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Islamic Banking Ethics: A Critical Theoretical Approach Between Sharia Principles and Practical Limitations

CHEBILA Aicha[1*]

[1] Associate Professor B, SIC Research Laboratory-Practical studies in Business and management Sciences HSC, Ecole Supérieure de Commerce (ESC Alger), ((Algeria), a_chebila@esc-alger.dz

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Summry

The current paper discusses the issue of ethics in Islamic banking and considers the discrepancy between the Sharia approach and the actual performance. To do this, the basic principles of Islamic finance are analyzed; specifically, the prohibition of interest payments, the introduction of risk-sharing schemes, asset-based transactions, and compliance with Sharia regulatory requirements. Based on the documentary analysis and literature review, the article proves that Islamic banks are guided by certain ethical principles and that there is a well-established control structure, including Sharia supervisory committees and related regulations. At the same time, the research has found some disadvantages. Namely, many Islamic financial instruments resemble their counterparts in terms of structure; more precisely, such contracts as murabaha play a key role. Moreover, there are differences in interpretations of Sharia provisions. Overall, it is possible to conclude that despite having solid ethical principles, the Islamic banking industry is not completely free from flaws.

Key words: Islamic banking, ethics, Sharia, governance, Islamic finance, critical analysis.

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* CHEBILA Aicha, a_chebila@esc-alger.dz

Introduction

Islamic Banking has proved to be an important innovation, providing a different kind of alternative in the field of finance because it is based upon unique ethical and religious underpinnings. Traditional banking systems are centered around profit-making through interest payments, whereas Islamic banking involves principles like prohibitions against interest (riba), excessive uncertainty (gharar), and speculation (maysir) in addition to concepts like risk sharing and asset-based financing among others.

Islamic banking has made immense growth in recent times, both globally and within the Muslim community as well. Its popularity has attracted considerable attention from academia to study its adherence to its own ethical principles. While having a very good normative base, there are worries over the disparity between principles and practice.

Both empirical studies and conceptual analysis show that many Islamic financial instruments depend heavily on structures that have conventional banking characteristics, specifically debt-based arrangements such as murabaha, thus raising doubts over its true ethical standing (El-Gamal, 2006; Dusuki & Abdullah, 2007).

Therefore, this article adopts a critical theoretical framework to analyze Islamic banking ethics, which is based on the conflict existing between the Shariah ideology and pragmatic issues. This research seeks to provide some insight into the debate that is currently prevailing in the academic arena.

Main Research Question

To what extent do Islamic banking ethics reflect Sharia principles in practice, and how do practical limitations affect their application in contemporary banking systems?

Sub-Questions

What are the fundamental ethical principles governing Islamic banking according to Sharia law?

How are these ethical principles implemented within Islamic financial institutions?

What are the main challenges and limitations affecting the practical application of Islamic banking ethics?

To what extent does Islamic banking differ from conventional banking in terms of ethical compliance?

Hypotheses

H1: Islamic banking is strongly grounded in Sharia-based ethical principles.

H2: There is a significant gap between Islamic banking ethical principles and their practical implementation.

H3: The dominance of debt-based instruments reduces the ethical distinctiveness of Islamic banking.

H4: Weak standardization of Sharia governance negatively affects ethical consistency across Islamic banks.

Research Objectives

The primary purpose of the current paper is to critically analyze the ethical underpinnings of Islamic banking and to assess how successfully the tenets of Sharia are incorporated in modern banking systems. To be more precise, this study will focus on theoretical concepts underlying Islamic finance, namely prohibitions on riba, risk sharing, and asset-based transactions, as well as their incorporation into actual financial operations. In addition, this study will address the issues that arise from the discrepancies between theoretical and practical dimensions of ethical Islamic finance. Another focus area of this study will be the problems associated with Sharia compliance, financial product structuring, and standardization within Islamic financial institutions. Finally, it is expected that the study will make an important contribution to the discussion of ethical issues pertaining to Islamic banking by addressing the gap between theoretical notions and practical application of ethics within Islamic financial institutions worldwide.

Importance of Research

The significance of this research is that it:

- Helps understand the connection between ethics and practice in Islamic banks.
- Addresses the difficulties that arise in terms of the validity of the Islamic financial products.
- Helps develop Sharia governance and regulations.
- Furnishes knowledge to policymakers, researchers, and practitioners in finance.

Research Approach

This research paper takes a qualitative and critical approach, which includes:

- Document analysis (books, scholarly articles, and other reports)
- Analysis of Islamic Banking Literature
- Comparison of theory and practice
- An analysis of conceptual frameworks of Sharia governance

The chosen approach is exploratory in nature and aims to comprehend the ethical aspects of Islamic banking instead of measuring them statistically.

