being ignorant towards marginalized people who have no access to financing from the banking system. It is considered inappropriate and awkward within the social sphere when female employees within Islamic banking do not wear a headscarf (*Hijab*) in their workplace. It is also considered unethical to let marginalized people have no access to the financial banking system.

When granting a loan, Islamic banking ought not to only consider the collateral or real guarantees, but should also consider the values of personal and social guarantees provided by the local networks in which the funding is allocated, such as in the case of solidarity lending in microfinancing, which is also provided in the mainstream ethical banking of Triodos Bank.

Islamic banking ought not to cause widespread anger amongst members of society by investing in projects and industries that lead to disharmony, incoherence, social disorder and environmental deterioration, such as gambling, weapons, pornographic or violent productions, exploitation of animals and other investments that are socially and environmentally harmful.

The logic of social relationships relies on the logic of reciprocity, exchange, gift giving and contributing (Klamer, 2016). Therefore, the relationships upon which the social sphere are predicated can be said to be social goods, insofar as

they are good that need to be shared with others in order for them to have social value. For example, the logic of reciprocity dictates that when you give something, you expect to receive something in return, such as in the case of a warm welcome from the community and the positive investment behaviour of Islamic banking, which reflects various shared goods, such as clean energy, air and a greener environment.

It also reflects the logic of contribution, which underlies the co-creation and co-production of the commons and is needed to generate shared goods. Knowing what to contribute, what to give, or how to contribute and how to give is a question of phronesis or practical wisdom (Klamer, 2016), which necessitates taking into account the cultural context, in order to be able to do the right thing and realize relevant values. This is because social control involves approval and disapproval, reputation and recognition, authority, power and hierarchy (Klamer, 2016), which primarily involves the cultural sphere.

In this matter, Islamic banking has to consider the people and community that surround it as partners, contributors and members of a greater society to whom they are able to provide support, contributions and a sense of control over other members of society. In this kind of relationship, bankers, and, indeed, all employees of Islamic banking institutions are also members of the society and community in which Islamic banking conducts its financial business. Since the cultural sphere is the all-encompassing sphere, insofar as the all-other spheres are embedded in it, it is therefore Islamic banking also needs to engage in the cultural sphere in order to realize its values and do the right thing.

6.7 Islamic Banking, the Cultural [C] Sphere and Cultural Logic

The cultural [C] sphere is good for intrinsic motivations. A cultural setting stimulates and gives meaning to certain actions, while, simultaneously making other actions senseless or even bad. For example, in the city of Kudus in Central Java Indonesia, the cultural setting stimulates people not to consume the meat from cows, but rather to substitute this with meat from buffalo. Despite the fact that meat from cows is *halal* meat, the majority of Muslims who live in the city of Kudus do not consume meat from cows out of respect for fellow Hindus, a which is a cultural practice that has been practiced and transmitted from each generation to the next. With respect to this particular cultural [C] sphere, the act of not

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consuming cow meat does not make sense from the perspective of Islam, insofar as it is *halal*, but yet it is simply not meaningful in this region to consume cow meat.

The cultural [C] sphere is the all-encompassing sphere in which all other spheres are embedded, which is especially the case with respect to how we engage with artistic work, religious faith, honoring of sacred artefacts and places, rituals or science, and various transcendental ideas and beliefs that lie beyond that which we can observe directly, as they are metaphysical. It is the all-encompassing sphere, insofar as it is the sphere that gives meaning to all of the behaviour and actions that transpire in the other spheres. Ultimately, Klamer (2016) posits, it is in this sphere that we all realize ourselves as cultural beings.

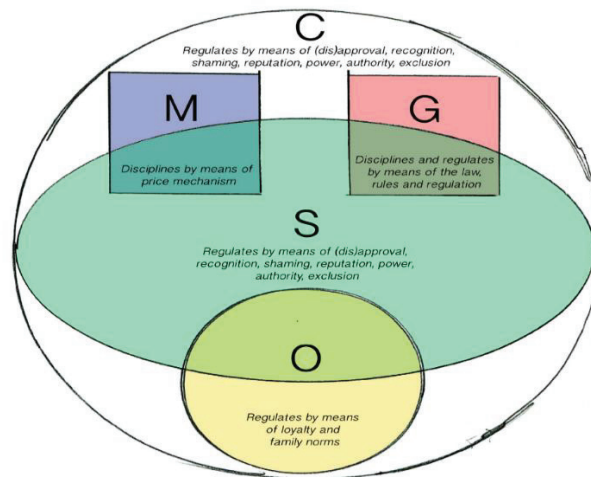


Figure 4: The Klamer model of the C sphere which is also the all-encompassing sphere Taken from the book "Doing the right thing; a value-based economy" by Prof. Arjo Klamer

The above figure or picture shows how the cultural [C] sphere is the all-encompassing sphere, that is, the sphere in which all other spheres are embedded. The cultural sphere is good for the realization of cultural values, civilization, religious and spiritual practices or transcendental practices, such as art, science, and religion, as well as transcendental goods like faith, truth, beauty, and moral rightness. Figure 4 above also shows how the spheres overlap, that is, how the logic of M can come to operate in S and O, as well as how the logic of S can come

to operate in the M and G spheres. However, it is important to stress that, despite such overlaps, there do exist distinctions between the logics in each sphere.

The logic of the C sphere is where people relate their behaviour and actions to the prevailing cultural, transcendental and religious values, by, among other things, engaging in celebratory rituals, honoring sacred artefacts or places, and sharing a common history (Klamer, 2016). Everyone has a cultural identity that they are attached to. In this respect, culture is for humans what water is for fish; we become aware of it only when it no longer surrounds us (Klamer, 2007).

Similarly, both myself and many of my Indonesian friends who live outside the country only come to realize what it means to be Indonesian when we leave it and live amidst foreigners, such as when living in the Netherlands in my own case. This is because humans are social beings and we need to engage in conversations to be able to function and flourish in our lives.

The logic of the cultural sphere is the sense-making process that manifests in rituals, honoring of sacred things and places, and respecting idioms, norms and values (Klamer, 2016). The sense-making process also underpins how we relate to ideas, beliefs and abstract entities that lie beyond what we can directly observe, due to the fact that they are metaphysical. For example, having a profound belief in a powerful being who lies outside of the grasp of human power and human sense-making, necessitates that humans engage in rituals, prayer, invocation, supplication etc., since it is ultimately an abstract relationship to beliefs and ideas. While visiting a grave to pray for a deceased family member may not make much sense to some people, as someone who was brought up in a Javanese Muslim family, it makes perfect sense to me. This is because it is recommended that people should visit the grave of family members who have passed way to pray for them, and thus it would be unethical to ignore this practice.

Each practice in the cultural sphere has its own idioms, metaphors, and narratives that are generally manifested in exemplary texts or great works, such as sacred books or the holy books that Muslims call the *Quran* and the *Sunnah* or the Bible for Christians.

The realization of values in the cultural sphere is a cultural practice, and, as such, people need to recognize the cultural significance of interactions and conversations within relevant cultural contexts, as these things or values relate to

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transcendental, spiritual, ritual, religious and other abstract ideas, such as science or art forms. The process of valorizing values in this sphere may require certain kinds of conversation or contemplation in order to attract other people to become interested in the idea, in terms of what it means, what it implies, and what its potential applications could be. Ultimately, they must recognize the value of an idea for such conversations to come about. These values transcend the personal, social and societal order, and are therefore called transcendental values (Klamer, 2016).

Cultural goods are transcendental goods when they are good in and of themselves, which pertains to those goods that have a shared artistic, historical, or symbolic meaning within the all-encompassing cultural sphere. Cultural goods ordinarily come into being through engaging in practices that subsequently become praxes when they contain or generate the good that is being strived for, such as in the case of Muslim people who live in the city of Kudus Central Java and substitute cow meat, despite it being *halal*, for buffalo meat in an act of respect towards fellow Hindus. These Muslims have practiced this from one generation to the next, even though some Muslims consider it to be irrational behaviour and non-sensical.

Moral values and virtue ethics or ethical values are deeply embedded in cultural values, which is to say that when we consider the goodness, righteousness or virtuousness of our actions and behavior, we invariably take our moral values into account. Religious or spiritual values are also firmly embedded in cultural values in our relationship to the transcendental, or what is called the metaphysical; in this plane, we realize values such as holiness, sacredness and enlightenment (Klamer, 2016).

Islamic banking and the cultural logic of religious and moral values

In the same way that the *Oikos* [O] or the home sphere that has the power to inculcate values related to the home sphere, such as love, affection, and the social [S] sphere that has the power to share and impose values, such as friendship, collegiality, trust, solidarity, social cohesion, harmony and social inclusion, the cultural [C] sphere has the power to embrace specific values, such as holiness, sacredness, enlightenment, in the form of religious and cultural activities, which

are practiced in religions, universities and cultural organizations. These values often have the objective of changing the values of people to act and behave in accordance with certain cultural goods and cultural values, including Islamic banking institutions in their capacity as a commercial organization.

