The Islamic Financial Intermediation Model and the Stakeholder Paradigm of Governance: A Theoretical Analysis

Dr. Sheharyar S. Hamid
Law School- University of Warwick

1. INTRODUCTION

The recent mushroom growth of Islamic finance in many countries has been hailed as a great achievement for the industry, especially after the financial crisis of 2007-2008. One of the main triggers for this mushroom growth is the assertion by the Islamic finance industry experts and academics that Islamic finance is an ethical and socially more responsible method of financial intermediation and therefore remained relatively risk free in the recent financial crisis.

This paper argues that the fundamental ethos of Islamic business and financial law and practices derive their legitimacy from the idea that business activity is considered to be a socially useful function leading to better social and economic conditions for society. Thus, any business activity that is deemed harmful towards the achievement of societal benefit is banned or restricted under Islamic laws. The importance attached to business activity and its surrounding regulatory jurisprudence in a society dominated by Muslims is attributable to the fact that the Prophet Muhammad was involved in trading for much of his life; he and his early followers attached great importance to views relating to consumption, private and public ownership of property, the ultimate goals of a business enterprise and the code of conduct of various business agents[(1)].

Whilst Islamic teachings regarding business activity are wholesome in the sense that these teachings supply a practical life program, it is also important to note that the Islamic socioeconomic system includes

(1) G Rice 'Islamic Ethics And The Implications For Business' (Feb 1999) Journal Of Business Ethics, Vol. 18, No. 4, 345-358, Published By: Springer Stable URL: Http://Www.Jstor.Org/Stable/25074059 Accessed: 17/09/2010 08:36

detailed coverage of specific economic variables such as ban on interest, taxation, circulation of wealth, fair trading and consumption because Islamic economics is deemed to be a complete system in its own right[(2)]. This paper argues that the modern day Islamic financial institutions (IFIs) are a practical manifestation of that economic system based on normative values as espoused by the Sharia (Islamic law)[(3)].

The actual essence of Islamic economic laws is to ensure a society and an economic system where by economic activity is considered to be a socially useful activity which should lead to better social condition for the whole of society. In the same stead Islamic financial and economic laws are determined by the basic edicts of Sharia, therefore an ideal Islamic economic and financial system ought to be dictated by the social, moral and legal jurisprudence of Islamic law to be 'Islamic' in true spirit.

This paper argues that relying on the jurisprudential and interpretive tool of Maqasid-al Sharia,[(4)] which is derived from the Sharia itself, is the most effective means of achieving the true goals of an 'Islamic' economic system. It is therefore asserted that for a proper Islamic economic and financial system to take root, there is a need to re-calibrate/ re interpret and understand the fundamentals of the Islamic economic system according to the principles of Maqasid-al-Sharia.

Sharia (Islamic law) is derived from the Qur'an and Hadith of the prophet Muhammad, and in context of business activities covers aspects related to buyer-seller, employer-employee, borrower-lender, trader and other connected relationships in depth, with very elaborate details of business and commercial activity having been dealt with[(5)].

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(2) I N Misri 'Reliance of The Traveller A Classic Manual Of Islamic Sacred Law (IL: Sunna Books 1994)

(3) In this paper the term Islamic law and Sharia are used interchangeably. However in contemporary understanding 'Islamic law' is deemed to be an all-encompassing term used to denote concepts like 'fiqh', 'usul', 'qanun', 'urf', 'madhab', 'fatwa' and 'Sharia' itself. JasserAuda, MAQASID Al-Shariah as Philosophy of Islamic Law: a systems approach. The International Institute of Islamic Thought, VA, USA, 2008.

(4) JasurAuda(n 3) 23

(5) A AHanafy ‹Employee And Employer: Islamic Perception› (1988), Proceedings Of The Seminar On Islamic Principles Of Organizational Behaviour (International Institute Of Islamic Thought, Herndon, VA)

It follows that Sharia acts as the governing source of business ethics, commerce, financial and economic norms for all adherents of Islam, whether dictating individuals actions or actions undertaken by society as a whole. This particular characteristic of Sharia compliant business and financial norms form the normative guiding principles for modern day IFIs and brings it in line with the stakeholder notion of governance, both in theory being driven by the need to ensure ethical conduct in the sphere of business and finance.

In practice, we can see that western neoliberal business philosophy and practices are very dissimilar to the Islamic approach, insofar as the whole socioeconomic system in Islam is based on religious teachings as derived from the Qu'ran alongside the teachings and sayings of the Prophet Mohamad called the Hadith, whereas the western neo-liberal approach to economics lacks the guiding moral principles of religious teachings(6). On account of Islamic finance, commerce and the business related provisions of Sharia being derived from a strict religious source, the overall architecture of Islamic business and economic activities maintains a careful balance between satisfying the needs of the individual along with those of society.(7) Islamic law not only allows people to satisfy all their needs, but actually encourages entrepreneurs in profit making (and not profit maximisation as understood in neo liberal literature)(8) as a useful social activity. It can be argued that the reason why Islamic business ideology is so different from the ideals of profit maximisation under neo-liberal ethos is because the neo liberal economics is centred around the basic premise of greed,(9) which in turn allows the wheels of the pure neo liberal capitalist economy to run.

It can therefore be argued that it is this basic human urge of greed and selfish pursuit of profits that Islamic law refutes by laying down a very elaborate system of taxation and charity at the macro level,

(6) Z Iqbal and A Mirakhor 'Stakeholder Model of governance in Islamic Economic system' (2003) in the Fifth International Confereence On Islamic Economics and Finance, IRTI Islamic Development Banks Bahrain.

(7) M A Afzalur-Rahman, Islam Ideology And The Way Of Life(The Muslim School Trust, London 1980)

(8) S O Alhabshi 'The Role of Ethics in Economics and Business.' (1987) Journal of Islamic Economics. 1 (1), 1-15

(9) J K Galbraith, The Affluent Society (Houghton Mifflin, Boston, MA 1958)

while at the same time at the micro level proscribes a system of economic activity and financial intermediation based on partnership form which leads to risk sharing and equity participation amongst the participants.(10) The idea of a partnership business model in Islamic law in essence is meant to promote 'risk sharing' amongst the participants as opposed to the neo liberal economic model of 'risk transfer' and 'externalising costs' on to unknowing third parties, which though economically effective and efficient tends to overlook the ethical and moral repercussion for other indirectly involved stakeholders.(11) It can hence be argued that by virtue of minimizing risk transferring and reducing externalities and encouraging risk sharing, Islamic financial laws and the resultant economic model promotes a more socially inclusive and socially responsible business environment, which is very much in line with the conventional stakeholder model(12).

Further, to ensure the enforcement of these ethical norms at individual and societal level, the Sharia norms regulating finance and business have established a structured legal doctrine in the form of a three tiered system of; Haram (things and activities that are prohibited), Makroh (things and activities that are allowed but discouraged) and Halal (things or activities that are encouraged and allowed)(13). In this manner, Islamic business laws remain morally and practically significant at both individual and societal levels thereby becoming adaptable with time and transcending geographical and jurisdictional boundaries, something which is of utmost importance for the modern day Islamic financial system as a means to enhance human wellbeing(14).

(10) Siddiqui, M. N. Partnership and Profit-Sharing In Islamic Law.(1987) The Islamic Foundation, Leicester, Islamic Economics Series Number 9

(11) M U Chapra, Islam and The Economic Challenge (International Institute Of Islamic Thought, Herndon, VA 1992)

(12) M Biraima 'A Quranic View Of Social Reality And Its Implications For A Universal Social Science: The Case Of Economics'(December 1996), Proceedings Of The Second International Conference On Islamic Political Economy, USM

(13) I Edge, Islamic Law and Legal Theory (Dartmouth Publishing Company Ltd, 1996)

(14) Al-›Alwani and El-Ansary, Linking Ethics and Economics: The Role of Ijtihad in The Regulation And Correction Of Capital Markets (Centre For Muslim-Christian Understanding: History And International Affairs, Georgetown University, Virginia 1999)

This paper is of the view that, whilst keeping in view the ethical and religious nature of the financial intermediation model under Islamic law, the main objective of the Islamic economic system is to set up a 'moral filter' whereby all economic decisions taken by individuals and society at large are gauged against a set of normative moral values(15). It is this particular aspect of the religious and socio-economic nexus in Islamic teachings which is the defining characteristic of a Sharia based economic and financial system(16). This gives Islamic financial laws an advantage over their conventional counterparts in the context of individual decision making and allows for a practical manifestation of religious values, since such values can be traced back to a predetermined set of principles and edicts derived from both the Qu'ran and the Hadith of the Prophet Muhammad(17).

