



**Islamic Banking and Finance (IBF): Challenges of
Putting Theory into Practice, and their
Implications for the Long-Term Viability of IBF**

By

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Abstract

Islamic banking and Finance (IBF) has been in existence for over two decades, and has seen it evolve into a formidable sector in the global financial system. However, this has not been without challenges, not least, winning acceptance in an environment where its basic concept run contrary to the established economic, social and political norms that were in existence for centuries. This study examines the effects of these challenges in shaping the theory of Islamic banking into what it is today and their implication for its long-term viability.

Theory of IBF is compared to its practice today using the characteristics of its products and services, its stakeholders and other economic agents, based on theoretical deductions from already published academic materials. The result suggests that IBF is heavily influenced by economic, political and social realities, and is slowly converging to conventional banking and finance practices.

Dedication

To my Dear Wife, Siman; and our two children, Huda and Hamza.

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Introduction to the Research and its Scope and Limitations

Islamic banking and finance is a system founded on certain fundamental principles whose sources are Islamic religious teachings. Theoretically, the system calls for specific benchmarks to be considered to be compliant with these principles and fulfill its primary objectives in society. As an economic system based on religious convictions, it demands its stakeholders (customers, owners, partners, regulators, governments and the general public) to demonstrate a minimum level of ideological coherence, and uniformity of purpose and characteristics, for it to qualify to be Islamic and be seen to be different from modern conventional banking and finance as we know it today. Chapter 3 - the theory of Islamic banking and finance is where I am trying to explain this uniqueness and the basics of Islamic banking and finance.

Islamic banking and finance is a relatively new concept even to those who confess the Islamic faith. The established economic order over time has created a status quo in every society including in Muslim society. Muslims are, in mind and body, part of the human economic community, and the influence of western economic practice, in particular the western financial services, permeates across every strand of all institutions in Islamic society. In Chapter 4 - Modern Social Order and its Challenges to the Theory of Islamic Banking and Finance, I try to explore the social, political and economic transformation of modern society especially the Muslim society as a result of western economic and political influence. I analyse what these transformations mean for the theory and practice of Islamic banking and finance and how this transformation influences the discourse on Islamic Banking and Finance. I question whether the experiences and preferences of modern society are compatible with what is envisaged by the theory of Islamic banking, and ask to what extent do these differences, if any, affect, negatively or positively, Islamic Banking in practice?

Chapter 5 - Modern Islamic Banking and Finance, explores Islamic Banking and Finance as it is practiced today. How much theory is put into practice and how far does its practice deviate from theory promoted by its proponents? Further, if there are any deviations, how much is as a result of what has been discussed in chapter 4 above?

In Chapter 6, Discussion and Concluding remarks, I try to connect the last three chapters to make an objective "guess" as to what lays ahead for Islamic banking and finance practice in the long run and suggest possible solutions and offer suggestions for further research. Two fundamental research questions I am trying to answer are these:

RQ1. If Islamic banking and finance, theoretically, is a good and useful alternative to established financial services practice, how far are all human systems (social, political, economic etc) ready to adopt its practice? Since this is where my main thesis objective lies and the established systems are not in line with what is expected of an Islamic finance system, what is the way forward? What changes to the Islamic banking theory should be made to fit into existing framework? If so, how much does this dilute the objective of Islamic banking and finance as a true alternative, and not become part of the modern financial system?

RQ2. Second, How far is modern society ready to change its established ways of doing business to accommodate Islamic Banking and Finance so as to reap its supposed benefits? Is there the will and the determination, even in Islamic society, to adopt a truly Islamic banking and finance system?

The analysis and findings of the literature cited in my literature review chapter (Chapter 2), would be the basis of my argument to answer these questions and make an informed guess as to where the Islamic banking and finance movement is headed.

There are, however, several limitations to this research. It is a secondary document analysis based on theoretical deductions from already published academic materials, as such, the reliability and integrity of its findings rest on the reliability and the integrity of the research material on which it is based. Moreover, some issues raised may have been overtaken by events considering a considerable time has passed between the conduct of this research and the publication of nearly all of the source documents.

Chapter 2: Literature Review

Islamic banking and finance has attracted a great deal of academic as well as research work in its three decades of existence. Many books¹, journal articles, research reports, working papers and conference proceedings are now available to those who are interested in learning about Islamic banking. However, the majority of the literature seems to be in English, which is, in a way, a good thing given the position of the English language in the business world.

Sundararajan and Errico (2002) found Islamic banking to be a unique financial institution providing financial services and products that conform to Islamic religious principles. As such, they pose special challenges for effective risk management. Globalization challenges have catapulted effective and efficient risk management in Islamic banks to the top of their priority list. This calls for a suitable regulatory framework as well as for new financial instruments and institutional arrangements to create enabling environment for Islamic banking operations. IFSB, AAOIFI and LMC are some of the organizations mandated to address these and other issues of IBF).

Arbouna (2007) says Islamic banking products and services development are based on the combination of various trade or sale contracts. However, Shari'a restrictions exists for the combination of two or more contracts and, any such combination must pass the established legal principles in terms of terminologies, purpose of contract, the degree of uncertainty and ambiguity, and the nature of bargain in the contracts combined. Murtuza and Abdallah (2007) found that Islamic history has a precedent

¹ (a) Ayub, Mohammad (2008), *understanding Islamic finance*
(b) Vernardos, Angelo M. (2006), *Islamic Banking & Finance in South East Asia: Its development & Future (2nd Edition)*
(c) Lewis, Mervyn K. and Algaoud, Latifa M. (2001), *Islamic Banking*
(d) Mannan, Mohammad Abdul (1986), *Islamic Economics: Theory and Practice*
(e) Khan, Zafar Ahmad (2000), *Islamic Banking and Its Operations*

for market regulation. The market discipline was enforced through the office of the Muhtasib (Public auditor). Its primary duty was to protect public interest through marketplace inspections and controls. Comparing it with CPAs, Murtuza and Abdallah argue that there could be contemporary role for a Muhtasib in modern Islamic economies and in the regulation of Islamic financial services sector.

Na'im (2006) examines the growth of the Special Purpose Vehicle (SPV) in Islamic banking. Financing large projects has usually involved the use of SPVs especially in structuring and issuance of Islamic Sukuk products. Examples include the State of Qatar's sovereign Sukuk. The positive uses of SPV include tax planning, risk management, project financing and company restructuring. Unfortunately, however, its useful role has been overshadowed by the huge scandals involving the use of SPVs, notably those of Enron and WorldCom. SPVs are used to hide identities, debts and other non-performing assets so that investors cannot assess the value and risks of firms and investments correctly. These are made possible by the lack of regulation relating to the use of SPVs.

Ariss and Sarrieddine (2007) consider protection of depositors' funds is the priority of any regulatory body. Capital adequacy ratio (CAR) is one tool, proposed by the Basel II Accord, to capture and measure major risks faced by banks. While conventional banks guarantee all deposits, Islamic banks do not. Therefore, they require a different approach to manage their risks. AAOIFI, proposed 50% inclusion of risk-weighted assets would exaggerate the CAR of Islamic banks, while the IFSB proposal addresses these shortcomings, it does not bind all Islamic banking players. Islamic banks face liquidity management issues in addition to a lack of adequate risk management instruments that are available to their conventional counter parts such as derivatives and overnight facilities. A number of Shari'a compliant risk hedging strategies are under consideration. Other risk management complications arise when it comes to measuring Shari'a compliance risks. It is present in every transaction of the bank yet no regulatory body has an idea of how to measure it. Matters are not

helped by the lack of standardization across Islamic financial institutions and countries.

Murray (2003) says reputational risk is considered the single greatest threat to businesses today. However, not many corporations manage it effectively. Top management is to take responsibility and NED (Non-executive Directors) should be appointed as the reputation guardians for the corporation in addition to their roles in audits, executive nomination and remuneration. NED will need powerful strategic and communication tools in order to respond appropriately to outcomes of their stakeholder audits. It is very difficult to recover from reputational damage. Listening and structured engagement with various stakeholders and the media that forge positive image of the corporation is essential to build and sustain corporate reputation. A risk to corporate reputation is a threat to its survival (Firestein, 2006). Protecting an enterprise's reputation is the most important and difficult task. In a survey, of 269 senior risk management executives, 36% of whom came from the financial services sector; reputational risk emerged as the most significant threat to businesses out of a choice of 13 risk categories (Ace, Cisco Systems, Deutsche Bank, IBM and KPMG sponsored the survey).

Ross (2005) investigated the sources of reputational risk. The biggest source of reputational risk is seen to be the failure to comply with regulatory or legal obligations, followed by failure to deliver quality products and services to customers, and third, comes exposure of unethical practices in the organization. However, financial performance as a threat to reputation only scores modestly. CEO's are the principal guardians of corporate reputation, and good communication is vital to protecting reputation and repairing damaged reputation.

A study by Naser et al., (1999) to assess the degree of customer awareness and satisfaction towards an Islamic bank in Jordan concluded that Jordanian customers patronized Islamic banks for its reputation followed by religious reasons. However,

the majority (75%) of them said they will deal with both banks for investment diversification. Some respondents were found to be totally ignorant about some of the specific terms used by Islamic banking. In terms of their satisfaction, the authors found that 84% of customers were satisfied with Islamic banks' reputation and customer confidentiality. Confidence in the Shari'a supervisory Board was ranked at a distant 14th with a 39.3% satisfaction rate. The findings, they say, echo those of other researchers who reported that Jordanian customers relied heavily on banks' reputation and image and institutional confidentiality when choosing their bank.

While many customers cited religious convictions, say Gait and Worthington (2008), as their primary criteria for banking with an Islamic bank, they showed preference for more usual factors such as bank reputation, quality of services and products, and pricing. Firms also used more conventional methods of selecting banking products and services such as the cost of funds in their decision making process. Financial institutions, despite their willingness to provide financing through Islamic methods, are nevertheless uncomfortable with issues pertaining to complications with firms' management, business conditions and lender-borrower risk sharing.

Haron et al., (1994) found no significant differences between Muslims and non-Muslims in their banking selection criteria, in other words they have a common perception in selecting their banks. Only 40% of Muslims believed religion to be an important factor in maintaining an account with an Islamic bank while they consider speed of transaction, attitudes of personnel and service quality to be more important. They also showed lack of complete understanding about Islamic banking. Metawa and Almosawi (1998) investigated the banking behaviour of Islamic bank customers in the state of Bahrain. Their subject customers were highly educated, had previous banking experience of over six years and were aged between 25-50 years. They found the commonly used services were current, savings, investments and ATM services, savings accounts being most popular among all ranks of bank customers. While the religious factor was found to be the predominant bank selection criteria,

investment accounts and savings accounts received the highest satisfaction score, with financing schemes receiving the lowest satisfaction score. The fact that 70% of the banks' liabilities were investment accounts, financial performance of the Islamic banks could be the moderating factor. Dash et al (2009), in a study among 156 Indian companies and 126 Canadian companies, showed that the level of individualism in a society determined their commitment to banking relationships through its moderation between social bonding and structural bonding. Commitments by social bonding were observed in the Indian sample that showed low level individualism while the Canadian sample, seen as more individualistic, showed structural bonding to be more important in bonding-commitment relationship. Therefore, cultural values, beliefs, attitudes and the mindsets of members of society have a huge influence on their decision processes and consumer behaviour.

Hillman (2007) has a different view. He finds the relative backwardness of Islamic society in income, growth and human-development indicators as the manifestation of Islam's prioritization of supreme values at the expense of economic achievements. He presupposes that economic development and achievement of supreme value under Islam are mutually exclusive issues. While supreme value attaches no value to existing/present life, economic development strives to improve and sustain the quality of present life. His findings, according to the author, have security consequences for the other societies that do not share this view. Islam does not only require its followers to adhere to this principle but it seeks to change others to adopt it too. Changes could be sought through constitutional changes—which requires voluntary abandonment of these supreme values—and education that does not promote these values but rather inculcates tolerance towards others.

Muslim followers will see reconciliation between Islam and other cultural values, as a temporary compromise, and so long as; in the longer run, the achievements of the supreme values are enhanced. If the emergence of Islamic banking and finance is seen in this light, then it will complicate its growth path and acceptance among non-

Muslims clients. Kuran (1996) agrees with Hillman arguing that Islamic economics is driven by cultural rather than economic concerns. Its main aim is to prevent Muslims from assimilating into the emerging global culture. He believes that many of the useful ideas of Islamic economics like the Profit-and-Loss sharing doctrine of Islamic banking could easily be incorporated into the existing financial system, and evaluated according to universally accepted standards.

Knowledge management has assumed a particular importance in this era of cut-throat competitions. However, knowledge is a necessary, but not sufficient, condition to bring tangible benefits to an organization. Knowledge with wisdom is the key. Nadan and Rebiere (2007) presented the impact of the Shari'a Supervisory Board's (SSB) role on bank performance through the concept of trust, knowledge and wisdom. Like the socially responsible investment (SRI) in the west, SSB brings with it wisdom into the operations and goals of the organization. This will help it, not only do things the right way, but also do the right things that will bring benefits to the society.

Chong and Liu (2009) accept that a unique feature of Islamic banking is the notion of profit-and-loss sharing (PLS). In practice, however, they found this is not a major feature of Islamic banking. A large majority of Islamic banks in Malaysia, as is the case elsewhere, use debt-like instruments that are permissible in Islamic law but are very much the same as conventional financial instruments. While only 0.5% of assets funds are PLS based, a substantial portion of liabilities of Islamic banks are also PLS based, but closely pegged to conventional deposit rates. Problems of adopting PLS modes of finance relates to issues of moral hazard, management and control of projects, and the existence of tough competition.