The value of the interest-free banking system places Islamic banking in contradistinction to conventional banking, despite in essence being the same thing. However, this religious value and the name of Islam in Islamic banking institutions has made public and most Muslim people in Indonesia alter their choice to deal with Islamic banking in the very beginning of their inception and establishment. The power of the cultural logic is such that it is able to influence the choice of people in their dealing with banking and financial transaction.

Despite of that warm welcome and acceptance, with the passage of the times, most of Indonesian Muslim people change their perception of Islamic banking from passion into doubt and from enthusiasm into skepticism, and in several years later, most of Indonesian Muslim people begin to realize that there is no essential difference between conventional banking which is interest banking system and Islamic banking which is interest-free banking system. However, the presence of Islamic banking system is indeed in need as an alternative in the financial and banking system in Indonesia, so that people have a choice.

Another issue is that, when people are badly in need of money, they can easily forget the purpose of life and the ideals that they should be striving for. In these situations, people forget that money is not an end in itself, but rather an instrument through which to achieve a particular end. For example, they may also forget the source and methods via which the money was obtained in the first place. This also applies to Islamic banking, due to the fact that it has an ethical responsibility to implement a fair return on an asset or a return on capital or profitability of somewhere between 3 - 5 %, as Triodos Bank (conventional ethical banking) explicitly states and follows through on in practice. Doing so is better for the people who work at Triodos Bank, the sustainability of their organization, and human life as a whole, economically, socially, politically and environmentally speaking. Triodos Bank sets this fair rate of return, because it believes that profit generation need not come at the expense of environmental deterioration and forms of socio-economic injustice. In this respect, Triodos Bank considers that culture is

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a powerful force for positive change, namely in terms of driving creativity and innovation within the business sector, and providing lasting opportunities for personal development. It also believes that generating profit or producing profit is no more than an instrument for producing further goods.

Consequently, boosting your organization's profits by charging an interest rate or rate of return that is higher than what can be considered as a fair return, is not the right thing to do, insofar as it does not reflect the ideals that Islamic banking should be striving for. It is not the right thing to do if, in so doing, it sacrifices your ideals and places an undue burden upon your customers, which, in turn, causes suffering. Morality and ethical values and virtue ethics are embedded in cultural values, in the context of the cultural sphere and cultural logic. It is on these grounds that I view Islamic banking charging a profit margin or interest rate in disguised form at a higher rate than that observed in conventional banking to be unethical conduct., irrespective of the fact there are no rules or regulations set out by the government (Monetary authority) in the governmental [G] sphere with regard to the high limit of interest that Islamic banking can impose and charge their customers or clients. This will be discussed at greater length in a Section 6.9 below.

6.8 The Overlap Between the Five Spheres

It is inevitable that there exists some overlap between the five spheres, which is to say that the logic of M may operate in S and O, while, similarly, the logic of S can operate in M and G. However, the logic of C ultimately operates within all the other four spheres, as illustrated in *Figure 6.1*. What is needed here is greater clarity over what makes the spheres different from one another, and why these differences matter in terms of realizing our values and doing the right thing. For example, the cultural dress code for Muslim women is to wear a headscarf (*Hijab*) in their daily lives, both consciously and culturally. However, Muslim woman who do not wear the headscarf (*Hijab*) in their daily lives have to do so when they become employees of Islamic banking organizations, due to the fact that this dress code is part of the organizational culture in the cultural [C] sphere and is mandated by management in the governance [G] sphere.

A further example of how overlap can occur between the different spheres is when an Islamic banking organizations decide in the governance [G] sphere to take a fair return on an asset or a return on capital or profitability that is between 3 - 5 % (as is the case with Triodos Bank), in order to strike a balance between generating profit in the market [M] sphere for the organizations and their long-term sustainability and behaving benevolently in their operations by contributing to social benefits in the social [S] and cultural [C] spheres.

This is because the profit and financial gains generated by commercial organizations is not an end in and of itself; for shareholders, gains are an instrument through which to realize goods that are important to them, while for employees and managers, gains are an instrument to strive for the goods that are important to them, which, in turn, require acting upon relevant and important values. They will work and do their best for their organizations by striving for these goods, be it personal goods, social and societal goods and cultural goods, in order to achieve their ideals. In doing so, the values of organizations and personal, social and cultural values have to merge and support one another (Klamer, 2016).

I short, the commercial organizations ought to act and behave in the five-spheres to realize the important values and thus do the right thing. This is also the case for Islamic banks.

6.9 Islamic Banking and the Right Thing to Do

I have put forth the argument that it is not enough for any commercial organizations that seek to do the right thing to operate solely within the M and the G spheres and comply merely with market and governance logics when conducting their business. In a value-based approach to the economy, the realization of values within these two spheres is insufficient for any organizations striving to do the right thing. This is because there are other values they must comply with and others that also have to be realized in the process of operating their business, which are the relevant and important values that guide them in doing the right thing. Such values exist in the home [O] sphere and the logic of *Oikos* [O], in the social [S] sphere and its corresponding social logic [S], and in the cultural [C] sphere and its cultural logic [C]. It has also been elaborated that the cultural [C] sphere is the all-encompassing sphere in which all other spheres are embedded.

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Islamic banking institutions, which are founded on the principles of justice, equity and morality as well as being based on Islamic ethical values, have the advantage and capability of being able to do the right thing, if they are able to realize the most important and relevant values in their day-to-day operations and practices, and strive for those goods that will help them to achieve their ideals, in a similar vein to the mainstream ethical Triodos Bank in Netherlands. This means that Islamic banking ought not to focus solely on adhering to Islamic law and Islamic jurisprudence, which merely talks about *Halal* and *Haram*, but rather must strive to go beyond this level to instead apply and adhere to Islamic ethical values in their operations and practices by adhering to the objectives of Islamic law (*Maqasid al-Shariah*), which to promote human well-being, bring about benefits and deter hardship, and prevent harm (Al-Ghazali, 1937).

By applying and adhering to Islamic ethical values, I mean that Islamic banking ought to incorporate values that exist in the home [O] sphere by complying with the logic of the *Oikos* [O], in the social [S] sphere by complying with the logic of the social [S], and in the cultural [C] sphere by complying with the logic of the cultural [C], in addition to operating in the market [M] sphere by complying with the logic of the market [M] and in the governance [G] spheres by complying with the logic of the governance or governmentality [G], when engaging in businesses and financial transactions.

It is important to note here that Islamic banking ought to be able to offer and provide uniquely high-quality services to their customers by appealing to their moral consciousness. Morality, ethical values and virtue ethics are deeply embedded in the cultural sphere, which encompasses all of the other spheres. Those features also exist in the religious teaching of Islam and serve as pillars for the establishment of socio-economic justice and the realization of a socio-economic moral order (as discussed in Chapters 2 & 3).

Since morality and ethical values and virtue ethics are embedded in cultural values, it is unethical for Islamic banking to charge a profit margin (interest in disguised form) at a higher rate than that found in conventional banking, despite there being no rules or regulations imposed by the government (Monetary authority) in the G sphere prohibiting Islamic banking from charging a high rate of interest on their customers or clients. This behaviour is considered to be

unethical, because Islamic banking's foundational principles are to create socio-economic justice and establish a moral order, support underprivileged or marginalized people, and foster conditions conducive to fair treatment and the equitable distribution of income and wealth.

Even if there existed a higher demand for money in the market, Islamic banking ought not to respond to it by increasing interest rates, as it only worsens the situation during periods of inflation if one follows the market logic to increase interest rates or the rate of return just to generate higher profitability. Simply put, profit generation ought not to come at the expense of others. The focus of Islamic banking should thus never solely be on profitability, but rather on producing social benefits for the wider community and achieving environmental preservation, by, for example, ceasing to invest in harmful and destructive goods and services that, despite the large amounts of money generated, contribute to the degradation of the environment, depletion of natural resources, loss of biodiversity and extinction of the species (as discussed in Chapters 3 & 4).

The right thing to do for Islamic banking in this case is therefore to comply with the logics of the social [S], the *Oikos* [O] and the cultural [C] spheres by realizing their relevant and important values, in addition to complying with the corresponding logics in the market [M] and the governance [G] spheres.

Another unethical practice of Islamic banking, which was discussed in the previous chapter, pertains to demanding further financial payment in the case of early settlement. It is self-evident that clients will no longer share profit and losses in the remaining period, insofar as the business has already been closed down, and, as such, the repayment of the amount of money has already been paid off. With respect to this case, the maxim that "*he who shares of the profit must equally share of the loss*" can only lead to unfair, unjust and unethical practices.

This practice is the same as that seen in conventional banking, whereby it imposes penalties in the case of early settlement. From my perspective, I can discern no appropriate ethical grounds for engaging in this practice, neither in Islamic religious faith and Islamic ethical values nor the Western moral philosophy of Kant's universal moral standard of deontological ethics or the virtue ethics of Aristotle. However, since ethical values are relative and relational, some people may deem that it is fair to impose such a penalty, provided it does not place

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an undue burden upon clients, which, from my perspective, should amount to no more than one month's worth of the instalment, like that which occurs in conventional banking. In this sense, Islamic banking ought to think of not hurting and offending its clients when demanding further financial payment, either in the case of early settlement or in terms of imposing a higher penalty on early settlement.