Despite having very specific norms derived from religious sources, it remains an issue of great importance for Islamic financial institutions that they have a general system of values and norms that are not restricted simply to jurisdictions where Sharia is deemed a main source of law. Therefore, this paper is of the view that there needs to be certain universally immutable principles governing Sharia compliant financial and economic activities applicable across all jurisdiction, appropriate for individuals as well as societies. It is therefore argued that if the Islamic financial industry is to compete and succeed in face of the intense competition from conventional financial institutions, the entrenchment of such values in the socio-economic consciousness of the stakeholders of Islamic finance is imperative to make Islamic finance a truly ethical and socially beneficial system of financial intermediation, not merely in 'form' but also in 'substance'. This, it is argued can be achieved through a governance framework which allows for the ethical and religious aspects of Islamic finance to be integrated into the operational matrix of firms that want to abide by the Islamic aspects of banking and finance. This must be a framework which is guided by the

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(15) S O Alhabshi 'The Role of Ethics in Economics and Business.' (1987) Journal of Islamic Economics. 1 (1), 1-15

(16) Rice (n 1) 12

(17) K Ahmad, Islamic Ethics In A Changing Environment For Managers in A. M. Sadeq, Ethics In Business And Management: Islamic And Mainstream Approaches (Asean Academic Press, London 2002) 97

Maqasid al Sharia of Islamic laws and economics ethos. This paper argues that one such governance framework is the stakeholder framework, which besides being based on ethical principles is not very dissimilar to Islamic business ethos, and can be practically implemented by individual IFIs as an alternative to Islamic legal norms and principles where Sharia is not a recognised source of law.

In essence it can be asserted that the goals espoused by Islamic business ethos are not primarily materialist and are in essence based on the principles of human well-being, the pursuit of socioeconomic justice, pursuit of common good (public good or public welfare) and a pursuit of a good and fulfilled life, the ideological foundations of which can be traced back to one of the main derivatives of the wider Maqasid al Sharia principles; the ideal of Maslaha (public welfare and public good)(18). The ideals of Maqasid and Maslaha stress the humane aspect of socioeconomic activities where harmony and balance can be achieved between that which is considered worldly and that which is considered divine and spiritual(19). In essence, it can be said that in Islam, it is religious morals and ethics that dominate finance and law and not vice-versa(20). This paper argues that all these qualities are to also be found in the literature surrounding the stakeholder theory, which is why it is argued here that a stakeholder oriented governance system is the best suitable governance framework for IFIs, especially when used as an alternative to Sharia norms. In the next section, we will carry out a detailed analysis of the contemporary literature surrounding the stakeholder theory and determine how it is similar to the edicts of the Islamic economic and financial ethos and how both the stakeholder theory and Islamic financial norms refute the efficacy of the neo-liberal shareholder model, not only for IFIs but generally as a governance theory for corporations.

(18) D Abdelkader, 'Modernity, the Principles of Public Welfare (Maslaha) and the End Goals of Shari›a (Maqasid) In Muslim Legal Thought,' (2003). Islam and Christian-Muslim Relations. 14 (2), 163-174

(19) M U Chapra, The Future Of Economics: An Islamic Perspective (Leicester: The Islamic Foundation, 2000a)

(20) S N H Naqvi, Perspective on Morality and Human Well-Being: A Contribution To Islamic Economics (Leicester: The Islamic Foundation, 2003)

2. SETTING UP THE IDEOLOGICAL FRAMEWORK OF THE STAKEHOLDER THEORY: A CRITIQUE ON THE NEO LIBERAL ECONOMIC MODEL

In the national meeting of the Academy of Management in 2007, an 'all academy' symposium on the future of stakeholder theorising in business was held; writers from across the USA gathered and delivered their short papers on the ongoing stakeholder debate and the criticisms of the conventional shareholder theory(21).

Presented at this symposium, Donald J Wood's paper quoted George Akerlof, the president of the American Economic Association, as criticizing in very open terms the current economic and the social structure(22). Phillips' works added that the current ability of the government to intervene has been curtailed to such an extent that the government is completely powerless to do anything about corporate abuses and market manipulation, and that this can be attributed to the fact that neoclassical ideology was allowed to take precedence over the other political ideologies in the economic sphere(23). It was this prevalent neoclassical political and economic approach that led to the downfall of the economic system, specifically the failure and the spate of scandals in the financial and the corporate sector. According to Sen(24) and Wood et al(25): 'whereas globalization has brought many good things, it has also led to the dominance of the MNC, a form of corporation which has no master, and has contributed greatly to the income inequities, dire poverty, human rights abuse, environmental degradation and so much more'. Ehrenreich asserted that 'the free market economy works best for the extremely rich and powerful but not for anyone else'(26). George

(21) B R Agle, T Donaldson, R E Freeman, M C.Jensen, R K.Mitchell and D J Wood 'Dialogue: Towards Superior Stakeholder Theory' (2008) Business Ethics Quarterly, Vol 18, Issue 2, 153-190
(22) Wood(n 492) 159-162
(23) K Phillips, American Theocracy: The Peril And Politics Of Radical Religion, Oil And Borrowed Money In The 21st Century (New York: Viking 2006)
(24) A Sen, On Economic Inequality (Oxford: Oxford University Press 1997)
(25) DJWood, J M Logsdon, P G Lewellyn, and K Deavenport, Global Business Citizenship: A TransformativeFarework For Ethics And Sustainability Capitalism (Armonk, NY: M.E.Sharpe 2006)
(26) B Ehrenreich, Nickel And Dimed: On (Not) Getting By In America (New York Metropolitan Books 2001)

Lakoff says that ‘the Chicago school neo classical economics is actually a socio political agenda based upon values that emphasis self-reliance over community health, discipline over nurturance and suffering consequences over creating opportunities’(27).

The ongoing debate surrounding the ethics of commercial strategies based purely on profit maximisation and the interests of shareholders has become increasingly relevant in recent years following numerous corporate collapses and scandals. Many of the aspects being called into question are global, such as the concentration of power in the hands of multinational global players, the legitimacy of European and American companies’ business practices in the Third World and the way that companies deal with their customers and competitors. There are, however, also internal aspects that are in need of review such as staff management, corporate decision-making structures and commercial objectives.

In addition to this, there is growing criticism of the economic and materialistic nature of our values and thinking(28). One reason for this is that economic theories are based mainly on the construction of models and this seems to be an increasingly unsuitable method of describing ‘reality’. Another reason is that the limitations of economic solutions are becoming ever more apparent(29).

It is thus argued that to counter this particular practice of determining economic and financial policies which are devoid of value based concepts, issues of ethics can only be successfully amalgamated into the overall corporate sector through looking to the stakeholder and the CSR perspective, which encourages different stakeholders to be a part of the corporate strategy both at the macro and the micro level(30). It does this whilst also making the corporation more socially and ethically

(27) G Lakoff, Moral Politics; What Conservatives Know That Liberals Don’t (Chicago: University Of Chicago Press 1996)

(28) W Hutton, The State We’re In (Johnathan Cape, London 1995)

(29) Zimmerli and Assländer, Corporate Ethics and Corporate Governance (Springer-Verlag Berlin Heidelberg, 2007)

(30) M T Jones ‘Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics.’ (1995) Academy Of Management Review. 20 (1), 404-437

aware and responsible[31]. According to Walther Zimmerli and Michael S. Assländer:

Because business and entrepreneurial action is determined by economic constraints, the economic decision-making process is dominated by the need to ensure stability and growth while aiming at making a profit, consolidating market position and constantly increasing shareholder value. This demand for economic rationality dominates other aspects of economic action[32].

Following from this, the CSR literature pursuant to business ethics ideals takes as the starting point of their critique of the neoliberal theory Milton Freidman's article in the New York Times which stated that the only social responsibility of a corporation is to increase profits for its stockholder[33]. Friedman was responding to the vastly growing and important conception of CSR, which on Earth Day in April 1970, finally became a verifiable concept in business and legal circles, forever to be etched into Anglo-American business practices[34]. The ensuing confusion of what a corporation stood for in the 1970s and the 1980s was perfectly summed up by Professor Lawrence Mitchell:

No institution other than the state so dominates our public discourse and our private lives.... Corporations make most everything we consume. Their advertising and products fill almost every waking moment of our lives. They give us jobs, and sometimes a sense of identity. They define communities, and enhance both our popular and serious culture. They present the investment opportunities that send our children to college, and provide for our old age. They fund our research. Individually and collectively, though, large corporations' presence may also harm us: They pollute our environments. They impoverish our spirits

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(31) Jones, Felps and Bigley 'Ethical Theory and Stakeholder related Decisions: The Role of Stakeholder Culture' Academy of Management Review 2007, Vol. 32, No. 1, 137–155.

(32) Zimmerliand Assländer (n 29) 16

(33)The Social Responsibility Of Business Is To Increase Its Profits,» N.Y. Times Mag., Sept. 13, 1970, Available At Http://Www-Rohan.Sdsu.Edu/Faculty/Dunnweb/Rprnts. Friedman.Dunn.Pdf Or Www.Ethicsinbusiness.Net/Case-Studies/The-Social-Responsibility-Of-Business-Is-To-Increast-Its-Profits.