Khan and Bhatti (2006) found that interest-free banking movement failed in Pakistan because;

“all intellectual, practical, political, constitutional and legal efforts undertaken to enforce an interest-free system were not meant in earnest and therefore they inflicted a serious damage to the cause of Islam as well as Islamic banking” (Khan and Bhatti, 2006, p.145)

Exploitative interest based institutions are deep-rooted with connections to the political and social elites who maintain control over political, economic and social spheres of Pakistan, and indeed most of the Islamic world. There is arguably a need for broad based support for the establishment of a more successful banking and finance industry based on Islamic guidance and principles.

Asutay (2008) says Islamic banking was supposed to be an instrument of, ‘Islamic Moral Economy (IME), an authentic value system for human-centred economic development and social justice’. Islamic banking and finance has seen tremendous growth in the last three decades, unfortunately, it is without an Islamo-ethical pillar. In responding to the realities of the international financial system, Islamic banking and finance has converged towards conventional banking and finance, emerging in a repackaged form.

Hanifa and Hudaib (2007) compared the Islamic banks’ ideal Islamic ethical identities and their communicated identities. They discovered great disparity between their communicated ideals and the expected ethical performance. The areas most wanting were their commitments to social development through contribution to and management of Zakat, charity and benevolent loans, corporate mission and vision, and information regarding top management and members of the SSB. Viewed in the context of the importance attached to the image and reputation of an Islamic bank by customers in their selection criteria, this result has important implications for Islamic banks’ reputation and competitiveness. Meera and Larbani (2006) have concluded that Islamic economics and finance cannot function properly under a fiat monetary system. Their findings call for redefinition of money and monetary

systems. They assert that Maqaasid Al-Shari'a or Objectives of Islamic law would not be met; in fact, it will exacerbate the socio-economic ills of interest-based systems. Comparing Return on Mudaraba Deposits (ROMD) and Return on Equity (ROE) of Islamic banks.

Rosely and Zaini (2008) found that there is no difference between them negating the idea of Islamic banking running on profit-and-loss sharing principles. They concluded from these findings that Mudaraba deposits are treated like fixed deposits and do not carry any risks as envisaged by the PLS principle. The competitive edge accruing from the use of PLS modes of finance are lost. However, there could be valid reasons why this is so. The risk appetite of bank stakeholders may have persuaded the Islamic banks to opt for quasi-debt instruments and practices to avoid sudden withdrawals or bank runs, should it report losses on Mudaraba deposits.

Mehmet (1997) explores the ideas of Al Ghazali, the medieval Islamic scholar whose ethico-economic doctrine is still relevant today especially within the field of development economy. He says human knowledge and reason shape man's ethical behaviour in life. Change of behaviour starts with education. Al Ghazali believed, as evidenced by the various human development indicators reports of UNDP, that there is no automatic relationship between economic growth and human development. The answer, according to the author, is the integration of economics and ethics and avoiding the tendency of capitalism enriching the rich while leaving the poor to get poorer. This requires equitable global governance that promotes knowledge, justice, wisdom and tolerance

Choudhury (2008) made the comparison between the Islamic epistemological premise of Tawhid (Oneness of Allah) and rationalism, which forms the epistemology of liberalism. His findings are that they differ in concepts, approaches and applications. He rejects the idea of Fiqh Taqlidi (Shari'a innovations as with the

development of Islamic banking products) or the Muslims' surrender to the forces of liberalism. He concludes that Islam and liberalism are incompatible

Metwally (1997) sees that there is no Islamic economy so far despite the existence of countries with majority Muslims. The degree to which Muslims follow Islamic principles differs greatly; largely no country is immune from western influence. In an assessment of the implications of applying Islamic principles in society, he affirms that applying Islamic principles in economics and finance does not require the use of known economics tools; be they Keynesian, classical or neo-classical. If used, they tend to discredit the whole notion of Islamic economics. The only attempt has been in the form of Islamic banking, which is faced with difficulties, in the absence of necessary legislation and change of attitude by participants who do not seem to lean heavily on Islamic values. However, he believes there is a place for Islamic principles in contemporary Muslim life. Only what is needed are new tools of analysis capable of dealing with its framework.

Wilson (2008) provides a summary or rather a short exploratory piece of work on Islamic economics and finance. He says Shari'a law provides guiding principles for everyday living. Its branch called Fiqh Muamalat deals with economic behaviour and life of the Muslims. However, adherence is a matter of conscience and belief and cannot be enforced by the state. Islamic scholars are expected to be fluent in Arabic so that they are able to provide informed fatawa or a decree since translations do not capture the exact meaning of the sacred texts. The economic behaviour of a Muslim is driven by the motive to please God and earn His favours and not to maximize material wealth. Markets are resource allocation mechanism but the justice of their outcomes depends on the behaviour of a market's participants. In almost all countries, Muslim countries included, national laws prevail over Shari'a law and the latter do not have independent powers of enforcement. National courts uphold Shari'a law only where it is consistent with national law. Shari'a compliance by Islamic Finance practitioners has been privatized. Conventional monetary policy

instruments pose a problem for Islamic Banking because of the prohibition of Riba (Interest) but no alternative have so far been provided. Under Shari'a law, deposits are not guaranteed and no fixed rate of return, but in practice this is not the case. Depositors get their nominal value guaranteed and, receive a "fixed" rate of return through the use of profit equalization scheme where the Islamic bank maintains a reserve from which to pay the depositors in case of the bank incurring a loss.

In corporate finance, Musharaka (partnership) is converted into a debt instrument using Special Purpose Vehicle (SPV). The author confirms that scholars are not comfortable with the pricing and structuring of Sukuk (Islamic Bonds) but he says this is driven by the desire of the investors to hold debt that pay returns with less risk compared to equity, which is preferred by the Shari'a. The formulation of Islamic equity index makes uncomfortable reading for Islamic scholars due to the heavy reliance on rationality as opposed to critical Shari'a provisions. The author points out that Islamic indices revealed that a mechanistic approach to Shari'a compliance is not enough as shown by the 2007 sub-prime mortgage crises, Dot com collapse and Enron scandal. Wilson concludes his argument by pointing out that Islamic banking has a long way to go and its contribution so far has been to highlight the need "to reconcile spirituality with the worldly".

Iqbal and Mirakhor (1999) claim that in an efficient and distortion-free market, Islamic finance system will be more efficient and stable. Lewis (2001) attempted to show the public (UK) perception of company's reputation as measured by its financial performance compared with its commitment to social responsibility. His study revealed that social responsibility awareness of the public is increasing in their decision process. Therefore, the public's perception of a business performance in terms of social responsibility mattered in deciding whether to purchase its product and services. Ismail and Ahmed (2006) contend that the design of a finance system matters. The prevailing political environment and the ideologies that affect its operations influence the design. They found that Islamic banking lacked accounting

and legal systems for it to be recognized as an alternative to the existing financial order.

Taube and Schramm (2003) studied the hawala financial system. They found that it is a highly efficient and robust institutional arrangement for overcoming the risks of opportunism. It has an institutional framework that ensures the enforcement of contracts without resorting to any national laws. It developed from trust among the participating partners embedded in their Islamic common creed and rationality plays little role. Reputation and honesty are the cornerstones of hawala participation.

Khan (2008) examined the features of interest-free banking movement in Pakistan between 1980 and 2006. His conclusion is that piecemeal implementation of an Islamic finance system will not work. The Pakistani experience is that attitudes and preferences of the Pakistani politicians, business people and the public were not prepared to give the system a chance. It also faced problems in micro and macro economic issues. The government of Pakistan finally abandoned an all-Islamic financial system in 2002.

Maurer (2000) examines the discourse on alternative Islamic derivatives. He says that the Islamic derivative, based on the principle of khiyar-Al Shart on Islamic forward contracts, is being considered. He acknowledges that unlike derivatives in the conventional system, these options are not assets in their own right but must be linked to a tangible asset. He mentions some of the problems faced by Islamic finance as the suspicions in the west of anything originating from the Muslim world and the fact that Islamic finance is developing much better in traditionally non-Muslim countries than it is in the Muslim countries. Allen (1964) explains the transformation of the Islamic community from a conservatively religious society with a tradition of virtues and morality to a highly liberal and materialistic society. He concludes that Islamic society has something positive to offer to the world, overwhelmed by extreme individualism and competitiveness.

Chapter 3: Theory of Islamic Banking and Finance

Islamic Moral economy is an authentic value system and human-centred economic development and system of social justice. Within the framework of Tawhid (Oneness of God or Unity), Al'adl wa'l-ihsan (Justice & equilibrium), Ikhtiyar (free will), Fard (responsibility), Rububiyyah (divine sustenance), Tazkiyah (for the good of others) and Khilafah (God's vice-gerant on earth), Maqaasid al-shari'a (objectives of Shari'a) must be interpreted to suggest that economic and financial activity must lead to human well-being. Islamic Shari'a law provides guidelines to encompass the allocation of resources, management, production, consumption, capital market activity and the distribution of income and wealth (Asutay, 2008).

According to Islam, wealth is a gift from Allah given to man as trust to use it for his benefit here on earth and in the hereafter. This has implications on the issues of ownership of wealth and the means of production. In the course of his economic activity, man must bear in mind his responsibility as God's trustee. This is in contrast with the principle of self-interest in the free market economy. The assumption of self-interest, individual sovereignty and methodological individualism are replaced by the principles of mercy, rewards and blessing for the practice of truth, and punishment for the practice of falsehood in this world and in the hereafter. Rationality in conventional economics is in sharp contrast with the sharing, reciprocity, moderation, cooperation and charity that form the bedrock of the Islamic economic paradigm (Mehmet, 1997; Choudhury, 2008).

While Islam recognizes the individual's right to private ownership, it is not absolute and unconditional; it is subject to the collective interest of the community. Property rights are to be held in accordance with the tenets of the Islamic Shari'a that not only establish claims but also impose duties on others. In Islam for every right, there is normally a corresponding duty. It is regulated through the levy of Zakat, prohibition

of interest (and socially harmful business practices and activities), just pricing and penalizing the destruction of mutual property rights of the society. Where the interest of the individual comes into conflict with that of the society as a whole (the state in this case as a representative of the community), then the individual must give up this right for the collective good of society (Metwally, 1997).

The acquisition of property through haram (unlawful) means—in ways that contravene the Shari'a principles—invalidate the right to ownership. All wealth gained by selling alcoholic substances, pork and all pig products, drugs, usury or interest, gambling, contraband, dispute, deception, hoarding and, any conduct in a manner harmful to the collective welfare of society is considered haram (Unlawful). The acquisition of wealth must be through individual member's participation in cooperative forces of the market place rather than the characteristic "man-eat-man-society" market of today's capitalism. Let there be amongst you traffic and trade, by mutual goodwill" (Qur'an, 4:29) (Metwally, 1997). Specifically, the mere existence of scarcity should not result in profit maximization in an Islamic Economy, since individualistic enjoyment of property with no regard to the suffering of the wider society is to be condemned. Benevolent forces must work hand in hand with the reciprocities of business activities in the Islamic economy. There are public goods that must remain in the hands of the state. These include all utilities, security, staple foods, fuel and mining. Zakat is an obligatory payment by the wealthy whose worth reaches a nisab (threshold). It is one of the five fundamental tenets of Islam. It means annual payment to the poor and the needy in order to have the remaining wealth sanctified. It is deductible from any annual surplus income or saving held over a year. The beneficiaries of Zakat funds are diverse and have been specified in the Holy Qur'an (Qur'an, 9:60) (Metwally, 1997). The Prophet Mohamed (PBUH) has clarified the form and the rates applicable to every property. Zakat is only applicable to savings and investment property or funds except gold and silver. Zakat is not the same as tax and the state can still levy tax to serve society better.

However, speculation is prohibited in Islam. Whether for profit or enjoyment, all forms of speculation must be avoided. These include all forward contracts that are the norms in today's financial markets, games of chance like gambling, hoarding for anticipated price rises in the future and sale of what is not in one's possession except contracts of salam (forward) and Istisna (manufacturing), which have their own stringent conditions to minimize risk to any of the parties involved. In other words, no savings will be invested in speculative transactions nor will there be any demand for money for this motive as in the Keynesian's Theory of Money. Interest payment in any form is prohibited in Islam, purpose or parties involved notwithstanding (Qur'an, 2:275-276, 278-279; 3:130-131; 30:39). Usury and Riba is one and the same thing. All types of loans must not attract interest and interest "avoidance" is not allowed (Metwally, 1997).

A Muslim consumer's objective is not to maximize utility through outputs and savings only. God's satisfaction with his behaviour plays a more important role. It's a function of "good deeds" too (Qur'an, 46:15; 18:46). Charity is one form of good deeds. Allah (SWT) praised spending on charity (Qur'an, 63:10). The Muslim consumer also faces restriction on what to consume. There are many products and services that are prohibited from the Muslim even if they tend to appeal. For example a Muslim cannot eat port, drink alcohol, enjoy the services of a prostitute or gamble. A Muslim is permitted to invest in real economic activity for profit or can invest in good deeds for God's favours both in this world and in the hereafter. The returns of the "good deeds" investment can take many forms including "good luck" and "fortunes" that manifest themselves in windfall profits, unexpected discoveries or advancement, etc (Metwally, 1997).

The analysis of a Muslim consumer has to be radically different from that of the traditional consumer whose utility maximization function does not consider "good deeds" to be an essential factor. The individual in the Islamic world is moderate with no excesses in any aspect e.g. consumption, respects and tolerate others, seeks

perfection through virtuous living and has a complex identity structure spanning from the self to a family to a neighbourhood and finally to a nation. All aspects (economic, social and political) of the Muslim person are guided by his rights and duties to Allah (Ibadat) and to others (Muamalat). In his/her Muamalat, the Muslim is characterized by such virtues as sharing, reciprocity and charity, and is concerned not to build reputation or brand loyalty for profit maximization but makes preparation for Akhira—the Day of Judgment. Therefore, for a Muslim, economic activity must be a means to an end—Akhira.

