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INTRODUCTORY ARTICLE

ISLAMIC BANKING AND FINANCE: BETWEEN IDEALS AND REALITIES

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1. INTRODUCTION

Islamic banking and finance as an industry is growing at an unprecedented rate. Currently, there are about 270 Islamic banks worldwide with a market capitalization in excess of US$13 billion. The assets of Islamic banks worldwide are estimated at more than US$265 billion and financial investments are above US$400 billion. Islamic bank deposits are estimated at over US$202 billion worldwide with an average growth of between 10 and 20 percent. Furthermore, Islamic bonds are currently estimated at around US$30 billion. In addition, Islamic equity funds are estimated at more than US$3.3 billion worldwide with a growth of more than 25 percent over seven years and the global Takaful premium is estimated at around US$2 billion.

Islamic finance is founded mainly on the prohibition of *ribŒ*’. Thus, the main aim of Islamic banking and finance is to provide an Islamic alternative to the conventional system that is based on *ribŒ*’. As an alternative to *ribŒ*’, the profit and loss sharing arrangements are held as an ideal mode of financing in Islamic finance. It is expected that this profit and loss sharing will significantly remove the inequitable distribution of income and wealth and may lead to a more efficient and optimal allocation of resources as compared to the interest-based system. Thus, it will ensure justice between the parties involved as the return to the bank on finance is dependent on the operational results of the entrepreneur (Siddiqi, 2001).

In examining the development of Islamic finance, one can easily observe that the early "idealistic" vision has significantly changed in practice. Idealist, liberal and pragmatic approaches to Islamic banking and finance can be identified in a continuum (Saeed, 2004). The idealist approach seeks to maintain the relevant contracts that were developed in the *shar¥cah* in the classical period. At the opposite end of the continuum are those scholars who argue that the term *ribŒ*'does not include modern bank interest. Between these two extremes lies the pragmatic approach, which is realistic enough to see that the idealist model of Islamic banking has significant problems in terms of feasibility and practicality, but which at the same time maintains the interpretation of *ribŒ*'as interest. Added to this continuum, can be an alternative idealist approach that blends the pragmatic approach and socially responsible financing where Islamic banks offer Islamic finance for microfinance purposes.

The above development of Islamic banking and finance theory and practice prompted the Institute of Islamic Banking and Finance, International Islamic University (IIUM), to organize the IIUM International Conference on Islamic Banking and Finance 2007 (IIC*i*BF). The conference was held in Kuala Lumpur from 23-25 April 2007 with the theme "Research and Development: The Bridge between Ideals and Realities." More specifically, the conference sought to provide an avenue for presentation and exchange of ideas on areas of improvement in the development of the Islamic banking and finance industry. The conference also discussed research findings and contemporary issues of Islamic banking and finance as a means for effective contribution to the development and progress of the Islamic banking and finance industry. There were 50 papers selected for presentation in the conference out of more than 100 papers received. The list of the papers accepted is provided in the Appendix. Four papers were selected from the conference for this special issue of the IIUM Journal of Economics and Management. The papers are as follows:

1. "A Critical Appraisal on the Challenges of Realizing *MaqŒ§id al-Shar¥cah* in Islamic Banking and Finance" by Asyraf Wajdi Dusuki and Abdulazeem Abozaid.
2. "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of *Homoislamicus* by *Homoeconomicus*" by Mehmet Asutay.

3. "Making Development Assistance Sustainable Through Islamic Microfinance" by Rodney Wilson.
4. "Agency Problems in *MuèŒrabah* Financing: The Case of Sharia (Rural) Banks in Indonesia" by Muhammad Akhyar Adnan and Muhammad.

The above papers, however, were selected not as the best papers but rather to represent the dominant themes and issues rigorously discussed and debated during the above said conference. The issues debated included the divergence between the theory and practice of Islamic economics and finance; whether the way Islamic banks are structured and current Islamic financial products offered were able to achieve the objectives of *shar¥ᶜah*; how to provide an Islamic alternative to microfinance and easy access of Islamic finance to the poor; and empirical issues such as agency problems in offering Islamic equity financing (*muèŒrabah*). This introductory note will attempt to give an overview of the papers and to deliberate on some of the pertinent issues raised.