Once again, the right thing to do here for Islamic banking is to comply with the logic of the social [S], the *Oikos* [O], and the cultural [C] spheres by realizing their relevant and important values, in addition to complying with the logics of the market [M] and governance [G] spheres.

An additional observation with regard to the unethical behaviour of Islamic banking concerns the financing aspect of its operations and practices, which, in my own and others estimation, often involve dishonesty and deception. These typical financial transactions involve three parties in order for them to be accomplished. Let us suppose that I need to borrow a certain amount of money; I am not able to borrow this directly from Islamic banking, but rather must bring with me and show them (Islamic banking employees) receipt from sellers listing the kinds of commodities that I want to buy. In this case, Islamic banking is the first party, I am the second party, and the seller is the third party, and all three parties are required in order for the financial transaction to be accomplished.

Islamic banking qua the first party is actually able to purchase certain types of commodities themselves, which can often lead to difficulties in accomplishing the financial transaction, if the second party (myself) does not agree with the purchased commodities and thus refuses to accept them. Consequently, in this kind of practice, it is typically always the second party who purchases these sorts of commodities. In this kind of financial transaction, various complications can arise, along with agency-related problems in the form of deceptive and dishonest behaviour. A clear example of such deception and dishonesty would be if I were to use the money that I borrowed from Islamic banking to conduct other business or purchase other commodities than those explicitly mentioned in the receipt that I brought and showed to the representatives of the bank.

Why do such deceptive and dishonest practices occur? Ordinarily, this occurs because the core business of banking is lending money and generating money via differences in the interest that the bank charges for the loans, which is invariably greater than the rate that the bank pays on the savings and deposits. This is also practiced by Islamic banking in the financing aspect of their business, insofar as their objective is actually to generate money from the difference between the interest rate that they charge for loans and the interest that they pay on savings and deposits. As a result, they care little, or, in fact, do not care at all, whether honesty or dishonesty or deception occurs in that financial transaction. This is a clear demonstration of how Islamic banking institutions fail to practice that which they preach and theorize. More specifically, they fail to live up to Islamic ethical values and norms, insofar as they merely adhere to Islamic law (as discussed in Chapters 1 & 2). The end result of this is that Islamic banking focus merely on the logic of the market in the M sphere and the logic of the governance in the G sphere, while, simultaneously, ignoring the logics in the *Oikos* [O], the social [S] and the cultural [C] spheres.

If Islamic banking were to instead operate not only in the market [M] and governance [G] spheres, but rather also in the *Oikos* [O], the social [S], and the cultural [C] spheres, in order to realize their relevant and important values, only then could they be said to be on the right track and doing the right thing. This is because doing the right thing is a matter of realizing important and relevant values, and those values exist in all five different spheres, as opposed to only existing in the market [M] and governance [G] spheres. The personal values that are related to personal goods in the *Oikos* [O], such as love, affection, trust, honesty, loyalty, self-discipline, integrity, generosity, can be applied within Islamic banking in their daily operations and practices by people working at all levels of the organization (ranging from the director to all staff members of Islamic banking). This is because these personal goods have a bearing on both societal goods (in the social sphere) and transcendental goods (in the cultural sphere).

In the social [S] sphere, Islamic banking are supposed to realize those values that can enrich the quality of one's social life, such as friendship, solidarity, social harmony and cohesion and social inclusion, for the express purpose of ensuring that everyone has access to the banking system and banking mechanisms, so that there will be no exclusion and exploitation. Within the cultural [C] sphere, Islamic

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banking are supposed to enhance those activities that relate people's behaviour and actions towards relevant and important cultural, transcendental and religious values. In this sense, Islamic banking can achieve this by financing businesses which strongly reflect the cultural identity of a nation, such as producing Batik clothes in the case of Indonesia, which is integral to Indonesian cultural identity.

Since the cultural sphere is the all-encompassing sphere, that is, the one in which all other spheres are embedded, there is indeed a need to strike a balance in every action and behaviour performed by Islamic banking in their daily operations and practices in the five different spheres, in order for them to truly be able to realize those values that are important and relevant to them and, in turn, do the right thing.

6.10 Conclusion

The Klammer model of doing the right thing is a value-based approach to realizing values within five different spheres, which posits that doing the right thing is ultimately a matter of realizing values. In order to realize values, people have to generate appropriate goods. This is because some goods are more important than others, and some are worth striving for, while others are not. Because the goods that we should strive for invariably embody the most important values, the goods that we strive for ultimately become our ideals.

The Klammer model of doing the right thing is also a value-based approach to economy or economics, which conceives of the economy and economics not simply in terms of the prevailing model of standard economics, but rather as an integrative and substantive approach. It is important to note that his approach does not wholly abandon standard economics, which operates in both the market logic in the market [M] sphere and the governance logic in the governance [G] sphere, but instead supplements this conventional approach to economics with three additional logics, namely: The *Oikos* logic in the home [O] sphere, the social logic in the social [S] sphere and the cultural logic in the cultural [C] sphere.

While, of course, there are many value-based approaches and models of the economy developed by Western moral thinkers, scholars and economists, the decision to draw upon Klammer's model in this research stems from the clarity with which he discusses each sphere, as well as his highly specific, detailed and

coherent argument. Every individual and organization who wants to learn how to do the right thing ought to apply and adhere to realizing those values that are most important and relevant to them. Simply put, if we fail to include and act upon our values in our actions and behaviour, then we will forever be moving in the wrong direction and going further astray from what matters to us.

The previous chapter identified the ways in which Islamic morality, Islamic ethical values and moral norms are, in fact, not that much different from the Christian and Western tradition of morality, ethical values and moral norms. The consequence of this overlap is that Islamic banking, which are part of Islamic economics, should also be understood and perceived as a value-based approach to economics, insofar as their daily operations are also predicated on the philosophical principles of justice, equity and morality due to the fact that religion serves as the source of their morality and ethical values.

Ultimately, Islamic banking have to go beyond Islamic law in their day-to-day practices and operations if they are to do the right thing and act in accordance with Klammer's model of realizing values in five different spheres. That is to say, Islamic banking ought not to stop at the level of merely talking about *halal* and *haram*, but rather must go beyond this to apply and adhere to Islamic ethical values in their daily pursuit to act in concordance with Islamic law (*Maqasid al-Shariah*), which requires promoting human well-being, producing benefits and mitigating against hardship, as well as preventing harm (Al-Ghazali, 1937). If Islamic banking can achieve this (going beyond Islamic law), then one will truly be able to say that Islamic banking are capable of operating in accordance with Klammer's Model of realizing values in five different spheres.

Finally, given that Islamic banking are founded on both the philosophical principles of justice, equity and morality and Islamic ethical values and moral norms, which exist in all five different spheres of Klammer's model of doing the right thing, they should seek to realize the most important and relevant values in their daily operations and practices and strive towards the goods necessary to achieve this ideal.

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7. Conclusion



Conclusion

A value-based approach to the economy or economics is a value oriented economic discipline and practice that aims to embed morality, ethical values and moral norms within the prevailing economic system. In this respect, this approach seeks to restore balance to the predominant *laissez-faire* economic market in the capitalist economic system, which often is devoid of morality, ethical values and moral norms. A value-based approach to the economy purports that economics is not only the study of wealth, but also the study of human character, morality, ethical values and moral norms. In other words, economics is above all the study of how people realize values. Values are embedded in everything, including within humans themselves, whose character is profoundly shaped by the everyday work that they engage in, particularly with respect to the home sphere. Human character is influenced by the religious ideals we acquire from religious values, and these religious motives are more intense than economics when they are related to commercial work (Marshall, 2013).

Hence, economics is not only the study of wealth, but also the study of human character and our perennial attempts to achieve the goals of welfare, happiness and well-being. Human character is heavily influenced by religious values, as well as to a lesser extent by the values of our family. This is because religious values encompass the values of individuals, social and cultural values, which are ingrained in humans during their upbringing and socialization.

As aforementioned, Aristotle also believed that economics was not merely the study of wealth; rather, when he touched on the question of the economy, he always stressed its relationship with society as a whole, by which he meant the wider community, nature and the environment in which humans live.

A value-based approach to the economy can also be understood as a substantive form of economics, which is to say that it underscores how human life and daily activity is dependent on our inherent nature and that of our fellow humans, as well as the interchange between human nature and their surrounding environment (Polanyi, 1957b).

All of the approaches that can be classified as value-based approaches to the economy aim towards the realization of values, as opposed to merely

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concentrating on the accumulation of wealth, capital formation and generating maximum profits.

There are a lot of approaches to a value-based economy including the Klammer model of a value-based approach to economy of realizing values in five different spheres. The Klammer model of a value-based approach to economy is discussed and elaborated in a very detail and coherent narration, and in a very specific and clear picture in every sphere (Klammer, 2016). Hence, for the purposes of this research, I opted to take recourse to the Klammer's model due to its coherence and comprehensive in demonstrating how value is realized in five-sphere logic model of realizing value and doing the right thing.