Private property and ownership in Islam are protected through the endogenous rules of moderation, honesty and integrity aimed at gaining good rewards in the hereafter. It is the self-centered, utility maximizing individual, with unhindered and insatiable quest for acquisition and accumulation of wealth constrained only by his/her budget, which needs exogenously enforced rules as in the contemporary economic order. The Muslim must avoid excessive accumulation of assets, savings, hoarding and stockpiling. All the restrictions and prohibitions are aimed at protecting the interests of all market participants in order to promote social harmony. Adherence to the Shari'a in a Muslim's everyday life is a form of worship (Mehmet, 1997).

The Muslim entrepreneur too is different from his conventional counterpart. An Islamic firm's goal is not based on maximizing profit but is content with a reasonable or fair rate of return so long as it contributes to the common good or society so as to please Allah for his favours in this world and the hereafter. Therefore, major components of an Islamic firm's contribution to society are a fair pricing policy and direct contribution to charity. Spending on charity may be considered as a "holy advert" that attracts more to the firm for its positive contribution to the larger community. It promotes Islam and maintains Islamic Ideology by adopting "good deeds" as one of its major goals. In short, the entrepreneur will invest in a project so long as its returns after Zakat are enough to satisfy him and maintain the business. Therefore, the utility function of the

entrepreneur is subject to the rate of Zakat and his propensity to maximize profit as well as good deeds. Idle savings attract Zakat. This impels Muslims to invest their surplus funds in real investments to avoid the depletion of their savings. It in effect constitutes the opportunity cost of non-investment of idle funds (Metwally, 1997).

Resource mobilization is determined by the demand in the real economy. Savings are not equated to investment rather it's a withholding of capital from potential output, hence, the justification for Zakat (mandatory charity). In this case, appropriate financial instruments that link, in a complimentary way, the mobilization of resources with productive enterprises and the "good things of life" such that the interest rate is replaced by real returns in the money, finance and real economy. Therefore, money is not a commodity from which returns are derived; rather it is a mere measure of value. In Islam, money has no value or market of its own like real goods and services. It manifests itself through its circulation in the real economy as a "quantity". Even goods and services in an Islamic economy must fall within the permissible lot. Hence, performance or real returns are measured in terms of prices, output and profits. It is the role of the Islamic banks, therefore, to mediate between the Central Bank, the economy and the community for these endogenous money-market interrelations (Choudhury, 2008; Choudhury et al., 2005).

The advantage of endogenous money is that it controls inflation since the value of transactions (as determined by demand that is subject to Shari'a rules) per unit quantity of money in circulation remains stable. It also creates a currency-denominated economy rather than demand-supply of money economy. Money becomes a means not an end in itself. More important is the fact that there is no need for interest rate or reserve ratio manipulation by the central authority to stabilize or stimulate growth in the economy (Choudhury et al., 2005). Allen (1964) beautifully summarizes the ideal characteristics of Islamic society thus;

The Great law of Shari'a of Islam rests upon the sacred foundation, the Holy Qur'an, which is God's ultimate revelation to his people. No intercession between God and a worshiper. The beauty of it all is that Mosques and prayer halls in and around modern markets and high-rise office blocks, occasionally calling people to prayers, act as the constant reminders of the Master of the Universe. Basic education and moral statutes are supposed to be imparted to the new members of society—children—by the mosque officials and teachers who are expected to be of the highest moral standing and virtuous living in the society.

Settlement of disputes, validation of contracts and agreements, conducting marriage ceremonies and social occasions, the Muslims have recourse to the Kadhi, a judge well versed in the Holy Law.

The Muslim's commercial activities are subject to rules and restrictions of the Shari'a. Any one involved in usurious business activities or whose fortunes are obtained through exploitation, deceit, hoarding, theft and any other way not in conformity with the letter and spirit of the Shari'a is to be condemned.

Islam encourages generosity, sharing, caring, and sense of communal belonging. Shari'a guides are to be found for every aspect of the human life on earth.

The selfish and the accumulation of private wealth from which no charity or Zakat is paid are despised. The Muslim must maintain high standard of morality and purity. This means the Muslim should, uncompromisingly, avoid all that is prohibited by the Shari'a and not strive to outdo others in what has been recommended by the Shari'a as the way to earn the favours of Allah, both in this world and hereafter.

Islamic law tends to be preventative rather than curative as with man-made laws that are enacted after the occurrence of undesirable outcomes. For instance, the legalization of polygamy in Islam can be seen as solving three problems simultaneously before they occur. These are the degrading and anti-social practices of prostitution, concentration of wealth in the hands of a few and domestic tranquility in society. By allowing polygamy to those who can afford to support more than one wife, the Shari'a in a way creates a channel through which wealth is transferred from the haves to the have-nots by way of dowry, inheritance or charity (Charity given to ones relatives—both

blood and legal—attract more rewards from Allah). In the countryside, where manual farm work means better living, more wives will add much needed labour resources for the benefit of all members of the polygamous family.

Islam does not tolerate caste and color distinction in the human society”. Islam is not for the idea of “some being more equal than others” or “First World” and “Third World” (Allen, 1934).

It has been recognized that banks play a critical role in the economy by mobilizing large financial resources and facilitating international trade. Proponents of Islamic Banking and Finance (IBF) believe that banking cannot be ignored but should be reorganized to comply with the Islamic code of ethics and Shari’a. Using various instruments like Murabaha, Musharaka, Ijara and Mudaraba, Islamic Banks aim at providing interest-free investment and developmental financing (Metwally, 1997).

It is expected that bankers and customers uphold the moral value system of the Islamic Shari’a by adhering to the ethical norms and social commitments. Islamic Banks are forbidden from dealing in and/or speculative finance (gharar), interest, gambling, prostitution, prohibited goods and services, drug trafficking and corrupt practices or any other business activity known to be detrimental to the collective interest of society. In other words, socio-economic development and ethical prerogatives become their major objectives. They play an important role of uplifting the economic and moral stature of the society in which they operate. They cooperate among themselves and with other developmental institutions including state institutions to meet the dual goals of the banks’ financial efficiency and the social well-being of their clients (Dusuki et al., 2007). The Islamic Banks objective is much more than the financial well-being of its shareholders. The Islamic Banks financial objective stands on Shari’a bedrock of precepts aimed at establishing social security, property rights and the protection of the rights of progeny combined with the preservation of the Islamic State. Therefore, an Islamic Bank must not only secure

the funds of their clients but must do so bearing in mind the various Shari'a tenets such as socio-economic development goals. By combining the totality of the Shari'a precepts, Islamic Banks become as much investment oriented financial intermediaries, as they are agencies of sustainability of socio-economic order, socio-political order and preservation of community assets. The resource mobilization must aim at creating a direct link between the monetary aggregates and real productive activities through the use of equity-participation financing techniques (Choudhury et al., 2005).

Islamic banking is founded on the principles of brotherhood and cooperation between providers (investors) and users (entrepreneurs), and the funds are for the benefit of both through equitable sharing of risks and stake-taking. IBF's principle operating mode is profit and loss sharing (PLS) where both the supplier and user of funds share the risks resulting from the employment of these funds. Profit-and-loss sharing is the ultimate concept of IBF as is debt for conventional banks. Its two principle forms are *Mudaraba* (profit sharing) and *Musharaka* (partnership) (Dusuki et al., 2007). Therefore, shareholders and depositors in an Islamic bank share the risks and rewards equitably commensurate with each one's participation in availing investment funds to the bank (Zaini, et al., 2008). This means both the supplier and user of funds prosper when the returns are good and suffer when there is a loss (Metwally, 1997).

Islamic banks mobilize funds to finance Shari'a approved products using Islamic financing instruments. In this way, bankers who have taken upon themselves to mobilizing the society's funds for productive purposes are bound by these principles (Zaini et al., 2008). IBFs are basically structured towards fee-based revenues for services rendered and profit-and risk-sharing structures. An Islamic Bank acts as an investor, a trader, a financial advisor, a consultant and a financing house (Ariss et al., 2007). In developing products and services based on Islamic concepts, IBF scholars must apply their own minds instead of Islamizing products and instruments of the

conventional capitalist system (Haniffa and Hudaib, 2007). The design and development of financial products, methods of financial analysis and basic concepts of project appraisal and asset valuations would have to be reformulated in order to meet the Shari'a objectives (Maqaasid Al Shari'a) and the integrated outlook of the Islamic economic life of society (Choudhury et al., 2005). This new knowledge is then to be imparted to the community through educational and practical training programs. Knowledge has been recognized as an asset in its own right. Intellectual capital is the knowledge that can be converted into profit, increases the value of the firm and is the main source of the firm's progress (Nathan and Ribiere, 2007).

The basic principles of IBF are;

1. Removal of Riba (Interest) and debt-financing;
2. Avoiding Gharar (ambiguity) through full disclosure of information, elimination of information asymmetry in contracts and avoidance of excessive risks;
3. Avoiding or not engaging in, prohibited business activities, goods and services or those considered socially irresponsible;
4. Emphasis on risk sharing through profit-and-loss sharing by financier and entrepreneur;
5. Emphasis on real economic transaction, i.e. every financial transaction must be backed by a real asset; and,
6. All parties to a financial transaction must observe Justice and Fairness (Gait and Worthington, 2008).

IBF offers banking services under these principles and aims at achieving the following goals;

1. Profit-and-loss and risk sharing in creating more value in the economy;
2. Community Banking in the sense that IBF should serve communities and not markets;

3. Responsible Finance in terms of corporate responsibility, ethical investment and reduction in consumer indebtedness; it must be both financially and morally accountable for its business behaviour.
4. An alternative paradigm in terms of stability from linking financial services to the productive, real economy and moral compass for capitalism;
5. Fulfill aspirations in the sense of widening the ownership base of society and offering success with authenticity. This requires that Islamic banks strive to balance the dual goal of profitability and compliance with Shari'a principles (Asutay, 2008).

The advantages of true Islamic banking include;

1. *Systemic stability*: The banks assets and liabilities are integrated such that losses and profits are shared between the bank and its borrowers on the asset side and between the depositors and the bank on the liability side. Therefore, systemic shocks are absorbed more equitably among the stakeholders in the banking system such that no one party will bare the brunt of the fall out as is the case with conventional western capitalist systems of finance. Due to the failure of one sector, housing, in 2007, the world's financial systems have plunged into a series of deep crises and in turn, lead to severe recession in the world economy.
2. *Real economic growth*: The risk-sharing concept enables the IB to engage in financing long-term projects that have significant economic impact, thus leading to economic growth.
3. *Market discipline and harmony*: Since IBs and their customers are partners, and IBs have few options in terms of risk management tools, its expected that banks will have to be involved more closely with their clients' business management and monitoring of accurate financial reporting, especially profit and loss reporting, so as to distinguish the good customers from bad ones. In this way, incompetent or unscrupulous entrepreneurs are weeded out from the

market. Furthermore, depositors are required to choose their banks more carefully to ensure that their funds are invested wisely and in accordance with Shari'a principles (Chong and Liu, 2006).

The ethical dimension of corporate identity is found to be very important in creating stakeholder satisfaction in all organizations. It is even more important for organizations such as IBs whose corporate philosophy is premised on ethics or religion and the attainment of their social goals is as important as making a profit. Profit is bound by religion and business ethics and IBs' ethical identity is expected to be communicated and reflected in their applied ethical values.

The ideal corporate ethics of IBF are;

- a. Underlying philosophy and values based on Islamic Shari'a
- b. Interest free products and services;
- c. Restriction to Shari'a permitted deal and activities;
- d. Aim at social development and goals; and,
- e. Regulation and supervision by a Shari'a Supervisory Board (SSB) whose members are drawn from Islamic scholars whose repute and competency in the Shari'a law is unquestionable. Confidence in SSB and the competence of its members form the bedrock of IBF (Haniffa and Hudaib, 2007).

It goes without saying, therefore, IBF managers must not only possess the knowledge and competence in banking and finance in general, and in Islamic Shari'a related to business activity or "Fiqh al-muamalat", but must be people who are imbued with piety and righteousness. There should also be consistency between brand value and staff behaviour. IBF staff need to be both knowledgeable in banking and Islamic principles underlying IBF, and committed to its social and financial goals for it to succeed in this highly competitive environment. SSB is entrusted with setting the Shari'a rules for IBF, regularly conducting Shari'a audits on the banks' transactions

and attesting to the fact that the banks' business activities have been conducted in accordance with the Shari'a (Haniffa and Hudaib, 2007).

Essentially, the role of SSB is to;

1. Monitor and control the religious side of the IB transactions, services and products
 - a. Through the review of BOD decisions and top management,
 - b. Approve articles of incorporation along with the entire policies, code of ethics and code of conduct,
 - c. Authorize all financial products and transactions and prepare standard contracts for future transactions,
 - d. Carry out regular Shari'a audits to ensure compliance with the set Shari'a rules which include appointing an internal auditor that reports directly to the SSB to monitor the day-to-day transactions of the IB, and;
 - e. Dispose of any revenue that it deems unlawful.
2. SSB assists with establishing policies and regulations according to the Shari'a rules. Therefore, SSBs should demand all relevant information from management, and the management is obliged to assist it with making informed decisions in applying Shari'a rules over the transactions and products regardless of the outcome. This is important since all of the bank stakeholders expect the IBF to provide Islamic financial services and products according to Shari'a.
3. The SSB should continuously counsel, advice and train the management and employees to apply Islamic rules, find religious proposals and suggestions where transactions do not comply with religious principles and reply to investors' queries and clarify any ambiguity in any transaction. SSB represents the public, and as such they are expected to be prepared to clarify any religious doubt that the stakeholders have regarding any transaction (Nathan and Ribiere, 2007).