2. REINVIGORATING THE GOALS OF *SHAR¡ᶜAH* AND ISLAMIC ECONOMICS

A pragmatic shift in Islamic banking and finance is the almost complete move from supposedly Profit and Loss Sharing (PLS) banking to a sales-based and debt-based system (Saeed, 2004). The literature of the 1960s and 1970s was clear that Islamic banking and finance should be based on PLS. Apart from the relationship between the bank and the depositor, in which a form of PLS that is based on *muèŒrabah* is institutionalized, Islamic banks in the vast majority now avoid PLS as the most important basis for their investment activities. Instead, such activities operate largely on the basis of contracts that are considered "mark-up" based such as *murŒbaúah*, *salam*, *ijŒrah* or *istisnŒᶜ*. For the bulk of their investment operations, Islamic banks have opted for these mark-up based, relatively safe contracts, which are similar, in some respects to lending on the basis of fixed interest. Simultaneously, the use of less secure and more risky contracts such as *muèŒrabah* and *mushŒrakah* have been dramatically reduced to only a small share of assets on the investment side.

The first paper by Dusuki and Abozaid (2007) examines and discusses the above challenges for the proper realization of *maqŒ§id* *al-shar¥cah* in Islamic banking and finance. The main focus of the paper is to address the need to revitalize Islamic banking and finance practices based on a proper understanding and implementation of the *maqŒ§id* of *shar¥cah*. Dusuki and Abozaid (2007) contend that the provision of equity based financing by Islamic banks will better serve the Islamic socio-economic objectives including social justice, economic growth, efficiency and stability. This is in line with the views of earlier generation of Islamic economists such as Nejatullah Siddiqui, Umar Chapra and others. The authors further support their claims based on later empirical studies such as those of Al-Harran (1990), Haron (1996) and Yousef (2004).

Dusuki and Abozaid critically question the excuses normally put forward by the present Islamic banks that there is a priority to facilitate the development of a new industry and to ensure the sustainability of the Islamic system within the structure of the conventional system. The authors, however, claim that all these excuses are misguided justifications and the modern approach in Islamic banking has treated *ma§laúah* (public interest) as priority over textual sources. The paper then supports this claim based on the controversies over the application of the concept of *bayc al-c¥nah*. This concept has been widely used in most Islamic debt financings in South East Asia. Dusuki and Abozaid claim that legal tricks (*ú¥lah*) have been used to circumvent *ribŒ'* and this is an abuse of the sale contract. Consequently, the authors classify the objectives (*maqŒ§id*) of Islamic law (*shar¥cah*) into two i.e. macro *maqŒ§id* (interests or benefits to the overall well-being and welfare of the economic system) and micro *maqŒ§id* (benefits pertaining to certain individuals in financial transactions). It is argued that in the case of *bayc al-c¥nah*, the transaction will benefit particular individuals in the transaction (micro *maqŒ§id*) but at the expense of the macro *maqŒ§id* or more specifically, the goals of Islamic law of transactions.

The paper by Dusuki and Abozaid concludes that in order for the *maqŒ§id al-shar¥cah* in Islamic banking and finance to be achieved, all of its transactions must be *shar¥cah* compliant not only in its forms and legal technicalities, but more importantly the economic substance. Such that if the economic substance of a given transaction is identical to that of a prohibited transaction, then this must render the transaction impermissible regardless of its legal form. Thus, there is a need to distinguish between permissibility and validity of financial contracts. The validity of the contract must also be determined by *niyyah* (intention) and the purpose or the substance of the contract, and not just by emphasizing on the form or the structure of the contract alone. The proper implementation of Islamic financial contracts is crucial not only to achieve the objectives (*maqŒ§id*) of Islamic law, but at the same time to promote economic and social justice. This is also the basis of the establishment of Islamic banks in the first place.