Previous Studies

There seems to be a consensus in previous literature that ethics in Islamic banking is based upon a certain set of ethical norms that have been formed based on Sharia and are meant to regulate financial processes based on such concepts as justice and equity. For example, El-Gamal (2006) suggests that the core feature of Islamic finance is that it does not include interest, excessive uncertainty, and speculation, which makes it an ethical concept.

Dusuki and Abdullah (2007) claim that the key goal of Islamic banks is to balance between financial success, religious rules, and customer satisfaction. However, at the same time, these authors state that some products developed by Islamic banks contain elements characteristic of the conventional financial system. In addition, AAOIFI (2015) and IFSB (2019) point to the necessity of implementing an adequate governance system to achieve Sharia compliance within Islamic financial institutions.

Nevertheless, current literature claims that there is a variation in interpretation of Sharia norms, which can make Sharia practices inconsistent within Islamic banks. Finally, contemporary scholars suggest the need for creating new and innovative financial instruments in the context of Islamic banking.

1. Theoretical Background and Key Definitions

1.1. Islamic Banking

Islamic banking is a type of financial institution based on Sharia norms that excludes the charging of interest and emphasizes profit-sharing and collateral-based business (El-Gamal, 2006).

According to us, this approach can be considered both as another form of financial institution and as some kind of effort to integrate economic activities with ethics and morality.

1.2. Islamic Banking Ethics

Islamic banking ethics pertains to the code of conduct that governs the operations of Islamic banks and includes such values as justice, honesty, and social responsibility (Dusuki & Abdullah, 2007).

Viewed from the critical standpoint, Islamic banking ethics form the essence of Islamic banking; however, their implementation might differ among individual organizations.

1.3. Sharia Principles

The Sharia laws are the set of rules and regulations based on the Islamic legal system and govern the financial dealings by adhering to the Islamic norms and prevent activities such as interest, uncertainty, gambling, among others (El-Gamal, 2006).

These Sharia laws offer a complete set of ethical guidelines; however, there is still a need for interpretation.

1.4. Sharia Governance

The notion of Sharia governance can be described as a system of management and control in Islamic financial organizations aimed at maintaining compliance of all activities conducted there under Islamic law using the help of Sharia supervisory committees (AAOIFI, 2015; IFSB, 2019).

In our view, the efficiency of this governance process is essential for ensuring that all Islamic banks maintain their ethical integrity.

1.5. Agency Theory

The agency theory elaborates on the link between the principal and agent. It underlines the necessity of control systems to minimize information asymmetry and encourage ethical behavior (Jensen & Meckling, 1976).

This concept can be applied to analyze the significance of control systems in the case of Islamic banks.

1.6. Institutional Theory

The institutional approach focuses on how organizations act because of external factors such as pressures, standards, and regulations, which determine how Islamic banks reconcile their adherence to Sharia law and their response to market forces (DiMaggio & Powell, 1983). It is possible that Islamic banks adjust their processes based on both religion and competition.

2. Exploratory Qualitative Assessment of Islamic Banking Ethics

2.1. Methodological Framework

For the current empirical analysis, a qualitative methodology, specifically documentary analysis, will be adopted that will include:

- Annually published reports of Islamic banks.
- Sharia governance reports.
- International accounting guidelines such as AAOIFI, IFSB.
- Academic publications related to Islamic finance.

The purpose of this approach is not to analyze the performance of the banks quantitatively, but to critically assess Islamic banking ethics.

2.2. Operationalization of Islamic Ethics in Practice

Table 1: Sharia Principles vs Practical Implementation

Sharia Principle	Theoretical Objective	Practical Implementation in Islamic Banks	Critical Observation
Prohibition of riba	Eliminate interest-based finance	Use of Murabaha and structured financing	Like credit-based lending
Risk sharing	Promote equity participation	Limited use of Mudaraba & Musharaka	Risk aversion limits implementation

Asset-backed finance	Link finance to real economy	Widespread use of Ijara (leasing)	Partial real-asset linkage
Ethical screening	Avoid prohibited sectors	Sharia compliance screening systems	Varies across jurisdictions

Source : Adapted from El-Gamal (2006) and Dusuki & Abdullah (2007)

There is an ongoing disparity between Sharia principles and their implementation by Islamic financial institutions in Islamic banking. In principle, Islamic banking is rooted in the complete prohibition of any form of interest (riba) and its encouragement for the adoption of an economy that relies on justice and equitable transactions (El-Gamal, 2006). Practically, however, Islamic banks largely depend on murabaha, a debt-based transaction despite its apparent compliance with Sharia law requirements.