I would like to restate with regard to my approach to this research. This research is grounded in the ontological and epistemological stance, according to which the truth and the right thing to do, or the search for the truth and the right thing to do, are things that can actually be attained and realized not only through one perspective, but through multiple perspectives; In other words, one entity cannot claim that it possesses the singular truth about a specific entity. In this respect, I am investigating points of similarity and difference between Islamic ethical values (morality) and Western ethical values (morality) and virtue ethics that converge within a value-based approach to economics, which is used as a tool through which to critically analyze Islamic banking.

For this reason, in this research, I employ Western virtue ethics and moral values to critically analyze the operations of Islamic banking, in order to evaluate whether they are doing the right thing in their banking business and financial transactions through the perspective of a value-based approach to economy.

The value-based approach to economy in this thesis follows the Klammer model that delineates a value-based approach to the economy, which posits that economics should not solely be geared toward the accumulation of wealth and generation of maximum profit and satisfaction for shareholders, but rather should also seek to realize important and relevant values as part of the process of trying to do the right thing and achieve the ideal of welfare, happiness and well-being. In order to achieve this, economics must go beyond merely market logic in the market

[M] sphere and the governance logic in the governance [G] sphere, which prevail in standard economics.

The Klamer model of realizing values within five different spheres is a comprehensive value-based approach to the economy, which does not wholly abandon standard economics per se, but rather also focuses on additional elements, namely the logic of the home or the *oikos* logic in the home [O] sphere, the social logic in the social [S] sphere and the cultural logic in the cultural [C] sphere.

7.1 A Value-based Approach to Economy or Economics and Islamic Economics

Islamic economics is a value-based approach to economy, insofar as it is a self-conscious and value-oriented mode of economics that aims to incorporate ethics and religious insights into its theories and practices by virtue of placing religion as the source of its ethical values. Islamic economics, and, hence, Islamic banking and Islamic financial institutions, declares itself to be a social science discipline that is entirely predicated on Islamic morality and Islamic ethical values, which derive from the *Quran* and the *Sunnah*. To be clear, Islamic economics wholly rejects the idea that economics should refrain from any value judgments or ethical convictions. Conversely, Islamic economics exclaims that ethics should be integral to economics. Specifically, ethical frameworks and codes of practice should guide human behaviour in the attainment of well-being, social harmony and spiritual salvation, while, simultaneously, anything that runs counter to basic Islamic ethical values is simply unacceptable within the Islamic economic system.

It is important to reiterate that Islamic economics does not completely abandon standard economics. Rather, it is compatible with the value-based approaches to the economy developed by Western moral thinkers and philosophers, especially Klamer's model of doing the right thing. Importantly, while neither Islamic economics nor Klamer's value-based approach abandon mainstream economics, both nevertheless supplement standard economics in specific ways, alongside wanting to reconnect it with its roots in moral philosophy and ethical thinking, so that the economy can realize important values and help people and organizations do the right thing. This is based on the belief that neglecting ethical values and moral norms ultimately serves to direct the economy

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in the wrong direction, driving it further and further away from the right path (McCloskey, 1996; Klamer, 2016; Taylor, 1991).

A value-based approach to economy is grounded in the Christian and Western tradition of ethics and predicated on the three main schools of ethical and economic thought: (1), the teleological-utilitarianism (consequentialist) theory of ethics and economics; (2), the deontological theory of ethics and economics; and (3), the virtue theory of ethics and economics. These Western schools of ethical and economic thought are not that different from Islamic ethical values and moral norms, insofar as they are all rooted in the Abrahamic religions, and, as such, are all predicated on religious teaching about humanity and human character, morality and virtue ethics, ethical values and moral norms.

Similarly, Islamic economics (Islamic banking) is based on Islamic ethical values and morality that are embedded in Islamic law (*Maqasid al-Shariah*), which aims to promote human well-being, produce benefits and deter hardship, and prevent harm. Indeed, Islamic law by its very nature embodies ethical principles, which are wholly inseparable from one another. Hence, Islamic law by definition is ethical in nature. For example, when the *Quran* commands that all contracts must be consensual and agreed upon by all parties involved, that they must be free from coercion, deception, misrepresentation or fraud, that contracts must be made in good faith by all parties involved, who must make every effort to honor their promises, it can be said to articulate and embrace virtue ethics and morality.

The Islamic ethical worldview derives from the fundamental belief that life and existence come into being as a result of the will, the desire, and the design of the one God the only creator. There are at least three fundamental principles that the ethical foundations of Islamic economics and Islamic banking are based on, namely: the oneness of God (*Tawheed*), the viceregency (*Khilafah*), and justice (*Adalah*).

It is important to view Islamic ethical foundations as tools and instruments through which to achieve the realization of welfare, happiness and well-being, both in this life and in the hereafter. In other words, the ideal or the goal to strive for is thus the realization of welfare, happiness and well-being. However, certain Islamic ethical values and moral norms, such as honesty, prudence, moderation,

honor, justice and love are ends in and of themselves, and, as such, become purposes in themselves. From this perspective, doing the right thing is a matter of realizing the most important and relevant of these values.

Since the objective of Islamic law (*Maqasid al-Shariah*) is to promote human well-being, produce benefits as well as deter hardship and prevent harm, the objective of Islamic economics is not that different from that of a value-based approach to economy in the Western economic and philosophical tradition.

The first finding of this research therefore is that a values-based approach to economy or economics is not that different from Islamic economics.

7.2 A Value-based Approach to Economy or Economics and Islamic Banking

Having concluded that Islamic ethical values and moral norms are not that dissimilar to the Christian and Western tradition of ethical values and moral norms, this thesis introduces and brings additional nuance to the investigation of the cultural spirit of Islamic banking in their operations and daily practices as commercial organizations, from the perspective of a value-based approach to economy in addition to the perspective of Islamic economics and philosophy rather than from the perspective of Islam or Islamic economics alone.

The rationale for this is that although there have been numerous studies on Islamic banking as commercial organizations, invariably these works have viewed Islamic banking from the perspective of Islam and with regard to Islamic law and Islamic jurisprudence, namely *halal* and *haram* issues.

Some studies have shown that it is the religious factor that affect customers' choice to deal with Islamic banking, rather than their ethical approach to conducting business and financial transactions. Almost all scholars state that Islamic banking institutions are de facto adhering to Islamic law, rather than operating in strict accordance with Islamic ethical values. In this respect, Islamic banking can be said to have de facto failed to adhere to Islamic morality, Islamic ethical values and moral norms, as well as failing to comply with the social and ethical goals prescribed by Islamic law.

This failure has occurred as a result of their myopic focus on market logic in the market [M] sphere and governance logic in the government [G] sphere, which

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corresponds to wealth accumulation, maximizing profit and satisfaction, complying with legal rules and regulations and relying on procedures and government or governance policy. Hence, Islamic banking have failed to pay due consideration to the logic of the *Oikos* in the home [O] sphere, the logic of the social in the social [S] sphere and the logic of cultural in the cultural [C] sphere.

This omission is problematic, due to the fact that profit generation ought not to occur at the expense of others. Rather, profitability must coexist with social benefits to humanity and the wider community, environmental preservation, avoiding socially harmful investments and environmentally destructive investment that leads to the depletion of natural resources, the loss of biodiversity and extinction of the species.

Moreover, the *raison d'être* of the establishment of Islamic banking was to help bring about socio-economic justice, a more equitable economic distribution of income and wealth, as well as a greater sense of well-being for the whole society, including, among other things, assisting marginalized people to gain access to financing via the banking system and banking mechanisms.

In this respect, Islamic banking is not all that different from mainstream Western banking, in terms of their underlying principles, practices and day-to-day operations, and, in fact, is the same in essence and substance. However, the fact that Islamic banks have the word Islam in their title does not mean that Islamic banks have necessarily been doing the right thing in their banking businesses and financial transactions vis-à-vis the realization of Islamic ethical values.

Several scholars have demonstrated that Islamic banking tend to closely adhere to Islamic law in terms of justifying *halal* and *haram* issues, but have de facto failed to adhere to Islamic morality, Islamic ethical values and moral norms, as well as failing to live up to their social and ethical goals. By this I mean that Islamic banking have hitherto not been able to apply and realize the most important and appropriate values in their operations and practices, which, in turn, means that Islamic banking can be said to not yet be doing the right thing.

This failure of Islamic banking to realize the most important values and do the right thing is evidenced by the fact that Islamic banking charges a higher interest rate (rate of return) than conventional banking do, as well as more than the

fair return of 3 – 5% that is practiced by Triodos Bank. Simply put, this specific practice does not reflect the ideal that they should be striving to attain. Hence, it is not the right thing to do, insofar as they (Islamic banking) sacrifice their ideals and place an undue burden and suffering upon their customers.

It also goes against the *raison d'être* of Islamic banking, which is founded on the principles of justice, equity and morality and based on Islamic ethical values. Moreover, raising the rate of interest only worsens the situation during periods of inflation by following the market logic to increase interest rate purely to generate higher profitability, despite both a higher demand for money in the market and no regulation from the government. Since that is not the good to strive for, it does not embody the most important and relevant values. Conversely, doing the right thing is a matter of realizing the most important and appropriate values.