The next paper by Asutay (2007) further discusses the above issues by focusing on the normative assumptions of Islamic economics. The paper asserts that the current practices of Islamic finance dominated by debt financing does not support, nor is it supported by the normative assumptions of Islamic economics. The current pragmatic approach is strongly referred to as internationalization of 'capitalist' desires into Islamic finance. The aims of Asutay's paper is to highlight the 'tension' between Islamic economics and Islamic finance by particularly making reference to its participants as homoislamicus and homoeconomicus. The paper also refers to its institutions, including the political economy of their construct in terms of normative and positive principles, and outcomes of both paradigms. The paper emphasizes that Islamic economics has a great potential to create an ethical Islamic financial system in which its ethicality should not be relegated only to the elimination of *ribŒ*'.

Asutay summarizes the foundational axioms, conceptualization and assumptions of Islamic economics paradigm including *tawú¥d*, *al-'adl wa'l-iúsŒn*, *tazkiyah* and others succinctly. Based on these axioms, the paper argues that Islamic economics can be characterized as a two-dimensional utility function (present and the hereafter) which represents homoislamicus preferences. On the other hand, the conventional economic system is a one-dimensional utility function which represents homoeconomicus preferences or the economic individual in a market system. By quoting various past empirical studies, the paper demonstrates that Islamic banking and financial institutions have opted for a more profitable Islamic financing such as *murŒbaúah* at the expense of *mushŒrakah*. The paper concludes that Islamic banking and finance has deviated from the aspirational stand of Islamic economics. The main reason, as interestingly put forward by the paper, is due to a realistic attitude based on positivism rather than the normative axioms imposed on, or assigned by, Islamic economics.

Asutay is not only focusing on the divergence between Islamic economics and Islamic finance, but also provides what he calls the second best solution. The best solution is where Islamic banking and finance should be restructured to incorporate the authentic appeal to ethics and social justice. Asutay however is of the view that this solution may not be the way forward. This is due to the failure of Islamic finance, within the present structure and operations of neo-classical economics, to internalize the social dimension and social justice. Thus, the second best solution has been identified, that is to develop a new model or re-orientate Islamic finance to emphasize community banking, social banking or microfinance.

The social banking movement has taken place in many European countries and could be taken as our example. Social banking is a socially responsible form of banking offered by mainstream private banking, state owned banks and specialist lenders that provide social lending and serve social objectives. Social banks with the philosophy of providing financing to promote entrepreneurship and social development could be a better platform to offer Islamic equity based financing such as *muèŒrabah* and *mushŒrakah*.

Asutay reminds readers that in reorienting towards social banking, Islamic finance should relate to the social and economic ends of financial transactions, rather than just focusing on the mechanics of the contract. Therefore, correcting the failure of Islamic finance, which has deviated from the aims of Islamic economics by giving way to the economic incentives, should be in the form of introducing robust social justice oriented principles into Islamic finance, by endogenising social justice into its operational nature as in the example of social banks. In other words, goals and objectives should have primacy over rules and regulations so that the correct institutions and financial products can be created and offered.

3. MAKING ISLAMIC FINANCE ACCESSIBLE TO THE POOR

Microfinance is normally defined as the provision of financial services for those too poor to have access to banks. Commercial banks are normally excluded from the domain of microfinance (rather, banks did not want to get involved in it) which for some time was the exclusive domain of specialized institutions, normally NGOs. NGOs, due to their knowledge and familiarity with local clientele in less developed countries, have played a fundamental role as intermediaries in managing funds for micro-financing (Ferro, 2005). Concerns about the lack of real profitability of microfinance prevented banks from getting involved in microfinance. The inherent risks posed by microfinance and the widespread belief that the poor are poor because of their lack of skills, has kept traditional banks, including Islamic banks, away from microfinance.

Most Islamic banks do not provide easy access to financing to the poor. Many elements of microfinance, however, can be considered consistent with the broader goals of Islamic banking. Microfinance advocates entrepreneurship and risk sharing and believes the poor should take part in such activities (Dhumale and Sapcanin, 1999). At a very basic level, the disbursement of collateral-free loans in certain instances is an example of how Islamic banking and microfinance share common aims. This close relationship would not only provide obvious benefits for poor entrepreneurs, who would otherwise be left out of credit markets, but investing in micro-enterprises would also give investors in Islamic banks an opportunity to diversify their investments.