(34) D M Branson, 'Corporate Governance "Reform" And The New Corporate Social Responsibility' University Of Pittsburgh Law Review, Vol. 62:605

with the never-ending messages of the virtues of consumerism. They provide a living, but often not a meaning. And sometimes they destroy us; our retirement expectations are unfunded, our investment hopes are dashed, our communities are left impoverished. The very power that corporations have over our lives means that, intentionally or not, they profoundly affect our lives(35).

According to Freeman(36), the social movements of the 60s and the 70s compounded with other such liberal movements like civil rights, consumerism and women's rights to give rise to the socially aware and responsible corporation. The academic movement was led by Post(37) and complemented by the likes of Sethi(38), Votaw(39), and Preston(40). The movement can be seen as still continuing strong in both the stakeholder-oriented and the CSR literature.

The literature on CSR has widely influenced the stakeholder debate. According to Johnson 'social responsibility in reference to firms concerns the balancing of a multiplicity of stakeholder interests'(41). Additionally, Davis enunciated that 'social responsibility begins where law ends'42, which in essence meant that social responsibility is something that is above and beyond the normal legal relationship in the company that includes taking into consideration other stakeholders and not merely existing fiduciary duties.

(35) L E. Mitchell, Progressive Corporate Law (Westview Press, 1995)

(36) Freeman, R. Edward, Strategic Management: A stakeholder approach, Boston: Pitman (1984).

(37) 'Research In Business And Society: Current Issues And Approaches.' Presented At Aacsb Conference On Business Environment/Public Policy And The Business School Of 1980s, Berkley, 1981

(38) P Sethi, Up Against The Corporate Wall (P Englewood Cliffs: Prentice Hall, Inc 1971)

(39) D. Votaw and P. Seth, The Corporate Dilemma: Traditional Values Nersus Contemporary Problems (Englewood Cliffs: Prentice Hall Inc 1974).

(40) L Preston Research In Corporate Responsibility And Social Policy, Volume1,. 1979. Greenwich: Jai Press

(41) H L Johnson, BusinessIn Contemporary Society: Framework And Issues. (1971). Belmont, Ca: Wadsworth.

(42) Davis, K. 'Can business afford to ignore social responsibilities?' California Management Review,2, 70-76, 1960.

The amount of influence that a corporation has in a given economy has grown exponentially, as has the number of stakeholders in a given corporation. This has resulted in the modern corporation becoming more of a social institution rather than a pure economic institution. This change of character has also forced changes in methods of governance.

Thus if examined closely, the CSR and stakeholder forms of governance are the practical implementations and manifestations of the much wider business ethics school of philosophy(43). Another important contribution by the business ethics school has been to directly target the conception of the agency theory and the finance model of governance that has been dominated by the shareholder primacy ideals. The shareholder primacy model posits that the corporation's sole aim ought to be to increase the overall income for the shareholders at all costs. In replying to this assertion, the business ethics and CSR literature state that one of the major flaws of the agency theory, which makes it ever more redundant, is that it does not take into consideration issues of ethics when dictating the overall company and corporate strategy at both the macro- and the micro-level(44). The agency theory, according to business ethics proponents, concentrates solely on the profit maximisation of a company which renders ethical issues as merely peripheral which makes the use of the neo-liberal ideology unsuitable for Islamic finance industry.

Looking at the stakeholder point of view in depth one can also assert that the external stakeholders influence organisational survival and prosperity in all corporations, since they often view CSR programs as a measure of the trustworthiness of an organisation(45). Thus, CSR initiatives tend to increase the relationship of trust between the business and the community, and this can translate into economic and social benefits in the form of a more loyal customer base, less stringent regulations, less public relations issues, less legal claims and a more effective marketing strategy.

(43) A Kitson and R Campbell, The Ethical Organization (London: Macmillan 1996)

(44) T. A. Kochan and S A Rubinstein,'Toward A Stakeholder Theory Of The Firm: The Saturn Partnership,'. (2000).Organization Science, 11(4): 367-386

(45) R Phillips, Stakeholder Theory And Organizational Ethics (San Francisco, CA: Barrett-Koehler 2003)

This paper acknowledges the fact that whenever a company implements CSR policy, ethical issues will inevitably arise. However, instead of taking this particular issue as a drawback, the organisation can systematically work through these issues and convince the major stakeholders of their viability and win approval of the regulatory bodies(46). This, in turn, will result in lower monitoring costs and thus be economically feasible for the corporation in the long run. Something which is usually found lacking in the Neo-liberal practices which tend to be focused more on the short term profit maximization policies.

Porter and Kramer put the issue of long-term versus short-term profits into perspective by emphasising that companies have to change their focus towards the social setting in which they act and interact because 'economic, social and environment goals with a long-term perspective are not independent or in conflict in spite of the fact that they can be contradictory in the short-term.'(47)

Levine also highlights managing risks as a main benefit of CSR in the short-term:

[w]hy implement a CSR program? In short, to manage risks and to ensure legal compliance, since companies may be exposed to a variety of legal and reputational risks if they do not have adequate social compliance or corporate social responsibility/sustainability programs in place.(48)

CSR is defined as 'a program of actions taken to reduce externalised costs or to avoid distributional conflicts. It is asystem of governance that has evolved in response to market failures, a Coasian solution to some problems associated with social costs'.(49) Thus, CSR can be looked at 'as an effort to take actions which reduce the extent of externalized cost'.(50) On the other hand, Beltratti emphasised the

(46) D. Llewellyn, 'The Economic Rationale for Financial Regulation.'(1999) The Occasional Paper Series No. 1. London, Financial Services Authority (FSA)

(47) M E Porter, Kramer and R Mark 'The Competitive Advantage of Corporate Philanthropy' (December, 2002) Harvard Business Review , 5-16

(48) B Thorston, Luclaevan and R Levine 'Finance, Firm size and Growth' (2008) Journal of money, credit and banking 40:1379-1405

(49) G Heal, Corporate Social Responsibility. An Economic And Financial Framework (Columbia Business School December 2004)

(50) Ibid Geoffrey Heal 41

importance of CSR by highlighting the weaknesses and shortcomings of the shareholder model and the agency theory: 'CSR is an attempt to escape profit maximization in the recognition that agency problems and incomplete contracts undermine the basic idea of shareholders supremacy.'(51)

Keeping the stakeholder point of view as the main focus, Koehn has further defined corporate governance as 'the art of governing in a principled fashion so as to maximize the welfare of the company and its relevant stakeholders'.(52) He further added that

[t]he agency problem involved in corporate governance would thus be better addressed not only with legal safeguards and economic incentives, but also with trust building institutional practices, governing well would thus ultimately mean acting in a trust worthy fashion. No company will ever succeed in the long run if it is not trusted by its customers, employees, suppliers, advisors, shareholders and other important stakeholders(53).

This assertion shows the importance of having good ethical practices in running a corporation, which helps to build a strong case for justifying the stakeholder and CSR method of governance.

Koehn's assertion regarding businesses being run on a relationship of trust can be construed as an attempt to reconcile the characteristics of ethics into business. Virtue has been used interchangeably with ethics by philosophers like Aristotle, who wrote that '[e]thics deals with the whole range of manifestations of virtue, from "fine actions" to "character"- which enable a state's citizens to aspire to the good life'(54). The philosophical debate surrounding the fulfilment of man's desire in society asks the question: are ethics enough to ensure happiness or fulfilment in a society? Sisson has argued that although ethics play a major role in the life of humans, external or material goods play an

(51) A Beltratti 'The Complementarity Between Corporate Governance And Corporate Social Responsibility' (2005) The Geneva Papers Bocconi University 30, (373-386)

(52) D Koehn, 'What Can Eastern Philosophy Teach Us About Business Ethics?' (1999) Journal Of Business Ethics, Vol 19, No 1, 1999

(53) Ibid Kohen 13

(54) W D Ross (Translated) Nicomachean Ethics By Aristotle 350 Bc, (Oxford University Press, USA ,July 9, 1998)

equally important part and so ethics without an external motivator like economics/commerce are meaningless(55).

Building up on the virtues of ethical conduct in business, writers like Freeman have also argued that 'ethical issues are as much a part of economic and business as accounting, finance, marketing and management'.(56) This statement supplements his assertion that the separation thesis(57) as understood by academics is a 'bankrupt discourse', meaning that the conception of business being amoral is unsubstantiated and unfounded. Another way to look at the separation thesis is from the point of view of the agency theory, which would presumably take the following stance: the management of the company is to be concerned with only the profit maximising function of the company at all costs, ignoring or rejecting all other claims whether ethical or not. Conversely, the stakeholder theory holds that rather than there being one goal of a business (profit maximisation), there are a multiplegoals, of which profit maximisationis merely one. Other goals include the pursuit of a 'common good'(58), building a relationship of trust amongst the stakeholders and establishing a sound crisis management policy that

(55) K Sisson, Personal management: a comprehensive guide to theory and practice, 3rd Ed Blackwell Oxford (1995)

(56) Freeman and Werhane 'Business Ethics: The State Of The Art' (1999) International Journal Of Management Reviews, Reviews; Vol 1

(57)The underlying understanding in the business circles including academics about the meaning of the separation thesis is that business and ethics are completely apart and have nothing to do with each other.