Another failure of Islamic banking, in terms of their inability to realize the most important values and do the right thing, pertains to Islamic banking's attitude with regard to the maxim: "*he who shares of the profit must equally share of the loss*", which is the principle of PLS within Islamic banking in the case of *Murabahah*. This pertains to the fact that Islamic banking ought not to demand additional payment (paying off the remaining installment) in the case of early settlement, in the context of financing and borrowing money (most of the time is in the case of *Murabahah*). That is to say, the customer is not supposed to share the profit and loss in the remaining period, due to the fact that the business has already closed and the repayment of the owed amount has already been paid off. The problem here is that this only results in unfair, unjust and unethical business practices, and, as such, it is not the right thing to do.

The other problematic element of Islamic banking pertains to their attempt to find a way to avoid employing an interest-based banking mechanism within their financing operations (to avoid the *haram* issue) by replacing the principle of PLS (in order to be referred to as a *halal* practice), which, ultimately, often leads to dishonesty and deceptive practices. The problems stem from the fact that financial transactions typically involve three parties, not to mention the fact that financial transactions can be complicated and that there is the issue of agency as well.

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Within this scenario, Islamic banks in their capacity as the provider of the funds (loans) are considered as the first party. The borrower is the second party. The seller of the commodity is the third party. Islamic banking in their capacity as the first party will not lend money if the borrower or the second party does not show the receipts for the commodities that have been bought from the seller to the representative from Islamic banking. However, Islamic banking are also able to purchase commodities from the third party (seller), which can make it difficult for the financial transaction to be accomplished if the second party does not agree with the commodities that have been bought and refuses to accept them. This kind of practice can at times lead to unethical behaviour, in the form of dishonesty and deception.

An obvious example of such deception and dishonesty is when the second party makes use of money borrowed from Islamic banking in other businesses or to purchase commodities that are markedly different from those documented in the receipt shown to the representative of Islamic banking. This can occur because it is typical for financial institutions to accept deposits and savings and to offer loans and earn income from interest from loans at a higher rate than that which they pay for deposits and savings, in addition to charging customers fees for services associated with managing their accounts, and earning money from bank charges.

This typical form of profit generation is always in the mind of a commercial bank, and, indeed, also factors into the decision-making of Islamic banking. The thought process here is to solely focus on the market by complying with the market logic in the market [M] sphere and the governance or governmentality logic in the governance [G] sphere, which is to say that they are conducting their business and generating income and profit without any consideration of the logic of the *Oikos* in the home [O] sphere, the logic of the social in the social [S] sphere and the logic of the cultural in the cultural [C] sphere.

This is problematic, in the case of Islamic banking, because profitability ought not to be the only value to pursue; rather, Islamic banking should be striving to provide uniquely high-quality services that appeal to one's moral conscience and contribute to positive development and employment. That is to say, Islamic

banking ought to question “What is this action good for?” or “What is the profit good for?”. Is generating profit while harming social life and contributing to the destruction of the environment a good worth striving for, or is it socially beneficial to lay-off employees to cut costs, increase profits and, in turn, contribute to higher levels of unemployment?

It is therefore important to realize the most important and relevant values in order to be able to do the right thing; in order for Islamic banking to be able to pursue those values, they must seek to go beyond merely the logic of the market in the M sphere, and the logic of the governance in the G spheres to instead adopt the other three spheres.

One of the findings of this research is that Islamic banks have failed to apply that which they espouse into practice. There existed a gap between the theoretical framework and the practical one. In other words, there is a disjunction between their theoretical framework and the practical implantation of this framework, which, ultimately, means that Islamic banks have not been doing the right thing. By this I mean to say that Islamic banks do not practice what they have been preaching. This is *the second finding* of this research.

Given that Islamic banking institutions do not practice what they preach and theorize, which stems from their myopic adherence to the logic of the market in the [M] sphere and the logic of the governance in the [G] spheres, and omission of the other three logics of the *Oikos* [O], the social [S] and the cultural [C] spheres, Islamic banking must therefore employ and embrace the five different spheres involved in realizing values if they are to truly do the right thing.

We know that doing the right thing is a matter of realizing values. Values need to be acted upon and materialized via the generating of goods. The goods to strive for, embody the most important and relevant values and are also our ideals (Klamer, 2016), which is to say that ideals are also the objectives that people and organizations (Islamic banking) should be striving for, including the values and the virtues they want to realize. This concerns the questions: “what is the act good for?” or “what is this or that good for?”, with the stated objective of Islamic economics (Islamic banking) being synonymous with the objective of Islamic law (*Maqasid al-Shariah*), which is to promote human well-being, bring about benefits and deter hardship, and to prevent harm.

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This objective constitutes the *raison d'être* of Islamic banking, which was founded on the philosophical principles of justice, equity and morality, and rooted in Islamic morality, ethical values and moral norms originating from the *Quran* and the *Sunnah*. Ultimately, Islamic banking aim to realize socio-economic justice, equitable economic distribution of income and wealth, economic welfare and the moral well-being of the whole society.

From this perspective, Islamic banks are not realizing the most important and relevant values and doing the right thing if they are: generating profits at the expense of environmental deterioration; ignoring the marginalized or the destitute who are unable to access banking mechanisms; engaging in immoral business activities and investments, such as channeling or allocating money into the production and sale of liquor, gambling, hoarding, pornography, etc.; encouraging dishonest and deceptive practices; and in favor of the concentration of wealth in the hands of the few via banking mechanisms without doing their utmost to redistribute money amongst society as a whole.

All of these aforesaid practices can lead Islamic banking to fall into a trap from which they cannot get out. This is because Islamic banking continue to operate within the logic of the market and the logic of the governance or governmentality spheres, while, simultaneously, ignoring the values in the logic of the other spheres. In so doing, Islamic banking are falling to the trap of solely indulging in and measuring themselves with regard to financial criteria, rather than evaluating themselves on the basis of a combination of social and financial criteria. Consequently, they are falling into the trap of solely focusing on the organization of profitability and failing to live up to their responsibility to provide social benefits for the wider community and environment.

The remedy for this deviant practice is to direct Islamic banking toward a value-based approach to economy, which is in this thesis referring to the Klammer's model of a value-based approach to the economy (that is in other word, adhering to Islamic morality and Islamic ethical values, rather than merely sticking to Islamic law), that is, to embrace the five different spheres associated with realizing values and doing the right thing. Doing so is of the utmost importance, insofar as Islamic morality, Islamic ethical values and moral norms do not exist merely in

the logic of the market [M] and the logic of the governance or governmentality [G] spheres, but rather also concern the logic of the *Oikos* [O], the social [S] and the cultural [C] spheres.

The third finding of this research posits that in order for Islamic banking to do the right thing in their daily operations and practices, they must strive for the goods that embody the most important and relevant values and seek to realize them in the five different spheres. In other words, they cannot only adhere to the logic of market in the [M] sphere and the logic of governance in the [G] sphere, but also must act in accordance with the other three logics; the logic of the *Oikos* in the [O] sphere, the logic of the social in the [S] sphere and the logic of cultural in the [C] spheres. They must do so, because if Islamic banking only apply the logics of the market in the [M] sphere and the logic of governance in the [G] spheres, then they will crowd out the remaining three logics, which, in turn, will lead Islamic banking further astray from doing the right thing in their operations, which is to help create socio-economic justice, the equitable distribution and redistribution of income and wealth, and enhance the moral well-being of society through the financial and banking system.

7.3 Policy Implications and Suggestions for Future Research

The permissibility of financial interest in the banking system is debatable within Islamic discourse. Some scholars permit an interest-based banking system on the condition that the spirit of that financial transaction is in the benefit of the public interest, that is, the spirit of mutual benefit, mutual help and the spirit of assisting one another and each other to realize welfare, happiness and well-being for society as a whole.

The findings of this research suggest that for Islamic banking to be able to do the right thing, they must operate within the five different spheres in order to realize the most important and relevant values. Islamic banking institutions do not suffice to operate solely in the logics of the market in the [M] sphere and the logic of the governance in the [G] spheres, and instead must go beyond that by embracing and applying the other three logics in the *Oikos*, the social and the cultural spheres. Therefore, this research has several recommendations for policy makers and Islamic banking.

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Firstly, the government via the monetary authority ought to introduce regulation stipulating that Islamic banking institutions should not charge more interest higher (either in terms of the rate of return or interest in disguise) than conventional banking charges.

The government through the monetary authority ought to prohibit Islamic banking institutions from demanding additional payment (payment of the remaining installment) in the case of early settlement, for the simple reason that customers are not supposed to share the profit and loss anymore in the remaining period, as the business has already been closed, and the repayment of the amount of money has already been paid off.

Since interest is debatable, Islamic banking are not supposed to take advantage of claiming to run an interest-free banking system in the name of Islam, or when offering their financial services and financial transactions to customers, especially in complicated financing and the lending process. Neither are they supposed to engage in interpretations of Islamic law in order to justify the issue of *halal* and *haram* vis-à-vis the financial and banking system, which means that the principle of PLS ought not to be contrasted with the principle of interest in the conventional banking system, insofar as both are the same in essence. As long as Islamic banking are able to operate within the five different spheres when realizing the most important and relevant values, then they can be said to be doing the right thing.