The main contention that micro-entrepreneurs are among the poor, and the poor are not credit worthy or bankable, needs to be seriously examined. Received wisdom that lending to poor households is doomed to failure: costs are too high, risks are too great, savings propensities are too low, and few households have enough to put in terms of collateral (Murdoch, 1999). Islamic banks definitely need to learn from the success of conventional microfinance in particular the Grameen Bank. As expounded by Muhammad Yunus, credit is a fundamental human right, where every person must be allowed a fair chance to improve his/her economic conditions. Credit has the capacity to create self-employment, thereby increasing their income, and they can use this additional income to satisfy the other basic human rights for food, shelter, health and education (Gibbons and Kassim, 1990).

The paper by Wilson (2007) explores how microfinance can be provided on a *shar¥ᶜah* compliant basis and what instruments and structures could be used. The author argues that even though the provision of alternatives to exploitative lending such as that provided by the Grameen Bank in Bangladesh, is applauded, it can be questioned whether these are sustainable if they conflict with the values and beliefs of local Muslim communities. Wilson argues that Islamic financial contracts are linked to real transactions and are designed for specific purposes such as: *murŒbaúah* for purchase and resale of commodities, *ijŒrah* applies to operational lease involving property or equipment, and *istisnŒᶜ* covers the manufacture or supply of specific items. All these instruments can be structured for microfinance purposes. In addition, *al-qarè al-úasan* is also identified by classical Islamic jurisprudence as particularly designed for those in need.

If Islamic banks consider giving financing to the poor is risky business despite the various risk mitigation techniques available, then the proposal made by Wilson for microfinance institutions to adopt and adapt the *wakŒlah* model as widely used in Islamic insurance (*takŒful*), should be seriously considered. Even though Wilson did not propose the model to be adopted by an Islamic bank specifically, it is worthy to examine the model. Under this *wakŒlah* model, the microfinance institution will act as an agent whereby microfinance funds could be provided from *zakŒh* funds or NGO donor agency. The microfinance institution will be paid management fees for their work in managing the fund. The micro-entrepreneur, as participants, will receive the fund from the microfinance institution, and repay the fund by installments with the element of *tabarru*^{c} (donation).

According to Wilson, an advantage of the *wakŒlah* model is that it combines some of the features of a credit union with professional financial management, but ensures the interests of the participants by the management as there is a potential for a conflict of interest, with participants losing out if management remuneration is excessive and not transparent. Hence, with the *wakŒlah* model, the management is remunerated by a fixed fee, and they do not share in the *wakŒlah* fund, the sole beneficiaries from which are the participants. The latter make a donation to the fund, which can be regarded as a *tabarru*^{c}, a term implying solidarity and stewardship.

Wilson also argues that the *wakŒlah* model can still be adopted by the Islamic bank. Here, rather than the fund coming from shareholders and depositors, it will be contributed by the government or *zakŒh* fund, and it will consequently reduce the inherent risks of the Islamic bank. As with credit unions, participants are entitled to draw disbursements from the fund, which can exceed their contributions at any given date. Obviously not all participants can withdraw funds in excess of their contributions at the same time as there would be insufficient funds to meet the demand. This implies a rationing mechanism is necessary. With the *tabarru*^{c} principle, the motivation is not a price incentive such as interest payment, but rather to help participants among the micro-entrepreneurs and the poor meet their financial requirements, while at the same time building up entitlements to similar help.

While Wilson focuses on a *shar¥*^{c}*ah* compliant structure for microfinance, Adnan and Muhammad (2007) provide an empirical evidence of agency problems in *muèŒrabah* financing. They study Islamic banks that provide Islamic equity investment based on *muèŒrabah* to small businesses in rural areas of Indonesia. The motivation of their study was due to many criticisms that Islamic banks did not provide sufficient equity based transactions as compared to debt based transactions. Islamic investment such as *muèŒrabah* involves two parties, capital provider (*rabb al-mŒl*) and entrepreneur (*muèŒrib*) and both parties enter into a contract of profit sharing from the business venture. However, where there is a loss, the loss will be borne by one party, that is the capital provider. This creates what conventional corporate finance theory calls an agency problem. This is due to the problem of asymmetric information where the principal (*rabb al-mŒl*) has imperfect or limited information while the agent who runs the business has full information. This in turn creates a moral hazard problem due to information asymmetry where one party might take advantage over the other party.