(58) The fundamentals of the 'common good' concept emanate from the writing of Thomas Aquinas, who introduced the concept of 'common good' as being something that binds a sovereign leader constraining him/her from acting only in his own interest. Aquinas states that sovereign leader's office or duty is to further the common good in such a way that the government or the state is not utilised to further the self-interests of those governing. Even though the idea of common good has been borrowed from the political studies, it can as easily be applied to the working of a corporation. This concept when transposed to the modern day corporation then reads as meaning that the purpose of the corporation is not to merely further the goals of the owners or managers, but rather to work to furthering the goal of a common good for a wider array of stakeholders. The idea of the common good in essence binds the office holder as to how they can act, whether in the context of a political office or in the context of the corporate office. The idea of the office - and hence executive power - is thus bounded by the fact that both power and office are to be used to further the common good for society as a whole.

would affect many stakeholders and society generally, whether direct or indirect.

The purposes of both virtue and business activities in a society are therefore similar, i.e. to pursue human fulfilment and happiness and eventually to pursue the 'common good' for society in general.(59) Thus, the immediate objective of a corporation is to provide the conditions that make the acts of virtue possible so that pursuits of goals such as the common good and formation of sound crisis management policies for the stability of the financial system are facilitated, keeping in view all relevant stakeholders.(60) This is similar to the point of view in Islamic business ethics regarding trusteeship (kifalah) where the interests of the society are given precedence over that of the individual and thus in the long term the individual is benefited as part of the collective. The individual, in Islamic philosophy pertaining to economics, is understood as being a trustee for the economic resources that he owns, holding those resources on trustfor God and subsequently for society. This idea of Khilafah forms a major similarity between the stakeholder theory and the Islamic finance theories.

Therefore, ethics and economy are dependent upon each other. Sisson has argued that based on the Aristotelian teachings 'all economic activity (firms, corporations) should function under the guidance of ethics, which is the practical science of acts of virtue (which is considered to be supreme human excellence)'.(61) He then continues by stating that 'the economy has as its mission to facilitate the practices of virtue or ethics by establishing favourable material conditions amongst the citizens of a state'.(62) As espoused by the concept of falah in the Islamic business ethics model, the pursuit of profit cannot be taken as the end in itself for any model. This 'end' is the fulfilment of human happiness and pursuit of common good for the society, which cannot be achieved without the presence of ethics. Building upon this particular argument, it can be seen why the neo-liberal shareholder model of corporate governance fails to fulfil these requirements and why the

(59) A Argandona, 'The Stakeholder Theory and The Common Good' (1998). Journal of Business Ethics. 17, 1093-1102

(60) Jones, Felps, and Bigley (n 31)

(61)Sisson (n 55)58

(62) Sisson (n55) 59

stakeholder model and the CSR model of corporate governance are the best possible models of corporate governance for all IFIs.

3. THE STAKEHOLDER THEORY AND ITS SUITABILITY FOR ISLAMIC FINANCIAL INSTITUTIONS

As seen in the previous section, the stakeholder theory addresses the question of 'in whose favour' should the corporation be run. But the underlying issue with the concept itself is the matter of defining who is to be considered a stakeholder. Having discussed the different views on who should or should not be included as a stakeholder for any organisation, the only definition that is satisfactory theoretically as well as practically is that given by Thomson,[63] and subsequently endorsed by Freeman,[64] where the stakeholder concept denotes 'those groups which make a difference', or more formally: 'A stakeholder in an organization is any group or individual who can effect or is affected by the achievement of the organization's objectives.'[65]

By using this particular definition of a stakeholder, in the corporation the manager will see different groups involved directly or indirectly with the organization as having a stake in the organisation. The stakeholder concept will therefore denote legitimacy by demanding that managers give due weight to the concerns of these groups in order to positively affect the direction of the organisation.[66] This would more clearly define what managers should spend in terms of time and resources on these stakeholders without any regard to the appropriateness of their demands. This results in giving legitimacy to the demands of all stakeholder and not only the shareholders.[67]

(63) J Thomson, Organisation in action(McGraw Hill 1967)
(64) Freeman (n 36) 41
(65)Freeman (n 36) 46
(66) T M Jones and A C Wicks 'Convergent Stakeholder Theory.' (1999) Ficadeini› of Management Review 24 (2), 206-221
(67) Freeman (n 36) 46

Freeman and other academics that support the stakeholder theory as the best possible corporate governance model have provided their endorsement because they are of the view that the consequences of not adopting this approach may very well lead to the company suffering from legal action, regulatory compliance costs and damaging regulation and the loss of market share to foreign competitors who can satisfy stakeholder needs.(68) This shows how important the integration of the stakeholders is in running an efficient and successful company both strategically and legally.(69) The other point that is made clear is the role that the government plays if stakeholders' concerns are not taken into account. A very strong case of regulating corporations by the government and quasi-government agencies can be made under the stakeholder approach because the government is also considered a stakeholder due to the direct/indirect effects of their policies. Consequently, the overall policy that the government would implement for the business environment will have to reflect these stakeholder concerns and ensure compliance with those policies by the corporations.(70)

This has been seen in the recent financial crisis when governments exercised minimal intervention in supervising important industries like banking and financial services. This non-interventionist role of governments led to banks being run merely for profits and 'projected' (artificial and superficial) profits manufactured by unethical practices.(71) As long as the bank's financial situation on paper was strong and the shareholders were getting dividends, there was no inquiry into the way those profits were being made. Government agencies declined to intervene until the collapse was all but inevitable. This non-interventionist policy led to the downfall of the wider economy simply because banks and other financial institutions have become such an integral part of the economy and their failure had a domino effect on other industries.72

(68) Freeman (n 36) 26

(69) Jensen M C. 'Value Maximization, Stakeholder Theory, And The Corporate Objective Function.' Business Ethics Quarterly 12(2)2: 35-256.(2000).

(70) B A Ackerman and A Alstott, The Stakeholder Society (Yale University Press, New Haven, CT 1999)

(71) J Armour and J A Mccahery, After Enron Improving Corporate Law And Modernizing Securities Regulation In Europe And The US (Hart publishing 2006)

(72) P OMulbert 'Corporate Governance Of Banks' (2009) Http://Ssrn.Com/Abstract=1448118, Working Paper N:130/2009

Thus, Freeman and other academics who propagate the stakeholder theory as the principal strategic and planning practice for the modern corporation - whether a bank or otherwise - are right to do so. Their assertions are valid because the inherent risk of making firms accountable solely to shareholders is very high(73). One of the reasons for the antagonism towards the company being responsible solely to the shareholders is the belief that they may not be interested in anything other than their share prices going up. Further, they may also be underqualified to absorb and decipher all of the complex information regarding the market, thus increasing the chances of the managers running the corporation for their own whims and wishes, bringing doubt to the hypothesis of the rational shareholder(74).

This paper argues that one primary advantages of using the stakeholder concept to govern IFIs is its roots in an ethical ideology making the business less risky and more inclusive, reflecting the ethos of distributive justice for the maximum number of stakeholders, including the society. As proposed by DomènecMelé and Manuel Guillén:

[a] stakeholder approach grounded in ethical theories presents a perspective of corporate social responsibility in which ethics is central. This represents clear progress in the understanding of the integration of ethics into strategic management. In fact, there is a connection between strategic thought and ethical reasoning(75).

According to Freeman, the term ‘stakeholder’ must be able to encompass a wide range of potential claimants(76). As previously discussed, any individual or group who may affect or who may be affected by the actions of the organisation shall be considered a stakeholder. According to this definition, it must also be taken into account that the concerns of such a group or individual should not be neglected as they may negatively influence the achievement of an organizations goal.

(73) Phillips, R. A. ‘Stakeholder Theory And A Principle Of Fairness’ Business Ethics Quarterly7: 51-66. (1997).

(74) Jensen (n 72)

(75) DomènecMeléand Manuel Guillén ‘The Intellectual Evolution Of Strategic Management And Its Relationship With Ethics And Social Responsibility’ (2006) Working Paper Wp No 658 October 2006, Electronic Copy Of This Paper Is Available At: Http://Ssrn.Com/Abstract=960663

(76) Freeman (n 36) 43

Building on this concept of stakeholder, a strategic management point of view will thus take into account the capability of an organisation to manage the relationships with its specific stakeholder groups in a practical or action-oriented way[77].