Islamic banking must prove that they are capable of offering a uniquely high quality service that appeals to customers' moral conscience, alongside contributing to positive development and employment, as well as providing financial services that lead to the realization of socio-economic justice, the equitable distribution of income and wealth, the redistribution of income and welfare, and the enhancement of moral well-being for society as a whole through banking mechanisms, which is only possible by operating in the five different spheres.

If Islamic banking can adhere to a value-based approach to economy or economics by realizing values in five different spheres, then this will mean that

Islamic banking have successfully gone beyond Islamic law and instead began to truly adhere to Islamic morality, Islamic ethical values and moral norms.

Postscript

I began this thesis by outlining my principal motivation for carrying out this study. Specifically, I underscored that virtue ethics and ethical values were the primary drivers for me doing this research. I explicitly delineated my own religious upbringing in a Javanese Muslim family, which presented a notable challenge for me in this research, in that I had to put my religious beliefs aside, despite the fact that my religious beliefs tell me that everything we do should be a tribute to and recognition of the mercy of God, the only deity. I had to tell myself that this was a scientific inquiry, which had to be systematically and critically executed at every stage of the investigative process.

It has been a long process, which has exposed me to Western thinking and practices as a result of having completed my studies and this PhD research in the Netherlands (Erasmus University Rotterdam). Exposure to the different ways of thinking and behaving have been crucial to both my life and my thinking. Although I started off with some skepticism towards the purity and integrity of Islamic banking practices in Indonesia, I was surprised to come across banking practices in the Netherlands that were in many respects in accordance with Islamic principles, with the principal exception being the charging of interest.

Moreover, although I expected to find some commonality in Western ethical thinking, insofar as Islamic ethical thinking relates to Western sources, I was nevertheless surprised to find considerable inspiration as a Muslim in virtue ethics in particular. I was even more surprised to encounter a value-based approach and subsequently adopt this as an expedient approach through which to study Islamic banking.

The results of the thesis are unexpected in many respects. Whereas I began the thesis with the express purpose of critiquing current Islamic banking practices and pointing towards the correct practices that they should adopt, I ended up engaging in an intercultural dialogue. Ultimately, I found out that we in the Muslim world can find relevant sources in Western thinking that lend support to our Islamic practices, including virtue ethics, a value-based approach, but also

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best-practices in Western forms of ethical banking. At the same time, the principles of Islamic banking and the values that support these practices can inform and support ongoing efforts to stress the importance of articulating purpose for capitalist-based financial institutions.

In this respect, I present this PhD thesis as an invitation to deepen the dialogue further between Western and Muslim practices. Needless to say, such dialogue is crucial in times of conflict and cultural misunderstanding.

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Samenvatting

Samenvatting

Een op waarden gebaseerde benadering van economie is een integratieve benadering van economie of inhoudelijke economie die verder gaat dan de standaard economie die erop gericht is moraliteit, ethische waarden en morele normen in het systeem op te nemen. Zijn aanwezigheid is om een laissez-faire economisch systeem in evenwicht te brengen dat als ongeldig of gebrek aan deugd, ethische waarden en moraliteit wordt beschouwd. Een op waarden gebaseerde benadering van economie stelt dat economie niet alleen een studie is van winst maximalisatie en rijkdom, maar ook van menselijk karakter, moraliteit, ethische waarden en morele normen. Economie is een studie over de realisatie van waarden.

Een op waarden gebaseerde benadering van economie in de westerse economie is geworteld in het concept van ethiek, of het nu gaat om de teleologisch-utilitaristische (consequentialistische) theorie van de ethiek, de deontologische theorie van de ethiek en de deugden theorie van de ethiek die zijn ontwikkeld door de westerse moraal filosofen en geleerden en die geworteld zijn in de westerse en christelijke ethische traditie.

Er zijn veel modellen van een op waarden gebaseerde benadering van economie ontwikkeld door de westerse morele denkers, wetenschappers en economen, maar dit proefschrift kiest het Klamer-model ontwikkeld door professor Arjo Klamer, vanwege de duidelijkheid die op elk gebied is uitgewerkt. Het Klamer-model voor het realiseren van waarden in vijf verschillende sferen is een zeer alomvattende benadering met betrekking tot een op waarden gebaseerde economie, waar het niet alleen de logica van de markt in de M-sfeer en de logica van governance in de governance-sfeer [G] bespreekt en uitwerkt, maar ook de logica van de Oiko's in de huiselijke [O] sfeer, de logica van het sociale in de sociale [S] sfeer en de logica van het culturele in de culturele [C] sfeer in een zeer gedetailleerde en samenhangende vertelling, en in een heel specifiek en duidelijk schema op elk gebied. Het allerbeste is dat het Klamer-model van een op waarden gebaseerde economie de standaard economie niet verlaat.

Het is heel interessant dat een op waarden gebaseerde benadering van economie niet alleen wordt aangetroffen in de islamitische economie, maar ook in

de westerse economie, ondanks dat ze in het kapitalistische economische systeem leven.

Islamitische economie is ook een op waarden gebaseerde benadering van economie waarbij de islamitische moraal, ethische waarden en morele normen zijn geworteld in de islamitische traditie die voortkomt uit de koran en de soenna. Omdat islamitische ethische waarden erg belangrijk zijn, niet alleen in het aspect van economie, maar ook in de hele aspecten van het leven, plaatst de islam ze op een hoger niveau, zodat ze in staat zijn om een dominante rol te spelen in het leven van moslims in het leven van hun leven. levens.

De opkomst van een op waarden gebaseerde benadering van economie, zowel in de islamitische wereld die islamitische economie wordt genoemd (islamitisch bankieren) als in de westerse wereld, die een op waarde gebaseerde economie wordt genoemd (ethisch bankieren), hebben dezelfde geest van hun bereidheid om de economie te sturen tot de realisatie van waarden, een sociaal economische rechtvaardigheid, een rechtvaardige en eerlijke verdeling van inkomen en rijkdom, en een rechtvaardige sociale orde, door niet alleen de standaard economie te onderzoeken, maar ook de inhoudelijke economie die individuen omvat, sociaal, cultureel en ecologisch.

Aangezien de deugdedthiek, moraal, ethische waarden en morele normen bestonden in de Abrahamitische religie, of het nu het jodendom, het christendom en de islam is, is het in wezen dezelfde deugdedthiek, moraal, ethische waarden en morele normen. Aangezien beide geworteld zijn in de Abrahamitische religie - islam, christendom, joods, moeten ze dezelfde wortel hebben van de religieuze leer van de mensheid en het menselijk karakter, moraliteit en deugdedthiek, ethische waarden en morele normen. Daarom is er gelijkenis tussen een op waarden gebaseerde benadering van economie en islamitische economie, *de eerste bevinding van dit onderzoek*. Met andere woorden, de islamitische moraal, ethische waarden en morele normen verschillen niet zo veel van die van de christendoms traditie van moraliteit, ethische waarden en morele normen.

Dat gezegd hebbende, dat de islamitische moraal, islamitische ethische waarden en morele normen niet zo veel verschillen van die van de christelijke en westerse traditie van moraliteit, ethische waarden en morele normen, doet dit proefschrift zijn best om nieuwe nuances te introduceren en te brengen voor het

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onderzoeken van islamitisch bankieren. als commerciële organisatie in een perspectief van een op waarden gebaseerde benadering van economie in plaats van in een perspectief van islamitisch recht of islamitische economie.

Sommige onderzoeken hebben aangetoond dat islamitische bank instellingen de facto veeleer vasthouden aan de islamitische wet dan aan islamitische ethische waarden. Ze hebben zich de facto niet gehouden aan de islamitische moraal, islamitische ethische waarden en morele normen. Ze hebben de sociale en ethische doelstellingen van de islamitische wet niet gehaald.

Deze mislukking is te wijten aan hun nadruk om de enige logica van de markt in de M-sfeer en de logica van het bestuur in de G-sfeer met zich mee te nemen in de vorm van het vergaren van rijkdom, het maximaliseren van winst en tevredenheid, het naleven van de wettelijke regel en regelgeving, vertrouwen over de procedure en het regerings- of bestuursbeleid, zonder rekening te houden met de andere drie gebieden van de logica die er zijn; de logica van de Oiko's in de O-sfeer, de logica van sociaal in de S-sfeer en de logica van cultureel in de C-sfeer.

Dit komt omdat het genereren van winst niet ten koste mag gaan van anderen. De winstgevendheid moet in evenwicht zijn met de aanwezigheid van de sociale voordelen voor de gemeenschap, de mensheid en het behoud van het milieu, waarbij sociaal schadelijke investeringen en ecologisch destructieve investeringen moeten worden vermeden die leiden tot uitputting van natuurlijke hulpbronnen, het verlies van biodiversiteit en het uitsterven van soorten, ondanks enorme winsten gegenereerd.