In Adnan and Muhamad’s mainly descriptive study, they found that Islamic banks avoided long term contracts when they provide *muèŒrabah* financing. The main sector that was financed through *muèŒrabah* was the trading sector while other sectors received significantly less such as agriculture and manufacturing. This indicates a normal tendency for Islamic banks to invest in low risk investment when it comes to *muèŒrabah* financing. Using factor analysis, the study identified five main factors i.e. business skill; business reputation; business commitment; financial report of the project; and length of the project as influential factors that are considered by Islamic banks when they give financing. These factors are also found as potential factors that can reduce agency problems.

4. CONCLUSION

The call for Islamic banking and finance to realize the goals (*maqŒ§id*) of *shar¥ᶜah* (Dusuki and Abozaid) and the axioms of the Islamic economic paradigm (Asutay) is not something new. This has been a challenging task for Islamic banks since the beginning of the development of Islamic banking (e.g. Ziaudin, 1991). The fact that most of the Islamic banks and financial institutions are commercially based, the profit criterion will always supersede social obligations. As Asutay correctly asserts, Islamic banks and financial institutions reflect the internalization of ‘capitalist’ desires into Islamic finance, whereby profit criterion would always be the ‘bottom line.’ However, we also have to consider that banks are by nature conservative and risk averse, as they are responsible not just to their shareholders but also to their depositors. As their depositors comprise of both small and large depositors, banks look upon themselves as trustees for these funds. As trustees they are bound to protect these funds and their depositors to ensure the banking system is fair, sound and most importantly, safe. Thus, Islamic equity financing modes such as *muḍārabah* and *mushārakah* that are considered more risky than debt financing modes will not be attractive to banks. Islamic equity financing also requires substantial trust between the banks and their customers. This requires monitoring and supervision, and *mushārakah* in particular requires more efforts and cost from the banks. Adnan and Muhamad have shown this fact in their study of Islamic banks in rural Indonesia.

The way forward for the development of Islamic finance should not be to engage in long standing unresolved issues and debates. Rather, the Islamic banking and financial industry must internalize both the objectives (*maqāṣid*) of *sharīʿah* and the axioms of Islamic economics. The proposal made by Asutay to realign the structure of Islamic banking and to function like social banks as practiced in many European countries deserves special consideration. This will theoretically shift the current attention of capitalist mindset of commercially driven banks to a more socially responsible banking. In the same vein, the provision of Islamic finance to the micro-entrepreneurs and the poor who are not normally bankable under the conventional system through the Islamic equity modes of financing also deserve special attention. The proposal by Wilson (2007) for Islamic institutions, not necessary financial institutions, to adopt a *wakālah* structure in order to attractively offer Islamic microfinance to micro-entrepreneurs should be explored further. Both well thought proposals must be subjected to further research and development by the industry, regulators and also scholars. This, in essence is well reflected by the theme and the focus of discussion during the IIUM International Conference on Islamic Banking and Finance 2007 "Research and Development: The Bridge between Ideals and Realities," from which the above four papers were selected.

Notwithstanding the above arguments, we also have to appreciate that the present Islamic banks in many Muslim countries with the exception of few, are operating parallel with the conventional banks. It is widely known that most Islamic banks operate within the so called "dual" financial system model. Regulatory issues could be crucial as both Islamic and conventional banks are regulated according to the same regime with some adaptations to accommodate Islamic banks.

Definitely for Islamic banks to practice according to the *maqŒ§id* may require re-orientation of the policies at the Central Bank, Inland Revenue, accounting standard setters and other relevant institutions. Another argument is that Islamic banks must also be prudently governed and supervised as their nature and operations are expected to be different from conventional banks. In this respect, the establishment of the Islamic Financial Services Board (IFSB) in 2003 marked another important development. The IFSB is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital market and insurance sectors.