The SSB is central to the integrity and credibility of IBF. The values brought about by SSB can be said to be transparency, trust, ethical behaviour, credibility, and the philosophy, values and beliefs underlying Islam—Aqida (faith & belief), Shari'a (practices & activities), and Akhlaq (Moralities and ethics). The remit of the SBB is to protect the rights of equity holders as well as the management and create trust between them through the dissemination of timely and sufficient information regarding IBF operations and performance. Its effectiveness depends on its human capital (abilities, skills, knowledge and creativity of its members), social capital (SSB-Management, SSB-public and Intra-SSB relationships built on social ties and trust) and structural capital (codified knowledge in the form of routines, policies and procedures). SSB's role should not be a passive one attending exclusively to the satisfaction of management. For instance, obtaining inadequate information from management will negatively affect an SBB's effectiveness in monitoring management performance. In addition, the decision-making of SSB members should be intellectually honest and seek to remain at all times free of any conflict of interest.

Wisdom can be defined as “the capacity to put into action the most appropriate behaviour, taking into account what is known (knowledge) and what does the most good (ethical and social considerations). Wisdom concerns how knowledge is put to use, and can be learnt through experience, spirituality and passion. Spirituality helps to clarify goals and objectives by providing a foundation of core beliefs and a better holistic understanding of one's purpose in life. Wisdom is inspired by the SSB in IBF. Wise corporate leadership from SSB to management is expected to result in wise strategies and implementation to inspire/promote ethical behaviours, trust, loyalty, transparency and respect for stakeholders (Nathan and Ribiere, 2007). Therefore, it matters who runs an Islamic bank, hence the need to disclose the profiles of the members of management as well as the Shari'a Supervisory Board (SSB) (Haniffa and Hudaib, 2007).

In an Islamic state, the SSB is accountable to the office of Muhtasib, an official appointed by the state to regulate and supervise, among other things, the behaviour of market participants. This is an institution mandated to ensure proper market functioning and prevent fraud and market manipulation. It can be said to represent a sort of Ombudsman and/or public accountant whose role is to ensure justice prevails among transaction partners in the market place. The institution of Muhtasib may be adopted for the successful implementation of the PLS modes of financing in Islamic banking services. By reducing moral hazard and information asymmetry among the stakeholders in the Islamic financial sector, Muhtasib can play a key role in the successful and authentic functioning of Islamic finance (Murtuza and Abdallah, 2007).

The definition of risk in IBF is the same as that in conventional banks. Islamic finance practice disagrees with the notion of risk-free rates in determining the opportunity cost of capital, rather internal rates of return are sufficient to provide an adequate allocation of capital to the economically competitive projects. Islam recognizes risk taking in pursuit of legitimate profit—al-ghunm bil-ghurm (reward-for-risk) is the maxim in Islamic finance

The principle of Tawhid in Islam is that man believes what lies ahead is only known to Allah, yet Islam exhorts its followers to confront risks and uncertainties with adequate planning and without inflicting any harm or injury to society or on any member of the society. “Hadith” of the prophet (pbuh) of the man who came to consult him but did not tie up his camel—it is Allah who determines the outcome of man’s actions but man has the faculty to choose the path of his actions. The Shari’a has prescribed paths that are acceptable to Allah. These are the Hudud of Allah. Any action taken in accordance with these prescribed manners is never left unrewarded by Allah. Nevertheless, the reward may not always be man’s intended results. The alternative rewards might be realized immediately or given in the hereafter. No risk transfers are allowed and only risk minimization strategies should be considered

where these do not contravene any tenet of the Shari'a. Risk in Islam is considered a part of doing business and earning an income. One therefore should not expect to receive capital protection nor fixed returns from any investment. However, the case is different for IBF depositors. They fall into two broad categories. Depositors for safekeeping or transactional purposes do not receive any returns for their money because of the guarantees offered by the Islamic bank for the return of their principle deposits, while investment depositors or the so called "mudaraba" depositors are classified as equity investors that are not entitled to capital protection nor predetermined fixed returns on their funds. Therefore, needless to say, Mudaraba depositors are expected to receive higher ROE (Return on Equity) compared to their conventional fixed depositors. The financial performance of an Islamic bank is important to Mudaraba depositors since it determines the quantum of profits to be distributed to Mudaraba depositors (Zaini and Rosly, 2008).

Summary of chapter

Islam is both a religion and a way of life to its followers. Starting from its core pillar—that is the belief in the Oneness of God—to its guiding regulation of the day-to-day lives of Muslims. Economic life of Muslims is not an exception.

Wealth in Islam is a gift from God and it must be acquired and spent according to the Holy Islamic scriptures. There are permitted ways of wealth acquisition, what to spend on and the right of ownership to property, and when the right to ownership of property is invalidated. Wealth must be created within the purview of Islamic Shari'a. The relationship between the various economic agents and market participants are guided by the principles of cooperative efforts, fairness, honesty, reciprocity and sharing, and charity. God has placed an obligation on the rich for the poor in the society through the payment of Zakat and promotion of charity and generosity. The objective of a Muslim entrepreneur is not only to maximize profit

but also to earn God's mercy and favours both in this world and hereafter. Therefore, a project or business venture is appraised for its potential to make profit as well as its benefits to the entire community.

Money is not considered a commodity or a capital that has its own tradable value. Its only a measure of the value of real goods and services. It's an endogenous value. Therefore, interest on money is not permitted. The implication is that banks and financial institutions that deal with money must be organized in such a way as to avoid trading in cash. Money must go through the real economy. In this way Islamic banks become partners of both those who have investible funds and those who are ready to utilize it in a productive enterprise. They are also guided by the Shari'a principles and objectives. Governance, risk management, regulation and the roles of Shari'a Supervisory Boards (SSB), Government and the management of Islamic banks are discussed in this chapter.

Chapter 4: Modern Social Order and its Challenges to the Theory of Islamic Banking and Finance

4.1 Social Transformation of Islamic Society

Islam has its own political, economic and cultural ramifications. Islam is an identity and a complete way of life. It acts in parallel to the present world order and provides a societal goal that is the re-establishment of the proto-Islam of the prophetic era. Islamic fundamentalism has risen due to the need for global Islamic value systems and a reaction against the west, western values and consumerism. Islamic banking is an attempt perhaps to counter the western dominance and the process of de-Islamization (Wong, 2007).

The Islamic world concept is fundamentally different from that of individual liberalism. Therefore, the understanding of world issues or systems is different. Muslims have however borrowed from the latter and not every sphere of the Muslim world is premised on the Islamic Worldview. While the Islamic WorldView is understood through God's revelation, liberalism relies on reason and human mind to understand reality. Liberalism is based on individual preferences that lead to marginalization of the human well-being. This same concept is extended to all human institutions, be they social, political or economic. The concept of globalization is a good example. "Globalization means the entrenchment of the philosophy of liberalism into all nations that intend to be members of the capitalist globalization process. Its conflicting polarity between the differentiated parts of the human order results in the loss of social worth of human existence premised on self-actualization that ought to be caused by the growth of consciousness" (Choudhury, 2008).

Muslims around the world do not all share the same values as is sometimes wrongly assumed by many. Influences of local cultures dominate the basic tenets of Islam in every Muslim society. Cultural influence and modernity have completely transformed Muslim society, which also differ on the degree of transformation. While the MENA (Middle East and North Africa) region is relatively conservative, Muslim societies in the South and Southeast Asia have a more liberal view and lifestyle. As a result, their approach to Islamic finance and economy differs substantially from those of the MENA countries (Dash et al., 2008).

Islam has had local customs and practices incorporated in it in order to provide it with “popular devotion and a non-Muslim legalistic disposition” (Wong, 2007). From consideration of cultural heritage, pure Islamic culture, for instance the Islamic dress, is seen as a form of dominance by oriental culture over the local culture hence the attempt to mold Islamic values in the light of local “adaat” (customs). However, while rejecting the western values, they adopt another approach labeled “Islamic” yet based on the same principles as western values of consumerism. Called Islamic but in coming to practice it you will be surprised by problems and inconsistencies. Modern Islamists practice the same style of western taste but in a way that is more discrete and sensitive to the general public who unfortunately strive for the same. The fight for ideal Islamic values is being fought on two fronts; against traditions that do not conform to Islamic principles; and western influence. An unfortunate political consequence is that these three protagonists’ struggle for dominance producing extremists on every side. Islam in South East Asia, like in Malaysia, has shown more “tolerance and moderation” hence it displays “pragmatic adaptationism” and “creative flexibility”. Many have secularized thought to accommodate the growth in the sciences. In Malaysia, like in many other Islamic countries, there are different versions of Islam that differ from each other in terms of their organizational structures, economic objectives and strategic direction. There is a struggle between nationalists and Islamists. “The former advocate for economic growth and the consumption of material wealth and objects in Islamically approved ways while

latter roundly condemn this focus on the acquisition of wealth and material goods as a manifestation of excessive materialism and individualism and antithetical to sound Islamic practice.” They advocate in favour of the supremacy of moderation and sacrifice. The state and ‘nationalist’ are for the modification of existing financial and economic principles, apparently, with no corresponding modification in the social and political reforms for the successful application of these new principles. The fundamentalists struggle against western influence and the westernized local elites, and their search for identity and equality has been dismissed as simply the rejection of modernity and merely a reactionary political movement—hence the term “political Islam” to describe Islamic revival as purely inimical to increased globalization and economic development (Wong, 2007).

Muslims, it has been said by some, lack originality and boldness and have been subjugated to imitation and subservience to the ideologies of western liberalism and individualism. A higher level of individualism results in a lower level of commitment to any relationship and negatively affects the social bonding-commitment relationship propagated by Islamic teachings. Individualism promotes selfishness and lack of compassion. The Islamic society, it may be argued, is now characterized by greed, moral decadence, racial prejudice, extremes of individualism and abandonment of Islamic traditional ways in its rush to become Europeanized. Today people’s lives have been reduced to a life of materialism characterized by the constant pursuit of wealth, competition, lack of compassion, poverty, falling traditional values, crimes, and less time for family and leisure.

Long gone are the traditions of chivalry, high esteem for virtue and morality, ideals of generosity and social welfare, responsible private ownership and acceptance of Islam as the guiding principles of everyday life of the Muslim, traits that are the bedrock of Islamic economics and finance practices. The bulk of Islamic society has already been transformed into consumer society with its low regard for collectivism as envisaged by the Muslim revivalists. Despite having differing degrees of Shari’a

enforcement among the Muslim populace, there is no Muslim society, at present, which follows wholly the Islamic Laws in a strict fashion and that is enforced by faith and civil laws (Choudhury, 2008; Metwally, 1997; Meera and Larbani, 2006).

The undoing of Islamic Shari'a has been fatalism (lack of ijtihad) and pride (false sense of superiority—many Muslims assumed that by just “believing” in Allah, they are Allah’s solely favoured lot and all others are inferior to them). It takes more than believing to be a true Muslim. With the closure of the doors of Ijtihad and isolation from the rest of the world, the Muslim umaah (nation) underwent a tremendous period of retardation and obsolescence (Allen, 1934). Muslim scholars are resorting to a distorted meaning of Fiqh (Fiqh Taqlid) and Fatawa (edict) to derive Shari'a rules (Ahkam) and have ignored the fundamental premise of the Islamic WorldView based on the Qur'an and Sunnah. The result has been devastating to the revival of Islamic scholarship and innovations in many spheres of the Muslim society. Nowhere has it been so apparent than in the finance and economic life of the Muslims. A lack of coherent and coordinated revivalist effort amongst the Muslims and the Muslim states has exacerbated the confusion, which has led to increased conflict within the Muslim community (Choudhury, 2008).

The education system and schools curriculum in Muslim countries have been changed to produce quasi-western graduates (in mindset and life style) whose differences from Europeans and Americans seems to be nothing more than their names. The Islamic education system has long been abandoned and the few remaining Muslim schools are being closed down in the name of fighting terrorism. “Intellectual Colonization” in the Muslim world has had tremendous effect on the practice of Islamic faith and how Muslims approached pertinent issues of Shari'a Law. Muslims, like all others, now view everything through the lenses of individualism and materialism (Meera and Larbani, 2006). Nothing can fittingly demonstrate this phenomenon more than the development of Islamic banking and finance.

Secular schools, whose managers and teachers are likely to have been educated in similar schools and receive their inspiration from western capitals rather than from Mecca, have replaced mosques and other centres of Muslim learning. The pride of Muslim parents is unprecedented whenever their children are accepted in prestigious business schools in London or New York for the mastery of Occidental business methods (Allen, 1934). Islamic society is left behind due to its failure to consistently seek and apply new knowledge. The contents of a society's education system in part determine its knowledge expansion and scientific advancement. Therefore, education and development go hand-in-hand (Hillman, 2007). The education system has long been used to reinforce and change the value system of the Muslim societies.

Educational curriculum reform is necessary if an ideal Islamic economic system is to be developed. Commercial activities have not been spared either; no longer are Muslims deterred by piety from lending money to gain interest. "Financial pre-occupation has reached such a stage that adoption of the Sunday holiday in conformity with European practice is even contemplated so that Muslims may not have to lose their Friday as a day of trading on the Stock exchange" (Allen, 1934, p.50).

4.2 Political Transformation of Islamic Society

Islamic society is facing a crisis in leadership. A God fearing ruler, whose objective of bringing development and prosperity to his subjects is through justice and equitability can achieve good governance. The regulation of a Muslim ruler's actions comes from two sources; first, his/her understanding that the authority of his/her reign is the trusteeship from God to whom he's ultimately answerable on the Day of Judgment (Akhira). Secondly, the day-to-day running of the affairs of the country is through consultations (Shura) with the learned scholars (Ulamaa) in the community.

However, today's Muslim nations are ruled by less democratic leaders surrounded by capitalist zealots and many who do not subscribe to the doctrine of the Oneness of God (Mehmet, 1997). Meanwhile, the Muslim scholars have been reduced to nothing more than prayer leaders and social workers presiding over only on such things as marriages—and more recently some have been incarcerated in jails for demanding their rightful place in Muslim society. The majority of independent Islamic countries lack democracy and their rulers are willing to go to any length to protect their power and wealth including restriction on private wealth creation, education, personal freedom and political participation. Therefore, protecting the ruler's wealth and power are prioritized at the expense of socio-economic development.