Daarnaast is de geest van de oprichting van islamitisch bankieren het helpen realiseren van sociaal economische rechtvaardigheid, een rechtvaardige verdeling van inkomen en rijkdom, welvaart, geluk en moreel welzijn voor de hele samenleving, inclusief het helpen van de gemarginaliseerde mensen om ervoor te zorgen dat dat er niemand overblijft op de markt en geen toegang heeft tot financiering van het islamitische bankwezen via het bank systeem

Dit falen om de belangrijkste waarden te realiseren en het juiste te doen, kan worden herkend aan de praktische toepassing van het islamitische bankwezen met betrekking tot het in rekening brengen van een hogere rente (rentetarief) die meer is dan die van een redelijk rendement en meer is dan dat van wat het conventionele

bankieren doet. Deze praktijk weerspiegelt zeker niet het ideaal om naar te streven. Het is niet het juiste om te doen, als het daarbij de idealen opoffert en alleen de klanten last en lijden geeft.

Een ander falen van de islamitische bankinstelling en hun onvermogen om de belangrijkste waarden te realiseren en het juiste te doen, betreft hun houding ten opzichte van de stelregel "hij die deelt in de winst moet evenredig delen in het verlies". Dit is het principe van het delen van winst en verlies van islamitisch bankieren. Er zou geen handeling moeten zijn om meer geldbetaling te eisen (de resterende betalings termijn) in het geval van de vervroegde afwikkeling

Het is de bedoeling dat de klant de winst en het verlies niet meer deelt in de resterende periode, aangezien het bedrijf al is gesloten en de terugbetaling van het geldbedrag al is afbetaald. Dit komt omdat het doen van een dergelijke handeling alleen maar zal leiden tot oneerlijke, onrechtvaardige en onethische praktijken van de uitgevoerde bedrijven en het is zeker niet de juiste keuze om te doen.

De andere mislukking en de ontoereikendheid van islamitisch bankieren gaat over een poging om manieren te vinden om rente praktijken of op rente gebaseerd bank mechanisme aan de financieringskant te vermijden (om haram kwestie te voorkomen), door het principe van winst- en verliesdeling te vervangen (om halal-praktijken worden genoemd), leidt deze poging echter vaak tot oneerlijkheid en bedrog. Omdat bij deze typische financiële transactie drie partijen betrokken zijn om de financiële transactie tot stand te brengen, bestond er ook een gecompliceerde financiële transactie en ook het agentschaps probleem.

Dit komt omdat de typische bank activiteiten van financiële instellingen deposito's en spaargelden accepteren en leningen aanbieden en rente inkomsten uit die leningen halen tegen een hoger tarief dan dat van wat ze betalen voor deposito's en spaartegoeden, naast het in rekening brengen van klanten vergoedingen voor diensten aan doen met het beheren van hun rekeningen, en geld verdienen met bankkosten. Dit kenmerkend voor het genereren van winst is altijd in de geest van een commercieel bankwezen, inclusief islamitisch bankieren

Wat in hun gedachten is, is om zich alleen op de markt te concentreren door te voldoen aan de logica van de markt in de M-sfeer en de logica van het bestuur in de G-sfeer bij het doen van bank zaken en het genereren van geldinkomsten en

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winst zonder rekening te houden met de andere drie logica's die zijn de logica van de Oiko's, de logica van sociale en de logica van cultureel.

Daarom hebben islamitische bankorganisaties nog niet het juiste gedaan. Hiermee bedoel ik dat islamitisch bankieren niet in praktijk brengt wat ze hebben gepredikt en getheoretiseerd, *en dit is de tweede bevinding*.

De remedie voor deze afwijkende praktijk is om islamitisch bankieren te sturen naar een op waarden gebaseerde benadering van economie (naleving van de islamitische moraal en islamitische ethische waarden, niet alleen vasthouden aan de islamitische wet), om de vijf verschillende sferen te omarmen bij het realiseren van waarden en het goede doen ding, zoals dat van een op waarden gebaseerde benadering van de economie van het Klamer-model. Dit komt omdat de islamitische moraal, islamitische ethische waarden en morele normen niet alleen bestaan in de logica van de markt in de M en de logica van bestuur in de G-sferen, maar ook in de logica van de Oikos in de O-sfeer, de logica van sociaal in de S en de logica van cultureel in de C-sferen, *en dit is de derde bevinding van dit onderzoek*.

Om ervoor te zorgen dat islamitisch bankieren in staat is om het juiste te doen in hun werking en bruikbaarheid, moeten ze streven naar de goederen die de belangrijkste en de relevante waarden belichamen en deze realiseren in de vijf verschillende sferen van de logica, zodat van het Klamer-model van het juiste doen en waarden realiseren in vijf verschillende sferen.

Summary

A value-based approach to economy or economics is an integrative approach to economics or substantive economics which goes beyond standard economics that aims at incorporating morality, ethical values and moral norms into the system. Its presence is to balance a *laissez-faire* economic system which is deemed to be void or lack of virtue, ethical values and morality. A value-based approach to economy states that economics is not only a study of profit maximization and wealth but also about human character, morality, ethical values and moral norms. Economics is a study about the realization of values.

A value-based approach to economy in the western economics is rooted in the concept of ethics be it the teleological-utilitarianism (consequentialist) theory of ethics, the deontological theory of ethics and the virtue theory of ethics which are developed by the western moral philosophers and scholars and which are rooted in the western and Christian tradition of ethics.

There are a lot of models of a value-based approach to economy developed by the western moral thinkers, scholars and economists, but this thesis chooses the Klammer model developed by professor Arjo Klammer, because of the clarity elaborated in every sphere. The Klammer model of realizing values in five different spheres is very a comprehensive approach with regard to a value-based economy where it discusses and elaborates not only the logic of market in the M sphere and the logic of governance in the governance [G] sphere, but also the logic of the *Oikos* in the home [O] sphere, the logic of the social in the social [S] sphere and the logic of the cultural in the cultural [C] sphere in a very detail and coherent narration, and in a very specific and distinct scheme in every sphere. The very excellent one is that the Klammer model of a value-based economy does not abandon the standard economics.

It is very interesting that a values-based approach to economy is not only found in Islamic economics, but also found in western economics, despite they live in the capitalist economic system.

Islamic economics is also a value-based approach to economy where the Islamic morality, ethical values and moral norms are rooted in Islamic tradition that originates from the *Quran* and the *Sunnah*. Since Islamic ethical values are

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very important not only in the aspect of economy, but also in the whole aspects of life, Islam places them at the higher level, so that they are able to play a dominant role in the life of Muslim in living their lives.

The emergence of a values-based approach to economy both in Islamic world which is called Islamic economics (Islamic banking) and in western world which is called a value-based economy (ethical banking), have the same spirit of their willingness to direct economy to the realization of values, a socio-economic justice, equitable and fair distribution of income and wealth, and a just social order, by investigating not only the standard economics, but also substantive economics which encompasses individuals, social, cultural and environmental.

Since the virtue ethics, morality, ethical values and moral norms existed in the Abrahamic religion be it Judaism, Christianity and Islam, it is the same virtue ethics, morality, ethical values and moral norms in essence. Since both of them are rooted in the Abrahamic religion -Islam, Christianity, Jewish, they must have the same root of the religious teaching of humanity and human character, morality and virtue ethics, ethical values and moral norms. It is therefore, there is similarity between a values-based approach to economy with Islamic economics, *the first finding of this research*. In other word, Islamic morality, ethical values and moral norms is not that different from that of the Christianity tradition of morality, ethical values and moral norms.

Having said that the Islamic morality, Islamic ethical values and moral norms are not that different from that of the Christian and western tradition of morality, ethical values and moral norms, this thesis is trying its best to introduce and bring new nuance to investigate Islamic banking as commercial organization in a perspective of a value-based approach to economy rather than in a perspective of Islamic law or Islamic economics.

Some studies showed that Islamic banking institutions are de facto very much sticking to Islamic law rather than to Islamic ethical values. They have de facto failed to adhere to Islamic morality, Islamic ethical values and moral norms. They have failed to meet the social and ethical goals prescribed by Islamic law.

This failure is due to their emphasis in taking with them the only logic of market in the M sphere and the logic of governance in the G sphere in the form of

accumulating wealth, maximizing profit and satisfaction, complying with the legal rule and regulation, relying on the procedure and government or governance policy, without taking consideration of the other three spheres of the logic that are; the logic of the *Oikos* in the O sphere, the logic of social in the S sphere and the logic of cultural in the C sphere. This is because profit generation ought not to be at the expense of others. Profitability must be in balance with presence of the social benefits to the community, humanity and the environmental preservation, avoiding socially harmful investment and environmentally destructive investment leading to depletion of natural resources, the loss of biodiversity and extinction of species, in spite of huge profit generated.

In addition to that, the spirit of the establishment of Islamic banking is to help realize a socio-economic justice, equitable distribution of income and wealth, welfare, happiness and moral well-being for the whole society including assisting the marginalized people to make sure that there is none who is left in the market and does not have access to financing from the Islamic banking through the banking system.

This failure of realizing the most important values and doing the right thing can be recognized from the practicality done by the Islamic banking with regard to the charging higher interest rate (rate of return) which is more than that of a fair return and is more than that of what the conventional banking do. This practice certainly does not reflect the ideal to strive for. It is not the right thing to do, if in doing so, it will sacrifice the ideals and will only give burden and sufferings to the customers.