As already discussed, it was Freeman whose seminal work popularized the stakeholder concept from a mere afterthought to a plausible theory for management and policy[78]. Freeman was of the view that the business environment globally has always 'dealt with non-market stakeholders' with the internal and external changes taking place especially post-WWII, within Anglo-American corporations[79]. With globalisation taking its stride, the simple explanation of the firm as merely a resource conversion entity was no longer appropriate. According to Freeman, the internal changes that have changed the face of the business environment include those relating to owners, customers, employees and suppliers[80]. The interaction of these and other factors (internal and external) necessitates a change in policy at the management and governmental level. The external changes that Freeman refers to are the expansion of federal, state and local government business-related activities. Increases in foreign competition, consumer activism and the growth of special interest groups like unions, environmental protection groups and gun control groups have also played a significant role in shaping the way that the firm is looked at from a stakeholder's perspective[81]. These changes all require a revamp of the current strategic and policy-based decision-making processes to integrate stakeholder theory into firms' overall structure, not as outsiders but as integral parts of the process.

It can be said that there are three levels at which we can divide an organisation as far as its ability to manage its relationship with the stakeholder is concerned.82This will give a better understanding of how and when to interact with a particular group of stakeholders. These are set out as follows:

(77) Freeman (n 36) 47
(78) Freeman (n 36) 35
(79) Freeman (n 36) 39
(80) Freeman (n 36) 110
(81) Freeman (n 36) 65
(82) Freeman (n 36)52

The first level is the rational level;(83) the most basic level on which it is decided which groups and individuals can actually affect or be affected by the organisation achieving a particular purpose. Hence, there is a need to identify specific stakeholders on this first level. This analysis will be detailed as regards the particular influence of a group and how that influence may arise.(84) This strategy will be important from both a managerial and a legal point of view, thus the overall strategy will have to take into account the underlying legal relationships between the company and the stakeholders and how these relationships may be influenced adversely or positively.(85) The other issue is deciphering what constitutes a "stake". Freeman considers any influence, whether monetary, political or social, as sufficient.(86) There is also a further category of 'stake' which may be seen as a middle ground between the traditional conception of stake as equity and Dill's definition of a kibitzer, called the 'market stake' by Freeman.(87)

The other definition of 'stake' that Freeman has offered is characterised by means of the power or influence that the stakeholder has over the organisation. This 'power' can be divided into three further types of powers; namely voting powers (owners have this), economic power (customers and suppliers) and political power (the government).(88) These categories are not mutually exclusive because according to Freeman, these powers and players overlap each other's boundaries and may interfere with each other's powers without awareness that they are doing so. But from a managerial or organizational point of view these differences may be vital for developing strategy. This is specifically true for the investment account holders (IAHs) in the IFIs who are major stakeholders, being investors and depositors, but have neither the protection of the traditional depositors nor the authority of the traditional

(83) Freeman (n36) 54
(84) I M Jawahar and G L Mclaughlin 'Toward A Descriptive Stakeholder Theory: An Organizational Life Cycle Approach.' 2001 Academy Of Management Review 26(3): 397-414
(85) C W L Hill and T M Jones 'Stakeholder-Agency Theory.' (1992). Journal of Management Studies, 29: 131-154
(86) Freeman (n 36) 59
(87) Freeman (n 36) 60
(88) Freeman (n 36) 63

shareholders.(89) This leaves them vulnerable to the abuse of power by management, which in essence means that IFI need to establish such a legal framework and governance structure where by the IAHs are given adequate power and authority. Thus it is even more important for IFIs to focus on a corporate governance model which is stakeholder-oriented to cater for their unique nature.(90) The drawback of this particular level is that there may actually be a problem when the stakeholder perceptions are not in line with those of the organisation. This introduces the need to explore other levels of analysis.

The second level is the organisational/process level according to Freeman's analysis. In order to manage their relationship with stakeholders, the management will generally rely on set procedures and patterns, and these procedures will give us a better understanding of which processes are actually more useful.(91) This level of interaction between the management and stakeholders is vital to IFIs' governance model because of their inherent nature, having a diverse range of stakeholders being involved in their operation including, inter alia, normal depositors, IAHs, shareholders, employees and the SSB.(92) Some of these stakeholders - being unique to the Islamic finance industry - require more attention, because of the number of stakeholders that are involved an IFI are more than their conventional counterparts, thus making it even more imperative for IFIs to be governed via a stakeholder model of governance.(93)

The third level is the transactional level.(94) At this level the inquiry tries to explain how managers carry out transactions with the stakeholders,

(89) Z Iqbal And A Mirakhor, Financial Contracting And Riba(Interest) in Z Iqbal and A Mirakhor, An Introduction To Islamic Finance , Theory And Practice (Jhon Wiley And Sons' Pte Ltd. 2007

(90) Luca Errico and Mira Farhbaksh 'Islamic Banking: Issues in Prudential Regulation And Supervision' (1998) IMF Money And Exchange Department, WP/98/30, Working Paper

(91) Freeman (n 46) 65

(92) M A ASarker 'Islamic Business Contracts, Agency Problem and the Theory of The Islamic Firm' (1999) International Journal Of Islamic Financial Services, 1 (2)

(93) E B Satkunasegaran 'Corporate Governance and The Protection of Customers Of Islamic Banks,' (2003) International Islamic Banking Conference 2003. Prato, Italy

(94) Freeman (n 36) 69-71

how managers interact and what resources they allocate towards that interaction. At this level, managers will be carrying out many different types of transactions with different stakeholders, and these transactions will result in many tangible strategic and managerial decisions being taken accordingly. For example, the more common transactions would be with the government, employees, the media and the consumers, all of which will determine how the company will react to different issues. In the case of an IFI, there will be additional categories of stakeholder like the SSB, IAHs and the two-tiered regulatory bodies (one for regulating the Sharia aspects and another for regulating the normal functioning of an IFI as a corporation). Thus, this level of interaction between the IFI and the concerned stakeholders will be an important feature of the stakeholder model of governance for the IFIs[95].

According to Freeman, a good company would be expected to understand this interaction process and adapt accordingly.[96] For example, when a significant amount of consumers become unhappy about a certain aspect of a company or its product, the company which responds well to that particular group of stakeholders will be considered a success. Similarly, an organisation that understands and responds accordingly to the demands or reservations of the stakeholders as a whole will be more aware of the external environment of the company.

Freeman also notes that the problem with understanding and implementing the stakeholder philosophy is not an external one, rather the actual frontline of conflict between stakeholders and the management lies within the company.[97] It is the lack of managerial understanding of the stakeholder concept and its likely implications on the business environment as a whole that leads to the lacklustre interaction with the stakeholders. Also, so long as managers remain ignorant to this issue, the business community as a whole will remain stagnant and unresponsive to changing practices both externally and internally. This paper argues that this issue is even more pronounced for the Islamic financial industry, wherein managers (including the BOD) have to be

(95) W Grais and M Pellegrini ‘Corporate Governance and Shariah Compliance In Institutions Offering Islamic Financial Services’ (2006) World Bank Policy Research Working Paper 4054

(96) Freeman (n 36)85

(97) Freeman (n 36)74

aware of the dual nature of the entity and have to respond accordingly. In essence, this means that the management will have to take decisions which will be acceptable by the shareholders and create wealth whilst also complying with the Shariaprecepts and focusing on the societal needs of a number of stakeholders, as the socio-economic inclusive model of financial intermediation goes to the heart of the Islamic economic model and forms its Maqasid-al-Sharia(98).

Furthermore, this paper asserts that the best way to implement the stakeholder approach is by means of 'voluntarism' since the change has to come from within an organisation/ industry. Something which is a given in the Islamic finance industry due to the inherent religo-ethical nature of the Islamic finance Industry(99). One major concern for writers like Freeman was that the cost of other means of implementing this approach are too high as there are many stakeholders involved and to cater for all of them externally is next to impossible. Freeman asserted that the only solution is that managers become aware of the stakeholders around them and act accordingly(100). Instead of trying to hide from the impending issues, they should voluntarily embrace and work with them and incorporate them into their strategies and day to day dealings. It is thus argued that in such a case, a meta-regulatory framework with a mixture of both voluntarism as well as some enforcement powers by a supranational regulatory authority is the most optimal way of regulating IFI internationally(101).

Friedman and Miles have argued that the most common way of classifying stakeholders is to 'consider groups of people with a distinguishable relationship with corporations: shareholders, customers, suppliers and distributors, employees and local communities'.(102) Another issue, according to Friedman, is whether the stakeholders are to be confined to those that are crucial for the achievement of corporate objectives, or

(98) Iqbal and Mirakhor (n 92) 43-63

(99) Freeman (n 36)75

(100) Freeman (n 36)75

(101) S Hamid 'A Re-reading of the Fundamentals of Islamic finance: principles of Contract law, Riba and Gharrar in light of the Maqasid Al Sharia and Maslaha principle' JISPIL 2 2015.