Many Muslim countries were colonized by western powers, and in some ways were “created” by these colonialists. They have bequeathed them a governance mechanism mediated by rulers and elite members of the society who were directly or indirectly connected to the former colonial power. They were the westernized and western educated elite. There emerged neo-colonial regimes that perpetuated the value systems left behind by the colonialists. Change of leadership in the Muslim world is met with resistance from western powers and local collaborators. Scholars such as Hillman deliberately distort facts and place the economic predicaments of the population on the choice of their way of life and not on the apparent historical and modern socio-economic imbalances.

Disunited and vulnerable, all Muslim majority countries have become targets of the western imperialists. The division and the loss of central religious authority or Caliphate for inspiration has led to each nation seeking its own way for survival in the new world order. Tradition and nationalism have replaced the Muslim caliphate or United Ummah. Whereas some countries' adoption of the western culture was more extreme than others, not a single country escaped the hurricane of western cultural dominance and the abandonment of religious practices in everyday life. In

Turkey, Islam was relegated to the position of the church in the west, divorced from all public and private institutions. Others, to avoid being labeled the enemies of progress, have attempted to “modernize” the old Muslim religious institutions albeit within the narrow sphere of individual conscience and social institutions. Religion was out of bounds in such areas as politics and economics. The Shari’a—the foundation of an Islamic state’s jurisprudence—has been replaced by a man-made constitution, more often than not, a replica of one or another western country’s constitution (Allen, 1934).

States’ effort to modernize Islam are attempts in various ways to stifle the influence of the Islamic fundamentalist movements. The state uses the Islamic identity to promote quasi-western political hegemony and subvert the clamor for Islamic renaissance. It does so through the control of religious institutions (such as mosques and schools), use of the state security machinery to clamp down on opponents (especially “the Ulama who are classically trained Islamic teachers”) and by the promotion of new forms of individualism, materialism and consumerism in the name of economic growth albeit not always without much development. In these ways, a new form of “Islamic” materialism is created by the state (Wong, 2007).

The Islamic world is economically backward and has an increasing disparity of income distribution (Meera and Larbani, 2006). The government, it can be contended, has misused IBF for meeting its political ends. Governments preferred to deal with conventional banks that were ready to provide capital and funds to meet their fiscal expenditures. Government officials, most of whom were educated in western top business schools, did not show any enthusiasm to implement the IBF system since they felt it was a threat to their control over the financial sector (Bhatti and Khan, 2006).

Islamic banking in some cases, such as in Malaysia, was born out of the government’s attempt to counter the support for growing Islamic opposition political

groups. It was not, so far as the state was concerned, the desire “to create Islamic state but to redirect Islamic resurgence from dogmatism and conservatism towards modernity and progress” (Wong, 2007, p.463). Others like Egypt deliberately blocked the Islamic finance movement that started from the grass roots in the village of Mit Ghamr in 1963. The government closed down the private savings banks and established the Nasir Social Bank in 1971 apparently to forestall any manifestation of Islamic fundamentalism in Egyptian society.

‘The state via its economic, political and social agenda plays a critical role. It offers the means through which a societal wide religious and social transformation can be effected, and as such cannot be neglected in any discussion of the relationship between consumption, religion, social identities and social transformation’
(Wong, 2007).

Western governments have associated Islamic Banking with terrorist financing (Nigel 2004), and faulted it for its perceived susceptibility to money laundering (El Sheikh, 2002). Study by Karbhari et al., (2004), revealed that the UK government did not support the establishment of Islamic Banks. No country, moreover, even majority conservative Muslim countries like Saudi Arabia, is actively pursuing pure a Islamic financial system. Those who attempted to establish Islamic financial systems like Pakistan, Sudan and Iran have so far failed because, it seems, no deliberate attempt has been made “to modify the perceptions, attitudes and knowledge of Islamic banking alongside any direct or indirect support or encouragement to the institutions themselves” (Gait and Worthington, 2008, p.805).

The behaviour of the various economic units that do not favour Islamic values and Zakat and other Islamic principles are not enforced by civil law in any of the Muslim societies (Metwally, 1997). State power anchored on sovereignty is challenged by capitalist power rooted in ownership or property rights. Individualism is transferred into institutional governance to further sustain self-interest and hegemony. Power, policy and governance replace self-restraint and fear of God as control instruments. In other words, rules based on individualism are not endogenously upheld nor are

they subject to ethical consequences rather they are exogenously enforced through coercive policies (Choudhury, 2008). In fact, all intellectual, practical, political, constitutional and legal efforts undertaken in many countries, especially Muslim countries, to enforce an interest-free banking system were not supported in earnest and therefore, they inflicted serious damage to the cause of Islam as well as Islamic banking (Bhatti and Khan, 2006).

4.3 Changing Experiences and Preferences of Society

Various studies, as summarized below, attest to the changing experiences and preferences of Muslims as indicated above. However, most of these studies found that speed and efficiency of service were as important to the Muslims as were religious factors in their selection of a bank, although community service irrespective of profitability also held some motivation for Muslim customers. Conversely, rate of return remained the primary motivation for conventional bank customers. Muslims and non-Muslims have a common perception in selecting their banks, and the majority of both categories used retail banking products and services.

In Bahrain, religion followed by profitability were the preferred factors (Metawa and Al Mossawi, 1998). Customers were dissatisfied with complex Islamic financing schemes and the relatively high associated costs. Muslims resident in a Muslim country have a greater awareness of Islamic banking than those living elsewhere but the latter gave religion as the most significant factor for their preference for Islamic Banking Services (Omar, 1992). Religious preferences existed for financial products and services in Saudi Arabia, Kuwait and Egypt (Metwally, 1996).

In Kuwait, some Muslims preferred conventional to Islamic banking due to a better service record, consequently the religious factor was subsumed by greater concern for the quality of bank services (Al Sultan, 1999). In Qatar, females, elderly and civil

servants as well as those with relatively low incomes, and moderate level of education preferred Islamic banks while the young, well-educated working professionals and highly paid public servants favoured conventional banks. The wealthy and relatively well-educated, also preferred foreign conventional banks to domestic conventional banks.

In the UAE, Muslim students preferred Islamic banking services due to religious factors. In addition, Arabic Muslim students were highly knowledgeable in Islamic financial terms and concepts while non-Arabic Muslim students had a higher knowledge of conventional banking (Bley and Kuehn, 2004). In Turkey, the primary motivation was found to be for Islamic banking services but a combination of both Islamic and conventional products and service were found to be more satisfying (Okumus, 2005).

Business firms prefer reliability and assurance and size of bank (Turnbull 1982, 1983) as selection factors. Bank reputation and reliability were also important in MENA countries in UK & Hong Kong (Tyler and Stanley, 1999; Chan and Ma, 1990; Lam and Burton, 2005). However each business type had a very particular attitude towards banks (Gerrard and Cunningham, 2000) and pricing and services charges were considered most important (Athanasopoulos and Labroukos, 1999). Price, service quality, delivery and the ability of the bank to offer services over the entire firm life cycle and scope of financial needs, determined bank choices in the US, Canada, South Africa, and Europe. Islamic Banks faced similar appraisals by business firms (Edris, 1997) in contrast to individuals' preference for Islamic banks (Metwally, 1996; Al-Sultan, 1999). Business firms in Kuwait likewise preferred to deal with conventional banks rather than Islamic banks. They considered banks' asset size factor as most important in their selection, and Islamic banking was only the 5th ranked factor. They tended to deal with multiple banks, too.

In Malaysia, Ahamed and Haron (2002) found that profitability and quality of service were the most important factors among 45 corporate customers surveyed although the majority was non-Muslims. They also found a low level of knowledge about Islamic banking & finance, especially business finance methods.

In Australia, a study by Jalaludin and Metwally (1999) surveyed 385 small business firms in Sydney about their attitude towards profit/loss sharing methods of finance and found that factors other than religion were relevant. Cost of borrowing of funds from alternative lenders, business risk and the expected rate returns were considered more important. Later research by Jalaluddin (1999), found that almost 60% of respondents were interested in profit/loss sharing methods of finance, not from religious motivations, but to obtain funds in high-risk business situations where the cost of debt-finance is expected to be prohibitive. However, lack of knowledge and other terms and conditions, including management intervention on a day-to-day basis by the financier, acted against the use of these funding methods. Jalaluddin (1999) interviewed 80 Australian financial institutions and found that about 40% of them were ready to lend under the profit and loss financing methods motivated by potential for higher returns to lenders, strong growth in the demand for funds, business support and its potential as a solution for the high default risks in conventional lending practices.

Karbhari et al., (2004) found that financial institutions in the UK felt that Islamic Banking can only be promoted through the use of Islamic banking products and services set within conventional banking operations in order to familiarize them with Muslim and non-Muslim clients. A significant portion of IB customers—30% in Bahrain—are not actually aware of Islamic Financing schemes and almost two-thirds of customers do not use these facilities. For those who are aware, their utilization of these facilities is far below their awareness level. This could be attributed to many customers' understanding of these facilities and, perhaps the realization that IBs are not significantly different from conventional banks or that their services are deemed

more costly and complex. The study also revealed high satisfaction (76%) among the “investment account” holders of IB in Bahrain. Surprisingly, only 37% of customers expressed satisfaction with IB’s financing facilities.

In Jordan, religious factors were not considered as important selection criteria for a bank (Erol and El-Bdour, 1989) and Erol et al., 1990). In Malaysia, religion was not considered in the selection of a bank (Haron et al., 1994). They did not differentiate between Islamic and conventional bank products and services although they had sufficient awareness of the existence of IBF products and services, considering that Malaysia is the largest centre of IBF outside the Middle East. Older people with family and stable income patronized Islamic banks. Influence usually came from spouses, friends and relatives and from innate religious motivations. They found that many Muslims did not understand the difference between Islamic and conventional banks—as recently as 1994, only 27.3% of Muslims in Malaysia fully understood the difference between Islamic and conventional banks and as might be anticipated only a mere 8.6% of non-Muslims knew the difference.

Summary of Chapter

The world has undergone tremendous social and political changes in the last two centuries. Islamic Society has not been exempted from this change. In fact, it is the single most affected by these changes. These changes in Muslim societies were as a result of either western colonialism or cultural influences of those who practice the faith.

People have become more individualist with a liberal mindset as opposed to collectivism propagated by the Islamic faith. Individual interest overrides collective interest where the two come into conflict. The Islamic Shari’a law has been abandoned as a system of jurisprudence in favour of western legal systems and the

governance system has changed from the Muslim caliphate into a varied and fragmented set of nation states with their own cultural heritage to promote. The education curriculum is aimed at perpetuating these changes. With these social and political transformation of society came with changing tastes and preferences. Consumption behaviour mirrored on western consumption has become the norm rather than the exception. Therefore, all products and services must be formulated with reality in mind. Unfortunately, the attempts to introduce Islamic Banking and Finance have been informed by the status quo as will now be discussed in the following chapter.

Chapter 5: Modern Islamic Banking and Finance

Despite seemingly a growing acceptance of Islamic banking, almost all serious scholarly studies on the subject reveal growing “skepticism on the “purity” of current products offered and the “sincerity” of those managing the institutions”. Yet other skeptics point out the tendency of Islamic banks to opt for pragmatism over “purity” in the products offered; a move that is likely to negatively impact on the confidence of the Muslim masses. Islamic banks’ deposit-taking and lending operations tend to be based on interest, although this fact is usually disguised through the use of terms like “mark-up” and “commission” to designate what is tantamount to a pure rate of interest (Haniffa and Hudaib, 2007). Islamic banking fosters an image of moral superiority by participation in religious causes and through communicating their Islamic aesthetics (Kuran, 1996). Banks nonetheless face challenges with the integration of the world economy, which requires greater flexibility in order to accommodate the many new investment instruments and products (El Sheikh, 2002).

Obstacles exist in the form of management complications, unfamiliar business conditions and risk sharing with borrowers. Islamic bank’s capital is exposed to risks that are associated with financing (Gait and Worthington, 2008). However, they face greater difficulties in identifying, quantifying and monitoring risks arising from the complexities of their unique financing instruments (Zaini and Rosly, 2008; Metwally, 1997). They cannot finance personal loans hence they have to channel their funds to corporate financing. IBF rely more on their equity to financing, face more difficulties in attracting deposits, face the problem of providing consumption loans and have less short-term investment opportunities for effective management of liquidity, as a result, they have to hold a higher cash to deposit ratio than do conventional banks (Metwally, 1997). No interest is paid on depositor’s saving account except “voluntary prizes” whose rate partly depends on deposit balances and bank’s profitability. This could be criticized for being an attempt to circumvent the Shari’a (Gait and Worthington, 2008).

Modern Interest-Free banks heavily rely on the Murabaha financing contract. It raises many issues:

1. The bank may not actually own the commodity required by the client
2. The bank may obtain some guarantee from the client in the form of down payment or security prior to finalizing the acquisition of the required goods from the supplier. The bank assumes no risk in this case
3. No clear method is available to determine the profit rate
4. The profit rate varies with the term of the debt, which raises the question of difference with term structure of interest (Metwally, 1997).

Murabaha has been criticized for being too similar (in its computations and applications) to a conventional product and could be construed as introducing interest through the back door. The heavy use of this mode of financing has subjected Islamic Banking to severe criticism. Thus, Islamic Banks have been found to be less different in their financial structures, somewhat contrary to expectations. Islamic banks offer similar returns to depositors as do traditional banks, and their profitability and efficiency follows the same trends as those of their conventional counterparts. The largest proportion of their funding goes to financing durables (collateralized financing) And some invest in bonds and interest-bearing instruments (Metwally, 1997).