Another failure of Islamic banking institution and their inability of realizing the most important values and doing the right thing is about their attitude with regard to the maxim of *“he who shares of the profit must equally share of the loss”*. This is the principle of profit and loss sharing of Islamic banking. There ought not to be an act of demanding more money payment (the remaining payment installment) in the case of the early settlement. The customer is not supposed to share the profit and loss anymore in the remaining period, as the business has been already closed, and the repayment of the amount of money has already been paid off. This is because in doing such an act will only lead to unfair, injustice and

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unethical practice of the businesses conducted and certainly it is not the right thing to do.

The other failure and the inadequacy of Islamic banking is about an attempt to find ways to avoid interest practice or interest-based banking mechanism in the financing side (to avoid *haram* issue), by replacing the principle of profit and loss sharing (in order to be called *halal* practice), however, this attempt oftentimes leads to dishonesty and deception practices. Because this typical financial transaction involves three parties for the financial transaction to be accomplished and there existed complicated financial transaction and the agency problem as well.

This occurs because the typical banking businesses of financial institutions is to accept deposits and savings and to offer loans and earn interest income from that loans at higher rate than that of what they pay for deposits and savings, in addition to charging customers fees for services to do with managing their accounts, and earn money from bank charges. This typical of profit generation is always in the mind of a commercial banking including Islamic banking. What is in their minds is only to focus on the market by complying with the logic of market in the M sphere and the logic of governance in the G sphere in doing banking businesses and generating money income and profit without taking consideration the other three logics that are the logic of the *Oikos*, the logic of social, and the logic of cultural.

It is therefore, Islamic banking organizations have not yet been doing the right thing. By this I mean that Islamic banking do not practice what they have been preaching and theorizing, and *this is the second finding*.

The remedy for this deviate practice is to direct Islamic banking into a value-based approach to economy (adherence to Islamic morality and Islamic ethical values, not only sticking to Islamic law), to embrace the five different spheres in realizing values and doing the right thing, such that of a value-based approach to economy of the Klammer model. This is because the Islamic morality, Islamic ethical values and moral norms do not exist only in the logic of the market in the M and the logic of governance in the G spheres, but also in the logic of the *Oikos*

in the O sphere, the logic of social in the S and the logic of cultural in the C spheres, and this is *the third finding of this research*.

Therefore, in order for Islamic banking to be able to doing the right thing in their operation and practicality, they have to strive for the goods that embody the most important and the relevant values and to realize them in the five different spheres of logic such that of the Klamer model of doing the right thing and realizing values in five different spheres.

About the Author

Higher Education

- 2021 PhD in Cultural Economics**
Erasmus University Rotterdam
Erasmus School of History, Culture and Communication (ESHCC)
Dissertation:
Islamic Banking in the Framework of a Socio-economic Moral Order:
Theoretical Foundations
(Critical analysis and ethical approach to a value-based economy)
- 2008 Master of Arts in Economics of Development**
International Institute of Social Studies, (ISS- Erasmus), Den Haag,
in 2008
Thesis:
Is Indonesia undergoing a Process of De-industrialization?
- 2005 Magister Ekonomi Islam (MEI) or Master in Islamic Economics**
The State Islamic University, Sunan Ampel (UINSA), Surabaya
Indonesia in 2005
Thesis:
The Concept of Money & Bank; Comparative study between
Conventional and Islamic economics.
- 1996 Bachelor of Business Administration, BBA.**
Faculty of Economics and Management. International Islamic
University, Malaysia (IIUM)

Short Courses

- Sep 2013 In Yogyakarta Indonesia**
Training of Trainers in Promoting Asset-Based and Citizen-Led
development, Conducted by Coady International Institute St. Francis
Xavier university, Canada
SILE, Supporting Islamic Leadership in Indonesia
LLD, Local Leadership for Development
- Mar 2013 In Surabaya Indonesia**
Certificate in Partnerships: University-Community Collaboration.
Coady International Institute, St. Francis Xavier university, Canada
SILE, Supporting Islamic Leadership in Indonesia
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- 2012** **In Antigonish, Nova Scotia, Canada**
Coady International Institute, St. Francis Xavier University,
Nova Scotia, Canada.
Certificate in Facilitation and Training Approaches for Community Change.
SILE, Supporting Islamic Leadership in Indonesia
LLD, Local Leadership for Development
- 2006** **In Bali at IALF**
English for Academic Purpose (EAP)
- 1995** **In Kuala Lumpur**
SEALTRAC, South East Asian Leadership and Training Course. in Kuala Lumpur. Indonesian Student Delegate of the International Islamic University of Malaysia (IIUM).
- 1991** **In Jakarta**
Institute of Islamic and Arabic Studies, LIPIA, Jakarta
Al-Qism al-Ta'bihi / Diploma in Arabic Teaching

Research & Publications in Indonesian Language

- 2014** An Analysis of *Mudharabah and Musharakah* growth in Islamic Banking Institutions in Indonesia: A Critical Study on their Opportunities and Constraints and the Application of *Maqasid al-Shariah*.
This research is financed by the Research Institute of State Islamic University (UIN), Sunan Ampel Surabaya, November, 2014
- 2012** Monetary Policy and its Implication in Economic Development”, Conceptual and theoretical review in Islamic perspective.
Tsaqafah, Journal of Islamic Economics and Business, Programme of Islamic Economics, Institut Studi Islam Darussalam Gontor. Vol. 02, No.01, Published in April, 2012
- 2012** Fiscal Policy and its Implication in Economic Development”, Conceptual and theoretical review in Islamic perspective.
El-Qist, Journal of Islamic Economics and Business, Programme of Islamic Economics, Faculty of Shariah, IAIN Sunan Ampel. Vol. 02, No.01, Published in April, 2012
- 2011** The role of Islamic Bank in Economic Development”, Case study of Indonesia.

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- El-Qist*, Journal of Islamic Economics and Business, Programme of Islamic Economics, Faculty of Shariah, IAIN Sunan Ampel. Vol. 01, No.01, Published in October, 2011
- 2011** The Impact of Foreign Debt on Economic Growth in Indonesia
This research is team research and is financed by the Research Institute of State Institute for Islamic Studies, IAIN Sunan Ampel Surabaya, November, 2011
- 2010** The Role and Contribution of Islamic Bank in Economic Development: Case study of Indonesia
This research is financed by the Research Institute of State Institute for Islamic Studies,
IAIN Sunan Ampel Surabaya, November, 2010
- 2009** The Concept of Money in an Islamic Perspective and in Conventional Economic Perspective
Journal of Islamic law "*al-Qanun*", Faculty of Shariah, State Institute for Islamic Studies, IAIN Sunan Ampel Surabaya. Vol. 12, No.1, Published in June, 2009
- 2008** The Role of Zakat and Fiscal Policy in Economic Growth
Journal of Islamic Law "HUKUM ISLAM", State Institute for Islamic Studies, STAIN Pekalongan. Volume 6. N0. 2, published on October 2008.
- 2007** The Role of Money and Bank in Interest free Economic System
Journal of Islamic Law "HUKUM ISLAM", State Institute for Islamic Studies, STAIN Pekalongan. Volume 5. N0. 2, published on October 2007.
- 2004** Capital Structure and Cost of Capital in an Islamic Financial System
Post-Graduate Journal of Islamic Studies "AKADEMIKA", State Institute for Islamic Studies, IAIN Sunan Ampel Surabaya. Volume 15. N0. 1, published on September 2004.
- 2003** Potency of Saving, Capital and Economic Development in an Islamic Perspective
Post-Graduate Journal of Islamic Studies "AKADEMIKA", State Institute for Islamic Studies, IAIN Sunan Ampel Surabaya. Volume 13. N0. 1, published on September 2003.
- 2003** Fiscal Policy and Public Finance in an Islamic Perspective
Tabloid Warta, Published in June 2003

Seminar & Conferences

- 17-19 Aug 2016 **In Yogyakarta**
Presenting a value-based economy (Contrasting Deontological economics with an Islamic economics).
at the 2nd International conference on Islamic perspective of accounting, finance, economics and management.
Faculty of Economics and Business, Universitas Gajah Mada Yogyakarta
- 23-24 Jun, 2008 **In Dublin**
Participant of the Conference / Seminar in Dublin, Republic of Ireland with the theme on “The Miracle of Economic Growth and Development, a Lesson from the Republic of Ireland”.
- 07 Mar, 2008 **ISS-Erasmus, Den Haag**
Deliver short speech on “Gender Equality and Development in the Light of Islam” in the International Women’s Day Program. The International Institute of Social Studies (ISS), Den Haag.
- 19 Dec, 2007 **ISS-Erasmus, Den Haag**
Deliver short speech on “Islam as Blessing for the Universe” under the theme Peace on the Earth to celebrate Unity in Diversity. The International Institute of Social Studies (ISS), Den Haag.
- 24 Nov, 2007 **Martha Church, Den Haag**
Deliver welcoming speech in the program of the National Interfaith Dialogue, held in Martha Church, Den Haag.

Lecture & Research

Lecturer and researcher at the State Islamic University Sunan Ampel (UINSA), Surabaya, Indonesia

Languages

Indonesian, English, Arabic and a little bit Dutch

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