(102) Friedman, A. L. And Miles, S. Stakeholders: Theory and Practice, Oxford: Oxford University Press.(2006).

if they include any entity that is directly or indirectly affected by the company's operations or actions. The latter definition may be too wide, as it may result in difficulties identifying whether a particular individual is a stakeholder, since the effects of a business in modern economies are widely felt across the different segments of society. However, from an Islamic finance point of view, corporate objectives should normatively be geared towards contributing to societal wellbeing and achieving distributive justice as this forms the basic essence (maqasid-al Sharia) of the Islamic economic model. Consequently, the list of potential stakeholders will have be longer than those accepted by conventional financial institutions(103).

Thus, Freeman and Bowie (and Reed in his works with Freeman) have divided this definition further into two different parts: the wide definition (which encompasses all those indirectly and directly affected by the workings of a corporation) and the narrow definition (which focuses on the distinguishable legal relationships that a company may have with its core stakeholders).(104) Accordingly, for IFIs, the categories of stakeholders falling within both these classifications are the IAHs, the SSB, the employees,(105) the depositors, the shareholders, the regulators,(106) their customers107 and if extended slightly further society as a whole may also form a group of stakeholders that the IFIs owe a duty to, indirectly and directly, under the Sharia norms(108).

(103) M H Karnali, Maqasid Al-Shari'ah: The Objectives Of Islamic Law (Islamic Research Institute, International Islamic University Islamabad, Islamabad 1999)

(104) R E Freeman, Stakeholder Theory Of The Modern Corporation in T.L. Beauchamp And N E Bowie (Eds) Ethical Theory And Business (7thEdn. Upper Saddle River, NJ: Pearson/Prentice-Hall) : R E Freeman and D L Reed, 'Stockholders And Stakeholders: A New Perspective On Corporate Governance' (1983), California Management Review, 25/3:88-106

(105) A A. Hanafy ‹Employee And Employer: Islamic Perception› (1988), Proceedings Of The Seminar On Islamic Principles Of Organizational Behavior (International Institute Of Islamic Thought, Herndon, VA)

(106) S Archer and R Abdel Karim, Islamic Finance: The Regulatory Challenge(Wiley publishers 2007)

(107) E B Satkunasegaran 'Corporate Governance and The Protection Of Customers Of Islamic Banks,' (2003) International Islamic Banking Conference 2003. Prato, Italy

(108) S N H Naqvi, Ethics and Economics: An Islamic Synthesis (Leicester, The Islamic Foundation 1981)

Another area of concern in the definitional debate is the unclear role of the managers. Some writers consider the management as stakeholders but others have treated them more significantly and considered them as the main focal point of the organisation.(109) The significance of the role of managers in this debate cannot be underestimated and it is very important to actually extricate what the managers do in the corporation in general. The role of the managers has to be viewed from the perspective of the stakeholders as to how they manage their relationship with them i.e. how well they cater to the needs of the stakeholders and how well they integrate them into their vision of the company and the corporate policy.(110) It is thus argued that management of the IFI has to be stakeholder-oriented, not only for the economic benefit of the IFI but as a matter of legal and religious duty as espoused by the basic principles of Islamic economics.(111)

Another important factor for defining the stakeholder is to identify which of them have a fiduciary relationship, and accordingly those who are owed fiduciary duties may be classed as primary stakeholders and those who aren't are classed as secondary stakeholders.(112)

Donaldson and Preston have distinguished between influencers and simple stakeholders.(113) However, there may be an overlap in this distinction; there may be some who influence the corporation and have no stake (such as the media), whilst similarly there may also be some who may have a stake but no influence (such as job applicants), and then there may further still be those who are both stakeholders and influencers like the stockholders(114).

Another justification for employing the stakeholder concept as the underlying ethos for the governance of the corporation is based on the premise that all stakeholders provide a source of capital implicitly

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(109) Jensen, M. and W. Meckling 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.' (1976). Journal of Financial Economics 3,305-360

(110) Freeman (n 36) 45

(111) M U Chapra and H Ahmed, Corporate Governance In Islamic Financial Institutions (Islamic Development Bank and Islamic Research and Training Institute. Jeddah 2002)

(112) A L Friedman and S Miles, Stakeholders: Theory And Practice (Oxford: Oxford University Press 2006)

(113) Donaldson And Preston (n362) 83

(114) Friedman and Miles (n 115)12-13

and explicitly by means of the different services and activities that they carry out. Blair, Etzioni, and Schlossberger present this justification in their defences as to why stakeholders should form an integral part of the company.[115] This is most pertinent for the IAHs in an IFI who do actually contribute capital for the IFI but are overlooked as not being owed a legal duty on the same line as conventional Shareholders as understood under conventional law. This is why IFIs need to have a structure in place which caters to this particular class of stakeholders specifically, and this can only be done through integrating the stakeholder ethos in the operational and governance structure of the IFIs.

4. SOCIETY AS STAKEHOLDERS AND CAPITAL PROVIDERS: MOVING TOWARDS THE IDEALS OF ACHIEVING A 'COMMON GOOD'

Blair has stated that the current conception of shareholders as capital providers for businesses is a concept that has its roots in history, dating back to when corporations were involved in setting up railway lines and operating canals.[116] It was in these scenarios that the initial investors were relied upon for initial investment and thus they were the largest stakeholders in the corporations' operations. According to Blair, this conception of the stakeholder is now redundant as investment has moved away from being reliant upon capital intensive wealth generation to the fusion of more intangible assets, where the 'skills and the ability of the workforce and the ability of the organization as a whole to put those skills to work for customers and clients' is now considered investment as much as capital contributions.[117] Thus, the validity of the shareholders having a legal and moral claim based on their capital contribution is no longer a justifiable claim, further weakening the viability of the shareholder primacy view in general, but more specifically for IFIs.

(115) Blair, M 'Ownership And Control Rethinking Corporate Governance For The Twenty-First Century.'. (1995).The Brookings Institute Washington, D. C: A Etzioni,The New Golden Rule. Community And Morality In A Democratic Society (New York: Basic Books 1996) ; A Etzioni 'A Communitarian Note On Stakeholder Theory' (1998) Business Ethics Quarterly, 8/4:679-91; E Schlossberger 'A New Model Of Business: Dual- Investor Theory', (1994) Business Ethics Quarterly, 4/4: 459-74

(116) Blair (n 118) 31

(117) Blair (n 118) 32

Schlossberger goes a step further, propagating that all businesses have a fiduciary duty towards stakeholders just as they owe a duty towards the Shareholders, not because of any underlying social or implicit contract, but because the modern day stakeholder is a category of shareholder that has invested capital in the business.[(118)] This is so because all businesses have two types of capital; 'specific capital' and 'opportunity capital' (this is well-suited for the Islamic banking model of IAHs and shareholders), the latter of which is attributable to the stakeholders, rendering them a shareholder of sorts, whilst the former type is conventional equity capital attributable to shareholders and partners. This 'opportunity capital' is provided by the society as a whole by way of material infrastructure, educational systems, monetary systems, policing and also the infrastructure of knowledge. Schlossberger argues that this capital is present and available to all businesses and whether they exploit it or not is up to them, but since society does in fact provide these facilities they are to be considered a category of shareholders regardless of their actual contribution[(119)].

Following from this argument we can establish that 'society is a shareholder in every business venture, though not the same type of shareholder as stockowners'.[(120)] Thus, every stakeholder is simultaneously a sort of shareholder and every business venture in a capitalist nation is both privately and publicly owned concurrently.[(121)] This means that corporations 'have the same kind of fiduciary obligation to society as to stockholders'.[(122)] This can, in strategic and policy terms, be read as saying that the responsibility of the corporation to take into account the interest of non-stockholding shareholders is not merely a responsibility and a constraint on the corporation and its management; rather, it is a part of the 'corporate objective'. Hence, according to Friedman and Miles,[(123)] the compelling nature of this argument by Schlossberger lies with its provision to determine 'a criterion for deciding on what degree of

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(118) E Schlossberger 'A New Model Of Business: Dual- Investor Theory', (1994) Business Ethics Quarterly, 4/4: 459-74

(119) Ibid Schlossberger ,71

(120) Schlossberger (n 122) 65

(121) Schlossberger (n 122) 95

(122) Schlossberger (n 122) 62

(123) Friedman and Miles (n 115) 90

ownership is required of government'.[124] This idea is in essence based on the concept of property ownership, which cannot be considered an absolute right that allows one to do as one pleases at the detriment of others. Furthermore, it becomes a part of the governmental obligation to establish a variety of public/private ownership relationships. So in essence, the more public the business is, the heavier it will demand opportunity capital and then consequently the higher the obligations are to the opportunity investors i.e. the stakeholders. This idea of individual actors not having an absolute right in property ownership is very similar to the idea of property ownership in Islamic finance literature and draws a very apparent parallel to the Islamic financial ethos, giving the idea of stakeholder theory credence in both Islamic literature as well as conventional corporate governance literature.[125] It can then further be argued that IFIs need to be governed under a stakeholder-oriented model and not the en vogue neoliberal shareholder primacy model because the shareholder primacy model does not cater for the Maqasid al Sharia (the raison d'être) of Islamic finance because it does not take into account the wider benefit of society as an integral part of the business environment. On the other hand, as we have seen the stakeholder ideals have the ability to cater for a number of stakeholders which, despite the fact that they are not contributing to the assets of the IFI, are considered as an integral part of the overall operational and governance ambit of the IFI. This is in line with the obligation of the Islamic finance model to be socially inclusive and concurrently be able to contribute to the socio-economic development of society in general.