PLS is used more on the liability side of the bank than on the asset side. Studies in Malaysia, as is almost the case with the rest of the world, indicates that only 0.5% of IBF financing is based on PLS, while the remaining 99.5% is based on mark-up modes of financing that are permissible under the Shari'a. Mark-up contracts are instruments meant to facilitate production and trading. Their use as financial instruments, though permissible, ignores the spirit of interest prohibition. Banks use Mudaraba as the principle instrument for deposit mobilization. They are, however, structured in a way that emulates the conventional bank deposit contracts. They

attract lower and less volatile investment rates than that of conventional deposits. Studies by Chong and Liu (2006) show that IBF PLS deposits practices are closely pegged to that of conventional banks' deposit rate-setting practices. Changes in the conventional deposit rate will cause changes in IBF deposit rates, but not vice versa. What is more important is that since Mudaraba deposits were supposed to assume the form of equity, no relationships have been found between the banks' Mudaraba rates and the return on benchmark equity index in Malaysia. The percentage share of musharaka declined from 1.4% in 2000 to 0.2% in 2006. Bai be thaminin ajil (deferred payment sale) and ijara wa iqtina (leasing with subsequent purchase) were 55.9% and 25.20% respectively in 2006. From 1984 to 2006, Murabaha constituted 88.1% of the mode of financing for Bank Islam Malaysia Berhad, and 67.3% for Dubai Islamic Bank. Mudaraba and Musharaka were 1.7% and 9.3% respectively (Chong and Liu, 2006).

IBF's have been reluctant to enter into PLS contracts for the following reasons;

1. Weak, corrupt or unjust judicial system
2. Unscrupulous entrepreneurs who, for one reason or another, would not wish to share their business secrets with outsiders. Some maintain double accounts to avoid paying taxes or hide ill gotten wealth (Bhatti and Khan, 2006)
3. Moral Hazard or principal-agent problems: Entrepreneurs have an incentive to under-declare or artificially reduce reported profits. They also have the incentive to undertake high-risk projects under Mudaraba financing "because the entrepreneur is actually given a call option whereby he gains on the upside but bears no losses at all on the downside. PLS financing, thus requires more costly monitoring"
4. Management and control right: The banks provide the risk funds, but the management and control of the project is in the hands of the entrepreneur. This accentuates the principal-agent problem
5. Competition and best practice: Individuals, religion notwithstanding, can chose to bank with an Islamic bank or conventional bank. Competitive

pressures force Islamic banks to adopt similar practices to those of conventional banks especially in determining returns on depositors' investments and profit rates charged to borrowers (Chong and Liu, 2006). General depositors are not willing to bear any real risk on their PLS deposits with Islamic Banks (Bhatti and Khan, 2006).

In conventional or traditional banking systems, shareholders are willing to risk their capital in exchange for a positive return on equity (ROE) while depositors are willing to lend their savings to bankers in order to receive predetermined positive returns as well as preservation of their principle amount lent. Because of their unwillingness (or the system's discriminatory design against their participation in risk sharing) to carry any risk on their investments, it is expected that depositors would receive lower ROE than do the banks' shareholders (Zaini and Rosly, 2008).

Zaini and Rosly's (2008) study found that Islamic Mudaraba depositors in Malaysia received 1.16% less ROE than fixed deposit holders in the USA, and the gap (11.82%) between the ROE and Return on Mudaraba deposits (ROMD) of the Islamic Banks in Malaysia is bigger than that (8.61%) of the interest based banks in USA despite the fact that Mudaraba depositors are exposed to more risks. Moreover, Mudaraba deposits, on average, were 7.56 times higher than the share capital among the Islamic Banks in Malaysia. The highest, Bank Islam Malaysia Berhad is 11.47 times the amount of its share capital and the lowest, Maybank Berhad is 2.9 times of its share capital.

Reliance on debt finance with no social lending by IBF has resulted in its deviation from the economic development and social welfare objectives of Islamic moral economy. Possessing no developmental finance instead IBF has had to rely on short-term retail and trade finance as opposed to industrial and agricultural finance. Profit maximization becomes the aim when IBF practitioners insist that IBF is not a charity

endeavour, rather they seem to be concentrating on becoming part of the international financial markets (Asutay, 2008).

Recent studies reveal that IBF scores less when it comes to ethical and CSR financing issues, an unfortunate observation. Therefore, IBF uses religion as a justification for its current operations in the form of ethicality and social responsibility. In avoiding PLS and venture finance, IBF does not help in capacity building or wealth distribution any better than conventional banks, and may encourage consumer indebtedness through the continuous use of debt financing. This also does not make it ethical either (Asutay, 2008). Research on ethical identity of IBF by Roszaini and Hudaib (2007) reveals a large disparity between IBF's communicated and ideal ethical identities. It also uncovered inconsistencies in what is communicated (through their annual reports) by the banks studied over the three-year period. The banks' disclosures were found to be inadequate in terms of their commitment to society and other social goals such as Zakat, charity, benevolent loans and information about their top management. IBF holds a restricted notion of what constitutes Corporate Social Responsibility (CSR) since its perception of CSR is limited to Zakat and other charitable work rather than working towards capacity building for developing communities. IBF is not linked to the real economy contrary to expectations given that practitioners prefer debt financing to equity financing and actually some debt-like product, like Tawarruq (personal loans) clearly undermines the whole welfare objective of the IBF movement. There is a gap between established expectations and the actual performance of IBF (Asutay, 2008). To take care of these apparent discrepancies, contemporary Islamic Banks are resorting to the less risky but more controversial debt-like financing instruments like Murabaha, Ijara and salam sales—in favour of the more aptly distinguishing but expectedly more risky PLS paradigm of IBF instruments such as Mudaraba & Musharaka modes—that are flexible enough to fit into the traditional risk management formulations. As a result, Islamic Banks continue to use conventional risk mitigating techniques, and the use of traditional risk management approaches such as high value collaterals, high

down payments and stringent credit enhancers are the norms rather than the exceptions. Debt trading is now common and relatively standard among Islamic financial services providers especially in South East Asia (Zaini and Rosly, 2008).

IBF is increasingly becoming akin to a mutual fund that screens existing investments like Sukuk (Islamic bonds), equity or property, Takaful (Islamic insurance), and Ijara (leasing) for compliance with Islamic Shari'a principles (Gait and Worthington, 2008). This does not mean that the whole idea of IBF is flawed as implied by some scholars (e.g. Kuran, 1996; Hillman, 2007), but rather that contemporary IBF has failed to internalize the social dimension and social justice into its own operational function (Asutay, 2008).

Islamic Banks face risk management formulations that forced many practitioners to adopt conventional practices in order to comply with existing regulations—which puts them at a disadvantage. Islamic banks are required to comply with the Basel Accord guideline for risk management in banking which was originally designed for conventional banks. Under the Basel II accord, the Capital Adequacy Ratio (CAR) is based on a conventional bank balance sheet, which substantially differs from an Islamic bank's balance sheet. CAR is a measure of the amount of capital that a bank must hold expressed as a percentage of the bank's total risk-weighted assets. It does not cater for the specific risks related to the nature of IBF activities. In many countries where dual banking systems exist, there is pressure to apply the same regulatory rules and common legal framework to both Islamic and conventional banks. In the absence of regulatory guidelines to cater for the specific or tailored issues that are inherent only in Islamic banking, Islamic banks are forced to follow the existing commercial banking laws, which on many occasions will contravene Shari'a. Given these circumstances, Islamic banks effectively can be regulated under the existing regulatory framework because they are not practically different from conventional banks. Malaysia and Indonesia have attempted to introduce a separate legal framework for Islamic banks but these laws are actually formulated along

secular principles such as allowing banks to participate in trading and owning trading assets which they hardly ever do unless through foreclosures (Chong and Liu, 2006; Ariss and Sarriddine, 2007).

The Mudaraba and Rabul Mal relationship is distorted by the legal requirement by the Central banks for all Islamic banks to support the deposits made by the public in accordance with Basel Accord which requires that all internationally active banks are required to maintain a minimum of 8% Capital Adequacy Ratio. Risk weights allocated to Mudaraba and Musharaka Financing products are legally absorbed by the banks' shareholders. In addition, margins on Murabaha and other credit-related products are too small to warrant an equal share of profit by Shareholders & Mudaraba deposit holders. The reason why this is true is that the regulators treat Mudaraba deposits in the same way as fixed deposits so that banking risks are borne by the banks' capital (Zaini and Rosly, 2008). The difficulties are further compounded by the practice that the majority of central banks in most Muslim countries do not offer the special treatment needed by IBF such as training, standard documentation and other technical assistance for them to successfully compete in the market place and to adhere to the approved Islamic modes of finance that would bring the desired benefits to the economy (Bhatti and Khan, 2006).

There is also the issue of lack of standardization in Shari`a rulings which often leads to the possibility of disagreement between management on one hand and the Shari`a Supervisory Board (SSB) members on the other regarding the interpretation of religious sources according to the various schools of thought in Sunni Islam. The decision making process is not clear since there are too many non-bankers who become involved in the systems' strategic management decisions. For instance, there is a need for clarification regarding the exact role of the Shari`a Supervisory Board (SSB). The SSB of each bank or group of regional banks are autonomous and produce radically different assessments of what is and what is not Shari`a compliant, thereby creating further confusion resulting in erosion of confidence in the system

(Michael, 1997; Nigel, 2004). In some jurisdictions, conventional banks that offer Islamic products and services are not required to have SSB to overlook their activities and therefore may lose the trust of potential clients (Nathan and Ribiere, 2007). There is no universally accepted regulatory and standard setting body. AAOIFI and IFSB are weak and not even known in many Muslim countries including Saudi Arabia, a concerning observation, considering its position in the Muslim world as the birthplace of Islam (Asutay, 2008).

There are attempts to solve one of the chief risks—liquidity risk—by involving special liquidity management entities like in Bahrain’s liquidity management centre (LMC) and Malaysia’s Islamic inter-bank money market (IIMM). Yet others suggest the introduction of Shari’a compliant derivatives products. A derivative is a financial contract, considered as an asset in its own right, which can be bought and sold. However, its value is “derived” from the value of an underlying real asset, which does not exist at the time this contract is traded (Maurer, 2001). The relationship between the value of a derivative and the real asset hinges on a hypothetical and complex rocket-science formulae striped of all ethical, religious, and “non-formalizable” and unpredictable realities of human behaviour and natural forces. It is the new name for the universally accepted game of gambling and betting. It worked well, or so it seemed, until the 2007/08 global financial quagmires, as instrument of “prudent” risk management and profit “manufacturing” since it was premised on oversimplified and flawed western economic principles. There is even an argument for “Islamic options” where the idea of “khiyar al-shart” is considered the basis for engineering Islamic derivative products. Derivatives got the so-called Islamic banking professionals, especially those who favour the “Islamization” of existing financial system, scratching their heads as it goes to the heart of what makes the difference between IBF and conventional banking and finance. How do derivatives fare in light of the Shari’a? Do they violate the doctrines of Riba, Gharaar and Maisir? Epistemological misconceptions over these Islamic doctrines means that these practices and instruments are, in the words of Bill Maurer, “subject to

considerable disagreement among Islamic Banking professionals” (Maurer, 2001, p.10).

Practitioners continue to dwell on ways and means to “panel beat” IBF operations to a form that can fit into the existing economic order, industry regulation and risk management framework. The AAOIFI suggests that Restricted Mudaraba funds be excluded from IBF’s balance sheet—treated as an off-balance sheet item—while unrestricted Mudaraba funds are treated as an on-balance sheet item. However, they cannot be considered as equity because they can withdraw their funds on maturity and they do not have voting rights. Other proposals suggest treating IBF like mutual funds that do not guarantee the original sum, but repay what remains of an investor’s funds after taking into account the operational result. Some others recommend segregation of investors into risk-averse and risk-takers, placing the funds of the former in asset-backed, low risk and marketable securities, with the latter’s funds invested according to their investment objectives. Yet others are in favour of the view of approaching the problem from the rights of the various accounts holders to appropriately categorize risks on the asset side of the IBF’s balance sheet (Ariss and Sarieddine, 2007).

IFSB is an organization formed by monetary authorities of several Islamic countries with the support of the IDB, AAOIFI and also the IMF. Its role is to;

1. Promote, spread and harmonize best practices in the regulation and supervision of the IBF industry;
2. Set-up international standards for regulatory & supervisory agencies specifically concerning Shari’a rulings on IBF practices;
3. Standardize risk identification and risk-weight assignment approach of Shari’a-compliant products that meet internationally acceptable prudential standards (Ariss and Sarieddine, 2007).

The efforts of the IFSB in dealing with CAR in IBF primarily aim to “standardize” IBF products and services so that they meet “internationally acceptable prudential standards”. This may mean the loss or dilution of the Shari’a objectives since the so-called “standards” are founded on Eurocentric premises that are quite different from basic “Maqaasid-a-Shari’a”. The risk management concept envisaged by the Basel II Accord will definitely magnify the risk exposure of IBF should the latter be required to comply with it. In the absence of the basic IBF paradigm, that is the concept of true profit and loss sharing (PLS) between an IBF institution and its clients as opposed to the creditor-debtor relationship of conventional banking institution and its clients, an IBF institution would have no choice but to compromise on some aspects of the Shari’a. This may include aspects such as use of LIBOR, profit equalization schemes, heavy reliance on debt-like instruments and some times an outright indulgence in interest based instruments as in syndicated loans in the name of Sovereign Sukuk (Ariss and Saredidine, 2007).

The biggest risk facing IBF under pure PLS will be Shari’a Compliance followed by moral hazards. The suggestion is to concentrate on endogenous regulation rather than exogenous regulation as concentrated on by Basel Committee, IFSB, AAOIFI and so on. The problem with the AAOIFI proposal is that they concentrate only on the sources of funds for the bank ignoring the assets side of the bank’s balance sheet. In doing so, the IFSB proposal on CAR only compliments—and does not in any way replace—Basel Committee’s Basel II Accord.