This can be viewed in line with the so-called "form over substance" argument, presented by Dusuki and Abdullah (2007), whereby the adherence to Sharia principles is only formal, not accompanied by any substantive change in financial operations. Another reason for the less frequent employment of profit-and-loss-sharing modes (such as mudaraba and musharaka) lies in high risks involved in such financial dealings.

Therefore, Sharia principles appear to be selectively implemented for the sake of financial security.

2.3. Islamic Financial Products Analysis

Table 2 : Dominant Islamic Financial Instruments

Financial Product	Ethical Foundation	Economic Logic	Practical Use	Critical Issue
Murabaha	Cost-plus financing	Debt-like structure	Dominant product	Closely resembles conventional loans
Ijara	Leasing contract	Asset-based financing	Widely used	Limited risk-sharing
Mudaraba	Profit-sharing	Equity partnership	Rarely used	High uncertainty for banks
Musharaka	Joint-venture	Full partnership	Limited application	Management complexity

Source: Adapted from Khan and Bhatti (2008) and El-Gamal (2006).

The prevalence of certain Islamic financing products such as murabaha and ijara reflects a predisposition towards safe and credit-based forms of financing. Murabaha, though meant to be an additional cost sales contract, is a fixed return financing facility that makes it almost like traditional loans.

As per Khan & Bhatti (2008), Islamic banks prefer using this approach due to its safety in terms of financial gains and certainty. However, instruments of equity financing such as mudaraba and musharaka are not widely used due to governance issues and moral hazards.

The disparity implies that despite innovations made around Islamic finance, the risk-averse nature of Islamic banks is limiting its true essence.

2.4. Sharia Governance Structure

Table 3: Governance Mechanisms in Islamic Banks

Governance Element	Theoretical Role	Practical Function	Key Limitation
Sharia Supervisory Board	Ensure compliance	Product approval & monitoring	Varying independence
Fatwa issuance	Religious validation	Product structuring	Lack of global standardization
Internal Sharia audit	Continuous monitoring	Compliance reporting	Limited enforcement power
External regulation (IFSB/AAOIFI)	Harmonization	Voluntary adoption	Non-binding standards

Source: Adapted from AAOIFI (2015), IFSB (2019), and Hamza (2016)

The Sharia governance system constitutes the fundamental organizational framework underlying Islamic banking ethics. As stated by AAOIFI (2015) and IFSB (2019), Sharia supervision committees should guarantee adherence to Islamic values in all banking products and processes.

Nonetheless, studies have identified major problems within the governance structure. For instance, a critical problem is the inconsistency between different Sharia supervision committees since there is no uniformity of practice in interpreting Islamic laws in all banks and countries. As a result, there is low comparability in Islamic financial practices worldwide.

Moreover, according to Hamza (2016), in certain instances, Sharia supervision committees can be independent due to their institutional ties to the banks they oversee.

2.5. Transparency and Ethical Disclosure

Table 4 : Ethical Disclosure Practices

Dimension	Expected Ethical Standard	Observed Practice (Literature-based)	Critical Assessment
Financial transparency	Full disclosure	High variability across banks	Inconsistent reporting quality
Sharia reporting	Detailed compliance reports	Present but heterogeneous	Sometimes symbolic
CSR disclosure	Social responsibility integration	Increasing trend	Often reputational strategy

Source: Adapted from Hasan (2011) and Dusuki (2008).

Transparency is one of the fundamental pillars of Islamic banking ethics, since transparency is related to accountability and trust among stakeholders. In fact, Islamic banks are gradually becoming transparent, as evidenced by the publication of Sharia compliance reports, financial reports, and other information.

Nevertheless, according to Hasan (2011), the level of information provided differs greatly between institutions. For example, some banks disclose Sharia audit reports, while others limit themselves to declarations of their compliance with Sharia requirements, which can be seen merely as an attempt at legitimacy rather than accountability.

Moreover, CSR reports in Islamic banks have gained prominence in recent years; however, Dusuki (2008) suggests that such reports are primarily aimed at building reputation rather than being integrated into Islamic banking ethics.

Consequently, transparency in Islamic banks has yet to become a norm.

2.6. Comparative Ethical Gap Analysis

Table 5: Theory–Practice Gap in Islamic Banking Ethics

Dimension	Theoretical Ideal	Practical Reality	Gap Level
Ethics compliance	Fully Sharia-based system	Partial compliance	Medium
Financing model	Risk-sharing economy	Debt-like dominance	High
Governance	Unified Sharia control	Fragmented systems	High
Transparency	Full ethical disclosure	Uneven implementation	Medium

Source: Compiled by the author based on El-Gamal (2006), Khan (2010), and IFSB (2019).