Freeman refused to accept there was any singular stakeholder theory; rather, stakeholder theory is merely a genre.[126] This view of his is motivated by what he calls 'pragmatism' as this then 'leads to one of many ways to blend together the central concepts of business with those of ethics'.[127] It was Freeman who took the stakeholder concept from being a simple discussion point to a practical strategy that could be employed both at the company and the state level.

(124) Schlossberger (n 122) 87

(125) M U Chapra, Islam and The Economic Challenge (Leicester, The Islamic Foundation 1992)

(126) Freeman (n 36) 32

(127) Freeman (n 36) 45

Thus, Freeman can easily be called the 'father' of the modern day stakeholder concept.

Since Freeman's conception of the stakeholder is normative, spelling out how corporations should be governed and how mangers should act, it can be argued that the stakeholder theory encompasses the normative ethical/moral question. It does so by defining the relationships between all the stakeholders and how they are managed ethically, keeping in view the requirements of society in general, and thus translates theory into practice by giving concrete suggestions as to how to go about implementing these ethical standards.(128)

According to Freeman, one of the major reasons of the scepticism about business ethics is the fact that the managers in the corporation are deemed to be agents of the company and this makes business ethics a part of a broader question of agents' responsibility to companies in general. This also helps us understand what kind of a duty is owed to the company by the managers.(129) This posits the question whether this agency relationship of the managers with the company as a whole overrides other moral rules and issues like the responsibility of the managers towards the larger stakeholder community, as opposed to being focused purely on increasing the value of the company stock.(130)

Since the morality or ethics of a company can be taken to mean the aggregate of its individual actors like the managers and stockholders, the question that can then be asked is: what does a company aim to achieve? Or more deliberately, as Goodpaster and Donaldson have asked, what is the nature of corporate responsibility?(131) The answer according to the neoliberal economist and agency theory proponents like Milton Friedman is simply 'to increase its profits as long as it stays within the rules of the game.'(132) But for business ethics, CSR and stakeholder proponents the answer is completely different. They take

(128) Freeman (n 36) 58

(129) Freeman (n 36) 32

(130) Blair (n 118) 76

(131) K E Goodpaster 'The Concept Of Corporate Responsibility' (1983) Journal Of Business Ethics, 2(1): 1-22; T Donaldson, Corporation And Morality (Prentice-Hall 1982)

(132) T Friedman 'The Social Responsibility Of Business' (1970) New York Times Magazine, Sept 13th 122-126

profit maximisation as one of the aims of the corporation and do not consider it as the end in itself. For them, the end is the common good of the society, whereby corporations consider their social and ethical responsibilities whenever taking actions and pursuing strategies; something which is resonant in Islamic finance literature.

Academics and policy makers like Friedman's point of view is based on the rational choice theory, which states that all rational human beings will make choices which will further their own interests, which in the case of the company and its stock holders and managers is to maximise the value of the company.(133) The rational choice theory has already been proven to be based on the wrong presumptions by writers like Wood,(134) Mitnick,(135) Arrow,(136) and Zimmerli and Assländer.(137) The argument given by the neoliberal proponents against the stakeholder and business ethics point of view is this: why should or why would a stockholder/investor put in money to benefit someone else like the other components of society (the 'indirectly affected stakeholders')? One of the counter arguments to this rational choice theory comes in the shape of the Integrated Social Contract Theory (the ISCT) as proposed by Donaldson and Dunfree.(138)

ISCT has its roots in the writing of Thomas Hobbes, who said that people tacitly consent to join together in societies and at least tacitly agree to laws and regulations on their behaviour, so that they can live in harmony and achieve their own ends in relation to others.(139) Don-

(133) Ibid Friedman

(134) Donna J. Wood 'Dialogue: Towards Superior Stakeholder Theory' Business Ethics Quarterly, Vol 18, Issue 2, 153-190 (2008)

(135) B M Mitnick, The Political Economy Of Regulation: Creating, Designing, And Removing Regulatory Forms. (New York: Columbia University Press 1980)

(136) K L Arrow, Individual Choice Under Certainty and Uncertainty (Cambridge, Ma: Belknap Press 1984)

(137) Walther ChZimmerli and Michael S. Assländer, Corporate Ethics and Corporate Governance (Springer Berlin Heidelberg, 2007)

(138) T Donaldsonand T Dunfee 'Towards A Unified Conception Of Business Ethics: Integrative Social Contract Theory' (1994) Academy Of Management Review, 18(2), 22-284

(139) R Tuck and M Silverthorne (Ed & Trans) ' Thomas Hobbes, On The Citizen (Cambridge University Press, Cambridge 1998 [1642]) and Edwin Curley (Ed) 'Thomas Hobbes, Leviathan' [1651/1668]) (Hackett, Indianapolis 1994)

aldson and Dunfree interpret this point of view to mean that there are basic moral norms or 'hyper norms' that govern all social relations at both the macro- and micro-level.(140) Like all other segments of society, these norms are practiced at the company level as well. At the micro-level, however, there are free moral spaces in this regard which are to be fulfilled by the said organisation in line with macro-level norms. So long as the macro- and micro-level norms do not contradict each other, they will be acceptable(141).

This can then translate to mean that at a company level the rational choice theory cannot be unequivocally accepted and it needs to be qualified by moral norms both at the macro- and the micro-level. So, if a profit maximising company is not meeting its ethical and moral obligations it will no longer be an acceptable justification for them acting in any particular fashion as is deemed necessary by the management of the company.(142) However, according to Freeman even this conception of the ISCT does not completely solve the conundrum that faces the legal and business community at the micro-level. Accordingly, it is 'the stakeholder theory that bridges the gap by eliminating the macro/micro distinction'(143) and it is argued that for an industry based on moral and ethical aspects like the Islamic finance industry, the stakeholder model for corporate governance is the most suitable. This is so because it fulfils all criteria of the Islamic economic and business ethos as well as providing modern IFIs with a suitable mode of governance and operation.

5. THE VALUE LADEN DUALITY OF THE STAKEHOLDER THEORY AND ITS SUITABILITY FOR THE IFIs.

Stakeholder theory brings in the dual concept of values and morality, operational in a real-world setting; something that both the individual moral point of view and the agency theory cannot offer. The agency theory focuses purely on only one facet of the whole agent principal relationship of maximising profitability and value, whilst on the

(140) Donaldson and Dunfee (n 143) 65
(141) Donaldson and Dunfee (n 143) 32
(142) Donaldson and Dunfree (n143) 24
(143) Freeman(n 36) 32

other hand the moral/ethical point of view only focuses on the values and normative issues of ethics regarding what a company ought to do, without going into nuances of the practical application in the business environment.[144] As Freeman puts it,

Stakeholder theory, by calling attention to the variety of roles that can be occupied by individuals all of whom have a moral stake in the organization, can thus provide a framework for understanding and explicating the possibility of conflict of values, of loyalty, of commitment and of interests[145].

The stakeholder theory also counters the argument that the corporation is 'soulless', by stating that the business or at least their managers behave in a way that safeguards the soul of the corporation.[146] Thus, the corporation is given a value-laden 'soul' which would and should take into account moral and ethical issues whenever conducting business. Clarkson posits that even though the concept of CSR is a good idea in theory, it is unworkable on a voluntary basis as the corporation cannot be expected to act benevolently unless they are either forced to or the corporation sees a benefit in it for itself.[147] Thus, CSR and stakeholder policy is only effective if combined with the regulatory and legal framework for enforcement. Otherwise, the idea of the company acting for stakeholders other than the shareholders becomes insignificant, apart from being utilised as a marketing tool to garner a good reputation. The underlying idea of the firm being a 'soulless' corporation was the pretext to the stakeholder debate's importance in both managerial and legal literature on the company. The alleged lack of the 'soul' in a corporation can be filled in by the value laden stakeholder concept, which is a moral theory regarding values being attributed to non-living beings. In this context, values are attributed to the company by virtue of the managers' value judgements. This is one of the ma-

(144) N M Wijnberg'Normative Stakeholder Theory and Aristotle: The Link between Ethics and Politics.' (2000) Journal of Business Ethics. 25, 329-342

(145) R E Freeman 'Divergent Stakeholder Theory' (1999) Academy Of Management Review, 24: 233-236

(146) Friedman, A. L. And Miles S, Stakeholders: Theory And Practice, Oxford: Oxford University Press.