Semantics are frequently invokes as a means of justification for an argument. For instance, the proponents of derivatives in IBF go to the extent of equating normal and everyday business risks to gambling and speculative risks. They say that speculation, the premise on which derivatives are based, is not the same as gambling referred to in the Islamic Shari’a as being prohibited. The issue of ijtiihad (reasoning) is being used to justify flawed arguments in the field of Islam. While many “professionals” write about a concept being “halal” or “haram”, the basis of their

argument is always ijtiḥād and no mention is made of the Qurʾān and the Sunnah of the Prophet (pbuh). This is where the whole meaning of Islamic finance is lost. Maurer (2001) goes so far as saying that the Qurʾān is untranslatable and so are many Islamic injunctions including riba. Consequently, the battle is lost before it even began.

Summary of Chapter

In theory, Islamic Banking & Finance, as we saw in the previous chapter, is premised on an entirely different concept of financial intermediation—one of partnership rather than a borrower and lender as with conventional banks. In practice, however, there is little that can today differentiate between Islamic Financial services and Conventional financial services.

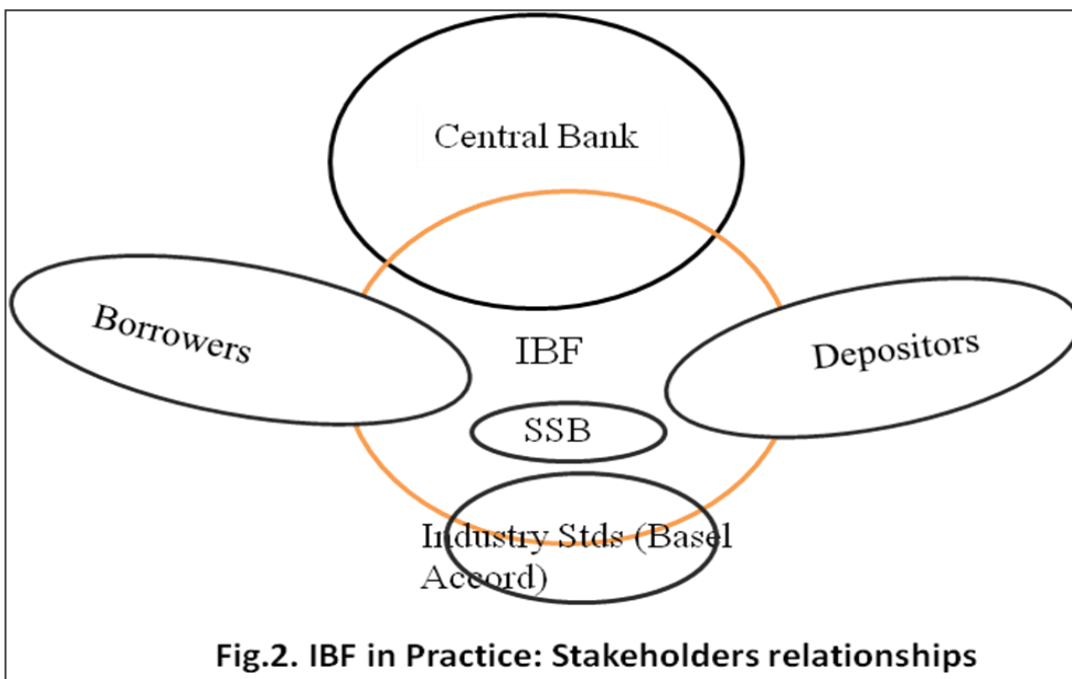
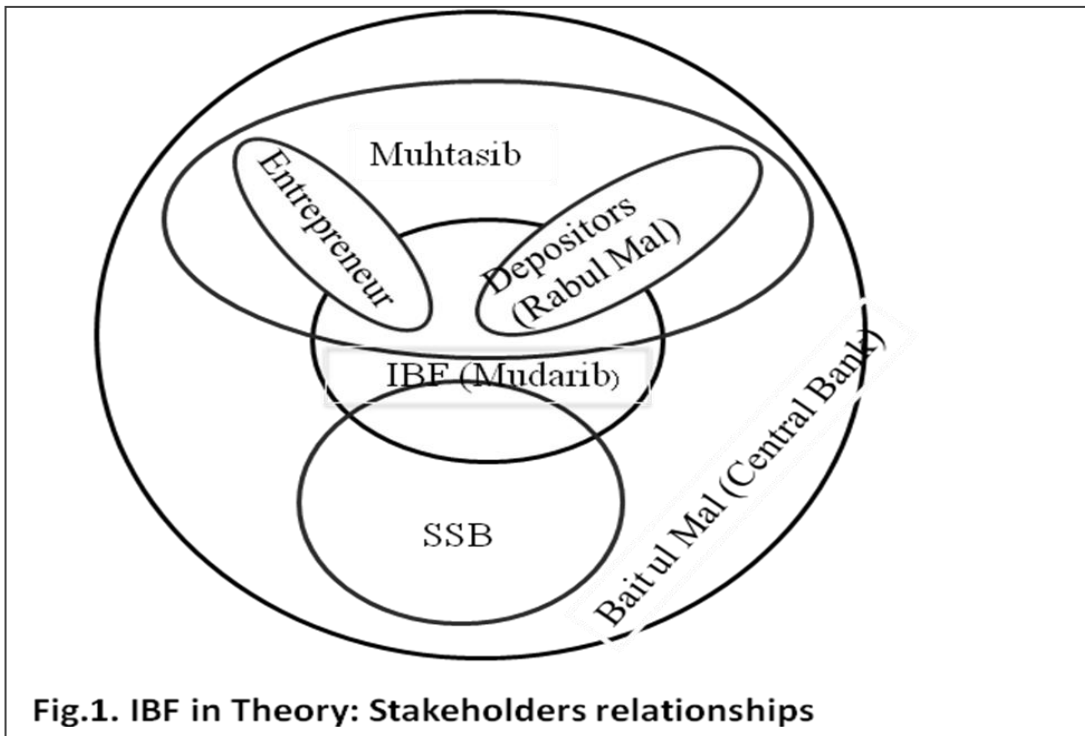
Various factors have conspired to make the practical implementation of Islamic Banking and Finance theory difficult. Chief among them is the lack of understanding of what constitutes Islamic banking and finance, in all sectors of today's society including Muslim society. The subject of Islamic banking and finance is fairly new. It emerged at a time when capitalism has been comparatively uniformly accepted as the single "economic Gospel" of the world. All aspects of peoples' lives have been formulated to conform to this doctrine. All economic policies of all countries are based, in one way or the other, on capitalism—both fiscal and monetary policies of countries have become standardized as accepted international standards represented by the Bretton Woods institutions.

Therefore, it was not surprising that Islamic Banking and Finance faced hurdles from the outset. In the absence of a relevant practical and legal framework, Islamic banking and finance practitioners faced problems in corporate management, product development, relationship management and marketing. As a result, Islamic banking

became too risky. Needless to say, practitioners had to devise ways to do business within the established economic framework. They resorted to the use of “product structuring” whereby the modus operandi of conventional banking is modified to comply with Shari’a provisions but the resultant product or service can be managed within the existing standards and regulations. It would also make it easier to sell to the general public accustomed with interest-based banking services. What emerged are quasi-debt financial instruments that transformed Islamic banking and finance into a financial archetype layered on conventional financial system archetype rather than a distinct financial system (Cooper, Hinings, Greenwood and Brown, 1996).

Table 1: Comparison between IBF in Theory and Contemporary IBF.

<i>Factor/Method</i>	<i>IBF in Theory</i>	<i>IBF in practice</i>
<i>Financing methods</i>	Profit-and-loss sharing	Debt based
<i>Risk management techniques</i>	Endogenous and pragmatic approach	Exogenous and pragmatic approach
<i>Regulatory Body</i>	SSB and “Muhtasib” (Public accountant)	Central Banks/Secular monetary Authority
<i>Aim/Objective</i>	Socio-economic development through wealth creation subject to collective interest and Shari’a restrictions	Economic development through wealth creation by way of capitalism
<i>Motivation</i>	Ethico-economic development and divine rewards in the hereafter	Earthly materialism with religious identity
<i>Decision process</i>	Faith/religion	Rationalized religion/”Fiqh Taqlidi”
<i>Stakeholder relationship</i>	Collectivism	Individualism
<i>Relationship commitment</i>	Social/religious bonding	Material/structural bonding
<i>Monetary System</i>	Real Monetary System	Fiat Monetary system



The two figures above represent the transformation of Islamic banking from a collaborative institution (Fig.1) bringing together various economic agents in an endogenous monetary system where it receives investible funds from depositors here referred to as Rabul Mal or capital owners, and invests in equity of the entrepreneurs' business. The profit realized is shared between the bank and the capital contributors. The bank is a fund manager, and referred to as Mudarib. The SSB under the central bank (Baitul Mal) set Shari'a Standards and conducts Shari'a audits. The office of the Muhtasib or the compliance officer under the central does the supervision of all the participants including the depositors and entrepreneurs making sure that no one interferes with the market operations. The Muhtasib can also be independent of the Central Bank and represents some kind of an Ombudsman for the government.

Chapter 6: Discussion and Concluding Remarks

6.1 Discussion

The central logic of Western economics is resource capture for profit-driven capitalism. Profit maximization is motivated by consumers' self-centred utility maximizations (Mehmet, 1997). Profit in this case can only be realized through deliberate market imperfections due to the impracticality of the basic capitalist economic theory of the definition of profit and ideal market economy symbolized in the so-called Pareto Optimum. Pareto Optimum is an economic concept where the economic outcome of an individual in society gets better without necessarily making any other member of the society worse of as a result. However, practically, market imperfections caused by human bias has been found to discredit this concept². Apparently—just like the proponents of the current Islamic banking system that seek to modify existing conventional banking products for the simple reason that for IBF to succeed it has to fit into the existing world financial systems—the flaws have been justified under the pretext of “rationality” practical constraints such as ‘externalities’, ‘transaction costs’ and ‘market failures’.

The concept of rationality, on which the model rests, is based on the rational behaviour of western individualism. In short “profit or surplus value is realized as return on risk and uncertainty, and from such strategic decisions as speculative buying and selling, or from gambling like dealings, during the adjustment process when markets fail”, which Keynes called “Laissez-faire capitalism”, the greatest of modern-day evils (Mehmet, 1997). It is unfortunate that the same market mechanism is being incorporated into the search for an Islamic secondary financial market and macro-economic policy instruments. If the axis of capitalism is market imperfections, then any offshoot of capitalism—no matter what is the precise nomenclature—inherits the same traits.

² http://en.wikipedia.org/wiki/Pareto_optimum

Banking regulators and international organizations are attempting to establish global standards to develop the growth of Islamic Banking for their potential to tap Islamic, Ethical and Conventional borrowers and investors. Organizations such as the Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization for Islamic Financial institutions (AAOIFI) were formed to establish and disseminate prudential and supervisory standards for the industry but their efforts were hampered by the fact that they function on the basis of existing guidelines for conventional banks (Nigel, 2004). Present day Islamic Finance and Economics has been framed along the basic micro and macro economic models, and policies such that interest based concepts of resource allocation, monetary and fiscal policy management, corporate governance and all economic interrelations have been legitimized. Therefore, the contemporary Islamic Finance movement could be seen in this light—repackaging of the abhorrent conventional/Occidental banking system to consumerism, wealth accumulation and in this way soften Muslim societies' indignation towards anything western (Wong, 2007).

Culture defines people of the same mindset 'which distinguishes members of one group or category of people from those of another' (Hofstede, 1991, p.5, in Dash et al., 2007). Groups/societies differ with respect to the values they hold dear and that impact upon group members' judgment and choices. Self-centred people tend to rely on their own devices to achieve their ends, and place less responsibility on others, and their commitment to others will likely be low. The self-policing framework produces social goods such as well-being, knowledge and human development that enhance diversity of opportunities with the least cost. On the other hand, liberalism engenders arrogance of self, collective hegemony, evil things and markets, and institutions that work against the letter and spirit of Allah's divine laws. Thus the implication for capital and labour is one of complementarity serving the mutual well-being of the human society unlike in traditional economic reasoning where everything else—labour included—are subordinated to capital, hence the justification for interest (Choudhury, 2008).

Cultural values, beliefs and attitudes are important factors in customers' decision process and researchers consider culture to be an important determinant of consumer behaviour. Establishing commitment is a fundamental condition for a strong relationship. Relationship bonding affected commitment and behavioral loyalty through trust. Structural and social bondings are important in terms of establishing committed customers. Clients patronize banks through banks' representatives and their experience with the bank representative may strongly influence their commitment to use the bank services. Reliance on key contact personnel remains more important than technology for the success of professional business-to-business services. Individualistic society values objective performance such as, good pricing and delivery time while collectivist society values personal and social relationships in doing business with its bank. The former derive commitment to their banking relationship on structural bonding while the latter emphasizes social bonding (Dash, et al., 2008). Many people today find it ideologically incomprehensible to practice moderation and ethics and maintain their rights to private property and enjoying the good things in this life while preparing for the life hereafter. Moderation and preparation for the hereafter have here, unfortunately, often been interpreted to mean self-deprivation and devaluation of worldly life.

In competition with IBF is the so-called Socially Responsible Investments (SRI) movement that has received wide recognition in the west. They do not claim religious adherence yet they shun most of the activities that IBF is forbidden to engage in. Therefore, they tend to appeal to both Muslims and non-Muslims who wish to be seen to be religiously neutral yet share these ideals. Corporations see these ideals as the cornerstones for building a good reputation with customers and suppliers, maintaining brand strengths and attract and retain a committed and skilled workforce so as to enhance performance in terms of profitability, competitiveness and risk management (Dusuki and Abdulla, 2007).

Many believe that there is no one “Islam” in IBF. Regulatory problems associated with IBF could be overcome but the “Islamic/religious” label and values attached to IBF are unlikely to be universally shared and adopted by all global customers. They have also been criticized for being “too religious” and that will often chase away potential non-Muslim customers whose ethical values are incongruent with Islam. Islamic Banks must not depend only on Muslims as their sole source of deposit funds or as their fund users. They have to target non-Muslims too by offering them products and services that do not compromise Shari’a principles yet are attractive to both Muslims and non-Muslims alike (Haron et al., 1994).