Practitioners, however, are often of the view that the aforementioned scholarly opinions are made devoid of adequate consideration of practical problems. As a result, such academic reflections are often dismissed as arising from naivety and lack of knowledge of operational issues. Hence, there exists a gap in conviction and understanding – the idealism of many scholars and academicians and the pragmatism of practitioners of the industry. Thus, critical and constructive discussion and engagement between scholars, practitioners and policy makers in addressing legitimate concerns as identified above requires research and development. Product innovation, infrastructure enhancement and human capital development, among other things, should be subjected to rigorous research that consolidates both fundamental *shar¥cah* principles, and operational aspects and concerns voiced by practitioners. The coming together of the different views, and more importantly, the resolving of them – the bridging of the identified "gap" of ideals and realities – are essential next steps for the development of a more globally harmonized Islamic banking and finance industry that would better serve the society.

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APPENDIX

IIUM INTERNATIONAL CONFERENCE ON ISLAMIC BANKING & FINANCE 2007 (IIC*i*BF 2007)

23 – 25 April 2007 * Crowne Plaza Mutiara Hotel, Kuala Lumpur

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4.	Hamim Syahrum Ahmad Mokhtar *Bank Negara Malaysia* Syed Musa Al-Habshi *Intl Inst of Islamic Fin Inc* Naziruddin Abdullah *Al-Hosn University, UAE*	Determinants of Islamic Banking Efficiency in Malaysia
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36.	Belal Abdul Mutalib Badawy *United Arab Emirates University*	صناديق الاستثمار من منظور قانوني وشرعي
37.	Habiba Saif Salem Rashed Al Shamisi *United Arab Emirates University*	مفهوم التكافل الإسلامي
38.	Salih Qadir Al-Zanki *IIUM*	البنوك الإسلاميّة بين حراسة وظيفة المال وانتهاكها
39.	Abd. Ghafar Ismail Ahmad Azam Sulaiman *Universiti Kebangsaan Malaysia*	Debt Default Probability, Asset Diversification and New Capital Accord: Implication for Islamic Banks
40.	Saiful Azhar Rosly *International Centre for Education in Islamic Finance(INCEIF)*	Risk-Return Analysis of Islamic Banks' Investment Deposits and Shareholders' Fund
41.	Fatima Abdul Hamid *IIUM* Sigit Pramono *Shari'ah Economics & Banking Institute, Indonesia*	Governance Committee & Governance Audit Model in Islamic Banks: How Will It Resolve The Problem of Information Asymmetry?
42.	Chithra Latha Ramalingam Janaletchumi Appudurai *HELP University College, Malaysia*	Current Developments of Corporate Governance in Islamic Banking and Finance

APPENDIX (continued)

43.	Zulkifli Hasan *Islamic Science University of Malaysia*	Roles of the Islamic Financial Institution in Combating Money Laundering: Legal and ***Sharīʿah*** Perspective
44.	Sayed Sikandar Shah *IIUM*	Issues in ***Fiqh al-Zakāh***: Implications for Islamic Banking and Finance
45.	Noven Suprayogi *Airlangga University, Indonesia*	The Internal ***Sharīʿah*** Supervision Activities in Islamic Banks
46.	Agus Triyanta *IIUM*	The Regulation on ***Sharīʿah*** Compliance (A Comparative Study Between Malaysia and Indonesia)
47.	Muhamad Kholid Raditya Sukmana Kamal AbdelKarim Hassan *IIUM*	***Waqf*** Through ***Sukūk al-Intifa'a***: A Proposed Generic Model
48.	Zohra Jabeen *Institute of Management Sciences, Peshawa, Pakistan.*	Significance of ***Sukūk*** Securitization for Banks: Structuring for Risk Regulation and Pricing
49.	Hanudin Amin *University Malaysia Sabah* Abdul Rahim Abdul Rahman *IIUM*	Financial Innovation in Malaysian Islamic Banks: Pricing Via Variable Rate of Financing
50.	Magda Ismael Abdel Mohsin *International Islamic College Malaysia*	The Institution of ***Waqf***: A Non Profit Institution to Financing the Needy Sectors