(147) M B E Clarkson 'A Stakeholder Framework For Analysing And Evaluating Corporate Social Performance.' (1995) Academy Of Management Review 20: 92 -117

jor reasons why the IFIs can adapt this theoretical framework in such jurisdictions where it is difficult to enforce Sharia norms on their own. As seen here that the stakeholder point of view is the closest to the maqasid al Sharia of Islamic finance, by adapting the ethical spectrum to judge on the efficacy of the overall operational ambit of a corporation and including other stakeholders besides the shareholders, it may allow IFIs working in non-Islamic jurisdictions to operate under secular regulations whilst maintaining their religious and ethical essence.

The stakeholder theory as promulgated by Freeman thus affirms the Islamic point of view regarding business activity having a moral and ethical foundation, and at the same time questions the separation thesis by removing the distinction between descriptive roles of all the stakeholders, preferring to attribute normative roles to them (the stakeholders).(148) The stakeholder theory also asserts that all stakeholders have an intrinsic value in being a part of the company and therefore also removes the distinction between the moral/ethical and practical aspects of business.(149) These two aspects of the stakeholder theory can thence be taken as arguments supporting the notion that the stakeholder theory is indeed the best method of reconciling the moral/ethical aspects of the company's working with the practical aspects.(150) This assertion will hold true at both the macro- and the micro-level for the Islamic finance industry as encompassing the value laden concepts that are embodied in the Sharia rules regarding finance and economics.

It is also asserted that another important question needs clarification. That is, 'what is the role of the company?' This can best be answered by the help of the stakeholder theory. Freeman and Evans state that 'the very purpose of the firm (and thus its managers) is to serve as a vehicle for coordinating stakeholder interests', which is similar to the concept of financial intermediation in Islamic finance literature.(151) This therefore serves as a solid foundational theory for the governance of

(148) R E Freeman, Strategic Management: A Stakeholder Approach. (Boston, Ma: Pitman 1984; Iqbaland Mirakhor (n 92) 54

(149) Argandona (n 59) 23

(150) R Phillips, E Freeman and A C Wicks 'What Stakeholder Theory Is Not?' (2003) Business Ethics Quarterly, 13(4): 479-502

(151) Freeman, R. E., And Evan, W. M. 'Corporate Governance: A Stakeholder Interpretation' The Journal Of Behavioral Economics1, 9(4):3 37-359(1990).

Islamic financial institutions. Freeman then continues by saying that '[i]t is through the firm that each stakeholder group makes itself better off through voluntary exchange. The corporation serves at the pleasure of its stakeholders and none may be used as a means to the ends of another without full rights of participation of that decision'.(152) This is also a notion which forms the basis of financial intermediation in Islamic financial literature, where business entities are deemed to be vessels through which the two main purposes of distributive justice are served. The first is the involvement of as many stakeholders as possible and the second is the discouragement of hoarding and interest-based transactions by encouraging society to form partnerships between those who have resources and those who have the ability to manage and act as agents (partnerships or the musharaka and mudaraba form of contracts). This way the wealth is circulated amongst society and hoarding and speculation are discouraged(153).

This statement shows that all stakeholders not only have a moral claim but also a fiduciary and legal claim in the workings of the firm and thus the collective morality of the all the stakeholders involved in the process of decision-making in the corporation forms what may be termed the 'morality' of the corporation.(154) It is this morality that would give rise to the ethical standards that the corporation decides to implement, and thus answers sceptics who query the role of ethics in business. It thus becomes inevitable to have ethics in any form of business, no matter the size of the legal vehicle conducting that business.

Once it is established that the company owes fiduciary and moral duties to other components of society, it becomes easier to ensure compliance by outlining the standards expected. The contribution of the stakeholder literature in the field of corporate governance cannot be underestimated, since it clearly establishes and highlights any and all relationships that may exist between a firm and its partners.(155) Fur-

(152) Ibid Freeman and Evans

(153) S Haron, The Philosophy Of Islamic Banking in A. Siddiqi, Anthology Of Islamic Banking (Institute of Islamic Banking And Insurance, London 2000a)

(154) K Gibson 'The Moral Basis of Stakeholder Theory' Journal of Business Ethics. 26, 245-257 (2000).

(155) R E Freeman and W M Evan 'Corporate Governance: A Stakeholder Interpretation' (1990). The Journal Of Behavioral Economics1, 9(4):3 37-359

thermore, the field of CSR the stakeholder theory has contributed in two different ways; the first being the fact that stakeholder theory defines and outlines the importance of information channels in the relationship between the society and the corporation and secondly, the stakeholder theory highlights the importance of the role of the stakeholders in the corporation by conceptualising information as a crucial element allowing the organisation to manage its relationships.(156)

On the other hand, in conventional corporate governance literature it was the major concern about the big corporation being run from mere profits that prompted the government(s) and academics alike to respond with a requirement that the corporation be run not solely for the economic benefit of the stockholder, but that the corporation should be more socially responsible and consider a wider range of stakeholders when deciding upon a course of action.(157) Hence, the concept of the stakeholder was conceived and conceptualised by academics and policy makers to meet the requirement that corporations act in a more socially responsible way. This is the reason that the stakeholder and CSR literature have a number of comparable underlying themes and notions that are at times used interchangeably, both derive their philosophical roots from the wider business ethics literature and are thus suitable governance and regulatory frameworks for the Islamic financial industry.

6. CONCLUSION: BUSINESS ETHICS, THE STAKEHOLDER THEORY AND THE PURSUIT OF COMMON GOOD AS PART OF THE REGULATORY CONUNDRUM FOR IFIS.

Sociological and economic researchers who propagate the concept of CSR draw an analogy between the social and economic controls prevalent in society to ensure adherence to social norms so that the rights of the individual are not violated. Within the corporate context, the concepts of CSR and the stakeholder theory ensures a basic level of participation for all the stakeholders in the company according to their respective stakes. These checks, prescribed by the stakeholder

(156) Y Pesquexand S Damak-Ayadi 'Stakeholder Theory In Perspective'(2005) Corporate Governance: 2005; 5, 2

(157) Freeman (n 36) 56

theory, form a very important 'antidote to the toxic effects of the pursuit of economic self-interest'(158) and address most of the false neoliberal presumptions built into the shareholder model. Furthermore, Donna Woods summed up the arguments by stating that

In this era of globalization, it is imperative that we all hold corporations accountable for meeting their economic goals in socially responsible and ethical ways. Capitalist business is the most efficient way we know of to organize an economy, but free markets, without any government intervention or countervailing powers, are not the most effective way to achieve societal goals such as environmental sustenance, human rights, distributive and social justice. Corporation that cannot earn profits legally, ethically and responsibly do not deserve to survive, nor can our planet afford for businesses to continue to treat their stakeholders as just another 'environmental factor' to be 'managed'.(159)

It is this line of argument that resonates with the Islamic finance jurisprudence, espoused by both contemporary and traditional writers, that promulgates an ethical and social conception of financial intermediation with principle-based checks and balances derived by religious edicts of the Quran and Hadith. This social and ethical conception of financial intermediation can be furthered in practical terms by a principle-based stakeholder based governance framework that caters for the stakeholder ideals to ensure proper compliance with Sharia principles (Maqasid) for all IFIs, especially for those IFIs operating in non-Islamic jurisdictions where applying pure Sharia norms may not always be possible.

It is thus argued that the value laden concept of a stakeholder-oriented corporate governance framework is logical as well as imperative for IFIs. This is further necessitated by the operational paradigm and unique features of modern IFIs in the shape of the SSB (the Sharia supervisory body) which acts as an additional supervisory body within the IFI combined with the issue of having a class of investor/depositors (IAHs) who are both investors akin to conventional shareholders as well as categorised as depositors, thereby creating an additional class of investor class who needs protection on the same lines as share-

(158) Wood (n 139) 158
(159) Wood (n 139) 161

holders. Then the fact that IFI have to work within religious and moral values that underpin the operational as well as ideological basis of the industry, which makes it unique in its nature amongst the international financial market players. Analysing the number of different stakeholders across the different spectrums, it is argued that rather than having shareholders as the sole beneficiaries of the governance framework (as is the case under the shareholder governance model), the Islamic finance industry needs to take into account a wider range of stakeholders when operating as financial intermediaries; this is in line with the conceptual fundamentals(Maqasid) of Islamic economics such as falah (the wellbeing of society), adalah (justice), the promotion of brotherhood and unity, economic freedom and distributive justice. Consequently, promotion of the principles of Islamic finance via modern IFIs requires a governance framework which can cater to the stakeholder nature of IFIs whilst remaining true to the religious ideals of maqsad Sharia (the objectives of Sharia). This paper has argued on the merit of the stakeholder (and the CSR model) that the IFIs need to adapt to these two governance models because these two model allow maximum operational freedom to individual IFIs whilst maintaining a compliance mechanism whereby the stakeholders involved are assured that Islamic financial institutions are actually 'Islamic' in both substance and form, thereby maintaining the essence of Islamic economics and finance's social and ethical outlook.

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