Islamophobia has been on the rise since the start of the Islamic renaissance. Issues of terrorism, demographic contestability, Shari’a law and violent suppression of the Muslims’ desire to develop their own socio-economic systems have taken centre stage. Many in the west see the development of an alternative and viable financial system based on Islamic principles in this negative light (Hillman, 2007). IBF faces an additional dilemma in the form of resistance to the idea of an alternative financial system from those who benefit from seigniorage of fiat money especially countries whose national currencies are used as reserve currencies like the US Dollar (Meera and Larbani, 2006).

Numerous studies have shown that customers will do business with Islamic banks that uphold their religious values. They also have found that it’s not the only criterion used by customers in selecting an Islamic Bank or Islamic Products. They should not assume that their clients will be prepared to deal with them solely on religious grounds; rather they need to demonstrate that they can offer quality services that satisfy the needs of their clients. The contradiction here is well captured by the secondary document analysis of more than 13 research papers on preferences and the satisfaction of Islamic banking customers by Dasuki and Abdulla (2007).

Nearly a half of the 13 research papers cited by Dasuki and Abdullah (2007) on this subject found that religious motivation was not a primary criterion in the selection of Islamic banking services. In their research paper on Malaysian customers, Dasuki and Abdullah (2007) found that knowledgeable and competent personnel were the number one criterion for the selection of Islamic Banking Services. Islamic Reputation & image and Islamic working environment came 4th and 7th respectively. IBF practitioners must investigate patronage factors, and identify to what extent the various characteristics of products and services influence customers' banking choices. The success and survival of an individual bank depends on the banker's ability to understand customers' needs and to find a way to satisfy these needs. The selection criteria are a combination of religious, financial reputation and quality services offered by the Islamic Banks. These are defined by staff friendliness and competency as well as efficiency and speed of services. Convenience, a bank's reputation, profitability factors, security and professional advice have also been found to influence customer satisfaction in banking, and in turn, it impacted positively on the continued loyalty of a customer towards a particular bank. Dasuki and Abdulla's (2007) findings underscore the importance of personnel training especially on the subject of the unique Islamic Banking products and services. They should be able to effectively handle customers' enquiries and provide adequate explanation about the various products and services offered by Islamic Banks. Therefore, needless to say, a 'highly skilled and qualified work force is indispensable for the smooth-running and effectiveness of Islamic Banks' (Dusuki and Abdulla, 2007, p.153).

Market transformation should take place with preservation and sustenance of life by the guarantee of necessities and upholding of Allah's divine laws. The Qur'an provides the general framework within which all human cooperative activity can take place harmoniously. The economy, market, polity, and social relations of the human community are naturally defined by issues of poverty alleviation, social justice,

common good, and empowerment by participation, entitlement by transfer payment and involvement in productive enterprise using cooperative instruments and so on.

The Islamically imbued socio-economic and political environment is a prerequisite for successful functioning IBF. Ignoring this fact, lead to the failure of Interest-free banking in many countries (Choudhury, 2008; Bhatti and Khan, 2006). It is a well-known fact that economic growth is a necessary but not sufficient condition for a community's development. A political will to establish Islamic order in all walks of life is also necessary. The socio-economic evils bedeviling the world today have been attributed to the inequitable distribution of wealth under the fiat monetary system. It is characterized by poverty, unemployment, inequitable income distribution, corruption, inflation, inadequate housing and health care, poor educational standards and even deadly conflicts—civil wars and wars between countries (Meera and Larbani, 2006). Currently, there are no mutually sustaining relationships between economic growth and human development, and as a result, the rich are getting richer and the poor are getting poorer (Mehmet, 1997).

Debt financing is attractive to firms because it is cheaper; however, the constant “risk less” repayments to the lender are at odds with the normally risky cash flows from business operations. As a result of the inherent imbalances, this phenomenon leads to many borrowers becoming heavily indebted to financial institutions. IBF was meant to remedy the apparent imbalance by emphasizing partnership rather than lending. Unfortunately, it has eventuated that Islamic Banking today is no different from conventional banking operations so far as bank-client relationships are concerned. Therefore, by adopting the same policy instruments as capitalism, Islamic finance inadvertently helps to contribute to this trend (Meera and Larbani, 2006).

Islamic banks must maintain a competitive edge and offer products and services that meet the needs of their clients if they are to capture and retain a significant market

share in a dual banking system. However, faced with lack of political and institutional support, social values and economic systems that are at odds with the anticipated socio-economic environment for a truly Islamic economic order, banks' response has been its tendency to converge towards conventional finance practices that negate the very foundational premise upon which they were established in their attempt to meet "internationally acceptable standard". IBF product innovation has further resulted in unnecessarily complex product structures. Consequently, banks adopted the excessive use of mark-up modes of financing that were not practically different from conventional practice. That could be the reason why the leading providers of Islamic banking services are "hybrid" institutions that mix Islamic with conventional banking services such as National Commercial Bank (KSA), MayBank (Malaysia) and Asean Bankers (Malaysia) (Dusuki and Abdulla, 2007; Asutay, 2008; Nigel, 2004; Metawa and Almosawi, 1998).

Conventional banks can participate in both systems while Islamic Banks cannot participate in conventional banking services. They are disadvantaged in a hybrid banking system. In fact, the assets of Islamic banking units of conventional financial institutions grew by as much as 9.7% more than those held by pure Islamic banks between December 2002 and December 2004 in Malaysia. The reason could be that these institutions are well established, have greater distribution networks and enjoy greater economies of scale and scope. More importantly, it reveals that many customers prefer quality services and probably more profit with less risk than they desire to comply with Shari'a principles. This is the so-called withdrawal risk coupled with the liquidity risk faced by Islamic banks in the dual banking system (Chong and Liu, 2006).

The Islamic mode is more attractive to the banker. Needless to say, "one should not be surprised by the enthusiasm and the zeal of all bankers—both Islamic and conventional—in promoting Islamic finance", hence its phenomenal growth during

the last two decades. This growth is, in part, fuelled by the arbitrage between Islamic banks and conventional banks under the fiat monetary system. This arbitrage will most likely be eliminated in one way or the other in the future. Unless Islamic finance proves itself as truly distinct alternative financial system to that of conventional finance, the absence of this arbitrage will have huge implications for IBF's *raison d'être*. Unfortunately, Islamic banks operating in a fractional reserve banking system are much worse than their conventional counterparts. Use of the quasi-debt profit and loss sharing financing instruments, in a fractional reserve banking system where both Islamic and conventional banks operate, exacerbates the debt burden on the Islamic bank borrower. In the event of the use of traditional monetary policy instruments (i.e. reserve ratio & interest rates) in an Islamic endogenous monetary system, it hampers growth and creates volatility in the economy. Loss of wealth through indebtedness leads to loss of sovereignty, which in turn makes the other Shari'a objectives unattainable. What is required is a system that balances knowledge, justice, wisdom and tolerance (Meera and Larbani, 2006).

The choice between venal and sacrificial behaviour is determined by the values of the participants in IBF and the interest of the larger environment. The objectives of IBF Management and the society in which they operate converge on the profit motive; hence, the lack of serious analysis of the validity of IBF's products' compliance with Shari'a principles and no one questions the commitment of IBF to social goals, one of the principle objectives of their existence. Overwhelmed by their materialistic considerations, different sections of the Islamic society dealt with interest-free banking in the context of their "self-interest"; thereby denying it the public legitimacy for it to develop into a truly alternative financial system. 'Therefore, Muslim aspirations for the Islamization of knowledge/disciplines which includes Islamic economics, banking and finance can never be truly established in this environment' (Meera and Larbani, 2006, p.30).

6.2 Conclusion

In this thesis, based on available literature thus far on IBF, I have attempted to explore the challenges of putting IBF theory into practice. I claim that IBF has something to offer humanity in the form of an alternative financial system founded on interest-free financial services that promote real economic value through cooperative efforts between various economic agents. To realize its full potential, however, these economic agents, who make up its stakeholders, must be ready to embrace IBF wholeheartedly by undertaking the fundamental reforms needed for its implementation. These changes are undoubtedly costly but I have argued are indispensable.

As is evident in the discussion and the preceding chapters, for all practical intents and purposes, no one is yet ready. On the contrary, we see that all major efforts undertaken to promote IBF has been the tendency to harmonize it with the existing economic realities. In the process, what has emerged is a system that imitates IBF, but in the majority of senses, is not substantively different from conventional Banking and Finance.

In the longer term, this is more dangerous than abandoning IBF altogether. The danger is that as the difference between IBF and conventional finance gets reduced, Muslims will see it as an attempt to repackage conventional finance so as to lure them into the capitalist's *riba* armpit while non-Muslims will be indifferent, ringing the death bell of Islamic finance movement for the foreseeable future (Haniffa and Hudaib, 2007).

6.3 Recommendations and Suggestions for Future research

It is important for all stakeholders to work together in taking advantage of what IBF has to offer by considering an honest cost-benefit analysis of adopting a pure IBF with the corresponding economic, political, legal and social reforms. It is the governments' responsibility to set the pace by initiating programs aimed at changing peoples' perceptions, attitudes and knowledge of Islamic Banking and Finance. One way it can be done is to begin regulatory reforms in all sectors of the economy aimed at encouraging more stakeholder participation and aiding the development of IBF. The economic agents should aim these reforms at eliminating interest-based transactions in the economy in the long run through the use of Profit and Loss sharing participation. Financial institutions offering IBF services should resist the temptation of taking the easy route of restructuring conventional banking products so as to remain relevant in this competitive environment. This may offer short-term advantages but may be counterproductive in the long-run. The society too has to be ready to be involved in this, because its perception and attitudes towards IBF do matter at the end of the day. It's the task of governments, financial institutions and traders to show the way, and demonstrate to the rest of society that adopting IBF is beneficial to all. Scholars and educationists have a role to play too. By undertaking useful research and presenting their findings to the relevant stakeholders they can go a long way in helping them to make more informed decisions quickly and thereby accelerate the transformation needed to make IBF practice easier and less costly to participate in.

Any actions or decisions geared towards the betterment of IBF operations must be guided by the Shari`a objectives which are the protection of: (1) faith (deen), (2) Life (Nafs), (3) Posterity (Nasl), (4) Mal (Property) and (5) Reason or Intellect (Aql). These are must and basic necessities (Daruriyaat) of human society without which the human society will not be able to live harmoniously. There are other Shari'a

objectives but these are less important which are referred to as “Hajiyaat” or requirements and Tahsiiniyaat or improvements that can be pursued after the attainment of the Daruriyat, Meera and Larbani, (2006). The following specific recommendations are therefore proposed;

6.3.1 Government/Central Bank

1. Recognition of IBF as a separate financial system different from the present day conventional banking and finance that requires a unique regulatory framework.
2. IBF is meant to function in a real money economy and not fiat monetary system, therefore, there is the need to evaluate the continued existence of IBF in a fiat monetary system and continuously seek to identify whether anything can be done to minimize the effect this has on Shari’a objectives. The disconnection between financial markets and the real economy under the capitalist system is said to stem from the nature and use of fiat money (Meera and Larbani, 2006).
3. Establishment of a Central Shari’a Board and Muhtasib agency that will be responsible for the Shari’a rulings and Shari’a audits, and monitoring and supervision of IBF institutions and their clients respectively. Muhtasib in an Islamic economic setting is the government office responsible for enforcement of market regulations through inspections and controls in order to protect market players as well as the public interest.
4. Banks and Financial institution in IBF system will be expected to hold equity in the projects they finance, therefore, there is a need to enact legislation that would increase transparency and reduce information asymmetry between parties and define accounting and tax/Zakat treatments.

5. Establish Shari'a commercial courts that will adjudicate commercial dispute and enforce the Shari'a contracts entered into by the various economic agents. The judges should be well versed in Shari'a law as well as commercial conventional law so that they can also pass judgment where one or two of the parties to a case do not profess the Islamic faith.
6. Globalization is a reality that cannot be escaped by anyone, needless to say, national government that chose to following full Islamic economic doctrine must find ways to interact with the rest of the world in ways that are mutually beneficial to both without violating the Shari'a provisions.

6.3.2 Banks and other financial institutions

1. Financial institutions, as the intermediaries, play the biggest role in the smooth running of IBF. The Shari'a provisions as provided by the central SSB should guide their mission and vision. As with legal departments, IBF institutions should have a Shari'a department that gives Shari'a advice in product development, marketing and relationship management.
2. Their Service quality does not stop at Shari'a compliance. As shown in Chapter 4, above, preferences and satisfactions of Muslim customers are the same as those of non-Muslims in terms of service quality as defined by availability, profitability, efficiency and the opportunity cost of complying with the Shari'a.
3. They should work with regulatory authorities in helping the industry grow to its full potential. One way of doing so is to participate in policy formulations and avail their industry expertise to the government agencies responsible for their regulation and supervision.

4. The banks are expected to undertake training of their staff and conduct regular research on the subject that help in innovations and service improvements within the purview of the approved Shari'a guidelines
5. Equity participation as a financing technique has its unique risks that require the formulation of specific risk mitigating ways. This may include sitting in the directors' board of the financed entity to reduce moral hazard improve the management of the business. Appropriate monitoring methods should be instituted in collaboration with the office of Muhtasib

It's hoped that policy makers, practitioners and researchers would find this work useful since, at least to my knowledge at the time of writing this thesis; no one has studied the role of stakeholder characteristics, at a macro level, in the transformation of IBF theory into what is practiced today. Lastly as mentioned in my introduction, this thesis is based on theoretical deductions and more empirical tests are encouraged on the same problems for IBF research and practice. For instance, there is need to establish what IBF practice considers to be the expectations of society, governments, customers and regulators when designing their product in addition to compliance with Shari'a.

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