The interaction between the two brings into light the existence of an ongoing gap from the ethical perspective in Islamic banking operations. The Islamic banking system ought to be a full-fledged risk-sharing system based on the principles of Sharia (El-Gamal, 2006). On the contrary, the actual scenario reveals that it functions more like a mixture of ethical considerations and standard finance practices.

These gaps exist in terms of financing models, governance consistency, and innovative products in Islamic banking. As observed by Khan (2010), there is intense competition faced by Islamic banks from traditional banks, thereby forcing them to incorporate risk mitigation strategies that might jeopardize their ethical validity.

Additionally, the environment within which Islamic banks function is another reason for this gap, since the regulations governing the activities of these banks have not been standardized across nations (IFSB, 2019).

3. Results and discussion

The results of this study indicate that Islamic banking is built upon a strong ethical and institutional framework derived from Sharia principles, including the prohibition of interest (riba), the promotion of risk-sharing, and the requirement of religious compliance. The presence of governance mechanisms, particularly Sharia supervisory boards, reflects a clear institutional effort to regulate financial practices according to ethical and religious standards (El-Gamal, 2006).

However, the findings reveal that, in practice, Islamic banks tend to rely heavily on low-risk financial instruments such as murabaha and ijara, while participatory modes of financing like mudaraba and musharaka remain limited. This suggests that Islamic banking has adapted to the constraints of the modern financial environment, where stability and profitability often take precedence over the full application of theoretical principles (Dusuki & Abdullah, 2007).

In terms of governance, although Sharia governance frameworks are widely implemented, their effectiveness varies across institutions. The lack of standardization and differences in Sharia interpretation reduce the overall consistency of ethical practices within the industry (IFSB, 2019). Furthermore, while transparency and

ethical disclosure have improved, these practices remain uneven and are sometimes used more as tools of legitimacy than as mechanisms of accountability.

From a critical perspective, several limitations can be identified. Islamic banking is often criticized for its close resemblance to conventional finance, particularly due to the dominance of debt-like instruments that replicate traditional financial mechanisms. Additionally, the limited use of risk-sharing instruments challenges the fundamental principles of Islamic finance and reflects a degree of risk aversion among institutions. Sharia governance itself is also subject to criticism, especially regarding issues of independence and the absence of unified global standards.

Finally, the study is limited by its qualitative and documentary approach, which does not rely on quantitative empirical data. While this approach provides valuable theoretical insights, it may restrict the generalization of the findings and suggests the need for further empirical research.

Overall, the results demonstrate that Islamic banking operates as a hybrid system, where ethical principles are present but only partially implemented, shaped by market pressures, regulatory constraints, and financial considerations.

4.Conclusion and recommendations

4.1. Conclusion

In summary, the ethical foundation of Islamic banking has been thoroughly analyzed in this study, with an assessment of how Sharia principles are applied. From this investigation, it is evident that Islamic banking operates on solid ethical foundations, with a high degree of emphasis on principles of fairness, transparency, and adherence to religion. The implementation of Sharia governance, especially the use of supervisory boards, shows how committed Islamic finance institutions are toward ethics and ethical conduct.

Nevertheless, there exists a significant difference between the theory and application of ethical principles in the Islamic banking system. In practice, Islamic banks prefer financial products that are less risky, resembling debt products such as murabaha, and avoid risk sharing, as well as the utilization of equity products. This suggests that although Islamic banking has been founded on ethical premises, it operates in line with the realities of the global financial world.

Moreover, it becomes apparent that there exist several issues regarding governance, among them standardization, Sharia compliance, and lack of supervision. Nevertheless, transparency and ethical disclosure have greatly improved.

4.2. Recommendations

Recommendations can therefore be offered as follows based on the above observations:

Improvement of Sharia Supervision:

- It will be highly necessary to strengthen the independence and effectiveness of Sharia supervisory boards in Islamic banking.
- Standardization of Ethical Compliance:

The standardization of Sharia practices and procedures is highly recommended to bring about uniformity in the operations of various banks and firms.

- Risk Sharing Financing:

Islamic banks are advised to embrace more risk sharing instruments like mudaraba and musharaka.

- Financial Innovation:

Creation of innovative financial tools within the framework of Islam could greatly contribute to making the products more unique to the Islamic banking system.

- Enhancement of Transparency and Disclosure:

Quality and enhanced transparency and disclosure in financial and ethical reporting are highly recommended.

- Future Studies:

More empirical quantitative analyses are highly recommended for the validation of this research study.

In conclusion, the success of future Islamic banking operations will largely depend on the extent to which the conflict between ethical compliance and practical application is resolved.

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